# 10 Reforming China's Public Finances for Long-term Growth

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## Introduction

In a modern state, the government performs three main functions: resource allocation—including the provision of public goods such as national defence, internal order and a legal system; the redistribution of income—including the provision of social protection and safety nets; and macroeconomic stabilisation. To finance these functions, the government raises revenues, and its ability to do so fluctuates with the size of the economy and its rate of growth. Since the global financial crisis in 2008, the general public has gained a greater appreciation of how important public finances are to a nations' well-being, affecting both its economic growth prospects and the welfare of citizens.

In the course of its transition from a planned to a market economy, China has had to rebuild the existing system of public finances, since the previous one was embedded in the central planning institutions and wholly unsuitable for a mixed economy. When administrative prices and monopoly state ownership of industry—two pillars of central planning—were gradually dismantled in the 1980s, government revenues went into a freefall, bottoming out in 1996 at just 11 per cent of GDP—one-third of their former size. This fiscal decline was reversed only after the Tax Sharing System reform of 1994 brought in a new tax system and created a national tax administration (Wong and Bird 2008).

In addition to the creation of a new revenue mechanism, rebuilding public finances required the reform of budget institutions. In China's centrally planned economies, the budget was mostly a bookkeeping function subordinated to the physical planning of inputs and outputs, and the Ministry of Finance (MOF) had a low status among central government agencies. With the end of economic planning, the budget became increasingly the government's primary tool for allocating resources, and major reforms were needed to build a system of budget management to support this new role. This process has proved trickier—and far from complete, because it required the elevation of the role of the MOF in managing public resources.

In this chapter I examine the current state of China's public finances and discuss the reforms necessary to improve their capacity for supporting the long-term growth of the economy. The focus of this chapter will be on the macroeconomic stabilisation role of the budget. Along the way I will note the prominent role played by local governments in making macroeconomic control more difficult, but reform of the intergovernmental fiscal system has been discussed elsewhere and will not be the main focus in this chapter.[1]

In the next section I will briefly review the reforms that have been implemented to date. In the following two sections I will focus on two critical areas where reforms have conspicuously failed—the persistence of extra-budgetary resources and fragmented control of the budget, and the government's inability to curb the tendency toward excessive public investment. Both are important parts of public financial management, and they have remained stubbornly resistant to the reach of reform. In the final section, I discuss the macroeconomic challenges faced by the new Xi Jinping – Li Keqiang administration, and propose some urgent fixes that will be required for the public finance system.

# Incremental Reform of the Fiscal System

Since embarking on its transition in 1978, China has come a long way toward building a new fiscal system to support the growth and operation of an increasingly decentralised, complex market economy. The list of reforms is impressive, and covers virtually all aspects of the fiscal system.

## Tax System Reform[2]

Since restoring fiscal health was of the utmost urgency, tax reform came first. As noted earlier, a new system of taxes has been put in place since 1994, centred around the value-added tax, a business tax, a corporate income tax, a personal income tax, and several taxes on property, land transactions, and land use. These are broad-based taxes with uniform rates of levy that have facilitated tax administration and the monitoring of tax capacity across regions. The system still has significant room for improvement. Currently, revenues are overly dependent on productive activities rather than income, which distorts resource allocation as localities compete to attract industry and businesses; and the heavy dependence on turnover taxes and small share of income taxes means the tax structure lacks progressivity, to name just two examples. Overall, though, the tax system is highly income-elastic, and has produced buoyant revenues that have grown at roughly 1.5 times the rate of GDP growth over the past decade.

1 See, for example, Wong 2009, 2010 and 2013.

2 A more detailed discussion can be found in Wong and Bird (2008), and World Bank (2002).

## Public Financial Management Reform[3]

With revenues recovering, the government began in the late 1990s to turn to financial management reform. Since then, a broad package has been introduced that includes reforms in budget preparation, budget classification, treasury management, government procurement, and the installation of new fiscal information systems. Until then, the budgeting process had changed little from the planned economy. A World Bank team found in 1997 that the budgeting process was passive and incremental, provided inadequate time for preparation, had little focus on strategic priorities, and was unable to shift expenditures to emerging needs or to adequately track how public funds were spent, or even how many people the government employed (World Bank 2000). As the budget gained importance as the key instrument for resource allocation and macroeconomic management, reforms were urgently needed to improve the effectiveness of the budget as a policy instrument for managing public expenditures.

Since 1999, the MOF has introduced new procedures for budget preparation and approval, and strengthened budget reporting to the National People's Congress (NPC). To adjust to the new budget procedures, the MOF underwent a radical restructuring in 1999 so as to streamline budgeting work (Wong 2005). The centrepiece of reform in budget preparation was the introduction of departmental budgets that clearly identify all resources and expenditures for each government department, the first step toward building a system whereby spending units could be held accountable for the public monies that they receive.

