Intergovernmental Fiscal Relations and Local Government Debt in Transitional China: After the Tax-Sharing System Reform

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Abstract: This paper analyzes China's local government debt against a backdrop of fiscal decentralization. Tax-sharing system (TSS) reforms gave rise to an imbalance in the revenue and expenditure of local governments. As a result, local governments rely heavily on extra-budgetary funds for local economic conditions. The reform of extra-budgetary funds makes local government investment dependent upon bank credit, fueling local government debt. To address the global financial crisis (GFC), a tremendous economic stimulus program was instated. This has worsened the local debt problem. The fiscal reforms over 2014-2016 mainly focused on local bonds issuance and the re-allocation of local expenditure responsibilities, but failed to adjust the local revenue mechanism. Hence the local debt problem persists.

1. Introduction

China's local debt problem is different from other countries. According to the Budget Law (passed in 1994 and revised in 2014), local governments were unable to borrow until 2015. So why has local government debt become one of China's main macroeconomic challenges in recent years? By explaining the unsustainability of local government revenue mechanisms after tax-sharing system (TSS) reform, the paper demonstrates that the accumulation of local debt is inevitable under the current IFS.

2. Local Government Debt in Transitional China

Due to the different statistical calibration and scope, data on local debt stock in China is varied. Differences are mainly due to the implicit debt related to LGFVs. For example, in the statistics of the Ministry of Finance (MOF) and other official institutions, the debt of LGFVs is classified as enterprise debt, such that the recording of real local government debt is statistically different across different institutions and research (see Table 1).

Table 1 Local Government Debt

Local Debt Balance (unit: RMB trillion)		Sources
Explicit	Implicit	
25.1 (2020.8)		Ministry of Finance (2020c)
24.16 (2020.6)		China Electronic Local Government Bond Market Access (2020)
24.2 (2020.5)	49.28 (2019.12)	Bank of China (2020)
	29.7-39.5 (2017.12)	Standard & Poor(2018)
	36.8 (2019.12)	The calculation of the author
16.47 (2017.12)		People's Bank of China (2018)
	30.6 (2017.12)	Jiang Chao et al. (2019)
	29.9 (2017.12)	Lam and Wang (2018)
17.9 (2013.6)		National Audit Office of the PRC (2013)

Sources: the author's compilation.
Notes: The numbers in parentheses are the date of statistics.

The most important debtor is the LGFVs. Their debt includes loans from banks, bonds, and loans

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from trust companies. Before the debt swap was implemented by the central government in 2015–2017, LGFVs' debt accounted for about 80 per cent of local government debt (Wingender, 2018). Considering other patterns of lending, local government debt will tend to be larger than what is officially announced. For instance, "by summing up the LGFVs' credit, government investment bonds, non-standard loans, infrastructure investment of financial leasing, and PPP projects, the scale of local implicit debt is about 49.28 trillion, accounting for about half of total GDP (49.7 per cent) in 2019" (Bank of China, 2020).

Generally, the local debt in developed areas is very high. For example, Jiangsu, Shandong, Zhejiang, Guangdong, and other coastal economic developed areas bear the most debt. Similarly, provinces with high GDP have high government debt. Nevertheless, the developed regional economy exhibits high solvency, and the debt usually does not constitute a serious problem.

In addition, gauging local government debt with per capita income shows different scenarios. Those regions with low per capita GDP have a higher debt-to-GDP ratio. For example, Guizhou, Qinghai, Gansu, Jilin, and other areas with slow economic development have the highest per capita debt. The debt of Guizhou and Qinghai exceeds their GDP. The cash flow of underdeveloped areas is limited, so how to repay the debt is a pressing issue. Moreover, there exist problems of "implicit guarantee" and "maturity mismatch" in these economically underdeveloped areas due to the political system, which poses additional important challenges to China's macroeconomy.

3. The Institutional Foundation of Local Debt

3.1 Imbalanced Local Finance under the TSS Reform

The increasing fiscal burdens of local governments after the TSS reform are mainly due to the need for large amounts of public social expenditure. With the development of a rural cooperative medical system and basic pension service in the 21st century, grassroots fiscal expenditure continued to expand. Imbalanced revenue and expenditure have fueled a local government fiscal deficit for a long time. Local finance has faced a long-term budget deficit after the TSS reform. The local fiscal deficit has risen to 10 per cent of GDP in recent years due to the acceleration of urbanization and the rise of social welfare expenditure.

