



China's urban future: Financing a new era of urbanization

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"China needs to learn more about the world, and the world also needs to know more about China."

- **Xi Jinping, President of China, speech at the Chinese and foreign reporters' conference of the new Central Politburo Standing Committee of the Communist Party of China, November, 15, 2012**

According to China's National New-Type Urbanization Plan (2014-2020), released in March 2014, approximately RMB42 trillion (USD6.75 trillion) will be required to finance China's urbanization efforts over the next seven years.¹ China's Premier, Li Keqiang, acknowledged that "the scale of China's urbanization is unprecedented throughout human history", and this New-Type Urbanization would unleash enormous consumption demand to restructure the economy and increase national development.²

The methods China employs to finance urbanization in a potentially transformative era will be critically important for central government policymakers to ensure sustainable growth and economic stability. Through a recent series of reforms, China's policy planners have demonstrated that they are facing tough issues by adopting critical measures in forward thinking ways. **As a result, dramatic opportunities now exist to transform the methods by which China allocates and deploys capital to increase economic efficiency.**

This article focuses and expands on the diverse elements underlying future financing mechanisms to support a new era of urbanization in China, including:

- The expansion of China's municipal bond market
- Central government granting local governments more revenue collection capabilities (such as commercial and residential property taxes)
- The promotion of more sophisticated frameworks offering local governments and private funds an incentive to cooperate and mitigate risks
- Expanding skill sets, training, and capacity building efforts to support China's local government officials, who will be asked to take on new and important treasury and finance management responsibilities

1. China's National New-Type Urbanization Plan (2014-2020); <http://cir.ca/news/china-urbanization-plan>
2. <http://www.scmp.com/comment/insight-opinion/article/1248418/what-does-chinese-premier-li-keqiang-think-urbanisation>
http://news.xinhuanet.com/english/china/2013-03/17/c_132240264.htm
<http://english.peopledaily.com.cn/90883/8182231.html>

John Veihmeyer

Global Chairman, KPMG International

"KPMG's Global China Practice was created to bring China closer to the world and the world closer to China. Mobilizing our firms' global expertise in local government and infrastructure finance is a top priority to help address China's market development needs, as policy makers continue to introduce innovative practices with local characteristics."

The backdrop – China's municipal finance situation

In China, local governments – not the central government – take primary responsibility for funding their respective urban development plans. Simply put, "local governments receive half the nation's fiscal revenue, but are responsible for 80 percent of the spending."³

To address this imbalance in the past, local governments relied on a balanced approach between bank loans and land sales to fund urban projects. In 2002, bank loans represented nearly the entire source of local government debt.⁴ Between 2008 and 2010, in an effort to bolster its own economy during a period of unprecedented global volatility, China's central government strongly encouraged local governments to increase spending for the purpose of sustaining economic growth. However, since local governments lacked significant means by which they could raise capital, they increasingly turned to alternative finance markets – in particular trust lending – as an immediate source of capital.⁵

As a result, local government debt-to-GDP rose quickly over five years: from 10 percent in 2008, to over 33 percent in 2013.⁶ The recent and rapid rise in local governments' debt has resulted in the central government providing a higher degree of scrutiny and oversight to ensure local government financial stability. Today, the current leadership is decidedly determined to address the local government debt situation by introducing measures to diversify funding sources, while also increasing the alignment of infrastructure project income streams and debt sources, resulting in significant improvements in the use of capital.

In one of the first efforts to understand the true depth of the present local debt situation, China's state auditor – the National Audit Office (NAO) – was called on to audit the growth of local government debt in mid-2013. Following the December 2013 issuance of the NAO report, the central government has increased its support, offering more policy options intended to diversify urban funding sources for local governments. During the Third Plenum in November 2013, and the National People's Conference and Chinese People's Political Consultative Conference (the Lianghui or 'two meetings') in March 2014, additional funding sources were outlined.⁷

3. *The Economist*, Special Report, Emerging from the Shadows, April 19-25th, 2014

4. China's viewpoint: China's debt, risk of debt crisis, and deleveraging. Bank of America Merrill Lynch. 08 October 2013

5. These loans are issued to local governments through indirect local platforms called 'urban development investment corporations' (also referred to as 'local government financing vehicles').

