Re-conceptualization of Local Debt Issues and Proposals for Their Resolution

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Abstract: Abstract: The huge local government debt in China is a consequence of development needs and investment impulse. It is both an economic and institutional issue. The analysis of local government debt should be built on the principle of neutral in-vestment. Resolving local government debt issues requires a series of reforms and institutional innovations promoted by local governments. This paper summarizes medium- and long-term factors contributing to the increase in local government debt in China, pinpointing the main characteristics of current local government debt. Additionally, it provides an in-depth comparison of Chinese and Western urban asset management models and analyses the differences between central and local government finances. Based on this foundation, the paper proposes several measures and suggestions to resolve these issues at both the local and central government levels.

Keywords: local government debt； investment lever； resolution measures； suggestions

The formation of the massive debt of local governments in China stems from the demand for development and the impulse for investment. Local governments around the world borrow for development, but they exhibit diverse crises due to differences in constraint mechanisms and their intensity. Thus, the issue of local debt is both a problem derived from development and a systemic issue. This requires us to recognize not only the adverse aspects of high local debt but also its favorable side, which is the opportunity amid the crisis during the process of resolving local debt--specifically, promoting various related institutional reforms in the government, significantly reducing general expenditures such as headcounts and rolling expenditures, and increasing investment in science, education, and efficient public facilities. This way, we can forge a new path that leverages debt resolution to promote development.

1. Medium- and Long-term Factors Contributing to the Increase in Local Debt in China

There are several reasons for the sustained increase in local debt in China, which can generally be categorized as follows: first, the impact of intensified international geopolitical conflicts, global economic recession, and the escalation of anti-globalization; second, the significant increase in disasters and corresponding losses caused by extreme weather events due to climate change; third, the rapid accumulation of government debt resulting from COVID-19 prevention measures over the past three years; estimates by Bai Chong'en, Dean of the School of Economics and Management at Tsinghua University, suggest that local fiscal expenditures directly caused by the pandemic exceeded 4 trillion yuan, with the actual figure potentially doubling; fourth, the decline in population and the downturn in the real estate market have led to the shrinkage of nearly a hundred related industries, resulting in a corresponding decrease in local tax revenues; fifth, local governments in China find it challenging to implement counter-cyclical adjustments through increased investments as they did in response to the central government's 4 trillion yuan proactive fiscal policy in 2008, further exacerbating the difficulty of self-driven debt resolution.

From the perspective of debt structure, there is a severe differentiation in the debt-bearing capacity of local governments due to the high variability in the national real estate market. For example, in 2022, Qinghai Province had a government debt ratio of 925% and a municipal investment debt ratio of 99%. Provinces and cities with high local government debt ratios and low municipal investment debt ratios heavily rely on central government assistance, while Jiangsu Province had a government debt ratio of 224% but a municipal investment debt ratio soaring to 913%, making it a typical province capable of proactively transferring debt leverage through self-reliance. The disparity in local government debt ratios and municipal investment debt ratios indicates that the ability and effectiveness of local governments in self-driven debt resolution can vary significantly.

It is important to emphasize that the volume and widespread nature of local debt, if not handled carefully, could lead to the intertwining and amplification of the risks, resulting in increased overall economic downward pressure and a vicious cycle of deflation.