3.2 Local Revenue Mechanism

3.2.1 Formal Tax Arrangements

Local formal revenue consists of central-local shared tax and local tax. These local tax revenues have several characteristics. First, central-local shared tax accounts for the lion's share of local official revenues. Secondly, reform "replacing business tax with value-added tax (VAT)" in central-local shared tax, which started in 2012 and was fully implemented in 2016, helped to avoid double taxation and reduce the tax burden of enterprises. Local formal taxes have been reduced. Third, the main local taxes, such as property tax, urban land use tax, land appreciation tax, deed tax, are highly related to the real estate market, which is greatly affected by price fluctuations. Distinct from the international experience, China's real estate tax is mainly aimed at the transaction market, not a recurrent property tax.

3.2.2 Fiscal Transfer Payment

Before the TSS reform, the proportion of FTP in local finance was not very high – the average was 24.2 per cent from 1989 to 1993. After the TSS reform, the dependence of local finance on FTP increased significantly. In the 1994–2014 periods, FTP accounted for 46.1 per cent of local fiscal expenditure. This proportion declined to 37.2 per cent between 2015–2019.

3.3 Local Informal Revenue

3.3.1 Local Extra-budgetary Revenue

Extra-budgetary funds are called local governments' second finance in China. Before the 1994

TSS reform, the extra-budgetary funds mainly originated from SOEs' retained earnings. After the TSS reform, administrative fees became an important source of extra-budgetary revenue for local governments. The proportion of SOEs' retained earnings accounted for 80 per cent of the total extra-budgetary revenue from 1980 to 1992. After the TSS reform, the average proportion of administrative fees and fines amounted to a 75 per cent share.

3.3.2 Land Transfer Fees

The TSS reform created urban land-use fees, land appreciation tax, and other land-related taxes and fees in the jurisdiction of localities. With the proceeding urbanization and industrial development, land transfer fees and taxes and fees linked to real estate have become an essential contributor to local extra-budgetary revenue. The importance of land transfer fees grew after 2000 and has recently had a critical impact on local finance. For example, in the 2008–2019 periods, the average proportion of land transfer fees equaled 55 per cent of local budget revenue. In some years (such as 2010–2011 and 2018), this ratio rose to more than 60 per cent, and in 2019, it was even higher at 71.8 per cent.

3.4 Local Investment and The Emergence of Local Debt

Local governments dominated fixed assets investment (FAI) in transitional China. The central investment projects decreased sharply while local investment projects increased rapidly after the TSS reform. Nowadays, nearly 95 per cent of investment projects are completed by local governments every year. In the 1982–2018 periods, self-raised funds accounted for 71 per cent of FAI. Since the TSS reform, this proportion has risen to 75 per cent. In the past decade (2009–2018), it soared to 82 per cent.

With the reform of extra-budgetary funds in the late 1990s, most local-extra budgetary revenue was incorporated into a formal budget. The land transfer fee was also included in government-managed funds, and revenue and expenditure were strictly regulated (The State Council, 2014). LGFVs ensue. The cities of Shanghai and Wuhu in Anhui province conducted pilot projects in which LGFVs were established in 1988 and 1998, respectively. This policy was gradually carried out in other provinces and cities. Local governments incorporated land and municipal infrastructure into LGFVs and then made loans to banks through LGFVs. LGFVs solved the problem of local construction funds but also created a local government debt problem.

3.5 Economic Stimulus Program and the Soaring Local Government Debt

After the outbreak of the GFC in the fourth quarter of 2008, the central government immediately launched a "4 trillion RMB" fiscal stimulus program, equivalent to 586.7 billion US dollars at the current exchange rate, accounting for 12.5 per cent of China's GDP in 2008. Most of the funds (about 2.82 trillion) in the economic stimulus program were raised locally. In order to facilitate local investment, the central authority relaxed constraints on local government financing and borrowing. LGFVs, in combination with land finance, borrowed heavily from banks, resulting in a drastic rise in local debt.

3.5.1 Credit Inflation

One of the outcomes of the central government's deregulation of local financing and borrowing was a sharp rise in the use of bank credit. The credit-to-GDP gap refers to the gap between the ratio of non-financial enterprises' credit scale to GDP and its long-term trend.

The gap was negative for a long time prior to the first quarter of 2009. This means that the willingness of enterprises to lend was low, as was the willingness of banks to lend. After the economic stimulus program was launched, the credit-to-GDP gap soared rapidly, from -11.4 per cent in the fourth quarter of 2008 to 14.6 per cent in the second quarter of 2010. After a decline, it began to ascend again in 2013 and gradually fell back after reaching the highest 27 per cent in the first quarter of 2016. With the rapid rise of credit, local debt soared simultaneously. The local government debt ratio (debt-to-GDP) increased rapidly from 10 per cent in 2008 to 17.2 per cent in 2009.

