Introduction

China started to promote nine-year compulsory education in rural areas throughout the country in the mid-1980s. To achieve that goal, the Compulsory Education Law, enacted in 1986, mandated that the central and local governments at all levels guarantee the operational and capital expenditures to implement compulsory education. In practice, the local governments, especially the county-level governments, played a main role in financing rural compulsory education. With limited fiscal resources, local governments financed rural compulsory education funds through a multitude of channels. In particular, to achieve the national goal of accomplishing universal nine-year compulsory education by 2000, local governments (towns and villages) resorted to borrowing to finance school facilities to help meet the minimum facility standards for all schools, although the borrowing was not allowed by the 1994 Budget Law of China.

In 2000, nine-year compulsory education became universal in China, a historic accomplishment. However, the accumulation of debt that resulted from borrowing to finance rural compulsory education had become a significant fiscal burden on local governments. The aggregate
rural education debt was about RMB 110 billion\(^1\) at the end of 2007, about 3.9 percent of aggregate subnational own fiscal revenue, excluding transfers. Of the outstanding compulsory education debt, about RMB 80 billion was used to finance capital expenditure, and about RMB 30 billion was used to finance operational expenditures. The negative impact of rural compulsory education debt on the rural economy and social development had become serious. The rural Tax-for-Fee Reform in 2001\(^2\) was intended to reduce financial burdens (such as taxes, surcharges, and fees) on rural households, but it also further limited local fiscal resources. At the same time, the rural reforms increased the demand for fiscal resources to finance rural infrastructure and social services.

Restructuring the legacy debt for financing rural schools thus became a priority of the central government in the mid-2000s. With the public policy goal in the late 1990s of inclusive economic growth, the debt financing of nine-year compulsory education in rural areas would be replaced by grant financing for all children. It was necessary to resolve the widespread indebtedness of rural local governments to make the debt-to-grant financing transition, and the debt-to-grant financing would need to address the legacy debt and its write-offs.

Resolving the legacy debt and making a transition to grant finance should be viewed as part of building a sustainable fiscal system framework to ensure the delivery of basic public services, including implementation of the Compulsory Education Law. With less fiscal capacity as a result of the rural Tax-for-Fee Reform, the county-level governments could choose new approaches to increase the fiscal burden of rural residents.

China’s central government, through the Ministry of Finance, initiated a program of restructuring the rural legacy school debt in 2007. This was a pioneering effort—the first time the central government undertook debt restructuring of subnational governments nationwide. A key design issue in any debt restructuring is how to avoid moral hazard. International experience shows that unconditional write-offs create soft budget constraints. To address the problem of moral hazard, the Ministry of Finance’s plan had two distinct features.

First, the fiscal resources to finance the debt write-off were distributed equally among the central government, provincial governments,
Restructuring of Legacy Debt for Financing Rural Schools in China

and subprovincial governments; that is, the central government, provincial governments, and subprovincial governments each contributed one-third of the financial resources.

Second, the distribution of central government grants was based on a formula that took into account the required expenditure to achieve basic provision of education and the local government fiscal capacity to deliver the results. Thus, the distribution of central grants to a particular local jurisdiction was not directly related to the size of the debt of that jurisdiction. This output-based approach was meant to prevent perverse incentives for local governments to increase the size of their debt or to reduce their service of debt in anticipation of more grants or bailouts.

This chapter analyzes the moral hazard aspect of the rural debt restructuring within China’s current intergovernmental fiscal framework. The remainder of the chapter is organized as follows. Section two summarizes the compulsory educational system and what responsibilities are assigned to each government level in China. Section three examines the features of rural education legacy debt. Section four focuses on China’s strategy to deal with moral hazard. Section five explains how China restructured the legacy debt for financing rural schools. Section six offers conclusions.

The Responsibility and Revenue Assignment for Education in China

China has a unitary system with five levels of government. The central government is at the top under which are four tiers of subnational government: provincial, prefecture (city), county, and township. The central government determines the establishment and the geographic division of the provincial, prefecture, and county governments, and the provincial government determines the establishment and the geographic division of the township governments.

The provincial government, directly under the central government, consists of the governments of the provinces, autonomous regions, and large municipalities with provincial status. A prefecture or a prefecture-level city under the jurisdiction of a province is an administrative division between a province and a county. At the end
of 2009, China had 333 prefectures or prefecture-level cities. A county or county-level city is the general administrative division at the local level. At the end of 2009, there were 2,858 counties or county-level cities in China. The township is the basic administrative division in the countryside. At the end of 2009, there were 40,858 townships in China.

According to the Chinese Constitution, the People’s Congress and people’s government at the levels of province, prefecture (or city), county, and township are the local legislative and executive organs of power, respectively.

**Law on Nine-Year Compulsory Education**

The Law on Nine-Year Compulsory Education, enacted by the central government on July 1, 1986, mandated requirements and deadlines for attaining universal education (to be tailored to local conditions) and guaranteeing school-age children the right to receive at least nine years of education (six years of primary education and three years of secondary education). People’s Congresses at various local levels were, within certain guidelines and according to local conditions, to choose the steps, methods, and deadlines for implementing nine-year compulsory education in accordance with the guidelines formulated by the central authorities. The program sought to bring rural areas, which had four to six years of compulsory schooling, into line with their urban counterparts.

The Decision on the Reform of the Education System by the Central Committee of the Party in 1985 divided jurisdictions into three categories: (a) cities and economically developed areas in coastal provinces and a small number of developed areas in the hinterland (approximately 25 percent of China’s population); (b) towns and villages with an average level of development (approximately 50 percent of China’s population); and (c) economically backward areas (approximately 25 percent of China’s population).

