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SUSTAINABLE URBAN DEVELOPMENT IN THE PEOPLE'S REPUBLIC OF CHINA*

Financing Urban Development in the People's Republic of China

Urbanization in the People's Republic of China

Urbanization in the People's Republic of China (PRC) has been on an extensive and accelerated path. In 2008, more than 600 million people were residing in 655 cities, pushing the urbanization level to 45.7%. Based on current trends, the urban population in the PRC is projected to cross the 1 billion mark in 2030 and eight megacities—each with a population of over 10 million—would be existing in the country by 2025 (Woetzel et al. 2008).

However, the rapid rate and sheer scale of urbanization are associated with increasingly pressing social, economic, and environmental problems. Clearly, new models of sustainable urban development are needed to cater to this phenomenal urban growth for the coming decades.

Changing Landscape of Urban Development Financing

The role of government in urban planning has evolved with changes in urban development in the PRC. Following the economic reforms that have occurred in the PRC since 1976, the central government has progressively delegated responsibilities to local governments in areas such as planning, land use, public works, and social welfare services. Local governments now have increased scope in decision making, receiving greater autonomy over investment approval, entry and exit regulation, resource allocation, as well as authority over state-owned enterprises.

However, this delegation of responsibility did not necessarily come with a corresponding increase in local budgets. For

Urban development investment companies have grown to become a key element in the financing and implementation framework for public urban development in the People's Republic of China.

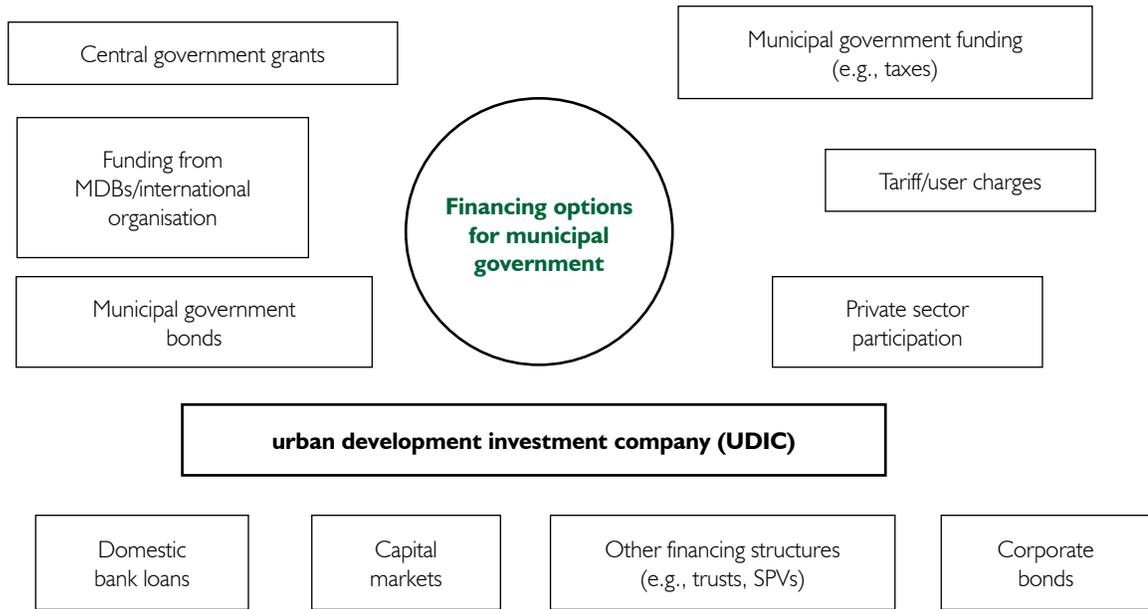
example, local governments at the prefecture and county levels are expected to cover expenditures on unemployment insurance, social security, and welfare, while education and health budgets are shared between governments in the province. The central government formally ended its financial responsibility for local expenditures in 1988, leaving local governments with a hefty financial burden in the 1990s and few financing options. For example, under the 1995 Budget Law, local governments were not allowed to issue bonds or borrow directly from commercial banks or the capital markets.

