China’s urbanization: Funding the future

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An essential ingredient in China’s growth and development over the past 30 years has been its ongoing process of urbanization, a transformation of unprecedented scale. China is changing from a predominantly rural society to a predominantly urban one; the urbanization process is still ongoing, and is expected to continue until about 2030. During this period, about 15 million people per year will join the ranks of China’s urban population.

Embedded within such a transformation is the question of funding. China plans to spend some RMB40 trillion over the next two decades on its urbanization push – equivalent to its annual GDP in 2012. As China moves toward its urbanization goals of 1 billion people living in cities, what are the options for funding this transformation in an efficient and sustainable manner?

This month’s China 360 examines China’s recent history of urban construction, including how China has paid for its urbanization process so far, and what challenges this presents for the next wave of urbanization. This issue also looks at a number of developments – including local government bonds and public-private partnerships – that may be pursued as part of China’s urbanization efforts in future.

1 FYI about 2030: 2030 is the date every source is using as China’s ‘maturity’ date. Urbanization maturity is the point at which a country has over 70 percent of its population urbanized. This can also be sourced from: http://www.scmp.com/system/rewrite-open/article/1236136/how-fund-chinas-urbanisation
China – Moving on up

China has the largest population in the world, but up until recently the majority of its 1.34 billion people resided in rural areas. In the early 1950s, China was predominantly a rural nation: only about 10 percent of its population lived in cities.4 Over the next 30 years, the population of China greatly expanded, but the rural/urban ratio changed only a little. In 1978, at the beginning of the reform and opening up process, China’s urbanization rate was around 15 percent.5

After China began its economic reform, however, large-scale migration from rural to urban areas began to occur. Surplus agricultural workers began seeking higher pay and turning to urban areas, just as millions of manufacturing jobs were being created in developing industrial areas. By the end of the 1980s, the level of urbanization had increased to 26 percent,6 rising to 35 percent by the year 2000.7

Although China’s urban growth rate has been relatively modest (3-4 percent per year versus 5-6 percent for other developing countries experiencing rapid economic growth)8, the cumulative effect of this migration is massive. In just the last decade, over 200 million9 people have moved from rural areas to urban areas in China. In 2012, China reached a significant milestone: for the first time in China’s history, more than 50 percent of its population resided in urban areas.

In China, there are three levels of cities, namely municipalities (直辖市), prefecture-level cities (地级市), and county-level cities (县级市). China has around 650 cities at present: of these more than 100 cities have a population of over one million.10

Currently, there are around 700 million people living in cities in China. Analysts project that an additional 300 to 400 million11 rural residents will relocate to urban areas by 2030. This will result in a total of over 1 billion urban dwellers in China, up from only 200 million in 1978.11

In 2011, a staggering 21 million people moved from rural China to urban areas, equivalent to two New York Cities.

Support structure implications

China’s transformation to a predominantly city-based nation in the span of two generations not only has enormous societal ramifications, but also financial implications. One of the most significant issues regarding China’s urbanization is how China has financed urbanization on such a scale.

Given China’s economic model and history of centralized planning, one might expect that a significant funding element would come from central government support to local government budgets.

In reality, however, China’s central government has provided only limited financial support to local governments, leaving the job mostly to local government officials and city leadership, i.e. the Party Secretary and Mayor. These leaders are responsible for managing the ongoing urbanization process in their city, identifying sources of capital, and utilizing funds needed to pay for ongoing urbanization projects such as housing, schools, roads and transportation links, hospitals, utilities and social and leisure infrastructure. Local governments also face additional costs to maintain the expanded social services for a larger urban population.

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At the same time, however, officials have considerable constraints that limit their funding options. The ability to generate funds from local taxation is one of them. A large portion of taxes collected locally is sent to the central government, with only a small portion retained or redistributed at local levels. Further, although local governments can impose and collect fee-based income from businesses – such as pollution charges and betterment fees from developers, in recognition of the burden their projects impose on the public infrastructure – these fees are currently assessed at very low levels.

As a result, most funding for urbanization at the local level has come from two sources:

### Local government funding sources

The first source of funds that can be utilized by local governments is through land ‘sales’.

These are not actually sales of land, per se, as the government retains ownership of the land. City governments collect the funds directly from developers and use those revenues to build roads, schools, and other municipal projects. Although China is a large country, there are obvious drawbacks to such a system. Land can generally only be sold once (or at least infrequently – land leases are typically of 40 to 70 years’ duration). In some eastern locations in China, where the development processes are more advanced, governments are already running low on land.

The second source is debt, which has to date primarily been via bank loans, and emerging measures such as the issuance of local bonds.

Technically, Chinese local governments may not borrow directly from banks. Despite this limitation, many have found ways to access bank funding using municipal investment entities known as Urban Development Investment Corporations (UDICs). The popularity of taking on debt to fund local projects has been increasing in the last four years, as the central government in Beijing has maintained relatively loose monetary policies.

As many as 8,000 UDICs now exist, and they account for between 80 to 90 percent of debt-funded urban infrastructure spending. Total local government debt is now approaching RMB20 trillion, and concerns have been raised over the sustainability of such debt levels and structures, with repayment timeframes often not well-matched to the underlying asset.
Despite rapid urbanization in the past 30 years, it is a fact that China still has decades of urban construction and development ahead. The ability of China’s cities to finance expanded public services and infrastructure for their growing populations has critical implications for the nation’s economic growth and well-being.

