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A Literature Review on the Causes and Spillover Effects of Local Government Debt Risk

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Abstract: ***Local government debt risk has become a significant challenge to the stability and sustainable development of China's economy. This paper conducts a literature review to analyze the causes, spillover effects, and countermeasures of local government debt risk, aiming to provide theoretical support and practical guidance for managing these risks.***

Keywords: Local Government, Debt Risk, Spillover Effects, Countermeasures.

1. Introduction

In recent years, with the rapid development of China's economy and the continuous advancement of urbanization, the issue of local government debt has gradually emerged and garnered widespread attention. Local governments have resorted to borrowing to promote infrastructure construction and public service provision. While this has spurred economic growth in the short term, it has also led to an expanding debt scale and the accumulation of implicit debt. This phenomenon not only places enormous pressure on local finances but also poses a potential threat to the stability and sustainable development of regional economies.

The current state of local government debt risk is concerning. The mismatch in the fiscal system, intergovernmental competition, implicit financial arrangements, and economic factors collectively contribute to the continuous accumulation of local government debt risk. This risk affects not only the fiscal health of local governments but also, through spatial spillover effects, impacts corporate investment, financing, real estate investment, location choices, and innovation activities, further exacerbating economic uncertainty.

In response to this complex situation, scholars and policymakers have proposed various strategies, including enhancing fiscal transparency, strengthening government audits, advancing digital development, optimizing credit allocation, setting reasonable debt limits, integrating local financing platforms, and considering real estate cycles and population mobility. These measures aim to address local government debt risk from different angles, ensuring economic stability and sustainable development.

This paper will systematically analyze the causes, spillover effects, and countermeasures of local government debt risk through a literature review, aiming to provide theoretical support and practical guidance for managing these risks.

2. Causes of Local Government Debt Risk

In the literature review on the causes of local government debt risk, we can analyze from multiple perspectives, including the fiscal system, government competition, economic factors, and policy impacts.

Firstly, the root cause of local government debt risk lies in the mismatch of the fiscal system. Imbalances in fiscal relationships are the institutional root of local governments' borrowing and financing (Liu Qi, 2023). The mismatch between fiscal authority and expenditure responsibility under a decentralized system, along with intergovernmental competition driven by decentralization incentives, are the main reasons for the emergence of local government debt (Qiu Lihua and Fu Runmin, 2015). This mismatch leads local governments to incur debt in the face of insufficient fiscal revenues while bearing significant public service and infrastructure construction responsibilities, thereby triggering debt risks. In terms of promotional incentives, growth-oriented promotional incentives significantly expand local government debt risk (Xu Lin et al., 2022). Sustainable fiscal promotional incentives help control local government borrowing behavior, while comprehensive performance promotional incentives focusing on livelihood services intensify local governments' borrowing impulses.

Secondly, competition among local governments further exacerbates debt risk. Han Fengqin and Cai Jiaying (2021) argue that fiscal decentralization increases the risk coefficient of local government debt, and intergovernmental competition exacerbates this effect. However, high-quality local competition mechanisms, such as innovation-led economic competition, can mitigate the adverse impact of intergovernmental competition on debt risk to some extent.

Furthermore, implicit financial institutional arrangements are also an important avenue for the irrational expansion of local debt. Ma Wanli and Zhang Min (2020) point out that a series of non-standard implicit financial institutional arrangements, in which local governments autonomously delineate and distribute the allocation and control of financial resources, have contributed to the irrational expansion of local debt. This implicit financial decentralization allows local governments to bypass central government oversight and engage in large-scale debt financing.

Economic factors are another significant source of local government debt risk. The large-scale, inefficient construction of new towns in China has increased the debt ratio of local governments (Chang Chen and Lu Ming, 2017). Infrastructure investment expansion is a major source of local government debt risk, and the issuance of special bonds can significantly curb this risk, especially in regions with weaker economic quality development and higher fiscal pressure, where the policy effects are particularly evident (Peng Fei and Wu Huaqing, 2023). Under significant economic downturn pressure, the growth rate of local fiscal revenue slows down, but the burden of local government responsibilities continues to increase. The inherent contradiction between local government revenue and expenditure cannot be fully resolved through legitimate borrowing channels (Shen Kunrong and Shi Yu, 2023). A cooling land market leads to increased local government debt risk (Zhou Jiayin and Lu Yi, 2024).

Lastly, trade shocks and industrial structural changes also impact local government debt. Ma Li et al. (2023) indicate that policies adopted by local governments to mitigate the effects of negative trade shocks, such as expansionary borrowing, can increase the debt of local government financing platforms. Additionally, negative trade shocks resulting in a decline in the proportion of the secondary industry may diminish local governments' future debt repayment capacities, thereby leading to a long-term increase in the debt of local government financing platforms.

