

China's Local Government Debt: Not (Yet) As Bad As It Seems

British Embassy Beijing

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Summary

China's local government debt situation is often cited as a likely source of future economic instability. The recent debt audit carried out by the authorities show that in recent years the level of debt has increased rapidly. There is risk that levels of debt in some lower level governments may become unsustainable. Local governments have spending responsibilities, but transfer most of their income to central government.

However, the overall debt level remains manageable. The Chinese government also appears have large good assets to repay the debt. Much of the debt has been spent on infrastructure. While there are some concerns about spending inefficiency, in general such spending ought to enhance future growth prospects.

Though the current situation is manageable, longer-term sustainability requires far-reaching fiscal reform. The will and ability to deliver this have been set out in the consistent rhetoric from the central leadership. Fiscal/tax reform is a key task among the 'Reform Decisions' set by the 18th Party Congress, up to 2020. And in the 2013 Central Economic Work Conference, the authorities for the first time prioritised managing local government debt as a key target for 2014.

Changes are needed to the tax system, the allocation of spending responsibilities between the centre and the provinces, and the capacity of

local governments to raise their own debt. One clear area where the UK has relevant experience to share is in Public-Private Partnerships (PPP), which offers an enticing solution to finance bureau officials at the central and local level wanting to both reduce public spending and improve public services.

Barriers remain to creating a supportive enabling environment in China for PPP. These include an inadequate legal framework, an inefficient pricing mechanism and capacity issues.

Detail

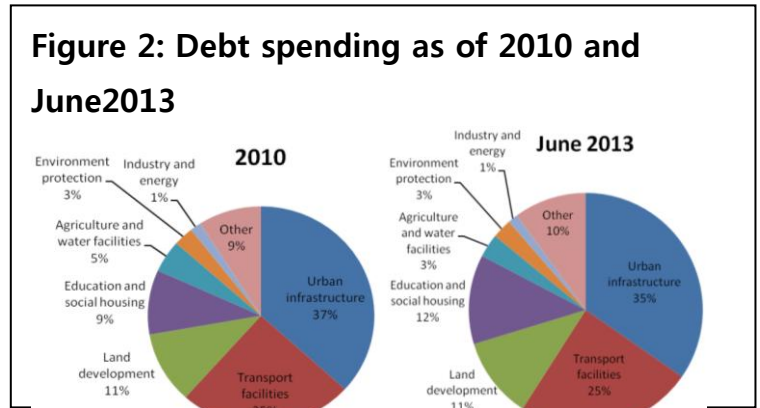
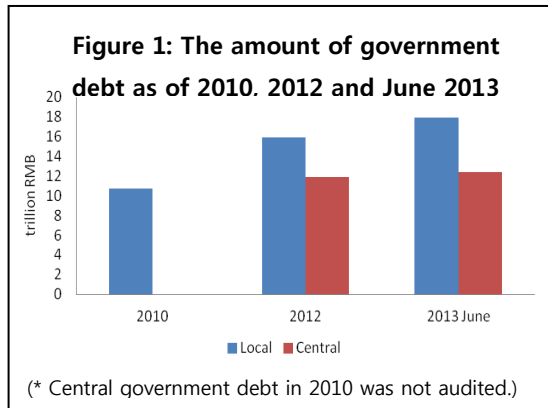
On the last day of 2013, China's National Audit Office (NAO) published its long awaited report on local government debt, its most comprehensive audit yet. 54,000 audit officials spent 2 months auditing 62,215 government departments, 7,170 local government financing vehicles and 84,075 agencies attached to the governments. Village and township governments were covered for the first time. It took the authorities 3 months to analyse the data and publish the result.

Most analysts believe this audit represents the best assessment yet of the local government debt situation.

