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 and remains slightly positive this quarter. Limited spending due to the pandemic and continued bond issuance stabilized the fiscal gap.

- Transfers from the central government supplemented falling tax revenue for local governments.

- As China recovers from COVID-19, lagging infrastructure spending will pick up, but bond revenue will decrease, pressuring already indebted local governments.

This Quarter's Numbers

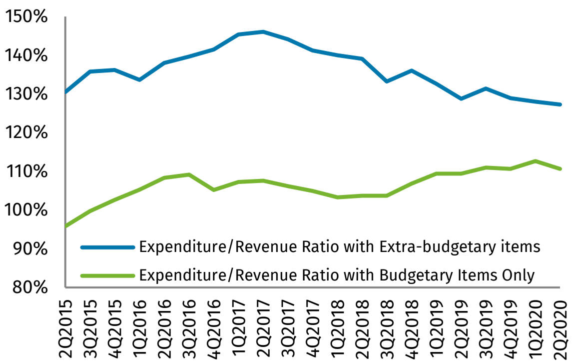
In 2Q2020, local governments continued to spend more than they took in, but the gap has narrowed slightly for the third consecutive quarter. The augmented **Local Expenditure-to-Revenue Ratio** stood at 127.3% in 2Q2020, compared with 128.0% in 1Q2020 and 128.9% in 4Q2019. Both revenue and expenditure rose from deep declines in the first quarter as China eased lockdown measures: the revenue rebound was greater than spending.

This improvement will be short lived: the expenditure-to-revenue gap will widen as local government bond issuance slows after October. Moreover, local spending delayed by COVID-19 will accelerate. As of August, local authorities had spent just 60.6% of the full-year budget, compared with an average of 67.4% the past three years. Spending by local government funds, which is used to finance infrastructure investment projects, was only half of the full-year budget and below historical levels. As long as the central government puts the burden of spending for economic growth on local officials, the incentives impeding fiscal reform will dominate.

Spending on social services as a share of all government outlays expanded modestly this quarter in response to COVID-19 (see **Government Social Expenditures**). Increased social security spending is being used to help those unemployed because of the pandemic, while local governments have stepped up healthcare expenditure to contain the virus.

Primary Indicator: Local Governments Expenditure-to-Revenue Ratio

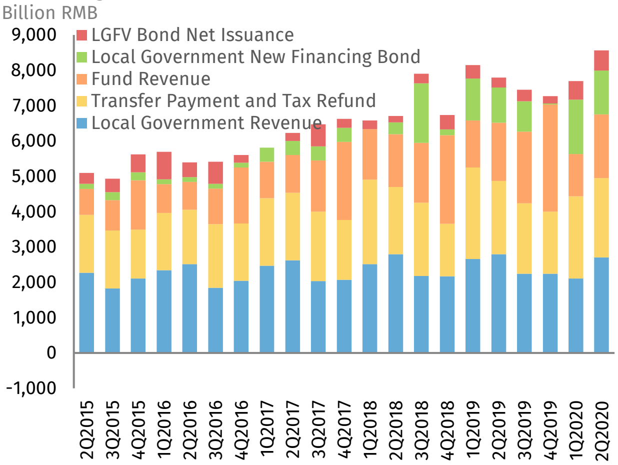
4qma, percent



Source: National Bureau of Statistics, Rhodium Group.

Supplemental 1: Sources of Local Government Financing

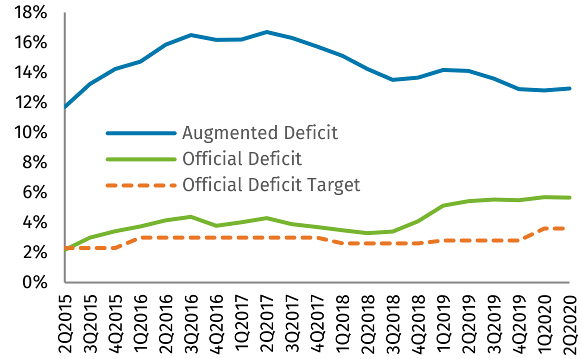
Billion RMB



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

Supplemental 2: Fiscal Deficit Measures

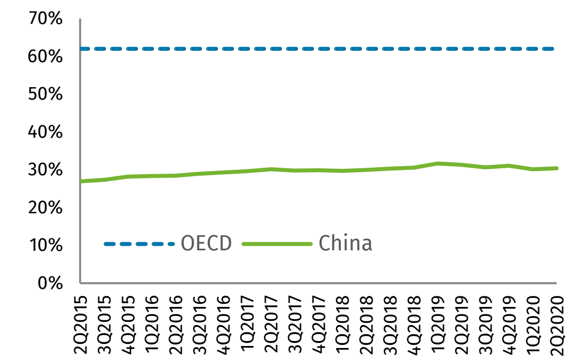
4qma, share of GDP



Source: Ministry of Finance, Rhodium Group.

