

Local Government Debt Risk: Current Situation and Formation Mechanism

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Abstract: *This paper explores the current state and formation mechanisms of local government debt risk in China. With the slowdown in economic growth and the reduction in land finance revenue, the scale of local government debt has expanded, and debt risks have emerged. This paper analyzes the impact of fiscal systems, regional competition, and promotion incentives on debt risk, finding that mismatched fiscal powers and responsibilities, increased fiscal decentralization, tax competition, and promotion pressures have driven debt expansion. To address these issues, the paper proposes three policy recommendations: central fiscal support to promote economic recovery, optimization of the debt structure to enhance transparency, and strict control of new debt with performance assessments. This research provides theoretical support for understanding the formation mechanisms of local government debt risk and offers references for policy formulation.*

Keywords: Local government debt risk, Fiscal system, Debt structure, Policy recommendations.

1. Introduction

To promote economic and social development, China's local government debt has gradually increased. According to data from the Budget Department of the Ministry of Finance, as of April 2024, the balance of local government debt in China reached 41.75 trillion yuan, with an average annual growth rate far exceeding the GDP and local fiscal revenue during the same period. As China's economy enters a new normal with slowing economic growth, the institutionalization of the land capitalization income distribution system, and weakening demand in the land market, the era of "post-land finance" is approaching. Local governments' financing needs continue to increase, and debt risks and scales are evolving to some extent, worsening local fiscal conditions. In some regions, local government debt issues have even gradually evolved into "gray rhinos" threatening local economic security. Therefore, exploring the current situation and formation mechanism of local government debt risk and proposing targeted suggestions have important theoretical and practical significance.

2. Literature Review

The implementation of the tax-sharing reform in 1994 increased the fiscal pressure on local governments, making it increasingly difficult for local fiscal revenues to meet their expenditure needs. In this context, local governments adopt various "open source and reduce expenditure" measures, such as expanding land finance (Fan Xiaomin and Xu Yingzhi, 2018; Tang Yunfeng and Ma Chunhua, 2017; Han and Kung, 2015), strengthening tax collection and management (Shen Zhennie, 2018; Chen, 2017), reducing the supply of related public services (Yu Jingwen et al., 2018), and expanding financial resources (Xie Zhenfa et al., 2017; Xi Penghui et al., 2017), including borrowing. To alleviate fiscal pressure, local governments issue large-scale local bonds (Hong Yuan et al., 2018). During the economic transition, the growth of local government fiscal revenue often cannot match fiscal expenditure, leading to increasing fiscal deficits and financing

difficulties with the deepening of decentralization (Wildasin and Wilson, 1996). The unreasonable division of fiscal powers between central and local governments results in inefficient allocation and increased borrowing behavior by local governments (Garciamilá, 2002). Additionally, the design of the tax-sharing system affects local government revenue sources and stimulates debt expansion (Mao Jie et al., 2019; Zhong Huiyong and Lu Ming, 2015).

Regarding the formation mechanism of local government debt risk, domestic and foreign literature mainly analyzes from the perspectives of fiscal system, regional competition, and promotion incentives. In terms of the fiscal system, Liu Qiongzi (2020) believes that the mismatch between fiscal power and expenditure responsibility is the main cause of local government debt, and the degree of fiscal decentralization significantly increases local government debt risk (Yu Yingmin et al., 2018; Hou Shiying and Song Liangrong, 2021). Under the fiscal decentralization system, local governments have the motivation to over-borrow, thereby reducing their debt repayment responsibility (Schaltegger, 2009; Weingast, 2009). In terms of regional competition, local government debt has obvious spatial correlation and agglomeration effects (Wang Fanyi, 2020). Some scholars (Keen and Marchand, 1997; Borck, 2005) believe that tax incentives adopted by local governments to attract capital and personnel inflows induce other regions to adopt similar policies, forming tax competition and generating borrowing motives to solve the insufficient supply of public goods (Jensen and Toma, 1991). In terms of promotion incentives, China has a unique "official promotion tournament" mechanism (Zhou Li'an, 2004), where the promotion game among officials leads to excessive infrastructure investment, resulting in significant debt accumulation by local governments to promote construction projects. Some scholars have found that promotion incentives promote the accumulation of government debt (Shen Yuting, 2019) and significantly expand local government debt risk (Wang Feng et al., 2020; Xu Lin et al., 2022).

