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Local Government Debt Financing Risk Management and Control Research

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Abstract

After the outbreak of the global financial crisis in 2008, in order to alleviate the impact on the economy, China adopted a proactive fiscal policy and increased the investment and financing capacity of local governments. In recent years, local financing platforms have grown barbarically, and local government debt has gradually risen and gradually become invisible, becoming an important source of systemic financial risks in China. The 19th National Congress of the Communist Party of China listed "preventing and resolving major risks" as the first of the three major battles, and resolving the risk of local government debt is one of the most important contents. This paper analyzes the current situation and problems of local government debt financing in China, studies the various risks that may occur in local government debt financing from a macro perspective, and seeks to be effective The risk management path.

Keywords

Local Government; Debt Financing; Risk Management.

1. The Basic Situation of Local Government Debt in China

1.1. The Evolution of Local Government Debt

In the first stage, under the dual pressure of the reform of the tax-sharing system and the implementation of the Budget Law of the People's Republic of China in1994, the contradiction between local government fiscal revenue and expenditure intensified, so it tried to set up various urban investment companies as financing platforms to replace the government with direct or indirect financing in the form of independent enterprise legal persons, so as to make up for the lack of funds for government investment projects. In the second stage, the "four trillion" policy promoted the first round of debt expansion of financing platforms, and in order to put local supporting funds in place, local financing platforms showed explosive growth, and the number of local financing platforms and the scale of debt showed a doubling growth. In the third stage, relying on "shadow banking", financing platforms carried out the second round of debt expansion, such as trust institutions, fund subsidiaries, P2P platforms, etc. "shadow banking" became an important source of financing for local financing platforms after bank credit, and with the rapid development of direct financing channels in the same period, the scale of open market bond financing on financing platforms rose rapidly. In the fourth stage, while the financing platform relies on the rapid expansion of government credit, the hidden risks of local government debt continue to accumulate, and the driving model of "debt-investment" is difficult to sustain, marked by the promulgation of the new Budget Law and Circular No. 43 in 2014, and local debt has entered a period of standardized development, but Local governments still rely on financing platforms and state-owned enterprises to expand their debts by injecting public welfare assets, issuing commitment letters, etc., or using government guidance funds, PPPs and other channels.

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1.2. The Current Situation of Local Government Debt in China

Overall, in recent years, the explicit debt ratio of local governments in China has shown an upward trend and may be close to the warning line. According to data disclosed by the Ministry of Finance, from the end of 2018 to the end of 2019, the balance of local government debt increased from 18.39 trillion yuan to 21.31 trillion yuan, while the local government debt ratio rose from 76.6% to 82.9%. Affected by the new crown epidemic and other internal and external shocks, by the end of 2020, the balance of local government debt in China has increased to nearly 26 trillion yuan, and the local government debt ratio is likely to have approached the warning line of 100%. In fact, the government debt ratio of 28 provinces in 2020 has increased compared with 2019, of which the debt ratio of 1 region (Tianjin) has increased by more than 50%, the debt ratio of 3 provinces (Shanxi, Hebei and Jiangxi) has increased by more than 20%, and the debt ratio of 8 provinces has increased by more than 10%; only 3 provinces have been significantly enriched by the government's comprehensive financial resources under the central financial subsidy, and the debt ratio has been reduced (Cheng Chen et al., 2021).

Second, there are problems in local government debt financing

1.3. The Scale of Local Government Debt is too Large, and the Government's Ability to Repay Debts is Limited

The result of liabilities using financing platforms or bonds is to rely entirely on the government's ability to pay. According to the audit results of No. 35 released by the National Audit Office in 2011, in 2010, the proportion of financing platforms and local government debt in the balance of local government debt in China was as high as 69.69%, and bank loans accounted for 79% of the balance of local government debt. Because there are no better management methods and supervision methods, the debt problem is getting more and more serious, and it is about to reach the brink of crisis, which has directly become a dangerous minefield for the risk of local debt in China.

