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 center-local fiscal reform is critical, and that it has a long way to go. The 2013 Third Plenum plans promised to close the gap between what the center commands local governments to spend 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 “swap bond” program to compel local governments to swap all nonbond 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. As of October 2018, only 256.5 billion RMB ($37 billion) of this debt remained to be swapped. The program improved local fiscal transparency and reduced interest burdens for local governments and has been extended on a limited basis in 2019.

- The central government initiated value-added tax (VAT) reform in 2012 in pilot form and officially rolled out the VAT nationwide in 2016. The VAT replaced China’s complex business tax with a more simplified scheme meant to cut the corporate tax burden. In practice, the VAT decreased local government tax revenue on net, 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 curtailting off-balance-sheet borrowing by local governments, in early 2018, Beijing required that local governments repay all associated contingent liabilities or implicit debt within three to five years.

While the exact amount of local government implicit debt is unknown, credible estimates put the actual level at 30–45 trillion RMB ($4.3–$6.5 trillion) as of today. Since the heavy debt burden has been crippling for localities, Beijing relaxed guidance on debt repayment in October 2018, allowing local governments to extend or renegotiate implicit debts.

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 “extrabudgetary” 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

![Graph showing expenditure-to-revenue ratio from 2014 to 2019.](source: National Bureau of Statistics, Rhodium Group.)

- We modestly upgrade our assessment of fiscal affairs reform: local government spending is still outpacing revenue, but Beijing is reducing this gap while engineering a slow transition of new debt issuance from costlier and riskier off-balance-sheet funding to official, on-balance-sheet funding through bonds.
• Our primary indicator shows that local governments narrowed the augmented fiscal gap in 1Q2019 by boosting their intake with bond issuance, even though they still outspent their budgetary resources.

• Beijing continued tightening policy against local government implicit debt growth, meaning that rising expenditures will increasingly be funded through stronger bond issuance rather than shadow banking channels. Local governments still bear the fiscal burden of delivering Beijing’s infrastructure-led stimulus.

This Quarter’s Numbers

Our primary indicator shows that local governments are relying more on official borrowing channels, although they are still spending beyond their budgetary resources. Our augmented Local Expenditure-to-Revenue Ratio improved as a result of unseasonably strong local government bond issuance, falling from 138% in 4Q2018 to 134% in 1Q2019, its lowest level since 3Q2015. Compared with peak levels, the gap between what local governments spend and what they take in is narrowing—a key fiscal affairs reform objective—but expenditure still exceeds even extrabudgetary revenue by 34%, which means that local fiscal practices cannot be described as prudent.

Local bond issuance is typically small in the first quarter, yet it was frontloaded this year to counter economic slowdown. Net special revenue bond issuance reached RMB 1.2 trillion ($173 billion) in 1Q2019, the second-highest amount on record and more than seven times higher than 4Q2018 issuance (see Sources of Local Government Financing).

Local governments continue to spend more than they receive, causing the budgetary expenditure-to-revenue ratio to rise as tax cuts and weaker land sales translated into smaller fiscal intake. Local government fund revenue, mostly from land sales, fell 7% year-on-year in the first quarter, its first drop since 3Q2015—the previous cyclical trough in the property sector—and far below the 23.9% growth seen in 2018. Local governments typically have up to one year to collect developer payments for land purchases, so falling revenue now reflects last year’s property market downturn, which currently shows no signs of recovery.

Weaker revenue also contributed to larger official and augmented Fiscal Deficits this quarter. The national augmented deficit ticked up in 1Q2019, from 14.0% to 14.5% of gross domestic product (GDP), while the official fiscal deficit also rose to 5.2% of GDP from 4.2% last quarter. Spending on transportation, urban and rural communities, and science and technology accelerated this quarter. Social spending, however, has not meaningfully changed as a share of total expenditure, and it even ticked downward in 1Q2019 (see Social Expenditure).
Supplemental 3: Direct Taxation Ratio
4qma, percent

Supplemental 4: Government Social Expenditures
4qma, percent

Policy Analysis

Improving fiscal health requires more standard and transparent local government financing. Expansion of the local government bond market can promote more responsible local fiscal behavior and is a necessary step in long-term fiscal reform. Over the past six months, stronger local bond issuance bridged the funding gap left by falling land sales revenue. National government fund income—the majority of which comes from land sales—in the first quarter was below the level targeted by the March budget report of the National People’s Congress (NPC), and spending far exceeded targets. Thus, additional local government bond issuance is needed to help fill the growing gap this year. Using transparent funding like bonds is a vast improvement over illicit shadow financing, but ultimately, local fiscal management should be determined less by infrastructure spending and more by stable income streams like tax revenue.

As Beijing opens the “front door” wider to on-balance-sheet financing, efforts to close the “back door” on shadow financing continue. The central government tightened fiscal measures to control local governments’ implicit debt growth. In May, Beijing banned the use of “engineering, procurement, construction, and financing”—short-term, leveraged funding from contractors—for local government investment projects. Authorities renewed crackdowns on public-private partnerships to eliminate projects that increase local implicit debt burdens. Together, these measures limit local governments’ access to costlier hidden borrowing and redirect future spending toward more affordable, official borrowing channels.

Localities are under more fiscal stress as intake falls and spending pressure rises, particularly in interior and western provinces. In April, the Ministry of Finance published its first-ever fiscal difficulty indicator quantifying fiscal stress at the local level. Qinghai, a western province where a local government financing vehicle defaulted on a bond earlier this year, ranked most troubled, while Beijing faces the least fiscal pressure. At a June NPC meeting, Standing Committee member Li Yuefeng warned that some local governments in western China, most of which rank among the highest in fiscal difficulty, are struggling to cover even basic spending on salaries, social welfare, and government functions.

Transparency is important for improving fiscal efficiency, but more imperative in the long run is narrowing the gap created by Beijing’s limitations on local fiscal autonomy. While local bond issuance is a medium-term solution, Beijing’s mandate to use infrastructure spending as a short-term economic stimulus worsens fiscal pressures on localities, which must carry out high-cost, low-return investments. The National Development and Reform Commission recently allowed local governments to use special revenue bonds as equity for infrastructure projects, suggesting infrastructure-led stimulus remains a priority. Material improvement in local fiscal health likely depends upon less central pressure on local governments to meet growth and investment targets and to deliver infrastructure-led stimulus, which is unlikely before 2020.