

Research on the Risk of Local Government Debt in China in the New Era

Qing Ye

School of Public Finance and Taxation
Zhongnan University of Economics and Law
Wuhan, China

Ming Chen

School of Public Finance and Taxation
Zhongnan University of Economics and Law
Wuhan, China

Abstract—After the promulgation and implementation of the new Budget Law in 2015, local governments have laws to abide by when it comes to the issue of debt in an independent manner. Focusing on the problem of local government debt risk prevention in our country, this paper analyses the causes of local government debt by means of combing the development process of local government debt in our country and the promulgation and implementation of relevant debt management policy measures. In combination with the specific risk problems encountered in the current debt management, and against the background of the new round financial system reform, this paper analyzes the current situation that large-scale tax reduction leads to the reduction of local government's financial resources and the increase of debt risks, so that this paper puts forward some suggestions on improving the local government debt risk management mechanism in order to maintain the stable economic and social development of China.

Keywords—local government debt; risk prevention; debt management; financial system reform

I. INTRODUCTION

The implementation of the new Budget Law in 2015 terminated the era when local governments could not borrow. In the form of legal provisions, the provincial government was clearly given the right to borrow, which means a major change in the new financial system of our country. Under the new financial system, the revenue and expenditure of debts of local governments are included in budget management. The subject, mode, scale, purpose, procedure and risk control of borrowing are clearly stipulated. First of all, China standardized the financing behavior of local governments, accelerated the replacement of local government debt, introduced PPP financing model, and established a debt risk early warning mechanism, so local government borrowing behavior has been further standardized, and debt risk has been effectively controlled. However, there are still many problems in the implementation of various provisions. Under the background of the new round of fiscal and taxation system reform, especially under the unprecedented tax reduction efforts this year, how to improve the debt risk prevention mechanism and effectively prevent debt risk is of great significance to the healthy development of China's economy in the face of the situation of local government financial resources reduction and debt risk increase.

II. LITERATURE REVIEW

At present, scholars' research on government debt risk mainly focuses on the causes of risk, risk assessment, countermeasures and suggestions to prevent and resolve local debt risk. [1] Zhao Yingchun (2006) believed that debt has the characteristics of recessivation, contingency, investment and publicity, and debt risk does not lie in financial risk, extrusion risk, financial risk, economic risk and other aspects, but in the management risk caused by system and organizational design. Therefore, the government should improve the system, strengthen the whole-process monitoring of the operation of debt funds, and establish early warning indicators to monitor debt risk. [2]

In terms of risk cause research, Miao Xiaolin and Fu Runmin (2013) pointed out that economic development, financial system, management system and government behavior have promoted the growth of local government debt, but they are not the real motivation for the generation of debt risk. An important reason is that local government is not a "responsible government". [3] Zhao Liangliang and Wang Ju (2015) proceeded from the basic situation of local government debt in our country and comprehensively analyzed the causes of government debt risk from such different perspectives as the boundaries between government and market, single political system, tax distribution system and debt management restraint system. [4] Brix H P, Schick A (2002) pointed out that implicit debt accounts for a large part of government debt, and local governments tend to keep it out of government public budget management. [5] Jia Kang (2013) emphasized that the fundamental reason for the formation of local debt is institutional and policy factors. [6]

In terms of risk assessment research, Zhang Zhiping (2011) used the grey system theory to evaluate the risk of local government debt, and established the early warning mechanism of local government debt risk in our country. [7] Xu Zheng (2013) used fuzzy comprehensive judgment method and analytic hierarchy process (AHP) to construct the debt early warning model, and made an empirical analysis and validation of the effect of local government debt risk. Based on the empirical results, some policy suggestions on debt management were put forward. [8] Zhang Tonggong (2015) established flexible evaluation index system, advanced traffic light warning system and risk index model

to evaluate the debt risk of local governments in our country, and put forward countermeasures and suggestions for the systematic management of the debt risk of local governments [9].

