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 (LGFSVs) 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 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 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

Primary Indicator: Local Governments Expenditure-to-Revenue Ratio 4qma, percent

![Expenditure/Revenue Ratio with Extra-budgetary items vs Budgetary Items Only](source)


- We modestly upgrade our assessment of fiscal affairs reform: local governments are slashing property-related spending while replacing riskier and more expensive shadow banking borrowing with formal bond issuance.

- Local governments narrowed the augmented fiscal gap in 2Q2019 after they spent less on shantytown redevelopment, but they still outspent their budgetary resources.

- Beijing’s tightening against the property sector, if continued, and retirement of the shantytown
redevelopment program in 2020 are conducive to long-term improvements in localities’ fiscal balances.

This Quarter’s Numbers

Local governments’ fiscal picture improved this quarter. The augmented Local Expenditure-to-Revenue Ratio fell to 12.3% in 4Q2019, its lowest level since 1Q2015, from 13.4% in the previous quarter and 14.2% a year ago. 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 extra-budgetary revenue by 30%.

Reduced spending on land and property-related items was the key driver of improvement this quarter. Growth in local government fund expenditures, which can include land, property-related development costs, and revenue-generating infrastructure projects, slowed to 15.1% in 2Q2019 from a hefty 55.5% jump in 1Q2019 linked to the unseasonal surge in local government bond issuance, which has since moderated. Although the Finance Ministry has discontinued land revenue and expenditure data releases—a strike against fiscal transparency—available data confirm the ongoing slowdown in localities’ land-related spending.

The fall in expenditure is related to a change in the shantytown redevelopment program, which was originally designed to replace rundown homes with newer, improved housing. Since late last year, the government has gradually transitioned from compensating resettled residents with cash, which residents use to buy new homes at market value, to offering newly constructed housing. As constructing housing is far cheaper than paying market value for it, the policy change greatly reduces localities’ spending responsibility.

Increasing revenue also helped (see Sources of Local Government Revenue). Land sales revenue improved to 7.7% growth in 2Q2019 from a contraction of 9.5% in 1Q2019 as localities stepped up collection of land-related fees to fill their own fiscal gaps. Land revenue and expenditure are typically closely correlated as local governments spend money to acquire and develop land and then sell it to developers. The divergence in land spending and revenue seen this quarter is rare and is best explained by the fall in shantytown redevelopment spending and the intensification of land fee collection. Local government bonds also contributed to stronger revenue this quarter, thus continuing to lighten heavy local implicit debt burdens.

The improvement in fiscal balance also saw a modest narrowing of augmented Fiscal Deficits this quarter, falling to 14.4% of GDP from 14.5% in the first quarter. While the off-budget fiscal picture improved, the budgetary deficit worsened, reflecting limitations of the current fiscal model in maintaining more sustainable budgetary outlays. Spending growth on transportation, urban and rural communities, and science and technology barely changed this quarter with a modest uptick in environmental spending; although as a share of total government expenditure, social spending in most categories has fallen since 2Q2018 (see Government Social Expenditures).

Supplemental 1: Sources of Local Government Financing

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<th>Billion RMB</th>
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<tr>
<td>LGFV Bond Net Issuance</td>
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<tr>
<td>Local Government New Financing Bond</td>
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<td>Fund Revenue (mostly from land sales)</td>
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<tr>
<td>Transfer Payment and Tax Refund</td>
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<td>Local Government Revenue</td>
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Supplemental 2: Fiscal Deficit Measures

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<th>4qma, share of GDP</th>
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<td>Augmented Deficit</td>
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<tr>
<td>Official Deficit</td>
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<td>Official Deficit Target</td>
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Source: Ministry of Finance, Rhodium Group.

China Dashboard Fall 2019
property policy and retirement of the shantytown redevelopment program will substantially ease local government spending expectations in the long run.

Beijing has also renewed tightening efforts against local governments’ implicit borrowing after relaxing its deleveraging campaign in late 2018 so local governments could step up spending to support economic growth. As soon as growth appeared to stabilize in 1Q2019, policymakers tightened the reins again. The banking regulator issued a circular reinstating key deleveraging measures focused on local governments and the property sector. In June, the government banned contractors from fronting funding for local government investment projects, and the Finance Ministry resumed inspections on public-private partnership (PPP) projects that add to local governments’ implicit debt. These measures will force localities to reduce spending or to borrow money from official channels or both, which is conducive to narrowing fiscal gaps.

The improvement in the fiscal balance will falter in the third quarter as governments run out of room to issue more revenue bonds. Policymakers are considering boosting bond issuance in the fourth quarter to offset a slowing economy, which would sustain local fiscal needs through the end of the year but leave the long-term picture unresolved.

Policy Analysis

Beijing has tightened policy toward the property sector, indicating a higher tolerance for a broader economic slowdown. In July, the Politburo made clear that property would not be used as a short-term stimulus to spur growth as in previous cycles. Since then, regulators have unveiled a slew of measures, including the central bank’s pledge to keep mortgage rates unchanged despite the August rate reform that should reduce lending rates for the rest of the economy. Both the central bank and the banking regulator have instructed banks to control or even reduce loans to property developers. If Beijing remains committed to rein in the property sector, local governments will have no choice but to rely less on selling land to developers for revenue growth and by extension will spend less on land development.

In addition, the shantytown redevelopment program is scheduled to be retired after 2020, removing a major fiscal burden. Together, land and property-related spending drove the explosion of local government fund deficits from 2.41 billion yuan in 2015 to 2.3 trillion yuan in 2019, and in 2018 land-related spending accounted for 90% of governments’ fund expenditure. That ratio fell to just 76% in the first half of this year, suggesting that tighter