A treasury single account was created to manage the government's cash receipts and payments. Before this reform, expenditure monitoring was one of the weakest links in the budget process, and the MOF had no information on when and how money was spent. Although much effort was spent on ex ante allocation, actual expenditures could not be monitored, and diversion and other abuses could be exposed only by audits, which took place only occasionally. With the general ledger of budget appropriations linked to the treasury single account, the government could, at least in principle, track the government's fiscal position in real time.

To support treasury reform and improved budgeting, the MOF began work on a new government financial management information system. A new budget classification system was rolled out in 2006 to improve the tracking of expenditure by functional categories. Standardised procedures for government

3 For more details of public financial reform, see Wong (2005, 2012) and World Bank (2000).

procurement were introduced to improve cost efficiencies and reduce the scope for corruption, adopting many of the procedures of international organisations for tendering large-scale purchases of equipment and services.

With these reforms, China has over the past decade put in place the basic infrastructure for a modern system of budget management. Great strides have also been made in budget transparency and reporting to the NPC. The annual reports to the NPC are providing far more detail than in the past; starting from just a few pages in the 1990s, the report for 2012 and draft budget for 2013 included 23 supplementary tables and 12 figures, which provide many details on revenues and expenditures as well as central transfers. At the last count, 91 central government departments had put their budgets on the web for public scrutiny by 2012, including the MOF's, whose departmental budget was 32 pages in length. This year it has grown to 38 pages.[4]

## Intergovernmental and Tax Sharing Reform

China's fiscal system is among the most decentralised in the world in terms of budgetary expenditures. The central government itself spends less than a quarter of the national budget, and this share has fallen from more than 50 per cent at the outset of transition to 17 per cent in 2011. This decentralisation was driven mainly by the changing composition of budget expenditures. With the government withdrawing from directly funding economic activities during the course of market transition, expenditures became more weighted toward public services. This has shifted expenditures toward local governments since nearly all public services, including some of the costliest, including basic education, health care, social security, and infrastructure, are assigned to local governments, often at the grassroots level. Counties and districts, for example, the fourth tier of government, account for a majority of the total national expenditures on education and health (Wong 1991, 2009; World Bank 2002).

Given the important role of local governments, getting the intergovernmental fiscal system 'right' should have been a priority focus of fiscal reform, but this area received little attention through the 1990s. Indeed, since the 1994 reform was aimed principally at stemming fiscal decline and especially the erosion of central government control over resources, it imposed a reform that recentralised revenues and gave the central government control over roughly half the budget. With expenditure assignments unchanged, local governments were left with a huge fiscal gap. With the central government unwilling or unable to provide financial assistance, they faced severe fiscal difficulties that resulted in pervasive

4 These can be downloaded at http://www.mof.gov.cn/zhengwuxinxi/caizhengshuju/201304/t20130416_825081.html

shortfalls and large regional disparities in public services (Wong 2007). By the late 1990s, many local governments were in arrears in pension payments, and wage arrears for teachers and civil servants were common. The rural sector bore the brunt of these deprivations, since they are at the lowest levels of the administrative structure and last in line to fight for resources (Fock and Wong 2008).

From the turn of the century, and especially over the past few years, the central government has made strenuous efforts to gradually address these funding problems. Under the government's 'three rurals' policy[5]—a signature program of the Hu Jintao and Wen Jiabao administration, fiscal resources have poured into rural services. Many new programs were introduced with central government subsidies, including the rural fee reform that abolished all fees and agricultural taxes, the 'new education funding guarantee mechanism' that ensured school fees would be eliminated and funding standards improved in rural compulsory education, the new rural cooperative medical schemes that now provide health insurance coverage to virtually all farmers, and income support for farmers under the rural *dibao* program. (Wong 2010). With these programs 'tilting' the balance, the share of the county and township governments has risen from 28 per cent to 40 per cent of total national budgetary expenditures since 1998.

A salient feature of the policies of the Hu–Wen administration is that they were implemented largely within the existing framework of intergovernmental assignment of revenues and expenditures, and relied heavily on the use of transfers. While the beneficial effects of increased funding for public and especially rural services are clearly visible, so are many of the distortions and inefficiencies common to the use of transfers. Moreover, the heavy use of transfers imposes an administrative burden on the central bureaucracy that seems mismatched to its small size, and the government's capacity to monitor and evaluate the use of central transfers is conspicuously lacking (Wong 2010, 2012).

In the longer term, it is likely that reforms will be considered to the expenditure assignments to improve efficiency and equity. Over the past decade, three reforms were implemented to adjust the intergovernmental fiscal system, all of them at the sub-provincial levels: the province-managing-counties reform, the county-as-key link reform, and the counties-managing-township-finances. Implementation of the county-as-key link reform began around 2002 and moved the responsibilities for providing education, health care and other key services upward from the township to the county level. Contemporaneously, the counties-managing-township-finances moved the accounting and disbursement

5 The 'three rurals' are 'agriculture, rural villages and farmers'. For earlier papers on the three-rurals policies, see Fock and Wong (2008), Lin and Wong (2012).

functions of township finances upward to counties. They were followed by the province-managing-counties reform, which removed the municipality as an intermediate level of management to allow a direct pass-through of fiscal resources and authorities from the province to the counties. Officially, these reforms are said to be aimed at enhancing the counties' fiscal capacity and improving financial management at the grassroots levels of government (Xie 2011). In practical terms they were equally important for facilitating the flow of central transfers by reducing the number of administrative layers from five to three.

