FISCAL AFFAIRS

THE STORY SO FAR

China's fiscal conditions are on an unsustainable path. Local governments spend much more than they take in, forcing them to rely on inefficient state-owned enterprises (SOEs), land sales, and risky debt-driven financing practices for revenue. This increases underlying risks and makes the economy less efficient. Leaders in Beijing acknowledge that fiscal reform is critical, and that it has a long way to go. The 2013 Third Plenum promised to close the gap between the central government's expenditure directives to local governments and the resources available to them.

- Beijing passed a new budget law in August 2014 that allowed local governments to issue bonds while banning all other forms of local government borrowing and guarantees, including the use of local government financing vehicles (LGFVs) to borrow from banks and the shadow banking sector. The law was meant to limit quickly growing local government debt levels – particularly riskier "implicit debts," or contingent liabilities – that are not recorded on official balance sheets.

- In March 2015, Beijing initiated a three-year "bond swap" program to compel local governments to swap all non-bond borrowing into lower-cost bonds. At the end of 2014, local governments had a reported 14.34 trillion RMB ($2.1 trillion) in official debt. Only 256.5 billion RMB ($37 billion) of this remains to be swapped as of October 2018. The program improved local fiscal transparency and reduced interest burdens for local governments.

- The central government initiated value-added tax (VAT) reform in 2012 in pilot form and officially rolled out VAT nationwide in 2016. The VAT replaced China's complex business tax with a more simplified scheme meant to cut corporate tax burdens. In practice, the VAT decreased net local government tax revenue, given that it offered more tax deductions and was in many ways a tax relief relative to the business tax scheme.

- Recognizing that the 2014 budget law had not succeeded in curtailing off–balance-sheet borrowing by local governments, in early 2018 Beijing required that local governments repay all associated contingent liabilities or implicit debt within 3 to 5 years. While the exact amount of local government implicit debt is unknown, credible estimates put it between 30 and 45 trillion RMB ($4.3–6.5 trillion).

METHODOLOGY

To gauge fiscal reform progress, we watch the gap between local government expenditures and the financial resources available to pay for them, including central government transfers. Our primary indicator shows the official trend in blue and an augmented calculation of the gap including off–balance-sheet, or "extra-budgetary," expenses and revenues in green – thus covering the range of estimates. The higher the expenditure-to-revenue ratio, the more concerning the side effects, including local government debt burdens. Our supplemental fiscal indicators include local financing sources, the national official and augmented fiscal position, the move from indirect to direct taxes, and the share of expenditures on public goods.

QUARTERLY ASSESSMENT AND OUTLOOK

Primary Indicator: Local Governments Expenditure-to-Revenue Ratio
4qma, percent
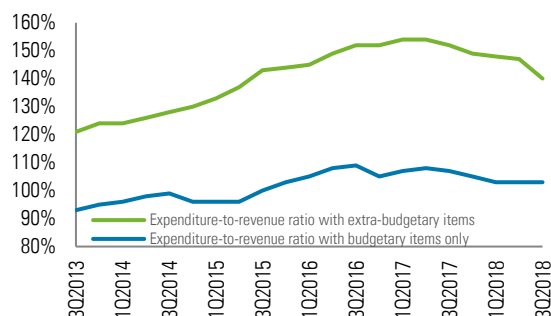
Source: National Bureau of Statistics, Rhodium Group.

- We slightly improve our assessment of fiscal reform but remain negative overall: fiscal conditions are deteriorating and policy change is insufficient to reverse that.

- A surge in local government special revenue bond issuance in the third quarter of 2018 drove the largest quarterly improvement in our primary indicator in six years.

- Policy developments were not encouraging: the State Council allowed local governments to renegotiate or restructure implicit debt, despite a requirement from earlier in 2018 that these debts be repaid, reinforcing moral hazard problems.

THIS QUARTER'S NUMBERS

Our primary indicator, the augmented **Local Expenditure-to-Revenue Ratio**, saw the largest quarterly improvement in our data sample, with the ratio declining from 147% in 2Q2018 to 140% in 3Q2018. This means that provincial governments spent 40% more than the revenue they collected in the third

quarter, even after accounting for some off-budget financing activities. While local fiscal conditions are still deteriorating, they are deteriorating at a slower pace than in our last review.

