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Multilevel finance and high-quality growth in the PRC

Towards sustainable green recovery from the Pandemic

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This presentation draws on: **ADB. 2020. *The Role of Local Governments in Driving High Quality Growth in the People's Republic of China* (Working Paper).** Manila.

NDRC-ADB engagement on the 14th Five-Year Plan


- NDRC and ADB Coordinated a broad-ranging set of proposals for the 14th Five Year Plan
- Financing options for high quality growth
- Many of the proposals included in the 14FYP and Perspective Plan
- In this presentation we ask whether there is **any need to modify objectives and policies to address the post-COVID effects?**
- We take an **analytic approach to building back better in China**
- **Some lessons post-2010 crisis and learning from COVID-19**
- **Towards an action plan for further cooperation**

High quality growth strategy 14FYP: Highlights



Some issues take on greater importance as a result of the pandemic recovery

- **Who does what, and how this is coordinated and financed?**
 - Extensions of the current *tiao-quai* governance model (intergovernmental linkages and data flows) to address incentive incompatibilities
- **Increasing importance of reducing vulnerabilities, financial, distributional and environmental risks with the local government financing model**
 - Absence of local own-source revenues (#22, PRC 2020)
 - Addressing responsibilities and assignments
 - Strengthening of sub-national “fiscal equalization”
 - Full information on the buildup of liabilities
 - Avoiding excessive post-Covid leverage, especially LGFVs



An analytic approach to building back better

Linking international best
practice to the Chinese
Governance Model

Approaches to sustainable recovery in global context

- **Public Investment and tax decisions must be coordinated**
 - Not just for revenues and expenses,
 - Also, to generate the appropriate incentives for firms, workers and local governments
 - Appropriate weights on human, social, and natural capital in addition to financial returns
- **Incentive structures facing local governments must be addressed**
 - Existing incentive to resort to “hidden” borrowing to face budgetary pressures (reduced shared revenues, given national policies, additional spending needs)
 - Incomplete information/local government balance sheets (Ahmad and Zhang, 2018, 2020)
 - Potential local debt spirals (Yang 2019)

Importance of a coordinated response during both the rescue and recovery phases

- **Policy level and governance:**

- Both vertical (*tiao*) and horizontal (*kuai*) actions important in Chinese governance framework
- National level policies, wide area taxation and transfer system, governance frameworks
- Local information flows transmission to higher levels, and local actions

- **Central responsibilities for rescue and recovery:**

- coordination and finance, also
- fiscal institutions and policies that influence firms, workers and local governments

- **Local governments:**

- Tracking and tracing, also importance of enhanced basic public services, including preventive health care and education
- Both may require co-financing, so performance indicators for national transfers especially, become important, along with ability to track earmarked transfers

The Chinese Governance Model

Table 1. China: Horizontal (*kuai*) and vertical (*tiao*) responsibilities and information flows

Level of Government						
Central government	State Council/Cabinet	Ministry of Finance	NDRC (Planning)	Ministry of Education	Other Ministries	Ministry of Health
State Council						
Provincial government	Governor					
Metropolitan government	Party Sec					
County government	Mayor					