## Extra-Budgetary Revenues and the Fragmentation of Budget Control

In the budget report presented to the NPC in March in 2013, then finance minister Xie Xuren reported on three 'budgets' that include four types of fiscal revenues: the 'public finance budget' comprising tax revenues and nontax revenues, the 'government funds budget', and the newly created 'revenues from state capital operations' comprising remitted profits from large state-owned enterprises (SOE). He also announced that, starting from the 2013 budget, MOF will also report on the 'social insurance funds budget'. In the draft budget presented for 2013, he reported, for the first time, the sum of social insurance contributions and fiscal subsidies as 'social insurance fund revenues' (MOF 2013).

Table 10.1 Composition of fiscal revenues in the comprehensive budget, 2012

| | Billions ¥ | Shares |
|---|---|---|
| Public finance budget | 11,721 | 64.2% |
| Tax revenues | 10,060 | 55.1% |
| Non-tax revenues | 1,661 | 9.1% |
| Government funds | 4,136 | 22.6% |
| Land revenues | 2,889 | 15.8% |
| Other government funds | 1,248 | 6.8% |
| Revenues from state capital operations | 157.3 | 0.9% |
| Social insurance funds (contributions only) | 2,255 | 12.30% |
| Total | 18,270 | |

Source: 2013 Budget Report to the NPC, 5 March.

Table 10.1 presents the revenues for each of these fiscal resources, including contributions to the social insurance fund (SIF), in what I term the 'comprehensive budget' for 2012. Because of the size of land revenues, I have listed them separately from government funds. It can be seen that tax revenues of ¥10.1 trillion were equal to 55 per cent, or just over half of the total ¥18.3 trillion in the comprehensive budget. The other components include:

## From Extra-Budgetary to Non-Tax Revenues

The rise of extra-budgetary funds (EBF) can be dated to the retreat of the budget in the 1980s and 1990s, when support for public services fell across the board. Public service providers, including primary and middle schools, received, on average, only one-half of their operating revenues from the budget, and had to find the rest through fees and 'other incomes'.[6] Even local police departments typically received only budgetary support for salaries, and had to buy their uniforms, batons and other equipment from revenues collected through fines and penalties (Bai 2004). To keep services going, local governments and public agencies were encouraged to find supplementary sources of revenue (Wong 2009). With incentives that allowed the collecting agencies to use a part of the receipts for bonuses and topping-up salaries, they obliged by levying fees, user charges, fines and penalties (World Bank 2005, Wong 2009). Fees and other levies proliferated; by the late 1990s revenue from these sources totaled eight to ten per cent of GDP, and they were reportedly financing half or more of local government expenditures (Fan 1998, and Wong 1998, 2001).

Since 1998, the government has taken a number of measures to reverse this trend. The strategy was to clamp down on unauthorised fees and levies, bring administrative fees collected by government departments and agencies into the budget as much as possible, improve monitoring of revenues and expenditures of the major items of the reported EBF, and to gradually convert them to taxes.

The efforts have achieved some measure of success. Many fees have been abolished and replaced by budgetary support—including, most famously, all rural levies under the Rural Fee Reform campaign that was implemented during 2001–2003. Administrative fees continued to grow, but are now incorporated into budget accounting, though not unified budgeting. Reclassifying and removing some of the biggest sources of EBF (see below) also helped the government whittle down what is reported in the formal category of EBF. Finally, in 2010, the MOF renamed them 'non-tax revenues' (NTR), ending the existence of 'extra-budgetary funds' as an official category. In 2012 NTR were ¥1.66 trillion, equal to 3.2 per cent of GDP.

6 For details of how public service providers were funded, see World Bank (2005).

## Government Funds

The category of 'Government Funds' (GF) was created in 1996 from reclassifying 13 of the largest items from EBF as government funds, including the road maintenance fee, the vehicle purchase fee, the railroad construction fund, electric power fund, the Three Gorges Dam fund, and airport management fees and construction fund, which together accounted for more than one-fourth of the EBF in 1997. The intent was to improve the reporting of fund receipts, as a first step toward converting some of the items into taxes and extending budgetary control over them. While this has happened with some—the road maintenance fee and the vehicle purchase fee, for example, government funds have grown steadily, with the addition of some large and rapidly growing sources of revenue. In 2010, it comprised more than 50 funds, with revenues of ¥3.7 trillion (9.2 per cent of GDP), compared to ¥7.3 trillion in tax revenues.[7] The biggest funds are 'user fees on newly developed (urban) land', 'railroad construction fund', 'water conservancy construction fund', and 'local education surcharge.' These are essentially quasi-taxes; they are authorised by administrative agencies, and do not require approval by the NPC. In other words, they are but a new name for the EBF of old.

