Local Government Debt Structures in China and the Central Government’s Response

By Junya Sano
Senior Researcher
Economics Department
Japan Research Institute

Summary

1. There has been growing concern about the debt problem in China, especially with regard to local government finances. In 2013 the Xi Jinping administration responded to this situation by conducting a nationwide audit (“the 2013 audit”). Data from this audit were used to predict the level of central and local government debt at the end of 2013 and 2014. According to these forecasts, while the scale of this debt is expanding, as a percentage of GDP, it is not especially high when compared to debt levels in other countries.

2. From a qualitative perspective, however, there are various fundamental issues relating to local government debt, and a number of problems were identified by the National Audit Office as a result of the audit. First, funding for loan repayments is heavily dependent on the sale of land. Second, there is a heightened risk that repayment plans will be derailed. Third, there have been continual regulatory violations. In addition, a comparison with the first accounting audit of local government debt, the results of which were published in 2011, revealed that “shadow banking” has become the main source of borrowed funds for local governments, and that state-owned enterprises have become major borrowers. This has become a source of increasing concern about local government debt problems.

3. The Chinese government has been focusing on measures to avert (reduce) the risk of bankruptcies among local governments and financial institutions. However, measures to strengthen management of local government financing vehicles and other entities could make it more difficult for local governments to raise finance, causing them to turn to higher-risk sources of finance.

4. The Xi Jinping administration is starting to reform local government finances and taxation systems. Some of the individual measures applied include a gradual increase in issues of local government bonds, and pilot schemes involving the taxation of private homes in some regions. The reforms are based on a policy that calls for stronger debt management and other improvements, while allowing local governments to exercise increased discretion.

5. The benefits of a reasonable increase in local bond issues would include not only the reduction of the risk of financial collapse, but also an improvement in the transparency of debt. Furthermore, since 2014 marks the first bond maturity peak, the government is likely to tolerate the refinancing of local government bonds as high-interest short-term debt as an emergency measure. However, the expansion of local government bond issues could lead to increased moral hazards for senior local government officials. China needs to improve the legal frameworks used to curb irresponsible increases in local government bond issues.

6. Consistency between policies will be a key priority in terms of improving the soundness of local government finances. For example, attempts to replace business taxes with value-added taxes would lead to a decrease in local government tax revenues. In order to avoid impoverishing local government finances, it will be necessary to change tax revenue allocations and take additional steps to strengthen the taxation base. It will also be necessary to secure appropriate tax levies from individual homeowners by simultaneously reforming tax systems relating to house ownership and real estate registration systems.

7. The solution of local government debt problems will require a combination of medium- to long-term reforms and short-term measures, based on an awareness of the possible disadvantages, and accompanied by efforts to ensure policy compatibility. The Xi Jinping administration has few options in terms of the countermeasures that it can deploy, and the difficulty of the problem continues to grow.
Introduction

Attention has increasingly focused on local government finances in China since 2013. This heightened interest was triggered by comments made by Xiang Huaicheng, a former Minister of Finance, at the Boao Forum in April. Mr. Xiang said that in his personal opinion, the balance of local government debt could be in excess of 20 trillion yuan. This issue has since been a focus of shared concern within China and internationally, with several international rating companies and official agencies identifying the financing methods of local governments and the debt problem as a serious risk factor affecting the Chinese economy. The Xi Jinping administration has responded to this situation by accelerating its efforts to tighten control over local government debt. Those efforts have included two nationwide audits since 2011.

The purpose of this article is to forecast the scale of central and local government debt, to clarify the results of the latest accounting audit and the problems identified as a result of progress toward local financial and taxation reforms, and to examine the likely impact of countermeasures.

This article consists of three sections. In Part 1 we will review the reasons for the heightened concern about the sustainability of local government finances in China. We will also use the results from the latest audit conducted by China’s National Audit Office to forecast the scale of government debt at the end of 2013 and 2014 in order to ascertain whether or not the situation has become dangerous from a quantitative viewpoint. In Part 2, we will identify likely risks and issues based on an analysis of (1) the tightening of controls over shadow banking and the local government-affiliated financing companies known as “local government financing vehicles,” and (2) the contrast between the increased autonomy granted to local governments and financial and taxation reforms that will require local governments to strengthen their debt management. In Part 3, we will examine how the Chinese economy will be affected by short-term measures that are likely to be implemented based on past bankruptcy cases, such as the failure of an international trust & investment company in the late 1990s.

1. Quantitative and Qualitative Problems Surrounding Local Government Debt

(1) Two Factors Leading to Increased Concern about Local Government Finances

Since 2013 there has been increasing concern within China and internationally about the sustainability of local government finances. This is attributable to the following two factors.

First, the high growth achieved by the Chinese economy in the past cannot be expected to continue. China’s real GDP growth rate generally remained over 10% in the 2000s, but it has fallen to single figures in each of the three years since 2011. The growth rate in both 2012 and 2013 was 7.7%, which is the lowest level since 1999 (7.6%).

Continued high economic growth would result in a natural increase in tax revenues, allowing the government to expand revenues without raising tax rates. On the other hand, slower growth means stagnating tax revenues. In the past, central and local government tax revenues expanded at a faster pace than the growth of nominal GDP, but in recent years, slower economic growth has been paralleled by stagnating revenues (Fig. 1).

