Comparative Study of Equity Finance and Land Finance: Changes and Challenges

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Abstract: This article provides an in-depth analysis of the intrinsic characteristics, advantages, potential risks, and future development prospects of equity finance and land finance. Equity finance refers to the model where relevant department obtain fiscal revenue by holding corporate equity, while land finance is based on land transfer and related tax revenues. Against the backdrop of a sluggish real estate market, land finance faces challenges, whereas equity finance is increasingly valued for its diversified fiscal revenue and long-term growth potential. Although the scale of equity finance is not yet on par with land finance, its potential in stimulating investment in emerging industries, meeting the financing needs of new industries, and developing data resources cannot be overlooked. Looking ahead, driven by strategy support, market demand growth, and technological advancements, equity finance is expected to become a new pathway to alleviate local fiscal pressures and resolve debt risks.

Keywords: Comparative Study; Equity Finance; Land Finance, Land Transfer, Corporate Equity

1. Introduction

In the current economic context, the diversification of fiscal revenue sources has become a focus of local governments. Equity finance and land finance, as two distinct fiscal models, have drawn increasing attention in terms of their concepts and functions. Equity finance refers to a model in which the government obtains fiscal revenue by holding and operating enterprise equity. The government derives income from the utilization of state-owned assets in its capacity as the owner of property rights and investor. [1]This model aims to exert the leading and amplifying functions of state-owned capital, attract social capital to invest in high-tech industries with core competitiveness, and achieve the preservation and appreciation of state-owned capital. For example, Anhui accelerates the construction of emerging industry clusters represented by information technology, new energy, and new materials, and Changzhou vigorously promotes the construction of the "New Energy Capital", incubating enterprises through equity investment and broadening the channels of fiscal revenue.[2]Land finance, on the other hand, pertains to the fiscal revenue and expenditure activities and interest distribution relationships carried out by local governments by leveraging land ownership and management rights. Its prominent feature is that the total fiscal revenue and expenditure of local governments highly depend on the revenue and expenditure of land and related taxes and fees obtained through the utilization of land resources. Land finance encompasses land-related taxes, such as cultivated land occupation tax, business tax of the real estate and construction industries, land value-added tax, etc., as well as land-related non-tax revenues of the government, such as land rent, land transfer fee, paid use fee for newly increased construction land, cultivated land reclamation fee, new vegetable plot construction fund, etc.

2. Current Situation and Challenges of Land Finance

2.1 Composition and Importance of Land Finance

Land finance mainly consists of land transfer revenue and related taxes. Among them, land transfer revenue is one of the important sources of local government fiscal revenue. Over the past few decades, land finance has served as a crucial pillar of local finance. Relevant data indicates that in 2021, local governments obtained revenue of 8.7 trillion yuan through land transfer, accounting for 42.5% of the total local revenue. Additionally, land-related taxes, such as property tax, deed tax, land value-added tax, urban land use tax, cultivated land

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occupation tax, etc., amounted to 2.1 trillion yuan in 2021, accounting for 10.2% of the total local revenue. Land finance has played a significant role in promoting China's urbanization and industrialization processes, providing financial support for infrastructure construction and people's livelihood improvement.

2.2 Current Difficulties

Currently, land finance is confronted with numerous difficulties. On the one hand, land transfer revenue is on the decline. With the downturn of China's real estate market, the land market has also performed poorly. In the first five months of this year, the land markets in 300 cities across the country have been sluggish, with significant decreases in the area of various types of land offered and transacted. Specifically, the area of residential land offered was 88 million square meters, a year-on-year decrease of 38.6%; the transaction area was 67 million square meters, a year-on-year decrease of 35.2%. The decline in land transfer revenue has exerted tremendous pressure on local government finances. On the other hand, the downturn of the real estate market has brought about a series of challenges. The decline of the real estate market not only affects land transfer revenue but also has a negative impact on the local economy. For example, in some regions that rely on land finance, due to the reduction in land transfer revenue, fiscal expenditure is facing difficulties, which may affect the construction of public services and infrastructure. Moreover, the downturn of the real estate market may also lead to the obstruction of the development of related industries, further affecting the development of the local economy.[3]

