

China's Budget System and the Financing of Education and Health Services for Children

by MEI Hong and WANG Xiaolin

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United Nations Children's Fund
12 Sanlitun Road, Chaoyang District
Beijing 100600
Tel: (010) 6532 3131
Fax: (010) 6532 3107

National Working Committee on Children and Women
15 Jianguomennei Avenue, Beijing 100730
Tel: (010) 6510 3316
Fax: (010) 6510 3304

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Forward (I)

This book contains two reports, *Public Expenditure in the Education and Health Sectors*, by Wang Xiaolin, and *The Budget System and Fiscal Transfers*, by Mei Hong, that present the findings of research on China's budget system and the financing of services for children, conducted jointly by NWCCW and UNICEF. Based on the existing literature and publicly available data, the two reports provide an analysis of the long-term planning of services for children, China's budget system, inter-governmental fiscal relations and budget issues in the education and health sectors, making recommendations for improvements in budget management, inter-governmental fiscal relations and the financing of services for children.

The Chinese government has attached great importance to the development of women and children. Since the 16th Party Congress, the Communist Party of China has deepened its understanding of the building of a harmonious society, giving this special attention in the development of the socialist cause with Chinese characteristics. In this context, the development of women and children, as a key component of the vision for a harmonious society, will certainly receive increasing attention. The National Programme of Action for Child Development and the National Programme of Action for Women's Development have been incorporated into the National Economic and Social Development Plan. The two reports published in this volume investigate the establishment of an effective resource allocation mechanism to ensure that public finances are effectively utilized for the provision of essential services for women and children.

China has made considerable progress in its reform of the public finance system. The organs responsible for public finance at various levels have increased their support for assisting people with difficulties, for agricultural inputs and for education, health, environmental protection and infrastructure construction. The concepts of standardization, equity and transparency have been gradually incorporated into the structure of the fiscal system. Over the past 25 years, China has witnessed a sustained growth in its resources for basic services for women and children and has made impressive progress in improving its fiscal system and advancing the harmonious society.

However, major challenges still remain. The income gap is increasing and regional disparities are widening. The Chinese government has taken measures to address the imbalance in financial capacities across regions through transfer payments, which can only address the regional gap in the provision of basic public services, but cannot overcome the gap in economic and social development caused by market factors. In terms of health, the public health system needs to be strengthened and major disease prevention still remains a severe challenge. The medical service system cannot adequately respond to people's needs and the 'unaffordability of medical treatment' and the 'difficulty of seeing doctors' have become issues of mounting concern to Chinese people.

In terms of education, the overall development is still at a low level. Education resources, in particular high quality education resources, are in short supply. There is a marked disparity in education development between rural and urban areas, among different regions and among different education levels. Financial inadequacy still remains a hurdle to the advancement of education.

All these challenges and problems have been encountered in the course of development. Some reflect the contradictions arising from profound social changes, affecting the development of women and children, and some are deep-rooted problems in the initial stage of socialism. Actions are being taken to address all these problems.

The recommendations contained in this book and the comments that have been contributed by other experts in the course of this research are very valuable. They will help us to identify areas for prioritized efforts and to select the best strategies, thereby contributing to macro-level decision-making and the promotion of the development of women and children.

The image shows a handwritten signature in black ink. The characters are stylized and appear to be '万燕' (Wan Yan), which corresponds to the name listed below. The signature is written in a cursive, flowing style.

Mme. Wan Yan

Deputy Director General, Office of NWCCW

Forward (II)

The government of China is fully committed to improving the lives of children, as part of its broader strategy of human-centred development. As China's leading government bodies have emphasized on many occasions, the development vision of building a harmonious society, with a moderate level of prosperity (*xiaokang*) by 2020, requires both a sound balance between the social and economic dimensions of development and a reduction of the large disparities between different parts of the country.

At its plenum on 11 October 2006, the Central Committee of the Communist Party of China adopted a resolution on the building of a harmonious society, which said that 'priority shall be given to less developed and disadvantaged areas' and that 'the Central Government shall focus fiscal transfer payments on the central and western regions with the aim of improving as fast as possible the infrastructure and public service facilities, such as education, health, culture, etc.'

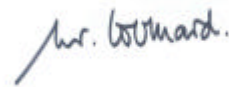
This means giving greater priority than in the past to social development, including vital services for children, and narrowing the gaps between rural and urban areas, and among and within different regions. In that respect, it is well to bear in mind that, despite all the progress made by China towards achievement of the Millennium Development Goals and the national targets for children and women, there are still huge geographical disparities across the country, with child mortality and maternal mortality in the poorest, most remote counties up to five times higher than in the cities.

The main challenge now is to operationalize the government's strategy of balanced, human-centred development. This requires adjustments in public expenditure and the strengthening of public financial management, so that a much higher volume of public funds goes to the social sectors, in particular in the most disadvantaged areas, where the challenges are greatest but the resources scarcest.

The two studies published in this volume provide an excellent overview of the budgetary issues that China needs to address if faster progress is to be made in social development and the achievement of child rights, particularly in the poorest parts of the country. The first study, which analyses the pattern of public expenditure on education and health services for children, highlights in particular the relatively low level of government spending on these services relative to total government expenditure and the size of China's economy, as well as the geographical disparities in expenditure on compulsory education and on maternal and child health.

The second study turns attention to the budget system itself, analysing the institutional and technical factors that explain why the distribution of public expenditure does not yet adequately reflect the priority given in the *xiaokang* vision and the 11th Five Year Plan to social development and disparity reduction. It highlights in particular the consequences of fiscal decentralization and the inadequacies of the current system of inter-governmental fiscal transfers, which only to a quite limited extent redistribute public resources to the poorer provinces and counties.

I strongly commend these studies, which are essential reading for an understanding of these important budget issues and make valuable and realistic proposals for improving the flow of resources for essential social services for children and women in the poorest parts of China.

A handwritten signature in blue ink that reads "Dr. Voumard." The signature is written in a cursive style with a long horizontal stroke at the beginning.

*Dr. Christian Voumard,
UNICEF Representative in China*

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This research was sponsored jointly by the United Nations Children's Fund (UNICEF) and the Office of the National Working Committee on Children and Women under the State Council (NWCCW). We are grateful to Dr. Christian Voumard, UNICEF Representative in China, and Mr. Anthony Hodges, Chief of UNICEF's Social Policy Section, as well as Mme. Zhang Liming, Deputy Director-General of NWCCW, and Ms. Song Wenzhen, Chief of the Children's Division of NWCCW, for giving us this opportunity. We would especially like to thank Mr. Hodges, who provided methodological advice, made many useful suggestions as the work progressed and edited the final text. At the same time, we wish to recognize the support provided by other UNICEF staff, including in particular Mr. Jia Guoping, Programme Assistant in the Social Policy Section, who facilitated the study and also designed the maps, Ms. Wang Xin, who provided secretarial support, and Ms. Liu Lian, who translated sections of the text and interpreted at meetings.

Many government agencies and research institutions contributed information and advice in the course of this study, chief among them the Ministry of Finance (MOF). We are particularly indebted to Mr. Zou Ciyong, Director, Ms. Yao Yixin, Deputy Director, International Department of MOF, for facilitating contacts with various departments of the Ministry, including the Budget Department, Comprehensive Department, Social Security Department, Science, and Education and Culture Department.

Following the first draft of our reports, we received detailed written comments and additional data from officials of the Ministry of Finance (MOF), the National Development and Reform Commission (NDRC), the Ministry of Health (MOH), NWCCW and UNICEF, as well as from experts in the Development Research Centre of the State Council (DRC) and the Research Institute for Fiscal Science. These comments and supplementary data were extremely valuable and made it possible for us to make major improvements in the second drafts, which were presented and discussed at a Seminar on China's Budget System and the Financing of Education and Health Services for Children, held in Beijing in September 2006.

We are especially grateful for the detailed comments made at the seminar by the four discussants on our reports: Dr. Su Ming, Deputy Director-General of the Research Institute for Fiscal Science; Dr. Yang Liangchu, Director of the Basic Research Office, Research Institute for Fiscal Science; Mme. Zhao Minmin, of the Comprehensive Department of MOF; and Dr. Wang Fazhong, of the Budget Department of MOF. Other valuable comments and suggestions were made during the seminar by officials and experts from the Education, Science, Culture and Public Health Committee of the National People's Congress, NWCCW, MOF, Ministry of Education (MOE), MOH, Chinese Academy of Social Sciences, Peking University, Beijing Normal University, UNICEF, the World Bank, UNESCO and the UK Department for International Development.

We have tried to take into account all these comments and suggestions in the final text of our reports, although in some cases we were unable to respond fully, as some of the suggestions concerned topics or issues that, to be addressed seriously, would require in-depth follow-up research. We very much hope that UNICEF and NWCCW, in cooperation with MOF and other

relevant agencies, will be able to undertake more detailed research on some of these specialized topics, such as the implications of migration for government financing of social services.

Finally, we absolve all those who provided comments of any responsibility for the final text of the two reports published here. The opinions expressed are entirely those of the authors and do not reflect the official views of UNICEF, NWCCW or any other organization or individual.

MEI Hong and WANG Xiaolin

Abbreviations

ACFHP	All-China Federation of Health Promotion
BOF	Bureau of Finance
CDC	Chinese Centres for Disease Control and Prevention
CMS	Cooperative Medical System
CNCC	China National Children's Centre
CPC	Communist Party of China
CRC	Convention on the Rights of the Child
DRC	Development Research Centre of the State Council
EOC	Essential obstetrical care
GDP	Gross domestic product
GER	Gross enrolment ratio
GIS	Government Insurance System
GOA	Government Office of Administration of the State Council
IMF	International Monetary Fund
LGOP	State Council Leading Group Office of Poverty Alleviation and Development
LGWRD	Leading Group for Western Region Development
LIS	Labour Insurance System
MCH	Maternal and child health
MDGs	Millennium Development Goals
MLSS	Ministry of Labour and Social Security
MMR	Maternal mortality ratio
MCA	Ministry of Civil Affairs
MOA	Ministry of Agriculture
MOE	Ministry of Education
MOF	Ministry of Finance
MOH	Ministry of Health
MOP	Ministry of Personnel
MPS	Ministry of Public Security
MOST	Ministry of Science and Technology
MTEF	Medium Term Expenditure Framework
NBS	National Bureau of Statistics
NDRC	National Development and Reform Commission
NEC	National Educational Committee (Former Ministry of Education)
NER	Net enrolment ratio
NHSS	National Health Service Survey
NPA	National Programme of Action for Child Development
NPC	National People's Congress
NWCCW	National Working Committee for Children and Women under the State Council
OECD	Organization for Economic Cooperation and Development
PBS	Provincial Bureau of Statistics
R&D	Research and development
RCMS	Rural Cooperative Medical System

SATCM	State Administration of Traditional Chinese Medicine
SCOPSR	State Commission Office for Public Sector Reform
SEPA	State Environmental Protection Agency
UK	United Kingdom
UN	United Nations
UNDP	United Nations Development Programme
UNESCO	United Nations Educational, Scientific and Cultural Organization
UNICEF	United Nations Children's Fund
U5MR	Under-five mortality rate
VAT	Value added tax
WHO	World Health Organization

Executive summary

The Chinese Government is firmly committed to achieving the Millennium Development Goals (MDGs) and the targets for children set out in the Government's National Programme of Action for Child Development (NPA) 2001-2010 and the 11th Five Year Plan. This commitment to children is a key part of the national development vision of a *xiaokang* society, which is a human-centred vision and one that emphasizes the importance of social development, as well as balanced development between urban and rural areas and among and within regions.

Furthermore, due to the high rate of growth of the Chinese economy, government revenue has been rising fast, making it possible to raise expenditure rapidly to meet a wide range of pressing needs, including in the social sectors. Overall, government expenditure on the provision of services for children has risen substantially in real terms over the past decade and a half, resulting in considerable progress towards the achievement of the MDGs and the NPA targets.

However, several weaknesses regarding the scale and distribution of public expenditure in the social sectors have limited the extent of progress. First, relative to the size of China's economy and the size of the overall government budget, expenditure on the social sectors remains low by international standards. Second, the structure of government expenditure in these sectors is tilted towards higher level institutions (higher education and hospitals at county level and above) at the expense of the institutions providing essential services at county, township and village levels. Third, expenditure is inequitably distributed both regionally and between urban and rural areas, due to the high degree of decentralization in the financing of education, health and other social services and the large differences in local levels of economic development and tax revenue, which are insufficiently offset by inter-governmental transfer payments. Fourth, government resources account for a relatively low share of total social sector expenditure, leaving individual households to assume much of the responsibility for paying for services, through fees and user charges, and this has placed a heavy burden on the poor, particularly in the rural areas and among migrants in the cities.

Expenditure on education

Each of these four problems can be seen clearly in the education sector, despite the impressive progress made towards achievement of the goal of universal nine years compulsory education.

1. ***The level of government expenditure.*** The ratio of public education expenditure to GDP in China remains very low, only 2.8% in 2004, compared with a world average of almost 5%

(and the government's own goal of 4%), and education's share in total government expenditure has been declining since the mid-1990s (from 13.6% in 1994 to 10.6% in 2003).

2. ***Imbalance in the distribution of government expenditure between education levels.*** The priority given by the government to achieving universal compulsory education is not adequately reflected in the structure of expenditure. According to data for 2003, only one quarter of government education expenditure goes to primary education, while middle schools account for 30% and higher education for 31%. It is even more striking that very few government resources are directed to pre-school education: in 2003, this component of the education system received only 1.3% of total government expenditure on education.
3. ***Equity implications of the rising share of private expenditure.*** The share of private spending in national education expenditure has been rising, while that of government has been declining (to 62% in 2003), creating financial difficulties for poor families and delaying the achievement of universal compulsory education in some of the poorest counties, which the government has begun to redress through the progressive extension of its policy of 'two frees and one subsidy' in rural areas. In the urban areas, migrant children have higher drop-out rates than resident children, mainly because of families' financial difficulties, which are exacerbated by extra school fees levied on migrant pupils.
4. ***Geographical disparities arising from fiscal decentralization and inadequate transfer payments.*** Government education expenditure is highly decentralized in China, mainly to the county level, with local governments responsible for 90% of expenditure in 2003. Due to the large disparities in economic development and tax revenue among counties, this high degree of decentralization and the inadequacy of transfer payments result in very large disparities in education expenditure among counties, adversely affecting the quality of education in poorer counties. In 2004, the amount spent per primary school pupil in Shanghai was ten times higher than in Henan.

Expenditure on health

Considerable progress has been made in reducing child and maternal mortality rates in China over the past decade and a half, and much of the credit for this goes to the expansion in the availability and use of maternal and child health (MCH) services, which in turn reflects the real growth of expenditure on health. However, progress has been tempered by the relatively low level of government health expenditure, the imbalance in spending on the different levels of the system, the equity consequences of the burden of 'out-of-pocket' health expenditure on households, and the large geographic disparities in expenditure and, as a result, health and survival outcomes.

1. ***The level of government expenditure.*** While China's national health expenditure (public and private) has risen very fast and has increased as a percentage of GDP (to 4.7% in 2004), this has mainly been driven by the rapid rise in private 'out-of-pocket' health expenditure. As a result of market-based reforms, the government's share of health expenditure fell from 25% in 1990 to 17% in 2004, which is lower than that of most developing Asian countries. The health share of total government expenditure declined from 4.6% in 1994 to 3.5% in 2003 and, relative to GDP, government expenditure on health fell from 1.0% in 1991 to 0.8% in 2004.
2. ***Imbalance in expenditure among health sector levels.*** The government mainly channels resources for health services to hospitals at county level and above (78% in 2004), while township health centres and maternal and child health (MCH) centres receive a very small proportion of resources and the clinics in villages even less. MCH centres accounted for only 3.1% of expenditure in 2004. Of this, only 34.2% was spent by MCH centres at county level and below. Not surprisingly, MCH centres rely on business income (i.e. user charges) for almost four fifths of their resources (78.5% in 2002).
3. ***Equity implications of the rising share of private expenditure.*** Individual health expenditure rose from 36% to 54% of national health expenditure between 1990 and 2004, and has increased much faster than per capita disposable income in both urban and rural areas. Health has become the third largest expenditure category for households after food and education. In the rural areas, the cost of a single hospital stay costs on average more than an entire year's average per capita household income. Meanwhile, the old cooperative medical system has collapsed and health insurance coverage is limited to only a minority of the population. In short, the financial barriers to access to healthcare, including costly obstetrical procedures, have increased and serious illness can be an economic disaster for poor families. The introduction of the new Rural Cooperative Medical System (RCMS) in 2002 is a positive development, but as of March 2006 this still covered less than half of the rural population. Although the official aim is to reach more than 80% by 2010, the scheme may be unaffordable for the poorest households. Furthermore, the reimbursement benefits are quite small, while the scheme's funding requirements also impose new financial obligations on already overstretched local governments. Urban migrants, including their children, are generally uninsured.
4. ***Geographical disparities arising from fiscal decentralization and inadequate transfer payments.*** Health expenditure is highly decentralized, with 98% accounted for by sub-national tiers of government (mainly at county level). Coupled with limited transfer payments, this has resulted in large disparities in the geographical distribution of public

health resources, contributing to the disparities in health indicators. In 2004, government recurrent expenditure on health, on a per capita basis, was 5.4 times more in the cities than in the rural areas. Per capita expenditure was 12.5 times higher in Beijing than in Hunan province. The disparities in expenditure on maternal and child healthcare reflect the general situation of the health system, with average recurrent expenditure per MCH centre 8.5 times higher in urban areas than rural areas in 2002.

Budget system issues

Underlying the problems in the level and distribution of government expenditure on education and health services for children are a number of weaknesses in the budget system itself. Without tackling these, it will be difficult to achieve a more appropriate pattern of expenditure in keeping with the priority given by the government to social development and the reduction of geographical disparities. Although there have been some important improvements in the budget system in recent years and more are on the drawing board, including a more modern budget classification system which will be introduced in 2007, four key problems remain.

1. ***Weak links between policy, planning and budgets.*** At present, although the goals of the NPA for Child Development are reaffirmed in the 11th Five Year Plan, it is not clear that these are properly taken into account in the process of annual planning and budget formulation. Moreover, most policies and regulations in the health and education sectors do not specify how the necessary financing is to be mobilized and shared by the different levels of government.
2. ***Fragmentation of the budget process.*** Off-budget revenue and expenditure flows remain significant, particularly at the local level. Budgeting is therefore not yet fully unified, which compromises budget transparency and the rationality of allocation decisions. The budget process is further fragmented by the fact that different government agencies review and consolidate line ministries' budget proposals for recurrent and capital expenditure. This may be one of the reasons why there are sub-optimal input mixes, including in the social sectors, with schools for example under-funded for non-personnel operating expenditure.
3. ***Weaknesses in budget methodology.*** The new budget classification system will introduce modern economic, organizational and functional classifications that will make it easier than in the past to analyse the effectiveness and efficiency of expenditure and thus to make better budget decisions. However, this may be insufficient for fully-fledged performance evaluation of expenditure, including on services for children, as there is not yet a programme-based budget methodology, nor a fully developed indicator framework and adequately detailed and disaggregated data. Furthermore, there is still a tendency for

budgeting, especially at the lower levels where most of the public financing of services for children takes place, to be conducted in an incremental manner. This makes it difficult to adjust spending by a big margin to reflect the new priorities resulting from the greater emphasis on social development in the *xiaokang* vision. The scope for such adjustments is also limited by the lack of a rolling multi-year fiscal framework for budget planning. These weaknesses have hindered achievement of the official targets of a 4% ratio of government education expenditure to GDP and a 10% share of MCH services in government health expenditure, as well as better planning of new funding commitments (for universal compulsory education and the expansion of the Rural Cooperative Medical System) to avoid adding to the fiscal burden on sub-national governments.

4. ***Weak equalizing effects of inter-governmental fiscal transfers.*** The 1994 fiscal reform recentralized government revenues but did not reassign expenditure responsibilities among central and sub-national governments, leading to a major vertical imbalance in central and sub-national budgets. Lower level governments, especially county governments, account for the bulk of expenditure on compulsory education, MCH care and other services for children. At the same time, the large differences in levels of economic development across the country mean that there are horizontal imbalances in revenue capacity. The government has tried to overcome these imbalances through fiscal transfers, but the equalization effects in the social sectors have been limited by the predominance of tax rebates, which reinforce rather than reduce horizontal revenue disparities, and by the incentives to use equalization subsidies to cover administrative costs, including staff salaries, and to prioritize economic development and job creation over social development. Earmarked transfers have been used to promote universal compulsory education and are set to increase as the policy of waiving all fees for compulsory education is extended throughout rural China. But, overall, transfers have not been sufficient to overcome the large geographical disparities in expenditure per pupil. Earmarked transfers have played a smaller role in the health sector and, although these will increase to support the expansion of the RCMS, there are huge disparities in expenditure on MCH services between urban and rural areas. A key gap in the current transfer arrangements is the lack of transfers to support migrant children's access to services, despite the fact that these children are among the most disadvantaged, facing inequalities in access to compulsory education and no opportunities to access health insurance.

Recommendations

This study was based on a review of existing literature and publicly available data. The proposals set out here should therefore be seen as preliminary suggestions. They are quite broad in nature and will need to be developed further following in-depth research, especially at county level.

1. ***Increase levels of government expenditure on education and health expenditure relative to GDP.*** Budget policy should aim to achieve quickly the target of raising government education expenditure to 4% of GDP. This would still be below the ratios achieved in most developing countries, and there would be a strong argument to set a longer term goal of achieving the 6% target established by UNESCO. Efforts should also be made to reverse the large decline in the share of government in national health expenditure, and to raise the ratio of government health expenditure to GDP to 2% of GDP. These targets should be easy to achieve in a context of rapidly rising government revenue, which makes it possible to raise health and education expenditure substantially without cutbacks in other sectors.

2. ***Raise the expenditure shares of services for children within the social sectors.*** The proportion of government education expenditure devoted to higher education, which takes almost one third of the total (and has high private benefits), should be reduced, in order to raise the shares of pre-school, compulsory and senior secondary education. Pre-school education should be a priority for expansion, given the crucial role it plays in the cognitive development of children and their preparation for primary school. Alongside increases in the share of compulsory education, aimed at overcoming geographical disparities in performance, more resources should be directed to senior middle school, which has become a bottleneck in the education system. In the health sector, a much larger proportion of government expenditure should be devoted to front-line health service institutions, especially at township and village levels (in the rural areas) and community level (in the urban areas), and less on hospitals.

3. ***Increase transfer payments to poor counties to reduce disparities.*** The government's vision of a harmonious *xiaokang* society and the emphasis given in the 11th Five Year Plan to achieving balanced development among regions and between rural and urban areas makes it imperative to redouble efforts to overcome the serious disparities in maternal and child health and in educational performance. The challenge is to channel adequate resources to the poorer provinces, counties and townships, so that they can meet their obligations to provide quality services. Transfer payments from central government need to be substantially increased, on the basis of clear criteria that take into account local levels of economic and social development and tax revenue. The best approach would be to review and define clearly the expenditure responsibilities of different levels of government, and clarify the functions of the different types of inter-governmental fiscal transfers, with a view to introducing improvements that would enhance their equalizing effects. Attention should also be given to extending earmarked

transfers to support access to medical insurance and compulsory education by migrant children and other poor urban children, in addition to children in the rural areas.

4. ***Improve the effectiveness and efficiency of expenditure.*** A related challenge is the improvement in the effective and efficient utilization of budget resources, including transfer payments. It is essential to strengthen the capacity for budget management, especially at the county level, and to provide incentives to local governments by setting performance targets for service delivery and benchmarks for evaluating expenditure, so that they allocate increased resources to high-priority services such as MCH care and pre-school, primary and middle school education.

5. ***Reduce the burden of fees on the rural and urban poor, including migrants.*** The proposed increases in the shares of government expenditure in the education and health sectors would make it possible to reduce the role of private (out-of-pocket) expenditure, which is proportionately higher in China than in most other large developing countries in Asia. It will be necessary to overcome the weaknesses in the present RCMS, to provide much higher levels of benefits, while also overcoming the problem of limited health insurance coverage of the urban population, including migrants and their children. It is also essential to develop a larger, more comprehensive programme of medical assistance for the poor who cannot afford health insurance. The introduction and phased expansion of the 'two frees and one subsidy' in the education sector should be extended to the urban areas in order to reach the urban poor, in particular migrants. The prohibition of discriminatory fees for migrant children needs to be rigorously enforced. In order to overcome the opportunity cost of sending children to school, which is a cause of drop-out by some children from the very poorest families, the government could consider a new scheme to provide cash transfers that would be paid to families on condition that their children attend school.

6. ***Improve budget methodology.*** Besides overhauling the system of inter-governmental fiscal transfers, several additional measures are needed to overcome the weaknesses in the budget process. First, the linkages between policies, plans and budgets need to be strengthened. This would make it easier, for example, to ensure that the commitments to children, as set out in the NPA and the 11th Five Year Plan, are reflected in both the annual development plans and annual budgets. Second, to achieve transparent rational budgeting, it is necessary to bring all remaining off-budget revenue and expenditure into a single unified budget framework, and also to integrate the budgeting for recurrent and capital expenditure, so that these are mutually consistent. Third, consideration should be given to adopting a multi-year fiscal framework, in order to facilitate medium/long term budget planning. The fact that some key public expenditure targets (e.g. the ratio of

education expenditure to GDP and the share of MCH services in health expenditure) have proven elusive over many years underscores the need to plan these shifts in expenditure over a multi-year horizon on the basis of a forecast resource envelope and policy priorities. This would also help to plan the sharing of expenditure responsibilities among the different levels of government so as to avoid over-burdening lower level governments. Fourth, attention needs to be given to strengthening performance evaluation. To enhance accountability and improve incentives for government agencies to use government resources efficiently and effectively to provide quality services for children, a performance indicator framework is needed, along with adequate data, as well as appropriate criteria for the evaluation of government agencies and officials. Fifth, the government could consider adopting a results-based planning and budget methodology. This would make it possible to link inputs to the achievement of policy objectives and outcomes, such as the reduction of child mortality or the achievement of universal compulsory education. It would require the development of programme classification codes and training officials in their use, as well as the nurturing of a 'managing for results' culture in the civil service.

7. ***Provide more detailed data on the financing of services for children.*** The government should publish more detailed, disaggregated statistical data on public expenditure on education, health and other services of importance for children, as part of a more open, transparent approach to public financial management in general. Key fiscal data on services for children should also be integrated into the NPAInfo data-base established by the National Bureau of Statistics for monitoring of the NPA. For planning and budgetary purposes it is also urgent to ensure the full inclusion of migrant children in statistics on population groups requiring services in urban areas.

Introduction

Background

China has enjoyed rapid economic growth over the past two decades and this seems set to continue in the coming years. According to the 11th Five Year Plan, GDP per capita is expected to reach RMB 19,270 (or \$2,408) by 2010, and longer term projections point to GDP per capita rising to RMB 36,514 (or \$4,564) by 2020.¹

However, the government has become increasingly aware that economic growth by itself does not necessarily optimize social development. Although China has made enormous progress towards the achievement of important social goals, including universal nine years compulsory education and the reduction of maternal and child mortality, there are large disparities in the provision and quality of social services between urban and rural areas, and among and within geographical regions, and there are parts of the country, mainly in remote rural areas, that are still mired in poverty, with social indicators that are far behind the rest of the country. Within the urban areas, there are pockets of poverty, particularly among laid-off workers from the state-owned enterprises (SOEs), youth and migrants, who now constitute about one tenth of the national population.

To overcome these problems, the Communist Party of China (CPC) decided in 2003 to strive for ‘five balances’ in the country’s development as part of its vision of achieving a moderately prosperous (*xiaokang*) society by 2020. These balances are between urban and rural development, development among regions, economic and social development, man and nature, and domestic development and ‘opening up’ to the outside world. This development vision, which aims to build a harmonious society that is based on equity and addresses the fundamental needs of all of China’s citizens, is reflected in the 11th Five Year Plan for 2006-2010 (NPC, 2006b). It also emphasizes investment in human capital as an essential component of the national strategy for growth and development.

This approach to development involves giving high priority to children and to overcoming the disparities in child indicators. This is shown by the Plan’s commitment to implementation of the National Programme of Action for Child Development (NPA), which was adopted by the government for the decade from 2001 to 2010 (State Council, 2001a). As Box I-1 shows, children make up one quarter of China’s population. Along with its ratification of the Convention on the Rights of the Child (CRC) in 1991 and the adoption of the NPA in the next year, the 11th Five Year Plan and numerous other programmes and projects as well as laws, regulations and policies demonstrate the government’s strong commitment to the rights of children. It is noteworthy that the goals and targets in the NPA are broadly consistent with the Millennium Development Goals (MDGs), in particular regarding the achievement of universal primary education, the reduction of child mortality and the elimination of gender inequality.

¹ Figures based on revised national accounts, following the national economic census in 2004, and on an exchange rate of RMB 8 to the US dollar.

Box I.1 – Children in China’s population

In this study, children are all human beings under the age of 18, in accordance with the definition in the UN Convention on the Rights of the Child (CRC) as well as in China’s Law on the Protection of Minors, which has been in force since 1992.

According to the population census in 2000, the total child population was 345 million, accounting for 27.8% of the total population. The 2005 China Population Statistics Yearbook reports that in 2004 the total child population declined to 326 million, which was 19 million less than in 2000, and accounted for 25.1% of the total population. The sex ratio in the child population was 53.4% male to 46.6% female.

Since the 1980s, internal migration has developed on a large scale in China. The 2000 census figures gave a total migrant population of 131 million, accounting for 10.6% of the population. This included 23.6 million children, who made up 18% of the total migrant population. At present, the migrant population is estimated to number some 140 million. The 11th Five Year Plan sets out a series of measures to facilitate migration from the rural to urban areas, and projects that the urbanization rate will rise from 43% in 2005 to 47% in 2010.

Table I.1 Population data, 2000

	Number (million)	% share			
		of total population	of child population	of migrant population	of migrant children
Total population	1,242.6	100.0			
Child population	345.3	27.8	100.0		
Male	182.6	14.7	52.9		
Female	162.7	13.1	47.1		
Migrant population	131.2	10.6		100.0	
Migrant children	23.6	1.9	6.8	18.0	100.0
Male	11.81	0.9	3.4	9.0	49.98
Female	11.82	0.9	3.4	9.0	50.02

Source: *Tabulation on the 2000 Population Census of the People’s Republic of China*, Population Census Office under the State Council and Department of Population, Social, Science and Technology Statistics, National Bureau of Statistics, China Statistics Press, August 2002.

One of the challenges facing the Chinese government is to find effective ways to operationalize the development vision encapsulated in the *xiaokang* concept and set out in the 11th Five Year Plan, including with respect to services for children. Budget policy is crucial in this regard, especially since public expenditure on social development is relatively low in China, relative to the size of China’s economy and the total resources available for public expenditure, and is unevenly distributed between urban and rural areas and among regions, provinces and counties.

The NWCCW-UNICEF studies on the financing of services for children

In view of the centrality of budget issues to the attainment of the goals and targets for children, and for social development and disparity reduction in general, NWCCW decided to initiate a

research project on the financing of services for children, with the support of the UNICEF China Office. This began in March 2006 with two desk studies, aimed at identifying key issues for subsequent in-depth research. The first study was a review of public expenditure on services for children. For practical reasons, it was not possible to cover all services of importance for the rights and well-being of children. The study therefore focused on services in two critically important sectors, education and health, giving particular attention to the level, composition and distribution of expenditure on compulsory education (primary and junior middle school) and to maternal and child health (MCH) services, with a view to identifying areas for improvement in budgeting so as to achieve the NPA goals and the MDGs. It should be a priority in future to widen research to other areas of public expenditure of relevance to children, in particular the financing of social protection services.

