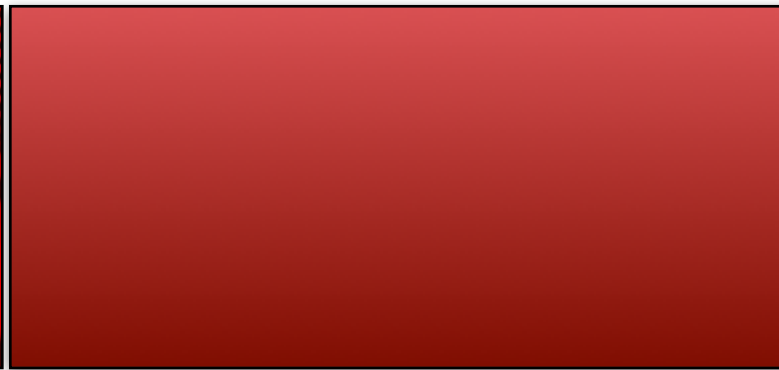
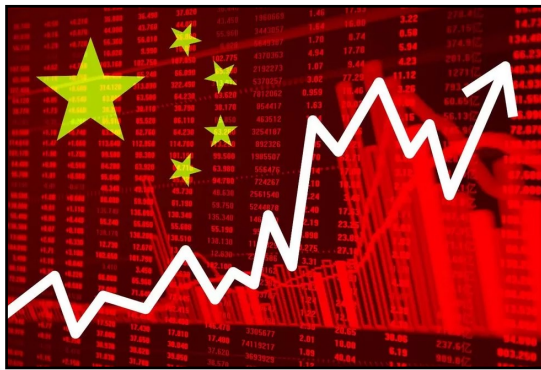




CHINA'S LOCAL GOVERNMENT DEBT AND FISCAL POLICY: Towards Consistency

Aneka Rebecca Rajbhandari



About the Author

Aneka Rebecca Rajbhandari is a Political Science student at Peking University, China. She was a Research Assistant at the Institute of New Structural Economics at Peking University.

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**CHINA'S LOCAL GOVERNMENT DEBT AND
FISCAL POLICY: Towards Consistency**

Aneka Rebecca Rajbhandari

Abstract

China's local governments play an important role in the country's overall macroeconomic stability. Every year, during the two sessions, the central government lays economic targets which is replicated at the local level and becomes a key criterion for economic growth. However, the local governments in China are also ridden with debt problems which have become a big issue in the financial stability for China. Due to increase in infrastructure spending to stimulate economic growth and also protection of people's livelihood, local government debt has been expanding. Since the start of the COVID-19 pandemic, local government borrowings in China have increased significantly and are close to using up early allocation of 2020 bond quota worth 1.8 trillion Yuan. Because local governments are responsible for welfare program of citizens, including employment generation, increasing debt while at the same time decline in overall Chinese economy GDP growth poses significant risk for the China's economy. The increasing local borrowings come at a time when there are growing concerns of impact on debt to other countries through its 'Belt and Road Initiative'. This paper explains the local government debt in China through examining the fiscal relationship between China's central and local government. It argues that central government could play crucial role in maintaining domestic economic stability for sustaining China's growth.