In fact, some jurisdictions in the first category had achieved universal nine-year education by 1985, and all jurisdictions in the category had achieved universal nine-year education by 1990. The jurisdictions in the second category had achieved universal nine-year education by 1995, and technical and higher education were projected to develop at the same rate. The jurisdictions in the third category should attain the
Restructuring of Legacy Debt for Financing Rural Schools in China

basic education target for all students with a timetable consistent with the pace of local economic development, and the central government would support the educational development. The central government also would assist educational development in minority nationality and remote areas.

Currently, there are over 260,000 rural primary and junior secondary schools with about 76 million students (see table 2.1).

**Distribution of Educational Responsibilities among Levels of Government**

Fiscal decentralization reforms in China after the economic reform started at the beginning of the 1980s provided local governments with significant fiscal autonomy in various areas such as the determination of their own spending priorities and policies on relevant aspects of local budgets.

In 1994, the central government introduced the Tax Sharing System (TSS) reform, with the two major goals of increasing the share of combined government revenue in total gross domestic product and the central share in combined government revenue (World Bank 2002). This reform introduced clear and stable assignments of tax revenues between the central and provincial governments, and created

<table>
<thead>
<tr>
<th>Item</th>
<th>Number of schools (unit)</th>
<th>Junior secondary schools</th>
<th>Nine-year primary-secondary schools</th>
<th>Total enrollment (person)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rural junior secondary education</td>
<td>30,178</td>
<td>22,921</td>
<td>7,257</td>
<td>19,345,061</td>
</tr>
<tr>
<td>Run by education departments and collectives</td>
<td>28,590</td>
<td>22,240</td>
<td>6,350</td>
<td>18,498,085</td>
</tr>
<tr>
<td>Run by private institutions</td>
<td>1,222</td>
<td>557</td>
<td>665</td>
<td>646,478</td>
</tr>
<tr>
<td>Run by other departments</td>
<td>366</td>
<td>124</td>
<td>242</td>
<td>200,498</td>
</tr>
<tr>
<td>Rural primary education</td>
<td>234,157</td>
<td></td>
<td>56,555,439</td>
<td></td>
</tr>
<tr>
<td>Run by education departments and collectives</td>
<td>231,360</td>
<td></td>
<td>54,941,004</td>
<td></td>
</tr>
<tr>
<td>Run by private institutions</td>
<td>2,395</td>
<td></td>
<td>1,260,235</td>
<td></td>
</tr>
<tr>
<td>Run by other departments</td>
<td>402</td>
<td></td>
<td>354,200</td>
<td></td>
</tr>
</tbody>
</table>

separate tax administration services at both levels of government. The TSS reform introduced the value-added tax as the major government revenue source, and established a uniform tax-sharing system that provided that the central government would receive 75 percent of the value-added tax and subnational governments 25 percent.

The taxes assigned to the center and the major taxes shared with the subnational governments were collected by the newly created National Tax Services, which operated in all provinces. The new system provided for separate local (subnational) tax services for the collection of the taxes assigned to local governments. The headquarters of the local tax services, the State Administration of Taxation, was empowered to supervise local tax services and prohibit the use of tax exemptions by local governments.

Given the main focus of the TSS reform on the taxation side, however, there was no apparent change in either policy or practice in terms of expenditure assignment between the central government and subnational government and among the four tiers of subprovincial governments. In fact, the TSS restated the prereform expenditure assignment and provided only basic guidelines to define expenditure responsibilities between the central and subnational governments. For example, the State Council Regulations on the Implementation of the TSS in 1994 defined expenditure responsibilities of central and subnational governments as follows:

Central budgets are mainly responsible for national security, international affairs, the costs of operating the central government, the needs for adjusting the structure of the national economy, coordinating regional development, adjusting and controlling the macro economy, and others. Detail items include: national defense, cost of military police, international affairs and foreign aid, administration costs of the central government, centrally financed capital investments, the technical renovation of central-government-owned enterprises and new product development costs, the expenditure to support agriculture, arts and culture, education and health, price subsidies and others.

Subnational budgets are mainly responsible for the costs of running subnational governments, and the need for local social economic development. Detail items include: the costs of running subnational government, the needs of local economic development, a part of the costs of
running the military police and militia, locally financed capital investments, the technical renovation of local government-owned enterprises and new product development, the costs of support to agriculture, urban maintenance and construction, and the expenditure to support arts and culture, education and health, price subsidies and others.

These guidelines illustrate that both the central government and subnational governments not only have extensive expenditure responsibilities, but also that these responsibilities overlap and are not specific. Adding to the lack of clarity in expenditure assignments is the fact that the subprovincial governments do not have explicit expenditure assignments. The expenditure assignments for subprovincial governments are basically at the discretion of their provincial governments. To improve expenditure at the subprovincial government level, the Ministry of Finance in December 2002 issued “Suggestions on Improving Subprovincial Fiscal Relations,” to provide further guidelines on subprovincial expenditure assignment. However, considerable challenges remain in clarifying expenditure assignment.

Education, for example, is mainly the responsibility of subnational governments. For compulsory education, the role of the central government is that of policy maker and overall planner. In addition, the central government has the responsibility for establishing special education funds for subsidizing compulsory education in poor, minority areas, and teacher education in all areas. The provincial government has the overall responsibility for formulating the development plan for compulsory education and providing assistance to counties to help them meet recurrent education expenditures. The responsibility for actually implementing compulsory education programs lies with the cities or districts of large cities in the case of urban areas, and with counties in the case of rural areas.

