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 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

- Our assessment of fiscal affairs reform is unchanged this quarter. Local governments' fiscal balance barely budged, with weak revenue due to COVID-19 offset by a decline in spending.

- The budgetary fiscal gap widened further because of a drop in tax revenue, straining local finances. Larger bond issuance and a sharp fall in off-budget spending helped fill the funding gap to some extent.

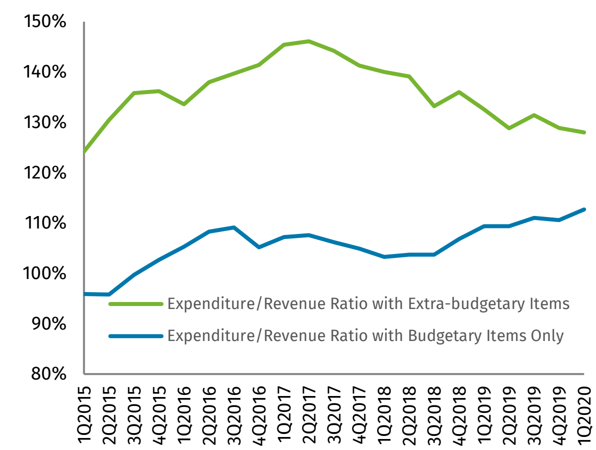
- Beijing is changing course by allowing localities to roll over debt. While this is a setback for fiscal reform, it will significantly cut local government interest payments, make local debt more sustainable, and improve fiscal health.

This Quarter's Numbers

In 1Q2020, local governments spent far more than they took in, but no worse than in the previous quarter. The augmented **Local Expenditure-to-Revenue Ratio** stood at 128% in 1Q2020, compared with 128.9% in the prior quarter and 132.6% in 1Q2019. The augmented ratio, which includes extra-budgetary channels, improved modestly as local government financing vehicle (LGFV) spending fell sharply (–46.3%) in the first quarter. The decline was a result of the COVID-19 lockdown measures, which prevented migrant workers from returning to work sites.

Primary Indicator: Local Governments Expenditure-to-Revenue Ratio

4qma, percent



Source: National Bureau of Statistics, Rhodium Group.

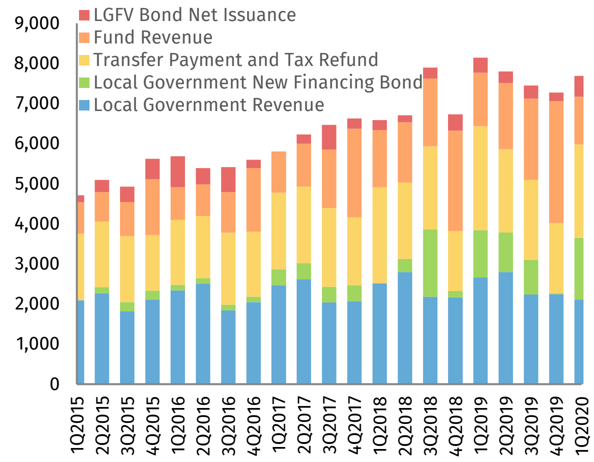
The decline in LGFV spending is not sustainable, as Beijing is ratcheting up infrastructure construction to help the economy rebound and offset weakness in the property market, exports, and domestic consumption. With most migrant workers returning to work in the second quarter and infrastructure investment picking up in May and June, spending is expected to increase further, widening the expenditure-to-revenue gap.

While the augmented ratio remained stable, the budgetary funding gap worsened, with expenditure rising to 112.7% of revenue in 1Q2020, its highest level since 1Q2015. Tax revenue took a heavy hit under COVID-19, falling 16.4% year-on-year (yoy) in 1Q2020. Local governments have limited room to adjust budgetary spending with most expenses hardwired, producing a larger gap.

Local spending on social services as a share of total expenditure narrowed this quarter, as local governments cut spending wherever they could in the face of declining revenue. While overall social services spending declined, unemployment benefits were the only category reporting an increase (see **Government Social Expenditures**). This resulted from the surge in unemployment, as more benefits were paid to the jobless and low-income families.

Supplemental 1: Sources of Local Government Financing

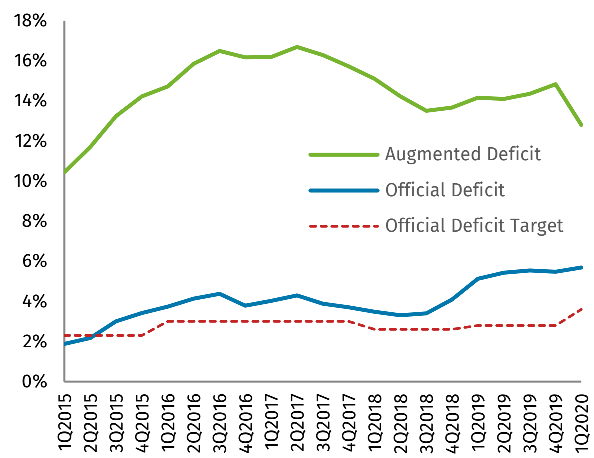
Billion RMB



Source: Ministry of Finance, National Bureau of Statistics, International Monetary Fund, Rhodium Group.