Tab.1 Ranking of local government debt ratio and urban debt ratio

Regions	GDP (in 100 million yuan)	Local Government Debt Balance (in 100 million yuan)	General Public Budget Revenue (in 100 million yuan)	Local Government Debt to GDP (%)	Local Government Debt to General Public Budget Revenue (%)	Bond-Issuing Municipal Investment Debt (in 100 million yuan)	Municipal Investment Debt Ratio (%)	Total Debt Ratio (%)
Qinghai	3610	3044	329	84	925	327	99	1025
Guizhou	20 165	12 470	1886	62	661	14 893	790	1451
Jilin	13 070	7168	851	55	842	4919	578	1420
Gansu	11 202	6008	908	54	662	5843	644	1305
Tianjin	16 311	8646	1847	53	468	12 757	691	1159
Hainan	6118	3487	832	57	419	712	86	505
Heilongjiang	15 901	7291	1291	46	565	1339	104	668
Xinjiang	17 741	7849	1889	44	416	4599	243	659
Yunnan	28 954	12 098	1949	42	621	16 119	827	1448
Inner Mongolia	23 150	9340	2824	40	331	2496	88	419
Ningxia	5070	1996	460	39	434	503	109	543
Liaoning	28 975	10 980	2524	38	435	1443	57	492
Hebei	42 370	15 749	4084	37	386	10 890	267	652
Guangxi	26 301	9722	1688	37	576	12 126	718	1294
Chongqing	29 129	10 071	2103	35	479	19 976	950	1429

Jiangxi	32 075	10 860	2948	34	368	19 293	654	1023
Hunan	48 670	15 408	3102	32	497	24 306	784	1280
Sichuan	56 750	17 705	4881	31	363	40 102	822	1184
Shanxi	32 773	9782	3312	30	295	16 234	490	786
Anhui	45 045	13 304	3589	30	371	18 415	513	884
Shandong	87 435	23 588	7104	27	332	40 738	573	905
Xizang	2133	568	180	27	316	649	361	676
Zhejiang	77 715	20 109	8039	26	250	60 364	751	1001
Hubei	53 735	13 900	3281	26	424	24 380	743	1167
Beijing	41 611	10 565	5714	25	185	11 292	198	383
Henan	61 345	15 130	4250	25	356	22 789	536	892
Shanxi	25 643	6286	3454	25	182	6532	189	371
Fujian	53 110	11 902	3339	22	356	16 316	489	845
Guangdong	129 119	25 082	13 280	19	189	23 806	179	368
Shanghai	44 653	8539	7608	19	112	8424	111	223
Jiangsu	122 876	20 694	9259	17	224	84 557	913	1137

Source: Reference [4]

2. Main Characteristics of Current Local Government Debt

In addressing potential crises, investment remains the only area where governments at all levels in China have independent authority to take action among the so-called "three drivers of growth." Currently, the financing amount of state-owned enterprises (SOEs) and central enterprises far exceeds that of private enterprises, and the passive shrinkage of foundational operating entities during this crisis is extremely detrimental to the overall revival of societal investment. Why has private enterprise investment remained sluggish and rarely seen in the past 20 years? The reason is that, apart from the time needed to repair balance sheets, the confidence and investment of most small and medium-sized private enterprises are closely tied to the incremental investment by local governments, which are currently in a phase of shrinking budgets and debt resolution. The expansion of investment by small and medium-sized private enterprises typically targets predictable project returns. However, the local governments' debt reduction and deleveraging have led to a deceleration in investment from the two traditional driving forces of China's economy--local governments and private enterprises--potentially triggering a prolonged vicious cycle. The broad fiscal deficit rate of China's central government has already exceeded 3%, and the central government's leverage ratio is notably lower than that of other countries. Nonetheless, this represents a critical safeguard for national fiscal security, which should not be easily surpassed.

Since the 13th Five-Year Plan, the primary contributor to fiscal leverage has been local finance. Local governments' explicit and broad debt ratios have significantly risen, primarily due to historical accumulation. After the central government implemented a 4 trillion-yuan stimulus package during the 2008 international financial crisis, local finances and financial institutions added approximately 30 trillion yuan in support. Subsequently, to align with the central government's ‘shantytown renovation" policy issued in 2015, local finances began to leverage comprehensively.

In August 2018, the central government issued the ‘Opinions of the Central Committee of the Communist Party of China and the State Council on Preventing and Resolving Risks of Local Government Implicit Debt,’ which set very strict requirements for controlling debt. If this document had been strictly followed, the current issue of high local debt might not have arisen. However, the onset of the COVID-19 pandemic by the end of 2019 derailed this plan, leading to a further acceleration in local debt during the three years of the pandemic, as shown in Figure 1.