In term of debt risk prevention policy research, Gu Jianguang (2006) put forward to make the risk factor of local government debt risk transparent, take forward-looking measures to control local government debt, specifically define local government debt responsibility, and rationally divide government administrative and financial powers at all levels. [10] Li Wei and Wang Suqing (2006) proposed the establishment of risk early warning mechanism for the scale of local debt, and the joint central-local debt risk supervision system and local debt risk emergency response system. [11] Kou Tiejun and Zhang Haixing (2006) summed up the source matrix of local government debt risk in China based on Hana Polackova's debt classification theory, made an empirical analysis of local government debt and risk situation, and put forward technical methods and institutional arrangements for preventing and resolving local government debt risk. [12] Jia Kang, Liu Wei and Zhang Licheng (2010) pointed out that the government should actively explore and innovate the way to provide public goods, and introduce PPP model into the field of public goods. [13] Yang Canming and Lu Yuanping (2013) discussed the reasons for the increase of the local debt system, debt financing system and debt management, pointed out that there are three potential risks such as large number of hidden liabilities, difficult to monitor individual risks, and serious land financial dependence, and finally put forward policy recommendations to prevent and resolve the risk of local debt. [14] Liu Huiting and Liu Hailong (2016) used KMV model to analyze the default risk of local government debt in 30 provinces and municipalities in China. Based on the results of empirical analysis, they put forward policy recommendations to prevent and resolve the risk of local government debt. [15]

III. THE CAUSES OF GOVERNMENT DEBT DEVELOPMENT IN CHINA

There are numerous reasons for the formation of local government bonds in China, which mainly boil down to institutional reasons. The first is the evaluation mechanism of official promotion. At the beginning of reform and opening up, China's economy was relatively backward. At that time, China must boost the level of economic development in order to meet the people's growing material and cultural needs, which possessed a specific historical significance at that time. Over the years, the pursuit of GDP by some local governments has reached a degree that is distorted and deformed. In addition, the assessment of leading cadres is based on the determinism of "GDP-only", so that GDP has descended to the "shackles of performance" of local officials. Due to "GDP-only" theory, some local governments, even if their financial revenue is extremely difficult, still need to launch "image projects" and "face projects" by means of loan and financing. Some local officials lack overall planning and management of local development and are wild about "leapfrog development". At the same time, they are wild about large-scale demolition and

construction, which have caused serious repetitive construction. However, the efficiency of capital usage borrowed from banks and other relevant departments is quite low. The large amount of borrowing and financing not only does not bring sustainable development benefits to the local government, but also makes the local government debt-ridden.

The second is the financial system. In 1994, China carried out the reform of tax distribution system, with the state's financial power centralized upwards. The proportion of central fiscal revenue rose from 15.5 percent in 1978 to a peak of 55.7 percent in 1994, and then declined year by year, basically approaching 50%. Because the administrative power is continuously declined, the central fiscal expenditure increased from 47.4 percent in 1978 to 52.5 percent in 1984 in the first, then declined steadily until it accounted for 14.81 percent in 2018. However, the proportion of local fiscal expenditure decreased from 52.6 percent in 1978 to 47.5 percent in 1984, and then steadily increased until the proportion of expenditure reached 85.19 percent in 2018. As a result, the central government's fiscal surplus became much larger and larger, and the fiscal gap of local government became much greater and greater. Financial power is mainly concentrated in the central government, while administrative power is mainly devolved to the local government. This mismatched situation between financial power and administrative power inevitably leads to local financial constraints. In the case of increasing expenditure pressure, local governments should try every means to borrow and finance in order to satisfy the demands of local construction.

The third is the investment and financing system. Before the amendment of the Budget Law in 2014, it stipulated that "local governments shall not issue local government bonds" unless otherwise provisions stipulated by the law and the State Council. In the case of limited local financial resources, local governments must raise construction funds by means of loans from financing platform of institutions and enterprises. From the perspective of the development history of local debt in China, the development of local financing platforms has gone through four stages. The first stage is from 1978 to 1994, during this period, Guangdong was in the forefront of reform and opening up and taken the lead in raising infrastructure funds through fund-raising loans, which also became the predecessor of local government financing platforms. The second stage is from 1994 to 1997, which began after the reform of tax distribution system and ended with the Asian financial crisis in 1997. The reform of tax distribution system made the financial power rise to the central government, but the administrative power moved down relatively. As a result, the inadequacy of the local government's financial expenditure ability is becoming increasingly salient. Meanwhile, more and more local governments raise funds through financing platforms, and the financing platforms have been further developed. The third stage is from 1997 to 2008. Because the outbreak of the Asian financial crisis, the Chinese government has carried out a series of policy measures to stimulate economic development, local financing platforms have made considerable progress in the process of dealing with the

