

THE EFFECTS OF REFORM ON CHINA'S PUBLIC BUDGETING AND ACCOUNTING SYSTEM

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18.1. Introduction

Government accounting in the West does not have an exact counterpart in China. After the People's Republic of China (PRC) was established in 1949, 'government accounting', being associated with the previous regime, with its Western capitalist orientation, was replaced by socialist 'budget accounting'. The latter, with its explicit recognition of the vital role of the government budget in a planned economy, has been in use in China for almost fifty years. During its first three decades, the PRC had a highly centralized system, with the national government monopolizing virtually all aspects of the economy and the public sector. However, since 1978 market reform has gradually reduced the primary role of the state (including state owned enterprises) as the producer of goods and services. More recently, the central government has transferred some taxing authority and service responsibility to provincial and local governments.

These economic and institutional reform measures have affected virtually every aspect of the Chinese public sector economics and finance, including budget policy and accounting standards. This paper extends a series of papers that have examined the history of Chinese government accounting (Chan, 1995), new budget law (Chan, 1996), governance (Chan, 1997), and offbudget resources (Chan, 1998). Its primary purpose is to explore the relationship between economic and institutional reform and China's budget policy and accounting standards, while incorporating the most recent developments.

Section 18.2. will describe the reform measures, with an emphasis on their effects on government functions. Sections 18.3. and 18.4. will analyze how the changes in government functions have affected budget policies and accounting standards. The final section will argue that the future success of reform in China will depend on the development of the institutional infrastructure that delineates and enforces accountability.

18.2. Economic and Institutional Reform in China

Reform in China has radically altered the relationship between the government and the rest of the economy as well as the rules of the game (Schell and Shambaugh, 1998). A command economy that relied on allocations from the top has been gradually replaced by a competitive market economy mediated by exchanges. Direct state control of business enterprises is being replaced or at least supplemented by incentive contracts, resulting in a greater autonomy in decision making and management at the enterprise level. While most public attention has focused on the emergence of a robust private sector in China, the restructuring of the public sector is no less remarkable. Financial burden and service responsibility have shifted from the central government to provincial and local governments, thus profoundly changing the dynamics of domestic economy and politics. In this section, we will focus on the changing functions of government in China.

18.2.1. FROM HIERARCHY TO AN 'ONION'

In an earlier paper (Chan, 1996), one of us has argued that the governance structure of China was changing from a hierarchy to one resembling an onion. Certainly the hierarchy still characterizes the formal structure. In a constitutional and political sense, the Chinese Communist Party (CCP) reigns supreme in policy making in China. The governmental structure itself is hierarchical. The Central Government ranks above provincial and local governments. At least constitutionally, the People's Congress oversees the executive branch and is increasingly assertive. The executive branch is organized as a hierarchy of administrative units. It is worth noting that an administrative unit can be very powerful by virtue of its authority to own or regulate state owned enterprises (SOEs) in a particular industry (e.g, transportation) or service institutions in a particular field (e.g. higher education). In the finance area, the State Planning Commission is extremely powerful in determining the basic direction of economic policies and approving major construction projects. In day to day operations, the Ministry of Finance oversees an extensive network of finance bureaus all over China. In the Chinese system, public finance agencies retain a remarkable degree of independence from the line agencies, which receive their appropriations from the finance bureau at the same level of government.

While the hierarchical arrangement still applies to the administrative units at the core of government, it no longer adequately describes the emerging realignment of social, economic and political institutions in China. This realignment may be best described as changing from a hierarchy to concentric circles like rings of an onion. The administrative units and the underlying Communist party policy-making structure will continue to function as a command center for governing China. However they are encircled by several organizational layers. The inner-most layer consists of public enterprises and institutions wholly owned by the state and directly controlled through administrative directives. The next outer layer consists of the quasi-public enterprises and institutions partially owned by the state. Under the new governance structure, profit or return on investment has begun to replace procedural control. Management is given a higher degree of discretion in running these entities and is free from frequent reporting requirements imposed on administrative units by accounting rules. Here we reach the outer parameter of what may be properly called the public sector. In the outer rim are private sector business and households whose economic conduct is regulated by law and contracts.