Background

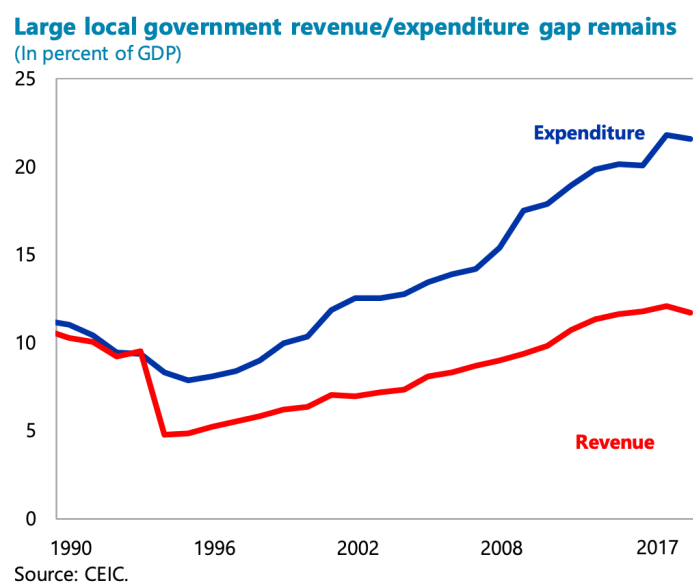
Since the 2008 financial crisis, China has experienced a rapid rise on its macro leverage ratios (debt/GDP). Data from National Balance Sheet Research Center (CNBS) shows that from 2008 to 2016, China's macro leverage has increased by an average 12.4 percent per year which is more than twice the global macro leverage in same period and so its macro leverage ratio was 243 percent by end of 2018 (Zhang X. , 2019). Since the COVID19 pandemic has unfolded, the local government borrowings have also significantly increased and are close to using up the early allocation of 2020 local government bond quota worth 1.8 trillion Yuan (Lee, Coronavirus: China local government debt could hit record high as Beijing front-loads more bonds , 2020). Does the availability of credit start to shrink has been the topic of understanding for many researchers, even more so when Governor Zhou Xianchuan warned of experiencing 'Minsky moment' (Reuters, 2017) for China's rising debt problem. Therefore, one such area to look into China's fiscal policy instance is the local government debt problem.

The local government debt problem is a big issue in terms of financial stability for China. Due to increase in infrastructure spending to stimulate economic growth and also protection of people's livelihood, local government debt has been expanding. In 2017, Wang Zhijun, director at Central Finance and Economic Leading group office pointed out that local government debt problem was one of 'gray rhinos' in the Chinese economy (Chen, 2017). This was also articulated in the press release of People's Bank of China (PBoC) PBOC during the China financial stability report 2018 as "during transition and structural adjustment of China's economy from high-speed to high quality growth, some 'gray rhino' financial risks may need to be released.

A way to understand the current local government debt is to look into China's central to local relationship from fiscal and administrative lens. Economic growth targets, set forward every year by the central government, is replicated at the provincial and local level which becomes a basis as a top criterion for official

promotion. This was prevalent since the Communist party issued a document in 1979 titled ‘Opinions of implementing cadre evaluation system’ which emphasized on four qualities (virtue, capability, diligence and performance) as key indicator for promotion (Su, Tao, Xi, & Li, 2012). Furthermore, China has centralized tax autonomy and decentralized public expenditure. In 2018, report from (Wingender, 2018) stated that local governments only retained 48.6 percent of tax revenue but was accounted for 85.2 percent of total expenditure. Because the local government is responsible for employment generation, attracting FDI, real estate and infrastructure development (World Bank, 2010), it led to setting up of Urban Development Investment Corporations, or also known as the Local Government Financing Vehicles (LGFV), to finance and develop large-scale infrastructure projects.

While although regulation of local debt was successful to some extent in the past few years, China’s economy has now been slowing down from double digit growth to around 6 percent at present and it brings issues of sustainability if the local government debt is going to increase further.



Source: International Monetary Fund, Country Report 2018, China. p. 28

This paper will delve into the local government debt problems and argues that central government in China are required to play more dominant role if it wants to solve the local government debt problems. One reason is that central government could ease local government’s burden through fiscal balance target

and there is required more intergovernmental transfer mechanisms to be kept in place for fiscal balance in the future.

The paper proceeds as follows: It starts with description of China's local government debt growth particularly after the 2007 fiscal stimulus program and the role of Local Government Financing Vehicles (LGFV)s on its contribution to the debt despite after the fiscal stimulus. The Institutional framework tries to provide some literature and policy framework on key institutional reforms undertaken since the fiscal stimulus program and provide brief on Chinese government regulation on the Public Private Partnership (PPP). It then proceeds to identify the role of local government bureaucracy in debt problems where frameworks like 'promotion competition' enables local officials to accumulate more debt with limited fiscal support from the central government. Then the final chapters will relate on managing the debt risks, in particular the role of central government and ways to manage the debt by providing some policy actions.

