



Spending preferences of local officials with off-budget land revenues of Chinese cities

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ABSTRACT

The paper examines the spending preferences of local governments on land revenues by developing an indirect approach in which public sector outcomes are regressed with land revenues, the most dominant source for off-budget incomes. By doing so, we are able to overcome the issue of unavailable itemized spending data on land revenues. The behavioral foundation of leading local officials on land revenues is that they may be treated as discretionary funds that will be spent on projects that can benefit local officials' political advancements. Thus it is hypothesized that Chinese local officials intend to channel land revenues more toward growth-oriented infrastructure such as urban roads, more toward image projects such as public squares and open space, and more toward projects that help to boost public impression of local economic success on which cadre evaluation weighs heavily. We test those hypotheses using a panel data of Chinese prefecture cities from 1999 to 2006. Econometric estimates confirm those hypotheses.

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1. Introduction

Attention has recently been focused on off-budget revenues, particularly in developing countries that are in the transition of decentralization, which in turn is accompanied by rising off-budget incomes in subnational governments. There are mixed views on off-budget revenues. The downside includes distortion in supply and demand in local economy, erosion of fiscal control, and damage of the effectiveness of government budgeting (Bennett & Dilorenzo, 1982; Shick, 2007). Off-budget activities also undermine the role of budgeting in managing the economy and formulating public objectives and priorities as they tend to weaken government's fiscal control (Shick, 2007). Off-budget revenues are often raised and used ad hoc, without the rigorous fiscal scrutiny that budgetary revenues are normally subject to. The lack of accountability and transparency associated with off-budget revenues contributes to issues of fraud and abuse of public funds, the boondoggle of public resources, rising fiscal risk, and corruption (Bennett & Dilorenzo, 1982; Ding, 2007; Liu, 2010).

On the positive side, off-budget incomes increase government spending as well as fiscal flexibility so that local governments can make more effective and intelligent decisions in response to local preferences and needs over public services and goods (Bennett & DiLorenzo, 1984; Blewett, 1984). Empowered by off-budget incomes, local governments have a larger fiscal capacity that can be used to promote

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local economic growth than otherwise. Tools for economic growth include priority funding areas, urban infrastructure and amenity improvement, and tax and incentive provision to attract private business and investment. Local officials are also encouraged by the positive linkage between government spending and economic growth when basic infrastructure and social capitals such as health care and education are inadequately provided. Empirical studies conclude that the relationship between government size and economic growth in less developed countries tends to be positive, and government investment on physical infrastructure and education are often found boosting economies (Aschauer, 1989; Bergh & Henrekson, 2011; Doppelhofer, Miller, & Sala-i-Martin, 2004). In countries in which basic services are inadequately provided, the effect of government size on growth is often positive when it is associated with spending on infrastructure, basic health and education (Alexiou, 2009; Bergh & Henrekson, 2011).

Perhaps there is no other country like China that has such an extreme size of off-budget revenues (Ding, 2007; Eckaus, 2003). Although accurate data on off-budget incomes are not available in China, as it is true in many other countries too, anecdotal evidences suggest that the size of off-budget revenues is outstanding (Ding, 2007; Eckaus, 2003). Land revenues, which are predominately land conveyance fees generated from public land leasing in China, are the most important source for off-budget incomes in subnational governments in China.¹ They were equivalent to 38.9% of total fiscal revenues in subnational governments in 2006.² As intergovernmental transfers contribute 45% to total fiscal revenue on average, the ratio of land revenues to tax revenues in subnational governments can be as high as 0.7. There are no other types of off-budget revenues that can match land revenues in terms of magnitude and significance to local governments.

Land revenues were managed outside the rigidly audited system of budgetary incomes and were not restricted by any spending guidelines from the central authorities.³ This made it possible for local cadres to spend land revenues in a way to achieve their political ambition and advancement. Fiscal revenue and economic growth are the two most important factors in cadre evaluation that is critical in the determination of official promotions (Li & Zhou, 2005; Shih, Adolph, and Liu, 2010; Pan, 2013). Therefore, it is not surprising to see land revenues are more likely channeled into projects or associated with incentives or subsidies that help local governments to promote economic growth and generate fiscal revenues.