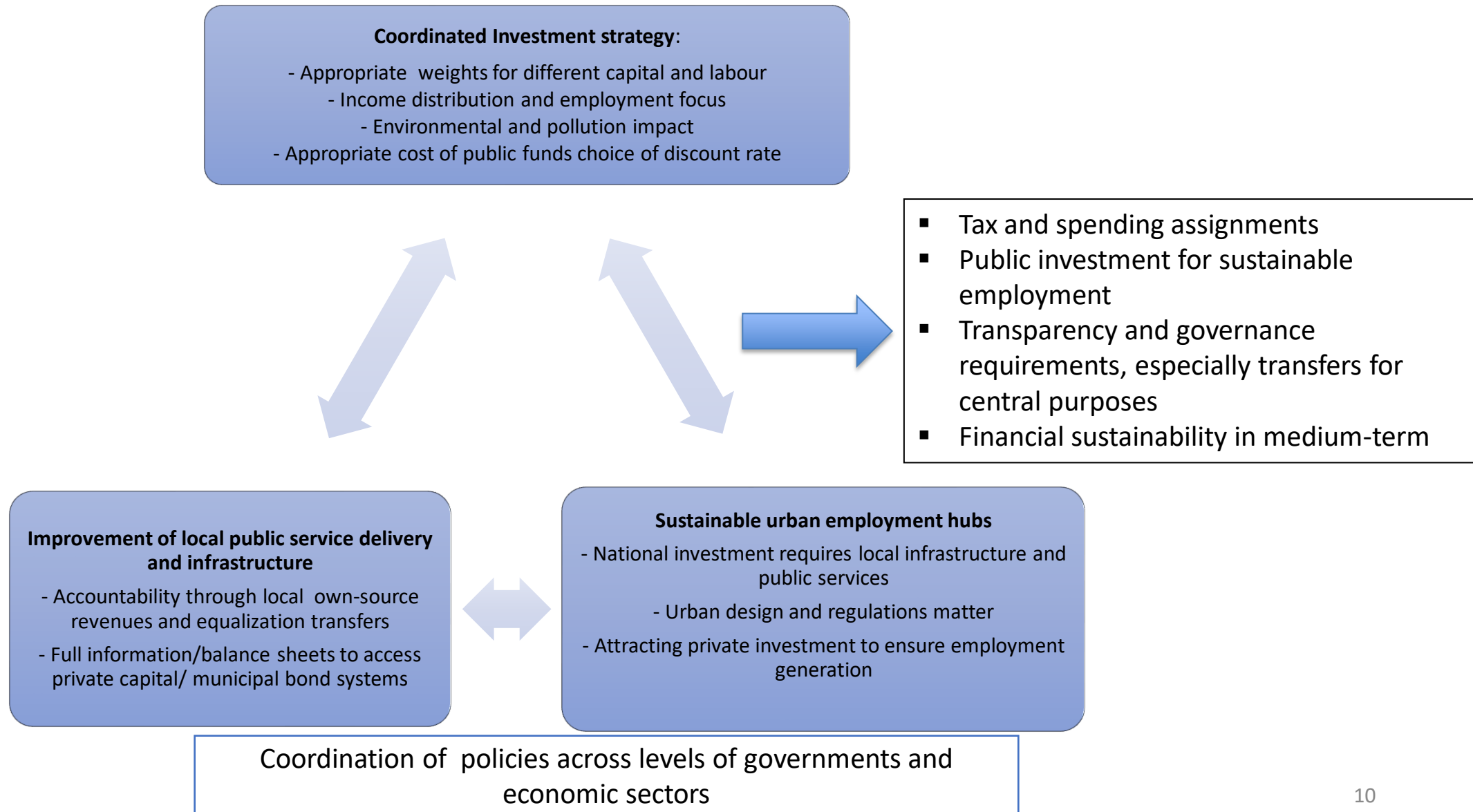
Note: This description builds on Yang (2019). The light arrows reflect the flows of funds, and instructions including at the departmental level. This shows a simplified version of three tiers of China's five-tier administrative structure. The dark arrows reflect the flows of information. Note that the Ministry of Health responds directly to the State Council, and does not go through the agencies indicated (e.g., Ministry of Health). Additional reporting by the Ministry is to the Ministry of Finance on the budget allocations and performance and to the NDRC on meeting plan targets, but these are not shown in the diagram.