In addition, the income that local governments earn by selling land is also expected to stagnate as the growth rate slows(1). According to the special account budget for 2012, income from the sale of land use rights declined by 14.4% year on year to just under 2.7 trillion yuan. If income from land sales, which accounts for the bulk of local government special accounts, continues to decline and no adequate alternative source of revenues can be found, there will inevitably be increased concerns about the capacity of local governments to repay debt.

Second, there has been a dramatic worsening of the fiscal balances (general account basis) of individual regions. Annual data for outstanding central government bond issues have been pub-
lished since 2005. However, no data are published concerning local government debt. In June 2011, the National Audit Office revealed the results of the 2011 account audit, which showed that outstanding local government debt had reached 10.7 trillion yuan as of the end of 2010. However, no nationwide survey has been carried out since that time, with the result that the level of local govern-

ment debt has been the subject of conjecture and estimation since 2011(2).

Until the mid-2000s, the fiscal deficits of local governments amounted to several hundred billion yuan per year. The amount has continued to increase rapidly since then, exceeding 4 trillion yuan in 2011 and 5 trillion yuan in 2013. This increase appears to have resulted from the preoccupation of local governments with high growth, and from the fact that local governments needed to undertake expenditure substantially in excess of their independent revenues because, according to Minister of Finance Lou Jiwei, items that should have been handled by the central government were left to local governments(3). Delays in disclosing information about local government debt and the expansion of fiscal deficits are responsible for the continual rise in concern about the sustainability of local government finances.

This situation has led one expert after another to suggest that local government debt has become a serious issue for the Chinese economy. This began with a statement by Xiang Huaicheng, a former Minister of Finance, at the Boao Forum on April 6, 2013 (Table 1)(4). When asked about the local government debt problem, Mr. Xiang admitted that there was a lack of transparency, and that the

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| April 6    | Former Minister of Finance Xiang Huaicheng | • The level of transparency concerning local government debt is not high, and the statistical data are inaccurate.  
• Local government debt may have exceeded 20 trillion yuan at the end of 2012. |
| April 9    | Fitch Ratings                      | • The lack of transparency surrounding local government debt is worse than in other countries.  
• There is a risk that local governments will incur substantial contingent debt resulting from the liabilities of government-affiliated companies. |
| April 16   | Moody’s Investors Service           | • The increasing reliance of local governments on land sales has had a significant impact on real estate markets, and there is a growing need for central government support to restore soundness.  
• Efforts to improve transparency about the contingent liabilities of local governments and curb the rapid expansion of credit have not made as much progress as hoped. |
| July 17    | IMF                                | • Local government finances, including funds procured by local government-affiliated companies, are regarded as one of the most serious risk factors for the Chinese economy. |
| October 7  | World Bank                         | • The growth of local government debt, and the complexity and opaqueness of the method used to raise funds are a matter of serious concern. |

Source: Combined by JRI using press releases and media reports
statistical data were inaccurate. He also indicated that local government debt may have exceeded 20 trillion yuan at the end of 2012, and that the sum of central and local government debt could have reached over 30 trillion yuan. Mr. Xiang emphasized that he was just stating the views of an individual who no longer held an official position. However, his status as the person who formerly headed China’s Ministry of Finance ensured that his comments received wide coverage and raised doubts within China and internationally about the state of local government finances.

Three days after Mr. Xiang’s comments, Fitch Ratings lowered the rating of yuan-denominated long-term government bonds by one rank, mainly because of the lack of transparency concerning local government debt. Moody’s initially left its rating unchanged, but on April 16 it lowered the outlook from “positive” to “stable.” The fragility of local government finances and the lack of transparency were also cited by Moody’s as reasons for this change.

In its annual report on the Chinese economy (published in July), the IMF estimates that the balance of government debt reached 45% of GDP at the end of 2012. While concluding that this level of debt would be “manageable,” the IMF also identified local government finances, including funds borrowed by local government-affiliated companies, as a key risk factor in the Chinese economy\(^{(5)}\). The World Bank’s *East Asia Pacific Economic Update* for October 2013 similarly lists the growth of local government debt and the lack of transparency about the procurement of funds as a “special concern”\(^{(6)}\).

The fact that major rating companies and official organizations have one after another expressed concern about local government finances has raised awareness that the reduction of the risk of local government bankruptcy is a vital requirement for the sound development of the Chinese economy.

### (2) Forecasting the Scale of Government Debt in China

In response to these expressions of concern from within and beyond China, the Xi Jinping administration has stepped up its efforts to clarify the real situation surrounding local government debt. In August and September of 2013 it conducted its second nationwide audit (the “2013 Audit”)\(^{(7)}\).

Included in the results of the 2013 Audit were balances and breakdowns for central and local government debt as of the end of December 2012 and the end of June 2013. Based on these results and a number of premises, we can forecast the balance of government debt at the end of 2013 and 2014 (See Column). If government debt is defined solely as the share of debt that central or local governments are liable to repay (government repayment liabilities), the balance of local government debt at the end of 2013 was 11.7 trillion yuan, or 20.5% of GDP (Fig. 2). If central government debt is included, the total rises to 21.9 trillion yuan, or 38.5% of GDP. By the end of 2014, local government debt is expected to reach 11.8 trillion yuan and central government debt 14.0 trillion yuan, making a total balance of 25.9 trillion yuan, or 40.2% of GDP.

