



# Can they put humpty dumpty back together again? A review of public investment in China

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Christine Wong  
University of Oxford

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# China's economic miracle

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- In 1985 average income in China was \$**293**; in 2007 the average income was \$**2,360**.
- **Employment in agriculture** fell from nearly **70%** in 1980 to **41%** in 2007.
- Share of population living in **urban areas** has risen from 18% in 1978 to 45% in 2007.
- China is the **second largest economy** in the world on purchasing power parity basis (after the United States).
- China contributed **one-third of global economic growth** in 2004.

# This growth has been fueled by high savings and investment

% GDP	1993	2003	2007
Total investment in fixed assets	36.5	40.9	55
Investment in infrastructure	6.5	7.7	8.9
State investment	22.4	15.9	15.5
Central government investment	7.9	3.1	5.3
State social sector investment	0.8	1	1.2

But concerns are growing on efficiency of investment.

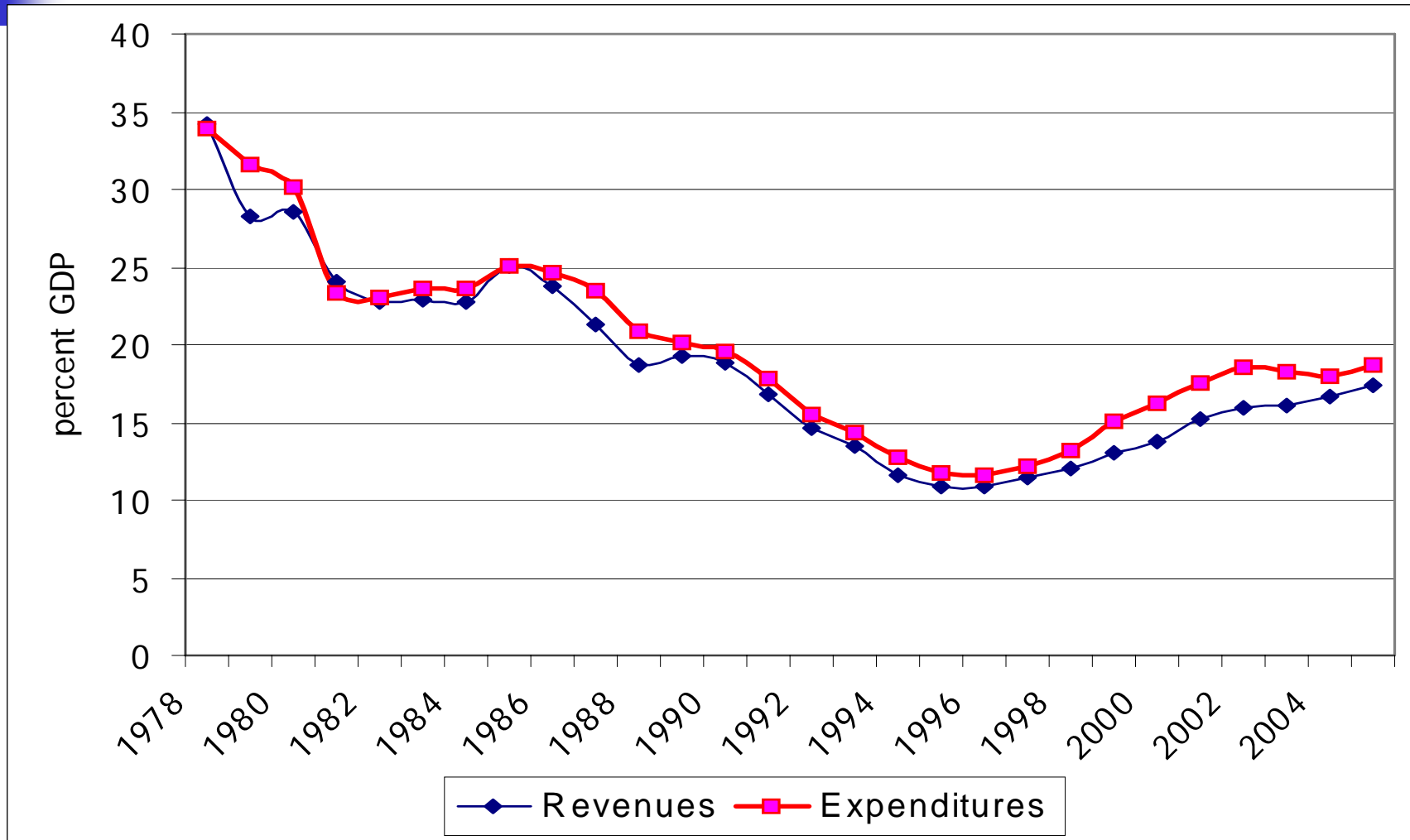


# A review of China's public investment management is timely

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Especially since the fiscal stimulus package just announced proposes to spend an additional 15% of GDP over the next 2 years, most of it on infrastructure.