3. Current Situation of Local Government Debt Risk

Local government debt plays an important role in infrastructure construction, public services, and economic regulation. However, when debt levels exceed reasonable limits, the positive impact of debt on economic growth diminishes and may even turn negative. High debt levels crowd out private investment, and to repay the debt, local governments may reduce public expenditure, affecting the provision of public services and maintenance of infrastructure, thereby inhibiting economic growth.

According to the latest data released by the Ministry of Finance, as of April 30, 2024, the balance of local government debt nationwide stood at 41,748.904 billion yuan. Although this remains within the debt balance limit of 46,787.43 billion yuan approved by the National People's Congress, it represents a significant increase compared to the 16,370.659 billion yuan at the end of 2017, with an average annual growth rate of approximately 13.7%. Figure 1 shows the balance of local government bonds from 2017 to 2023. From these data, we can observe that the balance of local government bonds has been showing an increasing trend year by year.

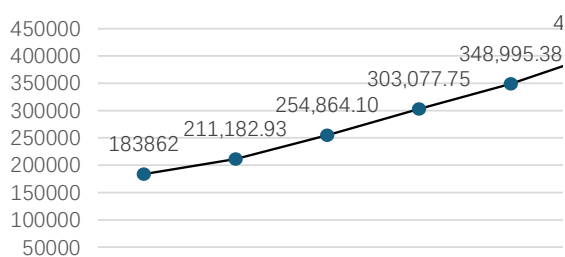


Figure 1: 2017-2023 Local Government Bond Balance (Unit: 100 million yuan)

A detailed analysis of the issuance volume of local government bonds from 2017 to 2023, as shown in Figure 2, reveals that the issuance volume remained relatively stable with slight fluctuations from 2017 to 2019. There was a significant increase in 2020, which could be associated with heightened economic stimulus and infrastructure investment in response to the COVID-19 outbreak. The issuance volume surged again in 2023, reaching 9,337.368 billion yuan. The consistently high levels from 2021 to 2023 reflect the ongoing demand for funds by local governments during economic recovery and development, as well as possible policy support from the central government.

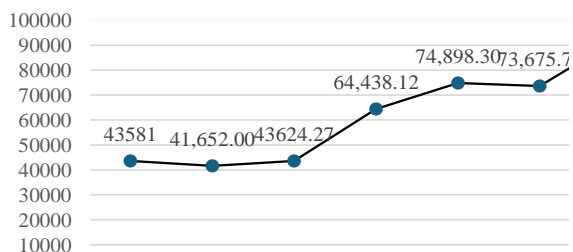


Figure 2: 2017-2023 Issuance Volume of Local Government Bonds (Unit: 100 million yuan)

Figures 3 and 4 list the average issuance term and average issuance interest rate of local government bonds issued from 2018 to 2023 (data for 2017 was not disclosed). The issuance

term reflects adjustments in local governments' debt management and financing strategies, showing a tendency to issue bonds with longer maturities to alleviate short-term repayment pressures. Additionally, the average issuance interest rate gradually declined from 3.89% in 2018 to 2.90% in 2023, possibly due to a more accommodative macroeconomic environment, lower market funding costs, and increased market confidence in local government credit.