However, the real level of government debt needs to be monitored using stricter criteria. There are also contingent liabilities, which are debts for which the government has only provided guarantees or may be required to provide a certain level of support. If these are included in the total, the balance of government debt at the end of 2013 was 32.4 trillion yuan (local government: 19.5 trillion yuan, central government: 12.9 trillion yuan), or 57.0% of GDP (Fig. 3)\(^{(8)}\). Government debt calculated on this basis is expected to reach 38.4 trillion yuan, or 59.7% of GDP, by the end of 2014. Whichever calculation method is used, it is clear that both the scale of government debt and the ratio to GDP have risen year after year.

Yet the ratio of China’s government debt to GDP is generally low compared with the main advanced and developing countries. Moreover, the Chinese Academy of Social Sciences, a government research institute, calculated government sector assets and liabilities and estimated that net assets amounted to 21.6 trillion yuan in 2011\(^{(9)}\). In addition, China’s current account balance has remained positive, and the balance of household
According to the National Audit Office, income from the transfer of land-use rights (i.e., land sales) was expected to pay for repayments of 3.5 trillion yuan out of the 9.4 trillion yuan debt balance of 11 province-level entities (provinces, directly controlled municipalities, autonomous regions), 316 cities and 1,396 counties. This is equivalent to 37.2% of total debt, which is still high despite a moderate (0.8% points) decline since the 2011 nationwide survey of local government debt (the “2011 audit”). Debt repayments could be hindered if income from land sales fails to increase as much as anticipated due to the economic slowdown. Concern about this problem is believed to have prompted the National Audit Of-

savings also continues to expand. When these factors are taken into account, the likelihood of a fiscal collapse in China seems low.

(3) Problems in Local Government Finances Highlighted by 2013 Audit

The real fundamental problem in relation to local government debt in China is uncertainty caused by the structure of the debt. Three qualitative problems were identified in the 2013 audit: (1) heavy reliance on land sales to fund repayments, (2) an increased risk, albeit localized, that repayment plans could be derailed, and (3) continual regulatory violations. 

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(1) Nominal GDP in 2014
⇒ This was calculated using the state fiscal deficit indicated in the March draft budget (1.35 trillion yuan) and the ratio of that deficit to GDP (2.1%).

(2) Rate of increase in balance of central government debt
⇒ The year on year rate of increase of central government debt in 2013 was deemed to be the average rate of increase based on the actual figures at the end of December 2012 and the end of June 2013 (8.1%).
⇒ The ratio of the government bond balance ceiling stipulated in the budget to actual issues was calculated, and the resulting value (16.1%) was assumed to represent the rate of increase in central government debt in 2014.

(3) Rate of increase in balance of local government debt
⇒ The average year on year rate of increase between 2011 and 2013 was calculated using the results of the 2011 and 2013 audits. That figure, 21.3%, was deemed to be the rate of increase in 2013.
⇒ It was assumed that the increase in new debt would slow moderately in 2014, in part because of the effects of measures introduced by the Xi Jinping administration to strengthen debt management, and the rate of increase was therefore set at 20.0%.

(4) Balance of local government debt in 2011 (not published by the National Audit Office)
⇒ The balance was calculated using audit results published in June 2013 for the 36 local governments (mainly province-level cities). The ratio of new debt in 2011 to total new debt in 2011 and 2012 was first calculated (36%). The debt balance of the 36 local governments at the end of 2012 was approximately 440 billion yuan higher than at the end of 2010. The debt balance of the 36 local governments at the end of 2011 was estimated by multiplying this increase by the aforementioned percentage and adding the result to the debt balance at the end of 2010. A year on year rate of increase of 4.7% was then calculated by again comparing the result with the debt balance of the 36 local governments at the end of 2010. This was assumed to represent the year on year rate of increase in the local government debt balance in 2011 and was applied to the local government debt balance at the end of 2010 in order to estimate the local government debt balance in 2011.
also shows that there have been changes in two significant aspects of local government debt (11). First, shadow banking has become a major source of finance for local governments and local government financing vehicles (finance companies affiliated to local governments) (12). If we define shadow banking as borrowing from non-bank financial institutions, and the raising of capital subscriptions, which are two of the categories of financing methods referred to in the 2013 audit, then shadow banking is the next biggest source of finance after bank loans and bond issues, accounting for 10.3% of the 17.9 trillion yuan balance of local government debt as of the end of June 2013 (Fig. 5). (This figure includes contingent liabilities. The same will apply in the remainder of this article.) This type of financing was not covered in the 2011 audit, and urgent action is needed.

According to the 2013 audit, a total of 210 local governments (two province-level entities, 31 cities, 29 counties and 148 towns and townships) used new loans to finance over 20% of repayments of existing debt in 2012. Judging from the language used in the commentary on this finding, the report emphasizes that there is no generalized problem but suggests that there is concern about defaults by some local governments. A breakdown by administrative level shows that city-level governments have the most debt, followed by county-level entities (Fig. 4). There is a need for improved risk management for city-level and county-level governments, which have less capacity to procure finance than province-level governments.

The main types of regulatory violations are the use of illegal methods to procure finance, the provision of collateral by local governments, and the investment of borrowed funds in the capital and real estate markets.

