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## In the Red? Debt levels at higher education institutions in China

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### Abstract

Borrowing from banks has become common practice among Chinese higher education institutions (HEIs), and operating with a heavy debt load has become a feature of Chinese higher educational development. Substantial financial commitments by HEIs during their rapid expansion since 1998 are now having serious consequences; numerous universities and colleges have found themselves with major debt problems and some are facing insolvency. This paper describes the background of Chinese HEIs' debt problem, assesses the present debt and repayment situation, and suggests a possible solution for the bank debt crisis, using empirical evidence from one HEI in China.

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*Keyword:* Higher education institutions; China; educational policy; funding.

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### 1. Background of Bank Debts

Borrowing from banks has been a very popular option for HEIs in China since the 1990s, and numerous institutions have accumulated significant debt very quickly. A number of reasons have encouraged Chinese institutions to seek financing from banks.

First, since the 1990s, there has been an ever-increasing discrepancy between the size of the higher education system and the funding received from the state. Enrolments in institutions of higher education in China started to grow steadily in the 1980s, but state funding of higher education did not keep up with that growth. At that point, some HEIs began to take loans from banks to finance their own development. In the late 1990s, as the scale of higher education continued to grow rapidly, and state funding continued to decline in relative terms, the funding shortfall intensified.

The shortfall of public funding has been a long-term problem in the Chinese education system. The national educational policy document, the Outline of Reform and Development of Education in China, issued by the Central Committee of the Communist Party of China (CPC) and the State Council in 1993, mandated that "... educational expenditure shall reach 4% of Gross Domestic Product (GDP) by the end of this century" (CPC Central Committee and State Council, 1993); however, this level has never been reached. The latest figure, in 2007, was 3.01% of the GDP (Ministry of Education et al., 2008), while most developed countries are above 5%, and many have exceeded

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6% (UNESCO, 2008). The current public educational expenditure only accounts for around 9% of total governmental expenditure in China, compared to an average level of 15% elsewhere (Yu, 2009).

After the 1997 Asian Financial Crisis, the central government made the decision to rapidly enlarge the size of higher education, hoping that an expansion of higher education would stimulate China's economy by increasing consumer demand and domestic spending (Bai, 2006). Before this decision, the national strategy on higher education had always been developing the sector steadily. The new policy encouraged HEIs' development. Institutions and local governments viewed this policy as a key opportunity for development, and responded positively. The expansion that followed in the following year was dramatic: enrolments increased from 1.08 million in 1998 to 1.59 million in 1999, or a 47% increase in a single year. From 1998 to 2005, the size of institutions of higher education increased on average by 19% annually. However, although the size of higher education had grown dramatically, the per capita funding for higher education declined in this same period: in 1999, the public funding per capita in higher education was 7,201 Chinese yuan; this decreased further to 6,816 in 2001, 5,772 in 2003, and in 2005 the figure was down to 5,376 (all in nominal terms). As a result, the institutions soon found themselves experiencing a shortage of resources. For example, in Henan province, the provincial development plan pointed out that the higher education in the province should reach 500 to 600 thousand students in 2005 and, based on the national requirements for educational resources, the province still needed 5,930 acres of land, 12 million square meters of teaching space, 2.4 billion yuan-worth of equipment, 120 million books, and 1 billion yuan in capital. Without sufficient funding, many of these gaps had to be filled through loans (Liu, 2004).

The second key factor was that the country's policy environment was lax. The 1995 Education Law specifically stipulates that: "The state shall encourage the use of banking and other measures to support the development of educational undertakings" (Article 62). The Decision on Deepening Educational Reform and Promoting Quality Education, issued by the CPC Central Committee and State Council in 1999, stipulates that the state shall "... utilize financial instruments and taxation policy actively to support the development of educational sectors." In her speech to the Ministry of Education's Annual Work Conference in 2000, the Minister of Education at the time instructed the authorities "... to use bank loans to strengthen the transformation and construction of university and college campuses, to improve educational, sports, and infrastructure facilities" (Chen, 2000). In practice, governments at various levels actively supported HEIs in borrowing funds.