The second study focused on institutional and technical issues in the budget system that indirectly affect allocations, including the allocations for services for children. These issues included the links between policy, planning and budgeting, the methodology used in budget formulation, and the extent to which inter-governmental fiscal transfers contribute to reducing regional and rural/urban disparities in public expenditure on key public services for children.

The two studies, which broadly cover the period since the early 1990s, were based on a review of existing literature and publicly available data, supplemented by information provided by government ministries. It should be noted that the studies have made use of the adjusted national accounts data resulting from the national economic census conducted in 2004. Thus, all GDP ratios in the two reports are based on the revised GDP data.

The first drafts of the two reports were circulated widely within government for comments and suggestions for improvements in the data and analysis. Detailed comments and supplementary data were received from experts and officials in the Ministry of Finance (MOF), the National Development and Reform Commission (NDRC), the Ministry of Health (MOH), the Development Research Centre of the State Council (DRC), and the Research Institute for Fiscal Science, in addition to NWCCW and UNICEF.

These comments contributed to substantial improvements in the second drafts of the reports. A seminar on 'China's Budget System and the Financing of Education and Health Services for Children' was then held in September 2006 to discuss the reports, attended by officials and experts from the National People's Congress (NPC), NWCCW, MOF, Ministry of Education (MOE), MOH, DRC, the Chinese Academy of Social Sciences (CASS), Peking University, Beijing Normal University, UNICEF, the UK Department of International Department (DFID), the United Nations Development Programme (UNDP), the United Nations Educational, Scientific and Cultural Organization (UNESCO) and the World Bank. Many valuable comments were made during the seminar, and these were taken into account in the third and final drafts of the two reports.

Structure

The final reports of the two studies follow this introduction. Part A is the final text of the study on the financing of education and health services for children, which has four chapters. The first chapter briefly reviews China's public finances from a macroeconomic and institutional perspective. The second and third chapters provide an in-depth analysis of expenditure in the education and health sectors, giving special attention to compulsory education and to maternal and child health, and the fourth chapter presents the main conclusions and policy recommendations.

The report of the second study, on the budget system and fiscal transfers, is in Part B and also has four chapters. Chapter 1 describes the planning and budget system, including the procedures for preparing, approving and executing budgets at the national and sub-national levels. Chapter 2 assesses methodological aspects of the budget system and how these affect the financing of services for children. Chapter 3 focuses on the relations between the budgets of the different administrative levels of government in China (central, provincial, prefecture, county/district and township), including the transfer payments made from higher to lower administrative levels, and assesses the extent to which transfers succeed in reducing urban/rural and regional disparities in expenditure on services for children. Each chapter provides examples relating to the education and health sectors in particular. Chapter 4 concludes with a series of preliminary recommendations.

Part A

Public Expenditure in the Education and Health Sectors

Wang Xiaolin

1 Public finance in China

This chapter provides an overview of key features of public finance in China, as an essential starting point for the analysis of expenditure on services for children.

1.1 Levels of public revenue and expenditure

With the rapid growth of China's economy, fiscal revenue is rising fast, making it possible for the government to raise expenditure rapidly to meet a wide range of pressing infrastructural, social and other needs. From 1990 to 2005, China's gross domestic product (GDP) increased from 1,867 billion yuan to 18,309 billion yuan (at current prices), with an average real annual growth rate of 9.5%. From 1990 to 2003, China's total volume of government revenue rose from 565 billion yuan to 2,628 billion yuan, with an annual rate of increase of 12.6% (at current prices).

Table A-1 GDP and government revenue (1990-2005)

	GDP (100 mn yuan)	Total government revenue			% of total government revenue	
		Value (100 mn yuan)	% increase	% of GDP	On-budget revenue	Off-budget revenue
1990	18,668	5,645.7	n.a.	30.2	52.0	48.0
1991	21,781	6,392.8	13.2	29.4	49.3	50.7
1992	26,923	7,338.3	14.8	27.3	47.5	52.5
1993	35,334	5,781.5	-21.2	16.4	75.2	24.8
1994	48,198	7,080.6	22.5	14.7	73.7	26.3
1995	60,794	8,648.7	22.1	14.2	72.2	27.8
1996	71,177	11,301.3	30.7	15.9	65.5	34.5
1997	78,973	11,477.1	1.6	14.5	75.4	24.6
1998	84,402	12,958.2	12.9	15.4	76.2	23.8
1999	89,677	14,829.3	14.4	16.5	77.2	22.8
2000	99,215	17,221.7	16.1	17.4	77.8	22.2
2001	109,655	20,686.0	20.1	18.9	79.2	20.8
2002	120,333	23,382.6	13.0	19.4	80.8	19.2
2003	135,823	26,282.1	12.4	19.4	82.6	17.4
2004	159,878	n.a.	n.a.	n.a.	n.a.	n.a.
2005	183,085	n.a.	n.a.	n.a.	n.a.	n.a.

Source: *Finance Yearbook of China, 2005*; GDP data from *China Statistical Yearbook 2006*, China Statistical Press, 2006.

This permitted a rapid expansion of government expenditure. From 1990 to 2003, the total volume of government expenditure rose from 579 billion yuan to 3,174 billion yuan, with an annual rate of increase of 14.0% (at current prices).

Table A-2 Government expenditure (1990-2003)

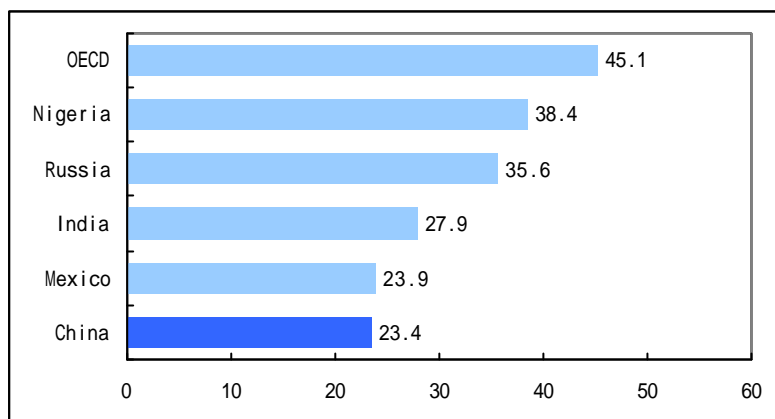
	Total government expenditure			Percentage (%)		
	Value (100 mn yuan)	% increase	% of GDP	On-budget	Off-budget	Social security
1990	5,790.7	n.a.	31.2	53.3	46.7	
1991	6,478.9	11.9	30.0	52.3	47.7	
1992	7,392.1	14.1	27.8	50.6	49.4	
1993	5,956.6	-19.4	16.9	77.9	22.1	
1994	7,503.0	26.0	15.6	77.2	22.8	
1995	9,155.0	22.0	15.1	74.5	25.5	
1996	11,775.9	28.6	16.5	67.4	32.6	
1997	11,919.1	1.2	15.1	77.5	22.5	
1998	14,491.4	21.6	17.2	74.5	20.1	5.3
1999	17,702.3	22.2	19.7	74.5	17.7	7.8
2000	21,333.9	20.5	21.5	74.5	16.5	9.0
2001	24,981.3	17.1	22.8	75.7	15.4	8.9
2002	28,778.1	15.2	23.9	76.6	13.3	10.1
2003	31,744.6	10.3	23.4	77.7	13.1	9.3

Source: *Finance Yearbook of China, 2005*.

As can be seen from Tables A-1 and A-2, historically there has been a high proportion of extra-budgetary revenue and expenditure, in other words there have been large flows of revenue and expenditure that are not covered by the regular system of budget management. These revenues are collected and expenditures allocated by various government agencies outside the framework of the official budget. The Chinese government has been taking measures to reduce these anomalies, which are inconsistent with fiscal transparency and accountability. For example, extra-budgetary revenue declined from 52.5% to 17.4% of total government revenue between 1992 and 2003. Likewise, extra-budgetary expenditure declined from 49.4% to 13.1% in the same period. It should be noted that social security funds are also managed outside the government budget system.

Looking at government expenditure as a whole (i.e. including off-budget and social security expenditure), and taking into account the size of the Chinese economy, it can be seen that government spending in China is not high by international standards. This is shown in Figure A-1, which compares the ratio of government expenditure to GDP in selected countries. Generally, developed industrial countries have higher ratios than developing countries. China's total government expenditure, including on-budget, off-budget and social security expenditure, amounted to 23.4% of GDP in 2003, compared with an average of 45.1% for OECD countries. China's ratio is also low, however, compared with some other large developing and transition countries, such as India (27.9%) and Russia (35.6%).

Figure A-1 Ratio of government expenditure to GDP in selected countries (2003)



Sources: Data for OECD from *National Accounts of OECD countries*, OECD, Paris, 2005; data for China from *Finance Yearbook of China 2005*; data for other countries from IMF Article IV reports.

1.2 The budget system

Compared to other economic reforms, the reform of the budget system has lagged behind. The national budget system established in the early 1950s after the founding of the PRC was designed to be compatible with the planned economy. It was only in 1998, in the *Classification of Government Budget Revenue and Expenditure*, that the ‘national budget’ was formally changed to ‘government budget’, to reflect the market economy era. In other words, China’s financial system would experience the transition from ‘national finance’ to ‘public finance’.

However, there have been several stages of reform in the budget system since the radical changes in China’s economy began in the late 1970s. During the 1980s, the centralized financial management system was reformed by the introduction of a contracted fiscal responsibility system. This meant that sub-national tiers of government signed contracts that set quotas for revenue to be raised for the central government but could retain a share of the revenue exceeding these quotas. By introducing this incentive to raise revenue, the fiscal contract system unleashed the vitality of local government, giving rise to revenue increases that reinforced the impact of other reform programmes at the local government level. In short, the reform renovated the centralized financial management model and stimulated local government’s inputs to key construction projects as well as the delivery of social services such as education and health, particularly in the coastal areas where economic growth was heavily concentrated.

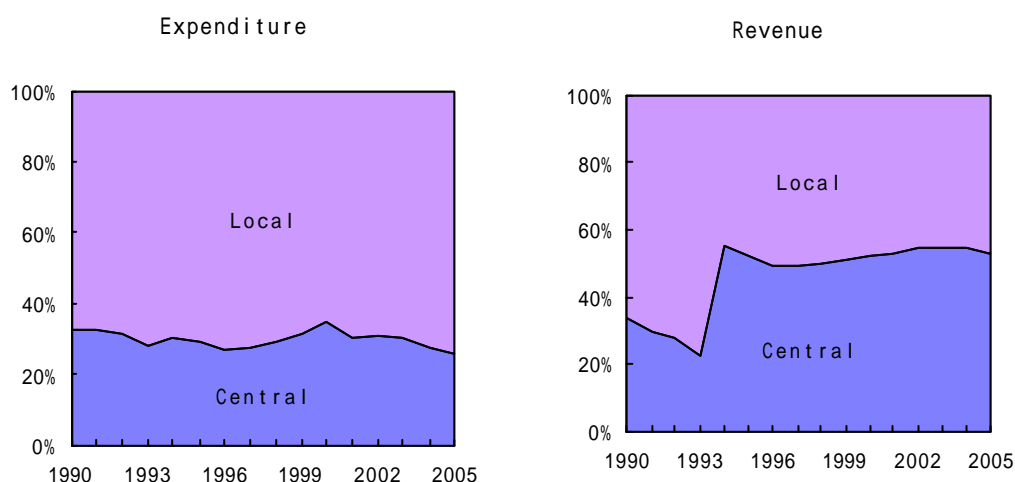
The growing share of the sub-national tiers of government in total revenue prompted a new stage of reform, however, in which the central government took measures to raise its share of revenue. In 1994, the tax sharing system was introduced. This divided the revenue from each type of tax between central government and the different levels of sub-national government. For example,

VAT was shared between central government (75%) and provincial governments (25%). Agricultural tax, until its abolition in 2005-2006, was shared between county and township governments. The introduction of the tax sharing system had two effects: first, by bringing some taxes and expenditures into the framework of the official budget for the first time, the proportion of on-budget revenue and expenditure increased; and second, the central government received a higher proportion of total tax revenue than under the contracted fiscal responsibility system. As a result, fiscal centralization has been re-strengthened on the revenue side.

Nonetheless, from an international comparative perspective, there is a high degree of fiscal decentralization in China, especially on the expenditure side, where there is substantial delegation of responsibilities from central government to various tiers of sub-national government. Local governments have remained responsible for the bulk of expenditure, despite the fact that, as a result of the tax-sharing reform of 1994, a larger proportion of revenue has gone to central government. Whereas in 1993, before the reform, the central government accounted for 22% of on-budget revenue and the sub-national tiers of government 78%, by 2005 the central government's share had increased to 52.3%, while the share of local governments had dropped to 47.7%. By contrast, local governments accounted for 74.1% of on-budget expenditure in 2005, while central government accounted for just 25.9% (see Figure A-2).

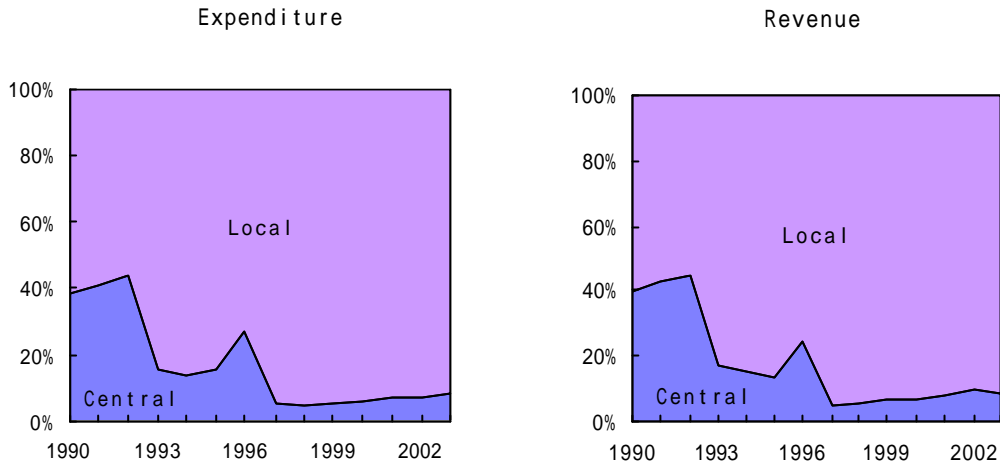
This is one of the reasons why local governments engage in extensive extra-budgetary revenue collection and expenditure. Local governments accounted for 91.7% of extra-budgetary revenue and 92.1% of extra-budgetary expenditure in 2003 (Figure A-3).

Figure A-2 Percentage shares of central and local governments in on-budget expenditure and revenue (1990-2005)



Source: *Finance Yearbook of China 2005*

Figure A-3 Percentage shares of central and local governments in extra-budgetary expenditure and revenue (1990-2003)



Source: *Finance Yearbook of China 2005*

According to the IMF's *Government Financial Statistics*, over the past decade the ratio of sub-national governments' expenditure to total public expenditure in developing countries averaged 15%, while in industrialized countries the ratio was around one third (Bahl, 1999). From this point of view, China has a highly decentralized fiscal system. The OECD (2006) has confirmed this point, noting that the degree of expenditure decentralization in China is much higher than in most industrialized countries.

While local governments have a higher share of expenditure than of revenue, this is offset by the fact that the central government makes fiscal transfers to provincial governments and these in turn make transfers to prefectures and counties. Approximately half of the revenue received by central government (57% in 2004) is transferred to local governments. However, as Jia Kang and Yan Kun (2005) have shown, most general transfer payments are not calculated specifically with a view to overcoming disparities in resources at the local level, which are considerable because of the major differences in levels of tax revenue between wealthier and poorer parts of the country. Only a small proportion of general transfer payments are based on equalization criteria, while the rest are tax rebates calculated in proportion to the average of local revenue over the previous few years. This means that provinces with higher levels of revenue receive higher transfers. In other words, tax rebates reinforce rather than reduce inequality. The situation is more complex for the earmarked transfer payments, which include some transfers specifically directed to less developed regions (notably the West).

In short, the division of revenue and expenditure responsibilities between central and local government is irrational. The large expenditure responsibilities of local governments, the inadequacy of their tax revenue, especially in the central and western regions, as well as

insufficient transfer payments to poorer areas, have led to the inadequate provision of basic public services by local governments, such as education and health, in these areas.

1.3 The structure of public expenditure

The basic functional classification of expenditure in the Chinese budget has five categories: economic construction (by which is meant expenditure in the economic sectors); social services, culture and education; national defence; government administration; and others. As shown by Table A-3 on the structure of on-budget expenditure, the percentage of expenditure on economic construction dropped year by year as marketization of the economy deepened, falling from 64.1% in 1990 to 27.5% in 2005. However, economic construction still accounts for the largest share of government expenditure. Over the past 15 years, national defence has also witnessed a marked decline in its percentage share of expenditure, from 15.0% in 1990 to 7.3% in 2005. Meanwhile, the percentage of expenditure on social services, culture and education increased sharply up to the mid-1990s, rising from 13.1% in 1990 to 25.9% in 1996, but has stabilized since then at around 26-27% of expenditure. The percentage of expenditure on administrative management has also risen, from 4.7% in 1990 to 19.2% in 2005.

Table A-3 On-budget expenditure by functional categories (1990-2005)

Year	Total (billion yuan)	% of on-budget expenditure				
		Economic construction	Social services, Culture & education	National defence	Administrative management	Others
1990	308.4	64.1	13.1	15.0	4.7	3.2
1991	338.7	58.2	16.2	15.8	6.1	3.7
1992	374.2	56.3	20.4	9.6	8.5	5.3
1993	464.2	45.7	23.7	8.9	13.7	8.0
1994	579.3	44.4	23.9	9.4	13.4	8.9
1995	682.4	42.2	25.1	9.8	12.2	10.8
1996	793.8	43.1	25.9	10.1	12.4	8.5
1997	923.4	39.5	25.4	9.2	13.7	12.3
1998	1,079.8	41.3	25.9	9.5	14.6	8.6
1999	1,318.8	41.9	25.7	9.3	14.6	8.5
2000	1,588.7	40.7	26.2	9.1	14.9	9.0
2001	1,890.3	39.5	26.7	8.8	14.7	10.2
2002	2,205.3	38.7	27.1	8.7	14.8	10.7
2003	2,465.0	38.4	27.6	8.2	15.3	10.5
2004	2,848.7	36.2	27.6	7.6	17.4	11.2
2005	3,393.1	27.5	26.4	7.3	19.2	19.7

Source: *China Statistical Yearbook 2006*, China Statistics Press, 2006.

According to official data, government capital expenditure accounted for 16.8% of total government expenditure between 1998 and 2003. This includes on-budget and off-budget expenditure on infrastructure and capital transfers to companies. However, much capital expenditure is in fact recorded under other expenditure items. One recent analysis of public finances in China (OECD, 2006) estimates that total government capital expenditure is more than twice as high as the official data indicate and was the main source of growth in overall government expenditure between 1998 and 2003, contributing 31% of total growth in expenditure. Overall capital spending appears to be much higher in China than in all OECD countries as well as most developing countries. Analysis of on-budget capital expenditure shows, however, that the social sectors have received only a fairly small proportion of investment (9% in 2003).

2 Expenditure on child education

Education is critical for children's development and thus one of the rights enshrined in the Convention on the Rights of the Child (CRC). It is also one of the top priorities of the 11th Five Year Plan, where education is seen as the instrument for unleashing the creative potential of China's huge population and building a competitive economy based on science and innovation.

One of the most important educational goals of the Chinese government is to achieve universal nine years compulsory education, covering the six years of primary school and three years of junior middle school, and to eradicate adult illiteracy. A Compulsory Education Law was promulgated in 1986 and specific targets were set in the Programme for China's Education Reform and Development, issued by the central government in 1993. This stated that the government would achieve universal nine-years compulsory education in areas covering 85% of the total population and eradicate illiteracy (in the population aged 15 and above) in areas covering 95% of the total population by 2000.

The Chinese government has taken strong measures to advance education development and reform and remarkable success has been achieved. Great headway has been made towards the two basic goals: in 2004, the areas where compulsory education had been achieved accounted for 93.6% of the total population. According to the *China Population Statistics Yearbook 2005*, adult illiteracy had been reduced to 10.3% of the population by 2004. Data from the *Educational Statistics Yearbook of China 2004* indicate that in the same year the gross enrolment ratio (GER) was 106.6% in primary school and 94.1% in junior middle school. The net enrolment ratio (NER) was 98.9% in primary school. However, important challenges still remain to achieve nine years universal compulsory education, especially in poverty-stricken areas. By the end of 2004, this goal had not yet been achieved in 278 counties.

Pre-school education is essential to the healthy development of children, but there are major disparities in access. Whereas the cities, especially in eastern China, have high levels of pre-school enrolment, the pre-school enrolment rate is still very low in rural areas. Since pre-school education is not included in the compulsory education system, the central and western regions have witnessed poor development in pre-school education compared to the more economically advanced regions.

Meanwhile, senior middle school education has been expanding, although still only about two thirds of those who complete junior middle school enter this level of the school system. In 2004, senior middle school (including vocational schools) had a GER of 48.1%. Despite this, higher education has started to become a mass phenomenon, with enrolment of more than 20 million and a GER of 19% in 2004. Vocational education has also made considerable progress and secondary vocational schools have reached a historically high level of enrolment. With rising education expenditure, school conditions have been improved, faculty capacity has been strengthened and IT-based education has been widely introduced. Educational quality and performance have been improved. According to UNDP statistics, China's education development index has reached 0.83, close to the average level of 0.85 for middle income countries (Zhou Ji, 2005).

There are four major education sub-sectors in China: basic education, vocational education, higher education and adult education. Of these, basic education is the sub-sector that most directly concerns children, which, in accordance with the CRC, we define as those who are under the age of 18. This includes pre-school, primary school (six years), junior middle school (three years) and senior middle school (three years). This chapter will therefore focus on analyzing budget expenditure on basic education in China, although it will begin with a broader analysis of expenditure on the education sector as a whole.

2.1 Government and private expenditure on education

In terms of the volume of government expenditure on education, there was an increase from 46 billion yuan in 1990 to 447 billion yuan in 2004. Since 2001, the central government has taken a series of measures to increase education expenditure, including the expansion of transfer payments. However, despite these absolute increases in education expenditure and the remarkable progress in education, government expenditure in the sector is still relatively low compared to the country's GDP and to total government expenditure. This suggests that there has been a contradiction between the priority given to education in government policy and the levels of expenditure allocated to education in government budgets.

The ratio of government education expenditure to GDP in 2004 was 2.8%. The Programme for China's Education Reform and Development, issued in 1993, put forward the goal of government education expenditure reaching 4% of GDP by 2000. However, that goal has not yet been met and it has recently been reiterated in the 11th Five Year Plan for 2006-2010. Moreover, in terms of the share of education in total government expenditure, there was a decline from 15.6% in 1997 to 12.1% in 2003.

Table A-4 Government expenditure on education (1990-2004)

Year	Education expenditure		Total government expenditure		GDP (100 million yuan)	Ratio of government education expenditure (%)	
	Value (100 mn yuan)	% increase	Value (100 mn yuan)	% increase		to GDP	to total government expenditure
1990	462.5	n.a.	5,790.7	n.a.	18,668	2.5	8.0
1991	532.4	15.1	6,478.9	11.9	21,782	2.5	8.2
1992	728.8	36.9	7,392.1	14.1	26,924	2.7	9.9
1993	867.8	19.1	5,956.6	-19.4	35,334	2.5	14.6
1994	1,174.7	35.4	7,503.0	26.0	48,198	2.4	15.7
1995	1,411.5	20.2	9,155.0	22.0	60,794	2.3	15.4
1996	1,671.7	18.4	11,775.9	28.6	71,177	2.3	14.2
1997	1,862.5	11.4	11,919.1	1.2	78,973	2.4	15.6
1998	2,032.5	9.1	14,491.4	21.6	84,402	2.4	14.0
1999	2,287.2	12.5	17,702.3	22.2	89,677	2.6	12.9
2000	2,562.6	12.0	21,333.9	20.5	99,215	2.6	12.0
2001	3,057.0	19.3	24,981.3	17.1	109,655	2.8	12.2
2002	3,491.4	14.2	28,778.1	15.2	120,333	2.9	12.1
2003	3,850.6	10.3	31,744.6	10.3	135,823	2.8	12.1
2004	4,465.9	16.0	n.a.	n.a.	159,878	2.8	n.a.

Source: *China Statistical Yearbook 2006*, China Statistics Press, 2006.

From an international comparative perspective, the ratio of government expenditure on education² to GDP in developed countries is higher than that in developing countries. In 1997 the global average ratio was 4.8%, with the figure varying from 5.4% in high income countries to 4.8% in middle income countries and 3.3% in low income countries. Although more recent data are unavailable except for high income countries, which had a ratio of 5.6% in 2004, the ratio in China (2.8%) has been much lower than in all categories of countries (see Table A-5). UNESCO has called on all countries to achieve the goal of reaching a ratio of 6% of GDP by 2000.

² UNESCO and the OECD use the term 'public education expenditure' to indicate the education expenditure by government agencies at various levels, not including expenditures on culture, sports and youth activities that are not directly linked to education, but including the expenditures on education by other government sectors such as health and agriculture. This definition stresses that public education expenditure is the education expenditure by government bodies at various levels, as distinguished from the expenditure by private organizations and individuals.

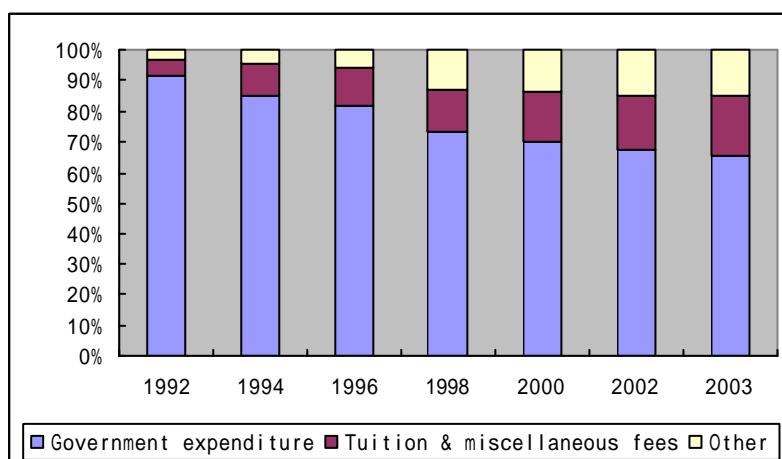
Table A-5 Ratio of government education expenditure to GDP: international comparisons

	Unit: %		
	1980	1997	2004
China	2.5	2.3	2.8
World	3.9	4.8	-
Low income countries	3.4	3.3	-
Middle income countries	3.8	4.8	4.4
High income countries	5.6	5.4	5.6

Sources: international data from World Bank, *World Development Report 2000/2001*, pp 284-285, and World Bank, *World Development Indicators 2006*; data for China from *China Statistical Yearbook 2006*, China Statistical Press, 2006.

One consequence of this situation is that the sources of education expenditure have become increasingly diversified in China. As is shown in Figure A-4, the share of private (i.e. non-government) spending on education has been rising steadily over the past few years. In 2003, total education expenditure amounted to 621 billion yuan, of which government expenditure was 385 billion yuan, accounting for 62% of the total. The balance was made up by private spending, in particular tuition and miscellaneous fees, which accounted for 172 billion yuan or 27.7% of the total. Other sources of funding, including grants and donations, contributed 10.3%. The fact that the government has announced that it will phase out all tuition and miscellaneous fees by 2007 is thus extremely significant, because it implies that it will be necessary to increase the percentage share of government expenditure substantially.

Figure A-4 Public and private resources for education (1992-2003)



Source: *China Statistical Yearbook 2005*.

2.2 The economic efficiency of government expenditure on education

Government expenditure includes recurrent and capital expenditure. In the Chinese budget classification, recurrent expenditure includes salary payments and operating expenditure, while capital spending is classified as school construction. Salary payments refer to all expenditure on personnel and so include base salaries, allowances, social security payments, grants and other items related to personnel. Operating expenditure includes all non-personnel recurrent expenditure on goods and services.

Table A-6 shows that salary payments account for a high percentage of on-budget education expenditure, while the non-personnel operating expenditure is relatively low. Moreover, the lower the level of school, the higher is the percentage of salary payments in education expenditure. For example, in 2003, salary payments accounted for 89% of on-budget expenditure in primary schools and as much as 91% in rural primary schools. In secondary education, the share of personnel in on-budget expenditure is lower but still very high: 85% in junior middle schools and 76% in senior middle schools. As a result, many primary schools face great difficulties in paying for the goods and services needed to provide an effective learning environment, since so much of the available resources is used to pay for teachers. The resources available for school construction are also low, especially in the rural areas: only 1.6% of expenditure in rural primary education and 2.0% of expenditure in rural junior secondary education.

Table A-6 Economic structure of on-budget expenditure on education (2003)

Type of schools	Unit: % of total			
	Recurrent expenditure			Investment (school construction)
	Total	Salary payments	Operating expenditure	
Senior middle schools	92.3	76.5	15.8	7.7
Junior middle schools	96.2	85.0	11.2	3.8
Rural areas	98.0	88.4	9.6	2.0
Primary schools	97.8	89.0	8.8	2.2
Rural areas	98.4	91.0	7.4	1.6

Source: *China Education Finance Statistical Yearbook 2004*, pp 22-23

Various studies (Jia Kang and Guo Wenjie, 2002, OECD 2006) have shown that government resources are used inefficiently due to the imbalance in spending on personnel compared with other operating costs and construction, and because a large proportion of the personnel expenditure is for non-teaching staff. China devotes a much larger proportion of education expenditure to personnel than most other countries. A field study in Huanxian by the World Bank (2005b) also confirms that, while there has been a substantial increase in teachers' salaries, the shortage of resources for non-personnel operating costs has not yet been adequately addressed. As a result, in many parts of the country, school buildings are in a serious state of dilapidation and

there is an urgent need for reconstruction and renovation. Han Jun (2005) has expressed concern about the ‘glaring shortages of money for school maintenance, operation and construction’ and has noted that some rural schools are deeply in debt.

2.3 The intra-sectoral composition of education expenditure

The distribution of education expenditure is analyzed here from the following four angles: (1) the share of expenditure by central and sub-national tiers of government, in relation to their respective responsibilities; (2) the distribution of expenditure among primary, secondary and higher education; (3) the distribution of expenditure between rural and urban areas; and (4) the distribution of expenditure among different regions. This section gives particular attention to equity issues concerning the distribution of expenditure.

The decentralization of education expenditure

As has been discussed in Chapter 1, there is a noticeable asymmetry between the expenditure responsibilities of the central and sub-national tiers of government and their financial capacity, which particularly affects local governments in the poorer parts of China. This leads to disparities in education expenditure that go against the principle of equal access to quality education, creating disadvantages for children in poorer areas, especially in the more remote rural areas. The disparities also have a significant impact on the sound and sustainable development of the national economy, since investment in human capital is uneven across the country.