China's Local Government Debt and its Growth

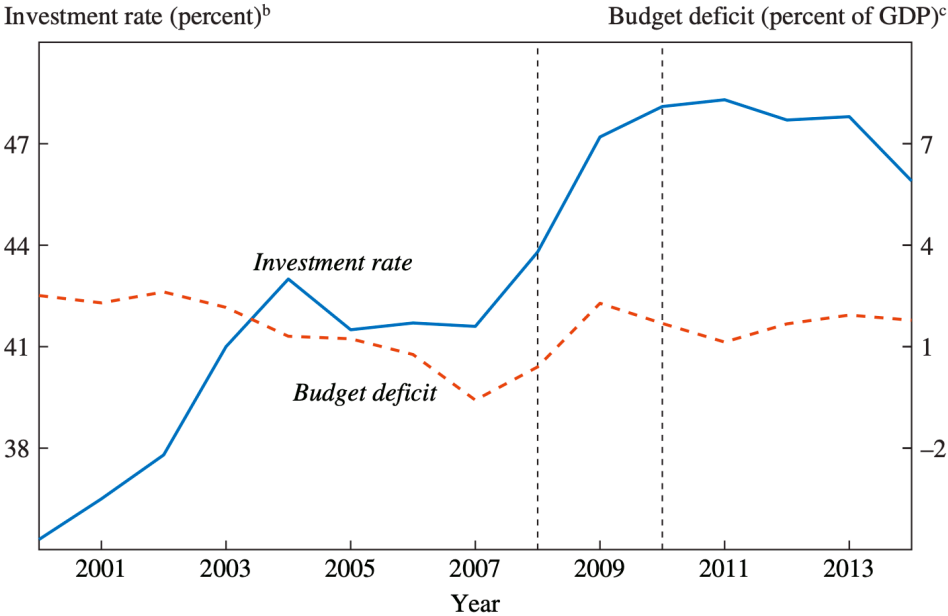
According to (Chi, 2019) there are basically two aspects in understanding the Local Government debt:

Explicit debt which is a part of local government budget liabilities that is recognized by the central government. The explicit debt is under regulations and includes local government bonds;

Implicit debts might not be under regulation and mostly includes the LGFVs which constitute off-budget borrowing and are not mostly recognized by central government.

LGFVs- a large part of China's local government debt. They are not a recent phenomenon, they have been in existence since 1980s when the first one was set up in Shanghai to facilitate local infrastructure development (Monson, 2015). According to International Monetary Fund report (Hui & Isabel, 2016), the LGFVs are 'off – budget' solutions used by sub-national governments (SNGs)

i.e. companies set up by SNGs to finance and develop infrastructure projects. In such case, the arrangement would be for local government to transfer the ownership of the plot of land to LGFV, and then it would use land as collateral to borrow from banks and shadow banks (Chong, Chang , & Zheng, 2017).By law, the local government are not allowed to borrow but since the late 1990s, many local governments started setting up such Special purpose vehicles (SPVs) to raise funds for facilitating various infrastructure projects. The pace of LGFVs debt accumulation has contributed substantially to increase in China’s overall debt level since Global Financial Crisis (GFC) of 2008-09 where Beijing injected 4 trillion Yuan into the system as a fiscal stimulus program (Naughton, 2008). From the stimulus plan, around 70 percent of the funds were required to be provided by the local governments and with local governments having lower financial revenue also contributed to the development of the LGFVs. According to the National Audit Office (NAO) investigation report, the debt in 2013 reached 17.9 trillion Yuan which was incremental compared to its 1.7 trillion Yuan in mid-2008 (Wang F. , 2019). This is also supported by the fact that in March 2009, the PBoC and China Banking Regulatory Commission issued a joint notice encouraging the use of LGFV (lib, 2009) financing. The borrowing thus took off, which also saw increase of establishment of LGFVs by 10,321 by 2009, an increase by over 7000 over 2008.



Source: National Bureau of Statistics of China.
a. The vertical lines indicate the beginning and end of the stimulus program worth 4 trillion yuan.
b. The investment rate is the gross fixed capital formation series provided by the National Bureau of Statistics.
c. The total deficit is the sum of the central and local government deficits.