A comparison with data from the 2011 audit also shows that there have been changes in two significant aspects of local government debt (11). First, shadow banking has become a major source of finance for local governments and local government financing vehicles (finance companies affiliated to local governments) (12). If we define shadow banking as borrowing from non-bank financial institutions, and the raising of capital subscriptions, which are two of the categories of financing methods referred to in the 2013 audit, then shadow banking is the next biggest source of finance after bank loans and bond issues, accounting for 10.3% of the 17.9 trillion yuan balance of local government debt as of the end of June 2013 (Fig. 5). (This figure includes contingent liabilities. The same will apply in the remainder of this article.) This type of financing was not covered in the 2011 audit, and debt procured from sources other than bank loans, bond issues and government funds from higher-tier governments accounted for only 9.8% overall. This change is indicative of the rapid growth of shadow banking as a major source of finance for local governments.

Finance obtained through shadow banking has shorter maturities than bank loans, and interest rates are higher. The rise in the percentage of debt
procured through shadow banking will increase the risk of local government debt defaults. Furthermore, the laxity of related regulations has allowed funds obtained through shadow banking to be diverted into projects that are unlikely to yield returns, and there is uncertainty about who will ultimately be liable for repayment of the debts.

Second, state-owned enterprises have emerged as a third category of borrowers. We cannot determine from the 2013 audit whether the proportion of debt incurred by state-owned enterprises has increased or decreased. However, there is evidence that the debts of wholly state-owned enterprises and holding companies had reached 3.1 trillion yuan, or 17.5% of total local government debt. It is possible that state-owned enterprises are functioning as an alternative financing route in place of financing vehicles. (The tightening of controls over local government financing vehicles will be discussed in Part 2.) Given the limited governance capabilities of state-owned enterprise, the expansion of financing via state-owned enterprises could heighten the risk of fiscal collapse among local governments.

2. Chinese Government Initiatives to Solve the Local Government Debt Problem

In addition to its efforts to monitor the local government debt situation, the Chinese government is also focusing on measures to mitigate the risk of local government fiscal collapse and the bankruptcy of financial institutions. At the Third Plenum (the Third Central Committee Plenum of the 18th Party Congress of the Chinese Communist Party) in November 2013, the Xi Jinping administration identified fiscal and taxation reform as one of its economic reform priorities\(^\text{(13)}\). In this section, we will gauge the progress made toward (1) the tightening of controls over local government financing routes, and (2) fiscal and taxation reforms in relation to local government finances. We will also analyze some of the challenges in these areas.

(1) Tighter Control over Local Government Financing Vehicles, etc.

The central government is strengthening controls over local government financing with the aim of reducing the risk of fiscal collapse\(^\text{(14)}\). The first target will be local government financing vehicles.

Local government financing vehicles have supplemented fiscal resources by raising large
amounts of money over short periods for investment in various types of projects. This approach clearly made a significant contribution to the implementation of large-scale stimulus measures after the Lehman shock, and also to infrastructure development. However, a lack of transparency in the operations of these companies and the financing processes employed has heightened fears of local government fiscal collapse.

In June 2010, the State Council (central government) announced that since there were now clear signs of economic recovery, it would strengthen controls in this area, including settlement of the debts of local government financing vehicles and the liquidation of the companies, as well as measures to prevent the illegal provision of guarantees by local governments (Table 2)(15). Since then a series of measures have been introduced with the aim of tightening controls over financing by local government financing vehicles. Of particular importance was the notice issued by the National Development and Reform Commission in December 2012, which defined regulations limiting issues of urban investment bonds by local government financing vehicles with low credit ratings. This can be seen as an important measure designed to prevent debt defaults(16).

The financial regulatory authorities have also moved to tighten controls on lenders to local government financing vehicles. For example, the China Banking Regulatory Commission has adopted policies and specific standards including qualifications for new borrowers, and limits on lending to financially weak local government financing vehicles.

| Table 2 Tightening of Controls over Local Government Financing Vehicles |
|---------------|---------------------------------|-------------------------------------------------|
| Date          | Issuing Agency                  | Name of Notice/Opinion                          | Main Content                                                                 |
| June 2010     | State Council                   | Notice Regarding the Issues of Strengthening the Management of Local Government Financing Vehicle Companies | • Requirement for local governments and central government agencies to implement measures centering on (1) checking and appropriate disposal of debts incurred by local government financing vehicles, (2) the liquidation and institutionalization of local government financing vehicles, (3) the reinforcement of controls over the provision of credit to local government financing vehicles, and (4) the prevention of illegal actions by local governments in relation to guarantees and approvals |
| December 2012 | National Development and Reform Commission | Notice Concerning Issues Relating to the Further Reinforcement of Measures to Manage Corporate Bond Risks | • Screening of bond issuing companies according to standards (e.g., bond issues not allowed if the asset-liability ratio is over 90%, guarantees required in principle if the ratio is 80-90%) • Requirement to obtain a guarantee or security (e.g., a repurchase agreement with a government or a company with a high credit rating) if the rating of the issuer of urban investment bonds (bonds issued by local government financing vehicles) is AA- or lower |
| December 2012 | Ministry of Finance, National Development and Reform Commission, People's Bank of China, China Banking Regulatory Commission | Notice Concerning the Prevention of Illegal Financing Actions by Local Governments | • Prohibition on the use of government buildings, schools, hospitals and other public assets to inject capital into local government financing vehicles • Prohibition on raising of finance from finance companies and trust companies, etc., by local government financing vehicles (except where allowed by law or under State Council regulations) |
| March 2013    | China Banking Regulatory Commission | Notice Concerning Problems Relating to Investment Operations by Commercial Banks for Wealth Management Services | • Adoption of policies, including quantitative limitation of trust lending and entrusted lending, etc., individual management and information disclosure for wealth management products |
| April 2013    | China Banking Regulatory Commission | Notice Concerning the Strengthening of Supervision and Management of Risks on Loans to Local Government Financing Vehicles | • Adoption of policies, including limitation of new lending (lending allowed only for projects approved by the State Council, and for which the organization has already paid in its own funds), limitation of lending to financially weak local government financing vehicles (percentage of lending limited to previous year's level or lower) |