6. China's viewpoint: China's debt, risk of debt crisis, and deleveraging. Bank of America Merrill Lynch. 08 October 2013

7. The Third Plenum of the Chinese Communist Party (CCP): A "plenum" is a meeting of the CCP leadership. This meeting, to be held in November, is the third plenary session in the five-year cycle of party leadership. Lianghui: Both Chinese People's Political Consultative Conference and the National People's Conference plenary sessions are often called the National "Lianghui" ('Two Meetings' or 'Two Sessions'), responsible for making important national-level political decisions.

Simon Gleave

Partner, Head of Asia Pacific Financial Services, KPMG China

"It becomes clear that China's policymakers have thought carefully about a synchronized series of reforms around not only infrastructure and municipal finance, but more broadly about the methods for allocating capital throughout the financial system. Frankly, we are on the edges of an era in China that could transform efficiency in the deployment of capital."

Arthur Wang

Partner, Head of Banking, KPMG China

"China has an opportunity today to build on the recent reforms and sharply improve the alignment of project duration and project income streams to create new and exciting opportunities for domestic and even international investors."

Municipal bond market expansion

Prior to 2008, "the vast majority of lending was done by the normal banking sector in the form of loans."⁸ Over the past five years, the increased role of non-bank institutions, such as trust companies, changed the complexion of China's financial markets. Trust companies typically offer short duration loans (two years or less), with relatively higher interest rates (over 10 percent in many instances).

As of the mid-2013 audit, regulated bank loans accounted for only 63 percent of total local government debt, down from 99 percent in 2002, while total assets under trust sector management represented RMB8.9 trillion, a 69 percent increase from the previous year.⁹ To monitor this expanding liability, in January 2014 the PBOC pledged to comprehensively monitor local debt risks, thoroughly cleanup local government-backed financing vehicles that are of poor credit quality or risky, and actively push forward preparation for municipal bonds.¹⁰

Previously, as part of the central government's municipal bond pilot program, the provinces of Jiangsu, Shandong, Zhejiang, Guangdong, as well as the Shanghai and Shenzhen city governments were granted the ability to issue municipal bonds to fund their respective urbanization agendas. These pilots were limited in scope given the central government's backing of the programs, therefore providing implicit guarantees to the underlying bonds.

Given recent government policy pronouncements, it is clear that more local governments will be encouraged to undertake preparations to issue local bonds, drawing on lessons from the initial pilots and increased understandings of efficient bond markets. Broader municipal bond issuance across a range of cities will offer greater flexibility for local governments to (re)finance high interest, short duration trust loans, and will be a critical debt management tool for China's local governments in the future.

Municipal bonds are not only debt diversification instruments for local governments, they also improve the alignment between the project life of local government assets (such as bridges, roads, subways, or schools), to the duration of debt instrument liability. For example, long duration assets such as highways may require a decade to produce positive cash flow, thus a 7 or 10 year municipal bond would lessen the duration mismatch, and significantly lower the interest expense obligation. Current market sentiment has been positive toward the emergence of a regulated municipal bond market, as yields-to-maturity on some municipal bonds are nearly as low as that of Chinese treasury yields, and in sharp contrast to trust loan yields.¹¹

8. <http://thediplomat.com/2012/10/the-rise-of-shadow-banking-in-china/>

9. *China's viewpoint: China's debt, risk of debt crisis, and deleveraging.* Bank of America Merrill Lynch. 08 October 2013

10. <https://mninews.marketnews.com/index.php/china-pboc-says-clean-risky-local-government-debt-firms?q=content/china-pboc-says-clean-risky-local-government-debt-firms>

11. <http://www.reuters.com/article/2013/10/20/us-china-debt-bonds-idUSBRE99J0AD20131020>;
http://news.xinhuanet.com/fortune/2012-07/26/c_123472494.htm

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“What makes China local debt different than municipal debt in the West is that, at present, every level of local debt ultimately links back to the central government. This type of centrally-backed funding has its advantages and disadvantages. The disadvantages arise by not aligning the risks of borrowing with default accountability.

If any local governments were to be singled out as insolvent today, it would likely occur only as a guided process from the central government, with an aim to not only help straighten out local finances in a given city, but to set an example that mismanagement is not an option for the future.”

To capture the bond market efficiency of more mature markets, the central government must promote greater openness, transparency, and accountability. One of the ways to do this is with a proper rating system. Currently, the vast majority of Chinese bonds are issued within China's interbank market. To attract and encourage diversified sources of investment, more must be done to ensure that the municipal bonds (as well as the issuing government) are rated appropriately and according to their inherent risk characteristics.