## Land Transfer Revenues

Aside from charging user fees and imposing quasi-taxes, monetising state assets was another avenue for supplementing the budget, and land is the principal asset of local governments.[8] In addition to existing city land, local governments earn revenues from the conversion of farmland into non-agricultural use—a profitable activity over which local governments have a constitutional monopoly, and where the law fixes the procurement price of farmland at a low level so that the bulk of the rising values of urban land accrues to local governments.[9]

Local governments began to tap this rich source of revenue in the early 1990s (Wong 1997, Guan and Peng 2011). With accelerated urbanisation boosting land values, it has grown to be a key source of revenue for municipal governments: in 2011 revenues reached ¥3.11 trillion nationwide, but fell back to ¥2.89 trillion in 2012. In 2007 the government designated land revenues as GF, and required them to be remitted to the treasury and budget management.

7 MOF final accounts for the 2010 budget, July 2011, accessed 18 February 2012, http://yss.mof.gov.cn/2010juesuan/201107/t20110720_578448.html

8 The 1982 constitution specifies that urban land is owned by the state while rural land is owned by the collectives.

9 See Cao et al. (2008) and Tao et al. (2010).

## Revenues from State Capital Operations

This category is at present a misnomer as it comprises only the remitted profits of the 117 giant state-owned companies (enterprise groups) controlled by the central government and reporting to the State-owned Assets Supervision and Administration Commission (SASAC), an agency created in 2003 under the State Council. At present the remittances are a fraction of the total profits of these companies, in 2012 they were just ¥97.1 billion, compared to combined revenues of ¥26.06 trillion, equivalent to half of China's gross domestic product.[10] It is likely that this budget component will grow in the future, as the new Finance Minister has vowed to extract a greater share of SOE profits for government coffers.

## Social Insurance Funds

The SIF was created in 1996, with the introduction of insurance schemes for urban employees that provide coverage for pensions, work injury, unemployment, maternity and health.[11] City-level pooling of pension obligations had begun in the 1980s—shifting from the system where enterprises had borne the pension costs of their retirees. The change was formalised in 1991, when the State Council introduced universal pooling of pension burdens and placed them at the city level—be they provincial, prefectural or county-level cities.[12] Through the 1990s, the system was adjusted in several steps, creating the framework that exists today.

Under the new system, each city is responsible for collecting the employer and employee contributions to each scheme and managing the fiduciary responsibilities for the SIF. Although the framework is based on regulations issued by the central government, many details of the schemes are left to the discretion of the provincial and municipal governments (Hussain 2007). To minimise fiscal risks, cities were permitted to set contribution rates and benefit levels to balance receipts and payouts, though, in recent years, there have been some efforts to harmonise contribution and benefit levels across pension pools.

Even though cities are the budget unit for social security, the SIFs are managed by the Ministry of Human Resources and Social Security (MOHRSS) and its subnational counterparts outside the budget.[13] With urbanisation,

10 http://blogs.ft.com/beyond-brics/2013/03/27/chinas-new-captain-of-industry/?utm_source=Sinocism+Newsletter&utm_campaign=e1a48e008c-Sinocism03_28_13&utm_medium=email

11 For the creation of the SIF and its component schemes see, for example, Hussain (2007), Wang (2005), and Watson (2009).

12 State Council decision on the reform of the pension insurance system for urban enterprise employees, June 1991.

13 The 'social security and employment assistance' expenditure item in the budget comprises expenditures on social welfare, disaster relief and fiscal subsidies to the SIF to cover shortfalls, while the main expenditures on social security are made under the SIF.

an ageing population, and with recent policies that have significantly expanded social insurance provisions, the SIF has grown rapidly. Coverage has grown from the initial pension scheme for SOE workers and an unemployment insurance program to include a pension program for residents who have never held a formal sector job, as well as a basic medical, work injury and maternity insurance programs. Contributions to the SIF have grown to 5.4 per cent in 2011.

## Fragmentation of Control

Although these various types of fiscal (extra-budgetary in the broad sense) revenues have been in existence since the 1990s, or even earlier, they will be presented to the NPC together, in a single report, for the first time in 2014. Indeed, a salient feature of these extra-budgetary revenues is that information is scattered in different channels. Under China's decentralised statistical system, for example, information on the SIF are reported by the MOHRSS, separately from fiscal data. Until recently there was little public information about the aggregate size of land transfer revenues because they accrue almost entirely to local governments, and the central government has struggled to gain access.[14] Moreover, until 2001, land transfers were mostly made by administrative allocation and negotiation, and the real value of the transactions was largely hidden. The Ministry of Land Resources has published national and provincial data back to 2001. The data were incomplete, however—an audit conducted by the National Audit Office (NAO) of 11 municipalities including Beijing, Tianjin, Chongqing and Guangzhou found that during 2004–2006, land transfer revenues were under-reported by 71 per cent.[15] With their designation as a government fund in 2007, reporting seems to have improved. The same NAO audit found that for 2007–2008, the 11 municipalities under-reported land transfer revenues by a much reduced 20 per cent.

