

# Toward a clean government in China: does the budget reform provide a hope?

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**Abstract** Fighting corruption has proven to be a difficult task in many countries. In this paper, using China as a case study, we argue that a properly designed budgetary institution helps remove many institutional incentives and opportunities for corruption in financial management and regulatory activities of the government. As a result of recent budget reforms, China's anticorruption effort has shifted from its earlier emphasis on exhortation and periodic crackdowns, which have been found to be ineffective, to the more fundamental issues of institutional incentives and opportunities for corruption. We propose that one consequence of the budget reform is the hope that China's effort to create a clean government will be advanced. However, there is still a long way to go since it will take time for the new budgetary system to be institutionalized.

## Introduction

Despite more than two decades of anticorruption efforts, China is still viewed as a country riddled with corruption. Corruption in post-Mao China has become more widespread as both the amount of money associated with corruption and the number of senior officials implicated in corruption have increased dramatically [40]. In addition, the scale of corruption has escalated in more sophisticated, complex, and destructive forms [7], such as organizational corruption [16] and collective corruption [8].<sup>1</sup>

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<sup>1</sup>Some recent studies concur on this. See Andrew Wedeman, "Anticorruption Campaigns and the Intensification of Corruption in China," *Journal of Contemporary China*, 2005 (14: 42), 93–116 and Ting Gong, "Corruption and Local Governance: The Double Identity of Chinese Local Governments in Market Reform," *The Pacific Review*, 2006 (19: 1), 85–102.

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Until recently, the Chinese approach to corruption control has been mainly “a mixture of exhortation plus periodic crackdowns” [44: p. 220]. Unfortunately, the effort has been proven to be ineffective and unequal to the task [40, 44: pp. 220–223]. As a result, there has been a shift in the focus of China’s anticorruption campaign in recent years, especially since the Asian financial crisis of the late 1990s. While the government still continues to use anticorruption crackdowns and exhortation to combat corruption, it is gradually shifting the emphasis to removing institutional incentives and opportunities for corruption. A variety of institutional measures have been implemented in the past few years, such as the requirement to use real names for personal financial services, the leader-accountability system, conflict-of-interest rules, end-term-audits, and a new government budgeting system [44: pp. 223–248].

Among these new measures, the budget reform initiated in 1999 may be the most noteworthy and promising. First, as budgeting lies at the core of state governance [31: p.1], it is expected that the budget reform, if successful, would establish effective control over most governmental activities, resulting in fundamental changes in administrative behavior. Second, based on historical experiences, such as those in European countries in the 19th century [38: chap. 6] and in the USA during the progressive era [11], a properly designed budgetary system would greatly contribute to the creation of a cleaner government.

This paper addresses the following question: Does the recent budget reform provide some hope for China’s battle against corruption? The impact of the recent budget reform on China’s anti-corruption efforts has not been totally overlooked in the existing literature. In his recent book *Remaking the Chinese Leviathan*, Dali Yang [44] correctly argues that the budget reform has contributed to corruption control by significantly enhancing the finance bureau’s capacity to monitor fiscal behaviors and fund flows of government agencies, thereby reducing government bureaus’ incentives for self-aggrandizing rent-seeking (pp. 235–248). Nonetheless, the link between the pre-reform government finance system and the rampancy of corruption hasn’t been adequately examined in this book. Moreover, the whole discussion has been presented without a theoretical framework elaborating the role of budget reforms in corruption control.

Here, we investigate these problems in depth by examining the changes in institutional incentives and opportunities for corruption before and after the recent budget reform. We begin by presenting a theoretical framework elaborating the role of modern public budgeting in the overall anti-corruption effort. We then analyze institutional incentives and opportunities embedded in the pre-reform government finance system and the changes brought about by the installment of a new budgetary system after the 1999 budget reform. We conclude with an interim assessment of the success of the budget reform as well as its limitations.

### **Modern public budgeting and corruption control: a preliminary theory**

Some areas of government are more vulnerable to power abuse than others. We identify two areas that deserve special attention—government finance and regulation. In these two areas, there tends to be more institutional incentives and opportunities for corruption when the institution (including budgeting system) is problematic. A properly designed budgeting institution will exemplify the proverb “to kill two birds with one stone” by removing institutional incentives and opportunities for corruption in both areas.

### Corruption in government finance

Corruption in government finance is as old as the government itself. Nearly 300 years ago before the Christian era, Kautilya observed that human nature was disposed to acquire public money for private gains. He subsequently proposed a series of checks and balances for government financial management. His writings are still relevant today.

“Just as it is impossible not to taste honey or poison that one may find at the tip of one’s tongue, so it is impossible for one dealing with government funds not to taste, at least a little bit, of the king’s wealth... Just as it is impossible to know when a fish moving in water is drinking it, so it is impossible to find out when government servants in charge of undertakings misappropriate money” [cited from 29: p. 148].

Nowadays, government finance is still a field prone to corruption when budgetary institutions are problematic. In revenue collection, when incentives and opportunities are nurtured by factors such as poorly paid tax bureaucrats, large personal discretion in tax administration, and problematic tax laws, corruption is likely to occur. Public expenditures, if lacking transparency and effective institutional control, will also be beset with corruption. The experiences of many countries suggest that the following areas are most susceptible to corruption: public investment projects, governmental procurement, extra-budgetary accounts, goods and services provided at below market prices, and “ghost” workers and dead pensioners [33: pp.1–17].

### Corruption in government regulation

Government regulation is another field vulnerable to corruption as public officials are able to enrich themselves using regulatory power to extract incomes from the private sector. Regulatory power does not cause corruption on its own; for corruption to occur, other facilitators are needed, such as bureaucratic discretion and the lack of a rule of law. However, regulatory power does “provide officials with leverage for generating ‘bottleneck’ or ‘red tape’ with cumbersome rules and regulations,” forming a variety of opportunities for corruption [32: p.144].

In general, the more regulatory power and discretion government agencies hold, the more opportunities there will be for regulatory officials to give “favorable” interpretations and enforcements of government regulations and rules to private sectors in exchange for illegal payments [32]. This is particularly true when regulatory units are funded inadequately within the framework of the formal budget. Such a situation acts as an incentive on regulatory officials, encouraging them to use their regulatory power to seek illegal payments from the private sector.