Source: Ahmad, E., 2020, *Journal of Chinese Governance*

Incentives for a debt spiral and weak accountability

- **Increasing budget pressures at the local level**
 - Financing gaps and absence of own-source revenues
- **Promotion criteria that might not include basic services**, but focus on expensive high-profile projects: sponge city and metro lines and hospitals in Wuhan
 - Absence of full balance sheets and off-budget operations of LGFVs, incentives to rely on additional debt issuance, with low danger of discovery during terms of officials
- **Important to sequence and align responsibility for functions:** policy, finance and administration, e.g., preventive health care
- **Increasing importance of earmarked transfers** for national objectives:
 - Performance basis for effective implementation
 - Design of GFSM14-compliant Charts of Account

Integration of investment strategy with sustainable growth





Lessons from Post 2010 economic crisis and learning from COVID19

Learning from the 2008-10 Global Economic Crisis

- **Post-2008 crisis also focused on counter-cyclical investments, but largely replicated existing structure of activities and production**
- **14th Five-Year Plan:**
 - Learning from early 2000s ineffective Western Development Strategy to post 2010 “rebalancing”,
 - “dual circulation” and “Go-West” post-Covid 19
- **What lessons can be learnt from past failures to ensure a more sustainable “building back better” agenda?**

Why is it so difficult to rebalance to interior cities—case of County T?

- County T, ideal location and connectivity in Central China
- Continues to lose population
- Spending assignments onerous,
- Absence of own-source revenues, apart from land-sales
- Buildup of liabilities, incentives to pass them on

Government liabilities	
Explicit liabilities	
General bonds	2.800
Accounts payable	0.887
+ Unreplaceable debt	0.032
+ Special bonds	2.744
Total explicit liabilities	5.576
Implicit liabilities	
Borrowing by local government financing vehicles	8.000
+ Government procurement	6.700
Total implicit liabilities	14.700
Memorandum: Public-private partnerships (PPP) (approximate city-level share of investment)	29.00*

Note: Implicit liabilities are approximate.

* Government capital is assumed to be 30% of total PPP investment

Source: Ahmad, E. and Zhang X., forthcoming. Local government liabilities and sustainable debt in China – evidence from County T in Central China.

Investments for sustainable employment hubs: clean cities and revitalized rural areas

- Connectivity infrastructure hasn't stopped inflow of workers to very large metropolitan areas (Shanghai and Shenzhen)
- Inequality within provinces remains an issue, as is management of risk
- Creation of interior sustainable hubs
 - Local public services and infrastructure constrained by buildup of liabilities and access to credit
 - Critical role of local “own-source revenues” recognized by 14FYP
- IMF's GFSM 2014 standards are formally accepted - but balance sheets at sub-national level largely incomplete
- Local incentive structures are not adequately aligned

Connectivity infrastructure is necessary for reduced costs, but not sufficient to attract firms, and skills

Hubs (N) and periphery (P)

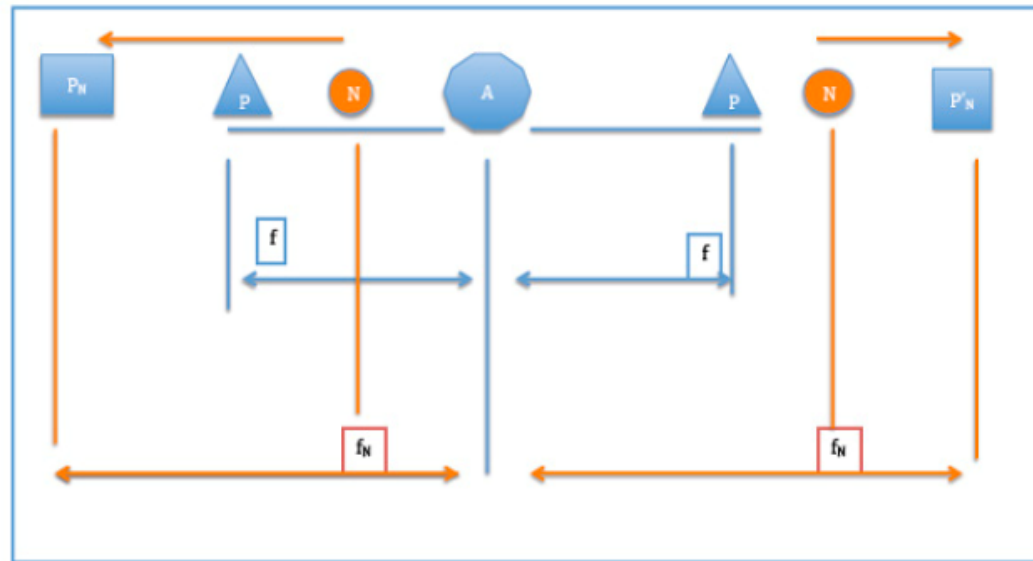


Figure 1. Sustainable hubs and “rebalancing” to the interior and the periphery.