18.2.2. CHANGES IN GOVERNMENT FUNCTIONS

China is building a socialist market economy on the foundation of an orthodox socialist economy. Public ownership used to dominate the entire national economy, producing most of the goods and services. Social order was highly regimented. The social and economic functions of government are joined together. The economy as a whole may be characterized as 'government owned and government operated' (GOGO). State owned enterprises, being the extensions of government ministries, assumed the 'cradle to grave' caring of their employees, thus performing many social welfare functions of the state. It was hardly possible to differentiate the political, social welfare and economic functions of the state. In keeping with the dominant role of the state, the guiding principle of Chinese public finance for decades was 'unified expenditures and revenues'. This means

the central government exercised a virtual monopoly over revenues and allocated budgetary resources to provincial and local governments (Wong, Heady and Woo, 1995).

That has changed under the unique system of socialist market economy with Chinese characteristics. China is attempting to retain the egalitarian features of socialism and introduce a competitive capitalist market economy (Naughton, 1998). It recognizes that all governments retain the ultimate responsibility for the people's general welfare. However, as a departure from the orthodox socialist system, the Chinese government has turned to market system for solving the nation's economic problems. The government retains the macro regulatory function, and refrains from direct control of micro economic activities at the enterprise level. The hope is that a market economy operating under state guidance and indirect control would satisfy the socialist ideals and take advantage of capitalist incentives (Cong, 1998).

China has pragmatically and gradually separated business from politics, and ownership from management. The CCP intervenes less frequently and forcefully in the operations of state owned business enterprises. While the state retains ownership of public property, it is increasingly willing to assume the role of investor, leaving business operations to professional managers. This system may be called 'government owned and contractor operated' or GOCO. The contractor is responsible for earning a negotiated rate of return on the state's investment and is allowed to retain the residual income. In order to be competitive, the cost conscious businessmen are disinclined to assume the social costs of life-time employment and an inefficient work force (Kemen, 1998; Tyler, 1998; Cheng, 1998). As a consequence, China's state welfare system has come under tremendous pressure from the almost 12 million unemployed in urban areas alone and 110 million people covered by the state pension system (Harding, April 14, 1999, p, 1).

In sum, the Chinese public sector is reinventing itself by shedding money losing state enterprises while keeping healthy and critical ones, by getting out of daily operations while strengthening regulatory regimes and macroeconomic fine tuning, and by devolving functions to lower-level government. By necessity, the public budgeting and accounting systems have to adapt to the new environment. The adaptations are described in the next two sections, beginning with the public budgeting system.

18.3. Budget System Reform

Reform has affected the Chinese public budget in four major ways; (1) the scope and the proportion of resources commanded by the public budget have been reduced; (2) multiple budgets have replaced the unitary budget; (3) offbudget funds have either been eliminated or placed under more rigorous control; and (4) state regulation of nonbudget funds has been tightened.

18.3.1. BUDGET SCOPE AND RESOURCES

Economic reform has greatly affected China's government finances. Government revenues increased more than six folds from 113.2 billion RMB in 1978 to 736.7 billion RMB in 1996 (approximately 8 RMB equal to US \$1). As a percentage of GDP, however, it declined around 30% in the late 1970s to between 20-30% in the 1980-86 period. It further dropped below 20% since 1987 and steadily declined during the last ten

years, reaching a low of 10-11% in the mid-1990s. This is a far cry from the situation in the pre-reform era. In 1960, nearly half of China's GDP was under government control (Cong, 1998, pp, 94-96).

Year	Revenues	Expenditures	Surplus (Deficit)	Debt
1970	66.3	64.9	1.35	
1971	74.5	73.2	1.26	
1972	76.6	76.6	0.07	
1973	80.9	80.9	0.09	
1974	78.3	79.0	(0.71)	
1975	81.6	82.1	(0.53)	
1976	77.7	80.6	(2.96)	
1977	87.4	84.3	3.09	
1978	113.2	112.2	1.02	
1979	114.6	128.2	(13.54)	3.5
1980	116.0	122.9	(6.89)	4.3
1981	117.6	113.8	3.78	7.3
1982	121.2	123.0	(1.77)	8.3
1983	136.7	140.9	(4.26)	7.8
1984	164.3	170.1	(5.82)	7.7
1985	200.5	200.4	0.06	9.0
1986	212.2	220.5	(8.29)	13.8
1987	219.9	226.2	(6.28)	16.9
1988	235.7	249.1	(13.39)	27.1
1989	266.5	282.4	(15.89)	28.3
1990	293.7	308.3	(14.65)	37.5
1991	314.9	338.7	(23.71)	46.1
1992	348.3	374.2	(25.88)	67.0
1993	434.9	464.2	(29.34)	73.9
1994	521.8	579.3	(57.45)	117.5
1995	624.2	682.4	(58.15)	155.0

Table 18.1: China's Government Revenues, Expenditures and Debt
(Amounts in Billions of RMB)

Source: *China Statistical Yearbook*, 1996, Table 7-3 for Revenues and Expenditures, Table 7-20 for debt.