### Properly designed budgeting system: to kill two birds with one stone

We argue that to curb corruption in the two areas mentioned above, a properly designed budgeting system is essential. Such a budgetary system should be so-called modern public budgeting designed according to such classic budgetary principles as comprehensiveness, annuality, unity, appropriation, and audit. Modern public budgeting, as a 19th century innovation in European countries, is control-oriented, incorporating administrative and legislative controls into government finance [1, 2].

The need for institutional control is not a new idea in the field of government finance.<sup>2</sup> However, a control-oriented modern budgeting system was not formed until the 19th century in European countries [1]. There have been two patterns of budgeting in fiscal history: *prebudgeting* and *budgeting*. The former, which was prevalent in absolutist European monarchies, “succeeded in raising relatively large amounts of revenues, despite low accountability and administrative control” [1: p. 55]. Government finance during this period was characterized by continuousness, decentralization, privatization, expediency, and institutional corruption due to the lack of both effective administrative control within the government and external checks on the government [2].

The 19th century witnessed a period of full-fledged modern public budgeting when government finance was brought into a new era, i.e., the *budgeting era*, when accountability was achieved by establishing administrative control within the government and legislative control over the government budget [2]. The new fiscal structure, “widely perceived to be efficient, productive, and, more than ever before, fair” [38: p. 301], greatly contributed to creating a cleaner government in European countries. The establishment of administrative and legislative controls reduced not only the opportunities for siphoning state revenues into private pockets, which was prevalent in the early modern period, but also the incentives to do so with the installment of institutional guards, such as the audit [38: p.230; 1, 2].

The USA during the progressive era provides another example of creating a clean government through budget reforms. Before the 20th century, no government in the USA had a coherent budgeting system and effective accounting system, making it difficult to keep administrative agencies accountable to the executive and the government accountable to the legislature—and both ultimately accountable to the citizenry. Among other problems, corruption periodically plagued municipal cities during the late 19th century, eventually giving rise to so-called “muckrake” movements which led to municipal reforms, the core of which was budget reforms aimed at inventing a modern budgeting system [11: pp. 1–28, 59–92]. To budget reformers at that time, municipal corruption was not “a simple matter of breaking the law,” it was simply because that “there were plenty of *opportunities* for ‘honest graft’” [11: p. 11, italics added]. Budget reformers thereby dedicated themselves to inventing a control-oriented budget system to eliminate those opportunities for corruption, preventing public officials, such as party bosses, from diverting public money to private ends without being held accountable [4].

To curb corruption in government regulation, the key is to reduce the regulatory power and discretion held by state agencies while still keeping them capable and responsible. The rationale for this is quite simple. It is only because state agencies are so powerful in regulating many aspects of the economic and social activities of the general public that they often become the target of bribery.

A properly designed budgeting system may rein in corruption in the area of government regulation as well. Corruption in this field mainly arises from the blurring boundaries between the public and private authority. A proper budgeting system, capable of accounting for all government activities and related costs and putting them under tight control, can help to locate power in its appropriate sphere. Again, the budget reforms during the American progressive era could shine a light on this issue. To budget reformers at that time, “[c]

<sup>2</sup> For example, Aristotle wrote: “Some officials handle large sums of money: it is therefore necessary to have other officials to receive and examine the accounts.” Cited from Arigapudi Premchand, “Public Financial Accountability,” in Salvatore Schiavo-Campo (eds.), *Governance, Corruption and Public Financial Management* (Manila: Asian Development Bank, 1999), pp.148–149.

ruption was not power in the hands of bad men; it was...a function of a system with no clear boundaries between public and private authority” [11: p. 61]. They therefore believed that “[t]he budget would eliminate corruption by locating power in its appropriate sphere and assigning it openly to specific institutions” [11: p. 61]. In his remarks on American experiences, Jonathan Khan further elaborates this idea.

“A proper system of budgets, both public and private, would normalize relations between the two spheres, specifying which activities properly fell under the purview of which authority. The very visibility of the budget would discourage attempts to transgress its boundaries and would shield government from excessive corporate influence...Budgets, however, could also serve the interests of savvy businessmen seeking to protect their interests from government regulation or even outright public ownership” [11: pp. 61–62].

### Corruption in China’s *prebudgetary era*

During the period between the establishment of the People’s Republic of China in 1949 and the 1978 economic reform, the government created a highly centralized economic planning system and unitarily implemented it throughout the whole country. In this system, resource allocation was determined by the plan, while the budget was just a tool for plan implementation. Despite its well-acknowledged shortcomings in economic performance, the planning system retained certain fiscal discipline and expenditure control. However, this economic vision has changed since the market-oriented economic reform in 1978. While the role of the plan as a tool of resource allocation began to decline, a new and effective budgeting system was not developed to fill the vacuum [18]. Consequently, the government finance from 1978 to the 1999 budget reform maintained the basic characteristics of the *prebudgetary era*, namely, low administrative control within the government and low accountability due to the lack of legislative control. First, the budgeting authority within the government was fragmented, thereby preventing the finance bureau from exercising effective control over governmental activities. Second, financial management was overly decentralized, which impeded the finance bureau from monitoring the revenue collection and spending of bureaus during budget execution. Lastly, for many years, government finance in China has tended to maximize executive discretion at the expense of legislative oversight [17, 20]. It then came by no surprise that corruption became a structural problem where corruption-motivated public officials were provided plenty of institutional opportunities for ‘honest graft.’

#### The fragmented budgeting system

Corruption was nurtured and facilitated by a fragmented budgeting system. This was first and foremost related to the expansion of off-budgeting finance, subsequently manifesting in the fragmentation of formal budgeting authority.

Off-budgeting finance was originally a strategy of fiscal expediency in the face of the fiscal stringency that were in force in the early 1980s. However, it exploded over time and became institutionalized as an important part of the Chinese government finance system. Consequently, government finance during China’s *prebudgetary era* was “a complex system of ad-hoc public finance evolved along side the formal budgetary system” [39: p.492]. In addition to formal or on-budget budgetary funds, a large amount of off-budgetary

money existed, including extra-budgetary and off-institutional funds [6]. Extra-budgetary funds refer to various earmarked funds collected in accordance to the laws and regulations issued by the central legislature and government, but which were put off budget. Off-institutional funds, on the other hand, were “illegal monies” in nature as their levies had no legal support while their expenditures were totally at the discretion of the levying agencies [39]. It has been estimated that around two thirds of governmental revenues and expenditures in this era were the result of off-budgetary financial practices [6].