Despite the fact that they often have limited financial capacity, local governments bear a heavy expenditure responsibility in the education sector, particularly for basic education (Table A-7). After the implementation of the county-based financial management system³ in the education sector, through which the central government increased transfer payments for compulsory education in western and central China, there was a slight increase in the proportion of education expenditure by central government. However, in 2003, only 11.6% of total national expenditure on education (including both public and private expenditure) took place at central level, while expenditure at sub-national level accounted for 88.4%. In terms of government expenditure on education (including both on-budget and extra-budgetary spending), the proportion accounted for by local governments amounted to 90.0%. This proportion was much the same for on-budget

³ *Decision on the Reform and Development of Basic Education* was issued by the State Council on 29 May 2001. Affirming that ‘basic education should be placed at a strategic position in the cause of socialist modern construction’, it stated that ‘the management mechanism should be improved and financial inputs should be guaranteed to advance the healthy development of rural compulsory education’ and ‘the county-based education management system will be implemented’. In order to ensure the timely payment of primary and middle school teachers’ salaries, it said that ‘county governments should strengthen the management of teachers’ salaries and from 2001 the management of teachers’ salaries should be shifted from village governments to county governments’.

expenditure, to which local governments contributed 90.3% of the total. It can clearly be seen that education expenditure in China is highly decentralized.

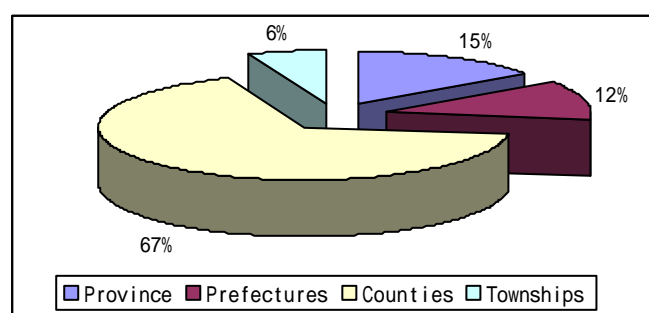
Table A-7 Resources for education at central and local government levels (2003)

	Total public and private resources		Government budget				Tuition & miscellaneous fees		Others	
			Total		On-budget		100 mn yuan	%	100 mn yuan	%
	100 mn yuan	%	100 mn yuan	%	100 mn yuan	%				
Total	6,208	100.0	3,851	100.0	3,454	100.0	1,122	100.0	1,236	100.0
Central	722	11.6	390	10.14	335	9.7	111	9.9	220	17.8
Local	5,486	88.37	3,460	89.86	3,119	90.3	1010	90.1	1,016	82.2

Source: based on data from *China Statistical Yearbook 2005*.

In fact, it is the county governments that have the main expenditure responsibility. Figure A-5 shows the share of education expenditure among provincial, prefecture, county and township governments of Henan Province in 2003. The county governments assumed 67% of the share, the provincial government 15%, prefecture governments 12% and township governments 6%. It can be seen that, under the county-based financial management system, the major education expenditure responsibility has been shifted from township governments to county governments. However, given the marked disparity in levels of economic development and financial capacity among different counties, there is a considerable gap in levels of education expenditure among counties which is not offset adequately by transfer payments.

Figure A-5 Share of education expenditure among four levels of government in Henan province (2003)



Source: *Henan Statistical Yearbook 2004*, Henan PBS, 2004

The distribution of education expenditure among levels of education

If kindergartens, primary schools, middle schools, vocational middle schools, specialized middle schools, schools of technology and special education schools are all considered as providing education for children, 64.2% of government expenditure on education goes to child education,

while 31.4% goes to higher education and 4.4% for other education, according to official data for 2003 (see Table A-8). For on-budget expenditure only, the proportion of funds for education of children is slightly higher: 71.9% compared with 24.1% for higher education.

Su Ming (2003) has argued that the structure of China's education expenditure shows a seriously unbalanced distribution of government expenditure between compulsory and non-compulsory education. As the data in Table A-8 show, only about a quarter of government expenditure on education goes to primary schools, although this is somewhat higher (one third) if only on-budget expenditure is taken into account. Middle schools (including specialized, vocational and technological middle schools) account for a much higher share of government expenditure (37.4%). It is also striking that the government allocates very little resources to pre-school education, despite its importance for early child development and children's later success in their more formal school years. In 2003, this component of the education system received only 1.3% of total government expenditure on education.

Table A-8 Government expenditure on education, by types of schools (2003)

Unit: % of total

	Government expenditure	On-budget expenditure
Education for children	64.2	71.9
Kindergartens	1.3	1.3
Primary schools	25.6	33.6
Middle schools	29.6	30.0
Specialized middle schools	4.2	3.7
Schools of technology	0.5	0.5
Vocational middle schools	2.7	2.5
Special education schools	0.3	0.4
Higher education	31.4	24.1
Others, including adult education	4.4	4.0

Source: *China Educational Finance Statistical Yearbook 2004*.

Although the government has made the achievement of nine years compulsory education one of its most important national goals, only about half of government expenditure on education goes to compulsory education (i.e. primary schools and junior middle schools). In 2003, compulsory education received 51.5% of government education expenditure (see Table A-9).

Table A-9 Expenditure on compulsory and non-compulsory education (2003)

Unit: 100 million yuan

Item	Total (public & private)	Government expenditure	On- budget expenditure	Tuition & miscella- neous fees	Other education funds
Total	6,208.3	3,850.6	3,453.9	1,121.5	1,236.1
Non-compulsory education	3,669.9	1,866.2	1,664.6	895.9	907.8
Compulsory education	2,538.3	1,984.4	1,789.3	225.6	328.3
Rural compulsory education	1,365.3	1,142.8	1,094.3	134.3	88.2
% share of non-compulsory education	59.1	48.5	48.2	79.9	202.6
% share of compulsory education	40.9	51.5	51.8	20.1	97.4
% share of rural areas in compulsory education	53.8	57.6	61.2	59.5	78.9

Source: calculations based on data from *China Statistical Yearbook 2005*.

The relative weight given to primary, secondary and tertiary education expenditure can also be seen by comparing expenditure per school pupil with GDP per capita. Data for 2000 from UNESCO (cited by World Bank, 2003) show that this rises from 6.1% for primary school to 12.1% for secondary (middle) school and 85.5% for higher education (see Table A-10). The ratio of the figures for tertiary to primary levels was 14 in China, compared with 8 in Malaysia and 3 in Thailand. Developed industrial countries generally have much higher ratios of expenditure per primary pupil to GDP per capita than developing countries. However, China's figure was slightly lower than India's (7.2%) and much lower than for Malaysia (11.2%) and Thailand (12.5%).

Table A-10 Ratio of government expenditure per student to GDP per capita: China and other Asian countries (2000)

Unit: %

Country	Primary school	Secondary (middle) school	Higher education
China	6.1	12.1	85.5
Japan	21.3	n.a.	n.a.
South Korea	18.3	16.8	n.a.
Thailand	12.5	12.8	38.2
Malaysia	11.2	19.9	86.1
India	7.2	23.1	n.a.

Source: UNESCO data in World Bank, *World Development Report 2003*, pp 256-257.***The urban/rural distribution of expenditure on basic education***

An analysis of education expenditure per pupil shows major disparities in the allocation of resources for basic education between urban and rural areas. As is shown in Table A-11, the

national average expenditure per primary school pupil (i.e. in urban and rural areas combined) was 1,296 yuan in 2003, but in rural areas it was only 1,058 yuan. The disparities are even larger for junior middle school, where the comparable figures in 2003 were 1,669 yuan and 1,211 yuan. Table A-11 shows that there are disparities in each of the three economic categories by which the Chinese government classifies expenditure: salaries, non-personnel operating expenditure and school construction.

For example, the data for salary payments per student in junior middle school show that the national average was 1,088 yuan, while the average in rural areas was 867 yuan. Likewise, in primary education, the national average salary payment per pupil was 972 yuan, while in rural areas it was 832 yuan. These disparities in rural and urban salary payments partly reflect the higher class sizes in rural areas, especially in junior middle school. In the education sector, salaries are budgeted on the basis of the approved staff establishments, which are fixed according to officially set ratios of staff to pupils. These ratios are set higher for the rural areas than the urban areas: 19 compared to 23 pupils per staff member for primary schools and 13.5 compared to 18 staff members for junior middle schools. With regard to teaching staff, the actual pupil-teacher ratio in primary schools averaged 19.5 in urban areas and 20.3 in rural areas in 2003. For junior middle schools, the ratio averaged 16.3 in urban areas and 19.6 in rural areas. However, the disparities in salary payments per pupil also arise from the differences in the salary scales between wealthier and poorer counties, as counties supplement the base salaries set by the central government. This is a perverse incentive structure, which leads to the loss of well qualified teachers from poorer rural areas.

Table A-11 Education expenditure per student in rural and urban areas (2003)

Unit : yuan

Type of schools	Government expenditure				On-budget expenditure			
	Total	Salary payments	Operating expenditure	School construction	Total	Salary payments	Operating expenditure	School construction
Junior middle schools	1,668.7	1,088.1	477.3	103.4	1,097.3	924.7	127.3	45.3
Rural areas	1,210.8	867.1	306.8	36.7	889.7	786.8	85.0	17.9
General primary schools	1,295.7	972.3	280.3	43.1	952.6	848.1	83.5	21.0
Rural areas	1,058.3	832.0	200.5	25.8	823.2	749.2	60.9	13.2

Source: *China Education Finance Statistical Yearbook 2004*, China Statistical Press, 2005, pp 46-47.

There are similar urban/rural gaps in the non-personnel operating expenditure per pupil. However, the disparity in school construction expenditure is the most conspicuous. In 2003, school construction expenditure per student in junior middle school averaged 103 yuan nationwide, but in rural areas it was only 37 yuan. As for primary schools, the national average was 43 yuan, while

the rural average was just 26 yuan. These disparities widen further the gap in school conditions and thus the learning opportunities for children in different parts of the country.

The regional distribution of expenditure on basic education

The regional disparities in expenditure on basic education are even greater than the national disparities between urban and rural areas. Since schools in China are largely financed by governments at the sub-national level (in particular by county governments), the regional differences in levels of economic development and thus tax revenue mean that there are large variations in the resources available for expenditure on education, resulting in inequality of opportunities for children in the western, central and eastern regions.⁴ In general, the central and western provinces have lower levels of expenditure on basic education than the eastern provinces. Due to a large increase in earmarked transfer payments for basic education in the western provinces, it is the central region that is now lagging furthest behind.

Due to data limitations, the analysis is restricted to on-budget expenditure. Table A-12 shows that with regard to the on-budget expenditure per primary school student, in 2003 the average figure for the 13 eastern provinces was 1,786 yuan, the average for the six central provinces was 711 yuan and the average for the 12 western provinces was 1,031 yuan. In short, the on-budget expenditure per primary school student in the east was 2.5 times higher than in the centre and 1.7 times higher than in the west. The central provinces are worst off because they have not benefited nearly as much as the western provinces from targeted transfer payments for education.

Table A-12 On-budget expenditure per primary school student (2003)

Unit : yuan

Region	National				Rural areas			
	Total	Salary payments	Operating Expenditure	School construction	Total	Salary payments	Operating expenditure	School Construction
East	1,785.8	1,491.8	263.3	33.3	1,597.9	1,406.8	177.6	16.0
Centre	711.2	658.5	44.7	8.0	677.1	626.7	43.0	7.4
West	1,031.3	892.4	85.4	53.6	991.1	859.7	78.5	52.8

Source: calculation is based on the data from *China Educational Finance Statistical Yearbook 2004*, China Statistical Press, 2005, page 378 and 380.

This pattern of disparities can be seen for both salary payments and operating expenditure. For each of these, the east has the highest levels of spending per pupil, followed by the west, with the centre far behind. For example, salary payments per primary school pupil in the east were 2.3

⁴ In this report, the eastern region includes Beijing, Fujian, Guangdong, Hainan, Hebei, Jiangsu, Shandong, Shanghai, Tianjin and Zhejiang, as well as the north-eastern provinces of Heilongjiang, Jilin and Liaoning. The western region comprises Chongqing, Gansu, Guangxi, Guizhou, Inner Mongolia, Ningxia, Qinghai, Shaanxi, Sichuan, Tibet, Xinjiang and Yunnan, while the central region includes Anhui, Henan, Hubei, Hunan, Jiangxi and Shanxi.

times higher than in the centre and 1.7 times higher than in the west. Non-personnel operating expenditure in the east was 5.9 times higher than in the centre and 3.1 times higher than in the west.

The situation is slightly different in the case of school construction, as the large transfers for school building in the western provinces have resulted in that region having the highest school construction expenditure per primary school pupil (1.6 times higher than the east and 6.7 times higher than the centre).

The regional data for primary education expenditure per pupil in rural areas tell a similar story, although they also show that it is in the east that expenditure on rural areas differs the most from the regional averages. This may not reflect higher urban-rural disparities in the east, but simply the fact that this region has a much higher urban population than the west and the centre.

There are very large provincial disparities in on-budget expenditure per primary school pupil. In 2003, the amount spent per pupil in Shanghai (7,030 yuan) was ten times higher than in Henan (677 yuan). As Map A-1 shows, four out of the six central provinces have levels of spending below 1,000 yuan per pupil. The two others are in the 1,000-1,500 yuan range. By contrast, all the 12 eastern provinces spend more than 1,000 yuan per primary school pupil and nine of them spend more than 1,500 yuan.

Intra-regional disparities among provinces within the east are very marked, with two of the provinces (Shanghai and Beijing) spending well over 5,000 yuan per pupil. There are also large inter-provincial disparities within the western region, where four of the 12 provinces spend less than 1,000 yuan per pupil, five spend between 1,000 and 1,500 yuan, two spend between 1,500 and 2,000 yuan (Xinjiang and Inner Mongolia) and one spends more than 2,000 yuan (Tibet). These last three western provinces benefit from unusually high transfer payments from central government, compared with most western and central provinces.

Regarding junior middle schools, the analysis is limited for data reasons to the rural areas and excludes Tibet. As Table A-13 shows, the pattern of disparities is similar to that for primary education in rural areas. Thus, in 2003, on-budget expenditure per student in rural junior middle school in the east was 2.2 times higher than in the centre and 1.7 times higher than in the west. Likewise, this was the ranking for both salary payments and other operating expenditure, while the west came top, ahead of the east, for school construction.

Map A-1 On-budget expenditure per primary school student (2003)



Source: *China Education Finance Statistical Yearbook 2004*, MOE, 2005a.

Table A-13 On-budget expenditure per student in rural junior middle schools (2003)

Unit : yuan

Region	Total	Salary payments	Operating expenditure	School construction
East	1,631.8	1,342.7	272.6	19.5
Centre	732.9	664.7	57.5	10.7
West *	968.4	814.6	111.4	42.5

* Tibet is not included.

Source: calculations based on data from *China Education Finance Statistical Yearbook 2004*, MOE, 2004a, page 374.

The empirical analysis by Wang Rong (2003) shows that nationally the disparity of educational operating expenditure per student in primary school and junior middle school is largely due to the disparity within provinces rather than the disparity among provinces. The analysis of rural areas also comes to the same conclusion that the disparity in educational operating expenditure among counties and districts in rural areas is mainly caused by intra-provincial disparities.

It is the wide variation in levels of off-budget expenditure that is the main factor causing the intra-provincial disparities in operating expenditure, particularly in primary schools. In junior middle schools, both on-budget and extra-budgetary expenditures play equally important roles in creating disparities. Areas with high levels of extra-budgetary expenditure per student in junior middle school tend also to have rather high levels of on-budget expenditure per student. For

primary schools, it is more common to find high extra-budgetary expenditure in areas where on-budget expenditure is low.

Box A-1 Special projects and funds for basic education

In order to achieve universal compulsory education and promote equal access to education for children in poverty-stricken areas, the central government has earmarked specific transfer payments to these areas, in particular in western China, through a series of programmes and projects.

Compulsory education project in poverty-stricken areas: In 1994, the Financial Department of the National Commission of Education and the Culture and Education Department of the Ministry of Finance completed a survey of compulsory education in Shanxi and Inner Mongolia and made a proposal for a compulsory education project in poverty-stricken areas. This is the project with the highest level of financial resources and the most extensive coverage for the promotion of compulsory education in poverty-stricken areas. During the first stage of this project (1995-2000), a total of 12.6 billion yuan was committed, including 3.9 billion yuan from central government and 8.7 billion yuan from lower level governments. From 1995 to 1997, 383 poor counties in the central and western regions received assistance and from 1998 to 2000 assistance was directed to 469 poor counties in the western region. From 2001 to 2005, the central government continued its efforts by implementing the second stage of this project, which focused on poverty stricken areas and ethnic minority areas. A total of 7.36 billion yuan was committed, including 5 billion yuan from central government and 2.36 billion yuan from sub-national governments. The government has recently launched a third stage, which aims to achieve the goal of universal compulsory nine-years education by 2010.

Project for renovating dilapidated rural primary school and middle school buildings: In order to improve school conditions in rural areas, the central government decided to implement a project for renovating dilapidated buildings of rural primary schools and middle schools from 2001, with the main focus on renovating buildings whose load-bearing structure cannot sustain normal use and poses security threats ('D-level' dilapidated buildings). During the first stage, from 2001 to 2002, the central and provincial governments invested a total of 5.2 billion yuan, of which 3 billion yuan was committed by the central government (mainly through the issuance of treasury bonds) and 17 million square metres of dilapidated school buildings were renovated. Since 2003, the government has committed 6 billion yuan for this project.

Special funds for the relocation of primary and middle schools: With a view to achieving greater efficiency in basic education, the central government created special funds for the merging of primary and middle schools in areas with a thin school-age population. In some areas the school-age population has declined substantially due to the family planning policy and migration. These special funds are used for the reconstruction and expansion of school buildings, as well as the purchasing of books, teaching materials and equipment. From 2000 to 2002 a total of 1.5 billion yuan was committed by the central government for this project.

Project for construction of boarding schools in rural areas: To ensure that the two basic goals of universal compulsory education and universal literacy are attained in the western region by 2007, this project was launched to address the problem that school-age children are dispersed over wide areas in the west of the country. This situation was accentuated by the decline in the school-age population and the closure of many local primary and middle schools. The central government is investing 10 billion yuan in the building and expansion of 7,700 boarding schools over the period from 2004 to 2007.

'Two frees and one subsidy': In order to overcome the financial barriers to access to compulsory education in rural areas and in particular to make boarding an affordable option for poor families, the central government launched a new policy in 2004 to provide students from poor families in poverty-stricken rural areas in Western China with free textbooks, to exempt them from paying miscellaneous fees and to grant living allowances to boarding students. This was extended in 2005 to all 592 rural counties officially designated as poverty-stricken, throughout China. In 2006, all miscellaneous fees for compulsory education in rural areas in western China were abolished and this policy will be extended to central and eastern China in 2007.

Project on modern distance education in rural primary and middle schools: In order to improve basic education quality in rural areas, the central government decided to implement a project to introduce modern distance education in rural primary and middle schools. Quality educational resources and advanced teaching methods will be delivered to these schools through the use of multi-media teaching, satellite communications and computerization of classrooms. Since 2003, the central government has earmarked 1,344 million yuan for piloting this project in the central and western regions. The piloting sites in the western region received almost two thirds of these funds. The aim is that within five years about 110,000 multi-media teaching systems and 380,000 satellite communication sites will be built in rural primary schools and 40,000 computer classrooms constructed in rural junior middle schools. This will help to address the shortages of education resources and improve teaching quality in western rural areas.

Basic education development project in western China: In December 2001, the Ministry of Education decided to launch a project in western China with a World Bank loan and a British government grant to support the achievement of universal nine-years compulsory education in 112 counties in Sichuan, Yunnan, Guangxi, Ningxia and Gansu provinces. This project, which started in the second half of 2003, is scheduled to conclude by the end of 2007. With a total financial input of \$147.3 million, including \$100 million from the World Bank and the UK government and \$47.3 million from Chinese government funds, the project is intended to improve school conditions, educational quality and school administration.

2.4 Impact on education development and equity

Overall trends

As noted at the beginning of this chapter, the government has made enormous progress towards the achievement of its goal of universal compulsory education. China appears to be well on track to achieve the MDGs of universal primary education and gender equality in education. The NER for primary education was 98.9% in 2004, compared with 97.8% in 1990, although there has been a slight decline in recent years (from over 99% in 2000), according to official data of the Ministry of Education. There is only a very small difference between the primary NERs for boys (98.6%) and girls (98.5%). The GERs for junior middle school have risen from 66% in 1990 to 94% in 2004. There has also been an impressive increase in senior middle school enrolment, with the GER rising from 26% in 1992 to 48% in 2004, although this level of education is now becoming the main bottleneck for education development in China. In 2004, the promotion rate of junior middle school graduates was 63.8%, much lower than the promotion rate of primary school graduates (98.1%). Enrolment in higher education has also been rising rapidly, from 3.4% in 1990 to 19.0% in 2004.

The enrolment of children in pre-school is still much lower than in primary education, reflecting the fact that the central and sub-national tiers of government have given much lower priority to funding the expansion of this part of the education system, resulting in high fees for pre-school

education and consequently the exclusion of the poor, particularly in the rural areas and in most of Western and Central China. This is unfortunate in view of the international evidence that investments in early childhood development pay off in higher learning achievement by children in the later stages of their education.

Geographical disparities

Despite the success achieved in education over the past two decades, especially in the progress towards universal compulsory education, there are still some areas in China that are lagging behind the rest of the country, partly due to the geographical differences in the resources available for expenditure on education. The provincial disparities in the primary school net enrolment ratio (NER) are very small, ranging from 100% in Shanghai in the east to 96.3% in the two western provinces of Tibet and Yunnan, which also have the lowest primary school promotion rates (92.2% in each province, compared with 98.4% nationally).

The disparities are more marked in junior middle school. Provincial NER figures are not available, but gross enrolment ratios (GERs) range from 117.8% in Heilongjiang to 70.3% in Tibet, although these figures are difficult to interpret because the GER can be inflated by the enrolment of over-age children. The promotion rates from junior middle school range from 98.1% in Shanghai to 44.1% in Guizhou, 46.6% in Yunnan and 48.7% in Xinjiang – all Western provinces. These figures suggest that the government is right to be directing more resources to the west than the centre, but that resources to both those regions should be raised relative to the east.

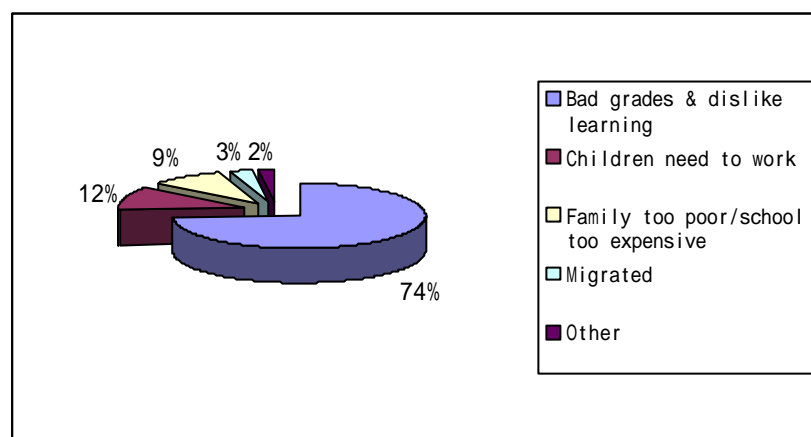
Financial barriers to access by the very poor

The government has taken a series of measures to reduce the financial burden of education on poor families in rural China under the policy of the ‘two frees and one subsidy’, which was first introduced in 2004 in poverty-stricken rural areas in Western China (see Box A-1). The policy provided compulsory education pupils from poor families with free textbooks, exempted them from paying miscellaneous fees and, to make boarding affordable, granted living allowances to attend boarding schools. The policy was subsequently extended to other poverty stricken counties in 2005. The abolition of miscellaneous fees for compulsory education was extended to all rural areas in western China in 2006 and will be extended to all rural areas of central and eastern China in 2007.

Nonetheless, financial factors may still result in school drop-out even when miscellaneous fees have been abolished. A survey conducted in early 2006 by the Gansu Provincial Bureau of Statistics (Gansu PBS, 2006), to investigate why some children of junior middle school age were

still dropping out of school after the abolition of school fees, found that the drop-out rate in different counties in the 2005/2006 school year ranged from 0.2% to 4.8%. Almost three quarters of parents gave ‘bad grades and dislike of learning’ as the reason for drop-out (see Figure A-6). However, 21% cited economic reasons: the family was too poor and the cost of sending children to school was too high even after the abolition of fees (9%) or the family needed children to work (12%).

Figure A-6 Reasons for children dropping out of junior middle school, Gansu, 2005/2006



Source: *Spring Survey on the Drop-Out from Rural Middle Schools*, Gansu Provincial Bureau of Statistics, 2006

The direct costs of school might include transport (especially for children in remote areas), school meals and uniforms. But, as the reference to child labour indicates, there is also an opportunity cost to school attendance. This suggests that an appropriate policy response would be to provide financial assistance for children of the poorest families to attend school, possibly in the form of conditional cash transfers, i.e. benefits that would be paid to families on condition that their children attend school.

Access to education by migrant children

Migrant children in the urban areas are one of the most disadvantaged groups of children, with lower rates of enrolment and promotion than urban resident children. According to the last population census, conducted in 2000, China has a migrant population of 131 million, including 23.6 million children (18% of the total migrant population) (Zhou hong, Qu Zhiyong et al, 2005). In view of the large size of the migrant population in the context of China’s accelerated process of urbanization and industrialization, and the effects of the household registration (*hukou*) system on access to services, the challenge of ensuring migrant children’s equal rights to education has become an urgent social problem.

According to a study conducted by NWCCW, the China National Children's Centre (CNCC) and UNICEF in 2002-2003 in nine cities (Beijing, Shenzhen, Wuhan, Chengdu, Jilin, Xianyang, Shaoxing, Zhuzhou, and Yining), the proportion of migrant children in school peaks at 99.2% at age 8 and then declines gradually to 93.0% by age 13 and more abruptly to 84.6% at age 14 (NWCCW et al, 2003).⁵ These figures suggest that there is a high rate of drop-out among migrant children, especially in junior middle school. Overall, between the ages of 7 and 14, there is a slightly higher proportion of boys than girls in school (97.4% compared with 96.1%). Enrolment in this age range is higher in big cities (97.5%) than in medium cities (96.3%) and lowest in small cities (94.3%). A quite high proportion of the children in schools are over-age: for example, 19.7% of the 9-year-old children are still attending the first or second years of primary school.

Financial difficulties are the main reason why migrant children do not attend school. According to the survey results, 56.9% of out-of-school children's families said that they could not afford to send children to school. There appear to be two aspects to this problem. First, many migrant children have to pay extra fees to attend urban schools. The survey found that on average migrant children pay 856 yuan more in fees than resident urban children. These include 'temporary study fees' (average 603 yuan), 'supporting fees' (average 214 yuan) and 'fees for administrative expenses' (average 39 yuan). Although many regulations have been issued by the government regulating these charges, parents reported that these regulations are often disobeyed by schools. A second problem is that some children drop out of school to enter the labour market and contribute to household income. The study found that 16% of 12-14 year old school drop-outs were in full-time employment and 44% in part-time jobs. Child labour may be a cause as well as a consequence of school drop-out.

As in the case of school-age children of poor rural families, a policy that could be adopted to reduce drop-out by migrant children would be to provide children from the poorest migrant families with cash transfers that are conditional on school attendance. This would complement the enforcement of all regulations prohibiting the charging of discriminatory fees, which would require adequate supervision and inspection of schools, as well as an increase in government resources for city schools to cover the additional costs of enrolling non-resident children.

⁵ Migrant children mainly attend government schools (81%), the rest going to private schools, including schools set up specially to cater for migrant children.

3 Expenditure on maternal and child health

Access to quality health care is vital for the survival and healthy development of children, especially in the earliest years of life. As in education, China has made remarkable progress in child health and this has been reflected in substantial improvements in the measures of child survival. The maternal mortality ratio (MMR) declined from 80 to 48.3 deaths per 100,000 live births between 1991 and 2004 (a reduction of 39.6%), while the under-five mortality rate (U5MR) declined from 61 to 25.5 deaths per thousand live births (a reduction of 59%). The infant mortality rate had fallen to 21.5 per thousand live births by 2004.

If these trends are sustained, China is likely to attain the MDGs for child and maternal mortality, as well as the national targets for the maternal mortality ratio (40/100,000 by 2010) and the infant mortality rate (17/1,000 by 2010), which were set in the National Programme of Action for Child Development (NPA) and incorporated into the 11th Five Year Plan. However, the decline in child mortality appears to have been slowing down in the last few years and is now concentrated heavily in the neonatal period, which accounted for 63.9% of under-five mortality in 2004. Likewise, the decline in the MMR appears to have slowed down since about 2001. Child and maternal mortality rates also differ widely across the country, with wide disparities between urban and rural areas, within rural areas and between the eastern, central and western regions.

A recent review of maternal and child survival strategy in China (MOH et al, 2006), conducted jointly by the Ministry of Health (MOH) and three United Nations agencies (UNICEF, the World Health Organization and the United Nations Population Fund), calculated that a small number of preventable or curable conditions account for over 75% of maternal and child mortality in China. In the case of maternal mortality, these include post-partum haemorrhage, pregnancy induced hypertension, embolism and sepsis, while the main causes of child mortality are neonatal asphyxia and trauma, preterm delivery, low birth weight, injury and pneumonia. Modeling showed that, by ensuring universal access to a basic package of the most effective maternal and child health (MCH) interventions, China could achieve a 50% decline in the MMR and a 34% decline in the U5MR, achieving levels well below the targets set in the MDGs, the NPA and the 11th Five Year Plan.

As in the case of education, government health services are largely financed at the local level, which means that public resources for health care, including MCH services, depend heavily on the local level of economic development and tax revenue. This leads to large disparities in the level of government expenditure on health in different parts of the country, as well as heavy reliance by health facilities on user charges. Thus, despite the great achievements China has made in the provision of health services and the improvement of survival indicators, the gaps between rural and urban areas are still considerable and some poverty-stricken areas are facing tremendous

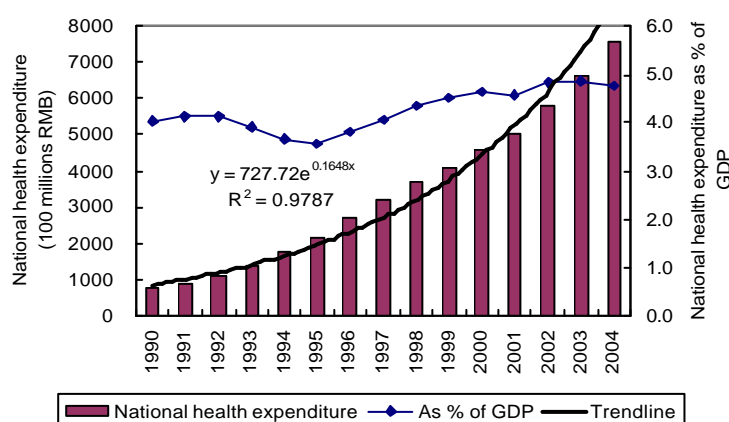
difficulties in the development of health services. Moreover, the fees charged for health services are a major factor impeding access, including access to MCH services, because of the high level of fees relative to household income, especially in the poorest areas, and the low coverage and reimbursement rates of medical insurance schemes. These are some of the issues to be analyzed in this chapter.