Escalating expenditures have outpaced revenues, resulting in greater deficits (table 18.1.). For the first time, the budget deficit of the central government reached 150 billion RMB for fiscal year 1999, which is 57% more than the 96 billion RMB for last fiscal year (*Chinese American News*, March 12, 1999). In order to finance the deficits and stimulate economic growth, public debt increased from less than 10 billion RMB in 1985 to 155 billion RMB in 1995. Fortunately since China's GDP also increased during this period at annual rates between 20-35% a year, the debt to GDP ratio increased only from 1 percent to 2.7 percentage during those ten years.

The statistics cited above may be termed 'nominal' government revenues because they did not reflect such things as revenues off the budget (e.g. revenues collected and retained by local governments) as well as revenues regarded as nonbudget (e.g. local government special assessments). After adjusting for these items, which will be explained in the following sections, government revenues as a percentage of GDP increased from 22% to 34% in 1985 and from 11% to 22% in 1995 (Cong, 1998, p. 106).

Even so, the ambiguous and shifting boundaries of the public sector - both as a whole and in terms of its components - make it extremely difficult to interpret statistics about China's public sector. Does the public sector still consist of state-owned enterprises? How about the state-affiliated service institutions, such as hospitals and universities? Many of these institutions have created their own businesses. Many provincial and local governments set up financial institutions ('trust and investment companies') to borrow funds from domestic and foreign sources. When some of them collapsed, as in the case of Guangdong International Trust and Investment with US\$4.7 billion in liabilities and US\$2.6 billion in assets (Landler, April 23, 1999, p. C2), the question 'Whose debt is it?' was not satisfactorily answered.

As the public sector's share of GDP - nominal or real - declined, concerns have been expressed about how well a fiscally feeble central government can effectively regular a robust economy to achieve economic and social goals (Wang, 1994). These have led in part to calls to scrutinize and regulate resources that flow outside of the official budget.

18.3.2. OFF-BUDGET REVENUES

Offbudget revenues are collected and retained for use by local governments, administrative units and until recently by state-owned enterprises and their supervisory agencies. The original intent was to give these organizations a modest degree of fiscal autonomy over certain revenue sources. For example, local governments were allowed to add a surcharge to some taxes and keep the receipts. Administrative agencies were allowed to collect fees for services. Finally state owned enterprises were allowed to retain a percentage of profit for employee welfare and equipment replacement. The amounts of offbudget revenues were quite modest during the era before reform; about 35 billion RMB or about one third of onbudget revenue in 1978 (Cong, 1998).

Under tight budget allocations, entrepreneurial government officials had every incentive to diversify their revenues by imposing a great variety for fees for public services (Chan, 1999). State owned enterprises were already charging for their products and services. Discretionary income for their managers came from earnings retained for legitimate purposes such as employee welfare funds as well as for their own prerequisites. As a consequence, offbudget revenues exploded ten fold to almost 400 billion RMB in 1992, when they almost equal to the amount of onbudget revenues. As a product of local autonomy and entrepreneurial spirit, offbudget revenues were susceptible to misuse, abuses and outright misappropriations. This led to demands to rein them in.

In examining the SOE offbudget funds, it has been noted that the SOEs themselves were in effect moved outside of the purview of the state budget. As independent economic entities, they contribute to government revenues by paying corporate income tax. Consequently, their retained earnings should not be equated with the unremitted

revenues of governmental bodies. This reclassification reduced offbudget revenue by 242 billion RMB to less than 150 billion RMB in 1993 (Cong, 1998, p. 104).