3. Rise and Characteristics of Equity Finance

3.1 Concept and Formation Background of Equity Finance

Equity finance refers to a model in which the government obtains fiscal revenue by holding and operating enterprise equity. With the decline of land finance revenue, the dependence of local governments on land finance has decreased, and equity finance, as a new source of fiscal revenue, has attracted extensive attention. In the current economic situation, the real estate market is sluggish and land transfer revenue continues to decline. Local governments urgently need new sources of fiscal revenue to relieve fiscal pressure. The proposal of equity finance aims to enhance the market participation of state-owned capital, build local characteristic industrial clusters, incubate enterprises through equity investment, and broaden the channels of fiscal revenue [4].

3.2 Typical Models of Equity Finance

3.2.1 Direct Investment Model by the Government: The government obtains investment income as fiscal revenue by directly participating in the equity investment of enterprises. For example, the Taizhou Municipal Government obtains profit dividends by investing in the equity of Taizhou Bank.

3.2.2 Fund Establishment Model: The government establishes funds through fiscal funds to guide social capital to invest in industries and jointly cultivate new industries, which not only cultivates tax sources but also harvests dividends. For example, Taizhou Jinchuang Group establishes funds to invest in industrial projects and primary and secondary markets and obtains income.[5]

3.2.3Capital Increase and Reorganization Model: The government increases capital or conducts strategic reorganization of state-owned enterprises through fiscal funds, optimizes the allocation of various assets of state-owned capital platforms through asset transfer, institutional reorganization, etc., establishes a market-oriented state-owned capital investment and operation platform, with the platform company handling asset management and the secondary company engaging in business operations, constructs the investment closed loop of "investment - financing - construction - management - exit" of state-owned capital, and incorporates the income of the state-owned capital operating budget into the public budget.[6]

3.2.4Data Resource Development Model: The government constructs a model of public data resource development and paid operation through equity investment, establishes a mechanism for the operation of data property rights and income distribution, realizes the monetization of data resources, and forms data finance.

3.3 Advantages of Equity Finance

3.3.1Create New Sources of Revenue in the Long Term: Compared with land finance, equity finance can diversify fiscal revenue. By attracting social capital to participate in the investment of high-tech industries with core competitiveness, it continuously expands the "cake" of state-owned assets, improves the return on investment of high-quality state-owned assets, and forms a virtuous cycle.

3.3.2 Stimulate Investment in New Industries: It can resist the downward pressure of real estate investment to a certain extent, give play to the leading role of state-owned capital, leverage social capital and private capital to cultivate high-tech industries, and promote economic transformation and industrial upgrading. It meets the financing needs of emerging industries and has become an effective tool for promoting industrial investment promotion. For example, the "Hefei Model" drives investment through government investment, attracts social capital to jointly participate in industrial cultivation, constructs a complete industrial chain, and promotes the development of industrial clusters.

3.3.3Develop Data Revenue Sources: Vigorously develop the value of public data resources and data of state-owned enterprises and institutions, cultivate state-owned data operators and market-oriented business entities, increase the total amount of state-owned assets, form the budget revenue of data assets, develop the digital industry, and drive the development of new quality productive forces.

4. Comparison between Equity Finance and Land Finance

4.1 Volume Difference

At present, there is a huge gap between the volume of equity finance and that of land finance. In 2023, the national governments at all levels achieved an income of 674.4 billion yuan from the state-owned capital operating budget, while the general budget revenue and government fund revenue in the same period were 21,678.4 billion yuan and 7,070.5 billion yuan respectively. As one of the components of equity finance, the income from the state-owned capital operating budget is much smaller than the government fund revenue mainly composed of land transfer revenue. For example, in 2021, local governments obtained revenue of 8.7 trillion yuan through land transfer, accounting for 42.5% of the total local revenue. In the short term, equity finance is difficult to replace land finance. If the income from the state-owned capital operating budget is to reach 1 trillion yuan, compared with the income of 568.9 billion yuan in 2022, the increase needs to reach 75.8%. Even if this goal is achieved, the absolute volume of 1 trillion yuan is still limited.