While the development of off-budgetary finance helped solve “the politically difficult problem” of bureaucratic restructuring by transforming Chinese bureaucrats into supporters of market-oriented reforms [5], it greatly distorted the incentive structure of the Chinese bureaucracy, transforming it into a rent-seeking organ [15].

The existence of off-budgeting finance first reduced the capacity of the finance bureau to provide other government agencies with sufficient funds through “on-budget” channels as most revenues were beyond its control. It also reduced the finance bureau’s willingness to do so in recognition that off-budgetary funds held by bureaus could compensate their revenue shortages. Therefore, for many years, personnel (e.g., salaries) and operation budgets for bureaus were set at a low level in the formal budget [see 16, 39].

This two-decade practice of combining limited formal budgetary appropriation with off-budgetary financing has been shown to be a hotbed for corruption. It not only motivated individual officials to seek extra incomes to enrich themselves, but it also prompted government institutions to search for extra revenues to compensate their inadequate operation allocation and to increase bonuses or other private gains for their employees. The latter has been referred to as “organizational corruption” [16].<sup>3</sup> Moreover, off-budgetary financing has given rise to a variety of opportunities for funds to be misused to enrich the bureaus and their officials in the process of levying and spending monies. While formal budgetary funds were subject to extensive control, extra-budgetary funds were subject to less stringent supervision and off-institutional funds as illegal monies were totally out of oversight [39].

Extra-budgetary funds were not completely exempted from supervision. They were collected according to specific laws or regulations, and their usage was earmarked. Local governments were also required to report their extra-budgetary funds to upper level governments, making it possible for the upper level to oversee the disposition of funds [39]. However, due to the decentralized management, it was easy for slippage to occur. For many years, the power of collecting and spending extra-budgetary funds was granted to a single bureau (*zuoshou zuozhi*). Moreover, it was impossible for the finance bureau to mediate the allocations of earmarked funds, which were instead totally at the discretion of collecting bureaus [44: pp. 239–240]. Lastly, to encourage bureaus to surrender their extra-budgetary funds to the special account as required, the finance bureau often allowed them to retain a share of the funds to cover the inadequate budgetary allocation for bonuses and operations. In Shenzhen, for example, this share amounted to 30–40%. This accommodation provided “a higher-powered incentive for these agencies to collect such extra-budgetary funds aggressively” [44: p. 239].

<sup>3</sup> Previous studies have found public officials confronted with economic hardships, such as low salary and delays in salary payment, are prone to corruption. See A. W. Goudie & David Stasavage, “A Framework for the Analysis of Corruption,” *Crime, Law & Social Change*, 1998 (29), 113–159 and Hung-en Sung, “A Convergence Approach to the Analysis of Political Corruption: A Cross-national Study,” *Crime, Law & Social Change*, 2002 (38), 137–160.

The very nature of extra-budgetary funds not only motivated but also facilitated public bureaus that had been inadequately funded by the formal budget to become involved in fiscal malfeasances, such as over-collecting funds as well as concealing and misusing certain portions of these funds, even though they were earmarked. According to a central inspection report, while the amount of local extra-budgetary funds reported to the Ministry of Finance (MOF) was 17.1 billion yuan in 1995, the actual amount collected was as high as 55.6 billion. These numbers mean that 69.3% of the funds were concealed by local finance bureaus [22: p. 98]. The central audit bureau estimated that in 1998, 21 out of 53 central units had not deposited 5.063 billion yuan extra-budgetary funds into the designated special account as required [23: p. 42]. A fiscal inspection by the Shandong provincial fiscal supervision office found that 74% of funds that were collected in violation of fiscal regulations belonged to extra-budgetary funds [16]. In one province, among 87 county-level cadres punished in 1997 for their involvement in economic crimes, 43% were related to the misuse of extra-budgetary funds [45].

Compared to extra-budgetary funds, the levying and spending of off-institutional funds was even more problematic and can best be described under the rubric of state corruption. As these funds were illegally levied and used by the public agencies, they were not subject to any form of oversight. Consequently, the whole process of collecting and spending these funds was under the complete autonomy of various public units and, therefore, totally opaque to any outsider [39].

Illegal funds were used primarily for the direct benefit of the personnel and group, hence providing a lot of incentives for aggressive and even predatory extracting behaviors among bureaus. This was clearly demonstrated in the explosion of the so-called “three unruly actions” (*sanluan*), including illicit levies, fines, fees, and apportionments. According to an investigation in 11 provinces and cities at the beginning of the 1990s, out of 89, 000 imposed fees 53,000 were illegal; of 13,000 imposed penalties, 12,000 violated local and/or state regulations; the total amount of illegal money involved was 10 billion yuan. In rural areas, predatory activities were almost out of control in the 1990s, generating widespread peasant unrest. For example, in Bo'ai county of Henan province, peasants had to pay 136 different illegally imposed fees, totaling 15.1% of their annual income in 1991, despite the fact that as early as 1985, the central government, recognizing the danger of stirring unrest in rural areas, had already stipulated that non-tax levies on peasants could not be more than 5% of their annual incomes [16].

The solicitation of illegal payment was not just a problem at the sub-national government level. Many central bureaus were also involved. According to a report of the MOF, in 1997 three central bureaus involved in transportation, construction, and public security collected 530 kinds of fees and funds, totaling 162.6 billion yuan; of these, 245 were collected without authorization [44: p. 239].

Although some illegal funds were spent on legitimate projects and activities, a huge chunk of them was easily misused to directly benefit the levying agencies. A portion was used to provide extra incomes, both in cash and kind for agencies' members. The rest went into unauthorized and even illegal activities—wining and dining, embezzlement, purchasing private houses, bribing upper-level cadres, overseas sightseeing trips, speculative investments, etc. [16, 39]. In a city with 2.6 million yuan illegal funds in the various secret accounts of its agencies in the fiscal year 1988–1989, only 13.7% was earmarked for the collective welfare of personnel and bonuses, the rest was spent on unauthorized activities [16].

