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THE LOCAL GOVERNMENT CRISIS 2007-2014: WHEN CHINA'S FINANCIAL MANAGEMENT FALTERED

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Abstract

This paper investigates why China's leaders were unable to halt the mounting crisis in funding local government from 2009. The analysis traces a long history of co-option of the banking system by local officials. The national leadership was obstructed in monitoring and controlling the escalating dependence on banks to fund local administrations because of a long-standing failure to reform key legal, fiscal and administrative systems. The ideological reluctance to implement reforms in land ownership fostered an unauthorised and often unlawful symbiosis between local officials, property developers and bank executives. The paper argues that the Government's plans for restructuring local government finances through the use of bond flotations in particular will face considerable delay.

Keywords: China, Local Government, Banking, Financial Crisis, Land Ownership, Reforms

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As the global financial crisis gathered momentum in 2008, China adopted bold measures to counter the threat of contagion. An economic stimulus package was adopted worth USD586 billion, considerably more than the USD475 billion in emergency spending finally approved by the United States Congress under the 'Troubled Asset Relief Program' (TARP). Some 70 per cent of the Chinese package was to be provided by local governments. This target was wholly unrealistic, and local administrations had run out of both cash and credit before the end of 2009.[1] The banks were compelled to cover the deficit, and they supplied 62 per cent of the local government funding. These borrowings were equivalent to 52 per cent of local government financial resources and to 20 per cent of GDP.[2]

'Borrowing by thousands of companies set up by China's local governments to fund construction is the nation's equivalent of the United States' subprime mortgage crisis', a prominent Chinese political personality told an international business forum in 2011.[3] Like the sub-prime disaster in the United States, the threat from dysfunctional local government financing in China should never have occurred. The bulk of the borrowings involved practices that were illegal or unauthorised, this paper will explain. Some 46 per cent of the total was estimated to have been raised indirectly through the 'more than 10,000' local government financing vehicles (LGFV) in gross disregard of the ban on banks making direct loans to these vehicles.[4]

Local officials had been confronted with a hopeless situation in managing their budgets long before the menacing surge in local government lending under the economic stimulus package. The dismantling of central planning after 1978 led inevitably to the collapse of the nation's traditional revenue base. This outcome had not been foreseen by the reformers, not surprisingly since China had 'no one recognizable as a modern tax official' who was qualified to draft the new legal and administrative structures that a modernising, increasingly market-driven economy would require.[5]

Local authorities were responsible for 'much of infrastructure investment, service delivery, and social spending', which together made up 85 per cent of China's total public expenditure. But the post-1978 economic reforms were to leave them with very limited tax and other revenue resources to meet their responsibilities for economic and social development. They came to rely increasingly on property

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1 National Development and Reform Commission, 'NDRC to review status of stimulus driven projects', *China Daily* (*CD* hereafter), 18 September 2010. President George W. Bush had originally sought approval for a UD700 billion TARP budget.

2 Jia Kang, Ministry of Finance Institute of Fiscal Science Research Director, 'China should be aware of local govt debt risks: Official', *New China News Agency* (*NCNA* hereafter), 2 November 2010; Liu Jiayi, Auditor General, 'China's local government debts exceed 10 trillion yuan', *NCNA*, 27 June 2011.

3 Cheng Siwei, formerly National People's Congress Standing Committee Vice-Chairman, quoted in 'Local government financing is China's "subprime": Cheng', *CD*, 17 September 2011.

4 'New local bonds OK'd to pay off old debt', *CD*, 2 January 2014; Professor Lin Shuanglin, Peking University China Centre for Public Finance Director, 'The art of maintaining a healthy debt', *CD*, 9 January 2014; 'China contains local government debt', *NCNA*, 17 December 2013; Finance Ministry, National Development and Reform Commission, PBOC and CBRC statement reported in 'China to further check local government financing', *NCNA*, 31 December 2012.

5 Christine C. P. Wong and Richard M. Bird, 'China's Fiscal System: A Work in Progress', International Tax Program, University of Toronto, *ITP Paper 0515* (October 2005), pp. 3-4.

development and on borrowings from banks and a variety of special purpose vehicles.[6] Both the land sales and the loans were generally unlawful.

- A large proportion of the land sold to developers was procured by local governments through unlawful expropriation regardless of the serious political and social discontent which illegal seizures provoked, according to the Ministry of Land and Resources.[7] Even where there was some compliance with legal formalities, the compensation rights of those evicted were widely ignored by local officials.[8]

- The financial transactions, almost always, were in breach of the law or of state regulations. The nation's Budget Law specifically prohibited local governments from borrowing from the market directly or by way of guarantees. This ban had been reiterated in a 2006 State Council directive to the banks to halt such lending and which had revoked local guarantees.[9]

This endemic defiance of both legal and political authority has survived, this paper will show, because there have been no effective systems or institutions to fund local administrations or to police their budgetary behaviour.[10] Thus, even before local governments were made responsible for the bulk of the economic stimulus package, their bank-financed deficits were causing serious alarm. The situation worsened with the state's demands after 2008 to meet the spending targets set by the package. These pressures on local governments were to prove so severe that borrowings mounted inexorably.

This paper reviews the political, fiscal, legal and commercial factors that made the crisis possible and rendered it so difficult to overcome. The analysis begins with the confusion in which the crisis started, with obvious signs of impending disaster obscured by repeated, optimistic reassurances from leading officials. The state's statistical systems proved totally inadequate, it will be shown, while remedial measures were frustrated by the serious time lags between reform proposals and their implementation, delays which are a prominent feature of China's political scene (discussed in detail in the companion paper, 'China's banking: how reforms lost momentum', *HKIMR 26/2014*).

The crisis itself had become virtually unavoidable even in the absence of the economic stimulus package, it will be argued. The paper reviews the dynamics of the close partnership between bankers

6 See, for example, the analysis presented in a recent, painstaking review of the local government budgetary dilemmas by Yuanyan Sophia Zhang and Steven Barnett, 'Fiscal Vulnerabilities and Risks from Local Government Finance in China', *IMF Working Paper WP/14/4* (January 2014), pp. 5, 13, 25-6.

7 Ministry of Land and Resources, 'China stresses rightful use of rural land, protection of farmers' rights' and 'Chinese supreme court pledges to protect citizens' rights in demolition cases', *NCNA* ,16 February 2011; State Council, 'Chinese central government says no to forced eviction of farmers', *NCNA*, 3 April 2011.

8 For an analysis of local governments' illegal expropriation of both rural and urban land, see Fubing Su, Ran Tao and Hui Wang, 'State Fragmentation and Rights Contestation: Rural Land Development Rights in China', *China & World Economy*, Vol. 21, No. 4 (July-August 2013), pp. 41-3.

9 Wendy Dobson and Anil K Kashyap, 'The Contradiction in China' s Gradualist Banking Reforms', *Brookings Papers on Economic Activity*, (Fall 2006), p. 125.

10 Zhang and Barnett, 'Fiscal Vulnerabilities and Risks from Local Government Finance in China', pp. 5, 26.

and local officials. It describes the legal vacuum in which local governments and the banking industry have operated. The discussion focuses especially on land ownership, because property development is at the heart of the local government financial crisis, and it examines why essential land reforms have been promised but postponed for a decade. The paper's conclusions are not optimistic about an early and comprehensive solution to funding the economic and social programmes of the nation's local administrations.