# Start with background on reforms in China's public sector





# Retrenchment of government (1980-1996)

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- Primary guiding principle: preserve status quo, avoid creating “losers”
  - No department/ministry was closed
  - No public service providers were privatized
  - No jobs were cut in civil service

# Background (1): China's growth and its benefits have been unequally distributed

	1990	1998	2006
<i>Five richest provinces<sup>a</sup></i>			
Share of GDP	20.8%	22.8%	28.4%
Share of population	12.5%	12.3%	12.9%
Share of revenue collections	18.0%	12.2%	15.6%
Share of gov't expenditures	11.8%	14.8%	17.6%
<i>Five poorest provinces<sup>b</sup></i>			
Share of GDP	11.0%	9.7%	9.3%
Share of population	16.8%	17.0%	16.5%
Share of revenue collections	8.4%	5.7%	3.9%
Share of gov't expenditures	9.8%	9.5%	9.2%
a Shanghai, Beijing, Tianjin, Zhejiang and Jiangsu.			
b Guizhou, Gansu, Yunnan, Anhui, and Guangxi.			



## Background (2a): China is among the most decentralized countries in the world

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Sub-National Share of Budgetary Expenditures (%)

China (2007)	77
Developing Countries (1990s)	14
Transition Countries (1990s)	26
OECD Countries (1990s)	32



# Background (2b): decentralization goes all the way down – vital services are delivered by low levels of government

Shares of total (2004)

	Budgetary Expenditures	Health	Education	Social Welfare and Relief *
Central	28%	3%	7%	0.7%
Province	19%	22%	15%	9.5%
Municipalities	22%	31%	18%	26.6%
County	25%	39%	46%	51.1%
Township	6%	5%	15%	12.7%

\* Estimated.



# Effects of this retrenchment

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- A. Collapse of redistribution
- B. Decentralization by default
- C. Underprovision of social services
- D. Increased reliance on user charges and “business incomes” of government agencies and public institutions



## B. Decentralization by default

Percent of expenditure	1978		1988		1998		2006	
	Central	Local	Central	Local	Central	Local	Central	Local
<b>Total</b>	<b>46.6</b>	<b>53.4</b>	<b>35.7</b>	<b>64.3</b>	<b>42.3</b>	<b>57.7</b>	<b>24.7</b>	<b>75.3</b>
Investment	49.9	50.1	69.2	30.8	34.0	66.0	24.6	75.4
Industry, Transport & Commerce	55.6	44.4	33.3	66.7	38.1	61.9	23.2	76.8
Agriculture	2.6	97.4	9.4	90.6	11.0	89.0	9.0	91.0
Social services	9.8	90.2	11.6	88.4	10.1	89.9	9.2	90.8
National Defense	95.8	4.2	99.1	0.9	99.3	0.7	98.9	1.1
Government Administration	8.2	91.8	16.3	83.7	7.4	92.6	11.6	88.4
Debt Servicing			100.0	0.0	100.0	0.0	100.0	0.0
Subsidies	38.8	61.2	24.8	75.2	53.5	46.5	37.1	62.9



## Decentralization of capital spending downward through the hierarchy

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Share of budgetary expenditures on investment (%):

	Central	Province	Prefecture	County	Township
2003	44.4	23.1	21.8	9.9	0.8
2004	39.1	22.4	26	11.6	0.9
2005	33.8	25.9	24.6	14.9	0.9



## D. Commercialization of the public sector

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- As revenues declined, the budget financed a declining portion of costs across all government agencies and public service providers
  - Increase in user charging
  - Increased use of state assets to generate “business incomes”
- Incentives were given to all public institutions to use proceeds to maintain and grow operations, and supplement salary payments