Supplemental 3: Direct Taxation Ratio

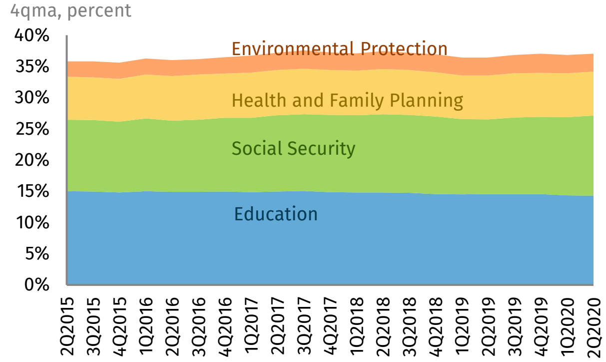
4qma, percent



Source: OECD, Ministry of Finance, Rhodium Group.

Supplemental 4: Government Social Expenditure

4qma, percent



Source: Ministry of Finance, Rhodium Group.

Policy Analysis

Prior to COVID-19, the fiscal policy priority was local government deleveraging after years of funding unprofitable projects. The virus emergency shifted the focus to shoring up local infrastructure spending to avoid a more severe recession. In effect, the policy guidance went into reverse, and that is likely to drive more fiscal problems in the future. Whether the 2020 crisis justified such a decision will long be debated. China is envied for its present growth recovery, but the final judgment must reflect the impact on long-term sustainability.

Although back in accommodation mode, Beijing did not offer the sort of blockbuster leverage growth that captured the world's attention in 2009–2010. That at least is positive for reform. Nominally, authorities are requiring local infrastructure projects to generate enough returns to cover borrowing costs. But after many years of heavy spending, finding such projects is hard, and the pressure to put money to work quickly has been intense this year. New regulations strip industrial and high-tech zones of their fiscal independence, tightening budget oversight in an effort to curb debt buildup. Naturally, reducing debt risk will put a damper on growth.

Local governments will also soon have a new source of revenue: real estate investment trusts (REITs), through which they can securitize local highways, warehouses, utility services, or even telecommunication networks to raise cash. Since the National Development and Reform Commission (NDRC) and China Securities Regulatory Commission (CSRC) set forth guidelines in an April circular, several firms filed paperwork to issue REITS in 3Q2020. This is particularly important given that a recent wave of state-owned enterprise (SOE) defaults has damaged local governments' creditability, making it more difficult for local governments and their financing vehicles to raise cash through bond issuance. In contrast, REIT cash flows are more transparent to investors and thus are easier to sell, making them a key source of future local government revenue.

Final Dashboard Assessment

Looking back, the primary fiscal goal of Beijing's 2013 economic reform plan—narrowing the gap between local government spending and revenue—has barely advanced. Part of the equation is creating new sources of revenue, but local authorities still cannot grow revenue without exploiting land sales and are skimping on crucial expenditures in public goods. The long-discussed property tax, which would go a long way toward increasing local revenue and cooling property bubbles, never made it into law. Beijing took a small step forward in 2019 by allocating more consumption tax revenue to local governments, but the absence of bolder steps failed to change the overall picture. Localities have greater room for bond financing, which reduces reliance on risky and expensive informal funding channels, making local accounts more transparent. That is a step toward reform, but only if proceeds are used productively.

Less progress has been made on the other side of the ledger: cutting erroneous spending. Regulations did limit land and property-related construction starting in September 2019. However, Beijing's decision to stimulate infrastructure spending after COVID-19 to spur economic growth is working against fiscal reform goals.

Success going forward must target not just closing the spending-revenue gap but also improving debt sustainability, which featured in the 5th Plenum Communique on the upcoming 14th Five Year Plan. Local government bonds will continue to be used to fill the fiscal gap and to finance existing debt as borrowing costs are high. However, local government debt is becoming increasingly difficult to manage, and defaults are on the rise. High-profile SOE defaults in late October will likely spread to local government financing vehicles (LGFVs) and accelerate, demonstrating how unresolved debt problems continue to diminish the ability to raise funds and erode local government credibility. REITs are one solution, but more fundamentally, Beijing needs to reduce local spending by shouldering more of the spending burden at the central level and by introducing more private capital into the infrastructure sector.