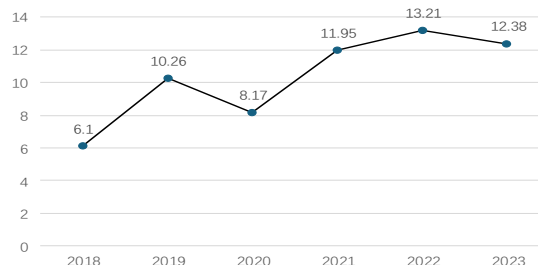


Figure 3: 2018-2023 Average Issuance Term of Local Government Bonds (Unit: Years)

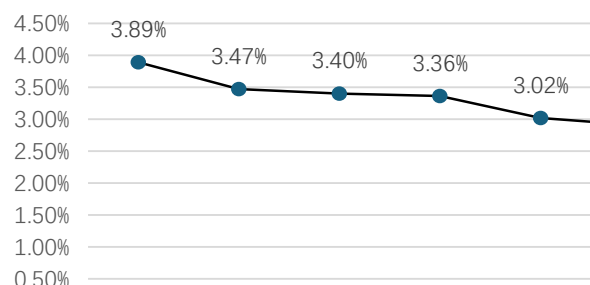


Figure 4: 2018-2023 Average Issuance Interest Rate of Local Government Bonds

Local government bonds can be further detailed based on their funding purposes into new bonds and refinancing bonds. Figure 5 shows the data of new bonds and refinancing bonds issued from 2017 to 2023. It can be observed that except for slight declines in 2021 and 2023, the issuance of new bonds has generally shown an increasing trend year by year, particularly after the outbreak of COVID-19 in 2020. This may be related to local governments increasing infrastructure investment and economic stimulus measures. The issuance volume of refinancing bonds, on the other hand, has shown a fluctuating trend, increasing to 4,680.307 billion yuan in 2023, approximately 1.69 times the issuance volume in 2017. This reflects the increased need of local governments for managing and refinancing maturing debt, with a significant increase in 2023 possibly in response to intense pressure to repay maturing debt.

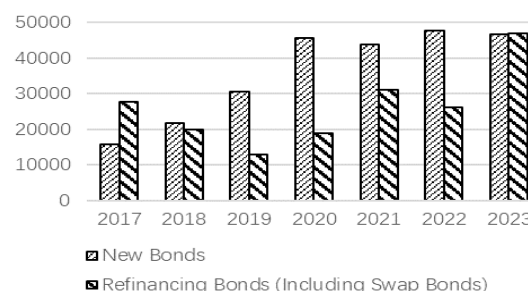


Figure 5: 2017-2023 Issuance Volume of Local Government Bonds Differentiated by Purpose (Unit: 100 million yuan)

Local government debt includes explicit debt and implicit debt. The data on local government bonds released by the Ministry of Finance mentioned above only covers the explicit debt of local governments. These debts are clearly recorded in the government's financial statements and are typically repaid by the local governments. However, there is also a significant amount of implicit debt in local governments. Implicit debt refers to the debt that is not explicitly recorded in the government's financial statements, such as debt raised through financing platform companies, local state-owned enterprises, and Public-Private Partnership (PPP) models. This type of debt is often acquired through alternative means to circumvent legal and policy restrictions. The increase in implicit debt adds unpredictability to local government finances. If large-scale implicit debts were to surge all at once, it could potentially impact regional, and even nationwide, economic stability.

4. Formation Mechanism of Local Government Debt Risk

4.1 Fiscal System Reform

In 1994, China underwent significant fiscal reforms, commonly referred to as the "Tax Sharing System" reform. The reform mainly comprised three components: Reclassification of Local Revenues: The reform eliminated the extrabudgetary funds of local governments and reclassified all local revenues into three categories: taxes exclusively for the central government, taxes exclusively for local governments, and taxes shared by both the central and local governments. Value-Added Tax (VAT) Sharing: VAT became the most important shared tax between the central and local governments. After the reform, local governments were allowed to retain 25% of VAT revenue, while 75% went to the central government. This change significantly increased the central government's control over tax revenues while substantially reducing the income of local governments. Local Fiscal Autonomy: Although the reform led to a centralization of a portion of tax revenues, the central government granted local governments new autonomy and resources to secure their cooperation. This enabled local governments to independently raise funds.