The generation of local government debt risk is the result of a combination of multiple factors. The mismatch in the fiscal system and intergovernmental competition are its institutional roots, while implicit financial institutional arrangements and economic factors further exacerbate debt risk. Policy measures and market changes, to some extent, influence the specific manifestations of debt risk. Understanding the logical relationships among these factors is crucial for formulating effective debt management policies.

3. Spillover Effects of Local Government Debt Risk

Scholarly research on the spillover effects of local government debt risk primarily includes spatial spillover effects, transmission mechanisms within the financial system, and regional economic linkages.

Firstly, local government debt risk exhibits significant spatial spillover effects. Shen Li et al. (2019) point out that local government debt risk in China has obvious spatial spillover effects and presents complex multi-threaded spatial spillover characteristics. Wang Zhouwei et al. (2019) further emphasize that the spatial spillover effects of local government debt risk among provinces are stable, with high network efficiency and multiple overlapping spillover effects throughout the network. Hu Cailong (2021) found that the risk of Chinese local government bonds exhibits a typical "scale-free network" structure, with spatial network correlations existing between geographically adjacent and distant regions. This indicates that local government debt risk not only affects the financial stability of the local area but also impacts the financial risk of neighboring regions through spatial spillover effects.

Further research shows that the increase in implicit local government debt leads to a rise in financial risk in neighboring regions through spatial spillover effects. Yin Lifeng and Yao Chi (2022) found that due to the crowding-out effect, investor asset choices, and investment preferences, the increase in implicit local government debt raises regional financial risk and affects neighboring regions through spatial spillover effects. These spillover effects are not limited to financial risk but also include economic and social risks.

Moreover, the spillover effects of local government debt risk exhibit complex dynamic relationships over time and space. Fang Yi et al. (2023) constructed a network model to analyze the interconnections of debt risk among multiple local governments and found significant spillover effects of local government debt risk between provinces. Provinces with higher levels of economic development are usually the sources of risk, and the patterns of risk spillover differ in the long term and short term. This indicates that the spillover effects of local government debt risk have temporal and spatial heterogeneity.

The financial system is an important transmission mechanism for the spillover effects of local government debt risk. The "financial accelerator" mechanism in the economy causes debt risk and financial risk to mutually reinforce each other (Li Yulong, 2019). Fiscal risk can directly or indirectly transform into financial risk (Zhang Tian, 2023). The substantial subscription of local government debt by commercial banks converts debt risk into financial risk (Mao Rui et al., 2018), and there is a strong dynamic correlation and risk spillover effect between shadow banking and local government debt (Zhang Peng et al., 2023). Ma Yaming (2021) empirically analyzed the spillover effect of local government debt risk on financial stress using the TVP-VAR model, and the results showed that local government debt risk consistently has a strong explanatory power for financial stress, generally presenting a positive impact. Zhang Xuan et al. (2022) constructed a system dynamics model of the interactive influence between local government debt risk and financial risk, finding that housing prices and property tax revenue are key influencing factors in the interaction between local government debt risk and financial risk. Wang Ruohan (2023) believes that the increase in implicit debt risk may lead to a rise in credit risk and liquidity risk, thereby affecting the stability of the entire financial system.

Additionally, the spillover effects of local government debt risk are also transmitted through the interbank market. Research on financing platforms and the interbank market indicates that implicit local government debt risk has significant cross-regional spillover effects, with the interbank market being an important channel for risk transmission (Xiong Chen et al., 2022). The increase in urban investment bond risk can affect the broader financial market through the credit bond market mechanism (Fan Xiaoyun et al., 2023). This indicates that the interconnectedness of financial markets exacerbates the spillover effects of local government debt risk.

Regional economic linkages are also an important factor in the spillover of local government debt risk. Wang Bo et al. (2022) point out that local governments use debt financing for infrastructure construction, directly enhancing the economic vitality and attractiveness of their regions, which not only promotes local economic growth but also stimulates economic growth in neighboring regions through the network effects of infrastructure investment. This economic linkage causes local government debt risk to be transmitted between regions, forming a risk spillover network.

Finally, the spillover effects of local government debt risk exhibit different characteristics in different regions. Li Cheng and Liu Yaxin (2022) found that local government debt risk in China is primarily symbiotic, with a larger spillover effect caused by implicit debt. The spillover effect is most pronounced in the eastern regions, while the western regions exhibit a negative spillover effect, indicating a clear trend of risk transfer.

The spillover effects of local government debt risk result from the combined action of multiple factors. Spatial spillover effects, transmission mechanisms within the financial system, and regional economic linkages are the main transmission pathways, while the economic development levels and policy environments of different regions influence the specific manifestations of the spillover effects. Understanding the logical relationships among these factors is crucial for formulating effective risk management policies.