Note: The blue figures represent the existing market structure, with A as the metropolitan areas (mainly along the coast), for production and export. P is the maximum reach with pre-reform connectivity. Infrastructure connectivity investments may create new hubs, N, that bring the excluded periphery P_N into play.

A—existing coastal hubs; new innovation zones (GBA, YRD)
P—interior hubs/rebalancing
N—new hubs in the interior, domestic consumption and BRI—dual circulation
critical importance of local public services in P and N

New sustainable urban designs—a complex pattern

- Restructuring large metropolitan areas, driven by shift to services and high tech
- GBA, YRD: high tech zones—are new administrative and financing arrangements needed?
- Capital city clusters
- Tier 2/3 cities—heart of the connected, compact and clean urban design, especially in the interior and the West
- Rural revitalization

Governance requirements: issues in addressing assignments

- **Centralizing spending assignments** (social security)
 - Together with reassessment of key subnational assignments and institutional arrangements (State Council Directive 2018/8)
 - Reducing unfunded mandates at the lowest levels of administration
- **Public investment in connectivity** (national and local); and
- **Local services** for sustainable private investments
 - BRI and new hubs (Khorgos?)
 - Changing relative cost structures
- **What do we learn from Covid-19 responses?**
 - Importance of coordination, national financing, local implementation, e.g., preventive care

Deciding on responsibilities

What is involved in clarifying spending assignments?

Economic classification/ GFSM Functions/COFOG	Compensation	Use of goods and services	Fixed capital	...	Acquisition of non-financial assets	Admin/ Units Codes	Projects Codes	Programs/ Sub-programs Codes	Output	Outcomes
Education										
a. Primary and secondary	M	M	C/R	C	M/C/R	X	X	X	A	A
b. Tertiary	R/C	R/C	C/R	R/C	R/C	X	X	X	A	A
Health care										
a. Basic preventive	M	C	C/R	M	M/R/C	X	X	X	A	A
b. Hospital	R	R	C/R	R	R/C	X	X	X	A	A
Water	M	M	R/M	M	R/C/M	X	X	X	A	A
Sanitation	M	M	R/M	M	R/C/M	X	X	X	A	A

Notes:

'C' represents a central assignment, 'R' is regional and 'M' is municipal.

X would be relevant codes reflecting the institutional arrangements and A are actuals for outputs and outcomes respectively, that depend on sectoral analyses.

Source: Ahmad (2015).

Subnational revenue assignments

- **Replace income tax revenue-shares with piggy-back**
 - Will not fluctuate as central rates are cut or adjusted
 - Becomes an own-source revenue and can be used to anchor local government bond system/PPPs
 - STA continues to administer, funds transferred automatically through central TSA
- **National carbon tax, with local piggy-back**
 - Piggy-back can be higher in Guangzhou than in Jieshou—encouraging firms to move to smaller and less congested, cleaner cities
- **Beneficial property tax at the city level**—to quickly replace land sales with improvements in urban design and incentives
 - Essential for the effective operations of the dual circulation/rebalancing strategy with the creation of interior employment hubs

Simulations of the 2% of GDP beneficial property tax for six metropolitan areas in China

