Institutional Cause and Policy Effect of Local Authorities' Bailout Measures

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Abstract. Economic growth has been considered to be central authorities' function in traditional theory. However, after sub-prime mortgage crisis broke out in USA in 2007 and threatened the world economy, provincial and municipal governments in China actually released measures positively to stimulate economic growth. The institutional reasons of local governments' behavior are: Faced with more severe financial crisis, central authority implements institutional innovations with the aid of local governments; decentralization reform strengthens fiscal incentives of local authorities and their investment impulsion; the unique urban management model causes the local authorities highly care about real estate market; regional separation strengthens the regulatory effect of local governments. The local authorities' behavior possibly leads to investment-pulling growth, increased fiscal risk and environmental pressure in future.

Introduction

Economic growth has been considered as the central government's functions in the traditional theory of public finance (Richard Musgrave, 1959).[1] Theoretically, if the factor market is open, the fiscal policy that the local governments implement will result in "leakage". Therefore, rational local officials will not make such kind of effort.

Edward Gramlich (1991) challenged the traditional theory. He claimed that in the U.S.A. the liquidity of factors is not as strong as described in theory. In many cases, the increased individual expenditure is spent on local services. In addition, because a lot of economic factors affect some particular industries, macro-economy become more and more regional rather than nationalized. Therefore, the local fiscal policy is often necessary. Empirical studies also demonstrated the concern of local government on economic growth. Bahl pointed out that the fiscal policies American sub-national governments implemented were counter-cyclical.[2]

China is the same. An empirical analysis of Sun Qun Li et al(2007) shows the expansion of local government significantly reduces fluctuation of output. However, the economic behavior of local governments is not fully consistent with the intention of the central macro-control.[3] Shen Kun-rong, Sun Wen-jie (2004) also suggests that the effect of central government's macroeconomic "fine tuning" is limited due to the local government's countervailing reaction.[4] Wang Yong-jun (2000) suggests local governments' behaviors aggravate rather than reduce economic fluctuation in China due to decentralized and diversified decision-making system.[5]

Local Governments' Bailout Measures in China after the Subprime Mortgage Crisis

After the subprime mortgage crisis in U.S.A. evolved into the global financial crisis in 2008, China also suffered from that. In the third quarter of 2008, China's GDP growth rate had fallen to its lowest point of that year. Meanwhile the range of loss of enterprises around the country continued to expand, and fiscal revenue declined as a result. Compared with the pro-active fiscal policies from 1998, current round of macro-control has shown an important feature: local governments were busy making their own policies at the same time as central governments, and implemented a lot of plans, including saving the property market, issuing consumption vouchers, making some investment plans and other regional economic measures.

Making Fiscal and Tax Policies to Stimulate Housing Market

Property transaction volume has been declining since 2008. The data shows that the transaction size of newly-built and second-hand housing in 40 major cities in the entire country decreased by 24.9 percent and 20.9 percent respectively from January to May compared to the previous year.

In August 2008, Henan Provincial Government announced from September 1st residents in Henan will get deed tax relief, decreased down payment, longer loan term, the most favorable mortgage rates, etc. In addition, Xi'an, Xiamen, Changsha, Chengdu and other cities also has formulated a series of strategies such as tax relief or tax reduction, purchase subsidies to stimulate the real estate market.

Issuing Consumption Vouchers to Local Residents

In January 20, 2009, Hangzhou proclaimed to issue coupons to local residents. The total amount of coupons is up to 1 million yuan, and it nearly benefits all the families in Hangzhou. Chengdu Municipal Government issued consumption vouchers before December 29, 2008 to the subsistence security allowances, rural "Five Guarantees", and key special-care recipients.

The enactment of issuing coupons shows that local governments are zealous about stimulating consumption. Those policies got permissions from central government. Nanjing and Guangdong issued 20 million travel coupons later. It is noteworthy that coupons are issued in those developed cities where local fiscal strength is powerful.

Making Investment Plans on a Large Scale

The scale of local governments' investment program in 2009-2010 has reached 18 trillion yuan at least, and the average annual scale runs as high as 9 trillion yuan. It is estimated that more than 65% of the current local public investment projects are invested in transportation, upgrading urban and rural power grids and rural infrastructure construction, and the remaining part are in environmental protection, independent innovation, and low-income housing and health care. This distribution pattern was basically consistent to the central government's spending plans.

Institutional Cause of Local Authorities' Bailout Measures

Faced with More Severe Financial Crisis, the Central Government Implements Institutional Innovation with the Aid of Local Governments

The impact of subprime crisis is greater on China than Asian financial crisis in 1997. After entering the WTO in 2001, the share of Exports in GDP rose from 19.2% in 1997 to 37.5% in 2007, and the net exports in GDP rose from 4.3% to 8.1%, the contribution of net exports to GDP growth is about one-quarter. That means that the negative effect of shrinking external demand on China's economy is more significant now. The macro-economic climate index was only 79 in December 2008 and China's economic operation stepped into the "light blue zone", which means a little cool.

