Indebted Dragon

The Risky Strategy Behind China's Construction Economy

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Article Summary and Author Biography

Financing the Middle Kingdom's recent building boom has been expensive: Estimates put local government debt alone at between $800 billion and $2 trillion, or around 13 to 36 percent of GDP. If the real estate bubble pops, financial and social crises will follow.

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SNAPSHOT

Construction workers install scaffolding on the top of a building in Shanghai. (Aly Song / Courtesy Reuters)

For four decades, the Chinese economy has grown by between seven and ten percent each year. It is the envy of the world, despite its relatively sluggish recent performance. Visitors to Beijing, Shanghai, and other major Chinese cities are quickly awed by impressive skyscrapers, glittering shopping malls, new highways, and high-speed rail lines, all of which leave the impression that China is a developed economy -- or at least well on its way to becoming one. Even in some smaller cities in inland provinces, government buildings make those in Washington and Brussels appear meager. In an area of Anhui Province that is officially designated an "impoverished county," the government office block looks exactly like the White House, only newer and whiter.

Underwriting the impressive facade, however, is an incredibly risky strategy. Governments borrow money using land as collateral and repay the interest on their loans using funds they earn from selling or leasing the same land. All this means that the Chinese economy depends on a buoyant real estate market to keep grinding. If housing and land prices fall dramatically, a fiscal or banking crisis would likely soon follow. Meanwhile, local officials' hunger for land has displaced millions of farmers, leading to 120,000 land-related protests each year.

RISKY BUSINESS

The recklessness can be traced to two things: First, local Chinese officials are evaluated for promotions and other rewards based on how well the economy they manage performs. Construction and real estate activities are among the most straightforward ways to stimulate growth. White-elephant construction projects thus offer eager officials a perfect opportunity to impress their political superiors, even if massive developments do not necessarily make any economic sense. Take, for example, the city of Ordos in Inner Mongolia: Its elaborate urban infrastructure and its sea of new flats and office blocks are nearly all unoccupied, making it China's largest ghost city.

Another factor was China's fiscal recentralization reform of 1994, in which the central government raised its own revenue by taking back power from local governments to levy some major taxes. The move lowered local governments' revenues but left their financial responsibilities -- providing education, health care, subsistence allowances, and pensions -- unchanged. So local officials had to find other ways to generate money.

In the wake of the tax reform, sales and business taxes on construction, real estate, and other service industries became the main source of tax revenue for municipal governments. Not surprisingly, in the 1990s, local authorities started to engineer real estate and construction booms. According to Chinese law, collectively owned farmland must be converted to state ownership before it is leased to private developers. Local governments were thus able to expropriate farmland from villagers and then rent it to private commercial ventures such as factory owners and real estate companies. According to a 2011 survey by Landesa, a Seattle-based nonprofit organization, local governments earn on average $740,000 per acre of land. That is **40 times the average amount** they pay to displaced farmers.

The involvement of municipal governments in land sales goes beyond leasing. To entice property developers, officials also invest in infrastructure. Although they sometimes finance that development directly with land transfer revenue, more often they simply use the land as collateral to borrow from state-owned banks. They generally work through local-government-incorporated urban development and investment companies (UDICs, or chengtou gongsi) and local government financing platforms to skirt laws prohibiting such borrowing. To service interest payments, local governments typically draw from land transfer revenue, taxes, or user fees and charges.

Using bank loans to finance infrastructure investment is not necessarily bad or unusual. It has been common practice in the United States for years, and tax experts say it is a fair and efficient way of building public infrastructure. The problem with China's approach is that the local-government financing platforms are not regulated or subject to any disclosure standards. And although the law formally prohibits local governments from borrowing recklessly, the central government's financing practices encourage them to do so in a roundabout way.

SHOW XI THE MONEY

Until Beijing started conducting audits in mid-2009, neither the central government nor the banking regulator knew how much debt local governments had racked up. Since then, official estimates by the National Audit Office, the People's Bank of China, and the China Banking Regulatory Commission have put the size of local government debt at 5 trillion to 14.4 trillion yuan (803 billion to over two trillion dollars) 13 to 36 percent of GDP -- as of the end of 2010. Private analysts often put the number much higher: between 50 and 100 percent of GDP, depending on whether local governments' contingent liabilities or indirect debts (debts owed by government-owned and government-related entities) are included.

On the surface, banks' balance sheets have remained healthy despite these debts, since banks tend to roll over or "ever green" loans by issuing new loans to help borrowers "repay" old ones. In addition, local governments have been able to make their interest payments using their land as collateral.

The banks' accounting tricks treat only a symptom of the problem. Eventually, banks will become unable to roll over loans because they will run out of fresh money. And officials' ability to pay off loan interest depends on the continued rise of real estate prices and a buoyant economy, neither of which can be taken for granted. Some analysts are already saying that **China's real estate bubble has burst**. That could be terrible, but as I have **argued elsewhere**, Beijing cannot and will not let banks that hold the savings of ordinary people go under. Bank runs would send millions of depositors into a panic and lead to widespread social unrest.

OUTSIDE THE BUBBLE

Even before it pops, China's real estate bubble is causing social harm. An inevitable effect of state-led urbanization is that farmers are forced to vacate their land. Close to 300,000 peasants are removed from their villages every year to make room for the construction of airports, highways, and buildings. Since 1980, more than 60 million peasants, roughly the population of the United Kingdom, have been moved.

The displaced are not usually consulted before relocation. Governments frequently force them to leave by suspending the supply of utilities, such as electricity, to their homes. Increasingly, local governments are even hiring or colluding with gangsters to intimidate villagers who refuse to move. Tellingly, in some villages, these mobsters are known as the "second government."

Compensation to farmers who do move is often inadequate, because negotiations over the value of their land take place without them. The opacity allows authorities to line their own pockets with funds meant for farmers. It is no surprise, then, that in a recent Landesa survey of nearly 1,800 rural households across 17 provinces, about 20 percent of the displaced (which made up 43 percent of the survey's sample) had not received any compensation. Of those who had received remuneration, 53.4 percent reported that they were "very dissatisfied" or "dissatisfied" with it, compared with 25 percent who were either "satisfied" or "very satisfied." When asked why, 80 percent complained of inadequate compensation, 47 percent said it was determined without their input, 38.4 percent said payment was insufficient to maintain their previous standard of living, 28.6 percent said they were unable to find nonagricultural income after having their land taken away, and 25 percent reported that compensation had been intercepted by local officials.

For Chinese farmers, farmland is both a livelihood and a form of social insurance. In bad times, when temporary work or factory jobs dry up in cities and towns, migrant workers can return to subsistence living in villages. By way of comparison, urban residents are entitled to state-provided social welfare, namely, subsistence allowance, unemployment insurance, and pensions.

Unsurprisingly, demolition, relocation, and land expropriation have become the leading causes of social unrest in China. Discontented peasants typically try to air their grievances using China's petition system, but when efforts through official channels prove futile, they take to the streets: The number of "mass incidents" in China continues to rise.

Given slower growth rates and falling real estate prices this year, the frequency of land expropriation is slowing down. But the truth remains that much of urbanization in China is a state-driven phenomenon, using resources drawn from the financial sector. Although the central government recognizes the seriousness of the problem, it seems to lack any real resolve to tackle the issue head on. Muddling through seems to be so much easier. So until a major slowdown in the economy happens, the Chinese real estate market will continue on its current course.

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An earlier verion of this article stated that 5 trillion to 14.4 trillion yuan is 800 million to over two billion dollars. In fact, it is 800 billion to two trillion dollars.