1. A Predictable Disaster

The potential for disaster had been identified almost immediately after implementation of the economic stimulus package got under way. In 2009, Xiao Gang, Chairman of the Bank of China, had warned publicly of how borrowings by local governments had surged that year 'beyond their repayment capacity', so that China's financial system was threatened by 'systemic risks'.[11] Local governments had been given no choice, a 2010 International Monetary Fund (IMF) report later pointed out, and 'the use of local government investment platforms to finance infrastructure and other projects has been extraordinary'. The illegal practices to expand 'this quasi-fiscal lending will end up as nonperforming loans', the IMF forecast, 'with negative implications for both local government finances, bank balance sheets, or, potentially, central government finances'.[12]

The nation's chief banking regulator shared this gloomy view. 'Outstanding loans to local government financing units' had risen by 70 per cent in 2009, he stated, and the banks were facing 'great risks' which required 'relentless efforts to manage'.[13] Local government indebtedness by the end of 2009 was more than three times its 2005 level, with almost 90 per cent of the funds supplied by the banks. The state media reflected a very high level of alarm within the nation's leadership about the on-going crisis. The borrowings were described as a 'major threat'.[14] Almost 40 per cent of servicing charges and repayment depended on land sales, a ratio described as too high for comfort.[15] A 'huge number' of the loans had been devoted to projects that 'have not generated any cash flow', it was reported.[16] In many cases, revenues were not enough to cover the interest payable.

A high proportion of the loans were short-term, and special measures to allow refinance facilities were unavoidable.[17] Data for direct borrowings showed that 23 per cent of these loans would mature in the

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11 Xiao Gang, Bank of China Chairman, 'Top Chinese banker warns of lending risks', *NCNA*, 9 November 2009.

12 International Monetary Fund, 'People's Republic of China Staff Report for the 2010 Article IV Consultation', *IMF Country Report No. 10/238* (July 2010), p. 15.

13 Liu Mingkang, China Banking Regulatory Commission Chairman, 'Chinese regulators highlight precautions against financial risks before Seoul Summit', *NCNA*, 11 November 2010.

14 'China vows to contain gov't debt risks', *NCNA*, 13 December 2013.

15 'Local debts surge to nearly US$3t', *CD*, 31 December 2013.

16 'China vows to contain gov't debt risks', *NCNA*, 13 December 2013.

17 'New local bonds OK'd to pay off old debt', *CD*, 2 January 2014.

second half of 2013 and a further 22 per cent the following year.[18] In the last resort, much of the borrowing was likely to be written off by the banking industry as non-performing loans (NPLs), it was predicted, thus setting back the banks' development as competitive and commercial enterprises.

- In 2011, official anxiety about the quality of these borrowings and their impact on banks' balance sheets had become so acute that USD438 billion in bank lending to local governments was 'reclassified'.[19]

- In 2013, a leading Ministry of Finance researcher called on provincial governments to set up asset management companies 'to help handle their growing non-performing assets', which had been the remedy adopted when USD223 billion worth of state banks' NPLs had to be written off in 1998-99.[20] These new vehicles started to appear the following year with special regulatory arrangements.[21]

The public had been repeatedly reassured by leading officials in 2011 and 2012 that local government borrowings were already being brought under strict control. Unfortunately, in the absence of a national, real-time monitoring system of local government finances, the available statistical information continued to generate a deceptively optimistic view of local government behaviour and badly underestimated the volume of reckless borrowing. The official estimate of local government indebtedness for 2011 was dangerously reassuring: it had reportedly risen by a mere RMB300 million. Premier Wen Jiabao was left convinced that there was no need for alarm, declaring publicly that local government debts were 'generally safe and controllable'.[22] The flow of official reassurances was to continue unchallenged. A senior budget official claimed that the banks' funding of LGFVs had been 'effectively curbed' in 2012.[23] The World Bank was also misled. 'China's stimulus package appears to have worked exceptionally well', declared a distinguished World Bank team in 2012, 'The success of China's fiscal stimulus offers several useful lessons for both advanced and emerging economies'.[24]

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[18] Wei Tian, 'Local govts get more say in choice of financing tools', *CD*, 6 March 2014.

[19] 'China to re-book some local govt loans', *CD*, 15 August 2011.

[20] Zhao Quanhou, Ministry of Finance Fiscal Science Research Centre Head, quoted in Wei Tian, 'Asset firms can resolve local debt', *CD*, 29 October 2013.

[21] For a useful overview, see 'China's Toxic Debt Doctors Prepare for Surgery', *Caixin*, 8 January 2014 URL: http://english.caixin.com/2014-01-08/100626405.html?p2

[22] 'China Focus: China ends financial meeting, urges serving real economy amid risks', *NCNA,* 7 January 2012; Premier Wen Jiabao, National People's Congress Press Conference, *NCNA*, 14 March 2012.

[23] Li Cheng, Budgeting Department Deputy Director, 'Local gov't debt controllable after enhanced regulations', *NCNA*, 18 May 2012.

[24] The World Bank team were not entirely uncritical and noted in passing that 'reforming both the local government finances and the domestic banking sector should be high priority areas for the policy makers in China'. Shahrokh Fardoust, Justin Yifu Lin and Xubei Luo, 'Demystifying China's Fiscal Stimulus', *World Bank Policy Research Paper WPS6221* (October 2012), pp. 17-9, 21-2.

In fact, borrowings had surged in flagrant defiance of directives from the nation's leaders to halt lending to local governments. Not until the end of 2012 did officials start to admit that measures to halt the flow of unauthorised borrowings had proved futile.[25] The true dimensions of the crisis only emerged after 54,400 auditors were mobilised for a nationwide investigation in July 2013.[26] They reported that borrowings had risen during the first half of 2013 by another 13 per cent above the 2012 total and that the total indebtedness of local governments had reached the equivalent of USD2.93 trillion. This figure, the National Audit Office (NAO) said, 'implied a 67 percent rise' over the original 2010 estimate of local government loans when the crisis first started to worry the government.[27]

2. Financial Desperation

The threat to financial stability from local governments' funding practices was not new. Already in the 1990s, their excessive borrowings had caused mounting inflation, according to a prominent economist, and they were responsible for much of the surge in banks' NPLs by the middle of the decade.[28] In 1999, an unsuccessful national campaign had been launched to halt their unlawful borrowings. By 2005, local governments' outstanding debts were described by one official as greatly exceeding their 'repayment capabilities' and as a 'menace to the country's fiscal system'.[29] In the same year, however, the local governments' dependence on the banks was further increased after fiscal reforms were implemented which reduced their budgetary resources.[30] In response, the Finance Ministry launched yet another campaign to end local borrowings which were reported to have a reached a level in 2006 'so huge that no one except the central government can clear it'.[31] By 2009, the sense of urgency had intensified, and banks were directed to review all borrowings by local governments by mid-2010 and to 'reclassify them if necessary'.[32]

Nevertheless, as Table 1 shows, it was the economic stimulus package itself which transformed long-standing, 'informal' funding for local governments into a potential disaster as their outstanding loans rose by more than 60 per cent in 2009. Table 1 also reveals how these borrowings were supplied

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25 Finance Ministry, National Development and Reform Commission, PBOC and CBRC statement reported in 'China to further check local government financing', *NCNA*, 31 December 2012.