The provision of compulsory education services in rural areas is one of the major concerns of the central government because of the generally worse service conditions, especially in poor rural areas. Some initiatives, especially the “Decision on Strengthening Rural Education,” issued by the State Council in September 2003, expanded the expenditure responsibilities of the central government on compulsory education. This basic service was defined as a shared responsibility with the goal of supporting students from poor families by waiving their payments for
textbooks, tuition, and miscellaneous fees, and by subsidizing housing expenditures for elementary and secondary education students.

In general, several important decision-making powers were decentralized to county governments in implementing the State Council 2003 directive. For example, the county governments were able to close schools or reduce their size in their jurisdictions. This decentralized power eventually influenced the education sector in significant ways. In addition, upper-level governments (the central and provincial governments) became more involved in financing education.

There were two driving forces behind the changes in the assignment of responsibilities for upper-level governments. First, as discussed below, the reduction in revenues that resulted from the Tax-for-Fee Reform rendered some local governments fiscally unable to finance education (Xiang and Yuan 2008), so more transfer funds were required to keep education services running smoothly. Second, reducing disparities in education expenditure was deemed to be a desirable public policy goal. Therefore, more transfer funds should go to poorer areas.

County governments have become the most important—but not the only—players in the current regime of education finance. Other levels of government, such as the prefecture, province, and central government, also have roles to play; even township governments and village self-governing bodies have some responsibilities in particular areas (Huang 2006). The power to make education policy is still centralized in the hands of provincial and central governments. Nevertheless, county governments have been given considerable latitude for making decisions on the daily operations of educational services, as shown in table 2.2.

**Revenue Assignment of Rural Compulsory Education**

Although there are various financing channels, compulsory education in general is mainly financed by the government, particularly by the government’s budgetary expenditure, as shown in table 2.3.

The finance system of compulsory education in China has evolved since the early 1950s, in three major stages.

The first stage was 1950–93. During that period, primary and secondary education services were mainly provided by subprovincial governments. The central government provided financial support, mostly upon
## Table 2.2 Assignment of Major Educational Responsibilities among Levels of Government in China

<table>
<thead>
<tr>
<th>Terms</th>
<th>Central government</th>
<th>Provincial governments</th>
<th>Prefecture governments</th>
<th>County governments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Policy</td>
<td>1. Establishing the educational system</td>
<td>1. Making policy for education development</td>
<td>1. Coordinating educational planning</td>
<td>1. Planning local school system structure</td>
</tr>
<tr>
<td></td>
<td>2. Curriculum, approval of textbooks</td>
<td>2. Planning for the reorganization of primary and secondary schools</td>
<td>2. Implementing educational examination and evaluation</td>
<td>2. Paying teachers</td>
</tr>
<tr>
<td>Financing</td>
<td>Transferring funds to help poor and minority areas</td>
<td>Providing support to poor counties</td>
<td>None</td>
<td>Purchasing equipment and books</td>
</tr>
<tr>
<td>Teacher salaries</td>
<td>Earmarking transfer funds for teacher salaries</td>
<td>Using transfer funds to support poor counties</td>
<td>Providing transfer funds to poor areas</td>
<td>Paying teachers</td>
</tr>
<tr>
<td>Operational costs</td>
<td>None</td>
<td>1. Determining teacher-student ratios and corresponding operational expenditures for rural areas</td>
<td>Helping county governments finance operational costs</td>
<td>Providing funds for operation of schools</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2. Transferring funds to help poor areas</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Construction costs</td>
<td>Earmarking subsidies for the repair of dangerous classrooms in poor areas</td>
<td>Providing subsidies to county governments to finance school facilities</td>
<td>Helping county government finance building of school facilities</td>
<td>Implementing plans for building schools</td>
</tr>
</tbody>
</table>

Source: Compiled by the authors.
request of the provincial governments. Education services were treated as local public goods, and education expenditure was financed mainly by budgetary funds, education surcharges, donations to education, and student fees. Minban teaching staff (nongovernmental employees) were commonly used in rural schools as instructors, and school facilities were financed mostly by local residents.

The second stage was 1994–2003. During that period, the education sector continued to decentralize. The 1994 TSS reform had an important impact on education finance. As noted, the TSS reform had two major goals: increasing the share of combined government revenue in total gross domestic product, and increasing the central share in combined government revenue. Given that larger shares of fiscal resources went to the upper-level governments, especially the central government, and that no changes were made in the assignment of expenditure responsibilities, local governments, especially township governments, began to experience increasing difficulties in providing educational services. During this period, off-budgetary resources, in particular school fees and charges, played a bigger role in financing education than in the first stage.

There were other policy shocks that added to the fiscal pressures facing local governments. For example, during 1996–97, many Minban teachers became government employees, in accordance with explicit
policies set by the State Council. Local governments were already struggling financially, and the accompanying increases in salary payments added to the burden. In addition, the Nine-Year Compulsory Education plan required all schools in rural areas to comply with regulations concerning school facilities. To comply with these regulations, local governments incurred large increases in construction expenditures.

As shown in table 2.4, with the expanding expenditure per student in rural primary schools in Henan province, salary payments increased significantly, and construction was more concentrated in 1999 to meet the requirement that schools implement the Nine-Year Compulsory Education plan. Meanwhile, a 1999 survey by the Ministry of Finance revealed that the minimum financial gap for the local government to implement the Nine-Year Compulsory Education plan was RMB 35 billion (Hu 2002).