1.4. The Debt is Concealed

The focus of this debt is implicit debt. In the debt of local governments in China, it occupies a considerable proportion, focusing on policy-linked debts, debts guaranteed by local governments, infrastructure construction liabilities and social insurance fund gaps. During this period, when local governments borrowed, they generally used some methods to change explicit liabilities into hidden liabilities, and directly transferred some debts that were originally borne by the government to the bank, so that the bank became a creditor of the government. However, it is a debt with considerable risk, and if there is a crisis, then local governments should also be held accountable, which will certainly expose local finances to huge risks.

1.5. The Debt Structure is Complex and the Supervision is Difficult

Most of China's local governments need to bear large personnel funds, social security fund gap subsidies, local loss-making state-owned enterprise subsidies, emergency rescue and other aspects of expenditure, and many places of infrastructure and public services need to be improved, the transformation of old infrastructure is an important political task of local governments, new urbanization, informatization and industrialization development led to the rigid demand for government investment and financing is very huge. The funding gap for local government infrastructure construction is gradually increasing, and the amount of bonds issued by higher-level departments for local governments cannot meet the demand for funds, and local governments can only raise funds through government financing platforms to borrow funds from social financial institutions and social capital to ensure the smooth progress of local economic development and tax source cultivation.

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However, as far as the current actual situation is concerned, there are many forms of borrowing entities, mainly government departments and institutions, fund subsidy institutions, financing platform companies, wholly state-owned or state-controlled enterprises, etc., resulting in increased difficulty in supervision, insufficient disclosure of some debt information, and lack of independent institutions to track and supervise the whole process of local government expenditure debt funds, resulting in an increase in regulatory costs. At the same time, the debt structure is relatively complex, nesting various transaction relationships, using various types of financial instruments, and the government credit endorsement is usually implied behind various types of debt, which aggravates the government's future debt repayment pressure.

1.6. Lack of Risk Management Mechanisms

The way other countries in the world control such debt problems is to quantify, build a "linear indicator system", visualize the use of "warning lights" to monitor the size of debt, and find many ways to deal with it. Nowadays, there are many kinds of bonds in China, the proportion of hidden debts is larger, generally many departments for financing, in terms of management is very loose, lack of corresponding regulatory system, so it is difficult to use quantitative methods to control, cannot establish an early warning mechanism. If there is a crisis in the debt borne by local governments, then local governments certainly do not have the energy and ability to build infrastructure, and investment in education, science and technology, etc. will be reduced, which will make the environment in which the economy is located increasingly harsh, and the lives of the people will become very difficult, and social problems and contradictions will appear. And if the risk of local debt breaks out, many government investment projects will end here, various capital chains will be broken, the economy will not grow at all, and some governments may go bankrupt due to debt pressure.

1.7. The Project Arrangement is Unreasonable, and the Budget Gap is Difficult to Contain

Local governments must start from the budget level and prepare a scientific financial budget plan, but at this stage, in the process of debt management, there are budget items that have not been implemented, and there is a large gap between the budget and the actual situation, which is mainly manifested in the following three aspects: First, the government investment project planning lacks rationality, rushes to start in the case of insufficient demonstration in the early stage, increases financial investment by increasing the project construction content in the later stage, and fails to fully consider the reserved funds to deal with emergency problems; Second, the use of debt funds and the timing of repayment are unreasonable, the debt funds are not in place in time after the start of construction, or the debt repayment time does not match the time node of the project income, and it is necessary to use financial funds to advance in advance, increasing the uncertainty of financial budget expenditure; Third, the budget performance evaluation system needs to be further improved, the performance target setting of the main body of budget project implementation lacks specific measurement standards, and the lack of process monitoring and management in the process of budget implementation, resulting in low reliability of performance evaluation results and affecting the efficiency of debt funds.

2. Local Government Debt Financing Potential Risks

At present, China's local government debt faces at least the following four potential risks, which need special attention.