The Ministry of Housing and Urban-Rural Development (MOHURD) has projected that the country needs CNY7 trillion (about \$1.03 trillion) to invest in its urban public infrastructure and facilities from 2011 to 2015 (Yu 2010). In the case of Shanghai, since development plans for Pudong were announced in 1990, the yearly nominal urban infrastructure investment in Shanghai has increased by a multiple of 36 times from 1990 to 2008.

* This is one of a series of case studies in sustainable urban development in the PRC.



Figure 1: Financing channels for public urban infrastructure and services



Notes:
 MDB=multilateral development bank, SPV=special purpose vehicle.

Case Study of Shanghai—Multiple Sources of Funding

There are several sources of funding for urban projects for a city such as Shanghai (Figure 1).

- Funds for public construction projects which have been approved by the National People’s Congress for the budget year are allocated by the National Development and Reform Commission (NDRC) as grants to provincial (municipal) governments. The funds are disbursed by the Ministry of Finance to the provincial finance departments. However, such grants may not fully cover the costs of projects and provincial (municipal) governments have to seek alternative sources of funding.
- Local governments also rely on taxes and other revenues such as land-leasing income, user fees and levies, or on nongovernment organizations to provide public goods and services. The Shanghai government has embarked on pricing reforms of the tariff and user fees charged to urban households in order to improve cost recovery rates for urban public services. The central government also started a system in 1988 allowing local municipal governments to

lease out land use rights for state-owned lands for terms of up to 80 years.

- Some state-owned investment companies, such as the Shanghai Chengtou Holding Company, which are listed on stock exchanges, can access capital markets for project funding.
- Local governments could also spin-off government agencies into quasi-private entities to circumvent restrictions, or subcontract-out provision of public infrastructure and/or services to private operators through a public–private partnership model.
- Other sources of funding for urban development projects include international assistance and loans from multilateral development banks such as the Asian Development Bank (ADB) and the World Bank as well as other international organizations. A number of urban projects in Shanghai, including the Shanghai Sewerage Project (World Bank) and the rehabilitation of Suzhou Creek (ADB), have been funded by multilateral development banks.



Rise of Urban Development Investment Companies

In response to the lack of financing options for municipal governments, by the late 1990s many cities had established an urban development investment company (UDIC) as nominally independent companies which could borrow and use funds on behalf of the local government. The main purpose of the UDIC is to mobilize financing for construction of new public infrastructure, carry out the construction, and oversee the operations of existing public infrastructure. UDICs have grown to become a key element in the financing and implementation framework for public urban development.

UDIC operations typically involve four aspects: serving as a financing platform, as a public sector investor, as a land development agent, and as a project owner and/or sponsor. Profitable operations may be bundled together with ones which are less profitable or unprofitable to allow for cross-subsidization under one state-owned or -controlled entity. A UDIC may generate revenue through a number of activities, such as receiving user fees from operating public services, entering into partnerships with other state-owned or private enterprises, or through land leases, although the exact revenue model will differ from one UDIC to another.

The range of financing options available to UDICs includes bank borrowing, corporate bond issues, medium-term commercial bills, and trust instruments. Government-owned or controlled enterprises have also been allowed to issue corporate bonds to finance infrastructure projects since 2000. The issuance of such corporate bonds and the projects to be financed (typically fixed-asset investment) have to be approved by the NDRC and the bonds are often restricted to a short repayment period of typically 3 years, with repayment starting in the first year. However, most UDIC infrastructure projects tend to be longer term and may not fulfill the 3-year repayment limit. Since 2009, however, some corporate bonds have been allowed to have a longer repayment period of 5–10 years. Moreover, there was a relaxation of policy at the State Council in 2009 and local governments are now permitted to issue municipal bonds.

Nevertheless, bank borrowing appears to be the most popular financing option for UDICs. UDICs generally have strong credit ratings as they are often implicitly or explicitly guaranteed by local governments (e.g., local governments issuing “comfort letters” to back bank loans taken by UDICs) and are able to use land leases as collateral (Caijinguanchabao 2010).

Shanghai Jiushi Corporation

The Shanghai municipal government established the Shanghai Jiushi Corporation (SJC) as an investment holding company in 1987 with a registered capital of CNY25.27 billion. Public

infrastructure investments made by the Shanghai government are channeled through the SJC, which accesses domestic and overseas financial markets for funding.