3.1 Government and private expenditure on health

China's overall health expenditure has witnessed rapid growth since 1990. However, this has been driven mainly by the increase in households' 'out-of-pocket' expenditure on health. Government expenditure on health has risen more slowly and remains relatively low. As a result, the 'unaffordability of medical treatment' and the 'difficulty of seeing doctors' have become issues of mounting concern to Chinese people. The Development Research Centre of the State Council (DRC, 2005) has observed that the marketization of the healthcare and pharmaceutical systems has resulted in soaring prices for medical services and drugs, and over-medicalization, creating inefficiencies as well as equity problems, while the development of the medical insurance system has met formidable obstacles. To many people, especially those in poor families, medical treatment is financially beyond their reach.

China's national health expenditure (public and private expenditure combined) increased from 75 billion yuan in 1990 to 759 billion in 2004, with an average annual rate of increase of 18% at current prices. During this same period, the ratio of national health expenditure to GDP rose from 4.0% in 1990 to 4.7% in 2004 (see Figure A-7). To a certain extent such a trend is to be expected, as countries with a higher GDP per capita tend to have higher ratios of health expenditure to GDP (Eggleston et al, 2005).

Figure A-7 National health expenditure and GDP (1990-2004)

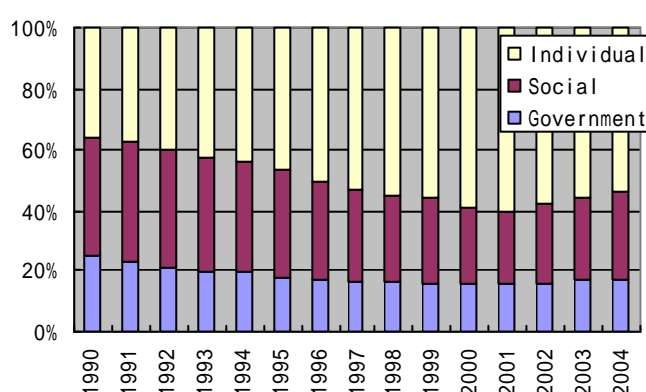


Source: *China Health Statistical Yearbook, 2005*

However, it is a matter of some concern that the growth in national health expenditure has been driven mainly by the rapid rise in health expenditure by individuals, rather than government health expenditure, which has declined as a proportion of GDP. Expenditure by individuals on health increased at an average annual rate of 21.5% between 1990 and 2004, rising from 26.7 billion yuan to 407.1 billion yuan. The ratio of individual health expenditure to national health expenditure rose from 35.7% in 1990 to 60% in 2001. In contrast with this surge in private health expenditure, the ratio of government health expenditure to national health expenditure dropped from 25.1% in 1990 to 17.0% in 2004 (see Figure A-8).

There has been a partial reversal of these trends since 2001, when the government began to adopt a series of health sector reforms including the establishment of the new rural cooperative medical scheme, which to some extent has reduced the proportion of health expenditure accounted for by private payments by rural people. By 2004, the share of ‘out-of-pocket’ expenditure in national health expenditure had declined from its 60% peak to 53.6%.

Figure A-8 Health expenditure by government, individuals and social organizations (1990-2004)



Source: *China Statistical Yearbook 2005*

It should be noted that, in addition to the government and individuals, there is a third category of health expenditure accounted for by ‘social organizations’. These were originally state enterprises and township and village collective organizations. As a result of the radical economic changes since the late 1970s, these enterprises and organizations have essentially ‘moved’ from the public sector to the private sector. Even if in some cases, enterprises remain state-owned, they are in effect run as commercial businesses. As can be seen in Figure A-8, the share of social organizations in national health expenditure declined significantly during the 1990s, from almost 40% in 1990 to 24% in 2001, due to the reforms, which led to the closure of some state companies, the privatization or commercialization of others, the conversion of the township and village collective organizations into small businesses, and the reduction of all these organizations’

involvement in the provision of social benefits such as health care. The slight increase in social organization's share of national health expenditure since 2001 has resulted from legislation requiring companies to provide staff with health insurance.

The ratio of government health expenditure to GDP declined from 1.01% in 1990 to 0.65% in 1996, but since then has recovered partially, reaching 0.81% of GDP in 2004. Government health expenditure has also declined in relation to overall government expenditure, falling from 6.1% in 1990 to 4.5% in 2004. The Decisions on Health Reform and Development issued by the State Council in 1997 stated that 'the central and local governments shall gradually increase inputs for health as the economy grows and the rate of increase shall not be lower than the rate of increase of fiscal expenditure'. But in fact, despite the slight recovery in the ratio of government health expenditure to GDP since 1996, the share of health expenditure in government expenditure has declined during this period, from 4.57% in 1993 to 3.52% in 2003, a change that is partly related to the tax sharing reform in 1994 (see Chapter 1) and the decentralization of responsibility for financing government health services. Overall, since reform and opening up, China has in practice adopted a policy of reducing the role of the government in the financing of health services, a policy that runs counter to the practices of many other countries.

Table A-14 Government health expenditure (1990-2004)

	Government health expenditure (100 mn yuan)	Government health expenditure as % of GDP	Share of health in total government expenditure (%)
1990	187.3	1.01	3.23
1991	204.1	0.94	3.15
1992	228.6	0.86	3.09
1993	272.1	0.77	4.57
1994	342.3	0.71	4.56
1995	387.3	0.64	4.23
1996	461.6	0.65	3.92
1997	523.6	0.66	4.39
1998	590.1	0.70	4.07
1999	641.0	0.71	3.62
2000	709.5	0.72	3.33
2001	800.6	0.73	3.20
2002	908.5	0.75	3.16
2003	1,116.9	0.82	3.52
2004	1,293.6	0.81	n.a.

Source: *China Health Statistical Yearbook 2005; Guideline to China Health Statistics 2006*

The reduction in the share of health in government expenditure has affected both recurrent expenditure and capital expenditure, known respectively in China's budget terminology as operating and construction expenditure. Although on-budget recurrent expenditure on health, including expenditure on both salaries and non-personnel operating expenditure, has continued to

increase, rising from 7.9 billion yuan in 1990 to 47.8 billion yuan in 2004, its share in total on-budget expenditure declined from 2.58% in 1990 to 1.68% in 2004 (see Table A-15). On-budget capital expenditure on health increased from 2.0 billion yuan in 1990 to 28.1 billion yuan in 2004, with an annual rate of increase of 20.6%, somewhat higher than the growth of total government fixed asset investment (16.3%).

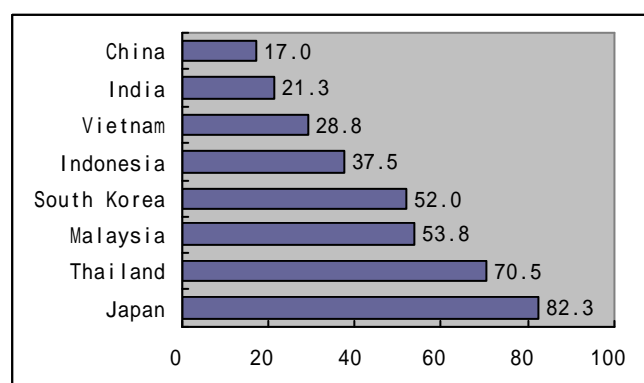
Table A-15 On-budget recurrent and capital expenditure on health (1990-2004)

	Total on-budget expenditure (100 mn yuan)	Health recurrent (operating) expenditure		Health capital (construction) expenditure		
		100 mn yuan	% of on-budget expenditure	100 mn yuan	% of on-budget expenditure	% of on-budget construction expenditure
1990	3,083.6	79.5	2.58	20.3	0.66	1.19
1991	3,386.6	86.4	2.55	26.2	0.77	n.a.
1992	3,742.2	96.1	2.57	35.8	0.96	n.a.
1993	4,642.3	107.9	2.32	48.3	1.04	n.a.
1994	5,792.6	147.0	2.54	60.5	1.04	n.a.
1995	6,823.7	163.3	2.39	73.4	1.08	0.99
1996	7,937.6	187.6	2.36	86.7	1.09	1.01
1997	9,233.6	209.2	2.27	104.3	1.13	1.05
1998	10,798.2	225.1	2.08	141.7	1.31	1.19
1999	13,187.7	247.9	1.88	147.4	1.12	1.18
2000	15,886.5	272.2	1.71	152.9	0.96	1.14
2001	18,902.6	313.5	1.66	182.6	0.97	1.23
2002	22,053.2	350.4	1.59	231.5	1.05	1.31
2003	24,650.0	439.3	1.78	280.2	1.14	1.22
2004	28,486.9	478.1	1.68	281.2	0.99	n.a.

Note: Health operating expenditure excludes expenditure on civil servants' health service benefits, traditional Chinese medicine, medical education and scientific research.

Source: Ministry of Health, *China Health Statistical Yearbook 2004*.

Figure A-9 Public health expenditure as % of total health expenditure: China (2004) and other Asian countries (2002)



Source: UNDP, *Human Development Report 2005*, pp 236-239

The level of government expenditure in national health expenditure is lower than that of most developed and developing countries. Figure A-9 compares China with several large Asian countries, all of which have higher public shares in total health expenditure, ranging from 21.3% (India) to 82% (Japan). In the developed industrial countries, the figures are highest, ranging from 44.4% in the USA to 90.1% in the Czech Republic (OECD, 2005).

3.2 The decentralization of health expenditure

Health expenditure in China is highly decentralized. Table A-16 shows that, from 1991 to 2004, the sub-national tiers of government accounted for 97.8% and central government only 2.2% of on-budget recurrent expenditure on health.⁶

Table A-16 Shares of central and local governments in on-budget recurrent expenditure on health (1991-2004)

	Recurrent (operating) expenditure (100 million yuan)	Share of central government		Share of local government	
		100 million yuan	% of total	100 million yuan	% of total
1991	145.53	3.77	2.59	141.76	97.41
1992	167.23	4.05	2.42	163.18	97.58
1993	201.77	4.34	2.15	197.43	97.85
1994	257.29	5.56	2.16	251.73	97.84
1995	297.31	5.99	2.01	291.32	97.99
1996	348.86	7.00	2.01	341.86	97.99
1997	390.71	7.83	2.00	382.88	98.00
1998	414.85	8.62	2.08	406.23	97.92
1999	445.68	7.19	1.61	438.49	98.39
2000	489.71	7.32	1.49	482.39	98.51
2001	569.30	11.76	2.07	557.54	97.93
2002	635.04	17.25	2.72	617.79	97.28
2003	778.05	22.07	2.84	755.98	97.16
2004	854.64	22.39	2.62	832.25	97.38

Note: Family planning operating expenditure is not included in health operating expenditure.

Source: *China Finance Yearbook 2005*, page 369; *China Finance Yearbook 1999*, page 475.

In fact, most government expenditure on health is concentrated at the sub-provincial level, particularly the prefectures and counties. Table A-17 provides data for Shandong, Henan and Anhui provinces, showing that in 2003 the provincial governments accounted on average for 12.9% of government expenditure on health at sub-national level. The government bodies at

⁶ Comparable data on on-budget capital expenditure and off-budget expenditure are unavailable.

prefecture level and below accounted for 87.1%. In short, provincial governments take only a minor responsibility for financing health services.

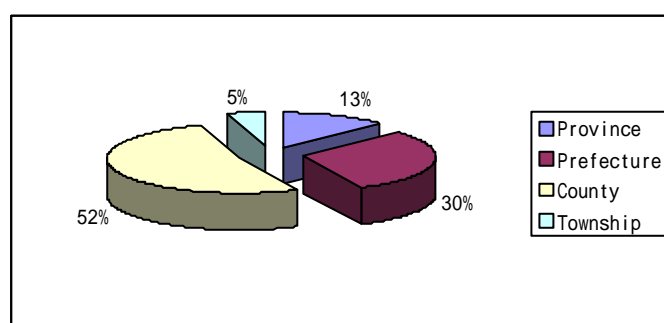
Table A-17 Shares of provincial governments and lower level government authorities in health expenditure in Shandong, Henan and Anhui provinces (2003)

Province	Provincial government	Government bodies at prefecture and lower levels
Shandong	14.1	85.9
Henan	12.7	87.3
Anhui	12.0	88.0
Average	12.9	87.1

Sources: *Shandong Statistical Yearbook 2004, Henan Statistical Yearbook 2004, Anhui Statistical Yearbook 2004.*

Figure A-10 takes Henan province as an example, showing that the provincial government accounted for 13% of the total health expenditure by sub-national tiers of government, the prefecture governments 30%, the county governments 52% and the government bodies at township and village level 5%. This demonstrates that China's health expenditure is highly decentralized with county level governments bearing the major expenditure responsibility. The heavy responsibility of sub-national tiers of government, especially the county governments, is compensated partially by transfer payments from the central government. Unfortunately, there are no readily available data on the volume of transfer payments in the health sector.

Figure A-10 Shares of four tiers of local government in health expenditure in Henan province (2003)



Source: *Henan Statistical Yearbook 2004*

3.3 The distribution of expenditure among health service levels

The government mainly channels resources for health services to hospitals at county level and above, while township health centres and maternal and child health (MCH) centres receive only a very small proportion of resources and the clinics in villages even less. Table A-18 shows that, in 2004, hospitals accounted for 78.3% of total expenditure on healthcare institutions. By contrast, only 9.9% of expenditure was executed by township health centres and 3.1% by MCH centres.

This pattern of expenditure is replicated rather than corrected by the earmarked expenditures from central government, which in any case account for less than 2% of the total expenditure of healthcare providers.

The low expenditure share of the township-level health centres and MCH centres appears to be at odds with their important role in the provision of the most common services required by the general population, including in particular children and women. In fact, the main provider of health care in the rural areas is the village clinics, then the township health centres and last of all the county-level hospitals. This is shown in Table A19, which gives the results of a survey in 2003 on the level of health facilities from which rural residents obtained medical treatment over a two week period: village clinics 53.5%, township health centres 25.8% and county-level hospitals 10.7%. Among the factors influencing choice, the most important was short distance, which accounted for 49.4%. Clearly, proximity is the main consideration for rural residents. In other words, the order of preference of health service users in the rural areas is the opposite of the order of priority reflected in expenditure by the different levels of health facilities.

Table A-18 Expenditure on medical institutions (2004)

Unit : 100 million yuan

Item	Total expenditure	% of total expenditure	Earmarked expenditure	% of earmarked expenditure
Total	4,725.1	100.0	85.0	100.0
Hospitals	3,698.7	78.3	62.3	73.2
Sanatoriums	15.3	0.3	1.4	1.7
Community health service centres	89.8	1.9	2.6	3.1
Health centres	486.9	10.3	11.9	14.0
Urban health centres	17.0	0.4	0.4	0.4
Township health centres	469.9	9.9	11.5	13.5
Outpatient departments	44.2	0.9	0.9	1.1
Clinics	200.1	4.2	0.0	0.0
MCH centres	145.6	3.1	3.5	4.2
Specialized disease prevention and treatment institutes	37.5	0.8	1.8	2.1
Emergency centres	6.0	0.1	0.7	0.8
Clinical laboratory centres	1.0	0.0	0.0	0.0

Source: *China Health Statistical Yearbook 2005*

Table A-19 Health facilities from which rural residents obtain medical treatment (2003)

Unit: % of total

	Total	Type 1 rural areas	Type 2 rural areas	Type 3 rural areas	Type 4 rural areas
Type of health facility used:					
Village clinics	53.5	51.8	59.6	55.1	38.2
Township health centres	25.8	25.2	22.8	23.8	38.9
County-level hospitals	10.7	13.8	5.5	10.0	12.8
Reasons for choice:					
Short distance	49.4	53.1	50.0	47.9	47.3
Low price	7.2	6.9	7.0	6.5	10.4
Good service quality	17.5	19.7	16.6	17.4	16.6
Trust in doctors	14.0	10.7	14.8	16.8	8.7

Notes: The data show the places where survey respondents (in the 3rd National Health Service Survey) obtained medical treatment during the 2 weeks prior to the survey. Rural types 1-4 areas are defined in terms of levels of development, rural type 1 areas being the wealthiest and rural type 4 the poorest.

Source: China Health Statistical Yearbook 2004

Examining more closely the situation of maternal and child healthcare, Table A-20 shows that total MCH expenditure reached 14.5 billion yuan in 2004, of which the MCH centres at county level and below accounted for 31.6%, while the centres above county level received 68.4%. This structure of expenditure appears to be much too heavily tilted towards the MCH centres at prefecture and provincial levels.

Table A-20 Expenditure structure of MCH centres (2004)

Unit: 100 million yuan

	Total expenditure	Operating expenditure	Earmarked expenditure	% of total expenditure
Total	145.6	125.3	3.5	100.0
Provincial level	9.4	8.8	0.4	6.5
Prefecture level				
Managed by provinces	50.6	47.2	1.2	34.8
Managed by prefectures	39.6	35.9	0.8	27.2
County level	45.5	33.0	1.2	31.3
Below county level	0.5	0.4	0.0	0.3

Source: China Health Statistical Yearbook 2005

3.4 Geographical disparities in health expenditure and resources

Coupled with inadequate transfer payments, the decentralization of responsibilities for health expenditure has resulted in an unequal distribution of public health resources, which contributes to the serious disparities in health indicators among different parts of the country, including in maternal and child health. This inequality, between urban and rural areas and between and within different regions, has continued to widen, despite the intention expressed in the *Decisions on*

Health Reform and Development, issued by the State Council in 1997, to the effect that ‘rural healthcare, disease prevention and traditional Chinese medicine should be strengthened with the aim of gradually narrowing regional disparities’.

Urban/rural disparities

According to the Ministry of Health, national health expenditure, including both public and private expenditure, amounted to 759 billion yuan in 2004. Urban health expenditure accounted for 65.1% of the total and rural health expenditure 34.9%. Per capita national health expenditure was 584 yuan, but in the urban areas it was 4.2 times higher than in the rural areas (see Table A-21).

As has been discussed above, the rise in national health expenditure has been due mainly to the rise in health expenditure by private individuals, particularly in the urban areas, with an average annual increase of 18.3% in 2000-2003, compared with 13.6% in the rural areas. Urban households spend a higher proportion of disposable per capita income on health (5.6%) than rural households (4.4%). However, in both urban and rural areas, the rate of increase of per capita health expenditure has exceeded the growth of rural households’ per capita disposable income.

According to WHO’s *World Health Report 2000*, among 191 countries and territories, China ranked 188th in WHO’s equality index on health resources allocation (by governments), following Brazil, Burma and Sierra Leone. Unfortunately, data providing an urban/rural breakdown of total government expenditure on health in China are unavailable. This limits analysis to the urban/rural breakdown of recurrent expenditure, which includes both personnel and non-personnel operating expenditure and constitutes the bulk of government health expenditure. According to calculations by Zhao Yuxin (2004), the ratio of recurrent expenditure for health in rural areas to the national total dropped from 33.95% in 1998 to 32.53% in 2002. The ratio of rural health operating expenditure to total government expenditure dropped from 0.76% in 1998 to 0.56% in 2002. In 2002, on a per capita basis, the government’s operating expenditure on health in urban areas was 5.4 times higher than in the rural areas (73.71 yuan compared with 13.75 yuan). This imbalance in recurrent expenditure on health in rural and urban areas, combined with the sharp differences in urban and rural incomes and the fact that only a minority of rural residents have so far been integrated into the medical insurance system (see Section 3.5), seriously hinders access by rural residents to health services (Su Ming, 2003).

Table A-21 Distribution of health expenditure in rural and urban areas (2000-2004)

	2000	2001	2002	2003	2004
<u>National health expenditure</u>					
Total (100 mn yuan)	4,586.6	5,025.9	5,790.0	6,584.1	7,590.3
Urban areas	2,621.7	2,793.0	3,448.2	4,150.3	4,939.2
Rural areas	1,964.9	2,233.0	2,341.8	2,433.8	2,651.1
% share	100.0	100.0	100.0	100.0	100.0
Urban areas	57.2	55.6	59.6	63.0	65.1
Rural areas	42.8	44.4	40.4	37.0	34.9
Per capita health expenditure (yuan)	361.9	393.8	450.7	509.5	583.9
Urban areas	812.9	841.2	987.1	1108.9	1261.9
Rural areas	214.9	244.8	259.3	274.7	301.6
Urban/rural gap (times)	3.8	3.4	3.8	4.0	4.2
<u>Individual health expenditure per capita (yuan)</u>					
Urban areas	318.1	343.3	430.1	476.0	528.2
Rural areas	87.6	96.6	103.9	115.8	n.a.
Urban/rural gap (times)	3.6	3.6	4.1	4.1	n.a.
Rate of increase (%)					
Urban areas	29.5	7.9	25.3	10.7	n.a.
Rural areas	25.1	10.3	7.6	11.5	n.a.
<u>Share of health expenditure in household income (%)</u>					
Urban areas	5.1	5.0	5.6	5.6	5.6
Rural areas	3.9	4.1	4.2	4.4	n.a.
<u>Household income per capita (yuan)</u>					
Urban areas	6,280.0	6,859.6	7,702.8	8,472.2	9,421.6
Rural areas	2,253.4	2,366.4	2,475.6	2,622.2	2,936.4
Urban/rural gap (times)	2.8	2.9	3.1	3.2	3.2
Rate of increase (%)					
Urban areas	7.3	9.2	12.3	10.0	11.2
Rural areas	1.9	5.0	4.6	5.9	12.0

Note: From 2001 health expenditure data exclude expenditure for higher medical education.

Source: *China Health Development Statistical Gazette 2005*, MOH, 2005c.

Provincial disparities

Overall, in 2004, the mean on-budget expenditure per capita on health of all 31 provinces was 87 yuan, the coefficient of variations 85.3%, and the range 333 yuan. This reveals that, in the context of China's highly decentralized system of government expenditure on health and limited transfer payments, local governments with lower levels of financial resources have lower levels of health expenditure per capita, which has led to big disparities in the availability and quality of health services among and within regions. The large disparities in on-budget health expenditure per capita among provinces can be seen in Map A-2, which shows data on on-budget expenditure on health in 2004.

The data, from a sample of 104 MCH centres (35 in urban areas and 69 in rural areas), show that business income accounted for 78.5% of the total revenue of these centres in 2002, while government resources (i.e. funds allocated to subsidize the functioning of MCH centres) accounted for only 19.8% (see Table A-22). This low proportion of government funding compared with business income is characteristic of all types of areas, urban and rural, apart from type 4 rural areas, which are the very poorest. In the latter, government funds provided about half of revenue in 2002. From an equity perspective, it is positive that the share of government funding in total revenue rises progressively from type 1 rural areas (15.6%) to type 2 rural areas (17.1%), type 3 rural areas (25.5%) and type 4 rural areas (55.7%). On the other hand, government resources provide a larger proportion of MCH centres' revenue in urban areas than in rural areas (20.1% compared with 18.9% in 2002), which shows that urban areas are in a preferential situation.

Table A-22 Major revenue sources of MCH centres (2002)

	Total	Urban areas	Rural areas	Large cities	Medium cities	Small cities	Type 1 rural areas	Type 2 rural areas	Type 3 rural areas	Type 4 rural areas*
Revenue (10,000 yuan):										
Total	1,337.9	2,908	541.5	3,967.4	4,125.6	1,130.9	870.7	535.6	356.5	135.0
Government resources	264.6	584.1	102.5	876.9	491.9	255	135.4	91.6	91.0	69.6
Business income	1,049.8	2,266.7	432.5	2,980.7	3,383.8	866.3	729	439.4	256.9	65.4
% of total revenue										
Government resources	19.8	20.1	18.9	22.1	11.9	22.5	15.6	17.1	25.5	55.7
Operating income	78.5	77.9	79.9	75.1	82.0	76.6	83.7	82.0	72.1	52.3

* Data for type 4 rural areas has errors in original.

Note: Rural types 1-4 areas are defined in terms of levels of development, rural type 1 areas being the wealthiest and rural type 4 the poorest.

Source: Third National Health Service Survey, MOH, 2004a, page 160.

Table A-23 shows that, from 1992 to 1997, the average annual rate of increase in MCH centres' business income was very high but roughly equivalent in urban and rural areas (28.2% and 28.6% respectively). From 1997 to 2002, however, the average annual rates of increase diverged, accelerating sharply in the rural areas (to 35.4%) and greatly exceeding the rate of increase in urban areas (20.6%). These data suggest that MCH centres, and especially those in the rural areas, relied increasingly on service charges for their operations. This trend, if not curbed, will place more and more of the burden of health expenditure on rural residents.

Table A-23 Business income of MCH centres (1992-2002)

	Total	Urban areas	Rural areas	Large cities	Medium cities	Small cities	Type 1 rural areas	Type 2 rural areas	Type 3 rural areas	Type 4 rural areas
Average operating income (10,000 yuan)										
2002	1,050	2,267	433	2,981	3,384	866	729	439	257	65
1997	353	890	95	1,374	745	473	158	129	46	15
1992	99	257	27	427	140	190	38	37	14	3
Annual average increase (%)										
1992-1997	29.0	28.2	28.6	26.3	39.7	20.0	33.0	28.4	26.9	38.0
1997-2002	24.4	20.6	35.4	16.8	35.3	12.9	35.8	27.8	41.1	34.1

Note: Rural types 1-4 areas are defined in terms of levels of development, rural type 1 areas being the wealthiest and rural type 4 the poorest.

Source: Third National Health Service Survey, MOH, 2004a, page 161.

The survey data indicated that urban MCH centres' recurrent expenditure was 8.5 times higher than that of rural MCH centres in 2002. The ratio of expenditure on drugs was about the same (8.2). It is also noteworthy that rural MCH centres spend proportionately more on personnel (33.8% of total recurrent expenditure) than do urban MCH centres (21.0%).

Table A-24 Average recurrent expenditure per MCH centre (2002)

Unit: 10 thousand yuan

	Total	Urban areas	Rural areas	Large cities	Medium cities	Small cities	Type 1 rural areas	Type 2 rural areas	Type 3 rural areas	Type 4 rural areas
Non-personnel operating expenditure	1,156	2,810	329	3,376	6,892	1,127	647	194	228	62
Drugs	295	712	87	750	1,974	372	144	66	66	35
Personnel expenditure	363	747	168	1,049	918	302	252	182	108	55
Personnel expenditure as % of total recurrent expenditure	23.9	21.0	33.8	23.7	11.8	21.1	28.0	48.4	32.1	47.0

Note: Rural types 1-4 areas are defined in terms of levels of development, rural type 1 areas being the wealthiest and rural type 4 the poorest.

Source: Third National Health Service Survey, MOH, 2004a, page 162.

The data from the Third National Health Service Survey also show large disparities in the assets of MCH centres in different parts of the country, as well as in their liabilities (or debt). As Table A-25 shows, the average total assets of urban MCH centres were almost 15 times higher than the MCH centres in rural areas and almost 50 times higher than the centres in rural type 4 areas. Significantly, the rural MCH centres also had a higher ratio of debt to assets (with gross debt equivalent to 21.2% of total assets) than in urban areas (12.1%). The rural type 3 areas' MCH centres were the most heavily debt-burdened, with a debt/assets ratio of 26.8%.

Table A-25 Average assets and debt of MCH centres (2002)

Unit: 10,000 yuan

	Total	Urban areas	Rural areas	Large cities	Medium cities	Small cities	Type 1 rural areas	Type 2 rural areas	Type 3 rural areas	Type 4 rural areas
Total assets	1,813	4,744	326	8,486	2,564	822	476	323	254	99
Current assets	787	2,157	93	4,099	638	232	149	95	54	34
Investments	24	40	16	82	0	1	40	1	12	0
Fixed assets	1,019	2,573	231	4,358	1,926	590	322	228	198	64
Intangible assets	26	77	0	154	0	5	0	0	0	0
Debt	240	576	69	964	453	140	101	54	68	17
Net assets	1,573	4,168	257	7,522	2,111	682	375	269	186	82
Debt as % of assets	13.2	12.1	21.2	11.4	17.7	17.0	21.2	16.7	26.8	17.2

Note: Rural types 1-4 areas are defined in terms of levels of development, rural type 1 areas being the wealthiest and rural type 4 the poorest.

Source: Third National Health Service Survey, MOH, 2004a, page 158.

Disparities in resources for disease prevention and control

The Third National Health Service Survey also showed major disparities in the financial resources of the Chinese Centres for Disease Control and Prevention (CDC), which, among various duties, are responsible for the immunization of children against the major vaccine preventable illnesses. The survey found that, in 2002, the resources received by the urban CDCs were 5.9 times higher than their counterparts in the rural areas (see Table A-26). This reflects the fact that not only the operating income of the urban institutions is much higher than that of the rural institutions (9.4 times higher in 2002), but so are the resources they receive from government (7 times higher in 2002). General transfers and earmarked funds have all been preferably directed to the CDCs in the urban areas.

Figure A-11 shows that the business income of the urban institutions experienced exponential growth over the decade from 1992 to 2002, while that of the rural institutions lagged far behind. Whereas the average business income of the urban institutions in 1992 was 3.25 times higher than that of the rural institutions, by 2002 it was 9.4 times higher. Unless this situation is reversed, the financial resources available in the rural and urban institutions for disease prevention and control will remain severely unbalanced, with adverse consequences for the effectiveness of disease prevention and control, for the country as a whole and in particular for rural residents, including rural children.

Table A-26 Revenue and expenditure of CDCs (2002)

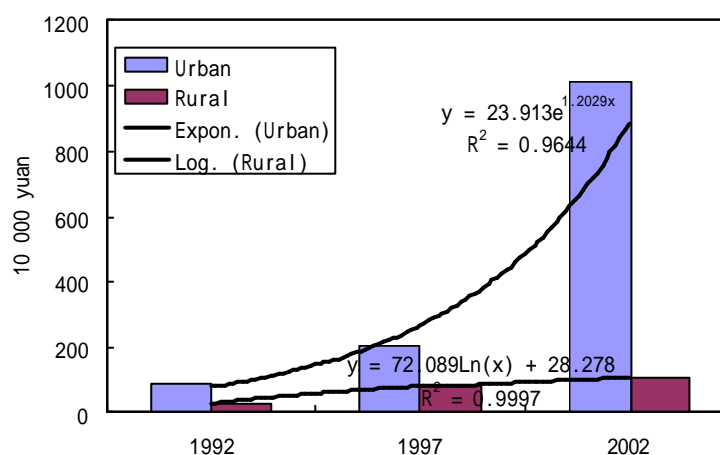
Unit: 10,000 yuan

	Total	Urban areas	Rural areas	Large cities	Medium cities	Small cities	Type 1 rural areas	Type 2 rural areas	Type 3 rural areas	Type 4 rural areas
Total revenue	568.5	1,042.7	175.8	1,302.9	959.3	273.7	217.2	194.6	139.7	68.7
Government resources	442.8	939.2	130.2	1,471.0	249.7	570.4	169.4	137.7	90.5	84.9
General transfers	147.8	290.9	57.7	440.7	206.4	147.6	73.1	51.1	50.8	51.6
Earmarked funds	154.6	340.0	37.8	703.1	14.4	36.0	78.3	18.0	23.5	21.1
Subsidies from upper level CDCs	140.4	308.3	34.7	327.2	28.9	386.8	18.0	68.6	16.2	12.2
Business income	550.0	1,008.9	106.8	1,204.8	927.9	85.1	139.1	119.3	84.8	13.4
Total expenditure	542.9	1,006.9	173	1,249.5	916.3	249.5	216.9	195.7	128.3	67.4
Operating expenditure	167.5	410.3	145.8	1,057.0	249.8	157.2	199.8	165.2	88.9	54.1
Earmarked expenditure	193.5	409.2	57.6	742.8	83.3	139.6	74.0	52.3	59.2	18.9

Note: Rural types 1-4 areas are defined in terms of levels of development, rural type 1 areas being the wealthiest and rural type 4 the poorest.

Source: Third National Health Service Survey, MOH, 2004a, page 165.