26 'Local debts surge to nearly US$3t', *CD*, 31 December 2013.

27 'Xinhua Insight: China's direct gov't debt risks controllable', *NCNA*, 30 December 2013; 'Local debts surge to nearly US$3t', *CD*, 31 December 2013.

28 Professor Fan Gung, 'The Chinese economy's secret recipe', *CD*, 24 August 2010.

29 The available statistics were known to be incomplete. Xie Liqun, Zhejiang Provincial Audit Department Director, 'Local government debts detrimental to state treasury: Chinese legislator', *Renmin Ribao* (*RR* hereafter), 12 March 2005.

30 An excellent summary of these developments is Achim Fock and Christine Wong, 'Financing Rural Development for a Harmonious Society in China: Recent Reforms in Public Finance and Their Prospects', *World Bank Policy Research Working Paper 4693* (August 2008), pp. 2-65.

31 'Chinese gov't investigating rural authority debts', *NCNA*, 28 November 2006.

32 International Monetary Fund, 'People's Republic of China: Detailed Assessment Report: Basel Core Principles for Effective Banking Supervision', *IMF Country Report No. 12/78* (April 2012), pp. 57-8.

almost entirely by the banking system and were thus unlawful. It took drastic measures, introduced by the China Banking Regulatory Commission, to achieve the abrupt decline from 2010 in the banks' share of local government loan finance shown in Table 1.[33] But this apparent improvement was misleading. The People's Bank of China (PBOC) admitted in 2014 that local governments had managed to circumvent the reimposed restrictions on bank borrowings. They had turned to 'more expensive lending from shadow banks' which appeared to have comfortably offset the fall in formal bank lending.[34]

A Chinese Academy of Social Sciences study of shadow banking put its value 'on the basis of government calculations' at RMB14.6 trillion by the end of 2013, equivalent to 11 per cent of the banking sector's total assets and 25 per cent of GDP.[35] The general opinion was that this sector's activities were indirectly financed by the banks themselves tempted by the significantly higher interest earnings.[36] The Vice Finance Minister in charge of macroeconomic research and fiscal policy quoted an annual average rate of 8 per cent earned on direct bank loans to local governments in 2012, with the rate higher by three to five or more times for funds supplied via the shadow banking sector.[37]

3. How State Controls Failed

The crisis was made possible in the first instance by the traditional conviction among China's leaders that the banks could be left to fund solutions for any economic disruption the nation might encounter.[38] The 2007-09 global financial crisis and its aftermath furnished a dramatic example of the heavy costs generated by such optimistic assumptions. Another crucial factor was the delays in the implementation of reform policies in general which even the highest-ranking decision-makers encounter in China, no matter how menacing the problems which they are seeking to resolve.

In the case of local government finances, the crisis was allowed to gather strength because China's legal, financial and administrative systems proved incapable of supporting the two remedies envisaged by the nation's leaders:

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[33] Gang Fan and Yan Lv, 'Fiscal Prudence and Growth Sustainability: An Analysis of China's Public Debts', *Asian Economic Policy Review*, Vol. 7, Issue 2 (2012), p. 212.

[34] The views of Pan Gongsheng, PBOC Vice Governor, and the statistical evidence, were reported in 'China Exclusive: Urgent supervision of shadow banking needed: official', *NCNA*, 15 January 2014.

[35] 'China Exclusive: Urgent supervision of shadow banking needed: official', *NCNA*, 15 January 2014.

[36] Zhang Yi and Lyu Dong, 'Xinhua Insight: China dodges major shadow banking default', *NCNA*, 27 January 2014 and 'China contains local government debt', *NCNA*, 17 December 2013. See also *China Financial Stability Report 2013* (China Financial Publishing House, 2013), p. 204.

[37] Wang Bao'an, Vice-Minister of Finance, 'Fiscal reforms to ease local govt debt pressure', *CD*, 11 June 2014.

[38] Dai Xianglong, PBOC Governor, 'China's Financial Industry at the Threshold of the 21st Century', Stanford University (17 October 2000) URL: http://www.pbc.gov.cn/english//detail.asp?col=6500&ID=1

- to monitor borrowings so that the government could track the true state of local government liabilities; and

- to float bonds and use other sources of funding for local governments to end their chronic fiscal deficits.

3.1 Monitoring Information

In theory, monitoring should have been no problem. The bulk of the borrowings came from the banks which, supposedly, were already able to generate comprehensive and reliable loan data.[39] In practice, the government did not get the information it needed from this source and so had to struggle to establish a specialised monitoring system between 2008 and 2013. But in vain.

- 2008: 'The Ministry of Finance ... set up a special department responsible for monitoring the debts of local government over the past months'.[40]

- 2010: The International Monetary Fund (IMF) warned that 'information on the activities of LGFVs (and their underlying financial condition) is sparse' and arrangements to collect the data were only just being created.[41]

- 2011: Premier Wen called 'for the banking institutions to establish a more complete and prudent risk monitoring regime'.[42]

- 2013: An IMF study published that year had been unable to rely on official estimates of local government borrowings and found it necessary to make use of data compiled by 'investment banks, academics, and research institutes'.[43]

- 2014: Premier Li Keqiang stated that 'to guard against and defuse debt risks, China will also implement a comprehensive government financial reporting system'.[44]

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39 The availability of the statistical information has been vigorously asserted: 'Although the operation of local "platforms" is not totally transparent, they cannot misreport their debt figures as most of money they received was from banks that are subject to a strict legal responsibility of accurate book keeping'. Gang and Yan, 'Fiscal Prudence and Growth Sustainability: An Analysis of China's Public Debts', p. 213.

40 Zhao Quanhou, Ministry of Finance Research Institute for Fiscal Science, quoted in Jing Ji, 'Local govts may be allowed to issue bonds', *CD,* 23 October 2008.

41 IMF, *People's Republic of China Staff Report for the 2010 Article IV Consultation***,** pp. 15, 16, 27.

42 'China Focus: China ends financial meeting, urges serving real economy amid risks', *NCNA*, 7 January 2012.

43 These sources included Bank of America, Citigroup and Credit Suisse although foreign involvement in China's financial markets was very limited. Zhang and Barnett, 'Fiscal Vulnerabilities and Risks from Local Government Finance in China', pp. 9-10.

44 Premier Li Keqiang quoted in 'China to standardize local government financing channels', *NCNA*, 5 March 2014.

3.2 Budget Deficits

The solution proposed for the acute budget shortfalls was to provide local administrations with adequate funding of their own. But rapid improvement was not possible. China's formal fiscal system was extremely complex, a senior Ministry of Finance official explained, and its informal fiscal arrangements even more so.[45] The entire taxation system was being overhauled in a bid to catch up with the transformation of the economy and the business environment in this century.[46] These reforms would take considerable time.

The easiest solution, the government had long felt, would be to turn to the financial markets through bond flotations. This optimism proved misplaced.