In 2013, The 'China Academy of Social Sciences' (CASS) aligned with a major Chinese credit ratings agency 中债资信 (zhōng zhài zīxìn)¹² to issue financial stability ratings of local governments. A rating agency that stresses an open and transparent framework of measuring economic health will provide the initial foundation required for diversified funding sources that demand transparency and accountability.

Sustainable funding for local governments

A significant hurdle for local governments funding urbanization is that they are unable to rely on steady, sustainable fiscal revenues to underpin investment efforts. In the present fiscal structure, the governments retain only a portion of taxes collected locally, and have few options – other than land sales – to generate revenues.

To enhance reform at the local level, the central government could grant local governments more autonomy and discretion toward the collection of certain taxes, such as: licensing fees and vehicle taxes, personal income taxes, corporate taxes, and property taxes. On January 28, 2011, the central government instituted a pilot program in Shanghai and Chongqing, allowing these local governments to collect property tax revenue. This pilot has yet to be expanded, but the central government appears to be leaning toward stronger support for such alternative revenue creating methodologies.

According to the *Urban China* report jointly issued by the World Bank and the Development Research Center of the State Council, The Chinese government should introduce property taxes as a major revenue source for local governments. Specifically, “a property tax on housing would provide a stable source of local government revenue,...and impose greater financial discipline on local governments.”¹³ Allowing local governments the ability to tax commercial and residential property is one of the most significant options under consideration, and would allow local governments to effectively match revenue against urban project expenses, ensuring fiscal responsibility without relying on less sustainable financial avenues.

In addition to tax collections, budget mechanisms are also in line for central government reform. During the 2014 'Lianghui', Premier Li Keqiang mentioned that “We will institute a comprehensive, well-regulated, open and transparent budget system, and will work hard to incorporate all government revenue into the budget.”¹⁴ This budget is designed for the central government to provide more allocations to

12. <http://www.chinascopefinancial.com/news/article/28459-china-to-introduce-credit-rating-system-for-local-government-debts?lang=en>

13. <http://www.worldbank.org/content/dam/Worldbank/document/EAP/China/WEB-Urban-China.pdf> Page 56

14. http://news.xinhuanet.com/english/bilingual/2014-03/15/c_133188534_3.htm; copy of the central government's economic work report

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"Although municipal bond issuance will be a new activity for many of China's local governments, they can draw on experience from more developed, international markets. We progressively expect to see greater diversification of local funding sources, increased transparency, and a highly regulated municipal bond market in China."

We observe exciting possibilities in the market by bringing a more diverse set of local investors to China's fixed income markets. KPMG's Global Debt Advisory Team is honored to have contributed resources and expertise toward early planning activities with the State Council's Development Research Center to support these market developments."

local governments (via transfer payments) based on the ability of local governments to attract and retain migrant workers. To retain migrant workers, the local government would need to support citizens' basic necessities by offering civil services and public infrastructure, such as specialized training programs and healthcare facilities. This model properly aligns the citizens' developmental interests to the local government's interest of receiving diversified revenue streams, while satisfying the central government's goal of "ensuring that the benefits of China's new urbanization are focused on the people."¹⁵

Alternative framework – accelerating use of public-private partnerships

The public-private partnership (PPP) model is a form of collaboration between the public and private sectors for the purpose of providing services that have traditionally only been provided by the public sector. Public-private partnerships are not new to China; they have been operating in various sectors since the mid-1990s. The primary benefits of PPPs include risk-sharing between the public and private sector, as well as other incentives for the efficient delivery of a project or service.

The central government is recently showing much greater support for PPPs, especially in the areas of public infrastructure construction and urban public services. Infrastructure projects may include railroad projects, public hospitals and vocational schools or universities, while urban public services may include urban road transportation, waste water treatment facilities, and energy infrastructure. Market-driven practices such as franchising, competitive pricing, financial subsidies and other such transparent methods will be utilized to attract private capital to urban infrastructure development.¹⁶

Historically, PPPs have been exposed to certain market risk factors in China. Since PPPs are long-term in nature, they must not only gain current local government support, but also continue to receive support for the duration of the project or service. However, China's mayors typically rotate positions every five years; if an incoming mayor does not support a PPP in progress, the PPP may encounter significant political risk. For PPPs to succeed and gain investment from international enterprises in China - an ultimate objective - this political support must be more transparent and codified in the eyes of international investors.

