



# State of the Local State in China: Challenges for Xi Jinping and Beyond

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Morrison Lecture  
Australian National University  
11 September, 2014



## Introduction: the challenge of managing a large multi-level system

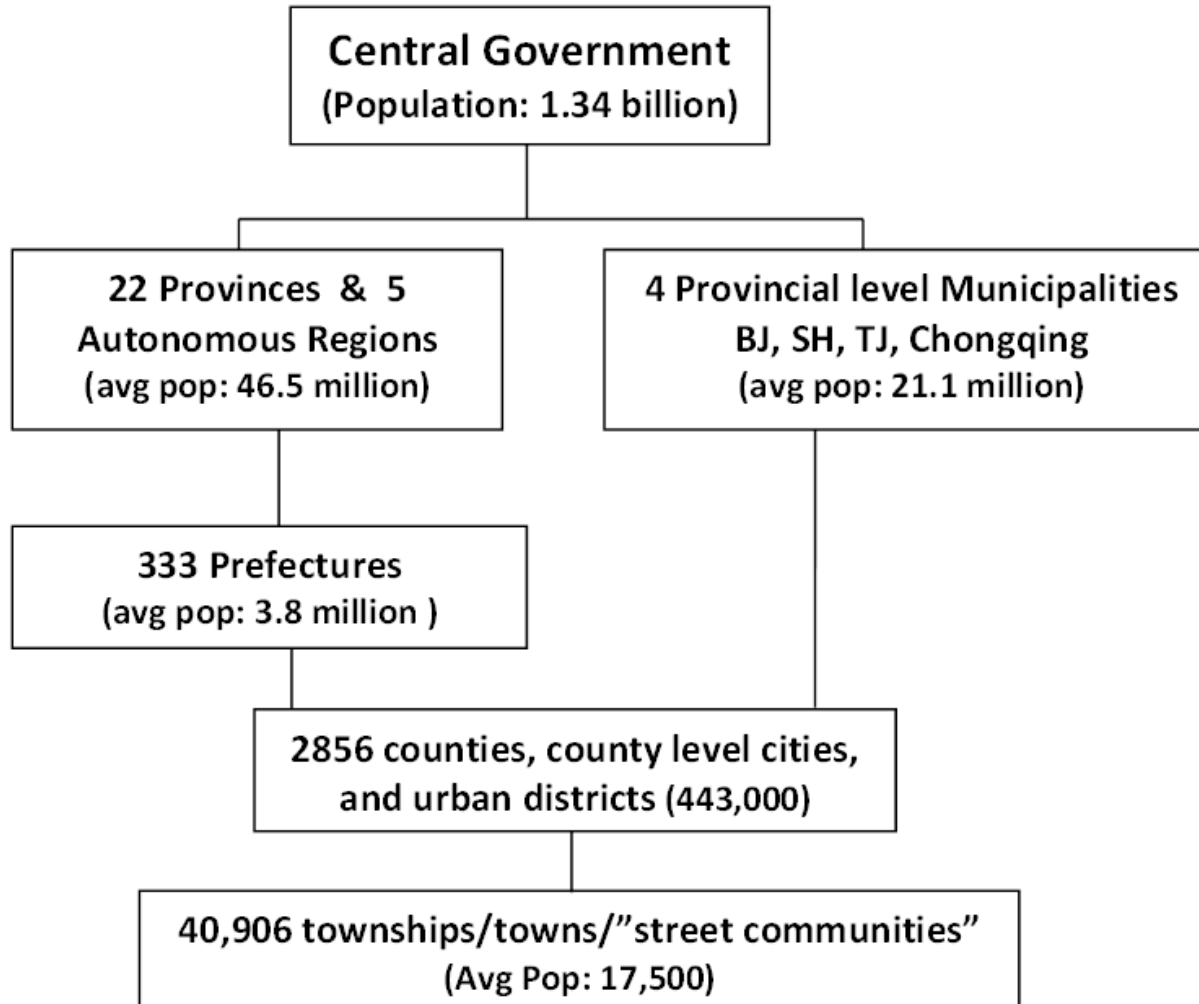
*“Can the economy, society, and culture of a modernising China be managed effectively from a single centre of political power? Nobody knows just what the appropriate format may be for governing a nation-state with more than a billion inhabitants. Until quite recently, it had never been tried..”*

*-- “Can China be governed from Beijing?” Philip Kuhn (1998)*

- This lecture will examine the challenge of managing China’s modernization through the lens of central-local relations
- China is a unitary state but local governments play important roles
- The state has grown in size and reach:
  - from <5% GDP to >35%
  - Last decade alone fiscal revenues have grown 10+ fold in real terms
- The government has maintained a five-tier structure of administration through most of the past 65 years