In short, during this period, the increases in expenditures and contracted budgetary revenues rendered some local governments unable to provide enough resources to fulfill their educational responsibilities. Many local governments suffered significant shortages in education funds, with the following consequences: (a) teachers in many provinces could not get paid on time—in fact, the total amount of unpaid teachers’ salaries (Beijing, Shanghai, Tianjin, Zhejiang, and Tibet were not included) was RMB 13.6 billion (Liao 2004); (b) students were charged high fees in order to finance the regular operation of schools; and (c) local residents were heavily taxed to finance the new school facilities (see, for example, Li 2006).

Table 2.4 Composition of Educational Expenditures of Rural Primary Schools, Province of Henan, 1999 and 2002

<table>
<thead>
<tr>
<th></th>
<th>1999</th>
<th>2002</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Education expenditure</td>
<td>364.45</td>
<td>545.76</td>
<td>181.31</td>
</tr>
<tr>
<td>Teacher salaries</td>
<td>224.42</td>
<td>450.23</td>
<td>225.81</td>
</tr>
<tr>
<td>As share of total expenditure</td>
<td>61%</td>
<td>82%</td>
<td>21%</td>
</tr>
<tr>
<td>Operational expenditure</td>
<td>97.16</td>
<td>81.59</td>
<td>-15.57</td>
</tr>
<tr>
<td>As a share of total expenditure</td>
<td>27%</td>
<td>15%</td>
<td>-12%</td>
</tr>
<tr>
<td>Construction expenditure</td>
<td>42.87</td>
<td>13.94</td>
<td>-28.93</td>
</tr>
<tr>
<td>As a share of total expenditure</td>
<td>12%</td>
<td>3%</td>
<td>-9%</td>
</tr>
</tbody>
</table>

Source: Henan Education Department 2003.
Note: Bolded text indicates expenditures.
The third stage began in 2003 and continues to the present. To reduce the tremendous financial burdens facing rural households, the central government in 2001 initiated the Tax-for-Fee Reform. The reform canceled various charges and fees levied on rural households by rural local governments, and improved rural tax structure and administration.\(^4\) While reducing the financial burdens on rural households, the reform also eliminated the revenue base for township governments, since their major revenue bases, in particular five agriculture-related taxes and budgetary funds, were no longer available. The central government also reassigned the responsibility for basic education services to the county-level government, and increased the central contribution for financing primary and secondary education.\(^5\)

However, the newly assigned responsibility to the county governments was not accompanied by revenues, since the agriculture-related taxes and other fees were also main sources of the county government budgets. In response to these budgetary constraints, county governments first closed a number of primary and secondary schools, then started to charge higher student fees to finance operational costs for the schools that remained open. Under the new arrangement, teacher salaries were increased and were more likely to be paid on time, while the operational costs were financed jointly by budgetary funds and student fees. The financial arrangements for construction costs, however, remained unsettled (Liao 2004).

The unevenness between revenue availability and expenditure responsibilities since the 1994 TSS reform created serious challenges in service provision at the local level (Jia 2008). Other central government policies also contributed to the financial challenge faced by local governments. In particular, implementation of the Nine-Year Compulsory Education plan required that all rural schools satisfy certain conditions, including good physical facilities and a qualified teaching staff.\(^6\) While this policy led to significant increases in local expenditure needs for education and construction costs, in particular, the central government made no new provision of funds for local governments (Zong 2010).

In response to the imbalances in their public finances, subprovincial governments developed two strategies.

On the expenditure side, both the quality and quantity of some public goods provided by local governments decreased. For example, in
some areas, local governments failed to pay teachers on time. In other areas, teachers were perhaps relatively luckier; they could receive their paycheck on time, but with a condition, say, that their salaries would be reduced by 20 percent. Failure to pay teachers was not an isolated occurrence; rather, it reportedly took place across the country, except in some rich areas like Beijing and Shanghai (Zhang 2005).

On the revenue side, it appears to have been difficult for rural local governments to increase revenue collection on their own, since the tax bases and tax rates are largely controlled by the central government. But local governments were able to collect additional funds to finance education and other local public goods through a variety of fees and charges, formally and informally. Given that no horizontal accountability mechanisms were in place, in the face of financial stress it can be reasonably expected that local governments would have increasingly and consistently exerted their powers to obtain money from rural households (Liao 2004).

Serious pressures from this situation redounded to the central government in a variety of ways. To protest unpaid and delayed salaries, teachers first loudly voiced their concerns through their representatives in the People’s Congress at different tiers of government. In addition, more teachers quit their jobs in rural schools or moved to schools in richer areas for higher and more stable salaries (Cai 2002; Wang 2004: Zhou, Liu, and Tian 2003). As a consequence, an adverse selection problem for teachers developed across rural schools; those teachers taking jobs at or remaining in rural schools were in many cases not the teachers those schools needed. The loss of qualified teachers reduced the quality of educational services provided in rural areas and raised serious concerns among parents about the quality of education. These concerns eventually filtered up to the central government. In particular, restructuring of legacy debt for financing rural schools needed the immediate attention of the central government.

Fundamentally, county governments assumed the key role in budgeting education finance following the 2003 State Council directive. County governments pool all revenues from own and transferred funds, and decide on their use to finance education and to distribute funds to all schools in all three categories in their jurisdictions. The roles played by upper-level governments are mostly supportive, although in some
instances they contribute a significant share to financing general education expenditure. Higher-level governments pay special attention to teacher salaries by earmarking funds, but do little in relation to other categories of expenditures.7

**Significant Features of Rural Compulsory Education Debt**

In general, there is a mismatch between responsibility and revenue assignment in China; in particular, the aggregated own revenue of county and lower governments amounts to only 42 percent of their expenditure, as shown in table 2.5. Although the central government required subnational governments to provide rural compulsory education, the county governments, which are responsible for its implementation, and other tiers of subnational government, had limited resources to do so, which forced them to borrow funds to finance the services (Xiang and Yuan 2008). However, as mentioned, borrowing is not permitted under the Budget Law of China, and this further complicated the debt issue and encouraged county governments to borrow off budget.