The 1994 fiscal reform aimed to increase the central government's share of tax revenue, control inflation, and strengthen the central government's monetary control. To address the financial gaps of local governments, the central government tacitly allowed local governments to create new financing vehicles such as Local Government Financing Vehicles (LGFVs) to sustain local economic growth. LGFVs are corporate platforms established by local governments primarily to raise funds for public infrastructure projects. These projects include the development of roads, ports, hospitals, schools, and industrial parks, making LGFVs a major source of local government debt. They meet corporate financing requirements by transferring land use rights and other assets, and by providing fiscal subsidies as repayment assurances when necessary.

The funding sources for LGFVs include bank loans, bond issuances, initial public offerings (IPOs), and trust loans, among others. Local governments provide implicit guarantees

for these loans, such as guarantee letters issued by finance bureaus or local People's Congresses, to back the bank loans of LGFVs or other local enterprises. These unregulated debts are not recorded in official accounts, but local governments might still be liable for their repayment to some extent.

LGFVs themselves have significant inherent flaws. On one hand, they excessively rely on bank loans, with most of these loans being short-term, while the investment projects are typically long-term. This mismatch between the debt structure and the project timelines can lead to liquidity issues. On the other hand, LGFVs suffer from poor corporate governance. Local government officials often serve as legal representatives or senior managers of LGFVs, resulting in inadequate debt risk management. In some cases, there have even been instances of local governments illegally raising funds or providing false collateral through shadow banking systems. Banks, as the main lenders to LGFVs, could face negative impacts if LGFVs are unable to repay their loans on time. This debt issue could also affect the stability of the bond market. Although LGFVs have played a crucial role in promoting local economic development and infrastructure construction, the debt risks they bring, including low fiscal transparency, risks to financial markets, policy risks, and the risk of economic growth slowdown, cannot be overlooked.

4.2 Inter-regional Competition and Performance Evaluation

Inter-regional competition is a significant factor contributing to the risk of local government debt. Local governments often engage in intense competition with one another to attract domestic and international investors, with the ultimate goal of promoting local economic development and increasing employment opportunities. This competitive environment urges local governments to strive to provide the most favorable conditions for businesses to establish themselves in their regions. Furthermore, in a bid to gain a competitive edge and secure their position among neighboring regions, local governments frequently embark on large-scale infrastructure projects. These projects encompass critical areas, such as transportation networks, including roads, railways, airports, and ports, as well as energy supply systems, water resources, and urban development initiatives. The comprehensive development of these infrastructures aims not only to create a business-friendly environment but also to enhance the living standards of residents, thereby making the region more attractive. The substantial investments required for these infrastructure projects, coupled with the financial incentives offered to businesses, can significantly increase local government expenditures. Typically, the revenue generated from taxes and other income sources may be insufficient to cover these costs. Faced with these financial shortfalls, local governments often resort to borrowing to bridge the funding gaps. This borrowing can take various forms, including issuing local government bonds, obtaining loans from financial institutions, or engaging in public-private partnerships. While these measures may provide the necessary funds in the short term, they significantly increase the debt burden of local governments. The reliance on borrowed funds also leads to heightened liquidity pressures, especially when a significant portion of the debt comprises short-term obligations. Additionally, if the anticipated

economic growth does not materialize or if the investments do not yield the expected returns, local governments may find themselves in precarious financial situations, unable to generate sufficient revenue to service their debts.