New regulations have begun to emphasize that local government and administrative agencies are acting as agents of the state in collecting revenues. The money belongs to the state and may be spent only for public purposes. The intent of the new policy is clearly to take over what has become or at least perceived as the ‘private’ money of the collecting government unit. Judging from the continuous discussion of the issues, the control of these resources remains problematic.

18.3.3. NON-BUDGET RESOURCES

If budgeted revenues are the inner ring of the government revenue pie, offbudget revenues become the second ring. There still exists a third ring, the revenues outside of the government’s financial system, or nonbudget revenues. These are also fees and assessments collected by administrative agencies and local governments. It has been estimated that they amounted to 23 billion RMB in 1985 and rose to 384 billion RMB or equivalent to about 62% of government revenues in 1995 (Cong, 1998, pp, 104-105). These figures are probably the lower bounds in view of likely underreporting.

Ironically, the burgeoning amounts of nonbudget revenues are a byproduct of devolution of government functions to local governments. As they assume more responsibilities and undertake more costly projects, they are tempted to resort to whatever means of financing available. It has been estimated that there were several thousand types of fees, competing with taxes and adding to the people’s financial burden (Cong, 1998, p, 105). As there is even less transparency and accountability for these resources, nonbudget revenues are fertile breeding grounds for waste and corruption. Regulations have been enacted to bring nonbudget revenues into the fiscal system. Specifically, the imposition of fees requires the approval of the local People’s Congress (Cong, 1998).

18.3.4. BUDGETSIZE RECONSIDERED

The existence of large amounts of offbudget and nonbudget revenues has rendered budget numbers less meaningful indicators of the size of the Chinese public sector. Analysts have adjusted onbudget revenue figures to arrive at a more accurate estimate of the total amount of government revenues (table 18.2.).

Description	1985	1990	1993	1995
Nominal Amounts of Revenues	200.5	293.7	434.9	624.2
Subsidies for SOEs (1)	50.7	57.9	41.1	32.0
Offbudget Revenues (2)	27.7	63.6	143.2	240.4
Nonbudget Revenues	23.3	76.0	143.3	384.3
Actual Amounts of Revenues	302.2	491.2	762.5	1,280.9
Nominal Amounts of Revenues/GDP	22.4%	15.5%	12.6%	10.7%
Actual Amounts of Revenues/GDP	33.7%	26.5%	22.0%	22.0%

(1) Unlike the IMF-recommended practice of treating subsidies to state-owned enterprises as expenditure, the Chinese handled these as deductions from revenue.

(2) These originate from local governments and administrative units.

Table 18.2: Government Revenues of China (in billions of RMB, except %)

Source: Cong, 1998, Table 3-3, p. 104.

Original Source: *1996 Yearbook of Chinese Public Finance Statistics*.

The clarification of offbudget and nonbudget revenues has helped to delineate the scope and properly measure China's budgetary resources. Having dealt with the boundary issues, we next turn our attention to the question: Is the unitary budget concept still appropriate to the China that operates a mixed - socialist and market - economy?

18.3.5. MULTIPLE BUDGETS

Beginning in 1992, China's public budgeting system adopted the concept of multiple budgets to reflect the numerous and redefined roles of the state. The core of the state budget remains but it now separates regular expenditures and developmental expenditures. This has in effect created an operating budget and a capital budget. Another budget monitors the performance of business enterprises that use government-owned assets. A new social security budget has been created to take over the functions assumed by the social welfare funds scattered throughout the Chinese economy.

The transformation from a unitary budget to multiple budgets is an important step in the evolution of China's public budget. It seeks to balance consumption expenditures and development needs, It also enhances the transparency of financial distributions, revealing government fiscal activities and the causes of deficits, pushing the reform of the fiscal system, tax and investment systems, and the enterprise financial management system. Table 18.3. shows the operating and capital budgets for a recent year. The alert reader may notice that debt proceeds are improperly grouped under revenues in the capital budget.