4.2 Effect Difference

Equity finance plays an important role in cultivating regional advantageous industries and expanding the tax base. The government obtains income by sharing profit dividends through directly holding or participating in the shares of enterprises, or by realizing value-added transfer through asset operation, gives play to the leading role of state-owned capital, leverages social capital and private capital to participate in the investment of high-tech industries, and promotes economic transformation and industrial upgrading. For example, the "Hefei Model" establishes regional advantageous industries, focuses on the investment model of "angel round - post-investment management", and jointly promotes the clustered development of industries with social capital; the "Suzhou Model" establishes a multi-level government investment fund system and sets up a combination of government investment funds for different rounds of investment for enterprises in different life cycle stages; the "Shenzhen Model" builds a government-guided fund with a scale of 100 billion yuan led by Shenzhen Venture Capital, and has a highly market-oriented and active venture capital ecosystem. [7] In contrast, land finance mainly promotes economic development through land transfer revenue and related taxes. In the past, land finance provided a large amount of financial support for the urbanization and industrialization processes. However, with the change of the real estate market, the sustainability of its pulling effect on the economy is facing challenges. Land finance depends more on the prosperity of the real estate market, while equity finance focuses on cultivating emerging industries, optimizing the tax base, and has longer-term development potential.

4.3 Applicability Difference

Land finance has wide applicability in the stage of rapid urbanization development, especially in regions with rapid economic development and abundant land resources. However, with the slowdown of the urbanization process and the adjustment of the real estate market, the sustainability of land finance is affected. The applicability of equity finance in different regions varies. [8] Developed regions have strong financial strength and rich models for carrying out "equity finance". For example, Shenzhen has a highly market-oriented and active venture capital ecosystem and can better play the role of equity finance. In less developed regions, the tolerance for mistakes is relatively smaller. If they blindly participate in equity investment to pursue financial benefits without focusing on the origin of industrial cultivation, the risks are relatively large. For most provinces, compared with cross-regional investment, focusing on local "equity finance" has better effects. Economically strong provinces have more local listed company resources, and state-owned listed companies in various provinces can better integrate into the regional economic development and form good interactions with regional industries. However, the benefits of local state-owned assets' cross-provincial holding of listed companies are not good, and cross-provincial mergers and acquisitions need to be treated with caution.

5. Challenges and Future Prospects of Equity Finance

5.1Current Challenges

5.1.1Fundraising Difficulties

Currently, China's guiding funds generally face problems in fund operation efficiency and investment effect. For economically underdeveloped regions, guiding funds face problems such as lack of professionalism, tight fiscal funds, and insufficient social capital. [9] For example, in the process of fundraising of some local government-guided funds, due to the lack of professional investment teams and successful investment cases, it is difficult to attract the participation of social capital. The biggest problem currently faced by the government's "equity finance" is the exit mechanism. In recent years, the A-share market has continuously fluctuated around 3,000 points, and the current IPO is almost suspended, resulting in the difficulty for the primary (venture capital) to exit, which in turn makes it difficult for venture capital companies to raise funds. Without funds to invest in innovative and entrepreneurial enterprises, the entire ecological cycle is basically disrupted. According to market statistics, after reaching its peak in 2021, the number of investments in the venture capital industry decreased by 14% in 2022 and continued to decrease by 12% in 2023. It is very likely to continue to decrease by 50% in 2024, becoming one of the industries with the most serious decline in China.

5.1.2 Investment Difficulties

Return Investment Restrictions and Formalities: Many places carry out equity investment, and the project income is not the biggest consideration for their investment. Their real purpose is to hope to support the local industry, so as to revitalize the local economy, boost employment, and ultimately increase the local fiscal revenue. Therefore, for the projects in which the local government participates in the investment, the GP (fund manager) will basically be required to return a certain amount of funds to the local area, with an average proportion of about 1.5 times. Similar return investment restrictions have greatly reduced the enthusiasm of investors.