# China's 44,126 local governments in 2010





- I. China's economic miracle and local governments' starring role in story
- II. Local governments also star in creating some of the biggest problems
  - The addiction to investment-led growth, environmental degradation, corruption, and inequality, etc.
- III. The current state of the local state and fiscal challenges
- IV. The reform program under Xi Jinping
- V. Conclusions



- GDP growth of 10% p.a. over 30 years has propelled it into the front ranks of world power. It is now
  - The second largest economy
  - Largest manufacturer
  - Largest exporter
  - Holds the largest foreign exchange reserves, CO<sub>2</sub> emissions, oil consumption etc.
- Lifted 500 million people out of poverty

## *Since 2000:*

- Per capita income in RMB terms has grown more than 5-fold
- A significant growth engine for the world
- Emerging as a model for developing countries



- Free basic education
- Near-universal health insurance coverage
- Income support for the poor – *dibao* programs
- Near-universal pension coverage
- Gradual integration of migrants into urban services



- Massive investments in roads and highways
- China had 147 km of expressways in 1988. Today it has 68,000 km





## Cities are increasingly linked by high-speed rail

- China has the world's largest high-speed rail network, with 11,028 km of tracks in service in 2013, built since 2007
- Will reach 15,000 km by end 2015





Ranking in the 2010 World Bank Logistics Performance Index (155 countries)

Int. LPI Rank	Country	LPI	Customs	Infrastructure	International shipments	Logistics competence	Tracking & tracing	Timeliness
27	China	3.49	3.16	3.54	3.31	3.49	3.55	3.91
	High income	3.55	3.36	3.56	3.28	3.5	3.65	3.98
	Upper middle income	2.82	2.49	2.54	2.86	2.71	2.89	3.36
	Lower middle income	2.59	2.23	2.27	2.66	2.48	2.58	3.24
	Low income	2.43	2.19	2.06	2.54	2.25	2.47	2.98



- Local experiments led the way in many reforms:
  - Decollectivisation under “household responsibility systems” - Sichuan and Anhui
  - Township and village enterprises – Guangdong, Jiangsu, Zhejiang
- Local dynamism and competition propelled other reforms:
  - Opening to the West
  - Competition for markets



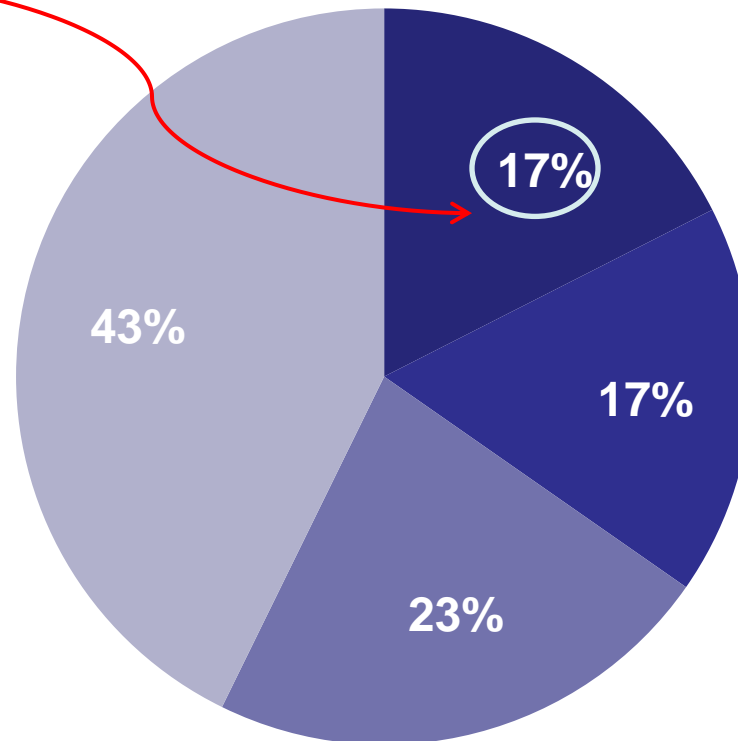
## Provision of social services is responsibility of local governments

(billions RMB)	National total	Local (%)		National total	Local (%)
<b>Total budgetary expenditure</b>	12595.3	<b>85</b>	job training subsidies	73.7	99
Foreign affairs	33.4	0	social relief	30.2	100
National Defense	669.2	3	urban dibao	66.6	99
Public security	711.2	83	disaster relief	27.2	99
<b>Education</b>	<b>2124.2</b>	<b>95</b>	rural dibao	69.9	100
o.w. primary schooling	525.9	100	<b>Health</b>	<b>724.5</b>	<b>99</b>
Junior middle school	353.7	100	Primary health centers	86.3	100
Senior middle school	169.8	99	Public health	110.2	99
<b>Social security and employment</b>	<b>1258.6</b>	<b>95</b>	Health insurances	365.7	100
Subsidies to urban residents basic pension scheme	252.7	97	New cooperative medical scheme (rural health insurance)	203.5	100
Subsidies to rural pension scheme	93.3	100	Urban residents basic medical insurance	46.9	99
Subsidies to public employee pensions	284.9	90	<b>Environment Protection</b>	<b>819.6</b>	<b>89</b>
subsidies for pensions of bankrupt enterprises	17.9	100	<b>Low income housing</b>	<b>448.0</b>	<b>91</b>