If funding for China’s urbanization is to be put on a more solid and sustainable footing, local governments need more (and more flexible) funding options and funding models. In recent years, this topic has been hotly debated with a number of solutions identified, two of which are discussed below: local government bonds and public-private partnership arrangements.

**Local bond program being expanded**

Funding by means of local government bond issuance is enabling some local governments to access capital markets to fund urbanization.

Previously, local governments were prohibited from issuing bonds directly: all government bonds were issued by the Ministry of Finance of China. Then, in October 2011, a pilot program gave authority to four local governments to issue bonds directly. Included in the pilot program were governments from Shanghai, Shenzhen, and the provinces of Zhejiang and Guangdong.

In July 2013, the central government further announced its plans to expand this trial program, to allow greater local government access to the bond market. In addition to the four localities above, governments from two more major coastal provinces, Jiangsu and Shandong, now have the authority to sell bonds directly. The bonds can be issued in 3-year, 5-year, and 10-year duration.

Analysts believe that giving local governments the right to sell bonds will help relieve their debt burdens, and help improve the transparency of their debts. These moves also could be viewed as a gradual transition to a new model, where local governments have more autonomy to decide on which funding methodology fits the need of the project, thus mitigating certain market risk factors.

**Public-private partnerships in China**

Another alternative for funding, delivering and operating urbanization projects is the use of public-private partnerships (PPPs). This is a model utilized extensively in some overseas jurisdictions. PPPs can offer collaboration between the public and private sectors for the purpose of providing public services that have been traditionally provided only by the public sector.

PPPs are not unknown in China. In fact, the Chinese Government has been applying a PPP scheme known as build-operate-transfer (BOT) on a large scale since the 1990s. Under the BOT model, the government grants a private company the right to build a project, and allows the private company to operate the project for a profit over an agreed-upon period. After the period expires, the private entity transfers the project to the government.

A well-known example in China was the Laibin Power Plant in Guangxi Province, the first major State-approved BOT in the mid-1990s. The project was awarded through international competitive bidding, and was a platform for other BOT launches in China.

The water and waste water treatment sectors are areas that have seen relatively high interest in PPP models. As of 2011, there were an estimated 400 water supply and waste water PPP projects in China.

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**References**


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PPP arrangements represent a small fraction of local infrastructure projects, and such schemes are not without risk for public and private interests. For example, China’s legal and regulatory policies are developing and subject to change. This can create business uncertainty for investors (e.g., to price certain risks). As has been the case overseas, letting and managing PPP contracts is complex and requires specialist skills in government, as well as private sector participants.

Nevertheless, PPPs in China may exhibit further growth in some sectors, as urbanization reforms continue to drive government policy. Local government spending on important urban services, such as healthcare, education and environmental protection, are lagging GDP percentage targets set by the central government. Some government officials acknowledge that government investment alone can no longer meet the needs of ongoing public infrastructures and services, which may boost the prospect of greater private sector involvement through mechanisms such as PPPs.


There will be two distinct mega-trends that will ultimately drive the global economy in 2030: The technology sector in the US, and urbanization in China

– DAVID O’BRIEN, Global Head, Cities Centre of Excellence, KPMG in Canada

Top ten urban populated cities

<table>
<thead>
<tr>
<th>City</th>
<th>Country</th>
<th>Population (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shanghai</td>
<td>China</td>
<td>17.8</td>
</tr>
<tr>
<td>Karachi</td>
<td>Pakistan</td>
<td>13.0</td>
</tr>
<tr>
<td>Mumbai</td>
<td>India</td>
<td>12.5</td>
</tr>
<tr>
<td>Dhaka</td>
<td>Bangladesh</td>
<td>11.9</td>
</tr>
<tr>
<td>Beijing</td>
<td>China</td>
<td>11.7</td>
</tr>
<tr>
<td>Moscow</td>
<td>Russia</td>
<td>11.5</td>
</tr>
<tr>
<td>Istanbul</td>
<td>Turkey</td>
<td>11.3</td>
</tr>
<tr>
<td>Sao Paolo</td>
<td>Brazil</td>
<td>11.2</td>
</tr>
<tr>
<td>Tianjin</td>
<td>China</td>
<td>11.1</td>
</tr>
<tr>
<td>Guangzhou</td>
<td>China</td>
<td>11.0</td>
</tr>
</tbody>
</table>

Notes:
(a) Beijing population is based upon the core districts: Dongcheng, Xicheng, Chaoyang, Fengtai, Shijingshan and Haidian.
(b) Shanghai population is based upon the core districts: Huangpu, Luwan, Xuhui, Changning, Jing’an, Putuo, Zhabei, Hongkou, Yangpu, Minhang, Baoshan, Jiading, Pudong.
(c) These are urban populations only, they do not include surrounding suburban areas.

23 www.geohive.com/earth/cy_notagg.aspx
Conclusion

China's urbanization is a long-term phenomenon – a process only partially completed. What is changing now is that local governments may be increasingly motivated to seek out new ways to finance their physical expansion. Fiscal reforms and greater flexibility granted by the central government are among the potential solutions.

Other options include further reforms and expansion to local government bond programs, or increased usage of PPP structures to share the finance burden and risks with the private sector.

While the central and local authorities do have a number of choices about how to pay for urbanization, it appears that the trend of development through land-sales may have peaked. It is likely that we will now see a period of experimentation, marked by pilot programs and incremental expansion, as opposed to a dramatic and sudden policy shift.

At the same time, the influx of new urban residents is a steady and relentless force, making ever more urgent the need for pragmatic policy solutions – solutions that will enable several hundreds of millions more people to take up residence in one of China's gleaming new cities.

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