There were signs of improvement in both local revenues and expenditures. The primary cause driving the lower local expenditure-to-revenue ratio (i.e., fiscal improvement) was a spike in local government special revenue bond issuance totaling RMB 1.68 trillion ($243 billion) for the quarter, up from RMB 0.33 trillion ($47.8 billion) in 2Q2018 (see **Sources of Local Government Financing**). Issuance of these bonds is highly seasonal, so the ratio's decline is likely to be temporary. Overall, the increasing reliance upon special revenue bonds is a long-term positive for local governments' fiscal positions.

Special revenue bonds can serve as a long-term supplemental funding channel for local governments, improving overall local government fiscal sustainability. Beijing is expected to boost full-year special revenue bond issuance in 2019, probably surpassing RMB 2 trillion ($290 billion). Compared to borrowing by local government financing vehicles (LGFVs), special revenue bonds bear lower interest rates and improve the transparency of local government balance sheets. Unlike general government bonds repaid from fiscal coffers, special revenue bonds are used to finance income-generating projects specifically, with repayment secured by cash flows from the projects. This is one reason the bonds are more attractive to investors. These special revenue bonds may become the foundation of a Chinese version of a municipal bond market in the future.

Issuance of special revenue bonds will drop in 4Q2018 and 1Q2019, as quotas are only approved at the March National People's Congress meeting. In 2018, issuance was particularly strong in 3Q because of complications related to the sunset of the three-year "bond swap" program in August, which had allowed local governments to replace a fixed amount of higher-interest debt with lower-cost bond financing. Local governments mostly sold these bond swaps in the first half of 2018 and only turned to selling special revenue bonds starting in August. Consequently, the primary indicator improved considerably in 3Q2018, but this probably will not continue into 4Q2018. This explains why our assessment of fiscal conditions is only modestly more positive than last quarter despite the substantial improvement in the indicator.

In terms of local government spending, infrastructure investment by LGFVs declined further in 3Q2018, by

10.7% year-on-year, larger than the 4.5% drop in 2Q2018. This was in line with official National Bureau of Statistics (NBS) data also published during the review period that showed record-low infrastructure investment growth of only 3.3% in the first nine months of 2018. Infrastructure investment showed signs of rebounding in October 2018 following a State Council circular permitting restructuring of local government debt (see **Policy Analysis** below), freeing up resources for additional spending.

Another worrying sign for local fiscal conditions is that fiscal revenue growth is flagging, as revenue from Beijing's supplementary fiscal account, the "fund budget" (heavily driven by local government land sales) was only up by 16.3% in 3Q2018, compared to 40.5% in 2Q2018. Property developers have a full year to pay localities for land purchases, so most of the growth in land sales revenue reflects purchases made in 2017, as most proceeds are paid close to the deadline. The slowdown suggests land sales were already weakening in the second half of 2017 and continued declining in 2018. This is highly problematic for local government fiscal conditions given their high reliance on land transfer fees as a source of revenue. Local governments faced strong pressure to repay implicit debt earlier in 2018, and they redoubled efforts to collect land sales revenue. As a result, revenue growth overall will likely weaken in the remaining months of 2018 and into 2019.
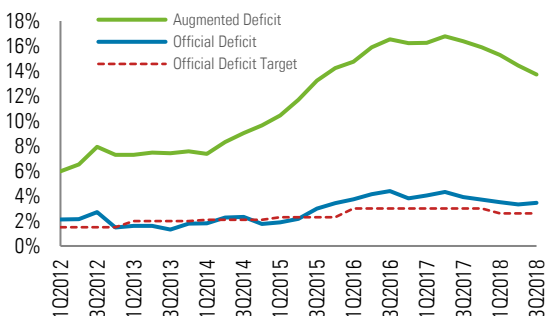
Supplemental I: Sources of Local Government Financing
RMB billions
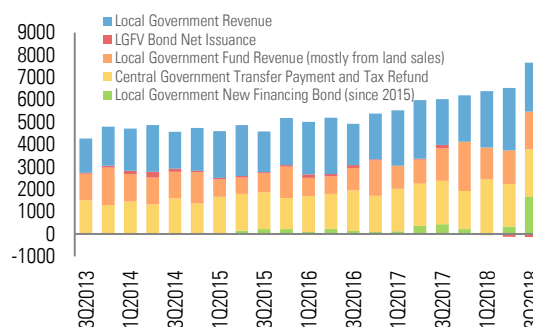
Ministry of Finance, National Bureau of Statistics, International Monetary Fund, Rhodium Group.