Many of the big [programs](#) introduced in recent years are delivered by local governments at the grassroots levels

## Share of direct budget expenditures, 2010

■ Central   ■ Province   ■ Municipality   ■ County+township



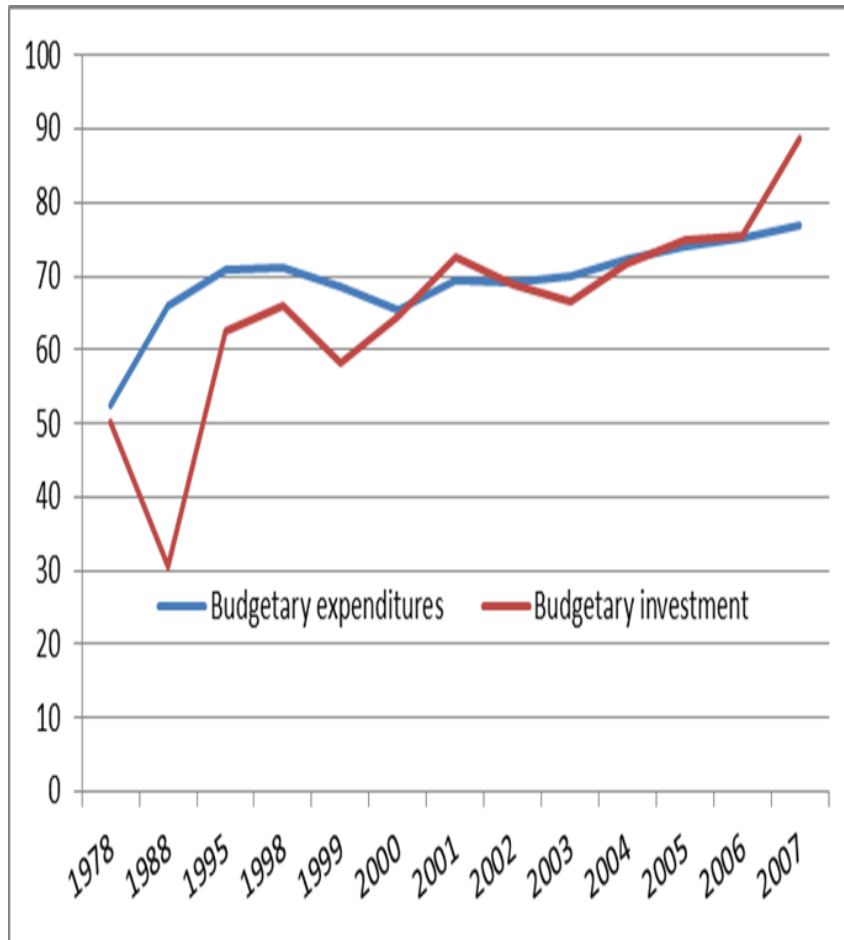


## A sample of big rural programs

<b>Program</b>	<b>Launch Date</b>	<b>Beneficiaries</b>
“Free Rural Compulsory Education”	2006	140 million
New Rural Cooperative Medical Scheme (NCMS)	2005	835 million
Rural minimum living stipend ( <i>Dibao</i> )	2005	52.14 million (2010)
Rural pension scheme	2008	835 million (potential)



### Local government share of total expenditure and investment (%)



- Of the 3 million km of road network, only 175,000 km are national level roads
- Even for the major highways, central funding comprised less than 10% of total investment through the mid-2000s
- Responsibilities are shared among all levels of government



## 1. The exclusion of migrants from urban social services

**MIGRANT PARTICIPATION IN URBAN INSURANCE SCHEMES (%)**

	2008	2009	2010	2011	2012	2013
Old-age	9.8	7.6	9.5	13.9	14.3	15.7
Work Injury	24.1	21.8	24.1	23.6	24.0	28.5
Medical	13.1	12.2	14.3	16.7	16.9	17.6
Unemployment	3.7	3.9	4.9	8.0	8.4	9.1
Maternity	2.0	2.4	2.9	5.6	6.1	6.6

## 2010 census data, selected cities

	unit: Million		unit: Thousand		
	Total population	Migrants	Potential migrant enrolment*	Reported migrant enrolment ( <i>year of report</i> )**	
Shanghai (2012)	24.30	10.50	1155.0	500.0	2012
Beijing	19.61	7.05	775.0	393.1	2009
Guangzhou	12.70	4.76	523.6	362.4	2011
Ningbo	7.61	2.29	251.7	289.0	2012
Chengdu	14.05	2.62	288.3	173.8	2010
<i>China</i>	<i>1370.54</i>	<i>221.43</i>	<i>24356.9</i>	<i>12000.0</i>	

- Based on the average 11.1% share of population enrolled in compulsory education in 2011.
- \*\* Estimated from various news reports.