The result was that not only was debt concentrated in the county governments, but there was also asymmetric information between the county governments and the upper levels of government, especially the central government, about the size of debt and its service cost. In addition, the debtor-creditor relationship was informal, in general, because the borrowing governments did not have the legal status to borrow (Shi 2004). More important, most county governments were not able to pay the debt by relying on own resources. These factors increased the difficulty of solving the problem of the rural education debt (Wang 2007).

<table>
<thead>
<tr>
<th>Level of government (consolidated)</th>
<th>Average</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provincial</td>
<td>53</td>
<td>8</td>
<td>75</td>
</tr>
<tr>
<td>Prefecture</td>
<td>55</td>
<td>2</td>
<td>85</td>
</tr>
<tr>
<td>County and lower</td>
<td>42</td>
<td>0</td>
<td>90</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance.
Table 2.6 presents the share of compulsory debt in subnational budgetary expenditures for 14 provinces at end-2005. Since most of the debt is concentrated in county-level governments, the share of debt in county-level expenditures would be much higher. The debt mainly consisted of arrears on funds owed to construction companies that built the schools and to suppliers, and on funds for teacher wages and pensions. A small part of the debt was incurred by local government off-budget vehicles to construct schools, that is, funds borrowed from financial institutions.

Restructuring the rural compulsory education debt became a priority of the central government in mid-2000. The main reasons include (a) it was an important step toward improving rural human capital and achieving equality between urban and rural education, (b) writing off the rural compulsory debt was the prerequisite to building a sustainable finance system for rural compulsory education, and (c) it was needed

<table>
<thead>
<tr>
<th>Provinces</th>
<th>Compulsory education debt (by end-2005)</th>
<th>Budgetary expenditure</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inner Mongolia</td>
<td>3.92</td>
<td>192.684</td>
<td>2.03</td>
</tr>
<tr>
<td>Jilin</td>
<td>2.31</td>
<td>147.921</td>
<td>1.56</td>
</tr>
<tr>
<td>Helongjiang</td>
<td>2.434</td>
<td>187.774</td>
<td>1.30</td>
</tr>
<tr>
<td>Jiangsu</td>
<td>5.75</td>
<td>401.736</td>
<td>1.43</td>
</tr>
<tr>
<td>Anhui</td>
<td>3.079</td>
<td>234.192</td>
<td>1.44</td>
</tr>
<tr>
<td>Fujian</td>
<td>2.312</td>
<td>141.182</td>
<td>1.64</td>
</tr>
<tr>
<td>Jiangxi</td>
<td>4.094</td>
<td>156.237</td>
<td>2.62</td>
</tr>
<tr>
<td>Hubei</td>
<td>3.074</td>
<td>209.092</td>
<td>1.47</td>
</tr>
<tr>
<td>Hunan</td>
<td>4.803</td>
<td>221.044</td>
<td>2.17</td>
</tr>
<tr>
<td>Sichuan</td>
<td>9.092</td>
<td>359.072</td>
<td>2.53</td>
</tr>
<tr>
<td>Ningxia</td>
<td>0.901</td>
<td>43.236</td>
<td>2.08</td>
</tr>
<tr>
<td>Guizhou</td>
<td>3.994</td>
<td>137.227</td>
<td>2.91</td>
</tr>
<tr>
<td>Shan’xi</td>
<td>3.065</td>
<td>184.164</td>
<td>1.66</td>
</tr>
<tr>
<td>Guansu</td>
<td>2.333</td>
<td>124.628</td>
<td>1.87</td>
</tr>
<tr>
<td>Total</td>
<td>51.161</td>
<td>2,720.189</td>
<td>1.88</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance.
to prevent increasing the fiscal burden on rural residents. In addition, writing off rural compulsory education debt was relatively easy in terms of size and complexity, and it could provide experience and knowledge for restructuring other subnational debt (Zhang 2007).

Although the size of the aggregate debt is relatively small, in the view of policy makers, how the debt was restructured would influence the future behavior of subnational governments. In particular, improper incentives could lead to moral hazard for local governments, which could lead to more problems in the future when trying to solve debt problems.

**Key Strategy for Dealing with Moral Hazard in Debt Restructuring**

The RMB 110 billion rural compulsory education debt accounted for an insignificant portion of the RMB 10.7 trillion in subnational liabilities at the end of 2010. However, the restructuring of the rural education debt represented the first effort to restructure subnational debt; thus, its design and approach would affect subsequent debt restructuring efforts. In particular, an improperly designed framework could create negative incentives for subnational governments concerning their future borrowing decisions.

A key issue in writing off the rural compulsory education debt concerns moral hazard. The soft budget constraint challenge exists in the fiscal system of many countries (see, for example, Liu and Webb 2011). An improperly designed fiscal system encourages moral hazard on the part of local government and creates the soft budget constraint. Not surprisingly, the soft budget constraint issue has also been a challenge for China’s fiscal system. To some extent, the compulsory education debt resulted from the soft budget constraint and the weakness of China’s intergovernmental fiscal relations.