Although the size of off-budget revenues are well recognized, unfortunately, their spending behaviors are little understood. In the paper, we develop an indirect approach to explore expenditure behaviors of local governments with regard to land revenues. More specifically we attempt to establish statistical associations between public sector outcomes and land revenues. We hypothesize that spending of off-budget revenues in local governments favors urban production infrastructure and urban amenity improvement. The dominance of land revenues in off-budget incomes justifies our approach of using land revenues as a proxy for off-budget incomes in Chinese prefecture cities. Since itemized spending information of land revenues are not available, the indirect approach helps to overcome the data issue and to implicitly reveal local officials' spending preferences on off-budget incomes.

The paper is organized as follows. Section 2 reviews the literature; Section 3 discusses institutional arrangement with public finance, land revenues, and incentive structure behind fiscal behaviors of local officials; Section 4 presents the model, data and variables; Section 5 discusses and interprets estimated results; and Section 6 concludes with final remarks.

2. The literature

Despite the importance to governance and public management, off-budget activities are far less studied. The existing literature has focused on their causes and effects. Marlow and Joulfaian (1989) conclude that the size of governments' off-budget activities is positively associated with local demand for government, represented by on-budget spending. Bennett and Dorenzo (1982) argue that evasion of tax and expenditure limitations is the primary reason behind off-budget spending. This conclusion is also supported by Joulfaian and Marlow (1991), as they point out that constraints on on-budget expenditures encourage off-budget activities in the following years. Specifically, they reveal that "direct and indirect controls on government activities lead to substitution from controlled activities to those activities not subject to those controls" (pp: 307) and conclude that past positive growth in on-budget activities has led to decline in off-budget activities, vice versa. If past positive growth in on-budget revenues suggests decreasing fiscal pressure, given all other things equal, there will be a positive association between off-budget activity and the extent of fiscal deficits for governments.

The size of government in terms of public spending increases with off-budget activity. The effects of the public spending, however, are mixed and inconclusive (Alexiou, 2009). So are those of off-budget activities. Studies by Afonso and Furceri (2010) and Folster and Henrekson (2001) conclude that a smaller government size is associated with faster economic growth and improved welfare. This conclusion is challenged by Aschauer (1989) and Knoop (1999).⁴ One explanation for such mixed findings is that the composition of public expenditure matters (Bergh & Henrekson, 2011). Indeed, government consumption is often found associated with declining growth rates (Barro, 1991), while public infrastructure including roads, highways and railways sometimes exhibit positive effects on

¹ Government revenues in China include budgetary revenue, extra-budgetary revenue, and off-budget revenue. Extra-budgetary revenues, referring primarily to the retained earnings of state-owned enterprises, are actually "budgetary" and involve planned collection and expenditure under certain regulation. Its share in total revenues declined dramatically over the past twenty years. Off-budget revenues, primarily consisting of land revenues, are not covered in formal budgets at any level, and are sometimes labeled as "extra-extra," "off-off," "out-of-system," "unregulated," "off-record," and "self-raised" revenues. See Fan (1998) for details. The off-budget revenues derive from public land leasing and rentals and revenues from direct government undertakings, but it is difficult to determine its magnitude because of lack of systematic recording in fiscal system (Eckaus, 2003).

² The data are from China Statistical Yearbook and China Land & Resource Yearbook. This number increased to 65.9% in 2010 (source: Pan & Li, 2011).

³ This was changed in 2007 when the central government mandated that all land conveyance fees should be put into budgetary management system that is subject to strict audit and inspection, and a significant portion of land conveyance fees should be reserved for land development, farmland protection and reclamation initiatives.

⁴ See Alexiou (2009) and Bergh and Henrekson (2011) for detailed review.

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