Supplemental 2: Fiscal Deficit Measures

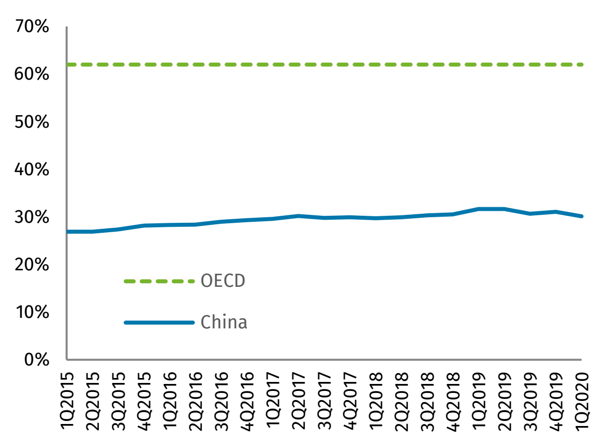
4qma, share of GDP



Source: Ministry of Finance, Rhodium Group.

Supplemental 3: Direct Taxation Ratio

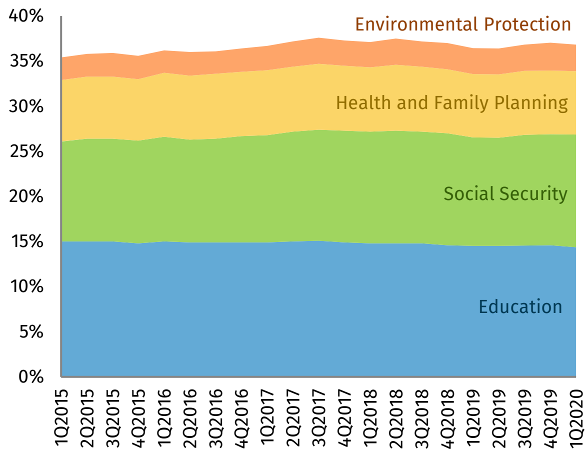
4qma, percent



Source: OECD, Ministry of Finance, Rhodium Group.

Supplemental 4: Government Social Expenditures

4qma, percent



Source: Ministry of Finance, Rhodium Group.

Policy Analysis

In the wake of COVID-19, Beijing signaled to markets that it would constrain its fiscal stimulus response by unveiling a smaller-than-expected spending package. In reality, Beijing does not have the ammunition to fire off another stimulus round on the post-crisis scale given the legacy debt from previous rounds. That said, China's leaders are using infrastructure spending as their primary tool to stabilize economic growth, as they did after the global financial crisis. This risks damaging the fiscal health of local governments. Infrastructure investment can boost growth in the short term as it creates demand for construction materials. However, repeated fiscal stimuli have buoyed construction for years, leaving limited room for further infrastructure investment in the more economically developed coastal areas. Beijing is shifting new construction inland; however, these infrastructure projects are unlikely to be profitable, and funding has been scarcer for companies in inland provinces.

Local governments face legacy debt burdens from past infrastructure investments. Another wave of unprofitable infrastructure investment is not conducive to fiscal health and is a clear step backward for center-local fiscal reform.

Local governments are told to spend to lift growth, but taxes to boost their fiscal intake are flat. The bond market continues to provide temporary funding to fill the fiscal gap. Issuance of official local government bonds rose 30% yoy in the first quarter, while LGFV bond issuance increased 38.5%. On the positive side, Beijing is not using fiscal funds to inflate the property bubble to deliver economic growth, as in the past. No local government special revenue bonds were used for property development in the first half of 2020, and we estimate more than 70% of remaining local bonds this year will go to infrastructure construction.

Beijing is shifting its approach to local government implicit borrowing—the indirect debt accrued by local government state-owned enterprises, financing platforms, and borrowing through shadow channels. Prior to the COVID-19 outbreak, Beijing pressed local governments to pay off maturing implicit debt. This contributed to a slowdown in the economy in early 2018. With the pandemic flattening tax income and land sales revenue, that is no longer possible. Policymakers will therefore allow localities to roll over debt—not through expensive shadow borrowing as they had in the past, but with proper bank loans and bonds at lower costs. As a result of this shift, Jiangsu and Yunnan provinces have required LGFVs to retire high-cost implicit borrowing and are prohibiting borrowing at interest rates higher than 7%–8%. This is obviously far from letting markets allocate capital.