Consequently, how to deal with a potential moral hazard challenge was a serious concern to policy makers in designing the restructuring package of the compulsory education debt. The restructuring of this debt served as a pilot from which to draw lessons. Finally, restructuring the rural compulsory education debt in China took place within the framework of intergovernmental fiscal relations. The process of the debt
Restructuring would help clarify intergovernmental fiscal relations in delivering basic education and help inform future reforms to the intergovernmental fiscal system.

There might have been other options to resolve the rural legacy debt. One would have the central government write off the entire debt. This option was not chosen because it would have encouraged moral hazard. Another option would have allowed provincial governments to resolve the debt of their local governments. This option was not chosen because the central government viewed the rural debt restructuring as an opportunity to realign intergovernmental fiscal relations with respect to rural education; letting provincial governments resolve the problem was not feasible given the existing intergovernmental fiscal relations. The chosen mechanism was based on the principles of burden sharing, transparency, and formula-based restructuring. As mentioned, the rural debt is only a small portion of subnational government debt, and there are broader issues concerning moral hazard and opportunistic behavior of subnational governments. The experience of rural debt restructuring can offer lessons on addressing these broader issues.

In restructuring the compulsory education debt, there were two types of moral hazard. The first relates to the overall borrowing size of local governments. As the debtors, the county governments might have an incentive to expand the size of total rural compulsory education debt in anticipation of seeking more central government grants to replace the incurred debt. The second type of moral hazard concerns the behavior of county governments in anticipation of a write-off. Instead of using their own revenues to contribute to the write-off of debt, the county governments might have an incentive to seek more bailout grants to write off the existing debt.

To deal with these two types of moral hazard, the central government designed a strategy with two distinct features.

First, the fiscal resources required for debt write-off and restructuring are distributed among three tiers of government: roughly one-third from the central government, one-third from provincial governments, and one-third from lower-tier governments. Thus, the fiscal burden of debt restructuring is shared.

Second, the distribution of the central grants was based on an output-based rather than an input-based formula. The output includes
two set of factors. The first set formed the base on which to calculate the total grants to a jurisdiction, and the second set formed the base to determine the performance of a local government in writing off the rural compulsory education debt.

Regarding the first set of factors, although the overall size of the central government grant was determined by the overall size of the compulsory education debt, the grant going to each individual jurisdiction was not directly linked to the size of the debt of that jurisdiction. The total grants were only a pool that provided the grants’ source; the linkage between the pool and its distribution among local governments went through the following two steps.

First, as mentioned, the grants would not be directly related to the total debt of a jurisdiction; that is, the central government grants would not be tied to actual indebtedness of county or town governments.

Second, the distribution of central government grants to local governments for write-offs was determined by a formula that considered four factors within local government jurisdiction: (a) number of students, (b) number of schools, (c) population density, and (d) local fiscal capacity.

By this method, a local government that borrowed excessively would not gain extra advantage, and another local government that borrowed less or paid off its debt would not be in an unfavorable position. By choosing objective factors and giving full consideration to the financial difficulties of all pilot areas, the grants to all pilot areas would be calculated uniformly according to the formula. The areas having more financial difficulty would enjoy a higher proportion of subsidy. Counties and towns that had not incurred debt but needed to cover a certain number of schools and students could obtain funds as a positive incentive. In addition, there was a penalty rule to prohibit new debt for compulsory education. The grants to a local government would be reduced by the central government if new rural compulsory education debt emerged. Provincial government grants were required by the central government to follow the same principles.

The second set of factors formed the base to determine the performance of a local government in writing off the rural compulsory education debt. To encourage subnational government effort in writing off debt, the central government established the incentive by providing
a subsidy for those that had made efforts to write off the compulsory education debt, and did not provide a subsidy to those that had not completed the work within the stipulated time limit. That is, central government grants to a province were based on performance, and only after the debt write-offs of lower-level governments could a province receive funds from the central government. The requirements, formula, and matching methods for writing off debt were included to preclude possible rent-seeking behavior.

All pilot provinces and their local governments were encouraged to mobilize revenues to contribute their share for writing off compulsory education debt. Subnational governments were encouraged to raise revenues through, for example, improving collection efficiency of local budgeted revenue, expenditure efficiencies, revitalizing idle school facilities, and mobilizing donations.

Restructuring of Legacy Debt for Financing Rural Schools, in Practice

Based on the above strategy, the central government launched the project to restructure the rural compulsory education debt. In December 2007, the General Office of the State Council transmitted the Advice Notice on Pilots Working on Resolving the Debt for Rural Nine-Year Compulsory Education, which was prepared by the Working Group under the State Council on the comprehensive reform in rural areas. The preparation work included the classification and audit of existing subnational rural school legacy debt.

Implementation of the project followed the existing framework of intergovernmental fiscal relations. Under this framework, rural compulsory education was planned by provincial governments and implemented by their county governments. Thus, the pilot project for writing off rural compulsory debt was organized by provincial governments and implemented by county governments. According to the State Council’s Advice Notice, all pilot provinces must have refrained from incurring new debt to finance compulsory education. All subnational governments were required to adjust their financial expenditure structure to establish reliable revenue sources for servicing new debt.
Of the total rural school debt of RMB 110 billion outstanding at the end of 2007, RMB 80 billion had been borrowed to finance capital investments (for school construction). An additional RMB 30 billion was used to finance operational deficits. The implementation strategy was designed to write off RMB 80 billion of debt for financing school construction, with two steps.

The first step was to write off the compulsory education debt of 14 provinces within two years (that is, by the end of 2009). During this step, all non-pilot-project provinces would choose two or three counties (cities, districts) to pilot the writing off of such debt. After progress was achieved in the 14 provinces and the pilot cities and counties, the second step was to extend the restructuring exercise to all other provinces, and to complete the write-off of the debt in all non-pilot provinces by the end of 2010.