- 2008: The Ministry of Finance hoped 'that local governments would be able to finance their share of the [stimulus] package with bonds'.[47]
  This proposal was promptly discredited by a senior researcher at the Ministry of Finance. 'Few local governments' could successfully issue bonds if required to disclose 'their debts and revenues', he predicted, 'If they reveal their books, no one would agree to lend'.[48]

- 2012: The National Development and Reform Commission stated that 'China needs to allow local governments to issue bonds to help tackle the financing bottleneck'.[49]
  The government then sought to delete from the Budget Law the ban on local government bonds. But opposition in the national legislature killed the proposal after critics insisted that 'without a proper supervision mechanism in place', local government bond issues would aggravate 'financial problems'.[50]

- 2014: Premier Li Keqiang announced that 'bonds will become a major financing mechanism for local governments this year'.[51]

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45 Jia Kang, Ministry of Finance Research Institute of Fiscal Science Director, 'Three-layered govt tax framework', *CD*, 4 November 2013.

46 Lou Jiwei, Minister of Finance, reported in 'Official pinpoints China's tax priorities', *NCNA*, 21 November 2013. Particularly challenging was the redistribution of revenues between the more prosperous regions and the rest, an issue on which the Ministry of Finance started to seek a solution in 2010 and was still grappling with four years later. 'China boosts financial support to counties', *NCNA*, 10 January 2014.

47 Jing Ji, 'Local govts may be allowed to issue bonds', *CD,* 23 October 2008.

48 Zhao Quanhou, Ministry of Finance Research Institute for Fiscal Science, quoted in Jing Ji, 'Local govts may be allowed to issue bonds', *CD,* 23 October 2008.

49 Xu Lin, National Development and Reform Commission Fiscal and Financial Department Head, quoted by Lan Lan and Wang Zhuoqiong, 'Call for local govts to issue bonds for projects', *CD*, 8 September 2012.

50 'Proposed budget law revision calls off easing local government bond issuance', *NCNA*, 26 June 2012; 'Test for Budget Law', *CD*, 7 August 2012.

51 Wei Tian, 'Local govts get more say in choice of financing tools', *CD*, 6 March 2014.

> Once again, legislators proved highly sceptical and 'called for caution in allowing local governments to issue independent bonds'.[52] By mid-2014, only ten local governments had been granted 'autonomy to issue bonds directly' (instead of via the Ministry of Finance).[53]

This fiscal liberalisation was presented as a major contribution to ending local governments' financial shortfalls. However, only provincial-level governments would be allowed to float bonds which would require prior approval by the National People's Congress (and its provincial counterparts) and would be subject to stringent monitoring.[54] The Ministry of Finance announced that, 'to enhance risk prevention', credit ratings would be introduced which local governments would have to publish, together with information on 'local economic development, fiscal income and expenditures, as well as the liabilities'.[55]

But the access to the bond market could not be extended to the bulk of China's local administrations for very cogent reasons. It remained unlikely that more than a handful could hope to meet the disclosure requirements that a public bond issue would involve. An impressive survey in 2013 had discovered that none of the nation's '289 cities and municipalities' was releasing comprehensive information on 'normal budget and expenditures; extra-budgetary and government debts', among other key financial indicators.[56] What hope could the average local government have of meeting the disclosure standards that credit ratings would require?[57]

These failures in financial management were the negative side to China's astonishing economic take-off. The inability to implement the leadership's preferred solutions highlighted how reliance on market forces to drive modernisation had its own limits.

4. Banking Partners: Coercion, Collusion and Cooperation

Local government indebtedness could not have reached such menacing levels without the full participation of the banking industry.

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52 'Chinese lawmakers highlight budgetary transparency, oversight', *NCNA*, 23 April 2014.

53 Of the ten provinces, four had already won this market access in 2011 and another two the following year. 'Four more local gov'ts get bond-issuance autonomy', *NCNA*, 21 May 2014.

54 'Xinhua Insight: China revises law to better manage government money', *NCNA*, 31 August 2014. It is worth repeating that provinces had previously been permitted to float bonds via the Ministry of Finance and thus, in theory at any rate, had been subject to similar central oversight as envisaged by the new legislation.

55 Ministry of Finance reported in 'China introduces ratings on local gov't bonds', *NCNA*, 13 June 2014.

56 This survey was conducted by Tsinghua University and featured in 'Cities' finance transparency unsatisfactory', *CD*, 23 July 2013. A full summary of the results was published in '中国 289 城市财政透明度报告公布：三地得分为零', *NCNA*, 23 July 2013.

57 Note the continuing concerns about local government financing in Xin Zhiming, 'Revised Buget Law to have far-reaching effect', *CD*, 1 September 2014.

To outside observers, it may seem intolerable that banks — especially the state-owned sector — should consistently break the law and defy national policies. It seems equally unacceptable that local administrations and government agencies should actively collude with the banks' unlawful behaviour and profit from it. But in the case of China in 1978 and for the decades that followed, this paper will show, the law offered virtually no protection to the banks against defaulting borrowers.[58] To a large extent, the only practical way that a bank could secure its assets, enforce repayment of loans and pursue fraudulent customers was through the exercise of political, not judicial, force. In this environment, local governments became the banks' partners by necessity and not always by choice.

The banks' collusion with local governments began with the political system. Throughout China's state-owned enterprises (SOEs) in general, managerial appointments have remained subject to control by the Chinese Communist Party.[59] The banks' immunity from interference by either Party or state officials had been proclaimed in 1983, but subsequent legislation showed that such autonomy would be very limited in practice.[60] During the 1980s, bank staff were in no position to resist political pressures at provincial and lower levels because their career prospects depended on assessments made by local Chinese Communist Party officials. In addition, local governments controlled access to essential public services, which could be denied to a recalcitrant branch and its staff.[61]

In the 1990s, local officials were accused of ruthlessly exploiting local banks.[62] Life was made somewhat easier for state banks after the Party assumed direct responsibility for the appointments of local as well as national personnel in 1998, which freed their staff from subservience to local administrations.[63] Sub-national banks, however, remained captive to local officials.[64] At this level, a 2009 study reported, the Party remained the most powerful single influence in a bank's management, and the 'the internal Party committee' exercised greater authority than directors and senior executives. This 'entrenched Party involvement' continued to be detrimental to 'effective corporate governance structure', the study claimed.[65]

58 Xiang Junbo, PBOC Deputy Governor, '2005 High-level Forum of China's Financial Reform' (26 April 2005) URL: http://www.pbc.gov.cn/publish/english/956/1942/19428/19428_.html

59 Yingyi Qian, 'How Reform Worked in China', *William Davidson Working Paper No. 473* (June 2002), pp. 45-6.

60 State Council, 'Provisional regulations on changing investment expenditure on capital construction in the state budget from appropriations to loans by the State Planning Commission, Finance Ministry and the China Construction Bank', *Zhonghua Renmin Gongheguo Guowuyuan Gongbao*, No. 3 (10 February 1985), pp. 71-7.

61 For an early complaint about the subordinate position of bankers, see Guo Shikun, 'The significance of obstacles and remedies in the transition from specialised banks into market enterprises', *Jingji Yanjiu*, No. 10 (20 October 1986), p. 22.

62 Liu Suinian, NPC Finance and Economic Committee Chairman, 'Safeguard the PBOC's independent administration', *RR*, 20 October 1995.

63 Sebastian Heilmann, 'Regulatory Innovation by Leninist Means: Communist Party Supervision in China's Financial Industry', *China Quarterly*, No. 181 (March 2005), p. 10.

64 Shimin Chen, Zheng Sun, Song Tang and Donghui Wu, 'Government intervention and investment efficiency: Evidence from China', *Journal of Corporate Finance* (2010), p. 12.