DEBT LEVELS HAVE RISEN RAPIDLY

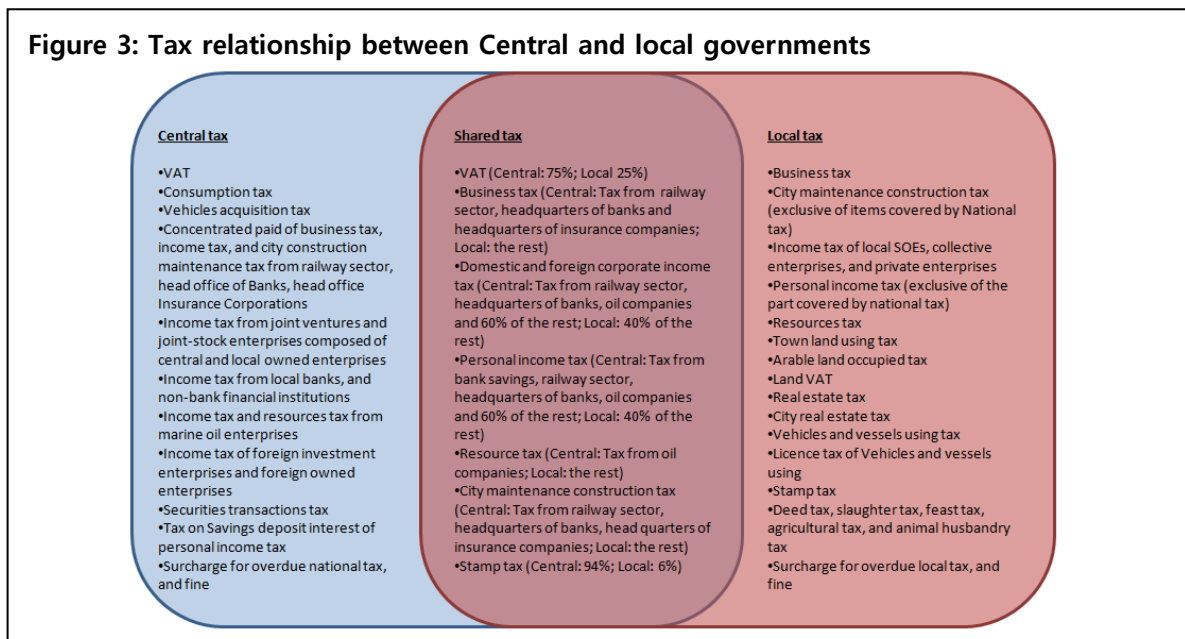
The audit result showed that local government debts have risen rapidly in recent years. The total amount (including contingent debt that the government guarantees or has potential bail-out responsibilities) reached RMB 15.9 trillion (£1.59 trillion) by end 2012 and RMB 17.9 trillion (£1.79 trillion) by June 2013, suggesting an increase of 49 percent and 67 percent respectively compared with end 2010 (**see Figure 1**). About a third of the

debt was invested in urban infrastructure (see Figure 2). This should support the authorities' ambitious urbanisation plan to migrate 13 million people to cities annually up to 2020.



LOCAL GOVERNMENTS' FISCAL RESOURCES DO NOT MATCH SPENDING RESPONSIBILITIES

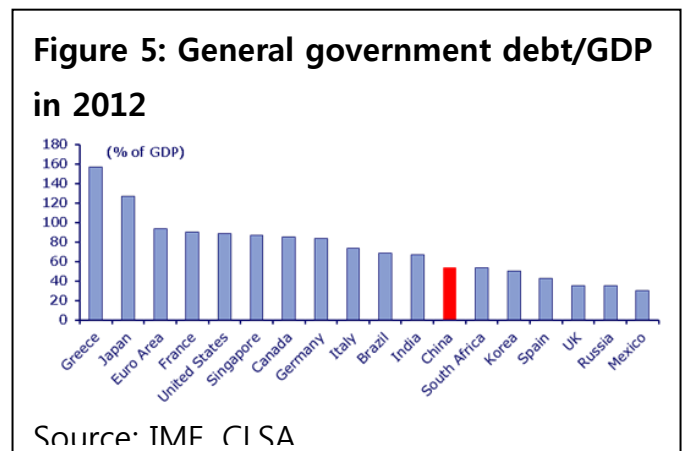
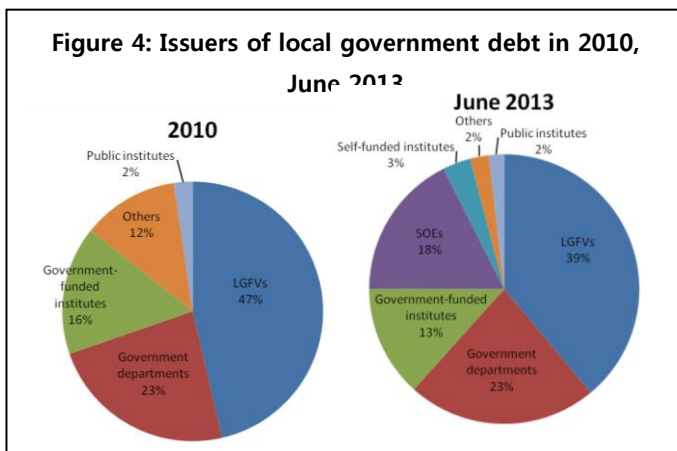
The relationship between the Central and local governments is the key issue standing behind the quick debt increase. After the major fiscal reform in 1994,



the Chinese government centralised the fiscal power. Local governments need to transfer a majority of their tax revenue to the central government (see **Figure 3**).

