Paulson Policy Memorandum

Improving China's Municipal Finance

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Prior to coming to Oxford in 2007, Dr. Wong was the Henry M. Jackson Professor of International Studies at the University of Washington's Henry M. Jackson School of International Studies (2000-2007). Dr. Wong has also held faculty positions in the economics departments at the University of California, Santa Cruz; University of California, Berkeley; and Mount Holyoke College. Dr. Wong's research focuses primarily on China's public finance and public sector reform.

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Introduction

Urbanization has been among the most important trends in China over the past three decades. It began with market reform and opening in the 1980s and has brought 500 million people into cities. During the decade of 2000 to 2010 alone, China's urban population grew by 210 million, even when the country's overall population grew by just 73 million. Shanghai's population grew by 44 percent between the 2000 and 2010 censuses, from 16 million to 23 million. In Beijing during the three years of 2008-2010, its population grew by 500,000 each year.

Providing infrastructure and public services to accommodate urbanization of this scale and pace is a gargantuan task that would strain any government. In China, the challenge was all the more daunting as the transition from a planned economy to a market economy was transforming virtually all aspects of social and economic organization, and brought a catastrophic collapse in the government's revenue mechanisms during the first two decades of reform, when budget revenues plunged from one-third of GDP in 1978 to just 11 percent before a new tax system began to restore fiscal health from the late 1990s onward. The upturn in urbanization thus began in a difficult fiscal environment; the fiscal mechanisms and strategies of Chinese municipalities were forged in this harsh climate.

Despite this inauspicious start, China's spectacular economic growth performance seems *prima facie* evidence that the government has managed the urbanization process well enough. New cities have cropped up. Existing cities have expanded. City centers have been renovated and modernized, infrastructure built, and urban facilities appear to be keeping up with demand. Visitors to China fly into world-class airports and are whisked into town on multi-lane expressways. The cities are crisscrossed by wide boulevards, and China is setting world records in the pace at which subway lines are being built.

In fact, a good deal of evidence points to an outstanding performance in providing growth-supporting infrastructural investments during this period. In 2010 China was ranked 27th among 155 countries in the World Bank Logistics Performance Index (LPI), a measure of a country's efficiency in moving goods to and from international markets. With an overall LPI score of 3.49, China is approaching the average of 3.55 for high-income countries, substantially outperforming its peer group.

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Behind this shiny façade, however, lies a more complex story. The system of public finance for municipalities is in tatters and in need of urgent repair. It encourages too much investment and imposes too little monitoring and control on decision-makers, producing inefficient, risky behavior that has brought a host of microeconomic and macroeconomic problems.

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How Did China Get Here?

Through the 1990s, reforms of the fiscal system made no accommodation to municipalities or the financing needs of urbanization. Except for a few favored cities in the rich coastal provinces, the current system of revenue-sharing does not provide sufficient resources for cities to meet their heavy responsibilities in service provision, including education, health care, social welfare and pensions, alongside urban facilities. Moreover, municipalities are prohibited from borrowing even for capital expenditures, making it difficult to finance infrastructure. In spite of these constraints, the remarkable growth and development of cities have proceeded because political leaders have been willing to tolerate a plethora of informal, backdoor solutions that enabled cities both to obtain the resources needed and to adapt to limitations on eligibility for benefits.


Photo: World Bank/Curt Carnemark

As it evolved, China's municipal finance has come to rely overwhelmingly on extra-budgetary resources and borrowing. Aside from charging user fees and imposing quasi-taxes on various services, municipal governments have used state assets to generate revenues to supplement the budget. And land is their principal asset. With accelerated urbanization boosting land values, land has become the biggest source of extra-budgetary revenue. In 2010, receipts from land sales[1] accounted for an estimated 35 percent of comprehensive fiscal revenues for prefectural level (second-tier) cities, compared with just 30 percent from tax revenues. In addition to sales receipts, municipalities collect a plethora of taxes from land and associated activities— property taxes, deed taxes on property transactions, and turnover taxes on construction and real estate companies, and so on. Even in Shanghai, China's largest city in both population and economic terms, land-derived revenues were a combined 35 percent of the total revenues during 2005-2009, and 50 percent of overall fiscal revenue growth during the period.