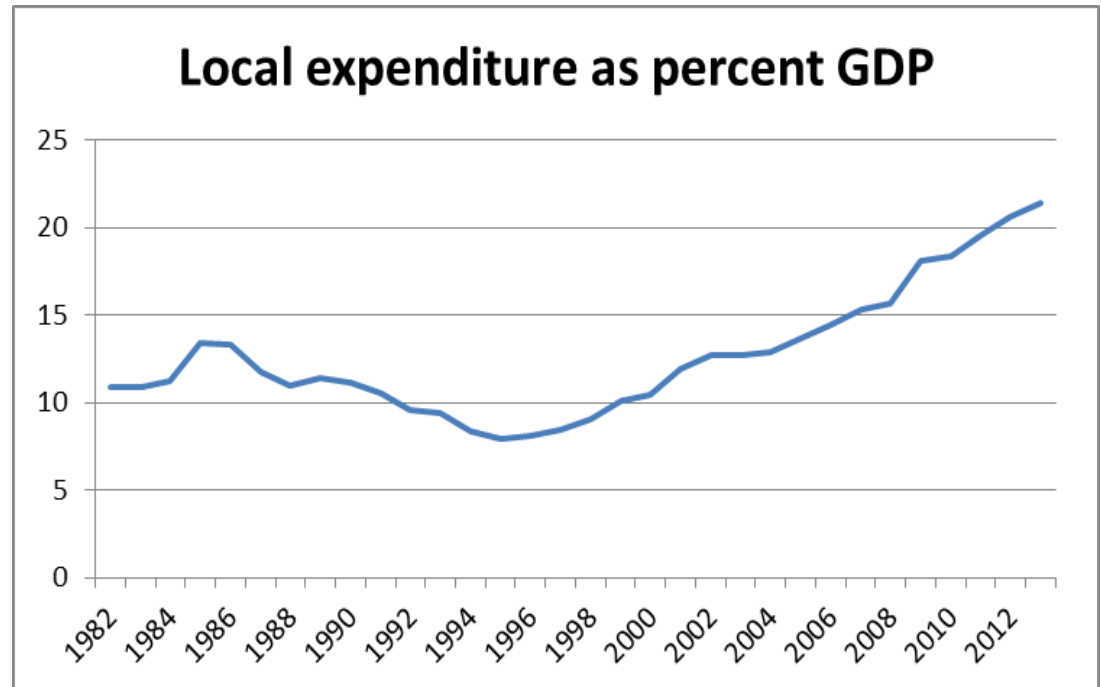
## 2. Local governments have run up a mountain of debt

- There were no national reports of local debt before 2011. First nationwide audit of local governments found total debt of ¥10.7 trillion at end 2010
- Despite clampdown, second nationwide audit found total debt of local governments had risen 70% by June 2013
- These numbers far exceed conventional measures of debt servicing capacity



## What is the state of the local state? -- A. Resource conditions:

**A well-functioning intergovernmental fiscal system channels resources to each unit of government to enable the financing of responsibilities**