65 Lynette Ong, 'The Communist Party and Financial Institutions: Institutional Design of China's Post-Reform Rural Credit Cooperatives', *Pacific Affairs*, Vol. 82, No. 2 (Summer 2009), p. 277.

A recent World Bank study found evidence of how political factors affected the personal relationship between a bank and a business enterprise's management and were an important factor in obtaining banks loans. Specifically, banks gave preferential treatment to chief executives 'appointed to their current position by local governments, indicating firm structural and CEO personal ties to those governments'. In contrast, chief executives without such connections had to 'face tighter financial constraints due to their inferior political status in the Chinese credit market'.[66]

Profitability became another, increasingly important incentive for banks to develop close relationships with local governments. In a study of rural conditions in the 1990s, Professor Christine Wong, a leading authority on local government finances, noted how local officials could work in partnership with a bank to restructure a business in danger of defaulting on a bank loan because of their control over labour and other cost factors.[67] In 2006, the 'excessively high' interest rates on loans to 'township governments and village committees' were estimated officially as 'generally above 15 percent, and even up to 30 percent'.[68]

The banks themselves were willing accomplices in the surge of local government borrowing that followed the economic stimulus package. They found the profit opportunities irresistible. In 2010, they were accused by the banking regulator of 'unscrupulous' conduct in seeking 'excessive profits' from illegal lending to local governments.[69] An IMF analysis described in 2013 how local governments had made themselves more attractive as borrowers. Local officials 'incentivized' banks to increase their lending, it reported. 'Explicit and implicit guarantees were provided by local governments' which included 'collateral, particularly land', which also 'provided banks with a certain degree of comfort'.[70]

5. Lawless Administration

The extent of the local government financial crisis, the absence of comprehensive data and the lack of state controls reflected a failure to put in place the conventional systems for the administration of public finances. Before 2010, there were no legal requirements for proper accounting and control of 'all fiscal funds and all government-related construction projects'.[71] Nor were there 'clear regulations … for managing government funds'. That year, the first 'tentative measures' were

66 Robert Cull, Wei Li, Bo Sun and Lixin Colin Xu, 'Government Connections and Financial Constraints: Evidence from a Large Representative Sample of Chinese Firms', *World Bank Public Policy Research WP6352* (February 2013), pp. 4-5, 35.

67 Christine P. W. Wong, 'Rural Public Finance', in Christine P. W. Wong (ed), *Financing Local Government in the People's Republic of China* (Hong Kong: Oxford University Press, 1997), p. 200 *et seq*.

68 'Chinese gov't investigating rural authority debts', *NCNA*, 28 November 2006.

69 Wang Zhaoxing, CBRC Deputy Chairman, 'Banking regulator urges structural reforms', *NCNA*, 24 October 2010.

70 Yinqiu Lu and Tao Sun, 'Local Government Financing Platforms in China: A Fortune or Misfortune', *IMF Working Paper WP/13/243* (October 2013), p. 10.

71 Prime Minister Wen had personally called for this reform the previous year. 'China boosts auditors' power as stimulus package spending prompts corruption concerns', *RR*, 21 February 2010.

introduced setting out 'requirements for the definition, application and approval procedures, collection, budget management and supervision of government funds'. The Ministry of Finance admitted that previously, the management of public finances had been so chaotic that local administrations had been able to collect unauthorised fees from the public.[72] Until the revised Budget Law of 2014, 'Chinas government budgets only included the general budget, largely made up of tax revenue and spending on public services and government operations'. SOE finances were neither 'budgeted nor supervised'. Also excluded were receipts derived from 'state land, accounting for a large part of local government revenues'.[73]

This situation was a legacy of the command economy era when the Chinese Communist Party had reigned supreme, and state budgeting was a straightforward administrative accounting exercise.[74] At the start of Deng Xiaoping's economic liberalisation, Party officials feared that the dismantling of the command economy would undermine their authority. Traditionally, a local administration's 'economic management office' had made itself responsible for virtually all aspects of life: 'party and mass work', welfare, oversight of government offices, directing the management of production and commercial activities. The post-1978 economic reforms and the switch to market forces were accompanied by a drive to reduce the Party's direct involvement in managing local business and financial affairs. A serious conflict was unavoidable between local Party officials determined to defend their political power and prestige and the national leadership convinced that China's modernisation depended on liberating China's professional, managerial and technical expertise.[75]

In addition, the Maoist era had left officials convinced that they were above the law.[76] Thus, even when the economic reforms had got under way, officials still firmly believed that 'the Party replaced government'; that 'the Party was above the law'; and that once 'the Party Committee' had made a decision, 'their duty was 'to obey orders and not the law'.[77] After a drive began to enact the legislation that China's modernisation required, senior national leaders complained that administrative laws and regulations were not taken seriously and that officials felt free to make their own decisions so long as

72 Wang Chaocai, Ministry of Finance Research Institute of Fiscal Science, reported in Qiang Xiaoji, 'Ministry of Finance regulates government funds', *CD*, 28 September 2010.

73 'China revises law to better manage government money', *NCNA*, 31 August 2014.

74 'The [1994] Budget Law was adopted when the country was still strongly influenced by planned economy concepts and at an early stage of applying budget management. It had only a very general definition of what the government budget covered, leaving huge room for interpretation by [local] governments'. 'China revises law to better manage government money', *NCNA*, 31 August 2014.

75 Yang Guojun, 'Roundup: China's new progress in streamlining administration', *NCNA*, 30 March 1987.

76 The 'rule of law' was never completely overthrown during Mao Zedong's lifetime. It was criticised during mass campaigns but then re-emerged, most notably in 1975 when the 'gang of four' were pushing Maoism to its extremes. See Shao-Chuan Leng, 'The Role of Law in the People's Republic of China as Reflecting Mao Tse-Tung's Influence', *Journal of Criminal Law and Criminology*, Vol. 68, No. 3 (September 1977), especially pp. 356, 373.

77 Commentator, 'Wiping out feudalism and its surviving influence is an important task in political and legal work', *RR*, 28 November, 1980. The authoritative status of this trenchant denunciation of seeking privilege and immunity from lawful obligations on the part of officialdom was demonstrated by its publication originally in a fuller version in *Faxue Zazhi*, No. 20 (1980) and in a shortened version by *Guangming Ribao*, 19 November 1980.

they implemented Party policies.[78] This insubordination was not entirely unjustified. A prominent lawyer complained of the fundamental weaknesses of the nation's administrative law in 1984. Basic legal terms were confusing and ill-defined. The legislative process itself was clumsy and ill-coordinated, with a plethora of over-lapping bodies involved at the national and local levels. Provisions for implementation and enforcement were very often not specified in the legislation.[79]

In any case, strict enforcement of the law was impossible to achieve in practice. In 1978, there had been no legal framework left after the Cultural Revolution to handle criminal and legal complaints, and 60 per cent of the nation's administrative units had no officials to carry out such duties.[80] In 2000, China had only 100,000 qualified lawyers. By 2013, their numbers had risen to 235,000, a large improvement but still a mere 1.6 per 10,000 of the population.[81] There were no trained lawyers employed by government agencies (or business corporations) until the beginning of this century, and their numbers have remained pitifully small. In 2005, 633 government departments employed 1,817 lawyers.[82] By 2013, 23,500 lawyers had been recruited as 'legal advisers for governments at all levels', an unimpressive figure given China's population but still 10 per cent of the country's total lawyers.[83]

The absence of a legal system designed to meet the needs of a modern economy has done little to undermine China's overall growth, it has been argued.[84] No such optimism is justified about the banking system, however, which has been particularly vulnerable to this 'lawless' environment.