financial crisis. The fourth stage is from 2008 till today. Because the outbreak of the world financial crisis in 2008, the Chinese government issued a "four trillion" economic stimulus plan, most of the supporting funds need to be raised by local governments themselves in the total amount of "four trillion" funds, resulting in the "blowout" development of local financing platforms, which makes the scale of local government debt reach a new high. According to the State Council's "Report on Regulating the Debt Management of Local Government in China" at the end of 2015, there are more than 100 cities and 40 counties in China whose debt rate exceeds 100% of the security alert line. From the perspective of total amount, the debt of local government in China has reached a relatively large scale.

The fourth is administrative management system. Due to the relatively slow reform of China's administrative system, the inadequate transformation of government functions, overstaffed institutions and inefficient work, the "offside" and "vacancy" problems of the government coexist, and the "big government, small market" situation highlights. The imperfect administrative management system results in the one-sided view on development, which focuses only on investment in construction funds, but neglects economic and social benefits, and lacks high-quality overall planning and industrial layout for urban development, resulting in confusion in functional zoning of urban development, serious duplication of construction and inefficient use of funds. At the same time, large-scale government investment will inevitably cause "extrusion effect" on private investment. At the same time, the "high threshold" of urban infrastructure construction and other industries will make it difficult for private funds to enter the investment.

In short, the imperfection of our country's system and mechanism has resulted in the long-term shortage of available local financial resources, which has promoted the "debt concept" of local governments to raise funds through financing platforms, and also led to the continuous expansion of local government debt.

IV. RISK PROBLEMS EXISTING IN CURRENT GOVERNMENT DEBT MANAGEMENT

Since 2014, the state has promulgated and carried out the new Budget Law and a series of debt control measures, which have strengthened the governance of local government debt, and effectively prevented the risk of government debt. However, there are still some risk problems that cannot be ignored in the implementation of these provisions.

A. *Information on Government Debt Is Not Transparent Enough*

The Budget Law of the People's Republic of China, which came into effect on January 1, 2015, proposes that China should establish a comprehensive, standardized, open and transparent budget management system. In recent years, China's budget disclosure has been steadily advancing, but due to the sensitivity of local government debt data, there is still a certain gap with the actual requirements in terms of debt information disclosure. First of all, local governments

use debt data as confidential documents and report them to leadership and make known to lower level in the form of confidential documents. No unit or individual is allowed to disclose debt data without authorization. Secondly, there is a certain amount of invisible debt which is not included in the debt management information system. There are two kinds of debt inside and outside of the system, and there are problems of invisible debt risk.

B. *Lack of Awareness of the Importance of Debt Risk Prevention and Control*

The newly revised Budget Law and the G.F. document No. 43 stipulate that all local governments shall issue local government bonds within the limits approved by the State Council. In addition, local governments and their departments shall not borrow by any means. However, some units and departments are not aware of the importance of debt risk prevention and control. Despite the provisions of the Budget Law and related documents, they do not adopt the suggestions of the financial sector, and they still put forward that the government should purchase services, PPP and other ways to meet the needs of disguised financing and irregular debt-raising in order to promote the local economic development. There are hidden dangers of irregular debt-raising.

C. *Understanding of Replacement Debt Is Insufficient and Replacement Difficulty Is Increased*

The signing of the replacement agreement requires the negotiation of local financial departments, stock debt creditors, debtors, relevant authorities and other parties. The sub-creditors do not agree to early replacement because of interest loss and other reasons. For example, for replacement debts in some areas, the National Development Bank initially agreed to replace the loans that had been withdrawn and used up. The Agricultural Development Bank only agreed to replace the repayable portion of the current year. It is not clear whether the debts due in the following year could be replaced. There is uncertainty about the state's request to complete the replacement work by the end of August 2018.