Off-budgetary finance was not the only area inundated with corruption. The fragmentation of the formal budget system also provided an abundance of opportunities



for corruption. The fragmentation of the formal budgeting system manifested itself in two aspects [20]. First, in addition to the finance bureau, several other government bureaus also held allocation authority over certain types of expenditures, such as the planning committee controlling basic construction expenditures and the science and technology bureau in charge of science and technology improvement funds. The normal practice was to allocate a certain amount of budgetary funds to these bureaus, and they would then distribute the funds—without a formal budgetary procedure or supervision from the finance bureau. Second, during this period, despite the weakening of the planning system, its budgetary format was comfortably inherited, and the government budget continued to be compiled in terms of functions of expenditures (usually in aggregate totals) rather than on a departmental basis. As there was no departmental budget, budgetary funds were repeatedly allocated to bureaus in a lump sum during the whole fiscal year, informally granting them the so-called “secondary budgetary power” to further allocate funds to specific expenditure objectives.

These two types of discretionary powers enabled the bureaus to divert funds for private or institutional interests easily. The annual inspection of fiscal and taxation discipline launched since the mid-1980s uncovered millions of budgetary funds each year which had been directly diverted by collecting or spending bureaus and used for private and group benefits. For example, a state audit of local extra-budgetary funds found that in 1995 local finance bureaus transferred 9.8 billion yuan budgetary funds to extra-budgetary funds [22: p. 98]. In 1996, the Ministry of Water Resources (MWR) took back 65 million yuan from the 135 million yuan in budgetary funds it had appropriated to one of its sub-units and deposited the money into a secret account opened by its general office; the MWR then loaned it to a financial company to earn interest [23: p. 42]. In this case, it was the secondary budgetary power of the MWR that enabled it to take money back from its sub-unit.

The rampancy of the so-called *small coffers* (*xiaojinku*) during this period provides the best example of how the fragmentation was closely related to the inundation of corruption. *Small coffers* refer to various secret accounts kept by government bureaus, state-owned enterprises, or other public units. The monies in these secret accounts were never reported, and spending of these monies was always kept unknown to upper level authorities and outsiders. During the past two decades, a variety of approaches have been “invented” to illegally create and maintain *small coffers*, such as levying illegal monies, concealing receipt records, impounding portions of profits or appropriations, and transferring or diverting budgetary and extra-budgetary funds [16, 39]. In 1985, when the state first audited 66,200 public agencies nationwide, it discovered secret accounts of 10 billion yuan, 76% of which were incomes illegally retained by these units. By 1990, it was estimated that incomes retained in various concealed accounts had jumped to 780 billion yuan, 15% of which, or 120 billion yuan, had been deposited into *small coffers* [16].

As funds in secret accounts eluded any sort of regular oversight, it was easy for them to be misused. An inspection of 16 prefectures/cities in 1989 carried out by the Henan Provincial Finance Bureau reported 2.744 billion yuan *small coffer* funds, 15.41% of which had been spent on unapproved construction, 21.02% on the purchase of automobiles and other luxurious items, 12.19% on bonuses and materials for individuals, 30.43% on gifts and banquets, 17.14% in the illicit possession of individuals, and 3.81% lost because of graft and theft [from 16: Table 1]. In Sichuan province, it was discovered that in 1994, 65% of *small coffer* funds were spent on bonuses, 15% on welfare benefits, 7% on banquets, and 7% were embezzled by officials [39: p. 505, note 46]. Even central government agencies were found to have maintained *small coffers*. In addition to the MWR mentioned above, from 1993 to 1997, the Quarantine Bureau of the Ministry of Health created a *small coffer*



worth 286 million yuan through illegally impounding extra-budgetary funds and levying fees (involving all agencies within it) and then depositing these monies into more than 50 bank accounts. During that period, 271 million yuan were spent to benefit the bureau: 160 million were appropriated to sub-units, 17 million were used to cover operational costs, 16 million were used for investment, and the rest was squandered in wining and dining, bonuses, traveling, and the purchase of cars, houses, and mobile phones for employees [28].

### Decentralized financial management

Opportunities for corruption were further increased by the decentralized financial management. As the former Deputy Minister of Finance Lou Jiwei [14] admitted, the treasury management system during this period had been operating with glaring shortcomings such as “frequent detention, diversion and unauthorized use of funds; and monetary inducements for corruption” (p. 60). Illegal monies deposited in various secret accounts were undoubtedly prone to corruption. However, extra-budgetary and even budgetary funds were also susceptible to corruption due to the overly decentralized financial management system.

Extra-budgetary funds, which were managed in a highly decentralized manner, created ample opportunity for corruption. Before 1999, the power of both collecting and spending extra-budgetary funds was granted to the same bureau with minimal external supervision. Therefore, during the *prebudgetary era*, almost all bureaus imposed and collected fines, fees, and levies, took in monies directly, deposited them into their own bank accounts, and spent them with a great deal of discretion [44: p. 239]. Not surprisingly, corruption became rampant in the process of collecting and spending of extra-budgetary funds. The following case, well-known in China, is illustrative of this. In China it was quite common that an under-funded police bureau would seek extra revenues by setting quotas to force its policemen to collect fines. Policemen would then arbitrarily impose fines in the street. Fines thus collected would first be deposited into the bureau’s account before their submission to the special account as required. This caused capricious law enforcement, and enabled low-paid policemen to put some fines into their own pockets or the police bureau to spend these funds on group benefits. According to a state audit report, of the various fees and fines collected by police bureaus nationwide in 1998, 1.356 billion yuan were concealed, impounded, and diverted, and 638 million yuan were not submitted to the special account as required [23: p. 42].

With regard to budgetary funds, loopholes were also abundant under the decentralized financial management system. A single accounting system (SAS),<sup>4</sup> which would function as the foundation for effective administrative control in budget execution, did not exist in the *prebudgetary* system. Instead, each and every bureau opened its own spending accounts in commercial banks for budgetary funds together with many transitional accounts in revenue collection. Once the accounts were widely dispersed, cash balances were dispersed, which means that budgetary funds were already appropriated to bureaus’ accounts even before actual payment was needed. This means a lack of outside control, such as appropriation control and fiscal direct disbursement. Procurement and payment were decentralized in such a way that each bureau purchased commodities and services and then paid for them from its own accounts [20, 37].

