In her presentation “Financing Local Government in China: Challenges in the Era after Hu Jintao and Wen Jiabao,” Christine Wong reviewed the sources of income and financial expenditures for local governments and suggested challenges posed by the current structure for government capacity and fiscal discipline. With the “people-centered” reforms of the Hu/Wen era, the role of local governments in the provision of public services and infrastructure has increased. Expenditure assignments have not been matched with central-allocated transfers and tax revenues, however. As a result, local governments increasingly rely on land revenues and other extra-budgetary sources of income. This has created significant challenges for the central government’s ability to manage macro-economic coordination and impose aggregate fiscal discipline.

With the shift in their development paradigm from GDP growth to greater equity, the Hu/Wen administration created many new programs to improve rural education, reform rural fees, extend health care coverage, and expand social security. The lion’s share of responsibility for administering and financing these reforms has fallen to local governments. Local governments have also taken on urban infrastructure projects, building China’s rapidly expanding roadways, transportation systems, and high rises. While their share of these expenditures has greatly increased in the past decade, the share of total revenues assigned to local governments has remained constant. How have local governments paid for these infrastructure and public service projects?

Local tax revenues, land revenues, and central transfers now make up the main sources of revenue for local governments, in almost equal proportions. This heavy reliance on transfers is poorly matched with China’s highly decentralized administration, however. A very small central government manages a huge national bureaucracy and fiscal system. This imbalance has serious implications for efficiency and results in much waste, cost containment problems, and cross-provincial inequality.

The limitations of central-directed funding have led to local governments’ increasing reliance on sources of income they control directly: land revenues and other extra-budgetary financing. Policies allowing local control over land have incentivized selling off suburban farmland. Extra-budgetary financing, especially borrowing through financial platforms under local investment companies (LICs), makes up the rest of local finances. LICs are corporate entities designed to bypass the Budget Law forbidding local government borrowing. The LICs are typically financed by land assets and guarantees by local government. They are not officially sanctioned and have largely operated under the radar.

The dangers associated with extra-budgetary financing of local governments are numerous. The LICs opened the door to soft budget constraints for local governments because the extra-budgetary financing raised by LICs is outside the authority and jurisdiction of central government ministries such as the Ministry of Finance. The banking sector too has scant capacity to appraise the credit-worthiness of LICs and local governments. Lending through the LICs is furthermore often based on “faith” rather than reliable information. Empty high rises and shopping malls dotting China’s urban landscape in cities like Guiyang are the products of runaway financing of this type.

In summary, rather than alleviating the problems of inadequate financing of the 1990s, the “people-centered” reforms of the Hu/Wen era have perpetuated the high and unsustainable expenditure assignments for local governments under the new programs. Support from central-government transfers has improved, but remains insufficient. Local governments have responded by
drawing on extra-budgetary resources such as borrowing through LICs to finance their infrastructure and social service projects. Growing regional disparities, low fiscal discipline, and weakened central capacity are a few of the adverse outcomes of these financial arrangements. Future reform would require realigning the local government responsibilities with their allocated revenues, allowing local governments to borrow directly, and strengthening financial management in the central ministries. China’s huge size and great regional diversity make a strong case for greater administrative capacity for the central government. To strengthen macroeconomic management, oversight of all fiscal resources must be placed under a single institution – most appropriately the Ministry of Finance.