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Research on the Changes of China's Local Government Bond Institution Based on SSP

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ABSTRACT. In 2009, China began to implement an administrative control on the institution of the local government bonds. The institution is centered on the central government's control. From then on, academic communities began to criticize and to study this new institution. Based on Situation-Structure-Performance (SSP) paradigm, the paper tries to analyze the interdependence among local government bond market participantsand the changing direction of local government bonds institution. It believes that different interest groups have different expectations and evaluation on the performance of the local government bonds, which, furthermore, influences institution choices and arrangements. Finally, the paper concludes that the main direction of local government bonds reform is the relaxation of the central government constraint and improvement of related institution.

1. INTRODUCTION

China's fiscal decentralization reform has always been plagued by the matching of local government's "fiscal power" and "duties and responsibilities". Budget Law of the People's Republic of China licensed in 1994 prohibited local governments from issuing bond financing[1]. This had led local governments to gradually accumulate huge amounts of hidden debt through various financing platforms. In response to the financial crisis in 2008 and regulation of local government financing, China resumed issuance of local government bond in 2009[2]. The initial issuance scale was 200 billion yuan. In the following decade, the issuance of Chinese local government bonds has gradually expanded. In 2015, China launched the local debt replacement plan, and the scale of local government bond issuance exceeded one trillion. In the following three years, the scale of the issuance was more than 4000 billion yuan. This paper adopted the analysis of institution change based on SSP to analyze the evolution of China's local government bond institution and sought the path of future changes in China's local government bond institution, as well as possible direction of future changes.

The management institution of local government bonds can be divided into two models: the administrative control model represented by Japan and the market constraint model represented by American. Currently the managemen institution of China's t local government bonds use the administrative control mode. In this mode, the central government directly controlled issurance, circulation, repayment by administrative measure. The proponents believe that the administrative control adapt to the current China's financial institu1tion[3]. Reform should focus on technical adjustments to make the central approval institution more flexible. The opponents questioned the administrative control mode. Jin yongjun (2009) pointed out that the establishment of the institution of local government bonds is a institution change for the needs of temporary economic growth and the local government bonds has been alienated into a kind of "quasi-government bonds"[4]. Most opponents believe that local government bond management institutions should take the local government as the main body and the local people's congress as the lead, adopt a more market-based management model and restore their "original intentions" .This paper argues that the study of the management institution should not be limited to discussion about the advantages and disadvantages of administrative control mode. Encompassed the local government bonds, there are closely interdependence within different interest groups. It mainly includes (i) funds and incompatible use, (ii) supervision and high information cost, (iii) insurance and risk, (iv) reform and path dependence. The paper is an attempt to answer the key substantive performance question: Who gets what in the local government bonds market? The aim here is to identify whose interests count or whose interests are made to count under different structural arrangements in the market. On this basis, we will explore the direction of the institution reform.

The paper heavily draws on the Situation-Structure-Performance paradigm (SSP hereafter), which allows for a rigorous treatment of the interdependences among different interest groups within local government bonds market. The SSP theory offers a typology of situations, a list of structural arrangements and hypothesized performances, a practical dynamic grid through which most interdependence can be filtered and understood. The SSP theory allows both impact and change analysis[5]. The remaining sections of the paper include two parts: Using the SSP to make a impact analysis of the interdependences among different interest groups within local government bonds market; using the SSP to make a change analysis of the course of Chinese local government bonds structural change and consider the possibility of adoption to the market constraint model.

2. The Impact Analysis

In the impact analysis, the interdependences among different interest groups within local government bonds market mainly relate to funds and incompatible use, supervision and high information cost, issuance and risk. To deal with these three situation, the administrative control model and the market constraint model make different institutional structure. The different structure result corresponding performance. All of these summarized to table 1.