This wide dispersion of accounts together with cash balance dispersion placed public funds in the hands of bureau officials without supervision, facilitating corrupt

<sup>4</sup> For the SAS, see more in the discussion of treasury management reform in the next section.

activities, such as embezzlement and fund diversion. In terms of revenue collection, the existence of transitional accounts allowed the collected money to stay for a long time with the collecting agencies instead of being submitted immediately and directly to the state treasury. Collecting bureaus were happy to “dip into” revenues retained in these transitional accounts. For example, from 1994 to 1999, the state tax bureau of Zhipei district of Yantai city in Shandong province created a *small coffer* worth 58.97 million yuan through a variety of illegal ways. It turned out that 43% of these *small coffer* funds were from retaining taxes that should have been submitted to the state treasury and 18% were interest incomes from bank deposits or loaning tax revenues to companies [24: p. 42].

In the expenditure process, there were also loopholes for various malfeasances. Government agencies controlled not only widely dispersed spending accounts and cash balances, but also procurement and fund disbursement. Until the recent reform, there was no transparency, competition, and external supervision in the process of procurement. Procurement decisions on where and at what price orders should be placed were completely controlled by spending bureaus, with no supervision from the finance bureau. This was undoubtedly a procurement system susceptible to corruption, such as bribes and kickbacks. To make things worse, spending bureaus were allowed to handle fund disbursements for their own procurements. As a result, corrupt officials and organizations could disburse funds to contractors who had “paid” or would “pay” for receiving favorite purchase contracts from the bureaus.

The 1999 state audit report found that 53 central ministries and institutions had misused budgetary funds of 16.405 billion yuan and that 43 of these had diverted funds of 3.124 billion yuan in budget execution. For example, between 1994 and 1998, the MWR and its sub-units diverted 116 million yuan of its budgetary funds for bureau benefits, such as constructing employee dormitories, purchasing office building, and even investing in the stock market [23: p.42].

Unfortunately, it was impossible for the governmental accounting system, which was both fragmented and decentralized, to carry out the function of accounting control during budget execution. The governmental accounting system during this period comprised three separate accounts—administrative unit accounts, service unit (*shiyew danwei*) accounts, and general budgetary accounts, each recording fiscal transactions in different areas and stages. The first was used by administrative units to record their fiscal transactions, while the second recorded fiscal transactions within service units. The third unit, representing the government as a whole, was used to record fiscal transactions occurring at the point of appropriation. Therefore, under this disjointed system, information about fiscal transactions was scattered and beyond the control of the finance bureau. In reality, after funds were appropriated to bureaus’ accounts, it became impossible for the finance bureau to monitor their flows, which was recorded by administrative or service unit accounts and controlled by the spending units [20, 37]. To make things worse, accountants of spending units were employees belonging to these organizations. It has been frequently observed that these accountants tended to collude with officials of these organizations or to succumb to pressure from these officials to “cook books” and make unwarranted reimbursements [44: p. 247].

### Invisible government and regulation

The Chinese government during the *prebudgetary era* was an invisible government as there was no government budget that accounted for all government activities and related costs.

Without such a budget, it was difficult for the legislature and citizens to determine whether public officials misused or abused public funds while leaving activities for public ends unfunded or inadequately funded. This has proven to be a major source of corruption.

First, it was easy for public bureaus—and even the finance bureaus serving as a ‘watchdog’ of public resources—to misallocate public monies for non-public purposes. Such cases were bountiful during the *prebudgetary era*. Service units or businesses affiliated with government bureaus (e.g., training centers and hotels) and even private companies, though not serving the public, would receive budgetary appropriation. For example, in March 1999, the first year the budget reform was experimented, the foreign affairs division of the Ministry of Finance (MOF) misappropriated one million yuan to the Chinese Painting Association in Beijing, which was not qualified for fiscal subsidies, to help with its marketing activities [24: p. 42].

Second, though serving the public, some service units and even regulatory bureaus often found themselves under-funded. They were forced to seek extra revenues by charging fees for services they provided, imposing fines, and even involving themselves in business [42: p.17; 15, 16]. These included not only those service units without regulatory power (e.g., elementary schools) but also many regulatory bureaus (e.g., public disease control centers, commodity quality monitor centers). Market-oriented reform during the past two decades has not only enabled some government bureaus (e.g., public health, price control) to wield more regulatory power, but it has also given rise to many new regulatory units (e.g., quality and standard control, land administration). However, many of these were inadequately funded or even unfunded [16]; this made them prone to corruption.

#### Feeble legislature: unable to ensure a clean government

During the *prebudgetary era*, the legislatures at all levels were unable to ensure that governmental bureaus and officials would make budgetary decisions faithfully and responsibly. In the process of budgetary review, it was impossible for the legislature to have an input of its own in budget making and to identify the misuses of public funds. The government budget presented to the legislature for review and approval was so simple (usually in aggregate) that the legislature’s annual budget review had become symbolic, as the legislature always approved the aggregate budget figures presented by the government [20, 44: p. 266].

During budget execution, although the standing committee of the legislature occasionally undertook investigations into bureaus’ misusing of budgetary and extra-budgetary funds, the legislature in general failed to monitor fund flows effectively and systematically [20]. Due to the lack of a system of departmental budgeting, budgetary funds were usually appropriated in a lump sum to the government rather than to specific bureaus, let alone programs. Therefore, even though the diversion of funds was known to be a prevalent phenomenon, the legislature could do little to stop the problem.

#### Budget reform and its implications for corruption control

China initiated a budget reform in 1999, with the aim of modernizing government finance by designing and implementing a control-oriented public budgeting system. The reform was composed of three major parts: Departmental Budget reform (DBR), Treasury Management Reform (TMR), and Government Procurement Reform (GPR). The first

reform was aimed at incorporating administrative control into budget compilation, while the latter two were meant to install administrative control in budget execution. The DBR has opened windows of opportunity for the legislature to play a more active role in the budgetary process. The reform therefore inaugurated a new stage in Chinese government finance, i.e., the *budgetary era* [17, 20]. Admittedly, with the exception of the GPR, which had been expressly advocated as an effective mechanism to curb corruption [44: p. 200], the budget reform was not so much designed specifically for reining in corruption as for improving allocation and operating efficiency. However, with the progress of the reform during the past several years, it has become increasingly apparent that the reform movement has had great anticorruption implications by recalibrating institutional incentives and opportunities for corruption.