The fragmented reporting is symptomatic of the fragmentation of control. Among the components, only tax revenues are fully under unified budget management by the MOF and its subnational counterparts. Even for NTR and GF, which are reported to the budget and partially remitted to the treasury, their 'ownership' and hence allocation rights remain with the collecting agency. Land revenues belong to local—mostly municipal—governments, and are allocated outside of the budget. As noted earlier, SIF are managed separately in the local SIF pools, also outside the budget. In other words, the pool of revenues allocated through the budgeting process, guided by the government's strategic

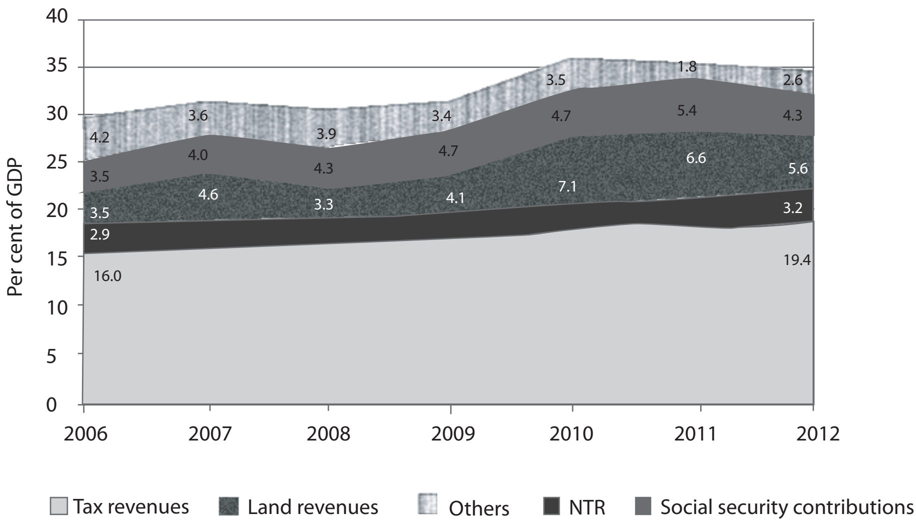
14 The difficulty of gaining information was made more so because, until recent years, the central government was continually asserting its right to share the revenue.

15 See Fu (2010).

priorities, includes only tax revenues and to some extent the nontax revenues. Virtually everything else is earmarked for specific purposes and allocated by different agencies and local governments. Most importantly, the MOF (and its subnational counterparts) lacks the authority to impose aggregate discipline over the comprehensive budget.

Figure 10.1 shows the trend for the comprehensive budget based on all known fiscal resources excluding borrowing. (One caveat to keep in mind is that these data are somewhat soft—they are collected by different agencies using definitions that are not always consistent, and are often subject to revision and adjustment.) Nationwide, the comprehensive budget has grown rapidly, from 30.1 per cent of GDP in 2006 to a peak of 36.2 per cent in 2010 before retreating to 35.1 per cent. This upward drift can be attributed to decentralised forces in the economy—each component grew (or shrank) according to its internal objectives and the economic environment it faced. Most of the growth came from land, a notoriously volatile revenue source. The public finance budget (tax revenues plus NTR) also grew steadily through these six years, from 18.9 per cent to 22.6 per cent, as has the SIF through steadily growing coverage and participation. The rapid growth of the overall envelope—by nearly one per cent of gross domestic product per year, should be alarming to policy makers.

Figure 10.1 China's comprehensive budget: 2006–2012 (%)




Source: Author calculations based on data from MOF final accounts, *Chinese Statistical Yearbook* (various years), and *China Land and Resources Communique* (various years). 'Others' includes government funds other than land, and state capital revenues.

# Public Investment Management

Among the most important changes in the role of government through the transition are those affecting investment, where reform has seen the government curtail its role and attempt to shift from directing the overall pattern of investment to ensuring adequate support to economic growth and public services. Negotiating the reduction in the scope of government has proved tricky, and progress in reforming the system of public investment management has been uneven.

On the upside, China's record in investing in public infrastructure has been outstanding. From having less than 10,000 kilometres of expressways a decade ago, the country now has more than 65,100 kilometres, second only to the United States in total length. During 2006–2010 alone, the road system was expanded by 639,000 kilometres, including 33,000 kilometres of expressways. China has also expanded the railway system by 16,000 kilometres over the same period. The country has some of the world's biggest and most modern airports, and has invested heavily in container port facilities. Chinese cities are remarkably well-served by urban facilities and services given the rapid rate of urbanisation over the past three decades, where some 500 million people have moved into cities (Wong 2013). In 2010, China was ranked 27th among 155 countries in the World Bank Logistics Performance Index (LPI)—a measure of how efficiently a country gets its goods into the global trading system. With an overall LPI score of 3.49, China is within striking distance of the average of 3.55 for High Income Countries, well ahead of its peer group of middle income countries. On the financing side, though, reforms have been problematic.