However, the local governments bear the main spending responsibilities, including infrastructure construction and the provision of healthcare and compulsory education, especially given the quick pace of urbanisation.

The gap between local governments' fiscal resources and spending responsibilities encouraged local governments to set up arms-length financing vehicles (LGFVs) to raise funding. The NAO's report showed that LGFVs remained the biggest borrower from 2010 to June 2013 (see **Figure 4**). Although local governments do not have direct liability for LGFV's debt, it is



thought that they will bail them out if any defaults. CBRC (the banking regulator) allowed Chinese banks to roll over maturing loans to LGFVs several times under the 'acquiescence' of the authorities.

BUT, LOCAL GOVERNMENT DEBT REMAINS MANAGEABLE

The total government debt to GDP ratio (including central and local government debt and all the contingent debt) was 53.5 percent as of end 2012, which is below that of many other countries, for example India or Brazil (See **Figure 5**). In addition, the total debt was 113 percent of the

government's fiscal revenue at the end of 2012, which was within the safe range (90 – 150 percent) by international standards. Overdue debt ratio was only 1.01 percent.

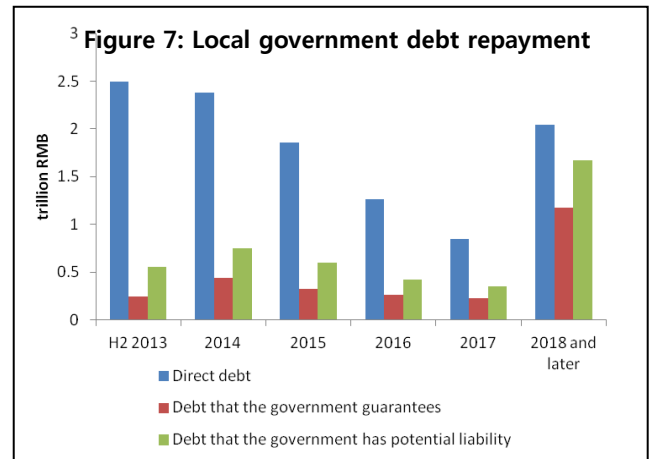
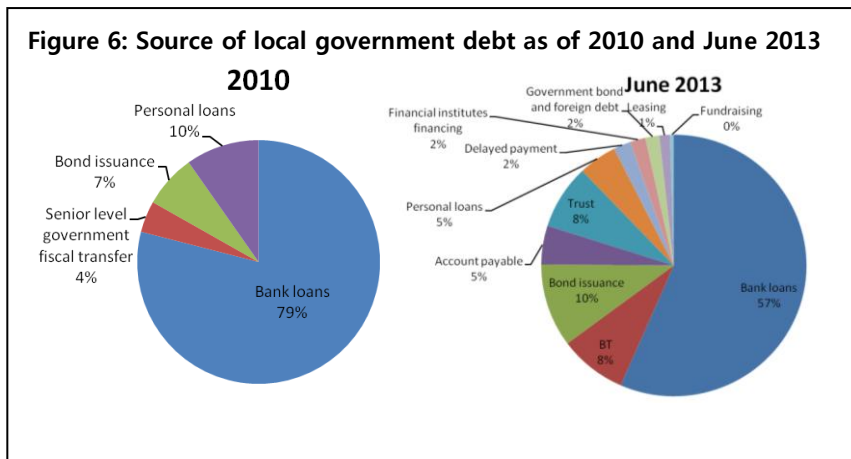
That said, the debt situation in some lower level governments (county and township level) was more critical. The debt-to-GDP ratios for some local governments were over 100 percent. But they accounts for a relatively small proportion of overall debt and there is little reason to doubt that as things stand the government as a whole has the wherewithal to bail out the odd bankrupt locality.