### Departmental budget reform

The DBR requires that the government budget be compiled on a departmental basis. To compile departmental budgets, the principle of comprehensiveness is emphasized, under which bureaus are required to consolidate all of their revenues and expenditures into a departmental budget. Standardized budgetary formats and procedures are designed, to which all bureaus are required to comply. Moreover, bureaus should itemize their budget in order to present detailed information on proposed activities and relevant costs [17, 20]. The reform has begun to tighten budgetary control within the government by enhancing the finance bureau's power vis-à-vis that of other bureaus' while reducing the latter's discretion in collecting and spending public monies. Moreover, the legislature has begun to take a more active supervisory role as the government budget is now presented in greater detail. The installment of these control mechanisms has helped curb fund diversions and other forms of fiscal malfeasance once prevalent in the government.

First, the DBR has consolidated off-budgetary monies into departmental budgets. To fulfill the principle of comprehensiveness, unauthorized levies and fees are prohibited, and local governments and bureaus are also forbidden to issue quotas for collecting administrative fees and fines. More importantly, the new measure of "Separating Revenue and Spending" (SRS, *shouzhi liangtiao xian*) for extra-budgetary funds, which was initiated in 1996 but not been forcefully implemented, is reinforced under the DBR. Under the SRS, extra-budgetary funds collected by bureaus must be first submitted to the *fiscal special account* controlled by the finance bureau. Bureaus are no longer allowed to withdraw these funds directly to meet their expenditure needs. Instead, they must submit budgetary requests for spending extra-budgetary funds to the finance bureau for approval [20, 44: pp. 239–240].

This reform was made possible by installing and enforcing in the revenue collection a system designation the "Separation of Bills and Money" (SBM, *piaokuan fenli*), under which bureaus collecting these funds no longer are able to take in money directly. Instead, they issue a payment bill (provided by the finance bureau) on the amount the payers should pay to the government, and the payers then make the required payments to a bank where the finance bureau holds a *fiscal special account* [44: p. 240].

Upon the consolidation of off-budgetary funds, more adequate budgetary funds for operations and payrolls are allocated to bureaus in the DBR system, accompanied by a standardized budgetary procedure and format for their requests [18, 20]. The reform has therefore brought an end to the previous practice of leaving a huge chunk of money off budget to satisfy the needs of individual government units. This has reduced institutional incentives and opportunities for putting public monies off budget and using

them for private gains. Consequently, the ethics and behavior of the bureaus have been reshaped. For example, in Guangzhou, its urban management enforcement agencies collected more than 100 million yuan in fines in 1998. However, since the implementation of the DBR, this has dropped to 80 million yuan in 1999 and 27 million yuan in 2000. Similar trends are found in other cities, especially in more developed localities where the formal budget is now able to provide adequate funding for payrolls and operations after consolidating off-budgetary funds into the departmental budget [44: p. 243].

Second, the DBR has greatly reduced the discretion bureaus once held in the allocation process. The reform began by incorporating budgetary constraints into the budgetary process by emphasizing that for each penny spent there must be a budget first, and that to have a budget, the bureau must have activities worth funding [18, 20]. This has eliminated the old practice of first allocating funds to bureaus and then letting them freely choose where to spend the money. The reform has also emphasized the requirement of itemization in compiling departmental budgets, taking away from bureaus the secondary budgetary power they held under the lump sum appropriation, thereby significantly reducing the discretion of further allocating funds which they enjoyed for many years. This, undoubtedly, removes institutional opportunities for corruption, as it is no longer easy for a bureau to divert funds which have been designated to more specific expenditure objectives for private or group gains.

Lastly, with the DBR, legislatures at all levels have gradually, and for the first time, gained real supervisory power over the government budget. The DBR requires the government budget to be submitted earlier to the legislature. Most importantly, the government budget compiled according to the DBR is department based, more comprehensive, and broken down by departmental details. This has greatly enhanced the legislature's capacity to supervise the compiling and implementation of the government budget [20]. The legislature therefore has been increasingly taking up the role of a substantial budgetary reviewer, serving as the checks and balances on the government's budgetary decision-making and ensuring that public monies are used for the collective good. For example, in the 2001 annual session of the National People's Congress, the availability of departmental-level budget details enabled delegates to scrutinize the government budget. Noticeably in that year, the legislative review particularly targeted the diversion of funds, which has always been related to corruption [44: p. 267].

### Centralized treasury management

The aim of the TMR is to create a centralized treasury management system to replace the old, overly decentralized system and to significantly enhance the finance bureau's capacity to monitor fund flows and fiscal behavior of the bureaus in terms of budget execution. It is expected the TMR will help curb embezzlement, diversion, and other forms of fiscal malfeasances. For example, facilitated by the new system, the treasury division of the MOF in the fiscal year 2002–2003 effectively detected various malfeasances in using and disbursing funds in 61 central ministries and 427 budgetary units, involving 2.96 billion yuan worth of funds [36].

The reform began with establishing a single account system (SAS), which has laid the foundation for an effective administrative control within the government and hence for reining in corruption. The SAS requires that only one single treasury account be allowed to exist at each level of government and that all public monies collected must be submitted to

**Table 1** Unused funds (in millions of yuan) in six Central Government Units, 2001 (Source: [46])

Government ministry	Total appropriation quota	Funds paid	Unused funds	Unused rate (%)
MWR	10048.83	5752.44	4296.39	42.76
MST	5869.25	4561.69	1307.56	22.28
MOF	211.77	207.66	4.11	1.94
LSO	7.61	6.01	1.6	21.02
CSA	750	750	0	0.00
NNSF	282.6	100.89	181.71	64.30
Total	17170.06	11378.69	5791.37	33.73

MWR, Ministry of Water Resources; MST, Ministry of Science & Technology; MOF, Ministry of Finance; LSO, the Legal System Office; CSA, the Chinese Science Academy; NNSF, the National Natural Science Foundation)

this account while all expenditures must be appropriated from it. Most importantly, before actual payment is made, all monies must be retained in this account. The reform has enabled all accounts previously held by the bureaus to be examined and closed down. In the 2001 nationwide inspection on budgetary unit accounts, 140,725 of 935,786 accounts were closed down or consolidated [34]. In the process, certain corrupt practices were detected; this represented a continuing crackdown on “financial fiefdoms” [44: p. 243], the seed which gave rise to organizational corruption in the previous system.