While the originally planned central government contribution toward writing off the RMB 80 billion compulsory education debt had been projected to be RMB 26.67 billion, the final central government contribution was RMB 30 billion, slightly higher than the originally planned one-third, and the subnational government contribution was RMB 50 billion. By the end of 2009, the central government provided RMB 14.5 billion in grants, about 90 percent of the total funds, for writing off the debt of 14 pilot provinces and Chongqing, consistent with the schedule of debt write-off.

In 2009, the central government launched a project of compulsory debt write-off in non-pilot areas. By the end of 2009, RMB 3.58 billion in grants had been provided to the non-pilot provinces, and in 2010, the remaining RMB 11 billion in grants was transferred to a central government account for distribution to the non-pilot provinces. By the end of 2011, the funds were almost completely disbursed.

Given the success of writing off rural compulsory education debt relating to capital financing in the pilot areas, the central government in 2009 initiated a new program to write off debt that was used to finance operational deficits in the pilot areas. The same output-based formula was used. The total pool of the central grants for writing off operational debt for compulsory education was 37.5 percent of total operational debt related to rural compulsory education, the same percentage as that for the capital debt.
The first 14 pilot provinces completed the task of writing off debt in 2009, which benefited about 1.7 million rural creditors. The 17 non-pilot provinces actively prepared for the write-off and started writing off debt in 2009. By the end of 2009, 31 provincial governments had paid RMB 56.6 billion of the rural compulsory education debt, among which the central government provided RMB 14.5 billion in grants, and subnational governments, including provincial governments, financed RMB 42.1 billion. By the end of 2011, almost all rural compulsory education debt had been restructured, including a RMB 30 billion operational deficit. Since 2007, the central government has contributed RMB 30 billion toward writing off rural compulsory education debt, or 37.5 percent of the debt.

To ensure implementation of the overall strategy, the central government has established a management system to supervise implementation. In principle, all central government grants were designed to contribute to the write-off of the compulsory education debt. Meanwhile, for an individual local government, the remaining grants from the central government after writing off compulsory education debt could be arranged to write off other local non-education-related debt, with priority given to the rural-education-related debt.

Subnational governments are required to establish a compulsory education debt control system to monitor grants from the provincial and central governments and the progress of writing off debt to make sure the grants are used effectively and follow central government requirements. In addition, the departments of finance of provincial, municipal, and county governments are required to report the use of the grants in their budget and final financial reports to the relevant People’s Congress or Standing Committee. The provincial finance department must report the progress of the write-off of compulsory education debt and the usage of grants to the central government on a monthly base. The penalty may be imposed if new debt were contracted. In addition, the Ministry of Finance retained RMB 2 billion to deal with contingencies.

It is too early to assess the impact of writing off the rural education debt, since the entire exercise was completed only at the end 2011. Several questions will necessarily arise, including: Do local governments continue to borrow to finance rural education? Given the transition from debt to grant financing of rural compulsory education, has
the grant allocation system been sufficient to finance compulsory education?

Although China achieved universal compulsory education in 2007, a key question is how to ensure the sustainability and quality of education. Evaluating the debt write-off and addressing these questions will need to be done in the context of the evolving changes in the intergovernmental fiscal system. Chinese reform of its intergovernmental fiscal system is ongoing, as are major discussions on the assignment of expenditure functions among the tiers of governments; the streamlining of the tiers, potentially into three tiers; and the need to continue to reform the intergovernmental revenue system to grant subnational governments revenue flexibility at the margin, which is critical to underpin their access to financial markets.

**Conclusion**

International experience has shown that it is difficult to undertake debt restructuring and to write off debt liabilities while managing moral hazard. In a unitary system of government, the design mechanism by the central government has an important bearing on the incentive signals to subnational governments and financial markets. Important lessons can be drawn from China’s experience of formulating its strategy and framework for dealing with the write-off of rural compulsory education debt.

It is important to have proper intergovernmental fiscal relations to assure the delivery of basic public services. Besides the proper assignment of expenditure and revenue among the tiers of government, it is necessary to provide formal fiscal instruments for subnational governments to manage capital expenditure. One of the main reasons for the existence of China’s subnational government compulsory education debt was the lack of fiscal resources and fiscal instruments, such as formal debt financing.

A suitable subnational debt management framework is a critical part of intergovernmental fiscal relations. In designing a sound subnational debt management system, it is important to have an information system and an accounting and statistics reporting system to ensure the risks of subnational debt are transparent and reported. In addition,
there needs to be a functioning audit department. More important, subnational governments in general have the incentive to overborrow because of the soft budget constraints and the common pool problem. Thus, it is important to provide proper incentives to avoid moral hazard.

Writing off subnational debt should proceed with the goal of improving intergovernmental fiscal relations. In China, county governments should be responsible for servicing their debt, which was consistent with the responsibility assignment of the existing fiscal system. However, the county governments may lack incentives to pay their debt without the effective incentive provided by the central government. Although the central government has sufficient fiscal resources to write off the entire rural education debt, such a write off would lead to moral hazard problems.

China established a system in which the distribution of grants was based on a transparent, rule-based, and output-based formula; the distribution of the grants to a particular local government was not related to the size of the debt of that local government. If a grant to an individual jurisdiction were linked to the size of its debt, it could undermine efforts by that local government to prudently manage its debt service, and at the same time could encourage accumulation of additional debt in anticipation of larger bailouts. The system, based on the performance efforts and standard factors of local governments, such as the size of the student population and their respective fiscal capacity, encouraged local governments to achieve the goal while managing moral hazard problems.