Figure A-11 Business income of disease prevention and control centres



Source: Based on data from the Third National Health Service Survey, MOH, 2004a, page 166.

3.5 Health insurance

Before the start of the process of reform and opening up, almost all Chinese people were integrated into the health insurance system. Chinese farmers and their families were covered by the Cooperative Medical System (CMS), employees in state-owned enterprises were covered by the Labour Insurance System (LIS) and civil servants and other government employees were covered by the Government Insurance System (GIS). Although the health insurance system did not extend to the entire population, the proportion of those left out was quite small. In the 1970s,

about 90% of farmers were covered by the Cooperative Medical System, which was regarded as the most important reason for the successful improvement of health indicators in China in the 1970s (World Bank, 2005a).

From the 1980s, with the transition from the planned economy to the market economy, the coverage of health insurance in China contracted sharply. The disintegration of the rural collective economy led to the virtual collapse of the cooperative medical system, which covered less than 10% of farmers by 1993. As of 2002, only 9.5% of rural residents were covered by cooperative medical insurance and 79% had to pay their own medical bills, according to data from the Third National Health Service Survey (see Table A-27). In the urban areas, 30% were covered by basic medical insurance, which companies are required by law to provide to their employees, but this does not cover major medical costs resulting from hospitalization. Furthermore, 45% of urban residents were found to have no form of health insurance or health benefits of any kind.

Table A-27 Percentage of population enrolled in medical insurance schemes (2002)

	Total	Urban	Rural
Cooperative medical insurance	8.8	6.6	9.5
Basic medical insurance*	8.9	30.4	1.5
Insurance for major medical problems	0.6	1.8	0.1
Government employees' healthcare benefits	1.2	4.0	0.2
Labour insurance	1.3	4.6	0.1
Other public schemes	1.4	2.2	1.2
Individual commercial insurance	7.6	5.6	8.3
Not insured; depend entirely on self payment	70.3	44.8	79.0

* Paid by companies, sometimes with local government subsidies.

Source: Based on data from 3rd National Health Service Survey, MOH, 2004a.

In October 2002, the Chinese government decided to establish a new rural cooperative medical system (RCMS), based on voluntary participation. Pilot trials of the system began in selected areas in order to gain experience and help fine-tune the system, which would be progressively scaled up. Currently the new RCMS is the major health insurance system for Chinese farmers, with coverage reportedly rising to 42.3% of the rural population by 2006, according to information provided to the press by the Ministry of Health. Under the 11th Five Year Plan, the government aims to extend coverage to over 80% of the population by 2010.

In the State Council's Instruction on the Establishment of the New Rural Cooperative Medical System, issued on 16 January 2003, the government pledged to provide 20 yuan per person for those participating in the new RCMS, of which 10 yuan would come from central government and

10 yuan from local government. By the end of September 2005, the overall volume of funds raised for 2005 amounted to 6.5 billion yuan, of which 2.7 billion yuan was paid in premiums by individuals and 3.5 billion yuan in subsidies by various levels of government. In terms of insurance payments to RCMS subscribers, within the first nine months of 2005, a total of 3.8 billion yuan was spent on subsidizing 82.7 million farmers, of which 4.5 million received subsidies for in-patient hospital treatment, 72.8 million for out-patient medical treatment and 5.3 million for medical examinations. The medical consultation rate and the rate of in-patient hospital treatment for rural people enrolled in the new RCMS have considerably increased and the economic burden on rural people has been partially reduced.

However, besides the fact that coverage is still quite small, the RCMS has some significant limitations. First, the scheme only covers a relatively small amount of individuals' medical costs. The benefits of RCMS membership are twofold: first, it pays for minor out-patient medical expenses up to the value of an individual member's account; and second it uses the government contributions to pay for in-patient hospital costs, up to a maximum of 5,000 yuan, on a sliding scale, with individual patients paying the balance. However, there is no government contribution to the payment of the minor out-patient expenses, and individuals still bear the largest share of the costs for hospitalization. Although the shares vary from county to county, a typical scheme would involve the government share rising from 20-25% of costs below 2,000 yuan to a maximum of 35-40% for costs ranging between 10,000 and 15,000 yuan. As can be seen, the individual burden can remain quite high for costly operations, including for EOC procedures such as caesarian sections, compared with the per capita disposable income of poor people, especially in rural areas.

Second, some experts have also pointed out that, while the new RCMS is intended to benefit people in poverty, rural people only receive subsidies from central and local governments if they pay their own cooperative medical fees. This is commendable in so far as it encourages the participation of rural people, but it may also lead to a situation where the poorest of the poor cannot obtain access to the subsidies from central and local governments because they are unable to pay their required contributions. In this sense, the financial subsidies may end up benefiting mainly non-poor households.

Third, the scheme adds to the financial obligations of local governments. At the start of the scheme, fiscal resources from central and local governments respectively subsidized 10 yuan for each person per year while individual subscribers paid 10 yuan a year. Taking into consideration the pilot experience of the new RCMS, the State Council decided that from 2006 the central government would increase its level of subsidy from 10 yuan/person to 20 yuan/person and that sub-national government bodies would also increase their subsidies, while maintaining individuals' contributions at 10 yuan/year. The sub-national contribution is normally shared by provincial, prefecture and county governments (a typical formula might be 40%, 30% and 30%

respectively). In order to meet their obligations to co-finance the RCMS, many piloting county governments in poverty-stricken areas have had to squeeze money from their highly constrained budgets. As a result, some provinces have designated counties with better financial conditions as the piloting sites, although these are the counties where households have the highest income levels and thus a stronger financial capacity to cope with illness (Jia Kang and Zhang Licheng, 2005).

That China has reinitiated the cooperative medical system indicates that the government aims to extend medical insurance to the vast majority of rural residents. However, several problems have already come to the fore in the pilot phase, including the low level of reimbursement of medical costs, the risk that the scheme will exclude the poorest of the poor and the fact that an additional burden is being placed on already overstretched local governments, which could have perverse effects on other areas of resource allocation at the local level. The central government is actively seeking to address these problems. In addition, the Ministry of Civil Affairs has set up a medical relief programme for extremely poor households. Although this is still a small programme with very limited coverage, it recognizes that insurance is not a solution for the poorest households.

3.6 Impact on health services and outcomes

This chapter began by noting that, while impressive progress has been made in reducing child and maternal mortality in China, there are still substantial disparities in the MMR and U5MR between urban and rural areas, within rural areas and among the western, central and eastern regions. The decentralization of responsibility for the financing of health services, including MCH services, combined with the wide variation in the levels of local government revenue and inadequate transfer payments to local governments in poorer areas, has brought about a situation of considerable inequality in the provision of services. In addition, the increased dependence of healthcare institutions on business revenue and the high and rising share of private individuals (relative to government) in expenditure on health have led to inequitable results, making health care unaffordable or a cause of extreme hardship for the poor. Insurance schemes have so far helped to redress this situation only to a limited extent. These problems especially affect the residents of poor rural areas. However, other vulnerable groups, notably migrants who have moved to the cities, also face great difficulties in obtaining access to affordable healthcare, including essential MCH services.

Maternal and child health

Data from the Maternal and Child Health Surveillance System (MCHSS) show that there are large geographical disparities in child and maternal survival indicators in China. Using the MOH's classification of rural areas into four types according to levels of development (type 1 being the

most developed and type 4 the least developed), and weighting for population, the MCHSS data indicate that the under-five mortality rate (U5MR) in rural types 2, 3 and 4 areas was respectively 2.9, 4.3 and 5.3 times higher than in the cities in 2004. Moreover, while U5MR has been declining in all areas, between 1996 and 2004 it fell more slowly in the rural type 4 areas (15.7%) than in the rural types 1, 2 and 3 areas (almost 50%) and the urban areas (22.8%). The decline in U5MR was also slower in the western region (30.3%) than in the eastern region (48%) and the central region (49.8%).

With respect to maternal mortality, the decline in the MMR over the same period was steepest in the eastern region (55%), followed by the western region (33%) and the central region (29%). In 2004, the MMR in the central and western regions exceeded the MMR in the eastern region by 4.1 and 7.7 times respectively. Furthermore, the gap in the MMR between rural and urban areas widened from 2.7 in 1996 to 3.2 in 2004, and in types 2, 3 and 4 rural areas the MMR in 2004 was respectively 2.9, 4.4 and 5.3 times higher than in the urban areas.

These disparities in survival outcomes have a variety of causes, including differences in nutrition (notably in essential micronutrients) and in access to clean water and adequate sanitation, but one of the key factors is the continued importance of the disparities in the use of key MCH procedures. The Third National Health Service Survey found that the hospital delivery rate in 2002 was 62% in rural areas (and only 32% in rural type 4 areas) compared with 93% in urban areas, and skilled birth attendance was only 52% in rural type 4 areas. According to the review of maternal and child survival strategy (MOH et al, 2006), financial and transport constraints are the main reasons why many women still give birth at home in poor rural areas. As a result, a large proportion of maternal deaths occur at home: 37-38% in rural types 3 and 4 areas and 26% in rural type 2 areas. Even if women deliver in hospitals, in the rural areas they often receive sub-standard services: only 20% to 50% of women in rural types 2, 3 and 4 areas have access to basic essential obstetrical care (EOC). There are also wide variations in the proportion of women receiving pre-natal check-ups and in the quality of these check-ups.

Regarding child healthcare services, the MCH strategy review noted that the full immunization rate for the four vaccines was only 56% in rural types 3 and 4 areas in 2004, significantly lower than in the rural types 1 and 2 areas (94% and 89% respectively). The fact that most child deaths occur at home (71% in rural type 4 areas, 65% in rural type 3 areas, 52% in rural type 2 areas and 40% in rural type 1 areas) suggests that in rural areas there are serious constraints on access to services.

Overall, since the early 1990s there have been considerable improvements in the availability and use of MCH services at an aggregate national level. According to data from the Third National Health Service Survey, deliveries in hospital rose from 39% of births in 1992 to 68% in 2002 and

the percentage of pregnant women receiving prenatal care at least once increased from 70% to 88%. Meanwhile, the 'systematic management rate' (the quality child health care rate) for children under 3 increased from 43% in 1992 to 74% in 2004 and the immunization rate for the four routine vaccines reached 88%.

However, according to the most recent data of the Ministry of Health, some of the improvements achieved in the 1990s have come to a halt or even gone into a slight reverse during the period of the 10th Five Year Plan (2000-2005). For example, in 2005, the maternal health care management rate (76.7%), the pre-natal examination rate (89.8%) and the percentage of postpartum visits by health personnel (86.0%) were all lower than in 2000 (MOH, 2005c).

Access to health services

The slow-down or partial reversal of the progress in some MCH service indicators and the difficulties experienced in reducing the large disparities in use of services and in maternal and child mortality rates appear to reflect the negative effects of the manner in which the market reform of China's health system has been implemented, as well as the relatively low levels of government funding.⁷ During the planned economy period, China's health service, although fairly rudimentary, was prevention-based and aimed to cover as much of the population as possible. After the reforms, the introduction of a market-driven system created incentives that drove the health service to rely heavily on business revenue and to become more treatment-based. Meanwhile, as health service fees rose, the collapse of the old cooperative medical system in the rural areas, combined with the loss of medical insurance coverage for many laid-off workers in the urban areas, made it more difficult for many households to access health care.

It is important to bear in mind that the rapid increase in households' health expenditure has exceeded the growth of per capita income. Expenditure on healthcare has become the third largest category of household expenditure following expenditure on food and education. According to the report of the Third National Health Service Survey, over the five years from 1998 to 2002, urban residents' income grew on average by 8.9% a year and rural residents' income by 2.5%.⁸ However, as for household's health expenditure, this rose by 13.5% in the urban areas and 11.8% in the rural areas. In 2002, urban residents' per capita medical out-patient expenditure was 219 yuan and their average expenditure per hospital stay was 7,606 yuan, representing increases of 85% and 88% respectively over 1998. For rural residents, per capita medical out-patient expenditure was 91 yuan

⁷ *Evaluation and Suggestions for the Reform of the Medical and Health System in China* by the Development Research Centre of the State Council (August 2005) provides detailed information on China's health system reform.

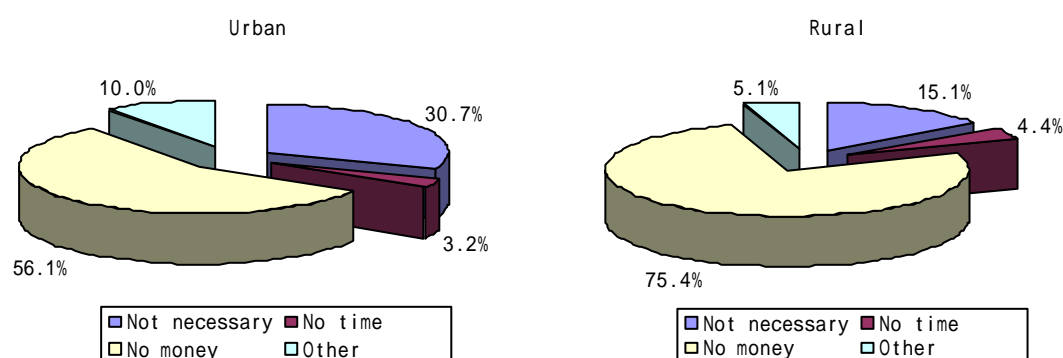
⁸ More recent figures, cited in the 11th Five Year Plan (NDCR, 2006), indicate that disposable income rose by an average of 9.6% in urban areas and by 5.3% in rural areas between 2000 and 2005.

and expenditure per hospital stay was 2,649 yuan, representing increases of 103% and 73% respectively over 1998. For rural residents, the average cost of a single stay in hospital exceeded the total annual per capita household income (2,622 yuan in 2003), while for urban residents the cost of hospitalization was only slightly less than annual per capita household income (8,472 yuan).

The Third National Health Service Survey confirmed the negative effects of the high cost of healthcare on access to health services, particularly by the poor. The survey found that high medical expenses are the main reason why individuals, when sick and referred by doctors for hospitalization, decide not to be hospitalized (see Figure A-12). It also found that the rate of use of MCH services was lower among low-income households. For example, the pre-natal examination rate ranged from 75% to 95% for the lowest to highest rural income groups and from 90% to 100% for the lowest to highest urban income groups. Similar correlations could be seen for the rate of hospital delivery, which ranged by income groups from 85% to 98% in the urban areas and from 45% to 81% in the rural areas.

Major illness can be a disaster for families with inadequate savings, sometimes pushing them below the poverty line or plunging them into debt. Indeed, a study by Han Jun and Luo Dan (2005) indicates that illness (followed by education) is the most important cause of debt among peasant households.

Figure A-12 Reasons for individuals declining hospitalization (2002)



Source: Third National Health Service Survey, MOH, 2004a.

Health services for children of the migrant population

The challenge of ensuring the rights of migrant women and children to healthcare has aroused considerable attention from government and society. In the National Programme of Action for

Women's Development (2001-2010) and the National Programme of Action for Child Development (2001-2010), the government put forward a series of goals specifically relating to migrants' health. Migrant women were to 'enjoy the same healthcare service as the women with registered residence' in the urban areas and they were to be 'integrated..in the maternal healthcare management system in their cities of destination'. As for migrant children, the goal was to 'gradually raise the coverage of healthcare management for..children among the floating population' (NWCCW, 2001).

In fact, health problems pose serious risks to the migrant population, including children and women, largely due to management problems regarding the registration and rights of migrants, inadequate knowledge and awareness among the migrants themselves and their low insurance coverage. According to Chen Gang and Lu Jun (2006), only 45.3% of migrant children have healthcare management information cards. According to the sample survey of migrant children conducted by NWCCW, CNCC and UNICEF in nine cities (Beijing, Shenzhen, Wuhan, Chengdu, Jilin, Xianyang, Shaoxing, Zhuzhou, and Yining) in 2002-2003, the hospital delivery rate among migrant women is lower than that of the urban resident population, but higher than in the rural areas. About 92% of expectant migrant mothers had received pre-natal consultations. Immunization rates among pre-school children ranged from 95% for BCG to 87% for polio, slightly lower than among urban resident children for all the standard vaccines (NWCCW, CNCC and UNICEF, 2003). Outbreaks of measles in the cities have often started among migrant children. The average maternal mortality ratio, infant mortality rate and under-5 mortality rate for the migrant population in seven of the surveyed cities (Beijing, Shenzhen, Wuhan, Chengdu, Xianyang, Shaoxing and Zhuzhou) were 73.0/100,000, 13.8/1,000 and 24.8/1,000 respectively, significantly higher than the figures for the urban population with permanent residence.

4 Recommendations

The high rate of growth of the Chinese economy has brought about a rapid increase in government revenue, making it possible to raise expenditure to meet a wide range of pressing needs, including the provision of services for children. The substantial real increase in expenditure on these services has helped to create conditions that have brought about steady progress in reducing child and maternal mortality, achieving universal compulsory education and achieving the other targets for children's wellbeing in the National Programme of Action for Child Development (NPA) as well as the Millennium Development Goals (MDGs).

However, the preceding chapters have highlighted four major problems that have limited the extent of progress in child education and in maternal and child health:

- Relative to the size of China's economy and the size of the overall government budget, expenditure on education and health remain low by international standards.
- The structure of government expenditure in these sectors is tilted towards higher level institutions (higher education and hospitals at county level and above) at the expense of the institutions providing essential services at township and village levels, including maternal and child healthcare, primary education and in particular pre-school education.
- Expenditure on services such as maternal and child healthcare, primary education and junior secondary education is inequitably distributed both regionally and between urban and rural areas, due to the high degree of decentralization in the financing of education, health and other social services and the large differences in local levels of economic development and tax revenue, which are insufficiently offset by inter-governmental transfer payments.
- Government resources account for a relatively low share of total social sector expenditure, leaving individual households to assume much of the responsibility for paying for services, through fees and user charges, and this has placed a heavy burden on the poor, particularly in the rural areas and among migrants in the cities. The policy of the 'two frees and one subsidy' is being progressively extended to relieve the burden of compulsory education on poor rural families, but the urban poor, including in particular migrants, are not benefiting, and access to pre-school education remains highly contingent on household income. Regarding access to health care, including MCH services, the high level of fees remains a serious financial barrier for the poor, which the new RCMS is beginning to address but in a quite limited way.

Policy recommendations

Against this background, and bearing in mind the importance attached in the 11th Five Year Plan to child rights, investment in human capital and the achievement of more balanced development among regions, between rural and urban areas and between the economic and social dimensions of development, this study concludes with the following policy recommendations:

1. ***Increase levels of education and health government expenditure relative to GDP.*** Since health and education are critical to the survival and development of children, as well as for the development of human capital, capacity for innovation and long-term growth and prosperity, it is vitally important that these sectors receive high priority in the allocation of government resources. Equity considerations, externalities and efficiency arguments

all justify an important role for government in the financing of health and education services, particularly primary health care (including MCH services) and pre-primary, primary and secondary education. Budget policy should aim to achieve quickly the target of raising government education expenditure to 4% of GDP, which has remained elusive since it was first announced in 1993. This would still be below the ratios achieved in most developing and developed countries, and there would be a strong argument to set a longer term goal of achieving the 6% target established by UNESCO.

Regarding health, efforts should be made to reverse the large decline that has taken place in the share of government in national health expenditure (only 17% in 2004) and to raise the ratio of government health expenditure to GDP (0.81% in 2004). It would be a reasonable target to double the government share of national health expenditure to about 35%, which would be close to the level in Indonesia, and to raise government expenditure on health to 2% of GDP. These targets should be easy to achieve in China, since the rapid increase in government revenue provides an opportunity to make significant adjustments in the composition of expenditure to the benefit of education and health without imposing cutbacks in other sectors.

2. ***Raise the expenditure shares of services for children within the social sectors.*** The structure of government education expenditure should be adjusted, to reduce the proportion spent on higher education, which takes almost one third of the total and where private benefits (mainly captured by the higher income groups) are high. The shares of pre-school, compulsory and senior secondary education should rise. The share currently devoted to pre-school is especially low (1.3% in 2003) and should be a major priority for expansion, given the crucial role that pre-school learning plays in the cognitive development of children and the known benefits this has on their later performance in primary school. Higher government spending on pre-school is also important from an equity perspective, as enrolment currently is affordable mainly to non-poor families due to the level of fees charged. Increases in the share of primary education (currently about a quarter of total government education expenditure) and junior middle school will be necessary in order to improve quality in rural schools and bring them up to the standards of urban schools, as well as to overcome regional disparities, and to extend the policy of the 'two frees and one subsidy', ultimately perhaps to urban areas and in particular to migrants. Senior middle school also deserves high priority because it is emerging as a bottleneck in the education system.

In the health sector, a much larger proportion of government expenditure should be devoted to front-line health service institutions, especially at township and village levels (in the rural areas) and community level (in the urban areas), and less on hospitals,

especially higher than county level. Hospitals accounted for 78% of expenditure by health service institutions in 2004. The very low proportion accounted for by MCH centres (3.1%) could be substantially increased without adverse effects on absolute levels of spending in the sector as a whole, due to the opportunities to raise overall government expenditure on health significantly at a time of fast rising tax revenue.

3. ***Increase transfer payments to poor counties to reduce disparities.*** The government's vision of a harmonious *xiaokang* society and the emphasis given in the 11th Five Year Plan to achieving balanced development among regions and between rural and urban areas makes it imperative to redouble efforts to overcome the serious disparities that still exist in maternal and child health and in educational performance. As the preceding chapters have shown, at the heart of the problem lies the challenge of channeling adequate resources to the poorer provinces, counties and townships, so that they can meet their obligations to provide quality services. The Ministry of Finance is attempting to address this challenge through the policy of 'rural areas in the sunshine of public finance'. It should be possible to overcome the present problems within the framework of a decentralized fiscal system and decentralized management of service delivery in the social sectors, on condition that the central government redistributes sufficient resources to the poorer areas through transfer payments. The proportion of central government revenue that is redistributed in this way needs to be substantially increased, on the basis of clear criteria that take into account levels of economic and social development and tax revenue. This would overcome the present problem that some poorer provinces and counties, especially in the central region, benefit far less from transfer payments than others, despite having comparable development profiles.

4. ***Improve the effectiveness and efficiency of expenditure.*** A related challenge is the improvement in the effective and efficient utilization of budget resources, including transfer payments. This is not an argument to justify reliance on the earmarking of transfers, as the sub-national tiers of government should be fully responsible for managing their own budget resources, including general transfers (block grants). However, it is essential to strengthen the capacity for budget management, especially at the county level, and to provide incentives to local governments by setting performance targets for service delivery and benchmarks for evaluating expenditure, so that they allocate increased resources to high-priority services such as MCH care and pre-school, primary and middle school education. Such incentives are particularly important in order to redress the current bias in the health system towards curative rather than preventive health and towards fee-paying over non-paid public services. Improvements in efficiency also require a more balanced economic composition of expenditure, notably to increase

the proportion of resources available for schools' non-personnel operating expenditure and capital spending on construction and repairs.

5. ***Reduce the burden of fees on the rural and urban poor.*** The proposed increases in the shares of government expenditure in the education and health sectors are intended to reduce the role of private (out-of-pocket) expenditure, which is proportionately so much higher in China than in most other large developing countries in Asia. As has been seen in Chapters 2 and 3, fees impose a large burden on the poor, particularly in the health sector. The creation of the RCMS shows that the government is seriously concerned about the burden of health care on the rural population and is anxious to find an effective solution. It aims to expand the RCMS's coverage to more than 80% of the population by 2010. However, it is clearly necessary to overcome some of the weaknesses in the present scheme. It needs to provide much higher levels of benefits, and it needs to be funded mainly by central government rather than local governments. It is also vitally important to overcome the problem of limited health insurance coverage of the urban population, including migrants and their children. In addition, health insurance is not a realistic option for the poorest households, which means that it is essential to develop a larger medical assistance programme.

The introduction and phased expansion of the policy of the 'two frees and one subsidy' in the education sector is a positive development. It needs to be extended to the urban areas, in order to reach the urban poor, in particular migrants, who in many cases still have to pay extra fees and charges to send their children to school. The prohibition of discriminatory fees for migrant children needs to be monitored and rigorously enforced. In order to overcome the opportunity cost of sending children to school, which is a cause of drop-out by some children from the very poorest families, in both rural areas and among migrant families, the government could consider introducing a new scheme to provide financial assistance for these children, possibly in the form of cash transfers that would be paid to families on condition that their children attend school.

Issues for further research

This study concludes with three suggestions regarding research priorities on the financing of services for children.

First, as this study has shown, the financing of these services is highly decentralized in China, with county-level governments bearing the major expenditure responsibility. For this reason, a deeper understanding of the financing issues that affect the delivery of services and their quality requires

field-work at the county level. It is strongly recommended that the desk studies initiated by the NWCCW-UNICEF project should be followed by field work at this level. For the purpose of comparison, it would be valuable to select counties in provinces in different regions and with different levels of social and economic development.

Second, the scope of research should be widened to cover some sectors and themes that it was not practical in this initial research phase to include. For example, it would be important to understand better the financing of services for the protection of children in situations of vulnerability, such as orphans, children with disabilities, child victims of abuse and exploitation, children in detention and street children. As China engages in the reform of its social security system, it would also be valuable to conduct research on the potential role of government-financed child benefits in poverty reduction and the achievement of compulsory education. More in-depth investigation of the financial issues concerning the access of migrant children to services in the urban areas is urgently needed. Likewise, it should be a priority to undertake more in-depth research on the financing of pre-school education, including the implications of pre-school fees on access at this crucial level of the education system where disparities and inequality are especially pronounced.

Finally, the research should move on to more operational issues and focus on providing practical ways to implement the government's commitments to improve the delivery of basic social services for children, reduce disparities and inequality, and attain the national and international targets for children. This could include detailed research on costing, the criteria and guidelines for transfers, and other practical issues that need in-depth study if progress is to be made towards the implementation of the broad policy recommendations set out above.

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Part B

The Budget System and Fiscal Transfers

Mei Hong

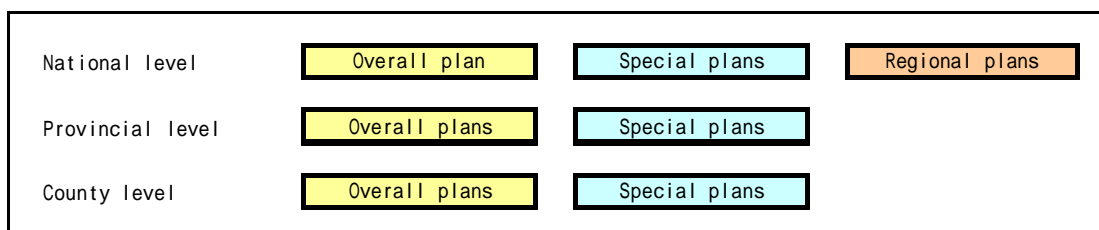
1 The Planning and Budget System

This chapter describes how the Chinese planning and budget system works.⁹ First, it introduces the main types of plans, as well as the annual budget, discusses the nature of these instruments and explains their role at both the national and sub-national levels of government. Second, the chapter discusses two features that tend to fragment the budget system, making it difficult to have a unified approach to budgeting: the large though declining proportion of off-budget revenue and expenditure flows, particularly at sub-national level, and the organizational divide between recurrent and investment budgeting. The chapter ends with a more detailed description of the main stages of the planning and budget cycle: formulation, approval, execution and reporting, auditing and evaluation.

1.1 Levels and types of plans and budgets

Although China began to adopt five year development plans from 1953, it has not enacted a planning law as such to guide the planning process. However, the Constitution has quite detailed provisions regarding the planning process and, in 2005, the State Council issued a document, *Opinions of the State Council on Enhancing the Formulation Work of the National Economic and Social Development Plan*, which made proposals on long-term development planning, providing for three types of long-term plans (overall, special and regional) and three levels of long-term planning (central, provincial and county), as shown in Figure B1. Long-term plans normally cover a period of five years or more. The key overall development plan is the National Five Year Economic and Social Development Plan. Examples of special plans include the National Programme of Action for Child Development 2001-2010 and the National Programme of Action for Women’s Development 2001-2010 (see Box B-1). There are also short term (one year) development plans, which exist at four levels: national , provincial, prefecture and county.

Figure B-1 Levels and types of long-term development plans



Source: *Opinions of the State Council on Enhancing the Formulation Work of the National Economic and Social Development Plan*, 2005.

⁹ The system and processes described in this and later chapters refer only to mainland China, excluding Hong Kong, Macao and Taiwan.

It may be noted in passing that the planning terminology has recently changed, with the 11th Five Year Plan being termed a ‘strategic plan’ (*guihuà*) rather than a ‘command economy’ type of plan (*jihuà*). The content has undergone a substantial change as well, which reflects the transition from a centrally planned economy to a ‘socialist market economy’, as well as a broadening of scope to emphasize the social as well as the economic dimensions of development, particularly in the 11th Five Year Plan, which followed the adoption of the *xiaokang* concept and the ‘five balances’.

The annual national and local development plans are extremely brief, indicating in broad outline some of the main targets to be achieved and measures to be taken during the year. Important outcome indicators for monitoring social development, such as the infant mortality rate and maternal mortality ratio, which are included in the five year plans, are not normally mentioned in the annual development plans. The annual plans do not provide specific targets for the distribution of government expenditure needed to meet government priorities, including in the education and health sectors. For example, the national annual plans have not set specific annual targets to reach the government’s goal of raising government education expenditure to 4% of gross domestic product (GDP).

Box B-1 The National Programmes of Action for Child Development and Women’s Development (NPAs)

The National Programme of Action for Child Development 2001-2010 and the National Programme of Action for Women’s Development 2001-2010 (the ‘NPAs’) may be regarded as a type of long-term special plan, though they are multi-sectoral and involve a wide range of government ministries and agencies. The NPAs are replicated at provincial and county levels, with all provinces and the great majority of counties having their own programmes of action for child development.

The articulation of these plans or programmes with the broader planning system is unclear. At the national level, the 11th Five Year Plan explicitly mentions the NPAs and calls for their implementation, citing some of their key targets for 2010, such as the reduction of the infant mortality rate (to 17 per 1,000 live births), the reduction of the maternal mortality ratio (to 40 per 100,000 live births) and an increase in the immunization rate (to more than 90%).

Some of the provincial CPC proposals for the provincial Five Year Plans, such as those in Yunnan and Sichuan, also refer to the provincial NPAs, but most do not, referring more generally to the protection of the rights of children and women.

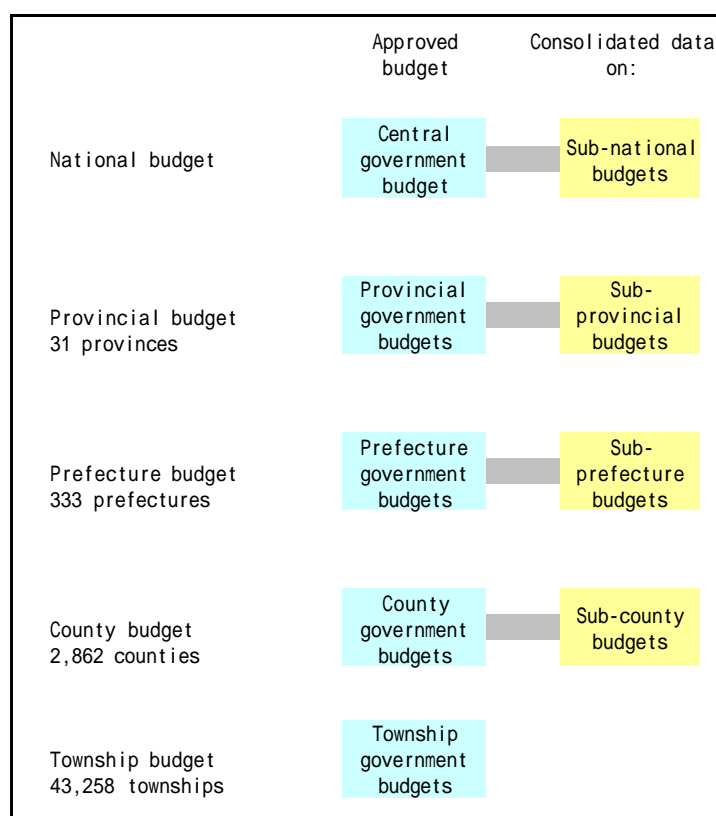
The NPAs are not usually mentioned as such in the annual development plans, although key areas of importance for children, such as education and health, are covered. There does not appear to be any explicit link between the NPAs and the process of annual plan and budget formulation.