4. The Impact of Local Government Debt Risk

When studying the impact of local government debt risk, scholars have conducted in-depth explorations from multiple perspectives, including the crowding-out effect on private enterprise investment, resource allocation efficiency, corporate financing costs, corporate mergers and acquisitions (M&A) behavior, real estate investment tendencies, corporate location choices, high-quality economic development, and green technology innovation. The core of debt risk lies in the efficiency of debt fund allocation (Miao Xiaolin and Shi Qianru, 2016), and borrowing itself does not necessarily lead to risk (Guo Yuqing, 2011). Around 2015, with the central regulatory orientation becoming stricter, the expansion mode of local implicit debt shifted from "active debt" to "passive debt" (Nie Zhuo et al., 2023). The factors influencing local government debt risk mainly focus on the use and repayment of debt funds (Song Chang et al., 2023).

Firstly, although the sharp rise in local government debt has supported the stable development of regional economies, it has crowded out private enterprise investment (Huang et al., 2020). This crowding-out effect is not only harmful to national fiscal development (Ismihan & Ozkan, 2012; Demirci et al., 2019) but also leads to resource misallocation and a decrease in total factor productivity (Liao Meng, 2024). Liao Meng et al. (2024) further pointed out that the heterogeneity of financial frictions exacerbates resource misallocation due to local government debt expansion, increasing private enterprise financing costs and the marginal product of capital, thereby worsening resource allocation efficiency.

However, debt swaps can mitigate this crowding-out effect. Li Zhisheng et al. (2024) found that debt swaps help alleviate the crowding-out effect of local government debt on non-state-owned enterprise financing, increase bank credit supply, and reduce implicit guarantee expectations, providing a favorable environment for non-state-owned enterprise financing and reducing credit discrimination between state-owned and non-state-owned enterprises, thereby effectively alleviating the problem of leverage ratio differentiation.

Secondly, local government debt also affects corporate M&A behavior and real estate investment tendencies. Wu Yuhui and Mo Yifan (2024) pointed out that the expansion of local government debt scale inhibits corporate M&A behavior, specifically by reducing M&A probability, frequency, and scale. The underlying mechanism is that the expansion of local government debt exacerbates corporate financing constraints, reduces risk-bearing capacity, and decreases investment opportunities. Xie Shenxiang et al. (2024) found that the expansion of local public debt significantly increases corporate real estate investment tendencies. The underlying mechanism is that the expansion of local public debt crowds out credit resources, intensifying financing competition among enterprises. To obtain a more favorable financing position, enterprises are forced to increase real estate investment to enhance the collateral needed for financing.

Thirdly, local debt levels also affect corporate location choices and innovation activities. Huang Zhiji et al. (2024) pointed out that local debt levels have a significant negative impact on corporate location choices, and this impact has a certain lag. Corporate innovation and government credit both play partial intermediary roles in this impact mechanism. For different regions, cities with different levels of fiscal self-sufficiency, and different types of debt structures, local debt levels have significant heterogeneous impacts on corporate location choices.

Local government debt also has certain impacts on high-quality economic development and green technology innovation. Zhang Yunxiao and Zhao Wenju (2023) found that local government debt has long-term dynamics and shows an "inverted U-shaped" relationship with high-quality economic development. This indicates that moderate local government debt can promote high-quality economic development, but excessively high debt levels will inhibit economic development. Additionally, local government debt also influences green technology innovation through environmental regulations. Wang Weian and Xie Zhubin (2024) pointed out that local government debt promotes green technology innovation by weakening guiding environmental regulations and strengthening punitive environmental regulations, thereby forcing enterprises and other entities to innovate.

Finally, local government debt risk is transmitted through the financial system and regional economic linkages. Fu Runmin et al. (2017) pointed out that local government debt risk in China has a crowding-out spatial spillover effect on the financing of resident enterprises within and between jurisdictions through medium- and long-term loans from financial institutions. Ren Xiaozhu and Xie Jiazhi (2022) further emphasized that the intensification of local government debt risk inhibits corporate financing capacity and significantly enhances the promotion effect of interest rate liberalization on corporate financing capacity. Ma Yong and Zhang Hongming (2023) explored the role of local financing platforms, pointing out that when fiscal policy generates financing demand due to economic downturns, local governments can use local financing platforms to tap into financial sector resources, thereby achieving a substantial credit easing effect. This can smooth economic fluctuations to some extent, but the Ponzi financing capacity of local financing platforms will gradually weaken as debt accumulates. Once it exceeds a certain level, the potential risk of economic fluctuations will significantly increase.

Local government debt has significant impacts on corporate investment, financing, M&A behavior, real estate investment, location choices, innovation activities, high-quality economic development, and green technology innovation. These impacts are transmitted through various mechanisms such as resource misallocation, financing constraints, credit competition, and environmental regulations, and exhibit heterogeneity in different regions and economic environments. Understanding the logical relationships among these factors is crucial for formulating effective risk management policies.