Third, there was a positive response from the education sector. At the beginning of economic reform in China, many state-owned enterprises took loans from banks, and this eventually resulted in a large amount of bad debt. Later, the state exempted these enterprises from their debt liability. Corporations that took few or no loans, because of their concerns about their ability to repay them, bitterly regretted their decision. In higher education, institutions' decision-makers drew their own conclusions from the "mistake" of these corporations. They believed that higher education was a public service, and borrowing for development was a way of making a contribution to the country; as long as there was no corruption, the decision-makers themselves could not be held accountable for the loans if the institutions failed to repay their debts in the future (Chen, 2006). Moreover, another rationale was that, when the debt was payable, the institution would already be administered by other bureaucrats. The current institutional leaders, as government bureaucrats, needed only to think about how to utilize the opportunity to glorify their achievement record and to climb the political ladder.

Fourth, the banks viewed HEIs as ideal borrowers. Recent bank reforms had transformed the commercial banks into market corporations, ruled by market principles. Banks had become responsible for their own development and risks and, as a result, they strengthened their risk awareness and adopted measures to avoid risky loans. One direct result was that the banks controlled the issuance of loans to state-owned corporations, as the state had reformed the state-owned corporations so that bankruptcy of these corporations had become possible. The rapid development of higher education provided an opportunity for the banks to use their "idle" funds. Commercial banks chose to ignore the growing levels of risk within higher education because HEIs received state funding and had a stable income from tuition fees. In addition, banks also believed that the state would bail them out if the educational institutions lacked the ability to repay the loans. Therefore, lending to HEIs consisted of virtually no risks.

As a result, HEIs have actively relied on borrowing to solve their funding shortfalls. A number of papers (Ru et al., 2005; D. Wu, 2007) have observed that, by the end of 2004, the total bank loans of provincially-administered institutions and ministry-administered institutions amounted to around 200 billion yuan. Borrowing from banks has become common practice for HEIs in China, and loans have become a significant source of income for HEIs.

### *1.1. Levels of Bank Debt: a Case Study*

This paper examines the bank loans of one HEI in China. As with all studies conducted by case method, the generalizability of this study is limited. However, as introduced later, the institution in this case study features many typical characteristics of Chinese HEIs, and especially of those HEIs that developed fast and benefited from the 1998 expansion. Complete financial and borrowing data up to 2005 were obtained from the institution through its management, and these data serve as the foundation for this study's analysis. Because of the sensitivity of the data, it was agreed with the institution that it will remain anonymous throughout this study. The financial data are prepared by the institution's accounting office in conformity with accounting principles for higher education institutions in China. HEIs in China are normally not required to submit their financial statements for external auditing, and the data used in this study have not been audited by an independent auditor, but it is the management's responsibility to ensure that the financial figures are free of material misstatement.

### *1.2. Brief Introduction of the Case*

The case HEI was formed as an undergraduate-level institution in the 1970s. The institution was initially built for, and supported by, an industrial ministry, and remained affiliated to and administered by that ministry until 1998, when the institution was re-allocated to provincial administration in the 1998 national administration reorganization of higher education. The same situation can be observed from many HEIs in China at that time. In the interests of the founding ministry, the institution was initially built in a remote, small and economically undeveloped city in north China.

The institution had faced many acute difficulties in its operations, most notably in the recruitment of students and staff. Before 1998, the institution had repeatedly been unable to meet its enrolment plan and had to lower its admission standards almost every year, and even then the drop-out rate was high. In the 1990s, the institution conducted a project to support and pay for postgraduate education for its teaching faculty but, ultimately, all of the staff members who received doctorates from that project left the institution, and only a few staff who received Master's degrees stayed. The main reason was the institution's isolated geographical location. The below-average pay and poor working and living conditions exacerbated the feelings of dissatisfaction among the faculty.

When the new national policy promoting the development of higher education was published, the institution put development firmly on its agenda. In an initial move, the institution changed its name, and established more subjects and disciplines. The new name is more general in nature, and shows that the institution aims to serve the whole region, instead of serving a specific industry, as was indicated by the previous name. The second step was to merge with a vocational secondary school located in the provincial capital. The third step was to expand the provincial capital's campus, in keeping with the national policy of developing higher education. However, the key problem of campus expansion was lack of funds. During the same period, hundreds of other HEIs in China did the same, including changing the name, merging with other institutions, and building and moving to new campus.

Although the national policy claimed that the state would support higher education development and expansion, for this and many other HEIs in the country, the central and local governments did not inject more funds. The institutional leadership made the decision to emulate other institutions' experience of taking bank loans to finance new development and construction. The institution established a special financial committee for this matter.