Among the long-term planning instruments is a five-year public finance development plan, which corresponds to the time period of the Five Year Economic and Social Development Plan. This provides a broad framework for management of public finances over the five year period. However, it does not perform the same function as a Medium Term Fiscal Framework, which, as practiced in many countries, provides on a rolling annual basis a quantified medium term forecast

of revenue and an expenditure plan to achieve government objectives for service delivery and macroeconomic/fiscal performance.

The current Budget Law, which took effect in 1995¹⁰, stipulates that China's five levels of government (central, provincial, prefecture, county and township) have their own budgets, as is shown in Figure B-2. This is a budget system with a high degree of fiscal decentralization in which the different levels have their own designated sources of revenue and specific expenditure responsibilities. Resources flow between the different levels, but these are transfers between bodies which prepare, adopt and execute their own budgets. In other words, the different levels have budget autonomy, even though the sub-national budgets at each level are presented for information and monitoring purposes in the budgets of the next highest administrative level.

Figure B-2 Structure of government budgets



Source: *China Statistics Yearbook 2005*, National Bureau of Statistics, China Statistics Press.

Thus, the national budget consists of two parts: the central government budget and a summary presentation of aggregate sub-national budget data, known as the 'sub-national budget'. The central government budget consists of the expenditure and revenue of all the line ministries and other central agencies, including their subordinate budget spending units. This includes revenue remitted

¹⁰ The Ministry of Finance is currently working with the Budget Committee of the Standing Committee of the National People's Congress to prepare for revision of the Budget Law.

to the central government by local governments, as well as resources transferred in the opposite direction in the form of returned tax revenue as well as grants to local governments to subsidize their expenditure.

This system is replicated at the sub-national levels. For example, provincial budgets include the budget of the provincial government along with, separately, consolidated data on the budgets of the next lowest government level, namely the province's constituent prefectures. At the lowest level, the township budget concerns only its own revenue and expenditure. Sub-national government budgets also include the revenue remitted to them by lower government levels, the revenue rebates and subsidies they receive from higher level government bodies, and the revenue rebates and subsidies they provide to lower level governments. These resource flows between the different government levels will be discussed in detail in Chapter 3.

1.2 The fragmentation of the budget system

At any government level (central or sub-national), budget management is fragmented by virtue of two important features of the system. First, there is a significant off-budget component within the fiscal system and, second, budget authority is highly dispersed.

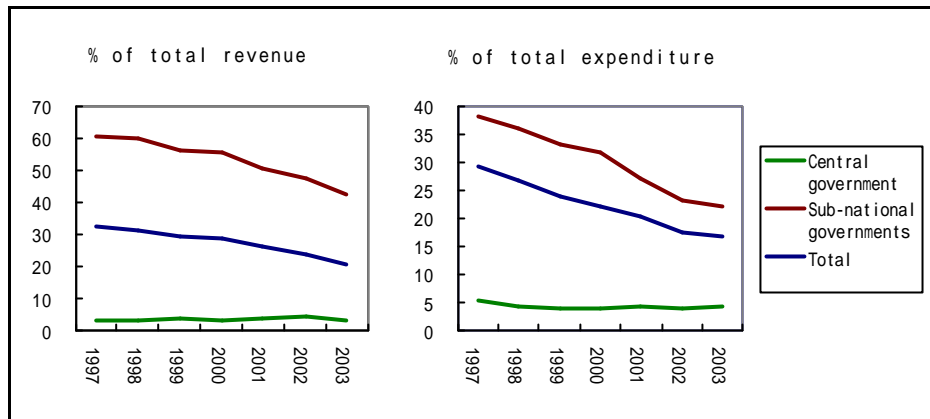
The off-budget phenomenon

The public finance system in China is not fully integrated, in so far as some revenue and expenditure flows take place outside the framework of the formal budget. This extra-budgetary component in China's public finances is quite large, although it has declined significantly in recent years. One reason for the decline has been the change in the relationship between the government and state-owned enterprises (SOEs), which has ended the large off-budget flows of revenue and subsidies between them since 1992. In addition, inter-governmental transfers were brought on-budget, starting in 1997.¹¹

Extra-budgetary revenue now accounts for a very low proportion (some 3-4%) of central government revenue, but is still an important component of sub-national revenue, although it declined from 61% to 43% between 1997 and 2003 (see Figure B-3). Likewise, extra-budgetary expenditure accounts for a very low share (some 5-6%) of central government expenditure, but a considerable proportion of sub-national revenue, although this declined from 38% in 1997 to 22% in 2003. Overall, local governments' share of total extra-budgetary revenue and expenditure is about 95% and 92% respectively.

¹¹ Thus the data on extra-budgetary revenue and expenditure are not comparable between the periods before and after 1997.

Figure B-3 Off-budget revenue and expenditure (1997-2003)



Source: Based on data from *China Statistical Yearbook 2005*, National Bureau of Statistics, China Statistics Press, September 2005.

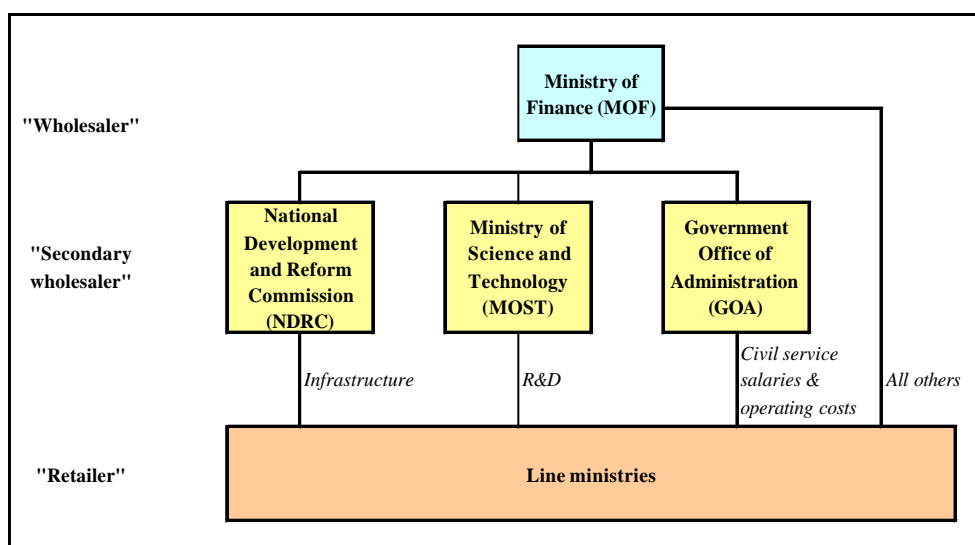
The segmented nature of budget allocation authority

Responsibility for the allocation of government expenditure is fragmented in so far as several agencies have a secondary level of discretionary budget authority within the overall framework of the national budget allocation process coordinated by the Ministry of Finance. This is a historical legacy of the old centralized planning system. Whereas the line ministries have a direct relationship with the Ministry of Finance for much of their expenditure, there are several intermediate agencies for assessing and approving certain specific categories of expenditure, notably infrastructure projects, research and development (R&D), and civil service salaries and operating expenditure. During the budget preparation process, the National Development and Reform Commission (NDRC) is responsible for assessing and approving all central government allocations for infrastructure projects, including those in the social sectors. Likewise, research and development expenditure is assessed and approved by the Ministry of Science and Technology (MOST). The salaries and operating expenditures of government agencies are approved by the Government Office of Administration (GOA) under the State Council. These three bodies effectively consolidate these components of the central government budget within overall ceilings set by the Ministry of Finance. Similar roles are performed by equivalent bodies at all sub-national levels of government.

Regarding salaries, it should also be noted that decisions on the staffing numbers of government agencies are made by the State Commission for Public Sector Reform. Since personnel account for the bulk of recurrent expenditure, this is a significant exogenous factor in budget formulation, although the Ministry of Finance is involved (together with the Ministry of Personnel) in setting the salary scales.

The segmentation of the responsibilities for assessing and approving different components of the budget complicates the budget formulation process, making it difficult for decisions on allocations to be made in an integrated way. Besides the time delays and the coordination difficulties inherent in such a complex process, there is a higher risk that line ministries will end up with a sub-optimal mix of resources for personnel, other operating costs and capital projects, or that the future recurrent expenditure implications of investment projects will not be properly taken into account in investment decisions. Given the historical nature of the different agencies' role in the budget process, the most feasible solution is the strengthening of the Ministry of Finance's overall coordination responsibility.

Figure B-4 Central government agencies' role in budget formulation



1.3 The planning cycle

In current practice, the process of formulation of the five-year development plans begins with the issuance of 'guidelines' by the Central Committee of the Communist Party of China (CPC). All government agencies are then involved in the process of detailed preparation of the plan, which is coordinated by the National Development and Reform Commission (NDRC) on behalf of the State Council. A similar process takes place at provincial and county levels for their respective five year development plans: provincial and county Development and Reform Commissions coordinate preparation of the plans for the provincial and county governments. The formulation of the annual development plans is likewise coordinated by the NDRC and its equivalent bodies at sub-national levels.

The 'special plans', which include sector plans, are prepared by the pertinent government agencies. For the formulation of the regional plans, i.e. those that encompass more than one province, NDRC coordinates the concerned central and provincial government agencies.

The Constitution and the ‘*Opinions of the State Council on Enhancing the Formulation Work of the National Economic and Social Development Plan*’ require the National People’s Congress (NPC) to review and approve the draft five-year and annual national economic and social development plans. The provincial and county people’s congresses likewise approve the overall development plans at those levels of government. “*Opinions of the State Council on Enhancing the Formulation Work of the National Economic and Social Development Plan*” also stipulates that major investment projects and national special programmes requiring relatively large amounts of central government resources require approval by the State Council, while other national level special plans are approved by the central government agencies that are directly concerned. Regional programmes covering more than one province are approved by the State Council.

NDRC oversees and coordinates execution of the five-year and annual development plans, while individual line ministries and other government agencies organize, monitor and supervise their own sector plans, reporting to NDRC, which in turn reports to the State Council. After the State Council’s endorsement, NDRC reports the implementation results to the annual plenary session of the National People’s Congress on behalf of the State Council. At the sub-national level, the local Development and Reform Commissions replicate the role of NDRC, reporting to the local governments.

1.4 The budget cycle

Budget formulation and approval

In accordance with the Budget Law, the Ministry of Finance drafts the national budget for submission to the State Council. As noted above, in section 1.2, other agencies, notably NDRC, MOST and GOA, coordinate the approval of important components of the budget, liaising directly with line ministries. The rest of the budget is prepared through a process of interaction between the Ministry of Finance and the central government agencies, based on a model budget preparation procedure for central government agencies designed by MOF, which includes ‘two steps up and two steps down’, as shown in Figure B-5:¹²

- ‘*Step one up*’: central government agencies (for example the Ministry of Education and the Ministry of Health) prepare initial budget proposals, which are compiled in a bottom-up process from their subordinate spending units and then submitted to the Ministry of Finance.
- ‘*Step one down*’: Relevant departments of the Ministry of Finance, such as the Department of Education, Science and Culture and the Department of Social

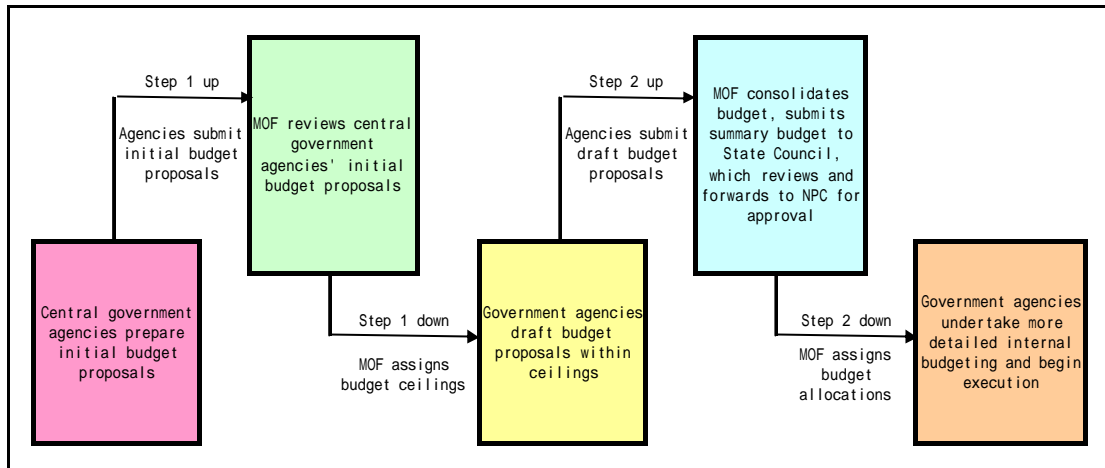
¹² The following description of the budget formulation process is derived from information on the Ministry of Finance’s website: <http://www.mof.gov.cn>.

Security, conduct a preliminary review of these initial budget proposals from the line ministries and other central government agencies. The Budget Department of MOF reviews the initial budget proposals from a broader perspective, balances competing resource needs and produces a tentative consolidated budget for the central government as a whole, which is submitted to the State Council. This is the basis for the budget ceilings, which are then communicated by the Ministry of Finance to all the central government agencies in order to begin step two of the process.

- **‘Step two up’**: The central government agencies draft a detailed organizational budget, based on the approved budget ceilings, and submit it to the Ministry of Finance.
- **‘Step two down’**: The Ministry of Finance consolidates the budgets submitted by the central government agencies and then prepares a summary budget with aggregate budget lines for submission to the State Council for review and approval prior to its submission to the Budget Committee and the Fiscal and Economic Committee of the NPC for preliminary review, and finally to the NPC for review and approval. Following the NPC’s approval of the broad lines of the budget, the Ministry of Finance assigns disaggregated budget allocations to the line ministries and other central government agencies. They in turn assign more detailed budget allocations to their subordinate spending units.

A more detailed presentation of the procedures for preparation and approval of the central government budget may be found in Annex 1, which shows in chart form: (1) the steps for the preparation of budget proposals by the central government agencies within their defined budget ceilings; (2) the procedures for the Ministry of Finance’s review of agencies’ proposed budgets and the submission of the summary consolidated budget to the State Council for approval; and (3) the procedures used by the Ministry of Finance to assign disaggregated budget allocations after the approval of the broad lines of the budget by the NPC.

Figure B-5 Procedure for preparation of central government budget



Source: derived from information provided in the Ministry of Finance website: <http://www.mof.gov.cn>.

The process described here takes place also at the sub-national levels for the preparation of the budgets of the provinces, prefectures, counties and townships, with the local Bureau of Finance (BOFs) preparing the draft budget for submission to the local government and NPC.

As indicated in ‘step two down’, it is the NPC which is responsible for formal adoption of the national budget. This takes the form of a vote on a short document that presents in a highly condensed form the main elements of the annual budget. The approval process is similar at the sub-national levels, where this role is performed by the respective people’s congresses. Although there are much more detailed organizational or departmental budgets, the fact that members of the NPC see only a short summary of the main lines of the budget limits the transparency and accountability of the budget process.

Budget execution, reporting and auditing

The Budget Law stipulates that each level of government manages its own budget, with the Ministry of Finance and the BOFs playing a coordinating role at national and sub-national levels respectively. There is a relatively high degree of delegation of budget management responsibilities within each government level. The individual spending units are responsible for managing their own budget execution and are monitored and supervised by the government agencies to which they are subordinate. The latter in turn report to and are supervised by the Ministry of Finance or the BOFs. Overall, the State Council, through the Ministry of Finance, organizes, monitors and supervises execution of the central government, and it reports to the NPC on budget execution. The local governments perform a similar role, through the BOFs, and report to their corresponding people’s congresses on budget execution. The local level BOFs also report

upwards, to the next highest administrative level, on budget execution. Thus, prefecture BOFs report to the provincial BOFs, which in turn report to the Ministry of Finance.

Since the annual budgets are normally approved by the NPC or local people's congresses after the start of the budget year¹³, which corresponds to the calendar year, the Budget Law permits government bodies to maintain operations before formal budget approval by undertaking expenditure on the basis of the budget allocations of the previous year. During the course of budget execution, all levels of government are entitled to make budget adjustments, but changes in the aggregate budget figures approved by the NPC or equivalent people's congress require review and approval by those bodies.

In 2000, there was an important reform in payments procedures, with the establishment by the Ministry of Finance of a Treasury Department, a Treasury Management Centre and a Single Treasury Account, facilitated by a nationwide on-line fiscal management information system. This allows for the timely authorization and liquidation of payments, while also facilitating the monitoring of fiscal performance and providing controls that limit opportunities for corruption.

While the government agencies' central and local budget departments and their respective divisions and sections are responsible for supervising and monitoring budget execution of government agencies at the same level, there are also budget supervision departments of the Ministry of Finance and BOFs with a specific responsibility for supervision and inspection of budget execution by line ministries and other government agencies. This is an internal monitoring function. External monitoring is carried out by the auditing offices and ultimately the people's congresses at each level. In accordance with the Constitution, the Audit Law and the Enforcement Regulations of the Audit Law, the National Audit Office and its sub-national branches at each government level conduct audits of the accounts of government agencies. The audit function covers both on-budget and extra-budgetary revenue and expenditure. Traditionally, the main focus has been on integrity and compliance. However, there is increasing interest in addressing issues concerning the effectiveness and transparency of government expenditure, through performance evaluation, but, as will be discussed in the next chapter, this has not yet been introduced systematically into the management of the budget cycle.

2 Budget Methodology

Budget methodology has important implications for the nature of budget management. Traditionally, governments have tended to use their budget management systems mainly or entirely to ensure the control of inputs. An input-based approach focuses on what budget units spend their resources *on* and aims to ensure that these expenditures are consistent with approved

¹³ In early March in the case of the NPC.

allocations, while giving very little if any attention to what expenditures are *for*. Only in recent decades have governments, particularly in the industrialized countries, attempted to develop budget methodologies that link expenditure to the achievement of specific objectives or results.

This has resulted in the development of various forms of results-based or programme-based budget methodologies that allocate resources to achieve defined objectives, outcomes or outputs. The adoption of such approaches has many implications, for the nature of budget management in general and for budget classification in particular. Increasingly, governments have also been adopting medium term fiscal frameworks (sometimes known as medium term expenditure frameworks or MTEFs) for the forecasting of macro-fiscal aggregates and the planning of major new spending initiatives. This chapter will examine China's budget methodology against the background of these international developments in public financial management and discuss the implications for the financing of services for children.

2.1 Budget structure

The current budget structure is based on a nationally unified classification system introduced in 1950, which is now known as the 'Government Budget Revenue and Expenditure Classification'. This is essentially a mixture of functional and economic classifications (MOF, 1998 and 2004b). Economically, the budget is composed of 'operating expenditure' and 'project expenditure', and their constituent sub-categories, while the functional classification has 66 categories, including, for example, education, medical and health care, and support to underdeveloped areas, which are in turn sub-divided into sub-categories, items and sub-items.

Operating expenditure refers to the expenditure for the basic administrative operations of government agencies. It includes five major categories: personnel expenditure, 'daily operating expenditure', subsidies (i.e. transfers) to individuals and families, special (earmarked) expenditure, and the operating expenditure of public service units. The budget rules and procedures include a 'prioritization rule' that requires government agencies to guarantee the financial resources needed for their normal daily operations, leaving the balance of funds for project expenditure. The rules also require that the personnel component of the operating budget is based on the officially established number of staff posts, while the non-personnel operating expenditure must be budgeted within set ceilings.

Regarding project expenditure, this is expenditure on specific administrative or development projects. This cannot be regarded as equivalent to capital expenditure, since it includes not only expenditure on infrastructure and other capital items but also other large scale expenditures on goods and services, including for example the organization of large international conferences, and related administrative costs. According to the budget rules and procedures, project expenditure

management is supposed to maximize economic and social cost effectiveness. All project proposals should therefore undergo feasibility studies and strict review, and be ranked according to their priority and the available financial resources, while project implementation should be tracked and monitored.

China launched a budget reform in 2000 that established a system of budgeting by government agencies (*bù men*). This was piloted in the Ministry of Education (MOE), the Ministry of Labour and Social Security (MLSS), the Ministry of Agriculture and the Ministry of Science and Technology, and then gradually extended to all the line ministries and other central government agencies. By 2004, all provincial governments, 87% of prefecture governments and 63% of county governments had adopted this organization-based budget methodology.¹⁴ This type of budget is intended to provide each agency with a unified, comprehensive budget based on needs derived from the agency's function. Although for practical reasons not all off-budget revenue and expenditure has yet been brought completely on-budget, agencies are required to provide data on these flows during the budget formulation process. Departments and subordinate agencies have budget lines and budget management responsibilities within this unified framework. The procedures require all government agencies to use zero-based instead of incremental budgeting.

The current budget classification system has clear weaknesses, which have been recognized by the government. There is not a clear distinction between recurrent and capital expenditure, and their respective components, and the functional classification does not adequately reflect the nature of government functions and activities (Lou Jiwei, 2005). The Ministry of Finance has therefore been preparing for the introduction of a new budget classification system, which will include separate economic, functional and organizational classifications, based on the guidelines in the IMF's *Government Finance Statistics*. This new system of government revenue and expenditure classification was piloted in six central government agencies and five provinces in 2005, and this was followed in February 2006 by the issuance of a document on the 'Design of the Reform of Government Revenue and Expenditure Classification'. Based on this design, the Ministry of Finance prepared the '2007 Government Revenue and Expenditure Classification', which is to be implemented from 1 January 2007.

The new functional expenditure codes classify expenditure according to categories, sub-categories and items. The 17 categories include, among others, education (5), social security and employment (8); social insurance (9) and transfers (17). The sub-categories are the main sub-functions and the items are areas of activity. The economic expenditure classification has two levels: categories and sub-categories. There are twelve categories: salaries and benefits, goods and services, subsidies to individuals and families, subsidies to firms and public service units, transfer payments (to other government levels), grants, interest payments, debt repayments, basic construction expenditure,

¹⁴ Data from *Comprehensive Briefing on the Organizational Budget Reform in Sub-National Governments*, Budget Department, Ministry of Finance, 2005.

other capital expenditure, on-lending and financial investments, and others. Other aspects of budget management will not change, in order to facilitate the implementation of the new classification.

Comparing the current and new functional budget classifications in the education and health sectors (see Table B-1), it can be seen that there are more far-reaching changes in the sub-categories for health than for education.

Table B-1 Functional budget expenditure classification in the education and health sectors

Current classification	New classification
<p>Education (9 sub-categories): general education, vocational education, adult education, radio and TV education, overseas education, special education, training of teachers and education officials. General education includes: pre-school education, primary school education, junior high school education, senior high school education, tertiary education and others.</p>	<p>Education (10 sub-categories): education management, general education, vocational education, adult education, radio and TV education, overseas education, special education, training of teachers and education officials, education surcharge and fund expenditure, and others.</p>
<p>Medical and health care (4 sub-categories): health care, Chinese traditional medical care, monitoring and supervision of food, medicines and medical facilities, and medical care for administrative and public service units. Health care covers: hospitals, urban community health care centres, township health centres, disease prevention, maternal and child health care, staff training, rural health care (financial support to rural cooperative medical system and medical assistance to poor peasants for medical fees).</p>	<p>Health care (10 sub-categories): medical and health care management, medical care and treatment, community health care, health insurance, disease prevention and control, health monitoring and supervision, maternal and child health care, rural health care, Chinese traditional medical care and others.</p>

2.2 Incremental and zero-based budgeting

Until quite recently, China practiced a form of budget preparation that could be described as being essentially incremental in nature. This was reflected in the Budget Law, which was adopted in 1994 and is still in effect. The law stipulates that central and local budgets should be prepared on the basis of actual budget execution in the previous year and the estimates of overall budget revenue and expenditure for the coming year. This incremental approach was spelt out further in the *Rules and Procedures of Enforcement of the Budget Law*, adopted in 1995, which established that budget formulation should be based on: (i) laws and regulations; (ii) national economic and social development plans, medium and long term fiscal plans, and fiscal and economic policies; (iii) the government level's budget management authority, its budget revenue and its expenditure responsibilities; (iv) the previous year's budget execution and factors changing the upcoming

year's budget revenue and expenditure; and (5) guidelines and requirements set by higher level governments.¹⁵

The formulation of budgets on the basis of the previous year's budget execution has meant that, during budget formulation, government agencies would tend to reproduce the structure of spending from the previous year. Both the Budget Department of the Ministry of Finance (MOF, 1997) and Zhao Zhiyun (2002) have commented on the weakness of this type of budget methodology, pointing out that it rolls over previous patterns of expenditure without fully taking into account the changing situation and new priorities and builds in constraints on cutting expenditure that may no longer be required. It also delays budget formulation until after the end of the previous budget year.

In order to overcome these weaknesses, some provincial governments began to pilot reforms in budget methodology in the 1990s, introducing a form of zero-based budgeting. Five provinces, namely Anhui, Henan, Hainan, Hubei and Yunnan, as well as the National Bureau of Statistics (NBS), piloted this budget method (MOF, 1997). In Anhui, some municipalities and counties began to implement zero-based budgeting from 1992-93 and the provincial BOF formally adopted this budget methodology in 1994. The past expenditure levels were no longer taken as the basis for budget formulation and instead expenditure needs were re-evaluated on the basis of new criteria and cost estimates. A standard fixed amount was calculated for the budgets of administrative and public service units, while special expenditure (on projects) was based on the prioritization of needs within an available resource envelope. In the case of Yunnan, the provincial and prefecture/municipality BOFs also adopted a form of zero-based budgeting from 1995, by costing and setting new standards for various types of expenditure, such as per capita expenditure on primary education, linking current expenditure to policies and regulations and prioritizing special (project) expenditure in accordance with medium-term economic development plans.

The introduction of the *bù mén* budget system in 2000 involved the extension of this form of zero-based budgeting to the central governmental level. The budget legislation has not yet been adapted to take this change into account, but this is expected to happen in the revision of the Budget Law, which is currently being prepared by the Ministry of Finance together with the Budget Committee of the National People's Congress.

Overall, these changes have made some headway in encouraging the re-evaluation of expenditure items, in order to detect and reduce unnecessary expenditure, and the restructuring of expenditure to meet needs in a more prioritized manner, taking into account both the available resources and

¹⁵ The incremental bias is also evident in the rules and procedures for budgeting by individual government agencies and spending units, which are required to base their budgeting on: (1) laws and regulations; (2) the requirements and guidelines set by the corresponding governments and BOFs; (3) the functions, tasks and development plans of the government agencies and budget units concerned; (4) the established staff quotas and the budget ceilings set for the budgeting process; and (5) the previous year's budget execution and factors changing the upcoming year's budget revenue and expenditure.

the objectives of government policies and plans. However, this is not a full zero-based budgeting approach. One of the main constraints has been the lack of control by the Ministry of Finance and BOFs over staffing levels. The established staff quotas have been taken as given – an important limitation, especially at the local government level where wages and salaries often account for over 70% of expenditure. Wages and salaries have thus not been part of the zero-based budgeting exercise (World Bank, 2002; Budget Department, MOF, 1997). Moreover, most local governments still formulate their budgets on an incremental, line-item basis, as has been shown in research by the Institute of Fiscal Science (Li Zhen and Zeng Yuqing, 2005).

2.3 Results-based budgeting and multi-year budget planning

China has not yet adopted a form of results-based budgeting aimed at explicitly linking resource allocations or expenditures to the production of outputs or the achievement of specific outcomes and objectives. A number of variants of such methodologies, known sometimes as programme-based budgeting or performance-based budgeting, have been devised and put into practice, with varying degrees of success, mainly in the developed industrialized countries. Their common denominator is that they all shift the focus from line-item inputs, such as salaries and purchases of goods and services, to the outputs produced and the outcomes achieved with government resources. This makes it easier to analyse the efficiency and effectiveness of government expenditure and thus to judge whether expenditures represent good ‘value for money’. The successful implementation of such methodologies is quite demanding. It requires not only that the ‘budget basics’ are in place, including for example the integration of all revenue and expenditure into a single unified budget (removing the off-budget problem), but also the adoption of a programme classification system with codes that correspond meaningfully to the programme results to be achieved, the training of staff to use these codes correctly to classify expenditure, and a high degree of delegation of budget management authority so that department managers can flexibly adjust inputs and activities to achieve the planned results.

Another issue that is under discussion in China is the adoption of a multi-year fiscal framework to assist budget planning. A real break from incremental forms of budgeting is quite difficult in a purely annual framework, as there are too many short-term rigidities. The annual budget exercise provides little scope for significant adjustments in expenditure allocations. By contrast, a medium-term fiscal framework (ranging normally from three to five years) provides an opportunity to adjust the pattern of expenditure in order to meet shifting priorities, introduce new spending programmes and ensure sustainability. This is normally based on the ‘top-down’ establishment of a resource envelope, through the forecasting of revenue and setting of sustainable macro-fiscal objectives, and a ‘bottom-up’ determination of the optimal expenditure allocations needed to meet governments’ policy priorities and objectives. MTEFs and other forms of medium-term budget planning usually have a rolling nature, with year 1 setting the parameters for

the annual budget and the subsequent years providing indicative figures that are reviewed and adjusted in subsequent years in the light of actual macroeconomic performance and changes in policy objectives and priorities.

Although the Ministry of Finance prepares a five-year public finance development plan, which matches the time period of the Five Year National Economic and Social Development Plan, this is not a rolling multi-year fiscal plan along the lines of an MTEF. This is a weakness that is recognised by the authorities and is likely to be addressed in the coming years. This would be a major step forward, with the potential to provide the central government (and sub-national governments) with a powerful tool to plan changes in the structure of expenditure on a sound and sustainable basis to achieve government policy objectives in the most effective way possible.

2.4 Performance evaluation

In China, as in most countries, there has traditionally been a stronger emphasis on ensuring compliance with approved budget allocations, through controls on expenditure on inputs, than on evaluating 'value for money'. In fact, the shortcomings in the current classification system and the absence of an explicit results-based framework for budget management would make it difficult in practice to evaluate expenditure in terms of results or performance.

Performance evaluation centres on three concepts, or the 'three Es': economy (the cheapest possible purchase of inputs), efficiency (the optimal relationship between inputs and outputs) and effectiveness (the optimal relationship between outputs and outcomes). The notion of cost-effectiveness combines these concepts, relating the cost of resources to the realization of expected social or economic goals or outcomes. Techniques based on these concepts are applied in public expenditure reviews and similar exercises with a view to improving the quality of expenditure budgeting.