Key investment projects include the Shanghai Line 1 Subway, Nanpu Bridge, Heliu wastewater treatment plant, and Hongqiao International Airport expansion. SJC's reach extends to numerous sectors and the corporation has set up subsidiaries in sectors such as public transport (including bus services), public infrastructure, financial services, manufacturing (especially electronics), and real estate.

With a AAA credit rating, the SJC has invested CNY81 billion since its establishment, partially financed by overseas (\$1.6 billion) and domestic (CNY61 billion) loans. Through five corporate bond issues, the SJC has raised a total CNY5.3 billion, while another CNY21.5 billion was raised through corporate guarantees.

Shanghai Chengtou Holding Company

The Shanghai Chengtou Holding Company was set up in 1992, with approval from the Shanghai government, on the back of the launch of the new Pudong district in Shanghai. The company serves as the UDIC for the Shanghai municipal government.

It is principally engaged in transport infrastructure development, property development, water treatment and supply, sewage treatment, and municipal solid-waste management. Other activities include environmental protection services, distribution of oil products, and pipeline engineering. The Shanghai Chengtou Holding Company's projects are largely in Jiangsu, Shanghai, and Zhejiang provinces.

The company has 24 subsidiaries or affiliates involved in a variety of sectors—environmental management, real estate development, urban water supply and distribution, capital investment and investment management, banking, and financial services. The company had reported capital assets of CNY157.9 billion in 2006, up from just CNY5.4 billion in 1992 (Shanghai Chengtou Holding Company website). The company, which has subsidiaries listed on the Shanghai Stock Exchange, has raised about CNY200 billion since its establishment to invest in key bridge, road, and rail infrastructure projects (Li 2009).

Rapid Growth in Bank Lending to Urban Development Investment Companies—A Worrying Trend

The phenomenal rate at which UDICs have been growing and absorbing bank loans has been viewed with some caution by the central government. The number of UDICs in the PRC is estimated to have increased significantly from 4,000 to 8,800 from October 2008 to March 2010 (Caijinguanchabao 2010; Credit Suisse 2010). About 80%–90% of urban



infrastructure financing is estimated to flow through UDICs in the PRC (PPIAF 2010).

The problem is further compounded by the lack of transparency and reliable statistics on UDIC activities, including the total size of bank loans involved. In this case, a UDIC could potentially borrow from banks and then make subsequent transfers or loans back to the municipal government for undisclosed uses. This in effect raises the project risk exposure for the banks.

Some estimates put the total bank debts incurred by UDICs at CNY6 trillion–CNY8 trillion (Tao 2010), while UDIC bond issues are estimated to be in the region of CNY200 billion (Zhengquanshibao 2010). At CNY8 trillion, Credit Suisse (2010) estimates that this is equivalent to 19% of outstanding bank lending, 24% of the PRC's gross domestic product and 180% of the equity base of all PRC banks. The potentially precarious financial situation for UDICs is exacerbated by the fact that land is often used as collateral for bank loans, and is thus vulnerable to corrections in the property market.

In 2009, the Shanghai government was permitted to issue CNY200 billion of local government bonds (with 3-year tenure) through the Ministry of Finance. This marked the first time a local government was able to issue bonds approved by the State Council and could signal a more flexible financing environment for local government bonds in the near future.

On the other hand, on 10 June 2010 the State Council decreed that local government investment corporations (LGICs)—including UDICs—should cease most of their corporate bond issues, with some distinctions made based on the individual LGIC's dependence on government funding. More importantly, the Banking Regulatory Commission concurrently started tightening credit facilities, loan assessments, and borrowing procedures for bank loans which involve LGICs (Caijinguanchabao, 2010). Local government guarantees for LGIC borrowings were also strictly curbed. The NDRC approval for corporate bond issues by LGICs was also halted with effect from 10 June 2010.

UDICs have arguably become too successful, especially on the financing front, at the expense of transparency and possibly stability of the larger finance sector. While the central government's clamp down on the UDIC's fund-raising activities will curb their expansion, the full impact on the viability of UDICs

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and public projects financed through UDICs remains to be seen. UDICs, especially those entrenched in the public sector and implementing or operating public infrastructure and services, are likely to continue to play a pivotal role in the public sector. However, as long as the lack of transparency in public finances persists, similar concerns could resurface, even as the central and local governments experiment with new financing channels.