Under market reforms, the financing of public investment has changed dramatically (Wong 2011a). By far the most important was the rapid withdrawal of budgetary inputs to investment that was driven by fiscal decline. Except for a small spike under the fiscal stimulus programs in the late 1990s and again in 2008–2010, the share of budgetary inputs has been below 5 per cent of total investment since 1993 (Table 10.2).[16] 'Self-raised' funds have always been large, and now finance more than three-quarters of total. Their composition is amorphous, however, and ill-defined.

16 For the 2008–2010 fiscal stimulus and its impact on public investment, see Wong (2011b).

Table 10.2 Sources of finance for fixed investment: 1982–2010 (%)

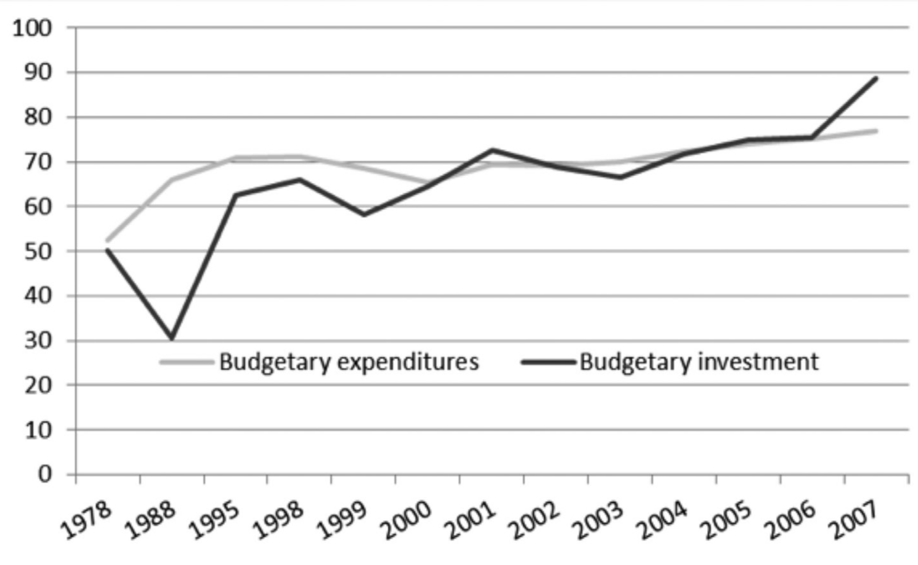
| | 1982 | 1993 | 1995 | 2000 | 2003 | 2007 | 2010 |
|---|---|---|---|---|---|---|---|
| Budget | 22.7 | 3.7 | 3.5 | 6.8 | 4.8 | 3.9 | 4.7 |
| Domestic credit | 14.3 | 23.5 | 21.7 | 23.6 | 23.0 | 15.3 | 15.2 |
| Foreign | 4.9 | 7.3 | 13.1 | 5.8 | 4.5 | 3.4 | 1.6 |
| Self-raised and other | 58.1 | 65.5 | 61.7 | 63.8 | 67.6 | 77.4 | 78.5 |

Note: Self-raised funds are own receipts of enterprises or institutions. 'Other' includes capital from bond issue by enterprises or banks, levies, own capital and donations.

Source: National Bureau of Statistics, *New China 55 Years Statistical Compendium*, and National Bureau of Statistics, *Chinese Statistical Yearbook*.

The second important change was that investment became decentralised. Figure 10.2 shows the local governments' share of budgetary investment rising in line with their share of budgetary expenditures.[17] An additional aspect of the decentralisation of investment responsibilities is that, just as higher level governments were offloading them to local governments, fiscally constrained local governments often devolved the responsibilities to public institutions such as schools and hospitals, and likewise encouraged them to find their own resources.

Figure 10.2 Local governments' share of budgetary expenditures and investment (%)




Sources: *Chinese Statistical Yearbook 2011*, and MOF data.

17 In 2007 the MOF changed budget classification systems, and stopped reporting capital spending separately from recurrent expenditures.