- 1986: Auditor General, Lu Peilian, warned that the economic reforms had seriously aggravated the risks of fraud and false accounting.[85]

- 1992: President Jiang Zemin called for 'further efforts …to tighten auditing and economic supervision'.[86]

78 See in particular the quotation from Peng Chen, Chairman of the National People's Congress Standing Committee, in Wang Lianchang, 'Some proposals on improving China's administrative law', *Guangming Ribao*, 24 December 1984.

79 This criticism was made by a survivor of the last group of lawyers to be allowed to graduate before legal studies halted in the 1950s. Wang, *Guangming Ribao*, 24 December 1984.

80 'Legal administration in the 2,200 counties into which China is divided falls upon local procurators. But at the end of 1978, only 40 per cent of the counties had appointed chief or deputy chief procurators'. Leo Goodstadt, 'Democracy and Development: The Chinese Debate in the Wake of the Disgrace of the "Gang of Four"', *Round Table*, No. 273 (January 1979), p. 18.

81 Zhao Dacheng, Vice Minister of Justice, 'China to improve publicity of prison affairs', *NCNA*, 29 November 2013; 'China Has 110,000 Lawyers', *RR*, 18 November 2000; 'China has 1.6 lawyers per 10,000 people', *NCNA*, 27 August 2013.

82 'More than 200 Chinese counties have no lawyers', *RR*, 10 June 2005.

83 Zhao Dacheng Vice Minister of Justice, 'Over 20,000 lawyers recruited as governmental legal advisers', *NCNA*, 11 August 2013.

84 A good example of such optimism is Franklin Allen, Jun Qian and Meijun Qian, 'Law, Finance, and Economic Growth in China', *Journal of Financial Economics*, Vol. 77, No. 1 (July 2005), pp. 57-116.

85 Auditor General Lu Peilian, 'Report on Auditing Work, 1985', *Zhonghua Renmin Gongheguo Guowuyuan Gongbao*, No. 18 (20 July 1986), pp. 555, 557-8.

- 2004: The PBOC Governor complained that most of the fundamental forms of legal protection for bank transactions were not in place. The courts' impartiality could not be taken for granted in disputes related to bank loans. Local governments interfered with 'judicial affairs', and law enforcement was 'poor'.[87] Urgently needed were 'laws concerning [insolvency], loan frauds, and accounting rules and standards'.[88]

- 2005: The PBOC Deputy Governor declared that the 'inadequacy and incompatibility of our legal rules' were a cause of significant risk for financial institutions and markets.[89]

- 2006: An extensive World Bank survey identified 'weak' legal protection for creditors; and 'unreliable' financial statements and audits as serious obstacles which deterred banks from lending to the private sector.[90]

- 2007: The PBOC Governor stated that defective legislation was compounded by 'large deficiencies in the standards of accounting, information disclosure and financial statements reporting'.[91]

- 2010: The courts were given powers for the first time to direct state agencies to cooperate with banks in pursuing defaulting borrowers; and in the next two years, the courts pioneered a data base of judgments against defaulters, to which the public had access.[92]

- 2011: The chief banking regulator complained of the damage being done by 'intentional failure' to comply with proper banking procedures and the continuing tendency for policies announced by the state or by head offices to be ignored at the local levels.[93]

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86 Jiang Zemin, 'Accelerating the Reform, the Opening to the Outside World and the Drive for Modernization, so as to Achieve Greater Successes in Building Socialism With Chinese Characteristics', *Report at the 14th National Congress of the Party* (12 October 1992) URL: http://www.bjreview.com.cn/document/txt/2011-03/29/content_363504_13.htm

87 Zhou Xiaochuan, PBOC Governor, 'Some Issues Concerning the Reform of the State-owned Commercial Banks', Speech at the IIF Spring Membership Conference, (Shanghai, 16 April 2004) URL: http://www.pbc.gov.cn/english//detail.asp?col=6500&ID=31

88 Zhou Xiaochuan, PBOC Governor, 'Improve legal system and financial ecology', Chinese Economists Forum (2 December 2004) URL: http://www.pbc.gov.cn/english//detail.asp?col=6500&ID=69

89 Xiang Junbo, PBOC Deputy Governor, 'Improve the Legal System to Prevent Financial Risks', speech at the '2005 High-level Forum of China's Financial Reform' (26 April 2005) URL: http://www.pbc.gov.cn/english//detail.asp?col=6500&ID=75

90 World Bank, *China Governance, Investment Climate, and Harmonious Society: Competitiveness Enhancements for 120 Cities in China*, Report No. 37759-CN (9 October 2006), pp. 55-6.

91 Zhou Xiaochuan, PBOC Governor, 'Instability and Evolution of the Financial System' (5 December 2007) URL: http://www.pbc.gov.cn/english//detail.asp?col=6500&ID=158

92 Wang Jingqiong, 'Court tries to rope in runaway debts', *CD*, 25 March 2011; 'China to freeze bank accounts of defaulters', *NCNA*, 31 August 2013; 'China to publish blacklist for defaults on judgments', *NCNA*, 1 October 2013; 'SPC targets payment defaulters', *NCNA*, 5 November 2013.

93 Liu Mingkang, China Banking Regulatory Commission Chairman, speech at Lujiazui Forum (20 May 2011) URL: http://www.cbrc.gov.cn/english/home/jsp/docView.jsp?docID=201106134F7B8902E3BAC6C5FFA807B15F8A0E00

- 2013: The courts were struggling to build up a body of case law which would cover disputes over financial transactions other than bank loans. This was a completely new area of responsibility for the judiciary.[94]

This time line illustrates how the nation's leadership has been aware of the defective legal and accounting systems since very early on. Their calls for reforms made little difference. The costs of having failed to introduce the reforms were highlighted repeatedly by the banking authorities in this century but progress has remained slow, following a widespread pattern in China's public administration of reforms postponed, which so frequently afflicts policy implementation.

6. Land: 'A Money-Making Machine'

Public ownership of land has been at the heart of crisis that has overtaken local government finances and its banking relationships. Increasingly, local officials have found the solution for their budget constraints in land and property through partnerships dominated by business interests, both commercial conglomerates and large-scale SOEs. A housing market which has successfully defied national efforts to restrain 'bubble' behaviour has been fostered by local governments' assistance to developers not only in providing building sites on favourable terms but also through ensuring privileged access to bank finance for their projects. These arrangements have become a major contributor to the nation's growth momentum but are not wholly benign.

Local governments had 'constantly violated state law' to fuel a property boom, China's Auditor General, Liu Jiayi, declared in 2010.[95] Among the consequences have been 'forcible land seizures, soaring prices of urban housing, and blatant violations of private and collective property rights, [which] enrich local officials and well-connected businessmen at the cost of social well-being'.[96] In 2014, the World Bank, in collaboration with the State Council's Development Research Centre, called for urgent measures to remedy serious defects in rural land ownership rights that were hampering economic and social development.[97]

6.1 Local Defiance

The primary cause of the land scandals is to be found in the original decision to make local governments responsible for financing and managing their own economic and social development. In

94 Chen Hai'ou, Beijing High Court Commercial Section President, quoted in Cao Yin, 'Court to issue guide on private loan cases', *CD*, 18 December 2013.