D. *Lack of a Sound Debt Management Coordination Mechanism, Making the Use of Borrowed Funds Liable to Come Apart from Project Implementation*

In the process of local government debt management, the financing platform or financial department is responsible for the management of borrowed funds, the audit department is responsible for the audit supervision and inspection of borrowed funds, and the relevant units are responsible for the specific work initiation of the project. Because the management responsibilities and powers of finance, development and reform, auditing and project implementation departments are different, the business focus is inconsistent, and the unified and perfect coordination mechanism is insufficient, which results in the disjunction between some fund arrangements and project implementation. As a result, it is difficult to carry out synchronic management. Because of the uncertainty of the project on the total investment of the local government debt

construction project, the source of funds, the time of using funds and so on, it is difficult to arrange the funds of the government debt revenue and expenditure plan according to the plan. [16]

E. The Marketization Degree in the Issuance of Local Government Bonds Is Insufficient

Local government bond issuance should follow the market-based requirements, and determine the bond price according to the supply and demand relationship. In essence, local governments and commercial banks have already reached some kind of agreement in the process of specific issuance. Feng Beilin (2015) pointed out that commercial banks have direct or indirect interest relationship with local governments by using their "pricing power" of issuing bonds in order to get stable financial deposits and better operating environment, and both of them can often reach over-the-counter pricing. [17] As a result, the local government bonds cannot be priced in accordance with the market situation, and the liquidity is not strong.

V. SUGGESTIONS ON PREVENTION AND SOLUTION OF THE RISK OF LOCAL GOVERNMENT DEBT

A. The Debt Management System of Local Government Should Be Improved

1) Legal system of debt management should be improved: The laws and regulations on local government debt management mainly consist of Budget Law, Guarantee Law and Securities Law. There are also the debt management measures and implementation rules promulgated by the State Council, the Ministry of Finance and other relevant departments. At the national legal level, since the promulgation and implementation of the Budget Law in 1995, no one has been punished for the violation of the law, and the rigid constraint of the law is slightly insufficient. At present, the government can timely introduce laws and regulations on debt management by synthesizing the existing debt management methods and implementation rules and [18] incorporating the contents of debt budget constraints, government financing guarantee, issuance, trading of government bonds and information disclosure, as a result, the borrowing procedures, use and repayment of local government debt from the legal level can be defined.

2) Debt information disclosure system should be improved: First of all, the government should improve the local government debt information statistics system, unify the debt statistics caliber, and improve the timeliness and accuracy of debt information disclosure. Secondly, local government debt information should be gradually made public in the light of the pace of government budget disclosure, and debt information should be regularly reported to the NPC. What's more, debt information should be disclosed to the public through the government portal website, and an effective question-and-answer mechanism

should be established to answer the relevant questions raised by the public in a timely manner. [19]

3) The financing model of local government should be widened: The government should actively innovate project financing methods, standardize and promote the development model of government's purchase of services and PPP. At the same time, the government strictly investigate the behavior of "real debts of stocks" by means of improving the review of fund management institutions, advocate private capital to participate in local construction, reduce the threshold of private capital access, further eliminate institutional barriers, so as to encourage more private capital to invest in public infrastructure, public services and other fields.

4) Local government stock debt should be digested: Extra-budgetary co-ordination, budgetary arrangements and comprehensive government resource-based income should be adopted to fully raise debt-servicing funds and gradually liquidate them. For debt projects that can be market zed, the process of marketization should be accelerated. Through market behaviors, such as overall auction, asset restructuring, leasing and operation, the debt will be pushed to marketization and digested by various market entities. For projects borrowed by government departments, according to the principle of "who borrows, who repays", the borrowing departments should be instructed to formulate detailed debt repayment plans and, if necessary, the method of budget deduction should be adopted to force them to gradually pay off. At the same time, the government should make full use of the way of replacement bonds to convert some government debts with short term and high interest rate into government debts with long term and low interest rate.