Description	Amount
Current Revenues and Expenditures Item	
<i>Total Current Revenue</i>	601.9
Total Taxes	573.7
Subsidies for Lossmaking Nonproductive Enterprises	(13.5)
Adjustable Fund Revenue	3.5
Other Current Revenue	38.1
<i>Total Current Expenditures</i>	512.0
Non-productive Capital Construction Expenditures	25.3
Social Development and Welfare Expenditures	196.9
National Defense, Armed Police and Administration Expenses	158.3
Price Subsidies	36.5
Other Current Expenditures	95.0
<i>Current Budget Balances</i>	89.9
Constructive Revenue and Expenditures	
<i>Revenue</i>	
Current Budget Balances	89.9
Special Construction Revenue	41.6
Subsidies for Lossmaking Productive Enterprises	(19.3)
Sub-total Construction Revenue	112.2
Constructive Budget Balances	58.2
Total Revenue (Less Current Balance)	624.2
Debt Revenue	155.0
Domestic and Foreign Debt Revenue making up Deficit of Central Budget	66.3
Principal and Interest Payment on Domestic Debt Revenue	87.8
Borrowing from Abroad for Important Construction	0.4
<i>Expenditures</i>	
Production Capital Construction Expenditures	53.7
Technical Updates, Transformation and New Product Promotion Expenses	49.4
Expenditures Supporting Agricultural Production	22.1
City Maintenance Expenditures	28.6
Other Construction Expenditures	16.6
Total Construction Expenditures	170.4
<i>Total Expenditures</i>	682.4
Principal and Interest Payments on Domestic and Foreign Debt	87.8
Key Construction Projects Expenditures Using Foreign Debt	0.4

Table 18.3: China's 1995 Operating and Capital Budgets (Amounts in Billions of RMB)
Source: *China Statistical Yearbook*, 1996, Table 7-4

18.3.6. SUMMARY OF BUDGET CHANGES

Table 18.4. highlights the changes in China's public budgeting system that have resulted from the economic and institutional reforms. In general, the tight-knit unitary budget has become a set of budgets with specific objectives. The operating budget will focus on the core governmental functions of providing public goods. The capital budget will finance developmental projects. The state asset management budget in effect functions like a huge holding company, monitoring the contractors' return of investment on the nation's assets. Finally, the social security budget will become the safety net for the hundreds of millions of needy persons unloaded by business-minded enterprises unable or unwilling to assume the cost of caring for them.

	Pre-Reform	Reform Measures
Scope of the Public Budget	All encompassing: vertical integration of all levels of governments; horizontal integration of executive units, service units and business enterprise units.	From integration to combination: a system of shared taxes for all levels of government; privatization, from GOGO to GOCO, market exchange replacing top-down allocation.
Content of the Budget	Unitary Budget: unit budgets are aggregated at each level of government; the budgets of all local governments in a province are aggregated for approval by the province; all provincial budgets are aggregated for approval by the national government; a general fiscal budget allocates all budgetary resources.	Multiple Budgets: governmental budgets for carrying out state functions; state assets management budgets to control the use of state assets by business enterprises (GOCO); social security budget to take over the welfare funds administered by units (including state owned enterprises).
Offbudget Funds	Defined as resources permitted to be retained for spending by local governments, fees collected executive units; special funds maintained by supervisory executive units; social welfare funds.	All fees collected are to be included in the budget. Local off-budget funds to be included in the budgets of local governments; investments in enterprises or return to the Treasury; social welfare funds brought into the social security budget.
Non-budgetary resources	AH means of financing (including fees, borrowing) of local governments.	The levies of fees have to be approved through the legislative process; all financial resources subject to regulation and control.

Table 18.4: Changes in the Chinese Public Budget System

In light of these changes, what has become of the accounting system whose primary objective is to support budget execution? The next major section will attempt to answer this question.

18.4. Changes In Public Sector Accounting

18.4.1. INTRODUCTION

Chinese accounting standards have traditionally been grouped in three major categories; (1) accounting for budgetary resources administered by the Ministry of Finance and the finance bureaus at lower levels of government, (2) accounting for component units of government, and (3) accounting for business enterprises. This basic structure has not changed. However, component unit accounting has been subdivided into accounting for administrative units (such as the State Commission on Education) and accounting for service units (e.g. colleges and universities, research institutes). This change will be explained, as will some other substantive changes.

Before discussing the changes, it is important to acknowledge what has not changed. In the Chinese system of public finance, there exists a finance bureau in each government, with the Ministry of Finance at the top of the financial management superstructure. The Ministry of Finance and its local branches are responsible for budget preparation, distributing appropriations and the subsequent accounting and financial reporting. They are independent of the line departments and directly control the departments' fiscal affairs. This basic institutional structure has not changed. Neither has the strong budgetary control orientation of the accounting system maintained by the finance offices. After all, one of their primary missions is to execute the budget and report the results (Liu, 1997a and 1997b).