The creation of the SAS has significantly improved the transparency of revenue collection and expenditure, enhancing the monitoring of fund flows by the finance bureau and taking money away from the greedy bureaus and their officials. In 2001, the new system was tested in six pilot central budgetary units, including the MOF, the MWR, the Ministry of Science & Technology (MST), the Legal System Office (LSO), the Chinese Science Academy (CSA), and the National Natural Science Foundation (NNSF). At the end of that year, all of these units, except the CSA, had accumulated unused funds (Table 1). Not all news from so large amount of unused funds is a good one as it is unfortunately related to unfinished programs and budgetary supplements. However, it is safe to state that the SAS had two achievements. First, some of these unused funds were generated by safeguards created by the new system. Second, all unused funds are now retained in the treasury’s single account and are therefore out of reach of the spending units [46].

Upon the establishment of the SAS, a system, named the fiscal direct disbursement (FDD), was also implemented in expenditure management that centralizes fund flows through the treasury rather than letting bureaus handle the disbursement as before. With the FDD, bureaus now can only see the “numbers” in their fund-using plans rather than the real “money” since the money is now paid directly from the treasury single account to suppliers of commodities and services for the government. Again, this has helped enhance the finance bureau’s capacity to monitor fund flows while taking money away from the hands of bureaus and their officials.<sup>5</sup>

<sup>5</sup> At the present time, not all expenditures are disbursed through the FDD system. Certain disbursements are carried out under the so-called “fiscal authorized disbursement” (FAD), in which bureaus, with the authorization of the finance bureau, can write an effective payment order to disburse monies from the treasury single account to receivers. See Jun Ma & Meili Niu. “Modernizing Public Budgeting and Financial Management in China,” in H. A. Frank (Eds.), *Public Financial Management* (New York: Taylor & Francis, 2006), pp. 691–736.



Clearly, the adoption of the FDD has begun to curb various fiscal malfeasances. For example, in Hebei province where the budget reform was first initiated, it has been reported that the adopting of the FDD in payroll disbursement in 1999 helped uncover 5096 illegal wage receivers, saving more than 37 million yuan [35: p. 131]. According to a report in October 2002, during 2 years of experimenting with the FDD in Hebei, the finance bureau refused more than 9900 disbursement requests, resulting in a saving of 28.3 million yuan [12].

The effectiveness of the TMR can be demonstrated by its adoption in the MWR, which was singled out for criticism in the 1999 audit report because of its notoriety of misusing funds between 1994 and 1998 under the old treasury management system. The MWR was thus chosen for experimenting with the TMR. In the new system, the MOF began to pay directly through the FDD salaries, materials procurement, and some major projects of the MWR. By 2002, the FDD was fully adopted for low-level units of the MWR. With the installment of the TMR, especially the FDD, corrupt behavior, such as fund diversion and embezzlement, once quite common in the MWR, has largely become “a thing of past” [44: pp. 245, 285].

### Government procurement reform

The aim of the GPR was to create a competitive and centralized procurement system, and its implementation has further plugged various loopholes in procurement, an area fraught with corruption in the pre-reforming period. First, the new system has centralized procurement activities to the finance bureau. As these were formerly dispersed in various bureaus, the latter has consequently lost the discretion of using procurement to take kickbacks from contractors. To pool procurements, a government procurement center was established within the finance bureau at all levels of governments except the township [20]. In 2004, 80.89% of government procurements were pooled, mainly at the sub-national levels (Table 2).

Second, open and competitive bidding, a mechanism proven to be effective in fighting corruption in procurement, has been introduced into the procurement process, although other procurement strategies (e.g., competitive negotiation) are still used [20, 44: p. 206]. In 2004, 59.55% of government procurements went through a bidding process (Table 2).

Third, the FDD has been adopted for the fund disbursement of many government procurements, especially large project procurements that were replete with corruption scandals in the past [20]. In 2004, 39.98% of government procurements were paid for through the FDD. Nonetheless, its percentage, especially that of the central government, was still very low (Table 2).

**Table 2** The progress of government procurement reform (Source: [3])

	Pooled procurement (%)			Open bidding (%)			FDD (%)		
	Central	Local	Total	Central	Local	Total	Central	Local	Total
2001	-	86.35	65.92	60.00	50.91	53.06	0.79	43.82	33.63
2002	37.94	82.64	73.00	45.03	48.88	48.04	-	49.74	-
2003	49.58	83.88	78.80	65.73	55.46	57.20	10.74	43.36	38.20
2004	55.94	84.86	80.89	57.75	59.84	59.55	13.84	44.14	39.98

FDD, Fiscal direct disbursement

### The visibility of the budget: assigning power to its appropriate sphere

With the budget reform, especially the DBR, activities undertaken by government bureaus and funded by public monies were gradually compiled into departmental budgets and submitted to the legislature for review. This has provided a chance for both the legislature and the executive to probe into whether these activities serve public purposes and should be included in the budget. Budget reform has therefore played an important role not only in prohibiting public funds from being misused for private gains but also in assigning public and private powers into their own spheres. This will undoubtedly help curb corruption, especially in a developing economy where the boundary of the state and society continues to blur.

The visibility of the budget has enabled delegates of the legislature to question whether certain activities serve public ends and deserve budgetary appropriation. For example, in both the 2003 and 2004 annual sessions of Guangdong provincial legislature, delegates fiercely questioned the government for allocating twenty to thirty million yuan to two kindergartens which had provided services only for cadres' children [13]. Now that the government budget is presented in departmental details, the legislature is able to trace questionable usage of public funds as never before.

The recent debate on the compilation of the State-Owned Capital Operating Budget (SOCOB) is also a good example. For more than a decade, due to the lack of a SOCOB, the dealings of state-owned assets (such as selling and leasing) and their proceeds remained off budget without any external control and supervision, thus creating opportunities for corruption. With the introduction of the budget reform, the Chinese government has increasingly recognized the necessity to compile a SOCOB to consolidate proceeds from the operation of state-owned capital and their expenditures into a single budget, ensuring that such revenues would not be inappropriately used for non-public goals [21: chap. 5].