Source: Compiled by JRI using Sekine, E., Chugoku no Chiho Saimu wo Dono Yo ni Toraseru Beki na no ka[How Should Local Government Debt in China be Viewed?], P40, and various media reports
vehicles\textsuperscript{(17)}.

A comparison between the 2011 and 2013 audits shows while the financing procured through local government financing vehicles expanded in terms of the amount of funds procured, it decreased as percentage of total local government debt (from 46.4% at the end of 2010 to 39.0% as of June 30, 2013). This can be seen as an indication that the tightening of controls from the lender side has started to yield results.

The next area targeted for stronger control measures was shadow banking. In December 2012, a notice was issued prohibiting the procurement of funds (loans) from finance companies and trust companies by local government financing vehicles, except where permitted by law or State Council regulations\textsuperscript{(18)}. Another issue raised in relation to shadow banking was the fact that funds gathered from investors are managed as a single pool of money, making it difficult to ascertain the local government investment project or financing vehicle to which the money was ultimately lent. To remedy this lack of transparency, the China Banking Regulatory Commission introduced regulations requiring commercial banks to provide individual management and information disclosure for each wealth management product.

(2) Reform of Local Government Finances and Taxation

We will now analyze local government finance and taxation reforms implemented by the central government over the past few years, and reform policies announced by the Xi Jinping administration at the Third Plenum, including reforms relating to local government fiscal management methods and sources of funds. One of the most significant central government reforms relating to local government finances and taxation is the gradual expansion of local government bond issues. Article 28 of the Budget Law, which took effect in 1995, prohibits the issuance of local government bonds by local governments except where permitted by law or under State Council regulations\textsuperscript{(19)}. This provision is still in effect. However, faced with the need to implement large-scale stimulus measures (public works) under local government leadership after the Lehman shock, the central government partially lifted the ban on local government bond issues\textsuperscript{(20)}.

Specific measures have included the proxy issuance of local government bonds and the integrated proxy repayment of principal and interest by the Ministry of Finance since the 2009 budget\textsuperscript{(21)}. Under this system, issuance amounts are determined on the basis of applications from local (provincial-level) governments and must be ratified by the local People’s Congress at the budget compilation stage\textsuperscript{(22)}. This is different from the system under which funds procured through central government bonds are sub-lent to local governments.

In 2011, the Ministry of Finance gave permission for Shanghai Municipality, Zhejiang Province, Guangdong Province and Shenzhen City (Guandong Province) to issue local government bonds autonomously (Table 3). Initially they were allowed to issue only three-year and five-year bonds, but in 2012 approval was also given for issues of seven-year bonds. In 2013, Shandong Province and Jiangsu Province were added to the list of local governments selected for the local government bond issuance pilot program.

At the Third Plenum in November 2013, the Xi Jinping administration approved bond issues by local governments for the purpose of infrastructure development. The number of local governments participating in the local government bond issuance pilot program and the amount of funds that can be issued are expected to expand gradually under this policy.

Even bond issues under the independent local government bond issuance pilot program are sub-

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<td>Selection of Shanghai Municipality, Zhejiang Province, Guangdong Province and Shenzhen for the local government bond issuance pilot program</td>
<td>2011</td>
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<tr>
<td>Approval for issues of seven-year bonds as well as three-year and five-year bonds</td>
<td>2012</td>
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<tr>
<td>Addition of Shandong Province and Jiangsu Province to the list of local governments selected for the local government bond issuance pilot program</td>
<td>2013</td>
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Source: Ministry of Finance
The collection of revenues under house property tax system as an urgent priority so that local governments can maintain their fiscal revenue levels while reducing their reliance on land sales and transactions. At the Third Plenum, the Xi Jinping administration stated that it would deepen fiscal and taxation reforms. It also announced the following policies concerning local government finances and taxation.

In relation to fiscal policy, the administration responded to the deterioration of fiscal balances by announcing a policy calling for (1) the clarification of local government expenditure responsibilities, and (2) the establishment of fiscal systems that are commensurate with the administrative authority and expenditure obligations of central and local governments (Table 4). From the viewpoint of providing efficient services, there will be changes to the way administrative authority is shared between the central and local governments. For example, the central government will be responsible for the development and management of market rules, while responsibility for some aspects of social security and public works that span multiple regions will be shared by central and local governments, and local governments will be responsible for local public services.