2.1. Excessive Macro Leverage has Brought Huge Interest Payment Pressure

Since the onset of the global financial crisis in 2008, China's government sector debt as a share of GDP has continued to rise, from 31.7% in 2008 to 50.6% in 2018. At the same time as, fiscal space is becoming more and more limited, the cost of interest payments by government departments continues to rise (Table 2). In the future, once the long-term interest rate rises, the pressure to repay the principal and interest of the existing debt of the government department will be further intensified, and may even lead to the outbreak of default risk. Therefore, high macro leverage is not only a potential risk in itself, but is also putting significant pressure on traffic. In addition, China's macro leverage ratio is high, which ultimately comes down to the high leverage ratio of the public sector, especially the broad government sector, and the contribution of local government hidden debt is quite obvious. Local financing platform debt accounts for about one-fifth of China's real economy debt, and if the hidden debt of local governments is taken into account, the debt pressure of China's public sector will be further highlighted.

2.2. Debt Risks Will be Transferred to the Financial Sector, Exacerbating Economic Volatility

The risk of local liabilities is caused by financial risks transmitted by financing platforms and land finance. Due to the promulgation of the "New Asset Management Regulations" and the withdrawal of the "New Financial Management Regulations," many shadow banks have been further liquidated, off-balance sheet financing has been greatly reduced or shrunk, the financing chain of the platform will face a test, and the risk of debt default will further increase. Moreover, regional financing platforms are highly correlated, and once there is a default, it is easy to spread to other platforms, thereby increasing the risk of debt financing of local governments. The pull effect of the new housing market in the real estate development industry is very significant, the channels of government capital revenue have narrowed, and the complex interconnection network pattern of local finance, real estate, and commercial banks will completely change in the short term. Under the "land finance" model, the debt risks of local governments will be transferred to the financial industry.

2.3. The Government Debt Pressure in the Central and Western Regions is Even Greater, and it is Difficult for Them to Repay the Principal and Interest Themselves

At present, the distribution of local government debt in China is uneven, and the debt burden in the central and western regions is generally larger. As far as the explicit debt ratio of local governments is concerned, the comprehensive financial resources of developed areas along the eastern coast cover the balance of government debt more fully, and the areas where the debt ratio exceeds the warning water level are basically central and western provinces, such as Guizhou, Inner Mongolia, Yunnan, Qinghai, Ningxia, Yunnan, etc. In terms of debt ratios, the central and western regions are still regions with heavy debt burdens, such as Qinghai and Guizhou, where the debt ratios have reached 81.1% and 65.1%, respectively, while the debt ratios of Yunnan, Gansu, Xinjiang, Hainan and Ningxia are approaching 50%. In 2019, the balance of local government debt in Hunan, Inner Mongolia and Tianjin is already close to the debt limit, and the space for new debt in the future is relatively limited, facing the challenges of significantly reducing the available space for debt, slowing down the growth rate of general public budget revenue, declining fiscal balance rate (general public budget revenue/general public budget expenditure), and over-reliance on higher-level subsidies.

2.4. Fiscal and Financial Risks Overflow from Each Other

If local bonds default, it seems that it is bond investors who suffer losses, but in fact the banking system is the ultimate buyer of China's local bonds (whether related loans, non-standard assets or bonds). This has led to the monetization of fiscal policy and the fiscalization of financial policy, and has increased the inter-spillover of fiscal risk and financial risk (Li Yang, 2021). This means that once local government bonds default, the security of the local financial system will

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be impacted, and it may even trigger a regional financial crisis. Considering the importance of the sound operation of the banking industry to China's financial system, once a banking crisis breaks out, the Chinese government is bound to intervene in the rescue. Whether it is to divest banks of non-performing assets, inject capital, or provide debt repayment guarantees for banks, it involves injecting huge amounts of financial funds to bail out. In the case of local government funds are stretched, the central finance has to raise funds through its own leverage.

3. Local Government Debt Financing Governance Path

3.1. Deepen the Reform of the Fiscal and Taxation System and Reasonably Match Fiscal and Administrative Powers

The fiscal and taxation system, which reasonably matches the financial power and the power of affairs, is the basis for the risk management of local debt. Further introduce plans for the division of central and local fiscal powers and expenditure responsibilities in other subdivisions, and form an all-round and clear system of central and local fiscal powers and responsibilities. At the same time, the tax system still needs to be further improved, forming a central and local revenue division system that is "mainly shared tax and supplemented by exclusive tax", appropriately increasing the proportion of local shared tax sharing, and increasing the source of tax revenue for local entities.