Faced with the serious crisis, central government had to implement "policy innovation" with the help of local governments. Due to uncertainty of innovation, central government often reserves some space of institutional innovation for local governments in order to confirm or adjust in the future.

Take the real estate market for example, after local governments made various rescue measures, central government's attitude was implicit tolerance or even encouraging at the beginning. State Council has clearly declared that local government should take more responsibilities of keeping the sustainable real estate market on December 21, 2008. However, in such a relatively favorable environment, local governments were inclined to abuse their power from the interests of the jurisdictions. Local authorities continued to promulgate the policies of tax returns for purchasing houses, tax deductions for prepaid Land Appreciation Tax and even the return of "land transfer fees" policy, etc. Some of these policies evidently stepped on the central government's bottom line. On January 9, 2009, local governments were forbidden to introduce more tax, financial and other policies to stimulate the real estate market beyond their authorities anymore.

Local Governments' Investment Impulse are Strengthened by the Decentralization Reform

China's fiscal reform is characterized by "decentralization" since the reform and opening policy in 1970's. Decentralization reform made it possible that local governments could share residual claim rights and pushed local governments to pursue economic growth actively. The reform of the selection and promotion of local officials made the promotion link to local economic growth performance since the beginning of 1980's, which strengthened the incentive of local officials to compete for growth. The tax-sharing system reform in 1994 further strengthened rather than weakened the local financial incentives. Moreover, the lower government level was, the stronger the fiscal incentives resulted from the reform.

In the process of decentralization, local governments began to look upon business invitation and investment attraction as an important political task. Which resulted in the over-investment in infrastructure. This situation is not unique to China. Estache and Sinha's empirical studies stated fiscal decentralization reform often increased spending on public infrastructure, and that trend was even more evident in developing countries.[6]

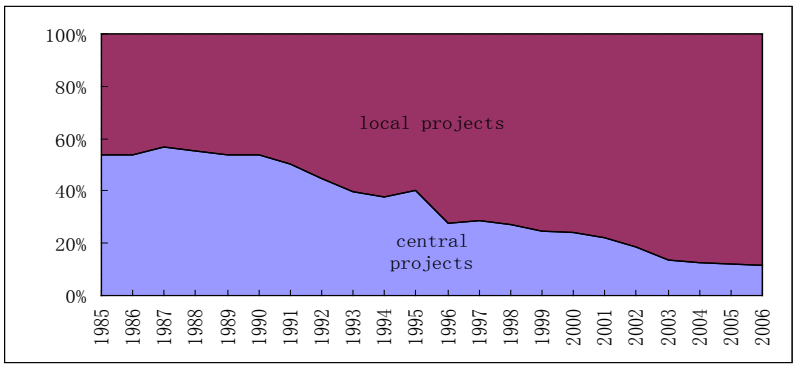

Fig. 1 Investment in Fixed Assets by Jurisdiction of Management in Urban AreaSource: China Statistics Yearbook (2007), China Statistics Yearbook (2000)

Fig. 1 shows that local projects occupied absolute majority of investments in fixed assets since tax distribution system reform. The historical data shows that the growth rate of fixed asset investment became higher when the government administration changed such as in 1993, 1998 and 2003, which shows that the newly appointed officials had a strong impulse to invest in fixed assets.[7] It is also the same in 2008. It could be seen from the 18 trillion investment plans made by all the provinces. Actually when the negative effects of global financial crisis on China began to appear, the local investment zeal was ignited again. Therefore, those investment plans is not so much the local government's efforts to overcome the depression as the continuation of local government's investment impulse all the time.

Urban Management Models Make Local Governments Pay Close Attention to Commercial Property Market

Fiscal decentralization reform has strengthened incentives for local governments, but it has failed to establish the risk control mechanism. The land transfer fees have no longer been turned over to the central government since 1994. Afterwards it became a major source of extra-budgetary revenue for local government. In China, the tenure of local government officials is 3-5 years but the period of land transfer fund is 50-70 years. The two periods are inconsistent so that local governments are motivated to act as opportunists ----- “enclosure” and the land sales.

Zhou Fei-zhou’s survey in 2003 showed that the land transfer fees equaled 25% to 100% of budgetary fiscal revenue at county level.[8] Ping Xinqiao (2006) pointed out that national Land transfer fees were conservatively estimated 1 trillion in 2006.

When the crisis came, land transfer funds declined markedly, which directly reduced the available financial resources of local governments. The downturn of property market also resulted in a substantial decline of local tax revenue from the real estate industry. The nationwide sales area and amount of commercial residential housing decreased by 19.7% and 19.5% respectively compared with the same period of the previous year. The business tax from real estate industry fell 3.4% over the previous year and the growth rate dropped 43.7% in 2008. Therefore, it is logical that local governments highly depending on land revenue pay more attention on commercial property market which is closely related to their interest.