There is, however, a greater recognition that accounting can provide reliable information for macroeconomic regulation and for establishing fiscal policy. As the central depository of financial information, the budgetary accounting system is crucial for the implementation of financial policy. This was especially the case when local governments rely on the central government for their budgetary allocations. The decentralization discussed in the previous section has reduced the scope of control of the central government. However, the information system infrastructure is there to monitor the fiscal conduct of all governmental units (Liu, 1997b). A very important part of the infrastructure is the authority of the Ministry of Finance in setting accounting standards. We will now examine the extent to which these accounting standards have changed in response to budget changes and reform in general.

18.4.2. INCLUSIVE SCOPE OF ACCOUNTING

As discussed in sections 18.3.2. and 18.3.4., there were huge amounts of public sector resources lying outside of the official budget or even outside of the fiscal system. As long as accounting focused solely on budgetary resources, these would be resources - and liabilities - off the books of governments. The reform that drastically reduced the amounts of offbudget and nonbudget resources has brought them under accounting control. Specifically, all offbudget funds should be included in the budget and should be

treated as revenues in the accounts, and expenditures financed by them should be similarly included in the total expenditures.

There remains, however, the much bigger problem of liabilities left out of the governments' balance sheet. To what extent is government responsible for the debt incurred by quasi-governmental organizations? Given the fuzzy nature of these entities, the line of accountability is often unclear. The further development of accounting standards on liabilities will have to await the resolution of legal and institutional issues.

18.4.3. SEPARATE ACCOUNTING STANDARDS FOR SERVICE ORGANIZATIONS

As the market economy expanded in China, services that were previously provided free of charge are increasingly sold for a price. For instance, public universities are now charging tuition; hospitals are requiring fees; patients have to pay for prescription drugs. These are only a few examples. These organizations - called service units, implying that they are component units of government - are doing so by necessity. Fees from customers are needed to make up for declining government budget allocations or subsidies. The pace is likely to accelerate to meet the government's goal of placing these organizations on a self-sustaining basis in three years.

As service organizations operate more like businesses, their links to the state budget is weakened. This is acknowledged by separating out service institutions - though still called service *units* - from the government's administrative units for purposes of setting accounting standards (Liu, 1997c and 1997d). The responsibility for setting their accounting standards has been shifted from the Bureau of Budget Management to the Accounting Bureau, which promulgates business enterprise accounting standards. New standards have abolished the classification of service organizations as being wholly subsidized, partially subsidized or self-sustained units. This classification is becoming less meaningful as financial self-sufficiency is the goal. (It is possible that government grants will replace direct appropriations, as the government realizes the need for public subsidies in order to achieve social equity.) Finally service organizations are required to use the accrual basis of accounting, just as Chinese business enterprises already are.

The decision to distinguish service units from administrative units has more than symbolic significance. It recognizes that these two types of organizations are different: service units can sell tangible services - private goods - to identifiable customers. In contrast, administrative units are charged with the formulation and implementation of public policies, which are public goods. In addition, the decision recognizes that in a market economy, a service unit has become an economic entity with its own rights and obligations - i.e. assets and liabilities - and has to earn adequate revenues to meet its expense to survive as a going concern. This requires a fundamental examination of their accounting model.

18.4.4. NEW ACCOUNTING MODEL

The primary objective of the accounting system of component units used to be the monitoring of budget execution. Its accounting model was represented by the accounting equation: sources of funds - uses of funds = fund balance. This model remains valid for

administrative units. On the other hand, service organizations as autonomous accounting entities now require an accounting model represented by:

$$\begin{aligned} \text{Assets} - \text{Liabilities} &= \text{Net Assets, and} \\ \text{Revenues} - \text{Expenses} &= \text{Profit} \end{aligned}$$

This model is endorsed by the service unit accounting standards that went into effect in early 1998. These standards also require the double-entry bookkeeping system and the adoption of the accrual basis of accounting. These recording and measurement methods are the foundation for preparing the balance sheet and statement of operations. Readers in the West would readily recognize these as the fundamental features of the corporate financial accounting model, which is based on the reciprocal nature of market transactions and service delivery as the basis of revenue recognition.