3.2. Promote the Disclosure of Local Government Debt Information and Improve the Transparency of Debt Management

Local government debt financing has many problems such as hidden debt, poor financing channels, and opaque information, and at the same time, local governments often relax restrictions on financing methods in order to pursue economic benefits, resulting in a large number of irregular and opaque financing behaviors. Therefore, it is necessary to improve the transparency of local government finances, standardize the management of various financing channels, and prevent the occurrence of local debt risks: First, establish an accrual financing mechanism; The second is to build a local government debt financing responsibility system. Under the responsibility mechanism, local governments should not only strengthen their sense of responsibility, actively assume the responsibility of controlling local debt financing and supervising local debt markets, and strictly control the chaos of debt financing, but also strive to promote the standardization and legalization of local government bonds, reduce the occurrence of hidden debts, and create a good development environment for local debts.

3.3. Improve the Debt Risk Early Warning Mechanism, and Increase the Intensity of Constraints and Penalties

Clarify the fiscal reorganization plan, including but not limited to suspending other fiscal and tax preferential policies other than laws, administrative regulations and the preferential fiscal and tax policies stipulated by the State Council, reducing various expenditures such as capital construction and government public funds, controlling personnel welfare, etc., and proposing to investigate the responsibility of relevant personnel in accordance with the law. In the debt risk early warning and prevention and control system, it is particularly necessary to pay attention to the hidden debt risk, and doing a good job of hidden debt mapping is the premise for further prevention and control of local government debt risks. At the same time, the accountability of relevant personnel in areas with greater hidden debt risks should also be further strengthened.

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3.4. Properly Resolve the Risk of Existing Debts and Standardize the Management of New Debts

To ensure the implementation of the series of policies that have been introduced, on the one hand, it is necessary to continue to promote the reform of the central and local fiscal and taxation system, on the other hand, the local government debt statistics and information disclosure work must still be strengthened, and at the same time, the supervision and accountability should be strengthened to ensure that the new debt strictly complies with the existing policy norms. In addition, in the current situation where the problem of reasonable matching of local financial power and power has not been fundamentally solved, local governments should also give full play to their subjective initiative to standardize the monitoring of tax sources, strengthen the management of tax sources, expand tax sources in many aspects, enhance their fiscal and tax strength, and reduce their dependence on debt development.

3.5. Strengthen Theoretical Research, Enhance Consensus, and Establish a System for Releasing Hidden Debt Information

Further strengthen the study of the hidden debt problem, and gradually unify the understanding of its connotation and extension. At this stage, the scope of hidden debt is defined in terms of investment and financing platform debt, state-owned enterprises, public institution debt, shantytown transformation project debt, affordable housing project debt and social insurance fund gap. The financial department, together with the auditing and other departments, shall establish a regular hidden debt information release system, improve the transparency of hidden debt, respond to the concerns of all sectors of domestic society and the international community, eliminate all kinds of speculation and unnecessary social panic, eradicate the soil for the breeding of various rumors, and maintain the normal order and sustainable development of local economy and society.

3.6. Achieve Large-scale Debt Replacement and Debt Restructuring in a Transparent and Orderly Manner

For some local governments in central and western China, the ability to dispose of debt on their own strength alone is relatively limited. This means that the central government and the commercial banking system should be the main force in resolving the risk of local government debt, and the central government will undoubtedly play a decisive role. Specifically, to fundamentally resolve the current local government debt risks, it is necessary to have both a Large-scale debt replacement led by the central government and a debt restructuring in which the banking system and local governments cooperate with each other.

4. Conclusion

As the main financing channel of local governments, while serving the stable development of local governments, finance should pay attention to potential risks from a macro perspective. Based on the macro perspective, this paper analyzes the development status and existing risks of local government debt in China, and seeks a governance path. This paper believes that we should promote high-quality economic development by deepening the reform of the fiscal and taxation system, reasonably matching fiscal and administrative powers; promoting the disclosure of local government debt information and improving the transparency of debt management; improving the debt risk early warning mechanism, increasing the intensity of constraints and punishments; properly resolving the risks of existing debts and standardizing the management of new debts; strengthening theoretical research, enhancing consensus, and establishing a hidden debt information release system.

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