(Chong, Chang & Zheng, 2017) paper argues that fiscal stimulus provided aftermath of 2008 financial crisis was just a partial liberalization. Through the figure above, they explain that financial constraints were only able to lift local government and not private institutions. For example, after the financial crisis 2008, the central government through its fiscal stimulus were able to allocate RMB 2.7 trillion for financing the local government's expenditure. But the total expenditure reached around 10 trillion RMB, which was four times of what central government had allocated (Haley & Haley, 2013). From it is evident that even after the stimulus program, the rate of investment had continued to increase for a while.

Institutional Framework

This section will briefly review the institutional mechanisms that have been put in place in regards to the local government debt. After the rapid growth of the LGFVs debt upon the 2008, the central government then began to pay attention and supervise them. In 2014, the State Council on its document 43 [point 4.] called for 'establishing local government debt risk early warning' mechanisms. Within this mechanism, the Ministry of Finance (MoF) calculates the debt rate, debt service rate, and other indicators based on general, special and contingent debt of each region, evaluates debt risk situation of each region and conducts risk in areas with high debt. The Ministry of Finance allocates debt quota to each province according to the proposals received from the provincial government (Chong, Chang & Zheng, 2017).

The government deployed three measures to control the increase of LGFV debt: a) overall fiscal measures, b) developing the domestic municipal bond market, and c) introducing PPP regulatory framework. Evaluating risks and with the new Budget Law revised in 2014, allowed the local governments to issue local government bonds within the ceiling set by the central government. Furthermore, the sub-regional debt limits are also determined by the Ministry of Finance within the scale of local government debt approved by the National

People’s Congress (Deux, 2018) where factors such as current financial situation or its status will be calculated and reported to the State Council for approval.

Date	Policies	Main Points
August 2014	New Budget Law	Local government will only use government bond to raise debt.
September 2014	Opinions on strengthening the administration of local gov. debts	1. Assess and clarify repayment obligations; 2. Three-year debt swap program;
December 2015	Opinions on implementation of quota management for local gov. debt	Top – bottom debt quota management system;
November 2016	Measure for budget management for Special and General Local Gov. debt	Sets specific practices of management of two types of local government debt;
March 2017	Measure for allocation of newly issued debt quota	Specifies a concrete formula for computing the quota for newly issued debt

List of Regulatory Policies after 2014.

According to the National Audit Office (NAO) report, the current LGFV debt in China is estimated to be between USD 4.2 trillion (30 trillion Yuan) to USD 5.96 trillion (40 trillion Yuan) (Lee, Coronavirus: China local government debt could hit record high as Beijing front-loads more bonds, 2020) which was significantly high as compared LGFV debt at 7.0 trillion RMB in 2016 (Hui & Isabel, 2016). Typically, before 2010 their transactions were not recorded on the budget nor were classified as budgetary units (Zhang & Li, 2016). However, upon the introduction of new regulations, the growth of LGFVs were prohibited from financing local government forward. According to the budget law before its revision in 2014, sub-national governments could not borrow the ‘on-budget’ without the central government’s approval (Jin & Rial, 2017). Because the local government bonds were limited and only provincial governments could issue bonds, some local governments instead opted for other means of financing some of which emerged within the system. For example, the central government began to promote Public Private Partnerships (PPP) after 2014. Prior to late 1990s, limited capacity of sub-national authorities added to higher degree of experience of foreign investors resulted in the early days of PPP model disproportionately benefiting to the private sector. After 2002, the use of PPPs gradually faded due to crackdown by State Council to renegotiate many existing PPPs. In all, Standard PPP projects did not increase the implicit debt of the local governments. However, in practice, some PPP projects were distorted: some local governments promised to gradually purchase partners’ shares at a fixed price in the future; some promised to guarantee the lowest

return (Chi, 2019). A senior official Zhu Mingcun, Vice-chairman of Standing Committee of NPC budgetary affairs commission acknowledged that some locales had off-balance sheet debts larger than their quota debt (Wang & Liu, 2019). Furthermore, the local governments were also involved in purchase of public services from the private sector and lease contracts to get financed (Shen, 2019). These practices increased the implicit debt where as the result MoF issued PPP re-evaluation to figure out if the PPP process has increased the off-budget investment (Jia, 2018).