In 1999, the institution started the renovation and expansion of the provincial capital campus. In 2002 it completed the project and designated the new campus as its main campus. This signaled a new phase of development for the institution. Within a few years, the institution had witnessed tremendous changes in its physical size, fixed assets, capital flows, and so forth. In 2005 the total student number was 3.4 times that of 2000. Also, the fixed assets were 12.1 times those of 2000. The modern campus and provincial capital location greatly helped the recruitment of students and teachers. However, the significant amount of debt also brought significant potential risks to the institution.

### *1.3. Borrowings from Banks*

Between 1999 and 2005, the institution negotiated sixteen loan transactions from nine different banks. The sixteen loans amounted to a total of 830 million yuan. Based on the respective interest rate and duration of each

loan, the interest due on the total amount was 258 million yuan. By the end of 2005, the institution had repaid 199 million yuan on the principal amount and 91 million yuan in interest. The interest rates used in this calculation are as determined at the time of loan agreement. The interest rates may have fluctuated subsequently, in line with changes in the national central bank rates. These interest rate fluctuations have not been taken into consideration in this study, as all calculations are based on the original interest rates.

As the figure below shows, the institution's cumulative balance of loans was increasing year by year during the period 1999-2005. By the end of 2005, after repaying 199 million yuan, the institution owed 631 million yuan to banks (total principle remaining). The institution's annual new borrowing was 3 million yuan in 1999, and 235 million in 2003. Although the amount of new loans decreased slightly from 2004 onward, the loan balance remained stable.

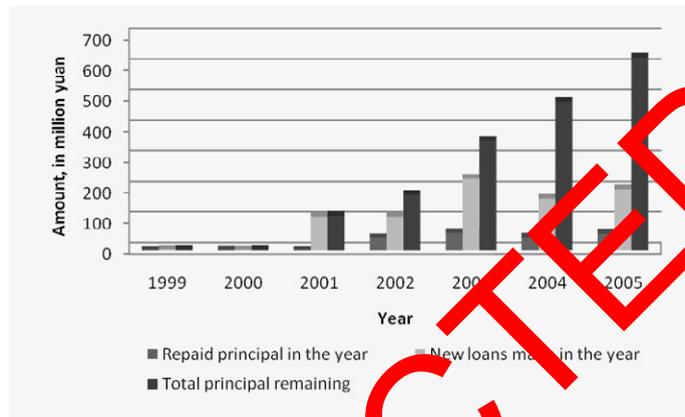


Figure. 1 Loans provided by banks, 1999-2005

Many of the loan transactions were for short-term financing. In fact, six out of the sixteen loans had durations of no longer than one year. But these short-term loans were also characterized by their small amounts, as the six loans represent only 11% of the total amount. Most of the large loans had a length of three to five years. This was mainly due to the demands of the banks. The banks preferred to limit the loan length to three to five years to control risks; by doing so they could examine the repayment situation before issuing further loans.

#### 1.4. Benefits of the Loans

There are three ways in which the loans have benefited the HEI:

#### 1.5. Enrolment numbers

The number of students at the institution had been increasing rapidly. The student population increased from 4,396 in 1999 to 9,900 in 2002 and 19,513 in 2005, while the bank loan balance increased from 3 million in 1999 to 182 million in 2002 and to 631 million in 2005. In the case of this institution, the increase in students and the increase in loans were associated. Without borrowing, it would have been impossible for the institution to expand and, conversely, the expansion of the student body made it possible for the institution to repay the loans. Generally speaking, loans to HEIs are repaid primarily by income from tuition fees. At this institution, tuition fees and other fees generated from the students provided around 60% of the repayment amounts. As a general rule, institutions have to maintain a certain size of enrolment in order to satisfy their repayment requirements, and enlarging the size of the student body is no doubt an important measure in repaying debts. However, as enrolment numbers grow, institutions also need to make new investments to ensure that teaching conditions and standards remain high.