The emphasis on properly assigning activities to the purview of their own authorities is also witnessed in the recent reform on service unit system, the success of which demands redefining activities eligible for budgetary support. The test of this reform in several places started with the classification of activities undertaken by various service units. Service units whose activities are totally market-oriented must be registered as business enterprises. Units of this kind should not be included in the system of government service units for fiscal support. On the other end of the spectrum, service units undertaking administrative functions (e.g., regulation) must be consolidated into the administrative system and fully funded by the formal budget. Those service units serving public benefits but unable or unsuitable to raise resources through market mechanisms should be adequately funded by the government budget—but they must not undertake any business activities and charge any fees [43]. It is expected that these reforms will help prevent public organizations from developing incentives to use public authority to extract extra incomes.

### The impact of the reform: an interim assessment

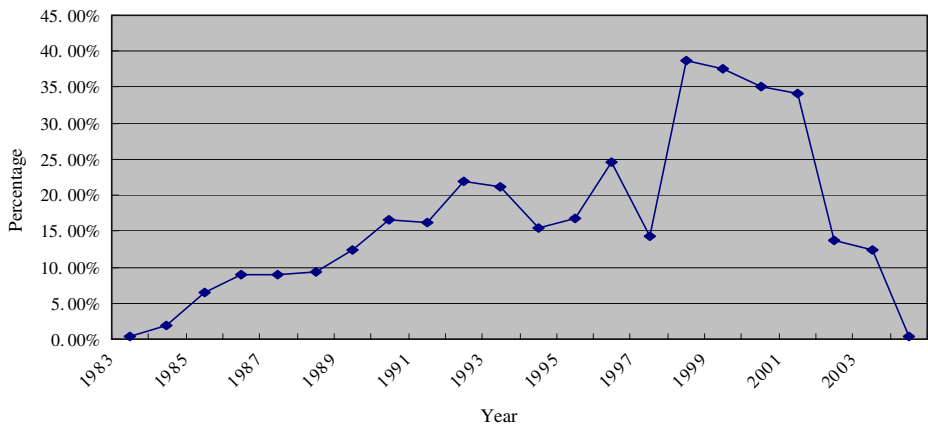
While it may be premature to assess the full impact of budget reforms on corruption control, it is safe to state that these reforms have refashioned China's anticorruption campaign in a promising way. With these reforms, China's combat against corruption began to concentrate on removing the institutional incentives and opportunities for administrative misbehavior. While tough law enforcement and punishment are still necessary, it may be more important to reduce incentives and opportunities in the first place rather than to catch the criminals once corruption has been committed.

We therefore conclude that the Chinese budget reforms introduced in recent years have clearly contributed to the fight against corruption. For many years, the Chinese government finance was beset by fund misuse, a major source of corruption. However, the budget reform has brought about a decline in fund misuse at local levels (Fig. 1). The percentage of misused funds in the total budget reached its peak in 1998 (38.68%). It began to decline after the 1999 budget reform and fell to 13.66% in 2002 and then sharply to 0.33% in 2004.

Nevertheless, this decline needs to be interpreted cautiously as it just refers to misused *budgetary* funds that have been found at the local levels, and it represents only part of fiscal malfeasances. In addition, the reform itself has certain limitations. First, although the modern public budgeting system is supposed to operate with two types of supervision—administrative and legislative, China’s budget reform mainly concentrates on the former. For the legislature to become an effective supervisor of the government budget and therefore hold the government accountable to the public, a fundamental restructuring of the power relationship between the legislature and the executive is needed. This will inevitably touch upon the sensitive subject of the relationship between the ruling party and the legislature [19].

Secondly, although the reform has improved fiscal transparency to some extent, there is still much room for improvement. At present, departmental budgets are labeled as “state secrets” and are not open to public scrutiny. With the DBR, legislators are able to review the government budget with departmental details in national and many local legislatures. However, only during the annual session (usually several days) do they have a chance to look at the budget, and they are required to return the budget back to the standing committee of the legislature when the annual session is over. Furthermore, the report of actual expenditures will be submitted for review and approval only to the standing committee of the legislature, not the whole legislative body. Most legislators do not have access to the actual expenditure report let alone review it.

Thirdly, the principle of comprehensiveness, which is essential for both administrative and legislative control, has not been carried out adequately. Despite the progress made during the past 8 years in consolidating off-budgetary revenues and expenditures into the budget, a large amount of revenues—and hence their expenditures—are still left off budget. For example, revenues from leasing land, which at present is a major revenue source for many local governments, are usually put off budget and will not be compiled into the



**Fig. 1** Local fund misuse rate (%). [Source: NAO (National Audit Office) 1983–2004]

government budget and submitted to the legislature for supervision. At all levels, bureaus still hold certain profit-generating assets, such as hotels, houses, and parking lots. Profits generated from these assets are also not put into the budget [21].

## Conclusions

Based on the analysis above, we believe that the budget reform does provide hope for China's anticorruption efforts. It reduces institutional incentives and opportunities for corruption, not only in the field of collecting and spending public monies but also in government regulations. It pushes China's anticorruption campaign in an encouraging and promising direction.

However, the success of these budget reforms should not be overstated. As already mentioned, the reform itself has many limitations, which may not be easily surmounted in the near future. Moreover, sustaining the progress of these reforms made in recent years will require a deep political commitment, which may be jeopardized by political uncertainty and resistance caused by major changes in the power structure or leadership. Moreover, a long period is needed for the new budgetary system to be institutionalized and, most importantly, for budgetary actors to change the way they behave or make decisions; this, as stated by Wildavasky [41: p. 411], is the basic justification of any budget reform. Although in recent years certain positive changes already took place, some politicians (i.e., leaders) continue to make decisions as in the past [19], while many bureaus still have strong incentives to bypass the rules set by the new budgetary system. Still many bureaus have been found to be involved in misusing and abusing funds each year since the budget reform [27].

In short, the budget reform is not a panacea for anticorruption. Corruption control is a systematic, comprehensive, and persistent effort. We are cautiously optimistic about the effect of the budget reform on controlling corruption and believe it will contribute to the making of a clean government in China.

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