The central government has identified this need, and according to China's National New-Type Urbanization Plan (2014-2020), the government is now taking steps to align the performance evaluations of the mayors to the long-term success of such projects. In addition, legal frameworks may be introduced to include regulatory oversight and dispute resolution at the national level, which would better protect the interest of the private investor, and ensure a more transparent legal landscape.

15. China's National New-Type Urbanization Plan (2014-2020);
<http://www.shanghaidaily.com/national/Urbanization-plan-focused-on-people/shdaily.shtml>

16. China's Ministry of Finance. China's National 2014-2020 Urbanization Plan

James Stewart

Global Chairman, KPMG's Infrastructure Practice

"Both foreign and domestic private market participants will be seeking opportunistic areas in China's continued infrastructure expansion, including but not limited to the construction and servicing of vocational schools and universities, as well as hospitals, railways, roads and other infrastructure facilities and services that are critical for urban development across China."

Greater local government autonomy will help properly fund urbanization

In April, 2014, the central government held a State Council meeting that pledged to open 80 new infrastructure projects to private investment, a significant move that promotes and encourages more competitive markets.¹⁷ This move shows the central government is aware of the increase in local government debt, and are increasingly seeking solutions to diversify funding sources. The goal is to move away from high interest, short-term borrowing and a reliance on land sales, and move toward a market model that not only provides more options for the local governments, but also provides sustainable and diversified access to capital.

The progressive creation of a sustainable, open and transparent local debt market, an increased ability to fund urbanization with revenue collection and budget capabilities, and additional measures to protect a private party's interest in a PPP will provide local governments with greater autonomy to manage and fund their urban development. The key for sustainable future market development is to ensure the right balance of government direction and support with the fundamental requirement to mobilize higher levels of private sector participation in financing, delivering, and operating public infrastructure.



17. State Council meeting with Li Keqiang; http://www.chinadaily.com.cn/china/2014-04/24/content_17458823.htm

Walkman Lee

**Partner, Head of Insurance,
KPMG China**

"Exciting opportunities will materialize for domestic and even international private investors as China transforms its methods of infrastructure investment. Insurance companies will be seeking to capitalize on these emergent opportunities."

Tim Wilschetz

**Partner, Infrastructure,
KPMG in the USA**

"China has a great opportunity for transforming the approach to infrastructure investment and improving the efficiency with which capital is used in the market. Our firms' work with local and central government officials in China and around the world suggest there are vast stores of experience and knowledge across KPMG's global client base that can be of great use to China as it embarks on a determined path of New Urbanization."

An integrated framework for sustainable New Urbanization

China's recent reforms present a clear indication of the central government's desire to enhance local governments' ability to finance the roads, schools, hospitals, power plants and water facilities that will be necessary to support and sustain an increasingly urban China. Doing so in environmentally sustainable ways takes on added importance in today's China.

The integrated series of recent reforms creates new financing measures and project governance methods, while placing new and significant demands on local public officials in China. Programs and measures that enhance local officials' ability to manage in increasingly sophisticated, multi-dimensional environments become paramount. The human side of China's New Urbanization path must not only take into account improving Chinese cities' ability to house and serve inhabitants, but also ensure capacity building and skill enhancement for local government officials.



Premier Li and other central and provincial government leaders have continued to demonstrate a determined focus that emphasizes the human benefits targeted in China's New Urbanization programs. These are important and far-reaching objectives that will require investments in enhancing local government official capabilities as well, a crucial task given that China has the potential to someday become the world's largest market for municipal bonds. Accomplishing the lofty goal of more efficient use of capital within municipal balance sheets will also require more sophisticated financial management skills at all levels of government, if China's rapid and historic economic transformation is to continue.

About KPMG's Global China Practice (GCP)



KPMG's Global China Practice (GCP) was established in September 2010 to assist Chinese businesses that plan to go global, and multinational companies that aim to enter or expand into the China market. The GCP team in Beijing comprises senior management and staff members responsible for business development, market services, and research and insights on foreign investment issues.

There are currently over 50 China Practices in key investment locations around the world, from Canada to Cambodia and from Poland to Peru. These China Practices comprise locally based Chinese-speakers and other professionals with strong cross-border China investment experience. They are familiar with Chinese and local culture and business practices, allowing them to effectively communicate between member firms' Chinese clients and local businesses and government agencies.

The China Practices also assist investors with China entry and expansion plans, and on both inbound and outbound China investments provide assistance on matters across the investment life cycle, including market entry strategy, location studies, investment holding structuring, tax planning and compliance, supply chain management, M&A advisory and post-deal integration.

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