Competing with the Private Sector and Squeezing Effect: Some people are worried that once equity investment is carried out on a large scale, in some regions with underdeveloped private economy, various state-owned enterprises will be established to monopolize the local market, resulting in competing with the private sector. In the recent market-oriented transformation of urban investment companies, individual places have shown signs of state-owned enterprises monopolizing the market by taking advantage of their congenital policy advantages.

Lack of Professionalism and Blind Investment: The success of Hefei is inseparable from the professional operation of the team and in-depth research on the characteristics of local industrial development and resource endowment. In order to introduce BOE, Hefei assembled a team of legal, financial and industrial experts to conduct a comprehensive due diligence on the intended enterprises and the developing industries. However, many regions have stumbled and even suffered heavy losses in the process of equity investment, mainly due to lack of professionalism and blind investment.

5.1.3Performance Evaluation Difficulties

It is difficult to improve and perfect the fund performance evaluation mechanism. It requires a lot of professional knowledge and experience to set up assessment indicators covering the degree of policy goal achievement, investment operation situation and investment benefit and effect, and assign corresponding weights. [9] At the same time, it also requires strict supervision and enforcement to set up a reward and punishment mechanism and arrange the budget scale according to the performance evaluation results, and seriously deal with institutions and individuals that violate relevant laws and regulations. The establishment of the fund should clarify the principle of risk sharing among partners. The investors jointly bear the loss risk and bear limited liability within the scope of the investment amount. It is also facing many challenges in practice to avoid the occurrence of situations such as fixed return commitment and buyback guarantee, and strictly prevent the emergence of new implicit debts.

5.2 Future Development Directions

5.2.1 Standardize the Development of Equity Finance

It is necessary to relieve the long-term pressure of local government finance by deepening the reform of the fiscal and tax systems and assessment targets. Clarify the status and role of equity finance in the fiscal system, improve the state-owned capital operating budget system, increase the proportion and quality of profits handed in by state-owned enterprises, and at the same time strengthen the performance assessment of state-owned enterprises to improve the return rate of state-owned assets. Strengthen the overall coordination of the construction of public welfare projects in the region and reduce the cost of generalized government debt. Integrate and optimize the regional state-owned equity investment management, expand the investment scope of local government industrial funds, and revitalize the stock assets through asset securitization, merger and reorganization, and sales.

5.2.2Relieve the Pressure of Local Finance

Clarify the boundaries of the government, enterprises and the market, and clarify the boundaries of finance and equity investment. The government should play the role of a guide and regulator in equity finance, avoid excessive intervention in the market, and at the same time strengthen the risk control of equity investment to prevent the loss of state-owned assets. Equity finance can attract social capital to participate in the investment of high-tech industries with core competitiveness, realize the preservation and appreciation of state-owned capital, and thus provide a new source of revenue for local finance. [9] For example, the government can set up industrial funds to guide social capital to invest in local emerging industries, which not only cultivates tax sources but also harvests dividends. Integrate and optimize the regional state-owned equity investment management to improve the operation efficiency and return rate of state-owned assets. Revitalize the stock assets through asset securitization, merger and reorganization, and sales to increase the disposable income of local finance. Strengthen the management and regulation of land finance and improve the use efficiency of land transfer revenue. At the same time, through the development of equity finance, gradually reduce the dependence of local governments on land finance and realize the diversification and sustainable development of fiscal revenue.

5.2.3Resolve Debt Risks

Equity finance can be used as a new source of revenue to make up for the gap of land finance, increase government revenue by improving the return rate of state-owned assets, make up for the income gap brought by the reduction of land finance, and help resolve the debt risks of local governments. Strengthen the management and supervision of local government debt and establish a sound debt risk early warning mechanism. Optimize the debt structure of local governments and reduce the debt cost through asset securitization, debt replacement, etc., and prevent debt risks. Promote the transformation and development of local government financing platforms and improve their market-oriented operation level and profitability. Through the way of equity finance, guide social capital to participate in the reform and development of local.

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