#### 1.6. Fixed assets

From 1999 to 2005, the institution's fixed assets increased in value by 1.37 billion yuan, while total loans amounted to 830 million yuan. For public institutions like this HEI, government funding was provided mainly to

cover the cost of personnel. Therefore, within a context in which government funding is lacking, the increase in fixed assets is associated with the increase of the loan's balance, i.e., the loan funds were primarily used to build or purchase fixed assets. This suggests that borrowing by HEIs has greatly enriched educational resources. As for this institution, its 830 million in loans were primarily used for the construction of teaching buildings, libraries, laboratories, and student accommodation, as well as land acquisition, the purchase of teaching equipment, and the repayment of other loans. Data also show that 36% of the institution's new loans in 2005 were used to cover other earlier loans.

### 1.7. Staff welfare

Along with the increase in loans, the per capita spending on staff has increased sharply since 2000. From 1999 to 2005, the institution's per capita spending on staff increased 22% every year on average, from 13,800 to 46,600 yuan per year. The rise has become sharper since 2002 and, interestingly, the loan balance curve also began to rise sharply in the same year. In fact, the loans had not been used directly to raise staff remuneration, as all of the loans were designated for construction projects and infrastructure purposes, but the loans did help expand the enrolment of students, and the new income that comes with the new students helped improve the faculty's welfare.

### 1.8. Risk Assessment

In 2004, in a circular distributed to all provincial educational authorities, the Ministry of Education and the Ministry of Finance stressed the "economic responsibilities" of HEIs and required institutions to "... strengthen the management of bank loans" and to "... prevent financial risks in a practical manner" (Ministry of Education and Ministry of Finance, 2004). The document also proposed a model for determining the Cumulative Loan Limit (CLL) of institutions and for evaluating financial risks. The ratio of the actual debt amount to the Cumulative Loan Limit reveals the risk level of the institution's finances - the higher the ratio, the higher the financial risks. This paper uses this model to assess the HEI's financial risks.

Some accounting concepts should be clarified here. The model distinguishes restricted income from discretionary income, the former including funds that are received for specified purposes, such as specific projects, and the latter including funds that are free for the institution to use at its own discretion. Only the discretionary income can be used to repay loans. The model also introduces the concept of obligatory expenditure, which includes basic spending on items such as salaries, maintenance, subsidies to affiliated bodies, and so forth, which are vital and obligatory. Therefore, the amount of funds that are available for loan repayments, or the discretionary net income, is the discretionary income minus the relevant obligatory expenditure.

The calculation of the Cumulative Loan Limit is based on the predictions of the institutions' future operating income and expenditure, and is equal to the cumulative discretionary net income of the same period plus funds available from the institutional reserve (if available). Put simply, the predicted income of the future determines the maximum amount an institution should borrow (including interest).

The model proposes that the cumulative discretionary net income of the next  $n$  years is calculated as:

$$I_n = R_0 \times f$$

where  $I_n$  is the cumulative discretionary net income of the next  $n$  years,

$R_0$  is the base discretionary net income, calculated as the average of the present and the previous year's total discretionary net income, and

Function  $f$  is calculated as

$$f = \left\{ \frac{(1+g)^n - 1}{(1+i)^n} \right\} \times \frac{1+g}{g-i}$$

where  $g$  is the predicted average annual growth rate of the discretionary net income,

$i$  is the bank's lending interest rate for the  $n$  year period.

A Cumulative New Loan Limit (CNLL) can be calculated as the difference between the Cumulative Loan Limit and the actual loan balance. If this figure is positive, it suggests the maximum amount an institution can borrow in addition to the borrowed loans during the n year period. A negative figure suggests that the institution’s loan amount has already exceeded its predicted capacity for repayment.

Based on the Cumulative Loan Limit and the actual loan balance, a Loan Risk Index (LRI) for the next n years can be calculated by dividing the Cumulative Loan Limit of the next n years by the actual loan balance. If the LRI is smaller than 1, it suggests that the Cumulative Loan Limit is higher than the actual loan balance, or at the end of the nth year, the institution is predicted to be capable of repaying its loans. Otherwise it is predicted that, based on the predicted income, the institution would be unable to fulfill its financial commitments. According to the document, the five levels of risks are:

- 0.8 < Loan Risk Index ≤ 1, very high-risk;
- 0.6 < Loan Risk Index ≤ 0.8, high risk;
- 0.4 < Loan Risk Index ≤ 0.6, moderate risk;
- 0.2 < Loan Risk Index ≤ 0.4, low risk;
- 0 < Loan Risk Index ≤ 0.2, basically risk-free;