Each debt restructuring will need to examine the origin of the debt problem and the specific historical and institutional context of the legacy debt. Any debt restructuring will need to pay close attention to the design and its incentive effects.

The experience and lessons learned from China’s rural debt restructuring can help generate lessons for developing a consistent strategy for debt restructuring in general. A rule-based debt restructuring reduces ad-hoc bargaining and adverse incentives, a hard budget constraint prevents moral hazard, and burden sharing provides proper incentives and avoids free-riding behavior, while also recognizing the incentive role played by higher levels of government to leverage reform.
Notes

The findings, interpretations, and conclusions expressed in this work are those of the authors and do not necessarily reflect the views of The World Bank, its Board of Executive Directors, the governments they represent, or any other institutions with which the external authors may be affiliated.

1. The exchange rate at the time of writing of the RMB (renminbi) to the U.S. dollar was US$1 to RMB 6.30. The RMB has appreciated continuously since 2005, at about 3–5 percent per year.

2. In 2001, a package of policies called the Tax-for-Fee Reform was enacted. See the next section for details.

3. Based on Article 30 of the Constitution of China of 2004, the administrative division of China is as follows: (a) the country is divided into provinces, autonomous regions, and municipalities directly under the central government; (b) provinces and autonomous regions are divided into autonomous prefectures, counties, autonomous counties, and cities; and (c) counties and autonomous counties are divided into townships, nationality townships, and towns. Municipalities directly under the central government and other large cities are divided into districts and counties. Autonomous prefectures are divided into counties, autonomous counties, and cities.

4. The reform started with a pilot program in Anhui province and later was implemented nationwide. Before the reform, there were five agriculture-related taxes, including various taxes on agriculture and a slaughter tax, and various charges such as an education surcharge. There were three core components of the 2001 Tax-for-Fee Reform: (a) cancelations of charges and fees imposed on rural households, including the cancelation of township general fees, the educational surcharge, and the slaughter tax; (b) two adjustments: (i) changes in the agriculture tax made the amount of taxable land and the tax rate fixed, and the production level should be determined by the average of the past five years; the maximum tax rate was set at 7 percent; and (ii) changes in the special agriculture tax. This tax is levied by the procedure applied to the agriculture tax but with a higher tax rate; and (c) one reform: the revenue the village can collect is essentially a surcharge on the agriculture tax, the maximum rate of which is 20 percent. This surcharge can be used to pay for three items in village expenditures: (i) salaries of the leaders in the village self-governing committee, (ii) the old-age support program, and (iii) the operational costs of the governing body. After this reform, only the agriculture tax remained. In 2006, the agriculture tax was also abolished.

5. In 2001, the State Council issued a new policy, the “Decision on the Reform and Development of Primary Education,” which assigned the responsibility of providing educational services to county governments. In May 2002, the State Council issued a complementary policy change for education. In the “Notice on Improvement of Administration of Compulsory Education in Rural Areas,” the
responsibility for financing compulsory education was removed from township to county governments. The two regulations ended the township-centered system of the previous 17 years (1985–2002), and the county governments began to play a core role in providing educational services.

6. In 1993, the central government issued a Blueprint on Education Reform and Development, which stated that “two basics” should be reached before 2000. In the following years, the Ministry of Education issued several regulations on the qualifications of teachers and the status of school facilities. To meet the requirements, township governments, administrative villages, and households made a big effort, but sizable debt was accumulated, since outlay expenditures were beyond the ability of local communities.

7. For example, 1,424 counties out of a total of 2,806 received earmarked transfer funds for teacher salaries in 2003.

8. Following implementation of the State Council Directive in 2003, township and village government debt was transferred to the accounts of their respective county governments.

9. This and subsequent sections are based on discussions with Ministry of Finance officials.


11. The deadline for calculating the size of debt was December 31, 2005.

12. The grants for writing off the compulsory education debt for pilot areas were based on a standard compulsory education input gap (standard compulsory education debt) and the coefficient of grants. The formula was: Grants for a particular pilot area = the standard input gap (of the area) × the coefficient of grants (of the area), where the standard input gap (of the area) = \[\sum\{(0.85 \times \text{the number of students in rural compulsory education} \times \text{standard input gap per student}) + (0.15 \times \text{the number of the schools} \times \text{standard input gap per school} \times \text{unit cost difference})\}\]. The standard input gap per student and the standard input gap per school are calculated, respectively, in accordance with the number of students and population density by provincial jurisdictions based on the overall input gap. The unit cost difference is calculated by county based on the factors related to construction cost, such as the geographic elevation and weather conditions. The coefficient of grants is determined by fiscal capacity. The coefficient grants for the middle and western regions follow the coefficient of fiscal difficulty applied in the general transfers.

13. The annual grants for a pilot area were based on the schedule of writing off compulsory education debt for that area and used the following formula: The amount of grants (in year T) = the amount of debt that had been written off (in year T) / the total amount of the compulsory education debt that should be written off × the total grants for the particular pilot area. The grants were partially advanced at the beginning of the year based on the anticipated write-off during the year, and the remaining portion was given at the end of every year.
after completion on schedule. The funds provided by the central and subnational governments earmarked for writing off the debt were managed in the single account system of the National Treasury and monitored regularly.

15. The 14 provincial jurisdictions were Anhui, Fujian, Guansu, Helongjiang, Hubei, Huizhou, Hunan, Inner Mongolia, Jiangsu, Jiangxi, Jilin, Ningxia, Shan‘xi, and Sichuan.

Bibliography


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