The promotion and evaluation mechanisms of officials are another crucial factor in the formation of local government debt risk. The promotion and performance evaluation of local officials typically depend heavily on economic growth performance indicators, such as GDP growth rate, fixed asset investment growth, and fiscal revenue growth. These indicators are considered important reflections of political achievements. To achieve significant local economic growth and investment during their tenure, local government officials are more inclined to allocate government funds to short-term, quick-result projects. However, the long-term benefits and economic sustainability of these projects may not be high. This blind pursuit of GDP growth can lead to excessive borrowing by local governments, creating a false sense of prosperity. If the investment projects fail to meet expectations, there can be a risk of a financial chain break and increased debt pressure. Many large-scale infrastructure and industrial projects require significant capital investment, have long payback periods, and carry high risks. The responsibility for repaying long-term debt may ultimately fall on successive officials, while current officials are often more inclined toward borrowing for immediate development, neglecting long-term debt risks.

4.3 Financial Crisis and COVID-19 Pandemic

The debt expansion following the global financial crisis further exacerbated the debt risk for local governments. After the global financial crisis, economic growth slowed, and unemployment issues worsened. To address economic recession and unemployment, local governments adopted a series of economic stimulus measures, such as increasing infrastructure investment, providing financial subsidies, and implementing social security projects. These funding gaps could not be filled by the local governments' own income-generating systems and could not be covered by existing fiscal revenues, making local governments inclined to finance through borrowing. However, the high proportion of short-term debt brought liquidity pressure, and local governments could not resolve the debt through high-speed growth. The funds for long-term projects initiated during periods of economic prosperity were also affected, forcing local governments to continue borrowing to meet new stimulus expenditures. Following the 2008 financial crisis, the central government implemented a 4 trillion RMB economic stimulus plan. It encouraged local governments to maintain economic growth through new projects and enriched their financing tools (such as issuing infrastructure investment bonds) to manage the debt growth, further expanding the scale of debt.

The outbreak and persistence of the COVID-19 pandemic since the end of 2019 have had profound impacts on the economies of countries worldwide, and the debt risk of local governments in China is no exception. Due to the pandemic-induced slowdown in economic activity, business difficulties, and reduced household incomes, local governments experienced a significant hit to their tax

revenues, and their reliance on land sale revenues saw a substantial decline. At the same time, increased spending on pandemic prevention and economic stimulus further exacerbated fiscal pressures. To cope with short-term fiscal pressures and stimulate economic recovery, local governments were forced to increase their bond issuance to raise the necessary funds. Some local governments rapidly raised funds by issuing short-term bonds, leading to a rise in the proportion of short-term debt. This mismatch in debt maturity increased the repayment pressure on local governments. Changes in the financing environment have made it more difficult for local governments to raise funds in the capital markets, raising financing costs. Additionally, the central government's regulation of local governments' implicit debts has made it increasingly challenging for local governments to secure financing.

5. Policy Recommendations

First, central fiscal support to promote economic recovery. The central government can alleviate local governments' fiscal pressures by increasing fiscal transfers to them. Issuing special bonds specifically to support key projects and infrastructure development of local governments can help reduce their financing stress. Through policy support and funding, the resumption of business operations can be promoted, thereby boosting local economic vitality. Additionally, supporting local governments' development of emerging and high-tech industries can expand sources of fiscal revenue.

Second, optimize the debt structure and enhance debt transparency. This can be achieved by swapping short-term high-interest debt for long-term low-interest debt, thereby extending debt maturities and reducing interest burdens. Replacing high-cost bank loans with low-cost government bonds can lower overall financing costs. Strengthening the disclosure and transparency of local government debt information ensures proper and standardized debt management. Conducting regular debt audits helps identify and correct irregular debt practices, preventing the accumulation of implicit debt.

Third, strictly control new debt and implement performance assessments. The central government could set debt ceilings for local governments, strictly controlling the scale of new debt. A rigorous approval system for new debt would ensure that new debt is used for projects with clear returns. Incorporating local government debt management into the performance assessment system, holding local governments accountable for poor debt management, and punishing those involved in unauthorized borrowing can prevent reckless borrowing behaviors.

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