Based on the analysis of the institution’s income, including grants, research income, logistics service income, and tuition fees income, it can be estimated that the institution’s discretionary net income could grow at 8% per year, while the average loan interest rate was set to 6.4%. Since the institution had no reserve funds, its Cumulative Loan Limit was simply calculated as its cumulative discretionary net income. Applying the case institution’s data to the model, the risk measures of the institution are shown in the figure below:

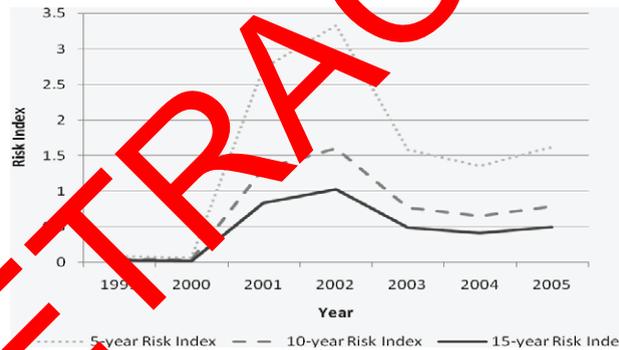


Figure. 2. The Loan Risk Indices, 1999-2005

It can be seen from Figure 2 that the shorter the loan duration, the higher the risks for the institution. For all of the three durations, the most difficult year for the institution was clearly 2002. The institution’s risk indices of 2002 greatly exceed the ceiling of the risk assessment model. Most of the loans obtained by the institution were for five years, and based on the 5-year model, the institution’s risk index reached 3.3 in 2002, meaning that the institution’s loan balance was as high as 3.3 times its predicted income. The table below presents the data that Figure 2 is based on.

Table 1. The Financial Risks of the Institution, 1999-2005 (in million yuan)

	1999	2000	2001	2002	2003	2004	2005
Discretionary Net Income	1066	767	822	1269	7413	6398	8506
Base Discretionary Net Income $R_0$	691.5	916.5	794.5	1045.5	4341	6905	7452

5-year Cumulative Discretionary Net Income	3616	4793	4155	5468	22704	36116	38974
Cumulative Loan Balance	300	300	11300	18200	35900	48600	63100
5-year CLL	3616	4793	4155	5468	22704	36116	38974
5-year CNLL	3316	4493	-7145	-12732	-13196	-12483	-24125
5-year Risk Index	0.08	0.06	2.71	3.32	1.58	1.34	1.61
10-year Cumulative Discretionary Net Income	7513	9958	8632	11359	47167	75031	80969
Loan Balance	300	300	11300	18200	35900	48600	63100
10-year CLL	7513	9958	8632	11359	47167	75031	80969
10-year CNLL	7213	9658	-2667	-6840	11200	26431	17869
10-year Risk Index	0.03	0.03	1.30	1.60	0.55	0.44	0.77
15-year Cumulative Discretionary Net Income	11712	15523	13456	17708	73525	116962	126218
Loan Balance	300	300	11300	18200	35900	48600	63100
15-year CLL	11712	15523	13456	17708	73525	116962	126218
15-year CNLL	11412	15223	2133	-491	37626	68362	63118
15-year Risk Index	0.02	0.01	0.83	0.02	0.48	0.41	0.49

Based on the current maturity and repayment terms of the loans, the institution's finances are significantly insufficient to repay the loans. However, using data from Table 2, it is suggested that, if the maturity of the loans were to be extended to 15 years, the Risk Index in 2005 would fall to 0.49, within the "moderate risk" margin.

There are also several problems with this risk model. It imposes a too simplistic view on institutions' future income, future borrowing, and fluctuation of interest rates. These factors all have impacts on institution's real risk level, but they are also variable and are difficult to predict. However, as educational entities, universities and colleges are expected to use prudence as a principle of operation, but the calculation and prediction based on the best current knowledge point out that the institution already had very significant levels of risks. If monitored and sanctioned properly by the authority, the use of this model may prohibit institutions from making large amount of new loans when they already have heavy debt loads, and hence help reduce the risk level in future, but the model itself does not offer solutions to the current debt of institutions.