The recognition of assets, liabilities, net assets, revenues and expenses as five elements of the new service organization accounting model represents a paradigm shift in Chinese public sector accounting. Service organizations are being transformed from cost centers to revenue centers whose survival depends on the ability to serve and get paid by customers. In an unfettered market economy, the ability to pay is the predominant criterion for the allocation of goods and service. It is almost inevitable that this will lead to social inequality, which would require government intervention in serious cases. Even Western capitalist countries do not practice a pure market model when it comes to the production and distribution of merit goods such as education and health. It is difficult to imagine China embracing the market philosophy so totally that it will abandon socialist ideals completely. China will constantly be forced to resolve the contradictions inherent in a 'socialist market economy'.

18.4.5. SUMMARY

In addition to the above major changes, the new standards made other advances as well. First, they identified qualitative characteristics of financial information, such as relevancy, comparability, uniformity, timeliness, transparency, proportionality, materiality, objectivity. Second, they reaffirmed the cost principle for recording assets. Third, they prohibited transfers to special purpose funds. Finally, service organizations are urged to develop better cost accounting systems to facilitate management planning and control (Liu, 1997a).

Table 18.5. summarizes the major changes discussed in this section.

	Pre-Reform	Proposed
Unit Accounting	No differentiation between administrative (executive) units and service provider units	Clear differentiation between administrative (executive) units and service provider units
Classification of Activities of Service Institutions	All activities classified as fully subsidized, partially subsidized, and self-sustaining	No classification by extent of subsidy; entire service institutions expected to be self-sustaining in three years
Offbudget Funds	Administrative fees are regarded as offbudget	Administrative fees are included in budget and subject to budgetary control
Recording Method and Accounting Equation	Single entry bookkeeping method	Double entry bookkeeping
Elements of Financial Statements	Fund receipts, fund disbursements, fund balance	Assets, liabilities, net assets, revenues, expenses/ expenditures
Basis of Accounting	Cash basis	Cash basis for executive units; service units may use cash or accrual basis of accounting

Table 18.5: Changes in Accounting Standards

18.5. Reform and Budgeting and Accounting

The economic and institutional reform in China during the last two decades has significantly altered the scope and function of the state, These have in turn had repercussions for public budgeting and accounting in China. We have found that public budgeting is more sensitive to environmental changes than accounting is. However, the effectiveness of budget reform depends in part on the availability of feedback information from the accounting system. Consequently accounting reform is at least as important as budget reform. While the budget remains an important fiscal policy instrument, there are also signs that the position of public sector accounting has been elevated. Market reform has created the need for reliable financial information for managing enterprises and institutions released from tight government control. Managerial accounting is ascending in importance as financial accounting has when firms try to raise capital from investors and creditors. As in the West, there is an emerging recognition of the importance of the balance sheets with information on assets and liabilities, away from the former exclusive emphasis on receipts and disbursements. As China engages in massive amounts of domestic and foreign borrowing for infrastructure development, the accrual basis becomes more imperative as it captures and presents information about long-term assets and liabilities.

18.5.1. PUBLIC POLICY ENVIRONMENT

The public budgeting and accounting developments in this chapter have taken place during a period when China was striking a delicate balance between the state, organizations and individuals. There is considerable concern over the ability of a weak state to ensure social and economic development. Within the public sector itself, the distribution between the central and local governments is a contentious issue. These financial issues cannot be resolved in isolation as they are intertwined with China's economic and institutional development. Currently, Chinese budget and accounting policies are based on the following premises (Liu, 1997a, pp. 16-17):

- Public ownership will remain the main foundation of the China economy.
- Economic order shall be maintained.
- Public property should be protected,
- Private enterprises should be promoted within the framework of state regulation.

According to Gao Qiang (Liu, 1997b, pp. 2-3), former director of the Bureau of Budget Management, budgetary accounting changes should be consonant with other economic, finance and institutional changes in China. Specifically, public officials are encouraged to manage their units rather than just relying on state appropriations. The supply model is being supplanted by an entrepreneurial model. In the new model, the former system of tight central control is giving way to the practice of generating, accumulating and effectively using wealth. Furthermore, financial management regulations are being codified and elevated to the level of legal requirements. The current system of direct control by administrative edict will also be replaced by decentralized monitoring.