Distributional impacts Atkinson index A_j , and Gini Coefficient G_j

City	Property tax 2% GDP (Y bn)	Current Education Spending (Y bn)	Property Tax (Y)/ m ²	Initial A_1	Tax Only A_2	Tax/ Benefit Education A_3	Initial G_1	Tax Only G_2	Tax/Benefit Education G_3
Guangzhou	39.2	32.12	121.4	.60	.76	.75	.39	.40	.39
Shanghai	54.9	84.10	90.81	.71	.51	.50	.40	.41	.40
Shenyang	10.9	11.51	52.68	.63	.49	.47	.33	.34	.33
Wuhan	23.8	23.11	85.11	.52	.47	.46	.33	.35	.33
Xian	12.5	11.96	48.8	.47	.57	.49	.35	.36	.34
Fuzhou	12.4	15.31	54.6	.51	.89	.55	.36	.37	.36

Note: Gini coefficient (G) and Atkinson index (A) are two different measures of interpersonal inequality. Atkinson index is more sensitive to lower-income groups.

Source: Ahmad et al. (2020)

Within Guangzhou - equalization framework would be needed to finance education

RMB billion			
Districts	2% GDP Property tax	Education Spending	Surplus/Deficit in Financing
Tianhe	7.60	2.43	5.18
Huangpu	6.01	2.17	3.84
Yuexiu	5.82	2.03	3.79
Panyu	3.51	2.96	0.81
Baiyun	3.28	2.66	0.63
Haizhu	3.10	2.08	1.02
Nansha	2.56	1.00	1.56
Huadu	2.34	2.24	0.10
Liwan	2.16	2.35	(0.19)
Zengcheng	2.09	2.63	(0.53)
Conghua	0.75	1.73	(0.98)

Source: Ahmad et al. (2020)

Enhancements in GFSM2014-compatible Balance sheets and Charts of Account

- Full information necessary on the buildup of liabilities and net assets at all levels of government
- Essential for the operation of local government bond markets and PPPs
- And for the effective operations of performance-based transfers

Tracking budgets, including performance in Central earmarked transfers

The logic of a GFSM2014-compliant Chart of Accounts

No.	Segment	Size	Description
1.	Institutional Entity	2	GFS2014 – Economic Entity, e.g. General Government Sector, Other Economic Entities
2.	Source of Funds	2	Funding Sources
3.	Functional Classification	8	UN/OECD classification of functions of government
4.	Administrative Classification	6	Ministry, Department, Division, Section
5.	Program / Sub Program Classification	6	To track specific programs
6.	Activities / Projects	6	To track detailed activities or projects that form part of general government
7.	Geographic	6	Regions/States/ Local Governments or Municipalities
8.	Economic Classification	8	GFSM2001 definition of Revenue, Expense, Assets and Liabilities
9.	Outputs and Outcomes (for performance budgeting)	6	Including for possible physical outputs and outcomes for evaluation purposes

Source: Ahmad (2015).

Towards a work program for the recovery period

Challenges and Opportunities for SNGs In Driving the HQG Agenda

Challenges

- Clarification of **spending assignments** across SNG tiers (new urban structures!)
- Lack of substantial **own-source revenues** for SNGs
- Incomplete **equalization** systems (esp. sub-provincial)
- **PFM**: strengthen investment planning, roll-out of TSA, credibility of balance sheets
- Further development of **(special/green) bond market** for SNGs
- Strengthen debt analytics and **debt management**

Challenges and Opportunities for SNGs In Driving the HQG Agenda

Opportunities

- Continue State Council's **rationalization of spending assignments**
- **Adapt national tax policies permit piggy backs at SNG level (on PIT and carbon tax) with STA admin;**
- **Local beneficial property tax**
- Strengthen the preconditions for the responsible **use of SNG Bonds and PPPs**
- Roll out the **performance-based budget initiative for Special purpose programs, and improved debt management practices** (spearheaded by MOF)

Links with ongoing work in PRC

1. TA with China Government Debt Center, part of MoF's Budget Department
2. TA with NDRC's Social Development and Systems Reform Departments
3. TA with Chinese Academy of Social Sciences
4. Fiscal management assessment for the PRC
5. Guidance note on local government debt sustainability assessments.
6. Technical paper on Green Recovery



Thank you.