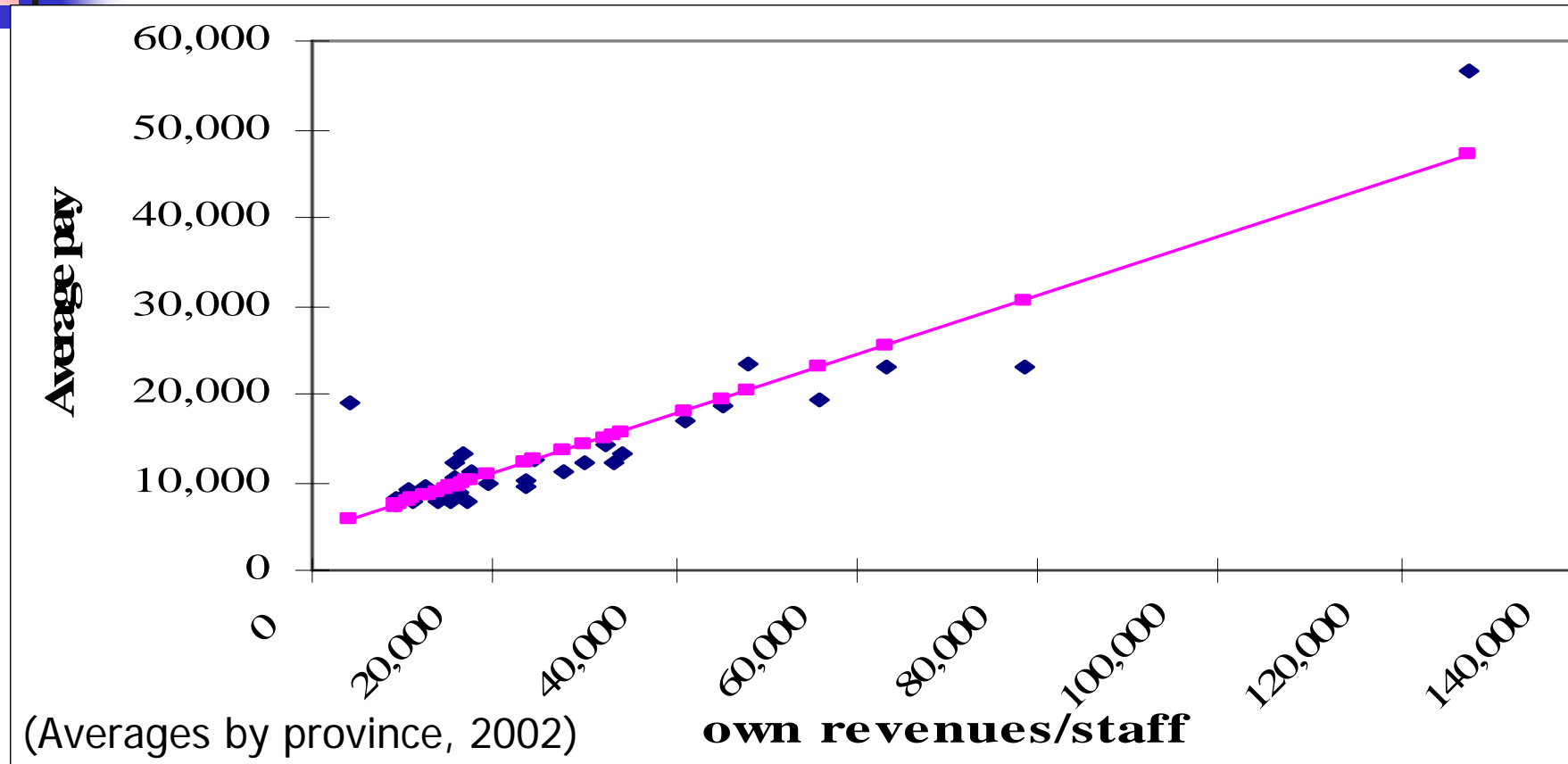


# Public employees became increasingly dependent on salary top-ups

Average pay for public institutions (2002):

	basic wage/total remuneration
National average	57%
By tier:	
Central	41%
Provincial	48%
Prefectural	51%
County	63%
Township	63%

# Correlation between public employee pay and “own revenues” of the institutions



Civil servants have similar remuneration structures.