In keeping with the urgency of transitioning to a market economy, Chinese enterprise accounting reform has proceeded at a fast pace. The reform of public budgeting and accounting could not go faster than the institutional reform. Furthermore, budget reform has moved ahead of public sector accounting reform. But progress has been made. Service institutions are viewed as more businesslike, rather than like government agencies. After three years, the umbilical cord feeding service institutions from the state budget would be severed, leaving these institutions to float or sink on their own. Almost inevitably these former cost centers of government would gradually (or suddenly as the case may be) become revenue centers, creating a 'fee for service' culture and economy. They may be forced to borrow and find resources for capital maintenance and expansion. All of these changes would lead to the need for meaningful balance sheet, income statements and cash flows statements, which are the core of business financial reporting.

18.5.2. BUDGETING AND ACCOUNTING AS 'INSTITUTIONAL INFRASTRUCTURE

Accounting is a social and institutional practice (Hopwood and Miller, 1994). As such many seemingly technical issues discussed in this paper reflect China's evolving institutional structure. China is still in the midst of developing an effective tax system, defining the authority and functions of central, provincial and local governments, a legal system that protects private and public property rights. Only recently has China revised

its constitution to recognize privately owned and managed economic entities as 'an important component of the socialist market economy' (*China Securities News*, March 17, 1999). These developments have - or should have - a direct impact on the resolution of accounting issues. Take the example of something as simple as the accounting equation: assets = liabilities + net assets. Before accounting measurement rules can be developed, property rights and financial obligations have to be recognized and enforced by the legal system.

By the same token, a strong accounting and auditing profession armed with rigorous standards and enforcement power is instrumental in cementing accountability relationships. The development of capital markets and lending on a commercial basis will enhance the leverage of investors and creditors. Investors and creditor will demand full financial disclosure. Transparency will be a key weapon for combating widespread corruption and other financial malfeasance. As analysts (Cheng, 1998; Oksenberg, Swaine and Lynch, 1998) have pointed out, effective public and private institutions will be essential for China's economic development. Budgeting and accounting are indispensable elements of the institutional infrastructure.

18.5.3. SUGGESTIONS FOR ACCOUNTING REFORM

Improving accounting policy and practice is a continuous process. China has made some initial progress; much more is needed to improve the performance of the Chinese institutions in the public and private sectors. We suggest that accounting policy makers pay greater to the following issues:

First, a closer coordination between budgeting and accounting reforms is required. For example, the requirement of a capital budget and social security budget is logically linked with the recognition of capital assets and long-term liability of government. The accurate determination of profits (or losses) of state-owned enterprise is essential for figuring out the amount of government subsidies and identify candidates for closing down. The resolution of these issues requires the cooperation of different agencies within the Ministry of Finance responsible for budgeting and accounting policies.

Second, budgeting and accounting for a variety of debts has become an urgent issue. By some estimates, public debt rose from 4.3 billion RMB in 1980 to 247.7 billion RMB in 1997. In recent years, budgeting and accounting standards have distinguished debt proceeds from revenues. Further research and standards are needed to go beyond bonded debt to recognize and measure many other liabilities, such as overdue salaries and wages, pension payable, social security benefits, insurance and loan guarantees. The bankruptcy and precarious financial condition of a number of huge investment and trust companies have exposed the government's vulnerability. These financial institutions, which borrow and invest billions are variously described as government owned, sponsored or related. Creditors have looked to their government backers only to face disclaimers.

The new requirement of the accrual basis will likely raise a host of implementation issues. Accrual is an illusive concept, and has been modified in varying degree for application in the public sector (Chan, 1998). Besides the technical issues of actuarial estimation, there will expectedly controversies surrounding the government's short-term and long-term liabilities as bureaucracies are reduced in size and state-owned enterprises

unload their unproductive or unneeded employees. The accounting recognition of such liabilities would likely heighten the pressure to provide funding for the social safety net.

Third, cost accounting is badly needed in service institutions, as is management planning and control in general. As these organizations are compelled to be self-sufficient, they need to know the costs of services they provide to have a rational cost-based pricing policy to operate on a nonprofit basis. This will require the resolution of such problems as product costing, overhead allocation, and transfer pricing.

In summary, improved budgeting and accounting standards have been made possible by China's economic and institutional reform. The economic rationality they embody and the accountability they promote can translate China's economic growth into the greatest benefit for one quarter of mankind.

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