95 'China's local gov'ts 3 trillion yuan in red with infrastructure, stimulus spending', *NCNA*, 23 June 2010.

96 Qiang Fu and Nan Lin, 'Local State Marketism: An Institutional Analysis of China's Urban Housing and Land Market', *Chinese Sociological Review,* vol. 46, No. 1 (Fall 2013), pp. 6, 9, 11, 21-2 in particular.

97 World Bank and the State Council Development Research Center, *Urban China: Toward Efficient, Inclusive, and Sustainable Urbanization* (Washington: World Bank, 2014), pp. 38, 40.

consequence, officials turned their control of local land supplies into a 'money-making machine', a careful study reported. 'Since the late 1980s, taking land from farmers and leasing it on the market has become a major business of local governments', according to this research. Their incentive to boost land transactions was reinforced in 1994 when they were given the right to revenues from land. Local administrations were monitored so minimally that as long as the receipts were classified as 'extra-budgetary', 'local officials could easily manipulate compensation figures and lease prices and fool the center'.[98]

Since then, 'selling land has become the main income driver for local governments', the Ministry of Land and Resources has said, which provides a powerful incentive for illegal transactions.[99] The scale of this largely unregulated and often unlawful market is huge. From 1996 to 2010, according to the Ministry's statistics, local governments disposed of 4.94 million hectares of rural land for urban development projects. In the current decade, the Ministry forecasts, new projects will need another 3.5 million hectares.[100] The pressure on local governments to service the surge in accumulated borrowings since 2009 (see Table 1) intensified this trend. In 2013, revenue from these land sales rose 45 per cent and reached 'a record 4.1 trillion yuan' (USD664 billion).[101]

6.2 Reform's Delays

The origins of this alarming situation date back to the start of the reform era. The government's efforts to create an institutional system for land ownership have long been frustrated. The process of introducing improvements followed the usual pattern of China's policy-making: a long cycle with repeated commitments to reform measures that were not to be fully implemented for several years. As a result, 'while China's rapid economic growth since 1978 has reshaped the nation', it has been pointed out, 'the collective rural land ownership and land acquisition systems have been left unchanged'.[102]

By 2003, there was growing awareness of a need to enforce a recently enacted rural land contract law.[103] Shortly afterwards, the Minister for Land and Resources was dismissed for corrupt practices including 'misuse of land'. He was the highest casualty in a national campaign to end the malpractices triggered by the huge appetite for building sites generated by breakneck industrialisation.[104] His

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98 Fubing Su *et al*., 'State Fragmentation and Rights Contestation: Rural Land Development Rights in China', p. 41.

99 Wang Qian, 'Illegal land use cases disclosed', *CD*, 26 November 2011.

100 Lan Xinzhen, 'New Lay of the Land: On collectively owned rural land, experts say farmers deserve more', *Beijing Review*, No, 44 (31 October 2013).

101 'China to audit government land income in corruption fight: paper', *CD*, 18 August 2014.

102 This account is based on a very well-briefed analysis presented in 'Gov't must enact land reform', *CD*, 5 November 2013.

103 'Wu Bangguo: rural land contracts should be protected', *CD*, 20 September 2003.

104 'Land and resources minister removed from post', *CD*, 29 October 2003.

replacement admitted publicly that the general public had been seriously victimised in the rural areas through officials withholding compensation and fees when land was requisitioned for development. The total owed to displaced occupants in 2004 was estimated at USD2.5 billion.[105] A full decade later, these malpractices were still flourishing. The Ministry of Land and Resources stated that, in an effort to improve relations with the public, it had 'urged local government bodies to pay more than RMB18.8 billion (USD3 billion) of delayed compensation funds to farmers for land that was seized' in 2013.[106]

In 2005, the Supreme Court had intervened after the state's attempts to halt 'rampant illegal land use' had made little progress. Not surprisingly because what was at stake was described by the judiciary itself in obscurantist language as 'a kind of property rights [acquired] through the signing of land contracts'.[107] To add to the confusion, the State Council's senior agricultural researcher declared that because rural land was 'collectively owned', the individual's rights were not 'secure' from arbitrary abrogation by local officials.[108]

In 2006, the State Council introduced measures to halt the worst abuses Local governments were to lose their 'total freedom to spend the money from land sales as extra-budget revenue'.[109] Henceforward, these funds would have to be incorporated into their budgets and be subject to controls.[110] In particular, land revenues were not to be used to cover the costs of general administration and services but would be authorised for use solely 'to support infrastructure constructions and land development'. But since land proceeds were 'a major source of income for local governments', it was admitted, local governments were not prepared to comply with the State Council's directive to surrender their financial autonomy. A 2007 investigation of 11 cities by the NAO reported that 'more than 70 per cent of net proceeds from land sales' — USD12.5 billion — had not been entered in their budgets as required.[111]

Officials were now warning of 'runaway investment'. Its 'leading cause' was said to be 'illegal land supply' which made up 'nearly 50 per cent of new land under development' in 2007, according to a Ministry of Land and Resources survey, and 'as high as 90 per cent in some cities'. A senior NAO official warned that this situation could undermine the quality of the banks' property and mortgage

105 Sun Wensheng, Minister of Land and Resources, 'Huge loopholes found in China's land requisition cases', *RR*, 21 April 2004.

106 Ministry of Land and Resources report quoted in An Baijie, 'Officials punished for violating frugality rules', *CD*, 12 June 2014.

107 Huang Songyou, Supreme Court Vice President, reported in 'Supreme court moves to defend farmers' rights on land contract', *NCNA*, 29 July 2005.

108 Han Jun, State Council Development Research Agricultural Department Centre Head, 'China grapples with thorny issue of rural land rights', *RR,* 1 September 2006.

109 However, the measure also reduced the State Council's own role in monitoring transactions. 'China grapples with thorny issue of rural land rights', *RR*, 1 September 2006.

110 See Zhang Xinbao, Ministry of Land and Resources, reported in 'Screws tightened on illegal land use', *RR*, 6 September 2006.

111 'Violations found in land proceeds management, sales', *NCNA*, 5 June 2008.

business.[112] By 2008, the serious vulnerability of public finances to property transactions was very plain but was now deliberately ignored in the scramble to fund the economic stimulus package. Previously, the Ministry of Finance had endeavoured to control local governments' reliance on land transactions. Now, the Ministry, desperate for additional money, encouraged land sales to finance stimulus projects.[113] In 2009, 46 per cent of total local government revenues came from land transactions, leading to 'illegal land acquisition and soaring house prices'. Local governments had been given no choice: they had to rely on real estate bubbles to pay the share of the stimulus package bill allocated to them.[114]

6.3 Reluctant Registration

The nation's land crisis should be tackled not only through tight controls on local government financing but also with a rigorous land registration system, declared a senior enforcement official at the Ministry of Land and Resources in 2008.[115] Registration of the nation's land holdings and their owners was supposed to be a crucial building block in the official land reform programme. But this basic information has not yet been compiled because, over the last 25 years, local officials have obstructed the creation of a national data base.