Along with financing, the authorities for investment decisions were also progressively devolved. Under the planned economy, investment projects went through a formal process of preparation that included feasibility studies, technical reviews and appraisals before approval. Project approval authority was vested with the State Planning Commission (now renamed the National Development and Reform Commission, NDRC) and its subnational counterparts, the DRCs. This was a key part of the macro-coordination function performed by the NDRC, since project approval was a precondition for application for land, raw materials, and funding including bank loans. Through the transition, project approval was progressively decentralised to lower level governments. The decisive reform came in 2004, when the government limited the requirement for administrative approval to only projects financed by public funds and mega projects with investments exceeding a specified threshold or in strategic sectors.[18] Given the diversified funding of public investments and a lack of clear definition on what constituted 'public funds', this decision was widely interpreted by local governments to mean that only projects funded by the budget were required to go through the approval framework. The vast majority of public investment was considered exempted from 2004 onward, and the gatekeeper function of the NDRC and DRCs has been severely eroded. Anecdotal information collected in fieldwork conducted in several provinces during 2008–2010 indicates that, even in localities where administrative approval procedures were retained, the exercise was largely pro forma, since approval was always granted if funding was assured.[19]

With market reforms unleashing rapid economic growth and accelerating urbanisation, local governments have faced tremendous pressure for investment in public infrastructure. They have managed to achieve and maintain high levels of investment, despite inadequate fiscal resources, partly by making extensive use of extra-budgetary resources. Many of the EBFs, and later, the GFs, were created to help provide funding for investment in infrastructure, such as the airport maintenance and construction fee, the railroad construction fund, and the Three Gorges Dam fund. In addition, local governments came to rely heavily on land revenues, which are mostly earmarked for investment in urban development. My estimates are that land transfer revenues comprised almost one-third of the comprehensive budget revenues of prefectural level cities, on average, in 2010 (Wong 2013).

Equally, or perhaps even more important, were the special financial vehicles. To work around the prohibition on direct borrowing, starting in the 1980s local governments—mostly at the municipal and provincial levels—turned to the

18 State Council document on Reform of Investment Institutions (2004). See Wong (2011a).

19 See Mikesell et al. (2011) for practices in Guangdong. I conducted fieldwork in Shandong, Jiangsu and Zhejiang.

creation of corporate entities to undertake the task of raising funds to finance public investment. They were initially created as financially independent, single-purpose entities, often for the purpose of taking on loans from international financial institutions. Being financially independent restricted their undertakings to those with the capacity for debt servicing and repayment, and these corporations were prevalent in the construction and operation of toll roads, power companies, water companies and utilities.

Shanghai created the first broad-based investment corporation in 1992 to undertake investment in urban infrastructure, the General Corporation of Shanghai Municipal Property, and gave it the mission to coordinate and provide for the construction of facilities such as water supply, sewerage, roads and utility hook-ups. To finance these tasks, the corporation was assigned earmarked revenues from the municipal budget and authorised to borrow from banks and issue corporate bonds. Its creation made possible a quantum leap in the financing available for investments in infrastructure to support urban renewal and expansion in Shanghai. This model was widely emulated. By the turn of the century, most cities had established local investment corporations (LICs)—sometimes called urban development investment corporations (UDICs), and they came to play a key role in financing urbanisation in China (Wong 2013).

As they became more accepted, the separation of LICs from local public finances was relaxed, and local governments began to guarantee bank loans for LICs. Typically, the LICs raise and bundle together bank loans and other financing, using municipal assets including budgetary and extra-budget revenues as equity and collateral. Increasingly, with urbanisation bringing rising land values, land became the principal asset backing LICs, and many municipalities have pledged future receipts from land revenues as collateral for bank loans.[20]

The extent to which the growth and development of LICs occurred 'below the radar' of central authorities was revealed only in 2010–2011. Because LICs were local experiments that lacked formal endorsement by the central government, they operated in the interstices of China's mixed economic system. They were never assigned a supervisory agency, and were not required to file regular reporting of their activities. During 2008–2010, asked to finance three-quarters of the 4 trillion ¥ stimulus program, local governments were invited to set up financial platforms from which to borrow. The response was overwhelming: LICs proliferated and grabbed large portions of investment funding and bank credit. Central authorities finally took notice, and found that no agency had systematic

20 The 2011 survey of LICs conducted by the NAO found that future land revenues were pledged as collateral for bank loans in 309 prefectures and 1131 counties, equal to 93 per cent and 56 per cent of the those administrative units, respectively (NAO 2011, p.11).

information on LICs—not the China Banking Regulatory Commission, the People's Bank, the MOF, the Ministry of Construction, or the NDRC (Wong 2011b)![21] Even after a massive nationwide audit in 2011 with 41,000 auditors led by the NAO, the picture remains clouded by the lack of consensus on what an LIC is, how much of their investments are 'public infrastructure', and what portion of their debts should be assigned to local government responsibilities.[22] Given the prominent role played by local governments and LICs in financing public investment, this is a clear indication that the government has lost aggregate control over public investment.