Under this basic policy, the government has introduced reform measures based on a “carrot and stick” approach. Local governments will be given

### Table 4  Local Government Fiscal and Taxation Reforms

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<th>Target</th>
<th>Basic Policies/Principal Measures</th>
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<td>Fiscal systems</td>
<td>• Establishment of fiscal systems under which administrative authority is commensurate with spending responsibilities, reinforcement of central government’s administrative authority and expenditure responsibilities</td>
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<tr>
<td>Budget management</td>
<td>• Audits to focus on purpose of expenditure and policy measures rather than the balancing of revenues and expenditure and the size of deficits</td>
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<td>• Fiscal transfers from central to local governments to be based in principle on general transfer payments (tax allocation grants to local governments), special item transfer payments (payments from the national treasury) to be reviewed</td>
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<tr>
<td>Government debt</td>
<td>• Local government bond issues to be allowed as a way of procuring funds for urban infrastructure development</td>
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<tr>
<td></td>
<td>• Establishment of government debt management and risk warning systems, amount of new debt to be used as a key indicator for personnel assessments</td>
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<tr>
<td>Land</td>
<td>• Reduction of scope for land appropriations, improvement of compensation systems for farmers whose land has been appropriated</td>
</tr>
<tr>
<td>Taxation</td>
<td>• Improvement of local government taxation structure and review of tax revenue allocations, tightening of controls of tax incentives provided by individual local governments</td>
</tr>
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</table>

Source: Compiled by JRI from Xinhuanet, Zhonggong Zhongyang Guanyu Quanmian Shenhua Gaige Ruogan Zhongda Wenti de Jueding (CPC Central Committee Decision on Major Issues Concerning Comprehensively Deepening Reforms)
greater discretion and allowed to strengthen their own fiscal resources, but they will also be required to manage their finances appropriately, including the improvement of debt management.

Among the measures that will expand the discretion of local governments is the decision to allow the use of bond issues to finance urban infrastructure, as noted in the previous section. The discretionary powers of local governments in relation to fiscal management will also be increased by other measures. First, the system of fiscal transfers from central to local governments will be reformed to create a system based in principal on general transfer payments (tax allocation grants to local governments), leading to the reduction of central government subsidy payments for specific projects. Second, there will be a change in the emphasis of budget audits, which will focus on the achievement of balance across multiple years rather than in each individual year, and on the purpose of expenditure and the content of fiscal policy.

The government has also indicated that local government taxation systems will be overhauled. Specific measures include tighter control over preferential tax systems introduced independently by local governments, the acceleration of work on the drafting of laws covering real estate taxation, the acceleration of resource taxation reforms, and the reinforcement of consumption tax systems. Apart from the tightening of controls over independent preferential tax systems, these measures are likely to have the effect of expanding the discretion of local governments and strengthening their taxation bases.

At the same time, the government has clearly stated its intention to require local governments to manage their finances appropriately. For example, the central party has indicated that it will make the amount of new debt a key indicator for performance assessments as a way of curbing the tendency of local governments to boost their GDP growth rates by using bond issues to finance increased fiscal expenditure. The requirement to produce balance sheets can be interpreted as having the same goal.

Other reforms call for the reduction of the scope of land appropriation, and the improvement of compensation systems for farmers whose land is taken. The aim of this measure is to end the practice of earning large revenues at low cost by appropriating land cheaply and selling it at high prices. However, the realization of this goal will not be easy. Policies and measures relating to local government fiscal and taxation reform have continued since the Third Plenum. The level of activity surrounding local government debt management has been especially intense. For example, the control of risks relating to local government debt and the solution of the problem were key economic management items discussed at the Central Economic Work Conference in December 2013. Also in December, the Organization Department of the Communist Party of China Central Committee, which is responsible for personnel assignments, issued a new notice concerning performance assessments for senior local party and government officials. This notice also referred explicitly to the importance placed on the local government debt situation.

(3) Challenges

In this section, we will identify the challenges for China’s efforts to solve China’s local debt problems by analyzing the progress made toward the reinforcement of debt management and the reform of local fiscal and taxation systems. As described below, there are three main challenges.

First, measures to strengthen debt management could make it more difficult for local governments to procure finance, thereby increasing rather than decreasing the risk of fiscal bankruptcy. The imposition of stringent limits on bond issues by local governments can be justified as a way of reducing fiscal deficits and government debt throughout China. However, local governments have funded their ongoing investment in public infrastructure by issuing bonds through local government financing vehicles and obtaining loans from banks. The use of financing via local government financing vehicles have undeniably had the effect of reducing the transparency of related information, such as the purpose for which funds will be used, and the prospects for repayment, compared with
direct bond issues by local governments.

Subsequent moves to tighten controls over local government financing vehicles, as outlined above, have started to slow the rapid expansion of debts incurred by these organizations. From the viewpoint of banks, these measures to strengthen debt management will help to reduce the risk that their loan assets will become unrecoverable. With their access to bank finance cut off, however, local government financing vehicles have increasingly shifted to shadow banking, which involves higher costs than bank finance, with the result that the risk of bankruptcies among local government-owned companies has in fact increased.

If measures to tighten controls over shadow banking are effective, local governments will increasingly procure finance through local state-owned enterprises or via other channels. This situation could lead to increased debt service burdens and even less transparency, and it is essential that such behavior by local governments is prevented through debt monitoring or stronger regulations. At the same time, without efforts to expand highly transparent low-risk financing channels, China will be unable to eliminate the risk that local governments with cash flow problems will turn to high-risk financing methods.