Table1 Independence in the Chinese local government bonds market

Situation	Structure	Performance
incompatible use funds	1. central approval 2. local autonomy	small scale market; secondary market is recession large scale market; secondary market is active
high information cost of local governmental credit	1. supervision and audit 2. credit rating	backward area get funds; lack of information the local government which have a high level of credit get fund; sufficient information
risk of issuance	1. reservations sales 2. restructure plan	guaranteed to raise fund; increase the risk of finance system issuance cost is uncertain; isolation risk

2.1 Incompatible use funds from the local government bands raise

In a certain time interval, the funds are limited in financial market. If local government get more funds, it means that the central government, enterprises and financial institutions couldn't raise more funds and vice versa. Therefore, funds are incompatible use goods: the use by one party excludes the other party from using the good. The interest groups get funds. And then, their preference will be satisfied. It also means they become a potential seller, not a buyer. The interest groups who get funds can bring the cost to the other groups who want funds. The decentralization reform couldn't change the incompatible use characteristic of funds. The approval right have a decisive influence on the amount, term, purpose and the other elements of local government bonds[6].

China use the administrative control model to manage the local government bonds market. In the institutional design, the central government for their own positions and benefits, will not consider the benefits of local governments and investors. The Chinese central government execute more stringent control to local government bonds issuance than Japan. The central approval system govern the issuance link. It makes a strict limitation on the procedure, scale, rate, term and payment of the local government bonds. These institutional arrangement reflect dual wills of the Chinese central government. On the one hand, the central government wants the issuance of local government bonds could more directly meet the financial needs of the local government, and then promote the national economy to grow steadily. On the other hand, he central government try to deliberately control the influence from the local bonds to the existing national monetary policy and fiscal policy by a series of constrained rules. In this arrangement, the supply of institution is insufficient for local government and investors. It couldn't satisfied the needs about funs from local government and income from investors. Their preferences have not been realized, which directly affect their economic behavior. Although administrative control mode ensured the completion of fund-raising goal under the pressure of the financial crisis, investors (except some organizations) in financial markets was lack of enthusiasm to the local bonds in the entire process of issuance, even if the scale of issuance was small. After bonds released, local government financing didn't change the dependence no the other financing ways[7].

2.2 High information cost of local governmental credit

Cost and availability of credit is central to the local government bonds market. It directly affect the main body's qualification, the rate, the scale and others elements of the local bonds. There is an asymmetry of information between the local governments and the investors in seeking real information of the local governmental credit. In the case of the high cost of information, investors can not match local governmental credit with bond's prices[8]. There out the investors could decide to leave the local government bonds market. If the costs of information is too high, supervision have also been hindered to effectively supervise the operation of local government bonds. For long-term considerations, managers of local government bond should make the necessary institutional arrangements response to the high informational cost of market.

In the audit system of the Chinese local government bonds insurance, the central government hold a dominant position. Taking into account the local government bonds insurance will lead to the "Matthew effect", in the distribution of circulation, the western regions occupy a larger share of the circulation. From the structure of the investors, the main body of investor is commercial banks in the local government bonds market. For the purpose of assets allocation, the bank bought the local bonds as an alternative to national bonds and would hold to maturity. The unitary structure of investors will reduce the needs of the information about the credit levels of local government and the use of funds in the market. China is difficult to create professional organizations to collect and analyze the information about local government bonds. Lack of information hinders ordinary investors into the local government bond market, and also increase the difficulty to monitor the use of funds and the situation of repayment for the relevant regulatory authorities.

2.3 Avoid the risk of local government bonds

The risk of local government bonds means the uncertainty of the loss in the operation of local government bonds market. It includes issuance risk, repayment risk and systemic risk etc. Managers of local government bonds judge the future depend on the standard procedures and estimation of the subjective probability. For the variability of outside world and the bounded rationality of managers, there always is some risk in the operation of local government bonds. The risk avoidance needs corresponding institutional arrangements.