To finance public investment, municipal governments have relied mainly on two sources: land revenues and borrowing. Prohibited from direct borrowing, they have resorted to the use of financing platforms. Set up as enterprises under municipal departments, these local investment corporations (LICs) coordinate and finance the construction of facilities such as water supply, sewerage, roads, and utility hook-ups. First piloted in Shanghai in the early 1990s, these LICs now operate in all cities and have been instrumental in helping local governments achieve world-beating levels of investment in infrastructure. Typically, the LICs raise and bundle together bank loans and other financing, using a variety of municipal assets, including budgetary and off-budget revenues as equity and collateral. Increasingly, with urbanization bringing rising land values, land has become the principal asset backing LICs.

The Fallout

Municipal finance in China today grew out of ad hoc, adaptive experimentation over the past three decades, a period during which the Chinese economy was undergoing three transitions: from a socialist planned economy to a market-oriented economy, from an agrarian society to an urban industrial society, and from being one of the world's poorest economies to a middle-income country. These transitions overturned pre-existing social and economic organizations, and new ones had to be created. With the central government preoccupied with the fiscal crisis brought on by the decline of the state economy, municipalities were left on their own to cope with their changing environment.

Photo: World Bank/Curt Carnemark

In this maelstrom, municipal governments faced enormous pressures to provide a new social safety net to replace the one under the state economy, and to provide infrastructure to support the fast-unfolding economic growth and the migrants flooding into cities. They improvised. One tactic was to limit eligibility for urban services to reduce the growth in demand for them, and the system of residency registration (*hukou*) instituted in the 1950s provided a convenient, fool-proof mechanism for excluding the new migrants. Another was to go off-budget in search of resources, and municipal governments displayed remarkable ingenuity in doing so.

This decentralized approach has been instrumental in enabling China's urbanization and growth, but it has also produced some adverse outcomes.

First, the current high dependence on land is risky and unsustainable. Land prices are notoriously volatile and land revenues are unsuitable as a pillar of local finance. With leases running 40-70 years, land is an exhaustible resource. In the coastal regions, cities are already running out of land to sell.

Second, the interplay between land and LICs has led to the overuse of both. The expanding resource envelope has softened the budget constraint for municipal governments and encouraged wasteful and inefficient investments.

Third, the reliance on extrabudgetary resources has led to a fragmentation of municipal budgets that renders macroeconomic control difficult. Revenues are collected by different agencies and local governments. Information is scattered in different channels and not always reported in full.

Finally, decentralized decision-making and benign neglect from the top have allowed the creation of a two-tier society where access to vital and costly public services such as education, health care, social welfare, and pensions is open only to those with urban *hukou*, leaving over 200 million de facto second-class citizens in Chinese cities.

Next Steps

China is an urban nation. How cities finance services for their growing populations and provide infrastructure has critical implications for the nation's economic growth and well-being. Putting municipal finance back in order should be at the top of the Chinese government's policy agenda moving forward.

Among the challenges in rationalizing municipal finance, the most pressing are: resolving the high levels of local debt, introducing a new framework for managing local borrowing, weaning cities from "land finance," and absorbing the "non-*hukou*" populace into mainstream urban services.

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Decisive steps should be taken to:

1. Resolve the mountain of local debt.

The National Audit Office estimates local government debt to total 10.7 trillion yuan at year-end 2010, half of it racked up under the fiscal stimulus program in 2008-2010. The central bank has a higher debt estimate of 14 trillion yuan. With land markets slowing amid the current policy to restrain housing price inflation, preliminary estimates in mid-2011 by the China Banking Regulatory Commission were that 2-3 trillion yuan were already in trouble; others estimate that up to 8-9 trillion yuan will eventually have to be written off.[2] With more than half of the debt maturing in 2011-2013, in February 2012 Beijing ordered banks to roll over local government loans while a resolution is worked out. Some restructuring of the debt and a quick resolution of bad debts would end the policy paralysis of the past two years and create more working space for municipal governments and banks. At 10.7 trillion yuan, the debt is equal to 27 percent of current year GDP and 263 percent of subnational revenue. Working out a resolution is well within the central government's capacity but beyond that of most local governments, especially since the burden is unevenly distributed.

In the interim, government must guard against banks passing on financial risks through repackaging these loans as complex financial products to sell to consumers hungry for yield.

2. Put in place a framework for managing subnational borrowing.

Borrowing to finance long term infrastructure is both equitable and efficient. By stretching out the payment stream to match the long

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stream of benefits for infrastructure, such as bridges, subways or schools, this financing method adheres to the user-pay principle and promotes greater inter-generational fairness. In most countries, local governments are permitted to borrow for capital spending, but this process has to be carefully managed to minimize risks, including project risk, repayment risk, fiscal risk, systemic banking risk, and macroeconomic risks of overheating.