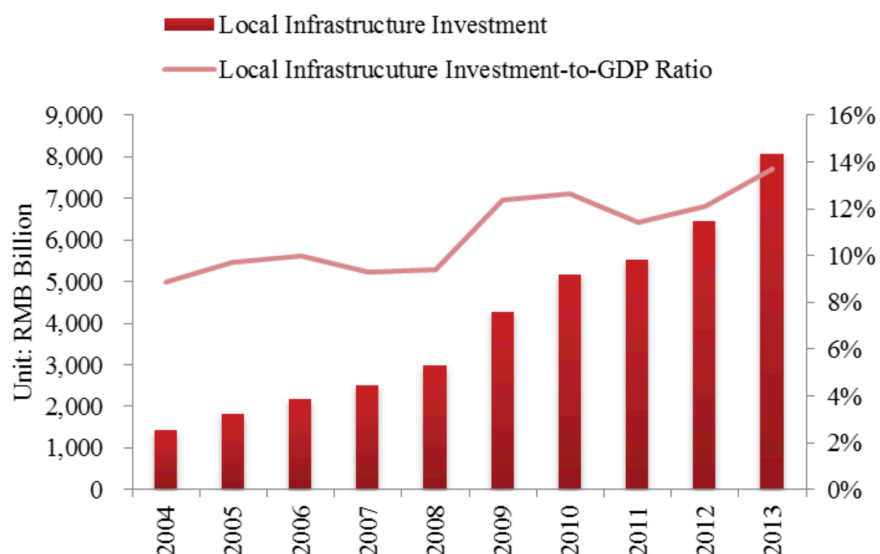
Relationship between Local Officials' Evaluation and Fiscal Expenditure

In China, local leaders have big influence in making macro-level decisions. Such decisions could include: giving tax breaks on certain industries, building commercial parks or relocating companies into certain sectors or zones. As China's bureaucracy entails promotion done through ranking and evaluation, the method of evaluating local leaders and their prospect for higher promotion is also substantially technical. The 'hard targets' were mostly economic in nature and during the reform and opening up era, these targets were quantifiable e.g. gross value of industrial output and the, total exports. This is because after 1978, local government gained more control over local affairs and the competition for became tough, officials would use any resource available to them, including the local fiscal expenditure to achieve their growth. One difficulty in regulating the local government debt is when central bank aims to achieve all three goals at the same time: economic growth, stabilize central government debt and stabilize local government debt (Zhenqian, 2016). Increasing fiscal expenditure might result in increase in debt while on the other hand, targeting debt level might limit the government's use of fiscal policy. Therefore, balancing these two aspects might make restrictions on local government debt difficult to sustain.

Similarly, pressure to outperform over others while prospect of getting promoted have led to increasing investment at an unprecedented scale for China. From the Figure 4, when making the five-year plan (2011 – 2015) , the Chinese central

government targeted a 7 percent national GDP growth rate, but all the provinces set higher GDP growth rate targets, ranging from 8 percent to 13 percent (Xun, 2015). Most of the risks of local government debt is undertaken by banks, which are the dominant institution in China’s financial system and local people’s congress has basically no influence on local government debt. Therefore, in order for escalating hurdles and gaining promotion, some officials would be willing to invest in livelihood – oriented projects as growth-oriented projects would be welcomed by everyone. In that sense, expenditures are also supervised strictly by the Local people’s congress.

The evaluation standard of local governance is the level of economic growth where the central government takes the economic growth as a target. (Ang, 2016) ...argues that the local government officials have to make an effort to increase GDP for promotion, or else they have to endure private benefits in hope to get promoted. As they have tendency to invest in infrastructure, the local officials put particular emphasis on investment from overseas, which is common practice in China. However, we know that the approval of such investment is held by top level officer under the system of competition for economic growth. The top person can or could make a judgment without scientific justification process. Besides, every local official has certain term in the office (i.e. 5 years) and to get promoted, the record must show significant or different investment during his/her term. To add on top, they seldom continue the projects initiated by their predecessor for they are not seen as their own personal contribution to the economic growth (Deux, 2018).