5. Strategies for Mitigating Local Government Debt Risk

When studying strategies to mitigate local government debt risk, scholars have proposed various suggestions and strategies from multiple perspectives. These strategies mainly focus on the following areas: fiscal transparency, government auditing, digital development, marketization processes, credit allocation, tax reduction and fee cuts, debt limits, local financing platform integration, and factors related to the real estate cycle and population mobility.

Firstly, improving fiscal transparency and marketization processes. Liu Lanbiao et al. (2023) found that granting local governments the right to issue debt generally helps in alleviating local government debt risk, but the effectiveness of this measure varies depending on the level of fiscal transparency. The higher the fiscal transparency, the better the risk management outcomes. Zeng Haizhou et al. (2020) further pointed out that fiscal transparency influences the financing cost, thereby having a heterogeneous impact on local debt risk. Duan Yanping (2020) found that regions with a higher degree of marketization are more conducive to mitigating local government debt risks. Li Yihua et al. (2022) suggested that unreasonable debt limit space could exacerbate the expansion of implicit debt risk.

Secondly, strengthening government auditing and accounting functions. Xu Yu et al. (2023) emphasized that government auditing plays an "immune system" function that can reduce local government debt risk. Du Feng et al. (2021) pointed out that national debt audits have a significant suppressive effect on local government debt risk, with regions that have stronger audit supervision seeing more significant reductions in debt risk post-audit. Zhang Guiqiao et al. (2023) argued that fully leveraging the accounting functions embedded with digital and intelligent technologies is crucial for effectively preventing and mitigating local government debt crises and improving debt risk governance performance.

Thirdly, promoting digital development. Zhou Shiyu and Zhou Mingsheng (2022) found that with the deepening of digital development, the incremental risk of local debt is being suppressed. This is especially true in eastern regions, where digital advancement is more conducive to managing local debt risk. Dong Haoran and Zhou Quanlin (2024) pointed out that the development of the digital economy indirectly reduces local government debt risk by enhancing fiscal decentralization and fiscal transparency.

Fourthly, optimizing credit allocation and reducing taxes and fees. Zhao Quanhou and Xu Jing (2022) indicated that the scale, maturity structure, and efficiency of credit allocation all impact local government debt risk. Changes in the scale of credit allocation negatively affect local government debt risk, and the higher the proportion of medium- and long-term credit, the greater the efficiency of credit allocation, the lower the debt risk. Liu Hua et al. (2024) found that the scale of tax and fee reductions is generally positively correlated with local government debt risk, but when the level of economic development passes a threshold, the growth rate of local government debt risk will significantly decrease. Guan Zhihua and Li Yinghao (2023) further pointed out that increased tax and fee reductions and rising fiscal pressure both have a positive impact on debt risk.

Fifthly, integrating and restructuring local financing platforms, real estate cycles, and population mobility factors are also key areas of focus for some scholars. Wang Qiushi et al. (2024) suggested that the integration and restructuring of local financing platforms can reduce default risk by leveraging implicit guarantee expectations. Under the moderating effect of implicit guarantees, the integration and restructuring of local financing platforms reduce default risk mainly through credit effects, operational effects, and interest rate effects. Luo Zhaoyang and Li Xuesong (2022) found that it is crucial to consider the real estate cycle and population mobility. There is a "counter-cyclical" relationship between the real estate cycle and local government debt risk, and promoting population inflow helps reduce local government debt risk.

6. Conclusion

By systematically reviewing and analyzing existing literature, this paper reveals the complex causes and widespread spillover effects of local government debt risk. The emergence of local government debt risk primarily stems from a combination of factors, including mismatched fiscal systems, intergovernmental competition, implicit financial arrangements, and economic conditions. These risks not only threaten the fiscal health of local governments but also, through spatial spillover effects, impact various aspects such as corporate investment, financing, real estate investment, locational choices, and innovation activities, further exacerbating economic uncertainty.

In response to these risks, scholars have proposed multiple countermeasures, including enhancing fiscal transparency, strengthening government auditing, promoting digital development, optimizing credit allocation, setting reasonable debt limits, integrating local financing platforms, and considering real estate cycles and population mobility. These strategies, addressing the issue from different perspectives, aim to comprehensively manage local government debt risk, thereby ensuring economic stability and sustainable development.

The research in this paper provides comprehensive theoretical support and practical guidance for managing local government debt risk. Future research should further incorporate real-world cases to verify the effectiveness of these strategies and explore more innovative solutions to meet the evolving economic environment and policy demands. Through collaborative efforts, the mitigation of local government debt risk can be better achieved, promoting the healthy development of regional economies.

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