Although there has been some research in China on performance evaluation of public expenditure, especially in the education sector, a well developed evaluation system is still lacking. Lv Chunjian et al(2005) conducted research on performance evaluation of fiscal expenditure on basic education in Hubei, arguing that this was critical to improve the efficiency and effectiveness of the use of financial resources in the sector. They designed an indicator framework for evaluating performance and tested it with a case study in Hubei. In 1998, the Ministry of Finance issued a revised set of performance indicators and procedures for evaluating financial management and expenditure in education, science and culture, improving an earlier version developed in 1990. More recently, the Ministry of Finance has also issued a document on the performance evaluation of central government projects in the education, science and culture sectors .

The Vice Minister of Finance, Zhu Zhigang, and other MOF staff have made more general proposals for indicators for expenditure performance evaluation, including in education and health, in a book on *Performance Evaluation of Fiscal Expenditure* (Zhu Zhigang et al, 2003) and, in 2005, the Ministry of Finance issued a document entitled *Management Measures on Organizational Budget Performance Evaluation for Central Line Ministries* (MOF, 2005c). This requires all line ministries to conduct performance evaluations of their expenditure and provides general rules and guidelines for defining and applying indicators. However, to be successful, performance evaluation of public expenditure requires not only the setting of clear and specific policy objectives and the development of appropriate performance indicators and techniques, but also the implementation of the necessary types of classification and an effective accounting system so that the quantitative data required for performance evaluation are available in practice to apply the indicators and techniques.

2.5 Implications for financing services for children

Despite the emphasis given to social development in the *xiaokang* vision and the 11th Five Year Plan, several institutional and technical factors hold back the higher prioritization of social services, including essential services for children, particularly at the sub-national level, where most of the expenditure on these services takes place. Not all these factors are directly related to the budget system as such. For example, the incentive structure facing local government officials, including the criteria for evaluating officials' performance, appears to place more weight on achieving high levels of economic growth and job creation than on development of the social sectors. And the health sector reforms have raised incentives for income-generating curative services at the expense of preventive services.

However, the methodological problems discussed in this chapter also have important implications for the financing of services for children. First, the shortcomings in the present budget classification system, along with the off-budget problem, limit the scope of analysis of the efficiency and effectiveness of expenditure at the different levels of the education system, including pre-school, primary and junior and senior secondary education, or on health services for children such as maternal and child health care. These limitations on the nature and comprehensiveness of fiscal data and thus the scope of analysis in turn constrain what can be done in planning and budgeting to improve allocative decisions. These shortcomings should be significantly reduced by the adoption of the new classification system, which is expected to take effect in 2007, and by the gradual progress being made to bring the remaining off-budget revenue and expenditure flows on-budget. As noted in Chapter 1, the off-budget problem is still a major one at the sub-national level (about 22% of total sub-national expenditure in 2003), although it has been greatly reduced at central level.

Second, the planned improvements in the classification system and the reduction of off-budget revenue and expenditure flows may still not be enough to undertake performance evaluation of expenditure on services for children from a results perspective. The latter would require a more systematic analysis of the relationship between budgetary inputs and outcomes (as measured, for example, by enrolment ratios, educational survival ratios or learning achievement indicators in the case of education) and thus the adoption of a fully-fledged results-based planning and budget methodology with a programme classification system and a civil service management culture geared to achieving results.

Third, the fact that most local governments still adopt a fundamentally incremental approach to budgeting holds back adjustments in the structure of expenditure. This is especially important in the social sectors, since local governments, in particular at the county level, are responsible for the overwhelming majority of expenditure in these sectors. This provides part of the explanation why it has proven difficult to raise the shares of education and health in government expenditure despite the greater emphasis given in recent years to the social dimension of development. Indeed, it is probably one of the main reasons why the goal of raising education expenditure to 4% of GDP has proven elusive ever since it was put forward in the Education Reform and Development Programme in 1993. Likewise, the incremental budget culture at local level makes it difficult to raise MCH expenditure to 10% of total government expenditure on health, as targeted in the Regulations on Maternal and Child Health Services adopted in 1986, from its current level of less than 5%.¹⁶ Along with poor data on the migration of school-age children, the incremental approach may also be one of the factors that has resulted in budget planners inadequately taking into account the consequences of migration, which have increased the number of children in urban areas requiring access to primary and middle schools.

Fourth and last, the lack of a rolling medium-term fiscal framework limits the ability to plan adjustments in budget structure or to introduce or expand coverage of new programmes, which can most easily be done in a multi-year framework. The development of such a budget planning tool would make it easier, for example, to plan the achievement of the 4% ratio of education expenditure to GDP, or to plan for the extension of free compulsory education throughout rural China (and ultimately perhaps to migrants and other urban poor) in a way that would avoid adding to the burdens on local government finances. Likewise in the health sector, it would be possible to plan a gradual expansion of MCH expenditure to achieve the 10% target mentioned above or to ensure adequate and sustainable financing for the universal coverage of the rural population by the new Rural Cooperative Medical System.

¹⁶ In 2004, MCH facilities accounted for only 3.6% of expenditure on medical institutions.

3 Inter-Governmental Fiscal Relationships

Since the 1980s, China's budget system has gradually been transformed from a highly centralized to a highly decentralized system. Expenditure responsibility for most basic services for children, such as compulsory education and maternal and child healthcare, is delegated to the sub-national levels of government, especially to county level governments. However, there is not complete clarity about the respective roles of the provincial, prefecture, county and township governments. Moreover, partly as a result of the 1994 tax-sharing reform, which raised the central government's share of total revenue without making a matched adjustment in expenditure responsibilities, there is also a disjuncture between expenditure responsibilities and the availability of resources at the local level. This is further complicated by the fact that levels of economic development and thus tax revenues vary greatly between different parts of the country. Fiscal transfers from the central government to local governments are intended in part to narrow these imbalances.

This chapter will examine the extent to which transfers succeed in ensuring that public services, including those for children, are provided on an equal basis in urban and rural areas and among different regions of the country. The regional analysis is based on four regions (west, centre, east and north-east) in accordance with the regional breakdown used in the chapter on promoting coordinated regional development in the 11th Five Year Plan.¹⁷

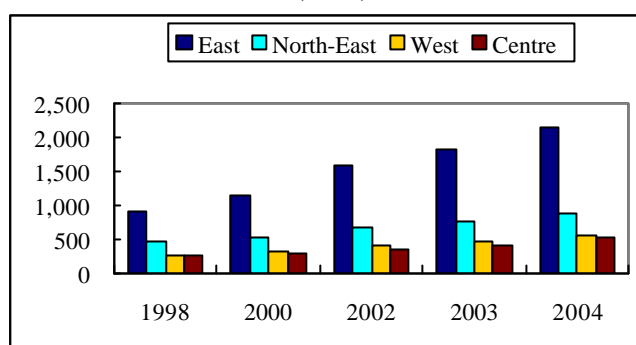
Although the *xiaokang* policy aims to reduce regional disparities, the regional imbalances in economic development remain substantial. GDP per capita in western China was only 61% of the national average in 2005, although this was 5 percentage points higher than in 2000.¹⁸ GDP per capita in central China was 71% of the national average in 2005, the same level as in 2000. The north-east had a GDP per capita close to the national average (97%) in 2005, 7 percentage points lower than in 2000. Put another way, GDP per capita in the east (excluding the three north-eastern provinces) was 1.7 times higher than in the north-east, 2.6 times higher than in the centre and 2.7 times higher than in the west.

These disparities are reflected in the regional variations in fiscal revenue, which on a per capita basis is approximately four times higher in the eastern region than in both the west and the centre and two and a half times higher than in the north-east (see Figure B-6).

¹⁷ Eastern region: Beijing, Fujian, Guangdong, Hainan, Hebei, Jiangsu, Shandong, Shanghai, Tianjin and Zhejiang. North-eastern region: Heilongjiang, Jilin and Liaoning. Western region: Chongqing, Gansu, Guangxi, Guizhou, Inner Mongolia, Ningxia, Qinghai, Shaanxi, Sichuan, Tibet, Xinjiang and Yunnan. Central region: Anhui, Henan, Hubei, Hunan, Jiangxi and Shanxi.

¹⁸ These are unweighted averages of provincial GDP per capita in the respective regions.

Figure B-6 On-budget revenue per capita by regions (1998-2004)
(RMB)



Source: Calculated from data in *China Statistical Abstract 2006*, China Statistics Press, May 2006.

3.1 Revenue and expenditure assignments between central and local governments

Government assignments or areas of competency refer to the functional responsibilities assigned to different levels of government for the management of administrative affairs and the provision of public services. Expenditure assignments concern the expenditure required to fulfill such obligations, while various types or shares of revenue can also be assigned to different government levels, either through direct retention of revenue or through redistribution (by means of transfers).

In China, the degree of centralization or decentralization of expenditure and revenue assignments has changed frequently since the founding of the PRC in 1949 (Budget Department, MOF, 1986). Broadly speaking, the evolution of inter-governmental fiscal relations can be divided into four stages:

- From 1949 to 1957, there was a highly centralized fiscal system with unified revenue and expenditure mechanisms (*tongshou tongzhi*) fully established by 1950.
- Between 1958 and 1979 there was some decentralization compared with the earlier period, with experiments in various forms of revenue-sharing between the central and sub-national levels of government.
- The system was further decentralized from 1980 to 1993 as a result of the introduction of the contracted fiscal responsibility system, under which local governments could retain revenue collected over and above revenue quotas that they ‘contracted’ to provide to the central government (Xiang Huaicheng, 2001).
- From 1994 until the present day, there has been a ‘tax sharing system’, which is relatively more centralized (on the revenue side) than the contract system of ‘eating from separate kitchens’ (*fenzao chifan*). The tax sharing system reform in 1994 and the subsequent income tax sharing reform in 2002 laid the basic framework for the current

system of inter-governmental fiscal relations. The defining feature of these reforms was that they divided the revenue from each type of tax between central government and the different levels of local government, according to fixed formulae, and from 1998 this new system began to give a higher proportion of total revenue to central government.¹⁹ On the expenditure side, however, there was no corresponding shift to the central government level. For example, sub-national governments, especially at the county level, continued to shoulder most of the responsibility for the provision of public services such as education and healthcare. As a result, the central governments' tax rebates and grants to local governments also increased (see Table B-2).

Table B-2 On-budget revenue and central government transfers to sub-national governments (1994-2005)

	Total on-budget revenue (RMB 100 million)	Central government on-budget revenue		Central government transfers to sub-national governments	
		RMB 100 million	As % of total on-budget revenue	RMB 100 million	As % of total on-budget revenue
1994	5,218.1	2,906.4	55.7	2,389.1	45.8
1995	6,242.2	3,256.6	52.2	2,534.1	40.6
1996	7,408.0	3,661.1	49.4	2,722.5	36.8
1997	8,651.1	4,226.9	48.9	2,856.7	33.0
1998	9,876.0	4,892.0	49.5	3,323.0	33.6
1999	11,444.1	5,849.2	51.1	4,095.3	35.8
2000	13,395.2	6,989.2	52.2	4,665.3	34.8
2001	16,386.0	8,582.7	52.4	6,002.0	36.6
2002	18,903.6	10,388.6	55.0	7,351.8	38.9
2003	21,715.3	11,865.3	54.6	8,261.4	38.0
2004	26,396.5	14,503.1	54.9	10,408.0	39.4
2005	31,628.0	16,535.9	52.3	11,484.0	36.3

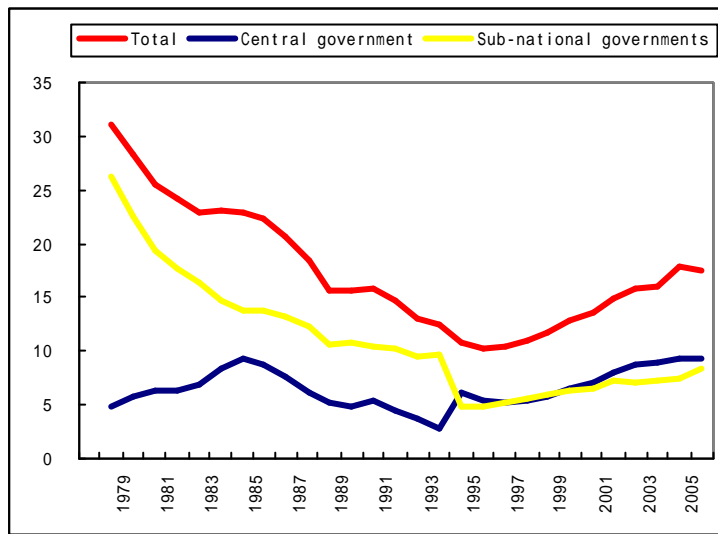
Sources: Data for 1994-1999 are from *Status Quo, Issues and Improvement of the Inter-governmental Transfer Payment System in China*, DRC, 2005; data for 2000-2004 are from *Finance Yearbook of China*, volumes for 2001-2005 (MOF); data for 2005 are from *China Statistical Abstract 2006*, NBS, and estimates.

The main factor on the revenue side has been a precipitous drop in the ratio of local governments' on-budget revenue to GDP. This declined from 26.2% of GDP in 1978 to a low of 4.8% in 1995 before rising again partially to reach 8.3% in 2005. Local governments' expenditure also declined between 1978 and 1995, but less steeply (from 16.2 % to 7.9%) and then rapidly increased to 13.7 % by 2005. In other words, by 2005, local governments' expenditure was almost twice as high as their revenue. This shows the extent of their current dependence on transfers from central government as well as extra-budgetary revenue to meet their resource gap. As was noted in

¹⁹ Initially, in order not to harm local governments, the new system did not reduce their existing levels of retained revenue and adjusted only the shares of the incremental amounts of revenue above these levels.

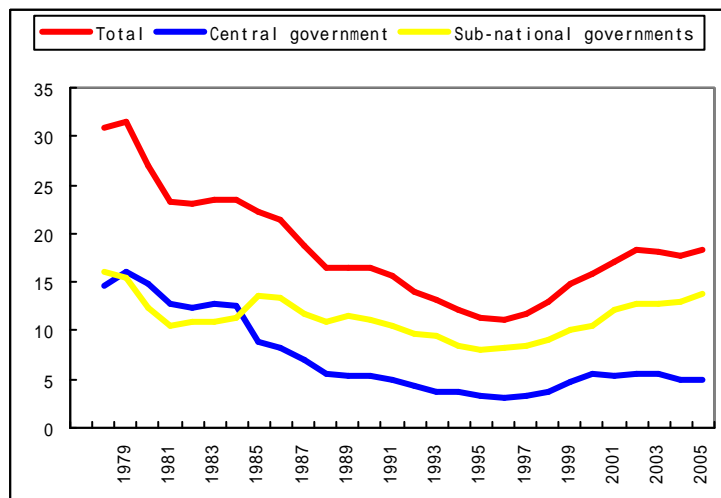
Chapter 1, extra-budgetary revenue accounted for 42.5% of local governments' total revenue in 2003. By contrast, central government's on-budget revenue was actually higher as a percentage of GDP in 2005 (9.1%) than in 1978 (4.8%), despite a period of decline from the mid 1980s to the early 1990s, and central government derives a relatively small share of its revenue from extra-budgetary sources (6% in 2003).

Figure B-7 Central and sub-national on-budget revenue as percentage of GDP (1978-2005)



Source: *China Statistical Abstract 2006*, National Bureau of Statistics, China Statistics Press, May 2006, using adjusted GDP data from 2004 national economic census.

Figure B-8 Central and sub-national on-budget expenditure as percentage of GDP (1978-2005)



Source: *China Statistical Abstract 2006*, National Bureau of Statistics, China Statistics Press, May 2006, using adjusted GDP data from 2004 national economic census.

The expenditure responsibilities of sub-national governments in China are heavier than in most countries, even those that are highly decentralized or have a federalist system of government. For example, the ratio of sub-national to total government expenditure in China (74% in 2005) was higher than in the USA (41.8%), Australia (49.6%), Canada (58.2%), Brazil (35.5%) and India (61.6%), even though all these countries have federal systems.²⁰

A more detailed breakdown of sub-national on-budget expenditure (see Table B3) shows that prefecture and county governments shoulder the main burden of expenditure (23.7% and 20.8% of on-budget expenditure respectively in 1997). The prefectures' share rose from the late 1980s to late 1990s, while that of the provincial governments declined.

Table B-3 Percentage shares of sub-national governments in on-budget expenditure (1987-1997)

Year	All sub-national governments	Provincial governments	Prefecture governments	County governments	Township governments
1987	62.6	21.1	15.4	20.2	5.9
1989	68.5	19.3	19.3	21.3	8.6
1991	67.8	15.7	21.3	22.7	8.1
1993	71.7	17.6	21.9	22.3	9.9
1995	70.8	16.9	23.9	21.2	8.8
1997	71.1	17.8	23.7	20.8	8.8

Source: Ruan Risheng, *Research on Local Fiscal Systems in China*, China Financial and Economic Press, December 2004.

3.2 The rationale for inter-governmental fiscal transfers

The purpose of inter-governmental fiscal transfers is to correct two different kinds of fiscal imbalance: vertical imbalances and horizontal imbalances. Vertical fiscal imbalances result from a mismatch between the expenditure assignments and revenue of central and local governments, while horizontal fiscal imbalances refer to disparities in the fiscal revenue generating capacity, expenditure level and public service delivery capacity among governments at the same administrative level in different geographical areas. Thus central governments can use a portion of central level fiscal revenue to make fiscal transfers to local governments in order to improve efficiency, by overcoming the vertical imbalances, and social equity, by addressing the resource disparities among different parts of the country.

In short, fiscal transfer payments should be viewed as a mechanism for revenue redistribution that permits the rational allocation of revenue according to the principles of matching revenue capacity with expenditure assignments *and* achieving equity in fiscal capacity. There are three fundamental justifications for this:

²⁰ By comparison, the ratios in more centralized states such as the UK (29.0%) and France (18.5%) are lower. The international data presented here are for 1994 and are cited from Ruan Risheng, 2004.

- (i) Equity requires that the central government should guarantee equal access to essential public services by all residents irrespective of the fiscal revenue capacity of the local governments in the areas where they live.
- (ii) the positive externalities in the provision of public services such as compulsory education and maternal and child healthcare (the social benefits associated with these services) apply everywhere.
- (iii) Transfer payments, when earmarked, are one mechanism by which central governments can ensure that local governments address national priorities.

The importance of these issues for children in China is self-evident. The National Plan of Action for Children's Development (NPA) for 2001-2010 calls for the equitable provision of education, including pre-school education, for children across all regions, including in poor, ethnic minority areas, as well as for girls, children with disabilities, orphans and migrant children. Likewise, the Chinese government is committed to providing equitable access to quality health and medical services for all Chinese people and their children, including the rural and urban poor and migrants.

However, the tax sharing system has reinforced the vertical imbalance between the expenditure responsibilities and the revenue capacity of different tiers of government, while there is also a major horizontal imbalance due to the large disparities in levels of economic development and tax revenue between urban and rural areas and among different regions, provinces and counties. As several studies have indicated, the issue of geographical fiscal imbalance was not really addressed in the tax sharing reform.²¹ Indeed, the 'hold harmless' rule, which was applied when the tax-sharing reform was introduced, meant that no local governments were to lose out from the increased centralization of revenue, limiting the scope for redistribution.

What this means in practice is that, while local governments shoulder the main responsibility for financing compulsory education, MCH and other essential services for children, the resources for exercising these responsibilities at the local level are inadequate and are very unevenly spread across the country, making it extremely difficult to overcome the major disparities in the provision of these services. If founded on the principles set out above, central government transfers would play a critical role in helping the sub-national governments, especially in the poorer areas, to fulfill their responsibilities to provide universal access by children to essential services with minimum quality standards.

The relative importance of the vertical and horizontal fiscal imbalances has implications for the design of the mechanisms and criteria used in providing transfers to local governments. In addition, the extent to which central governments wish to assert some control over the spending priorities of

²¹ See *Inter-Governmental Fiscal Relations in China*, a joint study of the Budget Department of the Ministry of Finance and the International Monetary Fund, *China Financial and Economic Press*, December 1993.

local governments affects the degree of conditionality or earmarking. Fiscal transfer payments can thus be divided into two broad types: unconditional and conditional grants. Unconditional transfers, or 'general transfers', are block grants provided to local governments without any specific purpose or earmarking of the use of the funds. How the money is spent is entirely at the discretion of the recipient local governments. Conditional transfers are special-purpose subsidies, which in China are of two types: earmarked transfers and categorical transfers. Earmarked transfers are for specifically stipulated usage, for example on projects or programmes. Categorical transfers give the recipient sub-national governments a little more discretion in the use of the funds. They usually stipulate the applicable area or sector of use, for example education or health coverage, rather than specific projects.

3.3 The pattern of transfer payments in China

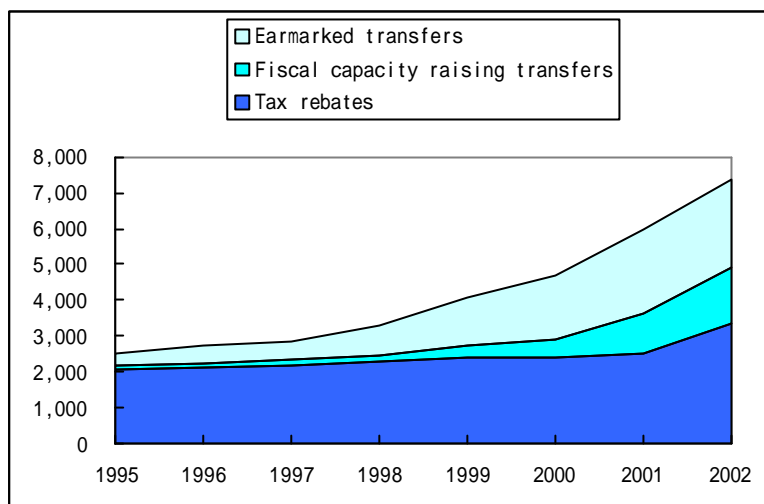
Overall, transfer payments made by central government to sub-national governments were equivalent to 36% of total government revenue in 2005. This proportion has been on a declining trend (from 46% in 1994), despite a substantial increase in their absolute value. As explained above, there are two types of fiscal transfer payments in China: special (earmarked) transfers and general transfers, which in turn may be sub-divided into tax rebates and general subsidies.

Whether tax rebates should really be considered a type of transfer is a moot point. Most researchers consider tax rebates as a part of general transfers, although Chinese officials tend to regard them simply as a mechanism for the internal reallocation of tax revenue between levels of government, aimed at correcting the vertical imbalance in revenue and expenditure responsibilities. They were introduced as part of the tax-sharing reform in 1994 and are proportional to the level of tax submitted to central government. Although they address the vertical fiscal imbalance between central and sub-national levels of government, they do this in a very unequal manner, since richer provinces with higher tax revenues receive higher tax rebates. In short, this reinforces the horizontal imbalances in resource availability. As can be seen from Figure 3.4, tax rebates are the single largest category of transfers, although their proportion of transfer resources fell from 82% in 1995 to 45% in 2002.

General 'fiscal capacity' subsidies that are explicitly intended to benefit disadvantaged areas were introduced in the mid-1990s on a pilot basis and then standardized in 2002. Their share of overall central government transfers to sub-national governments rose from 4% in 1995 to 22% in 2002. By 2002, there were five kinds of fiscal capacity raising subsidies: general subsidies, to enhance the fiscal capacity of local governments with low levels of per capita fiscal revenue; subsidies for the promotion of ethnic minority areas; subsidies to implement increases in civil service salaries; subsidies for the implementation of the rural 'tax-for-fees' policy; and subsidies to compensate for the cost of implementing various policy measures. By and large, these subsidies have permitted sub-national governments in poor areas to ensure the payment of civil service salaries and maintain

basic daily operations. Indeed, in 2002, the subsidies for civil service salary increases accounted for just over half of the total volume of fiscal capacity subsidies.

Figure B-9 Central government transfers to sub-national governments (1995-2002)
(RMB100 million)



Sources: Zhang Hongli, Xu Hongcai, Zhang Zhihua, Zheng Yong and Wang Fazhong, 'Status of Adjustment and Improvement of Tax Sharing Fiscal Management System and Ideas for Further Reform', in *On Fiscal and Tax Reform*, collection of papers on fiscal and tax reforms and research reports, Economic Publishing Press, September 2004; Zhao Limin, *Improvement and Perfection in Inter-Governmental Transfer System in China*.

Conditional transfers are used mainly for infrastructure and for projects aimed at achieving specific policy goals of the central government, such as the achievement of universal compulsory education in poor areas. Conditional transfers rose from RMB37.5 billion in 1995 to RMB243.4 billion in 2002. Their share in overall fiscal transfers rose from 15% in 1995 to 33% in 2002.

Despite the rising volume of general fiscal capacity-raising transfers, the inter-governmental transfer system has not yet completely solved the problem of vertical and horizontal fiscal imbalances. First, the legal framework is weak. While the Budget Law assigned revenues clearly between central and sub-national governments, the expenditure assignments are less clearly defined in the current laws and regulations. This may be improved by the adoption of a specific law on fiscal transfer payments, which the Ministry of Finance and the National People's Congress are currently working to draft.

Second, despite the vagueness about expenditure responsibilities, there is clearly a mismatch between the public service responsibilities that sub-national governments have been expected to take on and their resources, especially in the poorer areas.

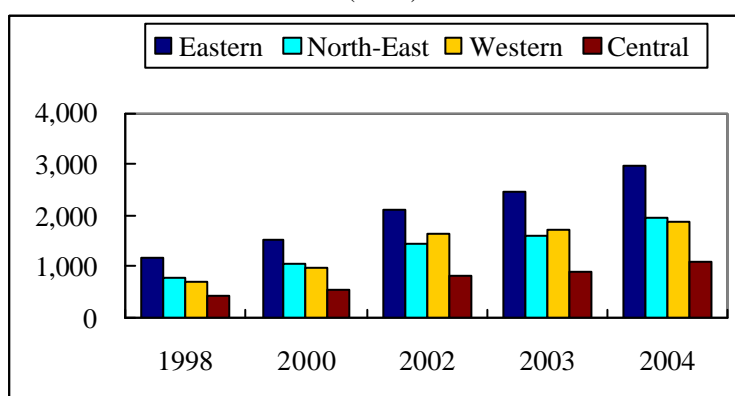
Third, the underlying problem of horizontal fiscal imbalance is worsening, despite the government objective of achieving balanced development. The eastern region's fiscal revenue per capita rose

from 183% to 195% of the national average between 1998 and 2004, while the central region's fiscal revenue per capita fell from 61% to 53% and the western region's fiscal revenue per capita fell from 56% to 52%.

Fourth, the adjustment effects of the transfer payment system are quite limited, because tax rebates still account for almost half of total transfers and disproportionately benefit richer areas. The transfers specifically designed to increase the fiscal resources of areas with low levels of per capita fiscal revenue, although much greater than a decade ago, still account for only 22% of total fiscal transfers. Some earmarked transfers, such as the funds to support the policy of the 'two frees and one subsidy' for compulsory education in poor rural areas, do have an equity character, but this is not the case for all such transfers, which support a range of special policy goals.²²

The consequence of this is that government expenditure per capita remains highly unequal among and within regions, as Figure B-10 shows, although there has been a slight decrease in disparities, mainly to benefit the west. The eastern region's government expenditure per capita was 143% of the national average in 2004 (down from 147% in 1998) while the western region's government expenditure per capita was 94% (up from 89%). The central region remains in the least favourable situation, with government expenditure per capita at 64% of the national average in 2004 (much the same as in 1998). The large difference in expenditure per capita between the central and western regions, despite the fact that their revenue per capita is almost the same (see Figure B-6) shows that transfers have been much higher on a per capita basis in the west than the centre.

Figure B-10 On-budget expenditure per capita by regions (1998-2004)
(RMB)



Source: Calculated from data in *China Statistical Abstract 2006*, China Statistics Press, May 2006.

²² In addition, the calculation of the general 'fiscal capacity' transfers, which uses a formula based on per capita fiscal revenue, may be compromised by the fact that a significant proportion of sub-national government revenue is off-budget, as well as by other weaknesses in statistical and accounting data.

However, it is also important to note that disparities are substantial within regions. For example, in the western region, government expenditure per capita in Tibet is almost five times higher than in Guangxi, due to the exceptionally high level of transfers to Tibet and its small population.

Fifth, the sub-provincial transfer system needs to be strengthened and improved, as county and township governments are in a relatively difficult fiscal situation compared with prefectures and districts (DRC, 2005c). By 1997, most provincial governments had established mechanisms for making fiscal transfer payments to prefecture governments and a framework had been established for fiscal transfer payments at lower levels too. This system is still developing, but by and large the mechanisms copy those described above for the transfer payments from central government to provincial governments: there is a mix of tax rebates, fiscal capacity raising general subsidies and conditional transfers (Ruan Risheng, 2004). At each level, sub-national governments transfer part of their own revenue down to the next lower government level, as well as a portion of the transfers they receive from above. The main problem is that not enough of the sub-provincial revenue is retained by or transferred to the county and township levels. About one third of sub-provincial revenue is 'captured' by the prefecture/district level, which shows that the fiscal difficulties of the lowest tiers of government are not totally caused by the centralizing of revenues at the top of the system.

3.4 Transfer payments and expenditure in education and health

The problems discussed above are clear to see in the financing of services for children, such as education and healthcare. Expenditure responsibilities in these sectors are almost entirely delegated to lower level governments, including county and township governments (Ruan Risheng, 2004; Fortuna et al, 2004). This contrasts with the situation in most other countries, as central and provincial governments normally share most of the responsibility for financing education and health services. The resource disparities across China, combined with the weakness of the equalization element in transfer payments, result in large disparities in on-budget expenditure per pupil in compulsory education and in health spending per capita.

Recent data on the sectoral breakdown of earmarked transfer payments were unavailable for this study, but earlier research by the World Bank indicates that only about 4-5% of these transfers are used for education and health (World Bank, 2002). How tax rebates and other general transfers are used is even more difficult to determine without in-depth field studies. However, there seems little doubt that decentralized decision-making and local fiscal discretionary authority, alternative priorities (in particular economic growth and job creation) and incentives (including, for example, the predominantly economic criteria used for the performance evaluation of local officials) can lead to education and health services receiving low priority in local expenditure allocations. The Ministry of Finance has recognized this problem and has adopted measures such as an increase in

the central share of stamp tax in order to fund earmarked transfers to the western region and supplement social security funds.

Compulsory education

The regulations on management responsibility for education development stipulate that the State Council and provincial governments are in charge of higher education. Pre-school, primary and secondary education is managed by sub-national governments. In 2001, the State Council stipulated that the main responsibility for managing compulsory education (primary and lower secondary education) should shift to county level governments. In practice, sub-national governments bear about 90% of the burden of public expenditure on education in China, with the bulk of this at the county level. In the case of compulsory education, local governments account for over 99% of expenditure.²³ This means that, given the large disparities in tax revenue across the country, equity in the distribution of government expenditure on compulsory education presupposes that transfer payments have strong equalization effects and are used in particular to boost expenditure on compulsory education. As has been discussed above, tax rebates, which account for the bulk of general transfers, reinforce rather than reduce disparities. The revenue capacity-raising general subsidies have equalization effects, but there is no guarantee that they benefit education expenditure in particular.

There are also, however, a series of specific-purpose transfers that are earmarked for compulsory education. These are oriented specifically to supporting the government's goal of achieving universal nine years compulsory education and have been targeted at poor rural counties, especially in western China. These specific projects through which the central government has channeled funds for rural compulsory education include:

- the compulsory education project in poverty-stricken areas (RMB 20 billion, including RMB 8.9 billion in central government funds, committed between 1995 and 2005);
- the project for renovating dilapidated rural primary and middle school buildings (RMB 11 billion committed since 2001);
- special funds for relocation of primary and middle schools in thinly populated areas;
- the project for construction of boarding schools in rural areas of the Western Region (RMB 10 billion in central government funds committed for 2004-2007);

²³ Data for 2004 from *China Educational Finance Statistical Yearbook 2005*, Finance Department, MOE, Social, Science and Technology Department, China Statistics Press, April 2006.