Regional Separation Strengthens the Regulatory Effect of Local Governments

If the factors are fully mobile, the effect of fiscal policy implemented by local government will result in a lot of “leakage”. But the mobility of factors is not as strong as in theory. In a country like China where the mobility of facts is constrained (such as the household registration system), local governments are able to adjust the local economy.

Young believes that China’s decentralization has led to “fragmented market” under the control of local officials.[9] Due to fiscal incentives, an artificial fragmented market formed based on the coercive power of government. The main forms of regional separation of market include: total prohibition or quantity limitation, technical barriers, and rates control and so on.

Many provinces and cities had introduced measures to encourage customers to buy local products since October 2008. The vouchers issued by governments often can only be used in designated merchants. It raises the sales income of local commercial enterprises, then it increases value added tax and corporate income tax directly. It is visible that consumption vouchers effectively retained the economic growth effects inside issuers’ regions.

The Effects of Local Authorities’ Bailout Measures

Form a New Round of Investment-Driving Economic Growth

World Bank predicts that the general economic downturn will continue in 2009. In that case, the effect of foreign demand on stimulating the economy will be relatively limited. Therefore, it is necessary to deepen structural reforms to actually boost consumer demand. But that was not built in one day. Under those conditions, investment will become the main driving force for China’s economy.

In fact, capital made significant contribution to China’s economy. The study of Lawrence J. Lau has shown that the contribution rate of the material capital to the economic growth of newly industrialized countries in Asia is 68% to 85%. China is not exceptional. Since the reform and opening up policy, China’s rapid economic growth has been mostly derived from the physical capital inputs, rather than from technology progress or the growth of total factor productivity. Investment growth accounted for more than 90% of China's economic growth.[10]

In the process of current round of pushing up the economy, that investment-driven economic growth will continue due to the investment impulse of local government. In fact, central government

and local governments are most likely to reach an agreement during the stage of economic expansion. Local governments' "soft budget constraints" caused the situation of "easy to start, hard to brake" in China's macro-economy. Therefore, the current round of macro-control may result in the same as in the former active fiscal policy when economic growth relied on government investment.

Increase Local Fiscal Risk

The ambitious local investment plans of 18 trillion have been introduced, but in fact the local financial condition is not optimistic. The rapid decline in land revenue, business taxes of real estate, and construction and installation industry has reduced available local financial resources. What's more, central authority has introduced various tax measures to further reduce available local financial resources.

According to past "Budget Law", local governments was not allowed borrow money. The local governments always borrow a lot of hidden debts by all means as the legal channels are blocked. At present, the common practices of local governments to borrow money are: establishing urban investment companies, who invest, finance and manage various urban infrastructure projects.

In fact, it is an important mean for local governments to finance for investment plan through these companies to obtain loans. A huge budget deficit in 2009 increased the central government's financial risk, but it did not exceed the deficit ratio. However, under the decentralized fiscal system the hidden financing of local governments face up with the "soft budget constraint": on one hand, because the term of government office is five years and financing term of urban bundling loan is generally more than 10 years, current administration can transfer risk to the next administration; on the other hand, you can transfer risk to the higher level of governments, forming the so-called "risk in the same big pot".[11] Therefore, the "rational" local governments have enough momentum to borrow more money.

Further Exacerbate the Pressure on the Environmental Protection

Oates' studies have shown that the local authorities prefer to attract new companies through lowering environmental standards or reducing the pollution controls. The boom of local governments' large-scale investment projects will aggravate the grim situation of energy saving and emission reduction.

According to the environmental Kuznets curve, China's GDP per capita was 3266.8 dollars and reached the turning point Shafik mentioned in 2008. However, China's environmental property rights are ambiguous and natural environment is "the commons" for local governments. The "tragedy of the commons" phenomenon on environmental issues emerges as the local governments race to chase the rapid growth of GDP in the political championship.

At the beginning of 2006, China set forth the target of reducing the use of energy consumption per unit of GDP by 4% and reducing major pollutant emissions by 2%, but she did not achieve it. In 2007, the central government began to regard that target as an important indicator for assessing local governments, so the situation became better in 2007.

However, when the crisis comes, the decision-maker will re-focus on economic growth, rather than environmental standards. Take fuel tax reform for example, the reform was originally an integral part of environment tax system and aimed at optimizing the automobile consumption structure by lowering fuel consumption and reducing greenhouse gas emissions. Nevertheless, the truth is that the fuel tax reform has become the means of reducing the cost of private cars and stimulating the automobile consumption in the short term. In this way, the environmental effect of fuel tax is questionable at least in the near future. Evidently, the pressures of pushing up the economic growth and the local governments' competitive patterns of attracting investment will exacerbate existing environmental problems in the short-term.

Conclusions

Local governments play an important role in China's macro-control. They are often active especially in the need of economic expansion. Therefore, local governments' bailout measures would have important impact on central macro-controlling effect.

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