The second challenge is to ensure that the expansion of local government bond issues is appropriate, and that effective debt management is maintained.

Compared with shadow banking or bond issues by local government financing vehicles, local government bond issues provide access to finance over longer terms and at lower interest rates. In addition, local governments can be expected to take steps to earn the confidence of the market, including the disclosure of information and efforts to reduce wasteful expenditure.

In 2013, autonomous and proxy issues of local government bonds amounted to 350 billion yuan, bringing the cumulative total since 2009 to just 1.2 trillion yuan (Fig. 6). However, the balance of local government debt reached 17.9 trillion yuan at the end of June 2013 and is estimated to have risen further since then. Based on the overall situation, there would appear to be considerable scope for further expansion of local government bond issues. The expansion of local government bond issues and a shift to a debt mix dominated by local government bonds would also be desirable from a risk management perspective.

Yet there is also the danger that haste in allowing local governments to expand their bond issues could create a moral hazard for senior local government officials, thereby increasing the risk of local government bankruptcies. In addition, the emphasis on local government debt in personnel assessments could turn out to be an empty gesture. What is needed is the improvement of legal mechanisms to curb the hasty expansion of local government bond issues. The government appears to be considering changes to Article 28 of the Budget Law, which prohibits the issuance of local government bonds in principle. From the viewpoint of avoiding the risk of local government bankruptcies, Article 28 should in fact be retained.

Further expansion of the pilot program for local government bond issuance could also create significant problems. Because of the large disparity in revenues, even if more local governments are allowed to issue bonds autonomously under the pilot scheme, there is no guarantee that interest rates will be as low as on previous bonds issues.
A considerable period of time would probably be required to extend the power to issue bonds autonomously, even to the 31 province-level governments. From a debt management perspective, the gradual expansion of proxy issues of local government bonds would be preferable to the hasty extension of autonomous bond issuance to more local governments.

The third challenge is to achieve policy consistency. There are two aspects to this challenge. First, it will be necessary to implement taxation reform measures that will not reduce the effectiveness of measures to strengthen local government revenues. Second, the government will need to take a coordinated approach to the implementation of reforms.

One of the measures in the first category is the business tax reform program (ying gai zeng), which will result in a progressive shift to a value-added tax system. This policy, which forms part of measures to stimulate the growth of tertiary sector industries, is designed to reduce the tax burden on companies involved in the service industries. However, while business taxes are in principle levied at the local government level, local governments are allocated only 25% of value-added taxes, of which the central government takes 75%. The reform process has included the introduction of a provisional system under which revenues that were previously allocated to the central government are added to local government revenues. However, no decision has been reached about whether this provisional system will be retained when the transition is complete. If the government retains the present rule, whereby 75% of value-added tax revenue is allocated to the central government, it will be necessary to take additional steps, such as changes to way other tax items are shared, or the reinforcement of local government tax bases.

Examples of areas in which reforms need to be coordinated include reforms relating to the property tax and real estate registration systems. To levy property taxes on all owners of non-commercial buildings, it would be necessary to create a real estate registration system capable of identifying not only current owners but also new owners after the transfer of rights. However, it was not until February 2014 that the government agencies concerned set up a council to discuss the integration of real estate registration systems. There is no nationwide system of real estate registration on the level needed to support taxation of privately owned buildings. To levy the potential revenues that would result from the full application of property taxation to private houses, it would first be necessary be to implement the reforms needed to establish a real estate registration system.

3. Anticipated Short-Term Countermeasures

Although China’s government debt is rising as a percentage of GDP, the level is not especially high. The central government budget is in surplus before transfers to local governments, and there are also substantial state-owned assets. On this basis, immediate fiscal collapse seems unlikely (25).

However, the reform of debt management and local government taxation systems, as discussed in the previous section, cannot be achieved overnight. In this section, we will examine the types of countermeasures that China is likely to employ to deal with localized local government debt problems or avert short-term bankruptcy risks. We will also analyze the likely effects of these measures on the Chinese economy.

(1) Existing Measures and their Characteristics

At present no local governments are subject to legal procedures arising from bankruptcy. For this reason, the following discussion focuses on three patterns based on actual bankruptcy procedures for international trade and investment corporations (ITICs) and the disposal of non-performing loans in the late 1990s (Table 5).

With the first pattern, legal procedures are followed, and debt is repaid from residual assets. The bankruptcy of Guangdong International Trust and Investment Corporation (GITIC) is a typical example.
In October 1998, the authorities announced that GITIC would be closed. The government also stated that foreign financial institutions would be given priority when creditors were repaid(26). However, a decision to invoke the bankruptcy law was taken in January 1999, with the result that all creditors, both Chinese and foreign, were treated equally with regard to repayments. Creditors ultimately incurred substantial losses, since they were able to recover only that portion of their claims that was covered by shares of GITIC’s residual assets(27). This change of stance reduced China’s credibility in the eyes of foreign investors.