B. The Reform of Financial and Taxation System Should Be Deepened

1) Financial system that matches financial and administrative power should be established: In the new round of fiscal and taxation system reform, the financial and administrative powers of central and local governments should be clearly defined, the principle of matching financial and administrative powers should be followed, the standardized revenue and expenditure distribution system among governments at all levels should be established, consequently, a set of perfect basic financial guarantee mechanism for local governments can be established, which is an important basis and prerequisite for promoting effective debt management of local governments. At the same time, the government should continue to carry out strict departmental budgets and comprehensive budgets, implement budgets in a strict manner, effectively improve the expenditure efficiency and transparency of financial funds, deepen the reform of government procurement, so as to further optimize the allocation of resources, establish financial performance evaluation system, strengthen the

supervision of financial funds, and ensure the efficiency of the use of funds.

2) *The pace of local tax system construction should be accelerated:* The government should gradually promote the collection of local "stock tax" such as real estate tax, inheritance tax and resource tax, accelerate the establishment of local main tax category and increase local fiscal revenue. At the same time, local governments should actively explore new tax sources with regional characteristics within the limits permitted by national laws and policies. Secondly, on the basis of full investigation, detailed calculation and scientific arrangement, and combined with the physical truth of various areas, local governments can increase their financial resources by means of increasing the proportion of local sharing tax in shared taxes and the proportion of central tax return. [20]

3) *The construction of local financial resources should be increased:* Governments at all levels should accelerate industrial transformation and upgrading and promote the new-type orientation of traditional industries. They should conscientiously implement various tax preferential policies promulgated by the state for small, medium and micro-sized enterprises and new high-tech enterprises, cultivate and elevate existing industrial clusters, focus on cultivating leading enterprises and promote diversification of pillar industries. At the same time, governments at all levels also should strengthen support to key industries and parks, make pillar industries bigger and stronger, promote the concentration of capital and resources to key industries, critical areas and superior enterprises, and promote the rapid development of superior pillar industries. In addition, they should increase investment in recruiting talents and attracting wisdom, intensify intellectual support for transformation and development, make the "secondary industry" much bigger, develop the "tertiary industry", vigorously cultivate new financial resources, and enhance financial strength.

C. The Mechanism for Issuing Government Bonds Should Be Improved

1) *The limits of local government debt issuance should be comprehensively examined:* At present, our country implements quota management on the scale of local debts, and local governments cannot exceed the quota approved by the state when borrowing. The Ministry of Finance mainly approves the borrowing quota of each region after comprehensive assessment according to such factors as debt risk and financial situation of each region. Because the "old, young, border and mountainous" areas enjoy poor economic development foundation, serious shortage of fiscal revenue, poor risk resistance, borrowing quota measured is much lower in accordance with document requirements. However, the developed areas enjoy rich economic strength, considerable fiscal revenue and relatively high borrowing quota. In case of such situation is allowed to develop, the

"Matthew effect" will become more and more serious. According to the requirement of regional coordinated development, the country should make a policy inclination to the borrowing approval quota of the post-developed and underdeveloped areas.

2) *The marketization of government bonds should be improved:* The country should vigorously cultivate and develop the bond market, boost the management of bond issuance, advance the market-oriented level of bond issuance pricing, and strengthen information disclosure requirements. Meanwhile, the country also should enhance bond liquidity, expand bond issuance in the stock exchange market, encourage bond issuance by means of commercial bank counter market, promote diversification of investors, and encourage various institutions and individuals such as commercial banks, securities companies and investment companies to take an active part in local government bonds investment. What's more, the country should further enhance the convenience of local government bond registration, perfect the design of local government bond varieties, optimize the structure of local government bond terms, and improve the bond principal repayment mechanism. Local bonds are allowed by the country to be issued to institutional investors such as social insurance funds and individual investors, and more tax preference are also provided. Financial regulators should also take appropriate measures to enhance the liquidity of local government bonds and improve market restraint mechanisms.

VI. CONCLUSION

This paper studies the problem of local government debt risk in China in the new era. By combing the development process of local government debt in China, combined with the specific risk problems encountered in current debt management work, aiming at the various risk problems of local government debt in China, this paper analyzes the causes of local debts. Against the background of the new round of fiscal system reform in the new era, it analyzes the current large-scale tax cuts, which leads to the reduction of local government financial resources and the increase of debt risks. It also puts forward constructive suggestions for improving the local government debt management system, deepening the reform of the fiscal and taxation system, and improving the government bond issuance mechanism, which is conducive to preventing local government debt risks and promoting the healthy and stable development of China's economy and society.