Supplemental 2: Fiscal Deficit Measures

4qma, percent

— Augmented Deficit
— Official Deficit
- - - Official Deficit Target

Source: Ministry of Finance, Rhodium Group.

Supplemental 3: Direct Taxation Ratio

4qma, percent

- - - OECD
— China Direct Taxation Ratio

Source: Ministry of Finance, Rhodium Group.

Supplemental 4: Government Social Expenditures

4qma, percent

Environmental Protection

Health and Family Planning

Social Security

Education
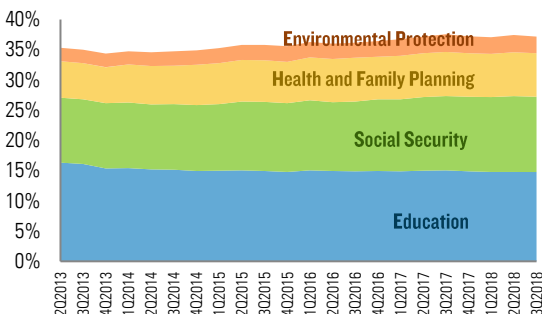
Source: Ministry of Finance, Rhodium Group.

POLICY ANALYSIS

Reform of the central-local fiscal system was a key focus for Chinese policymakers in the previous quarter, given the rising risk of defaults from local government debt. The most significant policy change in this review period was allowing localities to extend and restructure some of their contingent liabilities rather than repay them directly, with the shift announced in October in a State Council circular. The purpose of this adjustment was to stabilize weakening infrastructure investment and overall economic growth. While deleveraging worked to reduce some of the risks within the financial system, it stalled growth in the process.

While acting to stabilize the economy under the pressure of deleveraging and trade tensions is an understandable response from Beijing, the adjustment in local debt management reinforces moral hazard by strengthening market expectations of implicit guarantees for LGFVs and SOEs. Yields on LGFV bonds dipped below those of non-LGFV corporate bonds following the move, after LGFV bonds had traded at higher yields for most of the first half of 2018. Confidence in LGFV implicit guarantees was shaken since last year by multiple bond defaults – which was a positive story because financial markets were finally starting to price credit risk more accurately. Now market expectations that the government will bail out LGFVs have returned, to the detriment of financial market reform.

Other fiscal policy adjustments included new individual income tax thresholds and exemptions beginning October 1, a move to shore up household consumption. The central government also frontloaded 2019 fiscal year transfers to debt-strapped localities totaling RMB 2.1 trillion ($304 billion), revealing the severity of local funding stress.

The outlook for fiscal policy reforms in 2019 is somewhat brighter. Beijing is expected to merge the current value-added tax (VAT) structure from three rates to two, and corporate income taxes could also be cut, which would both simplify the overall tax structure and cut the central government's proportion of revenue collection. Contributions to social security pension funds are now being enforced by the State Administration of Taxation, which brings some short-term pain to companies but is a positive sign for longer-term fiscal reform as Beijing can obtain a more accurate picture of overall revenue collection, improving transparency.

Most importantly, the pressure from local government debt is likely to produce some relaxation in central government control of local fiscal autonomy. This centralization of control has been a key factor behind the fundamental mismatch in central-local fiscal policy, because the central government mandates local governments to spend well more than the revenue they take in. Over the past six years, Beijing has replaced business taxes – where revenue accrued to localities – with VAT, where revenue is shared between central and local governments (temporarily). The consequence has been a rapid accumulation of local government debt as

localities tried to manage spending obligations and maintain economic growth.

Now, with local government debt levels far too high, some reversal and relaxation of Beijing's control are probable. Implementation of a property tax may still be a difficult step amid a slowing property market, but it remains one of the most promising options for local governments to generate revenues. Some revisions of the relevant laws related to property taxes are expected to begin this year, although implementation would happen only in 2020 at the earliest. With China's home ownership rates at more than 80%, collecting taxes on existing homes is a more promising channel for local governments to obtain a sustainable new source of revenue than trying to sell more land to developers.