### 1.9. Risk Analysis

The Risk Index and the repayment capacity analysis both show that the institution's loan risks have greatly exceeded the warning level, and the institution was incapable of fulfilling its financial commitments in certain periods. However, although it is an indisputable fact that the institution had very high financial risks, interestingly enough, through the end of 2005, the financial risks had not triggered a real financial crisis. The institution had not become insolvent, was still running "normally" and, in fact, it was still securing new loans every year.

But the situation does not suggest that the financial risks taken by HEIs can be disregarded. As public HEIs are regarded as governmental or public authorities, it is highly unlikely that the state would let them go bankrupt. Compared to corporate entities, HEIs' loans are implicitly backed by the government, and therefore insolvency is unlikely. This explains why financial institutions in China were prepared to provide credit-backed (not backed by mortgage, as China's Mortgage Law prohibits mortgaging properties for public benefits and educational purposes) loans to HEIs, knowing that the HEIs' repayment capacity might be poor.

## 2. Concluding Discussion

The development of the higher education institution under study benefited greatly from borrowing. The borrowing activities have enabled the institution to relieve the funding shortfall in the stage of rapid development, and the use of loans has increased these institutions' vitality, improved their strength of operation, and advanced their developments. Without borrowing, it would be impossible to expand student numbers, increase educational resources, or to attract talented staff and students at such a massive scale.

However, for this particular institution as well as many other HEIs in China, the amount of debt they owe to banks has become too large, far exceeding their current repayment ability. For these institutions, their debt commitments have become a great burden on finance and have put the institutions in a potentially dangerous situation.

The primary cause of the current "debt crisis" in HEIs in China is perhaps the belief held by many HEIs' leaders that, because public HEIs are public authorities, they should not and will not go bankrupt (Chen, 2006). The government's explicit and implicit support for HEIs to borrow from banks also contributed to the current situation.

In fact, in addition to bank loans, many HEIs have utilized other forms of debt, including borrowing from non-financial entities and financial leasing. Some of these activities are not ethical or even legal, such as intentionally defaulting on construction contract payments and appropriating or retaining research funding (Ministry of Education, 2005b). In some HEIs these non-bank debts have also amounted to significant volume as banks have become more prudent in issuing loans to HEIs. The terms and conditions of these debts are more complex than those of bank loans. In addition, as some of these debts are not from "reputable" or "legal" sources, institutions would conceal them whenever possible, and the data for these debts are hardly available for outsiders.

Indubitably, operating with debt is an effective means of fast-tracking institutional development. But it should be noted that operating HEIs with debts imposes certain financial risks. If used improperly, the amount of debt can exceed the repayment ability of institutions, jeopardizing the institutions' recurrent expenditure and sustainable developments.

The analysis contained in this paper shows that, a large volume of funds has been used for development and on infrastructure, and as a result the short-term economic returns to institutions were relatively small. Assuming that the state will not allow a significant increase in tuition fees, it makes sense for the government to increase funding to higher education and/or to implement policies to ease the HEIs' current repayment burdens. It is equally important to build proper institutional safeguards to ensure that such risky borrowings do not incur again.

The estimate of the case institution's repayment capacity indicates that, the institution mainly has financial difficulty in the short-term, but over a longer period the institution will have the capacity to repay the loans, provided that the institution takes less loans in the future – which is the case as the rapid enrollment expansion has slowed down to a steady pace. This suggests that refinancing may be a workable approach for solving the debt problems higher education institutions in China are facing. This approach would allow institutions to secure loans for longer periods, and to clear the loans at a later date.

If an HEI is expected to have a stable operating surplus in the future that can cover the loan interest and a small part of the loan principal, extending the maturity date would be beneficial for both the HEI and the creditors. From the earlier analysis, it can be seen that the longer the loan duration, the stronger will be the institution's ability to repay. However, the current bank loans held by HEIs are almost exclusively provided by commercial banks and negotiated individually by institutions. HEIs are viewed by these banks as commercial entities, and the loans are characterized by high interest rates and short maturity durations, which do not fit with the HEIs' needs. Therefore, it may be desirable for the state to provide some policy or financial incentives for banks to issue long-term loans to HEIs. The state may also wish to convert the commercial loans into policy loans to offer HEIs lower interest rates and longer repayment durations.

To this day, numerous institutions are still having trouble finding a way out of this debt crisis and, as their financial burden continues to grow, financial risks have escalated. How to solve the debt problem of these HEIs has become an urgent and practical problem for the whole higher education sector in China.

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