3.5.2 Soaring Fixed Assets Investment

The result of credit inflation and debt surge was that FAI increased significantly. A significant amount of FAI is infrastructure and real estate investment. From 2001 to 2018, the average annual growth rate of FAI was 20.4 per cent, while that of real estate investment was 21.7 per cent. The biggest increase came from the economic stimulus program, in which the proportion of FAI in GDP jumped to 64.4 per cent in 2009, 10.3 percentage points higher than that in 2008. Infrastructure investment accounted for more than 16 per cent of GDP in 2009. As part of the economic stimulus program, 37.5 per cent of the investment was concentrated in infrastructure such as railways, highways, airports, and power systems.

Prior to 2015, these related investments by local governments were completed by means of extra-budgetary funds, including bank loans, local government bonds, LGFV bonds, trust loans, and so on. The LGFVs' debt derived from bank loans accounted for the lion's share of local governments' debt, accounting for 54 per cent of it in 2014. Moreover, most LGFVs borrowed from commercial banks with land as collateral and were guaranteed by local governments. At present, local governments are jointly and severally liable for about two-thirds of the outstanding debts.

4. Fiscal Reforms under the Debt Pressure (2014-2016)

4.1 The 2014 Budget Law Revision

One of the principal revisions of the Budget Law in 2014 aimed to allow local governments at the provincial level to issue bonds with the approval of the central government (Article 35 of the Budget Law). Subsequently, the central government strengthened the management of local debt and prohibited local governments from borrowing through SOEs and LGFVs. The existing LGFVs asked to remain separate from local financing. Existing local government debt was classified as general debt and special debt (or enterprise debt), which was transferred to a government-managed account. This also allowed the establishment of a national platform for local debt registration and warning.

In order to eliminate the potential debt crisis, the MOF promoted a large-scale debt swap program in 2015. By the end of 2017, about RMB 10.5 trillion, accounting for 22 per cent of GDP, of LGFVs debt was converted into local government bonds. In other words, the loans borrowed from commercial banks through LGFVs were converted into local government bonds held by commercial banks. Debt swaps greatly reduced the debt pressure of local governments.

4.2 2016 Central-Local Expenditure Responsibilities Reform

The 2016 fiscal reform aimed to adjust central-local expenditure responsibilities. However, this reform does not supersede the local income mechanism. The distribution schemes of recurrent property tax and resource tax, likely to play a critical role in local formal revenue, remain fruitless after years of discussion. In other words, local governments still face the problem of raising funds to meet their responsibilities. As mentioned below, the new fiscal reform made it easier for local governments to borrow money. Coupled with the utilization of other non-budgetary funds, local government debt continues to accumulate.

4.3 Unintended Consequences of Policy Reforms

The central government's policy adjustment brought unintended results. When the central deregulates credit control and local financing to reverse the continuous decline of economic growth in 2015, LGFVs borrowed from banks again. Accordingly, local governments' debt rises.

The revised 2014 Budget Law clearly defines the subject of debt raising, the purpose of borrowing debt, the scale of debt, the way of borrowing, the supervision and restriction mechanism, and legal liability (Articles 35 and 95 of the Budget Law). The subsequent debt swap program further reduces the debt burden of local governments. Nevertheless, as the economic growth rate has dropped drastically since 2015, the central government has begun to loosen the regulation of local governments' debt raising. At this time, LGFVs have conducted debt swaps. The deregulation of the central government makes it easier to lend or to issue bonds, which leads to a continuous rise of local government debt (World Bank, 2017).

It is estimated that the debt generated by LGFVs through bank lending and bond issuance after debt swap grew more than 20 per cent between 2015-2016, much higher the 14 per cent of other enterprise sectors. The share of LGFVs in all non-financial enterprise sector debt increased from 25 per cent in 2013 to 30 per cent in 2016. Meanwhile, under the "supply-side reform" promoted by the central government, localities can identify other channels for financing: shadow banking, PPP, local SOEs' loans, etc., which further push up local government debt.

5. Conclusion

From the perspective of IFS, this paper elucidates the evolution of local government debt since the TSS reform. This reform resulted in a serious imbalance of local fiscal revenue and expenditure. Local budget income only covers basic public services, while local construction mainly depends on non-budgetary funds. In the early 21st century, the reform of extra-budgetary funds means that local government investment gradually becomes reliant on bank credit of LGFVs, and a local debt problem begins to emerge.

In response to the GFC in 2008, the economic stimulus program launched by the central promoted investment growth and economic recovery through the expansion of credit and the relaxation of local financing channels, which also led to the rapid rise of local government debt. The revision of the Budget Law in 2014 and the fiscal reform in 2016 were mainly aimed at the local bond issuance and revamp of central-local expenditure assignments, while the problem of an unsustainable local revenue mechanism remains unsolved. In the future, local public expenditure will increase drastically with population aging, urbanization, and the citizenization of migrant workers. The existing local fiscal revenue system is insufficient to support inflated local expenditure. Therefore, local debt continues to accumulate in China.

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