In China, the process of moving public investment off the budget and into the financial sector appears to have been accompanied by an excessive faith in the ability of the financial market to exert discipline on local government borrowing. Little attention was paid to the potential fiscal risks. In 2011 the Ministry of Finance (MOF) introduced a monitoring and regulatory framework that requires local governments to report on their debt. The framework could be bolstered by some additional measures, such as undertaking annual audits of local debt, taking steps to ensure that local governments have a fully transparent budgetary process, with regular public disclosure of key fiscal data and full sharing of information with MOF. Local governments should be required to make regular and frequent reporting on their direct and contingent liabilities including borrowings made by LICs, loan servicing (including any defaults or delays in payments on loans), as well as their borrowing plans.

Photo: World Bank/Jiang Aijun

This is an opportunity to clarify the boundary between the public and private sectors, and to delineate more clearly what government should do and what could be left to market forces. It is also an opportunity to promote a full panoply of financial instruments for financing public infrastructure, including long-term bonds, public-private partnerships, along with LICs. As hybrid public corporations, LICs need careful supervision and special governance arrangements.

3. Replace "land finance."

Municipal governments need access to transparent and sustainable sources of finance from taxes, user charges, and grants. To reduce the degree of dependence on land, cities will have to find replacement revenues through broadening the municipal tax base. There is scope for making more effective use of user charges and transfers from higher-level governments. The caveat, though, is

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that many user charges in China—for example, education and health care—are already high, excessive, or onerous. Transfers from higher-level governments are also very large compared to other countries, and often notably ineffective in reaching their targeted uses. The biggest potential for improving the status of municipal finance lies in revising the tax-sharing system to improve the alignment of revenue and expenditure assignments and to reflect the recent demographic shifts.

The conventional wisdom among economists is that greater revenue discretion, along with transparent and regulated access to credit, would help to harden budget constraints for local governments and induce more prudent fiscal management. Short of a full-scale revamping of the tax-sharing system, the central government could give municipalities greater tax autonomy by giving them some discretion on tax rates for a few selected taxes, such as the vehicle tax and license fees.

They could also be permitted to piggyback or levy surcharges on central or shared taxes—the corporate income tax and personal income tax could be good candidates. A more radical option is to consider introducing some differentiation in the tax-sharing rates—for example, by giving a bigger share of the value-added tax (VAT) to large municipalities.

In the meantime, the current reform to convert the business tax to the value-added tax must be carefully managed to avoid further weakening the municipal tax base, since the business tax is the largest tax-type for local governments, accounting for over 30 percent of own revenues for the second and third tier cities (prefectural and county levels).

Going forward, land and real estate will, for the foreseeable future, remain a key source of tax revenues for municipal governments, since urbanization and rising incomes will continue to drive growing demand for housing. Innovative approaches could be found to create a new framework for the development of land and housing markets to produce a more stable, sustainable revenue stream for municipalities. One suggestion recently put forward is to open up to private investment in low-cost housing the vast tracts of un-utilized land currently sitting in the many development zones.

4. Absorb the non-hukou populace into mainstream urban services.

Integrating the non-*hukou* populace into mainstream urban services should be a core part of both building a harmonious society and investing in human capital for China's future. Nationwide, fully one-third of all urban population are non-*hukou*. In Shanghai, this share has risen from 20 percent of the population in 2000 census to 39 percent in 2010 census.

The costs of absorbing the more than 200 million people into urban public service provision will be huge, and will require central government injections. Ideally, these costs would be incorporated into the reform to revamp the intergovernmental tax sharing system. In the short-run the central government may need to provide subsidies on a capitation basis to induce municipal governments to take on the additional population, starting with basic education, catastrophic health coverage, social relief, and gradually adding others as budget resources permit.

After three decades of rapid growth and urbanization, China is now a regionally more interlinked, increasingly mobile society. Many of the formerly “local” public services such as health and education have far greater spill overs, taking on greater “national” characteristics. Their financing should be changed to reflect the new reality.

Endnotes

[1] Strictly speaking, land ownership remains with the state but the right of use can be sold.

[2] Green, Stephen, "China—Solving the Local Government Debt Problem, Special Report, Standard Chartered Bank," July 18, 2011, accessed at https://research.standardchartered.com/configuration/ROW%20Documents/China%20–%20Solving%20the%20local%20government%20debt%20problem_18_07_11_09_13.pdf.

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