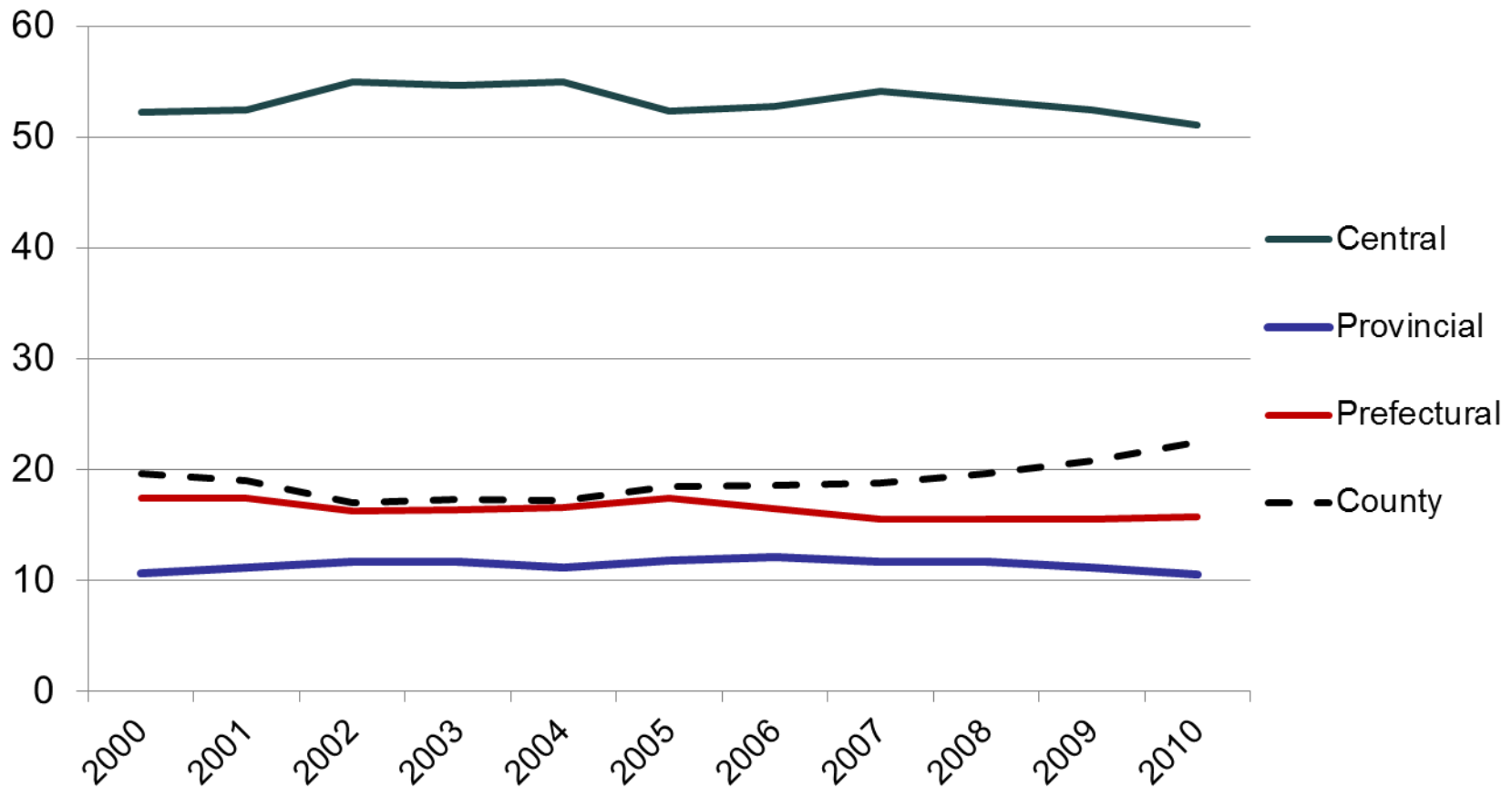


**Evidence from the spending on services show huge improvements especially since 2000:**

- Real budgetary expenditure on compulsory education has grown at an average annual rate of 24.1% to 2010
- Health expenditure grew 24.1% p.a. to 2011



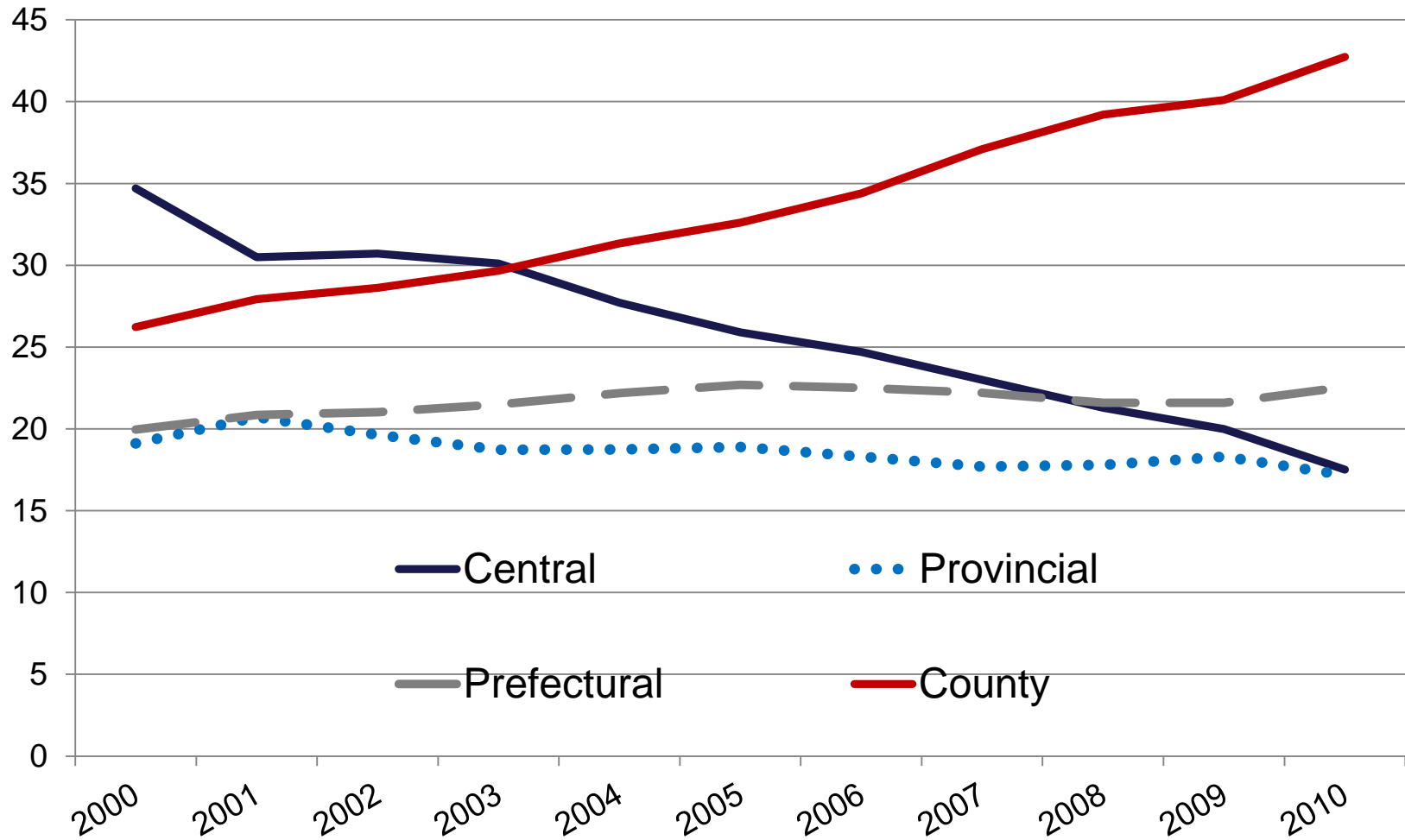
The vertical distribution of revenue has been fairly stable over past decade (% of total):