REFERENCES

- [1] Liu Zhenhai, Xiaofeng, Li Xiaodan. Research on the Risk Disposal of Local Government Debt [J]. *Financial Development Research*, 2017 (10): 10-15. (in Chinese)
- [2] Zhao Yingchun. Research on the Risk Prevention of Local Government Debt: Based on the Sample Analysis of Government Debt in Developed Areas [J]. *Journal of Central University of Finance and Economics*, 2006 (10): 6-9. (in Chinese)

- [3] Miao Xiaolin, Fu Runmin. The Connotation and Generation of Local Government Debt Risk: A Literature Review and Consideration under the Separation of Power and Responsibility in Time and Space [J]. *Economist*, 2013 (8): 90-101. (in Chinese)
- [4] Zhao Liangliang, Wang Jun. Research on Risks and Countermeasures of Local Government Debt in China [J]. *Times Finance*, 2015 (29): 79-80.
- [5] Brixi H P, Schick A. Government at risk : contingent liabilities, and fiscal risk [J]. *World Bank Publications*, 2002, 9(7): 533. (in Chinese)
- [6] Jia Kang. Research on Causes and Countermeasures of Local Debt in China [J]. *Bonds*, 2013 (9): 8-17. (in Chinese)
- [7] Zhang Zhiping. Grey Assessment and Early Warning of Local Government Debt Risk in China [J]. *Statistics and Decision-making*, 2011 (15): 135-138. (in Chinese)
- [8] Xu Zheng, Qixin. Research on Early warning of Local Government Debt Risk: based on the Empirical Data of a City in Northeast China [J]. *Scientific Decision-making*, 2013 (8): 30-47. (in Chinese)
- [9] Zhang Tonggong. Research on the Assessment and Prevention of Local Government Debt Risk in Chian under the New Normal State [J]. *Macroeconomic Research*, 2015 (9): 134-143. (in Chinese)
- [10] Gu Jianguang. Research on the Countermeasures of Local Government Debt and Risk Prevention [J]. *Economic System Reform*, 2006 (1): 10-15. (in Chinese)
- [11] Li Wei, Wang Suqing. Research on the Countermeasures of Debt Risk Management of Local Governments in China [J]. *Scientific Research Management*, 2006, V27 (5): 150-154. (in Chinese)
- [12] Kou Tiejun, Zhang Haixing. Research on Debt Risk of Local Governments in China [J]. *Financial and Economic Issues*, 2006 (10): 61-66. (in Chinese)
- [13] Jia Kang, Liu Wei, Zhang Licheng, et al. Local Government Debt Risk and Countermeasures [J]. *Reference for Economic Research*, 2010 (14): 4-30. (in Chinese)
- [14] Yang Canming, Lu Yuanping. Research on Status Quo, Causes and Countermeasures of Local Government Debt Risk [J]. *Fiscal Research*, 2013 (11): 58-60. (in Chinese)
- [15] Liu Huiting, Liu Hailong. Research on Debt Risk Assessment of Local Governments in China Based on KMV Model [J]. *Shanghai Finance*, 2016 (6): 52-59. (in Chinese)
- [16] Ye Yaping. Strengthen Local Government Debt Management Can Effectively Guard Against Financial Risks [J]. *Financial and Economic Circles (Academic Edition)*, 2013 (21): 4-5. (in Chinese)
- [17] Feng Beilin. Local Bond Issuance and Market Construction [J]. *China Finance*, 2015 (18): 55-56. (in Chinese)
- [18] Liu Mei. Thoughts and Strategies of Local Government Debt Governance under the Background of *New Budget Law* [J]. *Journal of Southwest University for Nationalities (Humanities and Social Sciences Edition)*, 2016 (10): 107-111. (in Chinese)
- [19] Bao Jinghai, Wang Fan and Hu Hengsong. An Exploration on the Debt Management Problem of Local Government in China [J]. *Financial Theory and Practice*, 2017 (8): 109-115. (in Chinese)
- [20] Liu Zhenhai, Xiaofeng, Li Xiaodan. Research on the Risk Disposal of Local Government Debt [J]. *Financial Development Research*, 2017 (10): 10-15. (in Chinese)