Overall, the Chinese government appears to have sufficient resources to repay the debt. The Central and local governments have large good assets. The State-owned enterprises (SOEs) assets were twice as large as the governments' liabilities. In Central and North China, local governments have shown themselves open to privatise the SOEs they own. Additionally, the Central government has a great amount of cash saving, which is equivalent to 6 percent of GDP. The foreign exchange reserves that the government sits on is massive - USD 3.8 trillion as of end 2013.

IMPLICATIONS FOR THE ECONOMY: SHORT TERM PAIN, BUT LONG TERM GAIN

Although local government debt has not yet reached a dangerous threshold, the quick build-up calls for the authorities to introduce measures to control increasing debt. To tackle local government debt will inevitably lead to a slower GDP growth. Since a significant part of debt was used to fund infrastructure construction, the slowdown in debt growth will likely cause a reduction in the rate of growth of investment, which was a main driver of China's economic growth - in 2013 investment accounted for 54.4 percent of headline growth.

The banking sector could also face higher risks if there are delays in the return on infrastructure projects due to slower investment. According to the NAO, the major source of local government debt was from bank loans (see **Figure 6**). The short-term of bank loans and long-term infrastructure projects



leave a gap between debt maturity and cash flow generated from projects. A big proportion of local government debt will mature in 2014 and 2015 (see **Figure 7**). Slower investment is likely to force the regulators to allow debt roll-over again and increase the risks for the banking sector.

The central and local authorities recognise that the current debt trajectory is unsustainable. For at least the past year now, the top leadership have emphasised their willingness to tolerate slower GDP growth and their determination to make progress on structural reforms.

PROSPECTS FOR REFORM

In the 2013 Central Economic Work Conference, the authorities for the first time prioritised managing local government debt as a key target for 2014. The NAO set four measures to manage local government debt, including improving local government budget management, linking debt to local

government officials' performance appraisals, transferring government's role by carrying forward fiscal and financing mechanism reforms, and setting up a local government debt risk alert system.

These measures should reduce risks relating to local government debt, if well implemented. In North and Central China, local fiscal bureaus (the provincial level HM Treasuries) consistently say that they are very focussed on reducing the growth in debt and managing debt issue, and well-versed in the direction that upcoming reforms are taking.

Among these measures, fiscal reform is a fundamental issue. In the Third Plenum of the 18th Party Congress last November, the authorities set deepening fiscal reform as a key task up to 2020. This includes improving budgetary management, optimising taxation system (e.g., VAT reform, expansion of tax base), and matching fiscal revenue and public services responsibilities between Central and local governments. Finance Minister Lou Jiwei, who participated in the major fiscal reform in 1994, is looking to drive forward this work.

In the short term, taxation system reform is likely to happen first. In the past 3 years, the authorities have piloted VAT reform. It is now rolling out to more sectors and provinces. Consumption tax, resources tax, income tax reforms are all being discussed. The authorities are expected continuously to take careful steps to introduce reforms.

Clarifying local and central governments' responsibilities and budget allocation is more of a medium term objective. Some responsibilities are difficult to allocate. For example, how to manage pollution in a local river caused by a centrally-owned SOE. Some local government officials would like to see the central government cover more public services, like education or healthcare, with ramifications beyond local government.

Allowing local governments to issue bonds on their own is another solution. According to China's Budget Law, local governments cannot issue bonds without the State Council's approval. This reflected the Central government's concern that local governments might indebt themselves beyond their repayment capacity. This restriction is likely to be loosened soon. In this year's budget issued by the Chinese Ministry of Finance (MOF), the authorities announced a pilot allowing local governments to issue bonds in support of public services.

PPP – WHAT THE UK CAN BRING TO THE TABLE

Public Private Partnership (PPP) is currently extremely popular among central and local government policymakers. Finance Minister Lou has publicly expressed his support for PPP by describing it as "a systematic reform to solve local government debt risks".

Over the past 12 months, the British Embassy in Beijing and the UK's PPP Unit in London (Infrastructure UK) have supported PPP policy development in China. UK expertise in PPP is clearly acknowledged and we receive regular requests for training events – the two PPP workshops that we have run together with the Chinese Britain Business Council were extremely well attended by a wide range of government departments. This year we continue our project collaboration with the Chinese government. Infrastructure UK will be involved throughout.

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