# While expenditure shares changed dramatically

% of national total





	1998	2002	2006	2010
Central	21	24	28	34
Provincial	-8	-8	-6	-7
Pref/ Municipality	-4	-5	-6	-7
County	-8	-12	-16	-20

- In aggregate, every level of local government faces a budgetary shortfall (= revenue share - expenditure share)
- Central surpluses are financing some portion of expenditures at all subnational levels through transfers: to the provinces, prefectures, and counties



## How it is executed -

Resources and policies are transmitted level-by-level downward through the hierarchy

Central Government → Provinces

Provincial Government → Prefectures

Prefectures → Counties

Counties → Townships

Townships → Villages/Farmers

This is a unique, core feature of China's decentralized system

Treasury system works the same way: transfers are sent from the central treasury to the provincial treasury, from the provincial treasury to the prefectural, and onward to the county treasuries.

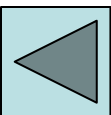
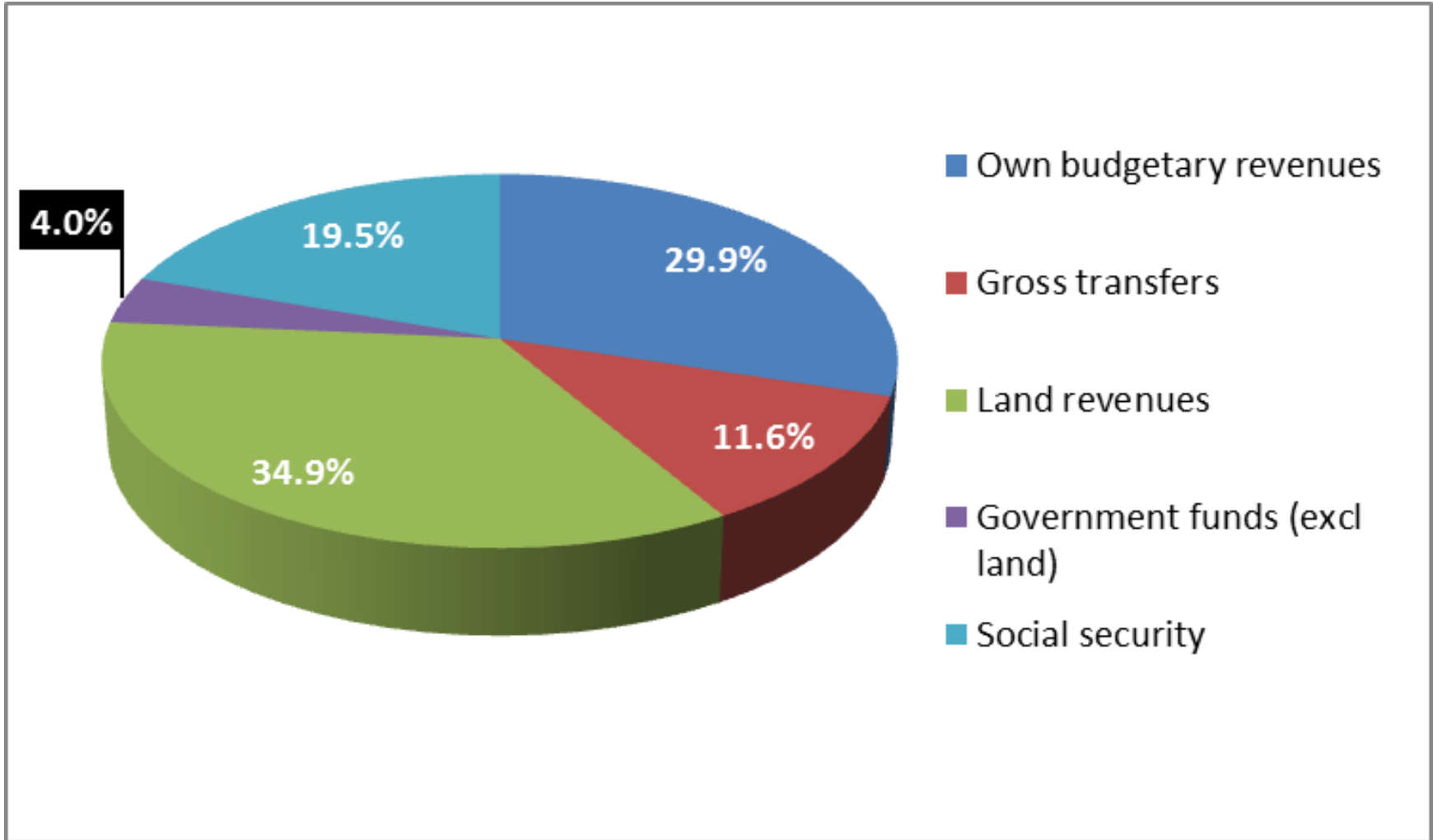