- the project on modern distance education in rural primary and middle schools of the Central and Western Regions (RMB 10 billion committed for 2003-2007 by the central and local governments);
- the basic education development project in the western region, co-financed by the central government (\$47.3 million) and donors (\$100 million from the World Bank and the UK government) in 2003-2007.

More recently, the central government has also provided funds to help local governments implement the policy of the ‘two frees and one subsidy’, which involves the waiving of all fees, the provision of free textbooks and the provision of subsidies to pupils attending boarding schools. Beginning in 2004 in western China, this was extended to all 592 rural counties designated as poverty-stricken in 2005. From 2006, fees for compulsory education have been abolished in all rural areas of western China and this is to be extended to central and eastern China in 2007.²⁴

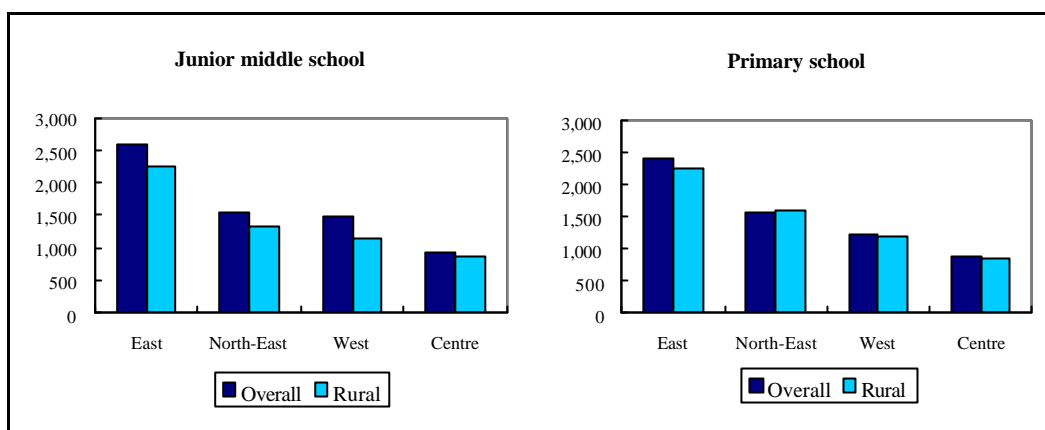
While the effects of the most recent policy initiatives cannot yet be assessed, data from 2004 indicate that at that time transfers were not sufficient to avoid large horizontal imbalances in government expenditure per pupil in the two stages of compulsory education: primary school and junior middle school. Compared with national averages, government expenditure per pupil in the rural areas was 11% lower for primary education and 15% lower for junior secondary education. However, the main disparities were among and within regions, as is shown in Figure B-11.

In 2004, expenditure per primary school pupil in the eastern region was 1.5 times higher than in the north-east, 2.0 times higher than in the west and 2.7 times higher than in the centre. As can be seen, the central region is in by far the worst situation, doubtless because it has benefited far less from transfers than certain provinces in the west. One of the central provinces, Henan, had the lowest expenditure per primary school pupil (RMB 663), which was less than one tenth of the level in Shanghai, the province that spent the most on primary education, at RMB 6,733 per pupil in 2004.

The shortfall in rural primary school expenditure per capita, compared with the regional averages, is most pronounced in the east, but this largely reflects the fact that the urban population accounts for a much higher proportion of the total population in that region compared with the west and centre. However, urban/rural expenditure disparities have been reduced somewhat in the western and central regions through the transfers made by central government to poor rural areas in these regions (in particular the west) for the promotion of universal compulsory education.

²⁴ In the urban areas, children of compulsory education age who live in families receiving minimum standard of living assistance will also be entitled to the ‘two frees and one subsidy’.

Figure B-11 On-budget expenditure per pupil in compulsory education (2004)
(RMB)



Source: Unweighted averages calculated from data from *China Educational Finance Statistical Yearbook 2005*, Finance Department, MOE, Social, Science and Technology Department, China Statistics Press, April 2006.

The disparities are more pronounced in the case of expenditure per pupil in lower middle school. In 2004, on-budget expenditure per lower middle school pupil in the eastern region was 1.7 times higher than in the north-east, 1.7 times higher than in the west and 2.8 times higher than in the centre. Once again, the centre was in by far the worst situation. Henan was also the province with the lowest expenditure per pupil (RMB 773), nine times less than in Shanghai (RMB7,014)

The gradual elimination of all fees and charges in compulsory education in the rural areas, which has been gradually extended since 2004, implies the need to increase government expenditure substantially, as fees paid by households account for 10% of total expenditure on compulsory education in rural areas, according to data for 2003 (see Table B-4). Put another way, government expenditure on compulsory education in the rural areas would have to rise by 12% (based on 2003 levels of expenditure) simply to maintain total education expenditure constant. It was announced in the 2006 budget that government expenditure on rural education, excluding expenditure on teachers' salaries, would increase by RMB218.2 billion over the five years from 2006 to 2010. On an annual basis this would be equivalent to about 0.2% of GDP in 2005.

Table B-4 Expenditure on primary and junior secondary education (2003)
(RMB 100 million)

	Total (public & private)	Government expenditure	On-budget expenditure	Tuition & miscellaneous fees	Other education funds
Total	6,208.3	3,850.6	3,453.9	1,121.5	1,236.1
Compulsory education	2,538.3	1,984.4	1,789.3	225.6	328.3
Rural compulsory education	1,365.3	1,142.8	1,094.3	134.3	88.2
% share of compulsory education	40.9	51.5	51.8	20.1	97.4
% share of rural areas in compulsory education	53.8	57.6	61.2	59.5	78.9

Source: Calculations based on data from *China Statistical Yearbook 2005*.

If this is not to become an additional burden on sub-national governments, central government will have to provide most of the additional resources and direct these to the county and township levels. The State Council issued a notice in 2005 on the financing of rural compulsory education, announcing new funding mechanisms that were due to start in early 2006 and be fully in place by 2010 (State Council, 2005a). The fiscal burden of waiving tuition and miscellaneous fees will be shared between the central and sub-national governments according to a fixed ratio of 8:2 in the western region and 6:4 in the central region. The sharing ratio for the eastern region is to be determined on a case by case basis according to local fiscal circumstances. The financing burden for providing free textbooks is to be fully borne by the central government for the central and western regions, while sub-national governments will have to shoulder the burden for providing subsidies for boarding costs.

This document also stated that the financing of operating expenditures in rural primary and junior middle schools will be shared using the same ratios as for tuition and fees. In 2009, the central government will establish a standard fixed amount for per capita operating expenditure. Central and sub-national governments will share equally the financing burden for reconstructing school buildings in the central and western regions. Central government will continue to provide support through transfers to ensure the full and timely payments of teachers' salaries in the central and western regions and some areas in the eastern region. Provincial governments were called upon to increase transfers to poor areas.

The newly revised Compulsory Education Law, issued on 29 June 2006 and effective from 1 September 2006, adds a chapter on the financing of compulsory education, which requires all levels of government to integrate fully the financing of compulsory education into their respective budgets. As for the sharing of financing responsibilities among the different levels of government, the law reaffirms the notice issued by the State Council in 2005 on the financing of rural compulsory education. The law also calls for an increase in general transfers and the regularization of earmarked transfers targeting compulsory education.

Box B-2 Financing services for migrant children

As the migrant child population increases rapidly with urbanization, ensuring equal access by migrant children to high quality compulsory education and affordable healthcare is becoming a key challenge. At present, earmarked transfers for the promotion of universal compulsory education and schemes like the RCMS, which are exclusively targeted at rural areas, do not take into account the urban poor and their children, including the large and growing migrant population.

The fact that the current transfer funds do not target the migrant population is one of the main gaps in the current financing arrangements. This is exacerbated by poor data on the migrant child population, due to inadequate coordination among government agencies, and the traditional reliance of budget planners on population data for the resident population in the urban and rural areas without taking into account population shifts caused by migration.

At the time of the 2000 census, migrant children numbered 23.6 million or about 7% of the total child population (see Introduction), and this segment of the child population is especially disadvantaged, with higher drop-out rates than for urban resident children, partly due to financial difficulties in paying school fees. According to a study on migrant children in nine cities, conducted in 2002-2003, the proportion of migrant children out of school rises from 0.8% at age 8 to 15.4% at age 14 (NWCCW, CNCC and UNICEF, 2003).

Although government regulations and policies require urban host governments to facilitate compulsory education for migrant children and explicitly prohibit the levying of discriminatory fees, the extra financial burden on urban governments and schools often makes it difficult for them to provide equal education opportunities for these children. According to the survey cited above, migrant children pay on average RMB856 more than resident urban children to attend school as a result of various supplementary fees charged by schools (temporary study fees, supporting fees and administrative fees).

Furthermore, many migrant children have to resort to inferior private schools set up to cater for migrant children. Migrants and their families are also rarely covered by urban medical insurance schemes, which in the urban areas are mainly based on permanent residence registration and long-term formal employment. At the same time, as a result of their departure from the rural areas, they cannot easily benefit from the RCMS. The lack of a unified medical insurance system, covering the whole country, including both urban and rural areas, leaves migrants and their children more or less entirely dependent on 'out-of-pocket' expenditure for healthcare.

Health services

Government financing plays a key role in ensuring the provision of equitable and efficient health services for all, including children. There are three basic arguments for the public financing of quality health care (Gottret and Schieber, 2006):

- (i) the need to mobilize sufficient resources to provide the population with a basic package of essential health services and financing security against catastrophic medical costs in an equitable, efficient and sustainable manner;
- (ii) the need to pool health risks equitably and efficiently;
- (iii) the need to ensure that the delivery of health services is allocatively and technically efficient.

As in the education sector, government expenditure on health services is highly decentralized. This has resulted both from the broader decentralization of public finances and from the reforms in the

health sector, which have also resulted in marketization and heavy dependence on private 'out-of-pocket' expenditure on healthcare. While the ratio of national health expenditure to GDP rose from 4.0% in 1990 to 4.75% in 2004, during the same period the ratio of government health expenditure to GDP declined from 1.01% to 0.81%. The share of health in total government expenditure remained fairly stable (3.5% in 2003 compared with 3.2% in 1990). Moreover, by 2004, sub-national governments accounted for 97.8% of government recurrent expenditure on health. The overwhelming majority of this expenditure is concentrated at prefecture level or below. This situation contrasts with that in most developing, middle income countries, where the government share in national health expenditure tends to be much higher and is concentrated mainly at the central and provincial government levels.

Given this decentralization of expenditure, the disparities in economic development and fiscal capacity place the poorer and less developed areas in China at a considerable disadvantage in the financing of health care. Not only is private household capacity to pay for health care much lower in these areas, but local government resources are lower too. A key issue therefore is the extent to which fiscal transfers contribute to overcoming these disparities and ensuring equal access to health services, including the services of most importance for children.

The remarks made above on general subsidies apply as much to the health sector as they do to the education sector. Tax rebates account for the bulk of general subsidies and are not equalizing, and the revenue capacity-raising subsidies are not necessarily used to boost the proportion of local government spending on health or other social services. Incentives are often stronger to use the increased resources for general administration or economic development.

Following the SARS outbreak in 2003, the Ministry of Finance and the Ministry of Health set up an ad hoc office in 2004 to coordinate the rising volume of central government's earmarked health sector transfers, which increased from RMB 1.0 billion in 2003 to RMB 4.6 billion in 2004. This included RMB 4.0 billion for projects and RMB 0.3 billion for the new Rural Medical Cooperative System (RCMS) in the central and western regions and RMB 0.3 billion for medical aid to the poor.²⁵ The government has announced (in the prime minister's work report to the NPC in March 2006) that it will provide transfers totalling RMB 20 billion for health infrastructure and facilities projects in township and county hospitals during the five years from 2006 to 2010 (i.e. about RMB 4 billion a year) and also double transfers for the RCMS in 2006.

²⁵ Data from *China Finance Yearbook 2005* (MOF, 2005). The transfers for projects were directed primarily to county governments (45%) and township governments (40%), while prefecture governments received 13.2% and provincial governments 2.2%. The projects covered six areas: (1) support for treatment capacity in county hospitals in the central and western regions and the treatment capacity in ethnic minority prefectures; (2) enhancement of the capacity for enforcement of health laws and regulations; (3) rural health system building, including three projects: rural health services and the new Rural Cooperative Medical System; the reduction of maternal mortality and neonatal tetanus; rural water and sanitation improvement; (4) catastrophic disease control and prevention, including seven projects, covering HIV/AIDS, tuberculosis, SARS, immunization and endemic disease; (5) building of the management system for food and drug monitoring and supervision; and (6) support for building management capacity for rural traditional medicine at county level.

A substantial increase in central government earmarked transfers will be required to cover the costs of the local government's commitment to co-finance the RCMS. Initially set at RMB 10 per person in 2003 (for rural areas in western and central China), the central government contribution was raised in early 2006 to RMB 20 per person. Local government contributions (distributed between provincial, prefecture and county governments) match those of the central government. Assuming RCMS coverage reaches 80% of the rural population by 2010, as targeted in the 11th Five Year Plan, the cost of meeting the central government's co-financing commitment would rise to RMB 23 billion a year by 2010 at the current levels of contribution. This is still relatively small: it would be equivalent to slightly less than 0.1% of projected GDP in 2010. This suggests that it would be affordable for the government to increase its contribution beyond RMB 20 per person, in order to increase the level of reimbursements for catastrophic medical coverage, extend reimbursements to out-patient costs and also lessen the co-financing burden on local governments.

While the full implications of the new developments in RCMS financing cannot be assessed at this stage, it is clear that fiscal transfers have hitherto been far too low to overcome geographical disparities in health expenditure. In total, earmarked health sector transfers accounted for only 3.6% of total government health expenditure in 2004.

Data from the 3rd National Health Service Survey (MOH, 2004b) clearly show that there are huge geographical disparities in health expenditure per capita, including in MCH expenditure, providing strong evidence that transfers do not succeed in equalizing access to services. According to the survey, recurrent expenditure by MCH centres in urban areas was 7.2 times higher than MCH centres in rural areas in 2002. The urban/rural ratio of expenditure on drugs was slightly higher (8.2). The MCH centres in the least developed rural areas ('type 4 rural areas') had by far the lowest levels of expenditure. Recurrent expenditure per MCH centre in the urban areas was 30 times higher than in the rural type 4 areas, with expenditure on drugs 20 times higher. This is one of the underlying reasons why there are major disparities in health indicators, including maternal and child survival indicators, in different parts of the country, with under-five and maternal mortality ratios more than five times higher in rural type 4 areas than in the urban areas (MOH et al, 2006).

Overall, there is much still to be done to establish an adequate legal and regulatory framework for the financing of health services, whereas in the education sector the challenge is now mainly one of effective implementation of the regulations already issued. Up to the present time, nine health-related laws have been approved by the NPC and 27 policies and regulations have been issued by the State Council. The Ministry of Health (MOH) has issued some 400 sector regulations and set some 1,500 health standards. Provincial governments have also issued many local health regulations. The 11th Five Year Plan requires in general that governments at different levels increase their inputs and meet their responsibilities for the provision of public health

services and basic medical care, while adding that the framework for sharing responsibilities and financial inputs should be clarified. Unlike in the case of education, the 11th Five Year Plan does not specify a target for the ratio of government health expenditure to GDP. MOH is now working with NPC to draft a basic health care law for the first time. Hopefully, this law will help to clarify the financing assignments for basic health services, including maternal and child health care, among the different levels of government.

4 Conclusions and recommendations

4.1 Conclusions

The Chinese Government shares a common vision with UNICEF and is firmly committed to achieving the Millennium Development Goals (MDGs) and the goals for children set out in the National Programme of Action for Child Development (NPA) and the 11th Five Year Plan. This commitment to children is a key part of the national development vision of a *xiaokang* society, which is a human-centred vision and one that, through the concept of the five balances, places great emphasis on the importance of social development, as well as balanced development between urban and rural areas and among and within regions. The Chinese government has issued numerous laws, regulations, policies, plans and projects to provide services for children, especially compulsory education and maternal and child healthcare.

One of the main challenges is to translate these goals and targets into operational strategies and ensure that they are adequately reflected in planning and budget allocations, so that plans and budgets become effective tools for operationalizing the *xiaokang* vision and achieving the goals for children. At present, although the goals of the NPA for Child Development are reaffirmed in the 11th Five Year Plan, it is not clear that the NPA is properly taken into account in the process of annual planning and budget formulation. Moreover, most policies and regulations do not specify how the financing to achieve social policy objectives is to be mobilized and shared by different levels of government, although a notable recent exception has been the government's announcement in 2005, reaffirmed in the newly revised Compulsory Education Law in 2006, about the sharing mechanisms for financing compulsory education, which provides the best model for future improvement.

A number of important improvements in the budget system have taken place in recent years and more are on the drawing board. Considerable progress has been made in reducing the scale of extra-budgetary revenue and expenditure flows. A new, more modern budget classification system is to be introduced in 2007. And the Ministry of Finance is preparing, with the Budget Committee

of the National People's Congress, revisions in the Budget Law along with a new law on inter-governmental fiscal transfers.

However, some important problems remain and these have major implications for the financing of services for children. These concern the fragmentation of the budget process, weaknesses in budget methodology and the inadequacy of inter-governmental fiscal transfers as a mechanism for equalizing revenue capacity and thus ensuring equity in the geographical distribution of expenditure on services.

Fragmentation of the budget process. While considerable progress has been made in reducing off-budget revenue and expenditure flows, these remain significant, particularly at the local level, where they accounted for 22% of expenditure in 2003. This means that budgeting is not yet fully unified, which compromises budget transparency and the rationality of allocation decisions. The budget process is further fragmented by the fact that the review and approval of the budget proposals from line ministries as well as their local branches are not fully integrated: different government agencies perform this role for capital expenditure and some other categories of expenditure, in addition to the Ministry of Finance and local finance departments. This may be one of the reasons why there are sub-optimal input mixes, including in the social sectors, with schools and hospitals for example under-funded for non-personnel operating expenditure and maintenance.

Weaknesses in budget methodology. It is expected that the new classification system will introduce modern economic and functional classification codes that will make it much easier than in the past to analyse the effectiveness and efficiency of expenditure and thus to make evidence-based budget decisions. However, this may be insufficient to undertake performance evaluation of expenditure, including on services for children, from a results perspective. This would require a results-based planning and budget methodology with a programme classification system, a fully developed indicator framework and adequately detailed and disaggregated data, as well as the development of a strong 'results culture' among civil service managers.

There is still a tendency for budgeting, especially at the lower levels where most of the public financing of services for children takes place, to be conducted in a largely incremental manner without reviewing the pattern of allocations to take into account the changing situation and the evolution of objectives and priorities. This has made it difficult to adjust spending to reflect the new priorities resulting from the greater emphasis on social development in the *xiaokang* vision. The scope for such adjustments is also limited by the lack of a rolling multi-year fiscal framework, since adjustments need to be planned over a longer term timeframe than is possible in the framework of the annual budget.

These weaknesses have made it difficult to achieve key expenditure targets for children, such as the increase of government expenditure on education to 4% of GDP and the increase in the share

of maternal and child healthcare to 10% of government health expenditure, and also hinder the planning needed to ensure that the roll-out of the new expenditures required to achieve universal compulsory education and the expansion of the RCMS do not add to the fiscal burden on sub-national governments. Although there is no official target for overall government expenditure on health, a medium term fiscal framework would also allow the government to plan for a substantial increase in its share of national health expenditure in order to reduce the burden of private 'out-of-pocket' health expenditure, which is much higher than in other middle income developing countries and a barrier to access, as well as one of the main factors for the very high savings rate which is holding back consumption demand and impeding sustainable long-term economic growth.

Weak equalizing effects of inter-governmental fiscal transfers. The 1994 fiscal reform recentralized government revenues but did not reassign expenditure responsibilities among central and sub-national governments, leading to a major vertical imbalance in central and sub-national budgets. Lower level governments, especially county governments, shoulder the bulk of the expenditure responsibility for compulsory education, MCH care and other essential services for children. At the same time, the major differences in levels of economic development across the country mean that there are large horizontal imbalances in revenue capacity among and within regions and between urban and rural areas.

The government has tried to overcome these imbalances through fiscal transfers, but the equalization effects have been limited. First, the predominance of tax rebates in general subsidies reinforces rather than reduces existing revenue disparities. Second, equalization subsidies are often not used to give social service delivery higher priority, despite the 'five balances', because of the incentives to cover administrative costs, including staff salaries, or to prioritize economic development and job creation over social development.

Special-purpose, earmarked transfers in the social sectors have played an important role in promoting universal compulsory education and are set to increase as the policy of waiving all fees for compulsory education is extended throughout rural China. But, overall, transfers have not been sufficient to overcome the large geographical disparities in expenditure per pupil. Earmarked transfers have played a much smaller role in the health sector and, although these will increase to support the expansion of the RCMS, there are huge disparities in expenditure on MCH services between urban and rural areas, with expenditure in the poorest 'type 4' rural areas far below that in more developed rural areas and in the cities. Finally, transfers have not been used to support the access of migrant children to services in urban areas – an important gap in the current financial arrangements, since migrant children are one of the most disadvantaged sections of the urban population, facing inequalities in access to compulsory education (and higher school drop-out rates than urban resident children) and no opportunities to access health insurance.

In short, the Chinese government gives priority to services for children, including compulsory education and MCH care, which are rightly seen as essential elements in a human-centred approach to development. It is also firmly committed to achieving more balanced development and equity in the provision of social services, as part of the *xiaokang* vision. However, there is still some way to go to ensure that the planning and budget system works effectively to align allocations with these objectives.

4.2 Preliminary recommendations

This study was an initial step in a process of policy-oriented research and was based on a review of existing literature and publicly available data. The proposals set out here should therefore be seen as preliminary suggestions based on the conclusions of the desk study. They are quite broad in nature and they will need to be developed further on the basis of in-depth research, including research carried out in the field, particularly at the county level, where most expenditure on services for children takes place.

1. ***Strengthen the linkages between policies, regulations, plans and budgets.*** In order to reflect fully the government's commitments to children, as set out in the NPA and incorporated into the 11th Five Year Plan, more attention should be given to ensuring that these are reflected in the annual development plans and annual budgets. This may require measures to improve coordination in this cross-cutting area among NWCCW, NDRC, the Ministry of Finance and pertinent line ministries, as well as to strengthen the analytical capacity of key departments within them to address planning and budget issues concerning services for children. NWCCW and its sub-national equivalents need to be fully involved in reviewing all overall development plans (both long-term and annual) as well as annual budgets during the formulation stage. MOF's role in understanding and coordinating public expenditure on services for children needs to be strengthened, perhaps by establishing a special cross-departmental unit for this purpose.
2. ***Unify the budget process.*** To achieve transparent rational budgeting, it is necessary to bring all revenue and expenditure into a single unified budget framework. The progress in reducing extra-budgetary revenue and expenditure flows needs to be stepped up, especially at the sub-national levels. At the same time, it is important to integrate the budgeting for recurrent and capital expenditure, so that these are mutually consistent. This means delegating to the Ministry of Finance the power for overall and comprehensive management of government resource allocation. Due to historical reasons in China, it will take a long time and a complicated process to integrate the responsibilities for allocating government resources.

3. ***Adopt a multi-year fiscal framework to facilitate budget planning.*** International best practice suggests that a rolling multi-year fiscal framework would be beneficial for medium/long term budget planning. The fact that some key public expenditure targets (e.g. the ratio of education expenditure to GDP and the share of MCH services in health expenditure) have proven elusive over many years underscores the need to plan these shifts in expenditure over a multi-year horizon, on the basis of a forecast resource envelope and policy priorities. To do this in the framework of annual budgeting alone is extremely difficult because of the inherent rigidities in the short term. This would also help to plan the sharing of expenditure responsibilities among the different levels of government so as to avoid over-burdening lower level governments.
4. ***Strengthen performance evaluation.*** To enhance accountability and improve incentives for government agencies to use government resources efficiently and effectively to provide quality services for children, a performance indicator framework is needed, along with adequate data, as well as appropriate criteria for the evaluation of government agencies and officials.
5. ***Consider a results-based planning and budget methodology.*** This would make it possible to link inputs to the achievement of policy objectives and outcomes, such as the reduction of child mortality or the achievement of universal compulsory education. It would require the development of a meaningful set of programme classification codes and training of officials in their use, as well as broader efforts to develop a 'results culture' in the civil service.
6. ***Provide more detailed data on the financing of services for children. The government*** should publish more detailed, disaggregated statistical data on public expenditure on education, health and other services of importance for children. Key fiscal data on services for children should also be integrated into the NPAInfo data-base established by the National Bureau of Statistics for monitoring of the NPA. These measures could be replicated at sub-national levels. For planning and budgetary purposes it is also urgent to ensure the full inclusion of migrant children in statistics on population groups requiring services in urban areas.
7. ***Further rationalize inter-governmental fiscal relations.*** To overcome the vertical and horizontal fiscal imbalances, which result in major disparities in expenditure per capita on essential services for children, it is necessary first of all to review and define clearly the expenditure responsibilities of different levels of government with respect to compulsory education, MCH care and other services. This should be followed by a review of the different types of inter-governmental fiscal transfers, with a view to introducing improvements that would enhance the equalizing effects of transfers.

8. The aim would be to overcome the disparities in expenditure per capita on key services of importance for achieving the national and international goals for children. Attention should also be given to extending earmarked transfers to support access to medical insurance and compulsory education by migrant children and other poor urban children, as well as children in the rural areas. However, besides using earmarked transfers to support the achievement of specific policy goals, the government could also use general transfers (or block grants) for this purpose so long as these transfers are clearly oriented to resource equalization objectives and are accompanied by changes in incentives to local officials to give greater priority to social development goals, including universal compulsory education and affordable access to MCH care and other essential services. The fact that a revised budget law and a new transfer payment law are now in preparation provides an opportunity to introduce the necessary changes in the purpose and nature of fiscal transfers.

4.3 Proposals for future research

This report is the result of secondary research based on publicly available data and documents, as well as published research. Follow-up primary research will be needed to obtain more in-depth understanding of the issues that affect the financing of services for children. Since sub-national governments, in particular county governments, play the key role in financing compulsory education, MCH care and other services for children, field studies at these levels will be crucial. For comparative purposes, it is recommended to undertake these studies in a balanced sample of counties with different levels of economic development, tax revenue and child service outcomes.

Specifically, it is suggested that follow-up research focus on the following seven areas:

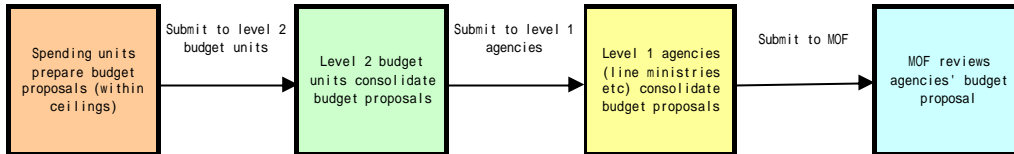
1. *Children's issues in plans and budgets.* It would be valuable to assess whether and how the long-term and annual overall development plans and annual budgets at different government levels address the goals and targets for children, with a view to making proposals on how this could be improved.
2. *Standards for government expenditure on services for children.* Through detailed research on actual expenditure levels on inputs for key services, along with cost-benefit analysis of expenditure, it would be possible to establish normative standards for levels of expenditure on key services for children.
3. *Expenditure responsibilities for services for children.* It is necessary to understand better the distribution of responsibilities, especially for compulsory education and MCH care, between different government levels, so that their respective roles can be more rigorously defined.

4. ***Purpose, nature and effects of fiscal transfers.*** Follow-up research, conducted mainly at the sub-national level, could investigate in more detail the role of different types of inter-governmental fiscal transfers, their value, the basis on which they are calculated and their effects on the equalization of resources and expenditure on services for children. The aim would be to make evidence-based proposals for improvements in the fiscal transfer system to help reduce the disparities in expenditure on these services.
5. ***Financing of services for migrant children.*** In 2002-2003, NWCCW, China National Children's Centre (CNCC) and UNICEF jointly conducted a study on the status of migrant children, including issues concerning education and health, in nine cities (NWCCW et al, 2003). There have also been other localized studies on migrant children's access to services. However, there has not yet been an in-depth study on the planning and financing issues concerning migrant children's access to government schools, medical insurance and other services in urban areas. Such a study should be a high priority.
6. ***International comparative experience.*** Useful insights could be obtained from laws, regulations and procedures used in other major developed and developing countries, particularly regarding the nature of fiscal transfers, the utility of medium term fiscal frameworks and experience with programme based budgeting, as tools for achieving sustainable and equitable budget outcomes.

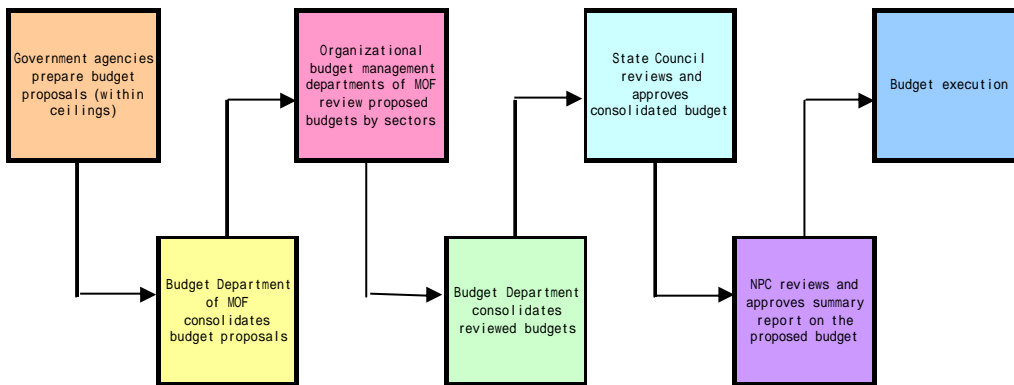
Annex

Procedures for budget formulation and approval

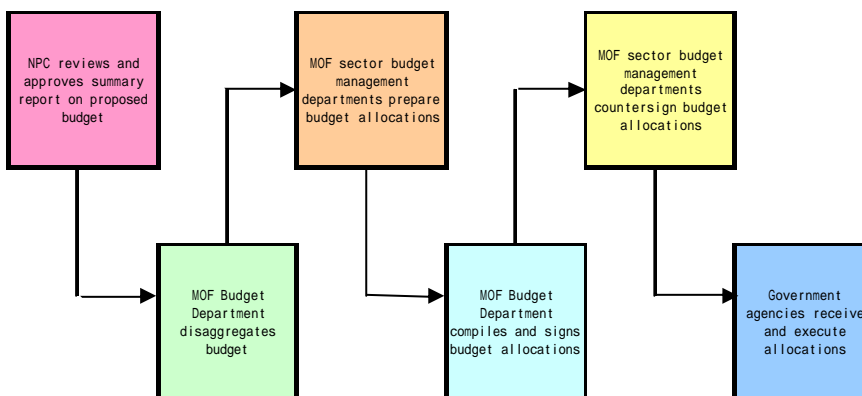
Procedure for preparation of budget proposals by government agencies



Procedure for MOF review of agencies' budget proposals and submission of consolidated budget to the State Council and NPC



Procedure for MOF's assignment of budget allocations after NPC approval of budget



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