In 1988, a decade after the rural communes and collective farming had come to an end, the government discovered that the nation's statistics on land use were highly misleading. Furthermore, provincial-level administrations were prepared to openly defy Beijing on land management and refused to comply with requests for statistics. Local administrations were found to be concealing the use and ownership of rural land on a very large scale. There was a powerful incentive to understate the areas under cultivation, for example, in order to evade agricultural taxes and state procurement quotas. There was an equally powerful incentive to misrepresent the volume of land diverted from farming to construction. Some provincial authorities claimed, for example, that reductions reported in the total area of arable land had occurred as the result of natural disasters.[116]

In this century, there has been continued opposition from local officials to compiling land data. A national campaign had been scheduled to start in 2007 to survey and record the ownership of all land, with work to be completed by 2008. Implementation did not begin, however, until late 2011 and made

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112 Zhai Aicai, National Audit Office Agriculture, Resources and Environment Audit Department Deputy Head, reported in 'NAO says violations found in land proceeds management, land sales in 11 cities', *NCNA*, 4 June 2008.

113 The negative consequences were reported in some detail for an international audience by *China Daily*: e.g., Wang Zhuoqiong, 'Officials punished for misuse of funds', 16 October 2009; Hao Yan, 'Local govts "want land sales" to pay back loans', 23 June 2010; 'Proceed cautiously on land-based funds', 13 October 2009.

114 See the critical observations of Professor Ye Jianping, Renmin University, and Huang Xiaohu, China Land Science Society Vice President, reported in *RR* and *NCNA*, 27 December 2010.

115 Zhang Pu, Ministry of Land and Resources Law Enforcement and Supervision Bureau Deputy Director, quoted in 'Thousands of people punished for illegal land grabs', *NCNA*, 15 April 2008.

116 Li Jianlin and Wang Qingping reporting a briefing by an unidentified official from the State Land Administration Bureau, *NCNA*, 30 July 1989.

only slow progress subsequently because of 'resistance [which] has mainly come from local governments, which rely on land transfer fees to pay for the rising demand in public services and to pay off debts', it was officially reported.[117] Quite simply, local budgets could not be balanced if officials lost their ability to sell off collectively owned land.

By 2014, land-use rights had been surveyed, registered and confirmed in a mere 150 counties, the Minister of Agriculture, Han Changfu, admitted. The programme would not be extended to all 1,500 counties to be surveyed until 2015, with final completion to take a further five years, it was revealed. In addition, provincial-level governments needed formal monitoring to ensure that they complied with the new property regulations and policies which were being promulgated.[118] To make matters worse, 'the drafting of a property registration regulation' was behind schedule and had yet to be finalised in mid-2014.[119] The gap between the first proposal for the creation of a modern property market on the basis of comprehensive registration of land titles and the 2020 target date for full implementation thus totalled 17 years. (This time lag is much the same as the companion paper identifies for the financial sector and other areas of government.)

7. Conclusions

There is little prospect of a rapid solution to the unsatisfactory state of local government finances. An entire financial infrastructure still needs to be built, virtually from scratch, to judge from the targets set by the government in 2014.

> We will strengthen management of local government debt, move faster to create a mechanism for local governments to borrow money mainly through issuance of government bonds, and work to put in place standardized, proper mechanisms for managing central and local government debts and giving early warning against debt risks.[120]

A 2014 study by the World Bank and the State Council Development Research Centre confirmed this gloomy prospect. Local governments financing must continue 'in the short term', the report predicted, to remain heavily dependent on what are unlawful and excessive bank borrowings and on 'shadow banking' facilities. The nation lacked the fiscal transparency, the financial oversight, the land legislation and the institutional framework to allow the early creation of efficient bond markets and similar funding facilities, this authoritative study warned.[121] Another report in this World Bank series

117 'Gov't must enact land reform', *CD*, 5 November 2013.

118 'China to complete land-use right registration in 5 years', *NCNA*, 25 December 2013. The total number of county-level administrations is 2,862, many of which are now urban in character. 'China to send teams to inspect property regulation', *NCNA*, 24 July 2012.

119 See the leak from 'an anonymous MLR [Ministry of Land Resources] source' reported in 'China speeds up drafting of property regulation', *NCNA*, 23 July 2014.

120 'Full text: Report on China's economic, social development plan', *NCNA*, 15 March 2014.

121 World Bank *et al*., *Urban China: Toward Efficient, Inclusive, and Sustainable Urbanization*, pp. 60-2.

uncovered a daunting 'infrastructural' deficit. Almost every aspect of the administrative and legal framework that a modern economy requires was either missing from the Chinese landscape or was largely incomplete, it declared. The examples cited ranged from the government's own budgets, their coverage and transparency, to insolvency legislation.[122]

The implications of the continuing problems with local governments go well beyond the ability of ministries and state agencies to enforce national policies and legislation. The capacity of the Chinese economy to grow its way past institutional shortcomings and infrastructural deficiencies was reaching its limits even before 2008. This paper indicates how reform initiatives to reduce state controls and to let market forces take command had ceased to be enough. The next stage of modernisation required the central authorities to introduce new systems and legislation together with adequate monitoring and enforcement agencies. But it is reasonable to predict that the search for solutions will follow the usual decade-plus time lag in the implementation of policy commitments.

In the meantime, the most draconian measure taken by the Chinese Communist Party so far to solve the threat posed by local government borrowings was the Central Committee decision at the end of 2013 to adopt 'a new system to evaluate officials' in which 'local government debt will be an important indicator in assessing performance'.[123] It was not a good omen that this initiative had first been proposed publicly in 2011, which made it another example of the delayed reforms which plague China's public administration.[124] Furthermore, the pledge to penalise individual officials was not convincing because the nation still lacked the capacity, this paper has shown, to monitor the financial transactions of local governments with any accuracy and, in the process, to identify those personally at fault. Nor has the government provided a viable substitute for illegal and irregular borrowings to finance the economic and social development on which the political survival of local officials ultimately depends.

[122] World Bank and State Council Development Research Center, *China 2030: Building a Modern, Harmonious, and Creative Society*, pp. 102, 122.

[123] 'China vows to contain gov't debt risks', *NCNA*, 13 December 2013.

[124] Yuan Shuhong, State Council Legislative Affairs Office Deputy Director, reported in Zhao Yinan, 'Leaders to face penalties over local govt debt', *CD*, 11 July 2011.

Table 1. Local Government Borrowings, 2000-2013[125]

Year	Total local government borrowings (RMB trillions)	Index of total local government borrowings (2005=100)	Bank loans/local government borrowings (%age)
2000	0.8	3	86
2005	2.83	100	87
2006	3.57	126	87
2007	4.52	160	87
2008	5.58	197	87
2009	9.04	319	87
2010	10.72	379	80
2013	17.87	633	54

[125] For 2000-10, data are based on Gang and Yan, 'Fiscal Prudence and Growth Sustainability: An Analysis of China's Public Debts', 'Table 3 Local government debt situation: 1999–2010' p. 213. The data available for the next two years are omitted because they are of dubious quality, as this paper demonstrates. For 2013, the figure for total borrowings is as at end-June and is compatible with the earlier statistics. ('Local debts surge to nearly US$3t', *CD*, 31 December 2013.) Outstanding bank loans to local governments in June 2013 totalled RMB9.7 trillion. (Shang Fulin, China Banking Regulatory Commission President, 'China's banking sector achieves goal of risk control: CBRC', *NCNA*, 31 July 2013)