## C. Incentives for local governments

- Local officials embrace the promotion of economic growth as their top priority mission
- Investing in infrastructure has been vital to supporting urbanization and economic growth
- This has been mostly financed by local (urban) governments
  - Lacking resources in the budget, local governments have turned to land revenues and borrowing
  - Prohibited from borrowing, they used special financial vehicles - “financial platforms” or “local investment corporations”



## Composition of revenues for an average prefectural city (2010)







- Set up as enterprises under municipal departments, LICs are a workaround to the prohibition on local government borrowing
  - Local governments acquire farmland and transfer it to an LIC
  - The LIC uses it as collateral to borrow from banks
  - Funds are used to prepare the land for development
  - Land is sold to developers
  - Profits are turned over to the local government
- At the peak, there were more than 10,000 LICs and existed in all cities and even some towns



## Cities have thrived under a policy of benign neglect

.. where land selling and backdoor practices such as local financing platforms (LICs) were tolerated

- they played a useful role in helping to finance urban facilities and infrastructure such as roads and subways
- but the process opened a soft budget constraint for municipal governments
- Unsupervised, the interplay between land and LICs led to too much land taking, too many LICs and too much borrowing
- Ready availability of funding led to too many wasteful and inefficient investments and contributed to urban sprawl



# Third Plenum decisions on reforms to the fiscal system

- Rebalancing central-local assignments to better match responsibilities with revenues, including allowing local governments to borrow for long-term capital spending
  - “opening the front door and closing the back door” by allowing local governments to borrow through bond issuance
- Reining in local government financial vehicles and land finance
- Strengthening financial management of fiscal resources, including making budgets more transparent
- Recent statements by Xi Jinping and Finance Minister Lou Jiwei call for intergovernmental fiscal reform
  - Local governments instructed to propose changes
  - New revision of the budget law has further clarified central-local relations



# The thrust of reform is centralizing

- Rebalancing is to be effected by centralizing some functions – e.g. social security and the construction and maintenance of large projects that affect more than one region
- For programs that have spillover effects, the central government will provide transfers to offset local financing burden
- Emphasis is on
  - Improving the system of transfers
  - Stopping unfunded mandates – provide transfers when central policy causes local expenditure to rise



# China is already heavily dependent on the use of transfers

	<i><b>Transfers as Percent of</b></i>		
	Subnational government expenditures	GDP	Tax collections of higher level government
<b><i>China 2012</i></b>			
including tax rebates	42.3	8.7	80.8
excluding tax rebates	37.5	7.7	71.6
Average for 20 industrialized countries	41.7	5.4	23.2
Average for 37 developing countries	48.8	3.0	24.3

Transfers have had only limited efficacy in reducing regional disparities

# Not all schools are equal

Students in Hubei bringing their own desks to school





## The key challenges:

- Centralizing reforms are ill-suited to the decentralized administrative structure
- Land revenues currently significant portion of financing to local governments
- More fiscal rules and more stringent financial management will further strengthen incentives for local government to pursue extrabudgetary revenues and activities



- Fewer than 60,000 work in the core ministries and agencies
  - Key ministries such as the Ministry of Finance and National Development and Reform Commission have only 1000 staff
- Nor are institutions in place to support management from the top:
  - A statistical reporting system supplying timely and accurate information
  - An audit system, strong public financial management systems, rule of law, etc.
  - An independent judiciary to enforce laws and mete out punishment for violations