Through 1980s and 1990s, all attention was focused on reviving revenue collection, not on expenditure management

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- Budget process was extremely weak in late -1990s :
  - Spending poorly linked to policies
  - Poor control over aggregate spending – large extrabudgetary expenditures
  - Low efficiency of spending
  - Large regional disparities



# Government had little information on:

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- How much was spent
- How it was spent
- How many people it employed and how much they were paid



# Reforms to budget management began only around 2000:

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Changes applied to the whole budget cycle:

- Formulation
- Approval
- Implementation
- Audit



## The key reforms:

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- Introduction of organizational budgets
- Treasury reform
- Introduction of a procurement law and guidelines for large purchases by government
- Introduction of GFMIS



# The reform process has been

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- Incremental and experimental, relying on pilots at each stage
- Differing pace of implementation of the separate components
- Decentralized implementation – separate processes at the central, provincial, municipal and county levels
- Pace of subnational implementation is left up to each province, though with national target dates for treasury reform, introduction of organizational budgets, etc.



## Major challenges remain:

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Budget is not comprehensive:

- Formulation of the capital budget is done separately from the recurrent budget
- Extrabudgetary revenues and activities of government remain large, many are unreported



# MOF does not have comprehensive oversight on government spending:

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Personnel expenditures are outside of MOF control:

- Staffing decisions are made by a separate (Party-controlled) agency
- Pay increases are often decided with little/no vetting from MOF



# Public investment management is an integral part of PEM

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- Suffers from all the same problems..
  - PI is not well linked to policies
  - Poor control over aggregate spending
  - Low efficiency
  - Large regional disparities

# Capital spending was mostly pushed off budget

Share of GDP (%)

	1978		1988		2006	
	Central	Local	Central	Local	Central	Local
<b>Budgetary expenditure</b>	15.8	18.1	7.1	12.9	4.8	14.5
O.W.:						
Investment	8.1	8.1	3.8	1.7	0.9	2.9
Investment share of total	51%	45%	53%	13%	20%	20%

# Diverse sources of public investment funding:

(RMB Billions)

	2000	2006
Budgetary appropriations	408.9 (32%)	862.1 (28%)
Budgetary fund	171.4 (14%)	827.3 (27%)
Extrabudgetary expenditure	88.2 (7%)	146.7 (5%)
National debt	415.4 (33%)	692.3 (22%)
Loans from China Development Bank	179.6 (14%)	576.0 (19%)
Loans from IFIs	2.3 (0.2%)	16.0 (0.5%)
Total	1265.8	3120.4

PLUS: commercial bank loans of unknown magnitude



# China Development Bank

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- Set up in 1994 as one of 3 policy banks
- Main function: to supply credit for national priority projects at discounted interest rates
- Has developed a large portfolio of commercial loans and investments including large stakes in Barclay's Bank (UK)

%	Budget	Loans	Foreign	"Own"	Other
<b>Social Service Facilities</b>					
Education	12.3	12.9	0.6	66.2	8.1
Health	9.3	11.7	0.6	72.6	5.8
<b>Infrastructure</b>					
Urban water	11.1	20.3	3.7	58.1	6.8
Electricity	6	43.6	1	43.5	5.9
Transportation	13.5	33.3	1.5	43.2	8.4
Telecom	1.5	1.9	0.9	92.9	2.8
<b>Industry</b>					
Coal	1.3	11.5	1.2	82.7	3.4
Gas & Oil	0.9	13.6	2.2	75.8	7.5
Mining	0.6	6.1	2.7	82.3	8.3
Chemicals	0.1	15.7	7.4	73.9	2.9
Transport Equip.	1.5	8.6	6.4	80.7	2.8
Machinery	0.4	6.9	5.8	84	3
Electronics	0.2	6.6	9.4	81.1	2.6
<b>Infrastructure</b>	<b>9.8</b>	<b>34.1</b>	<b>1.4</b>	<b>47.7</b>	<b>7</b>
<b>All Investment</b>	<b>3.9</b>	<b>15.3</b>	<b>3.4</b>	<b>60.6</b>	<b>16.8</b>



# 2004 State Council Document on Reform of Investment Institutions

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- Rationalize the scope of government investment
- Reform the project selection mechanisms to make it more objective and transparent
- Improve management of funds by integrating allocation
- Simplify approval procedures
- Create mechanisms for allowing private financing of public investment projects
- Etc.



# Areas of concern with PIM

## process:

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- Undue political interference in PIM
- Lack of objective criteria for project selection
- Unclear lines of responsibility and accountability
- Shortage of project appraisal, procurement and management skills
- Lack of coordination between different levels of government, across jurisdictions