Source: NBS and WIND

Size of Local Infrastructure Investment.

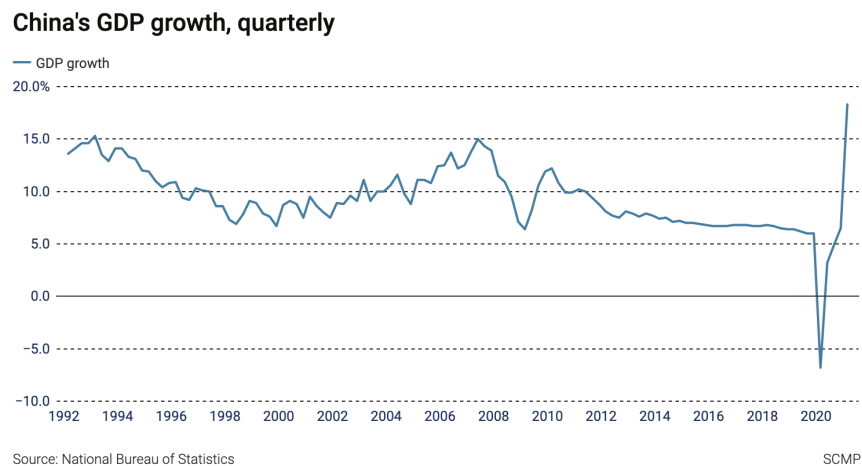
In that aspect, every local official would want to invest and approval authority from the top makes this feasible. This investment behavior causes local government with dire need to invest more frequently and thus they finance even more frequently. The same goes for taxation where a lot of taxation in terms of rates (Hui & Isabel, 2016) are decided by the central government and the local government could only increase the taxes for objects that are taxable, which is not possible usually in one term-period and hence they look for diverse source of investment.

Managing the Debt Risk and Current COVID-19 Crisis

One of the prime concerns about the Local government debt is its sustainability. Firstly, the local government debts remain localized. China's public debt is funded by domestic savings, denominated in RMB, thus ruling out a foreign-debt currency crisis (Chi, 2019). Furthermore, same article prevails the possibility for Beijing to service its debt problems as China constitute the highest savings rate in the world. Part of the regulations in an attempt to curb the local government rising debt and the LGFVs, the central government has allowed the local government to issue bonds subject to an annual cap as part of the efforts to reign in rising fiscal risks from local government's off-budget borrowing. Before 2015, local government bond financing was negligible due to central government restrictions. This restriction was determined by central bank while the annual cap on issuance of the bonds were determined through the National Congress (Raphael & Jingshen, 2018).

China's local debt burden could also be due to the fact that higher-level government's fiscal balance goals had led to shift in fiscal burden to lower-level governments. According to the Asian Development Bank report (Zhang & Li, 2016), as outlay responsibilities of county and township government are reduced, and provincial government play an important role in providing public service. Top level government determines the distribution of fiscal revenue and expenditure between themselves and lower-level governments and since they

would like to reduce their fiscal deficit, they could be retaining more revenue while leaving lower-level governments with more fiscal expenditure responsibilities. If every public service is made possible with standardized services and regulations with reduced burden for local governments, then the financial stability could be made possible.



China's GDP growth in 2020

According to Wind (HSN, 2020), borrowings from the LGFVs make up around 9.5 percent of China's total Yuan bond outstanding, which stands at around 102.3 trillion Yuan. The start of year 2020 saw "LGFVs raising USD 206 billion (1.46 trillion Yuan) between January to April" (Xie, 2020). On the other hand, the government is also issuing its "on-budget" borrowing to support the economy. Also known as 'special-purpose bonds' local governments are now close to using up the early allocation of 2020 bonds quota worth 1.8 trillion Yuan (Xinhua, 2020). According to Yang Zhiyong, researcher at the Chinese Academy of Social Sciences, "there is still room for expansion of local debt. However, considering the risks, more attention should be paid to actual projects" arguing to examine projects that were less economically valuable.