In the 21<sup>st</sup> Century, rapid growth of the public sector has made it increasingly clear that the present administrative structure is unable to support the modern welfare state China wants to build

Going forward, the government faces some big choices

The choices may fundamentally change the organization of government, the alignment of authorities, and indeed, the nature of government

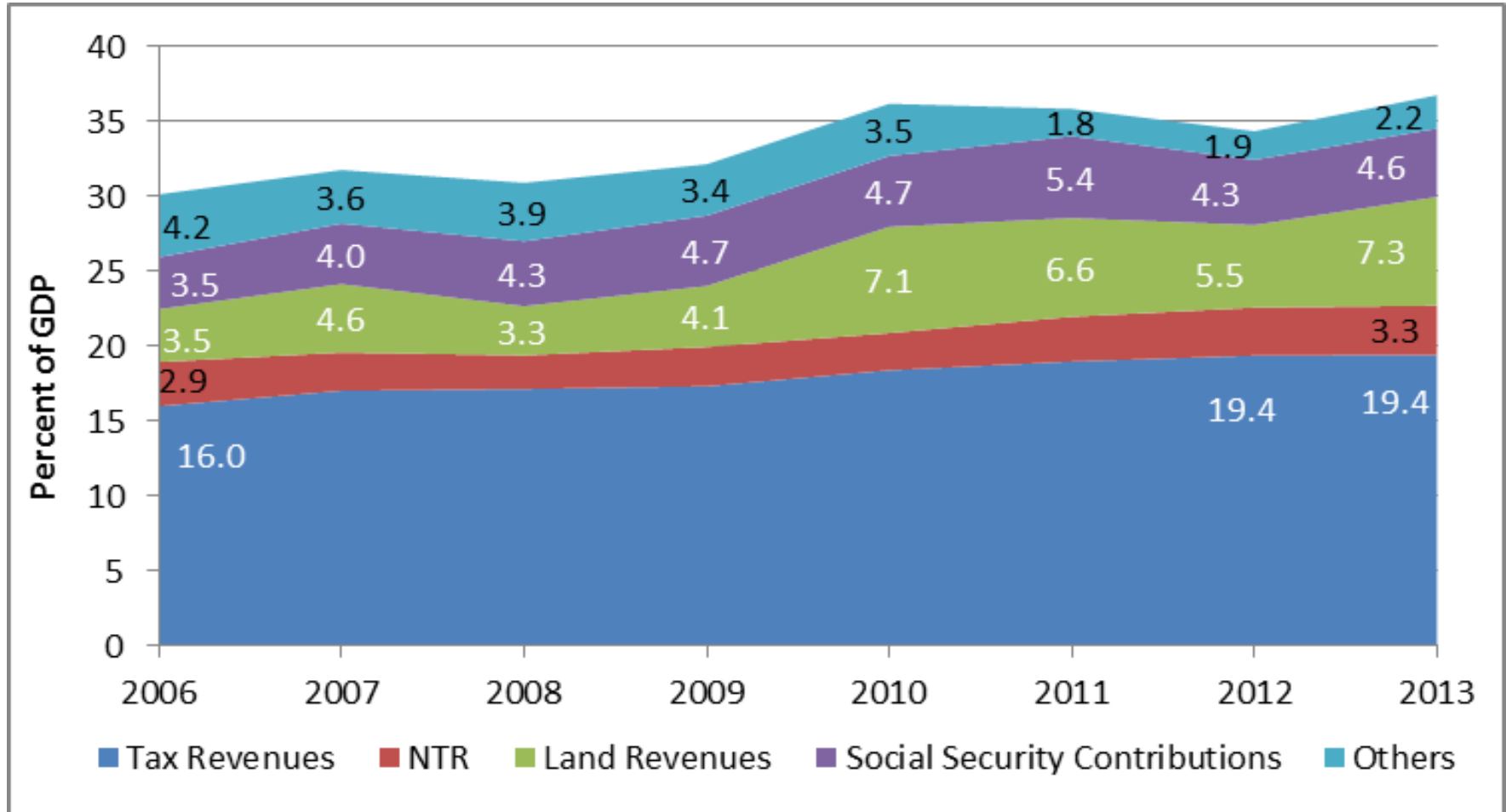


- How best to implement national goals:
  - The choice of instruments: financial vs. planning and direct allocation of resources; quasi-fiscal tools
  - Who will allocate fiscal resources: Ministry of Finance vs. National Development and Reform Commission and other [ministries](#)
  - Which level of government to deliver which services
  - How will these responsibilities be financed
- What kind of accountability mechanisms:
  - Top-down, bottom-up, and checks and balances





## Management of fiscal resources is compartmentalized and fragmented





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