In borrowing to finance infrastructure, China is following common practice in other parts of the world, and borrowing to finance capital spending is considered good public policy when it matches the economic life of expenditure to its financing. By stretching out the payment period to match the long stream of benefits from infrastructure such as bridges, subways or schools, this financing method adheres to the user-pay principal and promotes greater efficiency and intergenerational fairness. Where China differs is in the unsupervised nature of the borrowing, not only by national authorities, but apparently at the local level as well. In a trenchant critique, researchers in the NDRC Investment Research Institute described the current system of local investment finance as operating under 'the three nos': with no guiding framework, no limit, and no accountability.[23]

In fact, the critique can be applied more generally to public investment over the past decade, where there is no overall framework that defines the scope of public investment. Municipalities often lack an investment plan that includes consideration of total debt levels. LICs often do not compile an assets and liabilities account, and they are so closely linked to local governments that it is difficult to separate out and define their responsibilities. In China's immature financial system, banks are ill-equipped to provide the discipline expected from capital markets, especially when local government finances are so complex and non-transparent. In any case, after more than 20 years of hyper-growth, there was a widespread belief that land values will always rise, and government can make good on guarantees.

21 LICs grabbed nearly one-third of all new loans issued in 2009, and in the first quarter of 2010 they accounted for 40 per cent of all new bank loans (*Investors Bulletin*, 2010; Wei, 2010).

22 According to Zhang and Batson (2011), estimates diverged significantly across agencies:

| Agency | Number of LICs | LIC debt (RMB trn) |
|---|---|---|
| People's Bank of China | >10,000 | <14.4 |
| China Banking Regulatory Commission | 9828 | 9.1 |
| National Audit Office | 6576 | 5 |

23 Wang et al. (2010).

Today it is not possible to fully identify and account for total public investment in China and its configuration. Clearly, in the absence of an effective system of monitoring and evaluation, the unsupervised borrowing by local governments and public institutions created a soft budget constraint that encouraged excessive borrowing and investment, and wasteful and inefficient use of both land and capital.

## Macroeconomic Challenges and Next Steps in Public Financial Reform

Over the past three decades, China has harnessed a process of gradual, incremental reform to achieve spectacular economic growth and development. Through this transition, the public finance system—albeit with many problems, appears to be doing its main job in providing support for government functions. By focusing on the fragmentation of budget control and the decentralised and extremely problematic management of public investment, I have traced the roots of the government's current macroeconomic problems to weaknesses in the fiscal system.

To support sustainable, long-term growth of the Chinese economy, the government must regain control over macroeconomic management. The technical part of the work would start with curbing local government borrowing and investment, a process already begun in 2010, when administrative controls were placed on bank lending to LICs.[24] While the immediate, short-term task is to clarify the size of local government debt and devise a plan for its resolution, reforms must aim to change the incentives for decentralised investment and borrowing, to avoid reverting to what Yu Yongding has called the Groundhog Day cycle that has characterised Chinese economic growth over the past two decades.[25]

This process could start with putting in place a framework for managing subnational borrowing. Having seen that the prohibition on local government borrowing served only to push it underground and out of the purview of national authorities, the reform should explicitly endorse local government borrowing

24 This began in June 2010, when the State Council issued a circular on enhancing the management over subnational government financial platforms (Guo Fa [2010] no. 19).

25 Yu describes a pattern where 'high investment supported by expansionary policy drives growth; inflation follows after lag; policy is tightened; growth drops away, but inflation is still high; more tightening; inflation falls at last, but growth falls away more than desired at the same time; policy is shifted from tight to expansionary; again, led by investment, growth rebounds,' and the whole cycle starts again (2013).

for the purpose of financing long-term infrastructure. In most countries, local governments are permitted borrow for capital spending, but this process has to be carefully managed to minimise fiscal and financial risks.

To manage the potential fiscal risks, in 2011 the MOF introduced a monitoring and regulatory framework that requires local governments to report on their debt. This merely continued a decade-long effort by the MOF to build a national monitoring system for local debt, and is likely to prove no more effective than past efforts unless it is bolstered by support from additional measures, such as annual audits and legal requirements for local governments to make regular public disclosure of key fiscal data including their direct and contingent liabilities (including LICs), loan servicing, as well as their borrowing plans.

The government also needs to regain control over aggregate fiscal discipline by assigning the oversight authority and responsibility over the comprehensive budget with all of the components to a single institution: most suitably the MOF. The high degree of reliance on extra-budgetary revenues in China is unusual but not unique. For example, the public finance system of Singapore consists of four 'pillars': the budget itself, the Central Provident Fund, the government investment agencies, and various special funds that are not consolidated into the budget. The budget process, however, is indisputably managed by the MOF, and is characterised by close inter-ministerial cooperation and the use of constitutional fiscal rules (Blondal 2006).

For these reforms to 'stick', they require political support from leaders to adjust the distribution of authorities across central institutions so as to elevate the MOF and put it firmly in charge of all fiscal resources. Support should also be given to enhance the capacity of the NPC to play its supervisory role over the budget—and hence the MOF—that is assigned by the constitution. The NPC should also be asked to empower the NAO to expand its auditing over budget implementation—as it has done several times since the mid 1990s (Wong 2012), to include the comprehensive budget as well as public debt management.

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