Large revenue and expenditure gap that persists in local government needs to be filled by central government fiscal transfers which in turn calls for 'round table' negotiations between the two sides. Through delegation of administrative tasks also requires fiscal support at the same. There needs to be a proper intergovernmental reform align plan that aims to realign transfer mechanisms from top-down and centralized role of central government in burden-sharing.

In such regard, the central government has to play a dominant role in maintaining consistent fiscal policy in China's local government debt. Because the central bank possesses large sum of fiscal revenue and balances, in times when the economy is slowing down, the central government should be able to increase the fiscal transfer to the local government, rather than loosening the restrictions to them only to accumulate more debt. This is because, according to the Brookings report (Chong, Chang , & Zheng, 2017), evidence found that after scaling the debt – revenue ratio back in 2010 – 2011 through the fiscal stimulus program, listed firms since then continued to expand their debt at a much faster rate relative to their revenue. Furthermore, according to IMF country report 2018, while the corporate debt to GDP ratio had stabilized, government and especially household debt is continuing to rise by continued strong off-budget investment (IMF, 2018). Furthermore, with Beijing's introduction of policies to increase transparency across the regional administration, local governments are now relying more on 'municipal bonds' (Deux, 2018) authorized and 'on par with budget' by the government which will help the central government keep track record and organize local government spending.

Conclusion

This paper has focused on China's local government debt, in particular after the Global Financial Crisis 2008 where the government planned the fiscal stimulus program. In particular, doing this research has led to exploration that while the 2007 fiscal stimulus plan did not work out well for curbing local government debt, there are further reasons as well. For instance, one could argue that the existing situation of local government could be from the result of "competition for economic growth" where activities such as 'promotion tournament' prompts for more debt rather than its resolution. Also, there is a required persistent role of central government in order to solve the local debt problem. Firstly, it is evident that current role of central government could be correlated to "ordering dish" while the local government "paying the bills" (Zhengping & Genliang, 2019). In order words, role of central government has been targeting setting while local government aims to fulfill it without proper fiscal transfer or support. The same problem could exist within local governments at different sectors or

levels in a province. In such regard, the central government should provide ease on transfer payments to local governments that will help to improve the basic services.

There should be more reforms made in terms of intergovernmental relations so as to increase the availability of resource and support to the local government. By doing so, it could further reduce the burden of the local government in some sectors where the central government could be actively looking into, and allows them to focus on financial stability undertaking ‘right’ projects.

Looking forward, more rules-based approach in terms of revenue-sharing could lead to more openness and predictability as a result of local-government funding. Timely disclosures could play a big role in improving credit towards local government financing and among to investors. Such disclosures, according to IMF working paper on LGFVs, could include status of balance sheet, debt situation and risks in fiscal situation and the like which can further help the local governments adjust policies as per the funding provided. Therefore, in all of these circumstances, we see a big role central government could play in managing and sustaining the local government debt.

Furthermore, China’s GDP growth fell by 6.8 percent in the first quarter of 2020 while some analysts including rating agencies like Moody’s (Tang, 2020) warned that greater infrastructure spending with reduced economic growth could lead to “local government’s financial risks amid a sharp slowdown in tax revenues”. Despite the central government trying to compress down on ‘off-budget’ borrowings in recent years, it is forced now to raise funds by increasing the limit for local governments to issue bonds for infrastructure spending in an effort to boost economy amidst the COVID19 pandemic. As local government tax revenues are expected to decline in 2020 by 200 billion Yuan, it could have a significant long-term impact on debt repayment. Excessive investment projects without generating sufficient revenue, according to China Power, brings limited productivity and “increasingly inefficient use of credit [...] and deteriorating capacity to repay existing debt”. The increasing LGFV borrowings come at a time when there are growing concerns of impact on debt to other countries through its ‘Belt and Road Initiative’. Much remains to be seen how China’s fiscal policy will determine the stability of both its domestic debt level, and also

external debt as BRI even though it remains an attractive investment for developing countries around the world.

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