The second pattern involves the establishment of non-performing loan disposal institutions (companies) to separate non-performing loans from financial institutions. In 1998 and 1999, four asset management companies (AMCs) were established under the sole ownership of the Ministry of Finance to dispose of the non-performing loans of China’s big four commercial banks. These four AMCs then purchased non-performing loans from the banks at book value and disposed of the debts by converting them into shares. The purchase of non-performing loans at book value by non-performing loan disposal institutions has also been used to dispose of non-performing loans in Vietnam and is far from being a unique approach. Purchasing at book value allows the financial institutions to remove the loans from their balance sheets. Another advantage with this method is that it helps the financial institutions to improve their loan recovery rates. However, it is uncertain whether the AMCs were able to generate earnings by selling the loans for more than the purchase prices, and there is still a possibility that the loans will ultimately become a fiscal cost to the Ministry of Finance.

With the third pattern, defaults are avoided through an injection of capital in some form. For example, the government of Guangdong Province approached the central government with an offer to rescue GITIC, although this did not occur because of opposition from then Prime Minister Zhu Rongji(28). According to media reports, there have also been a number of cases in which local governments have repaid principal to investors by purchasing wealth management products, either directly or indirectly(29). It is possible that local governments will use public money to avert defaults if they believe that failure of a local government enterprise would have a serious economic or social impact in the region concerned. There is also the possibility that province-level governments will step in to prevent the fiscal collapse of city or county governments, and that the central government will take similar action to rescue province-level governments.
(2) Response Options and their Impact on the Chinese economy

Based on this scenario, several options can be excluded from the list of possible short-term measures.

First, purchases of loans by non-performing loan disposal institutions would be unlikely to occur unless the situation had become so serious that the financial institutions concerned would be unable to continue operating while still burdened with non-performing loans. This option would also be unsuitable as a short-term response because of the complexity involved in setting purchasing criteria.

Another possible response is a capital injection funded by a temporary tax increase. While this approach would be theoretically possible, it seems unrealistic given the potential for a major backlash and a serious economic impact.

For these reasons, the method that is most likely to be used is refinancing.

The first peak for local debt maturities falls in 2014 (Fig. 7). Furthermore, it appears from the issues identified in the 2013 audit that in many cases debt that fell due in the second half of 2013 was repaid using short-term finance procured at high-interest rates.

Under these circumstances, it is likely that local governments will be allowed to take emergency action by using funds procured through long-term bond issues to repay debts with imminent maturity dates. One advantage with refinancing through local government bond issues is that this method helps to improve the management and transparency of local government debt.

On the other hand, the refinancing approach has the disadvantage of amplifying the moral hazards facing the economic entities that support the investment-driven economy, while increasing the difficulty of shifting to a consumption-driven economy. There is increasing reliance on the tacit assumption that the government (local or central) will somehow take care of problems, in part because there has been a series of situations in which local governments appear to have taken some form of action to avert defaults.

Also, as noted in Part 2, although there has been a gradual increase in the value of bonds issued under the pilot scheme allowing local governments to issue bonds autonomously, and also in the size of proxy local government bond issues, the total amount of issues is only a few hundred billion yuan per year. Even taking into account this expansion of bond issues, refinancing through local government bonds would be unlikely to cover the full cost of repaying just the debts that fall due in 2014 (3.6 trillion yuan). This approach would actually increase rather than mitigate concerns about local government finances.

A senior official of the National Development and Reform Commission reportedly said that under these circumstances, the Commission would tolerate the use of low-interest bond issues to refinance high-interest short-term debt in order to avoid defaults by local government financing vehicles. The text of this report can be interpreted as meaning that apart from the option of bond issues by local governments, there is also the possibility that local government financing vehicles will use bond issues for refinancing purposes. The latter approach offers fewer benefits than the former,

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**Fig. 7 Local Government Debt Maturities (Including Contingent Liabilities)**

- Debt
- Percentage (right axis)

Notes 1: The total for 2013 consists only of debt due in the second half of the year. The other totals are for entire years.

Notes 2: The percentage graph shows the amount of maturing debt each year as a proportion of the balance of local government debt as of June 2013.

Source: National Audit Office data (December 30, 2013)
while the moral hazards for bond issuers would be even more serious. There is also concern about the risk of unnecessarily increasing the payment burden on future generations. To minimize the economic disadvantages, refinancing should be funded primarily through long-term bond issues by local governments, and bond issues for refinancing purposes by local government financing vehicles should be kept to a minimum.

**Conclusions**

Eliminating the local government debt problem and achieving healthy local government finances will require a combination of medium- to long-term reforms and short-term measures. These measures cannot be delayed. As these problems are addressed, it will be necessary both to ensure policy consistency, and also to take into account the likely disadvantages. The Xi Jinping administration has few options for dealing with the local government debt problem, the difficulty of which continues to increase.
12. The local government companies used to raise finance are referred to as “local government financing vehicles” or “local government financing platforms.” Except in specific cases, such as when there is a notified name, these will be referred to consistently as “local government financing vehicles” in this article.


17. Sekine, E. [2013] P41


19. The full text of the Budget Law can be found on the Ministry of Finance website (http://www.mof.gov.cn/preview/jiangxi/1anmudaohang/zhengcefagui/200908/t20090817_194360.html)

20. Xu [2011] P120
21. However, province-level governments are required to pay the Ministry of Finance the amount of proxy repayments.


23. Provisional Order on Property Taxation, Article 5 The full text of the order can be found on the Chinese government website (http://www.gov.cn/banshi/2005-08/19/content_24823.htm)


25. See an interview with Professor Xu Chenggang of the University of Hong Kong in the February 26, 2014 edition of the Asahi Shimbun.


27. See Yabuuchi [2014], P.25.


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