In the process of central approval, the central government give more consideration to the economic development balanced. When the central government audit the qualification and allot the portions, there is lack of evaluation and limitation to the credit of local government. Currently the Chinese local governments could not select the local tax type and tariff by the actual situation, so they can not adjust the taxes or broaden the tax revenue sources. This will affect the stability of local government revenue[9]. This rules introduce the credit guarantee from the central government to the issuance system. The central credit guarantee and tax-free policy attracted some of the institutional investors which are based on the bank to buy local government bonds, and ensured full distribution of local government bonds. In the maturity of the bonds, if the local government cannot repay capital with interest, the central government as the double guarantor will share the risk. It will directly affect the stability of national financial system.

3. The Institutional Change Analysis of The Chinese Local Government Bonds

The institution of Chinese local government bonds has experienced 60 years of development. The institution of local bonds was abolished in the planned economy period, and gradually recovery in the transform economic period, and formed its own distinct characteristic. In the local bonds market, the change of the resources, technology and subjective sense of interest groups will lead to the changes of the interdependences among different interest groups. These changes will affect the interest groups to change their behavior. The conscious behaviors will produce a pressure to change the Chinese local government bonds institution. The existing path dependence will largely affect the degree and direction of the management institutional change.

Table2 The institutional change of the Chinese local government bonds

Situation	Structure	Performance
The shortage of funds for local construction; The path dependence: compulsory institutional change; The bounded rationality	1. The planned economy (fiscal concentration) 2. The transform economic (fiscal decentralization)	Stop the issuance of local government bonds Under the administrative control, recover the issuance of local government bonds

The designers of the local government financing platform management system are a large number of local governments, which are gradually induced system changes driven by the local government's intrinsic institutional needs. The local government financing platform management system mostly comes from the existing institutional arrangements in the Chinese financial market, the whole system is gradually improved during the game process of local governments, investors and the central government. The gradual process of system change is stable, with less impact on existing political and fiscal systems but higher success rate of institutional arrangements [10]. However, on the issue of reducing information costs and reducing negative externalities, the local government financing platform management system established by local governments has always been flawed. Both the central government and investors lack effective access to local government information on capital use and repayment preparation. In the case of non-transparent debt management, the opportunistic behavior of local governments is difficult to control, and leads to high local debt in fact.

The reconstruction of the Chinese local government bond system during the financial crisis was similar to the abolition of the early local government bond system, they both adopted a form of compulsory system change. In the context of the global financial crisis, the local government bond issuance system had been able to complete the process from the deliberation, to the announcement, and then to the implementation in a relatively short period of time with a low system change cost, which fully embodied the advantages of central government-led system change [9]. Local governments had thus fully accepted this new expansion of financing channels. The local government bonds issued by the Ministry of Finance, with the support of the existing government bond sales channels, were supported by system investors with the support of the central government's credit guarantees, and were sold smoothly during the financial crisis. However, when designing the local government bond system, the central government first considers its own institutional requirements for regulation, and regulates the total amount and distribution of local government bonds through budget management. Efficient financing systems and comprehensive information management systems have not been realized in the new local government bond system.

4. Conclusion

From the perspective of the change of Chinese local government bonds, the central government has always been in a dominant position. Although the initial administrative control model guarantees the central government's power to regulate local government bonds, in order to standardize and integrate local government financing platforms, the central government needs to gradually guide local governments to use local government bond financing. This means that the local government bond system needs to introduce institutional arrangements that meet the financing needs of local governments. The new budget law was implemented in 2015, and local government bonds became the only legal financing channel for local governments. The issuance of local government bonds also climbed to 3.8 trillion yuan. The issuance of local government bonds cannot always rely on the issuance of government bonds. Relying solely on government bond underwriters is unable to meet the needs of the expansion of the local government bond market. In this case, the central government introduced a series of new management systems to attract more investors into the local government bond market. As a result, the institutional needs of local governments and investors will enter the local government bond system through bottom-up induced system changes.

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