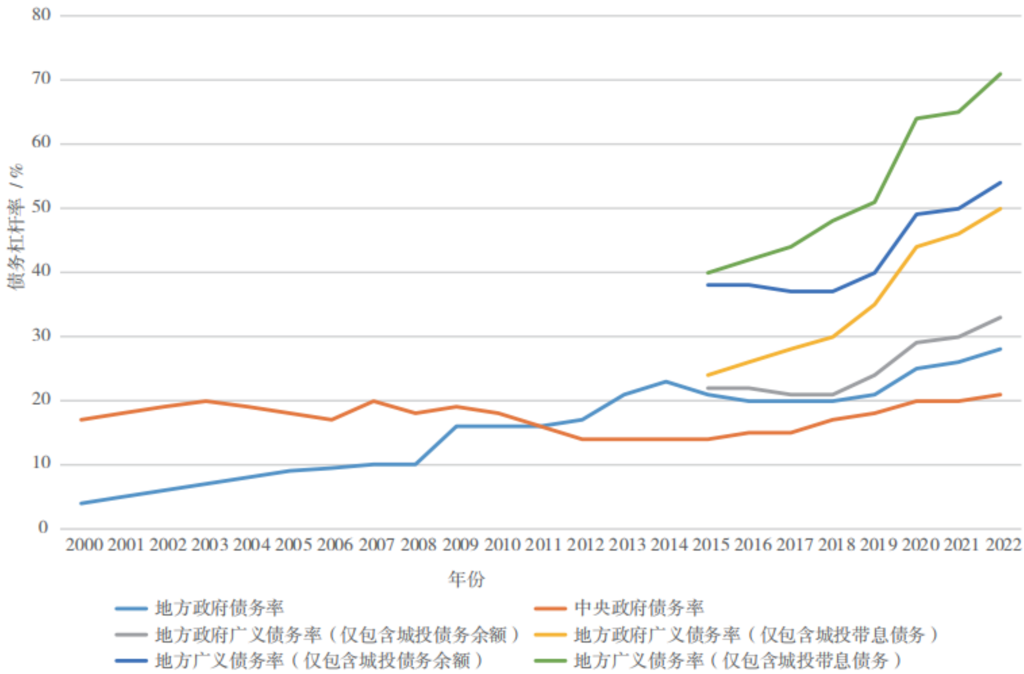

Fig.1 Central and local government debt leverage ratio

Source: https://mp.weixin.qq.com/s/z7eRC6O_9F5dvrukD9V2hw

Another characteristic is that the proportion of interest on government debt is excessively high, resulting in wasteful and ineffective projects becoming rampant. Japan's total government debt rate is 260%, but the proportion of debt interest expenditure to overall revenue is only 5%, thanks to its substantial overseas assets that yield high returns and low interest payment pressure. In contrast, the debt of platform companies within China's local debt generally has a much higher interest rate than that of government debt. In 2021, China’s total debt ratio was 96%, yet debt interest expenditure accounted for more than 15% of total revenue. Some issues with local debt stem from excessive expansion, misallocation of funds, and wasteful spending. As British Prime Minister Winston Churchill famously remarked during World War II, ‘Those in power have an impulse to leave their mark on the earth,' and the careless spending of public funds can be a fatal issue. Combined with the short terms of local officials who are eager to achieve results, this has led to a proliferation of ineffective and image-driven projects in some regions.

3. Differences in Urban Asset Management Models Between China and the West

When studying local debt, it is important to note that most of the debt is urban debt, while rural debt is relatively low. There are significant differences in urban asset composition and management models between China and the West. China's urban debt development has four main advantages: first, there is a vast amount of local state-owned assets; second, urban land is state-owned, which allows the government to benefit from land appreciation resulting from infrastructure investment; third, in contrast to western cities that are at a more advanced stage of urbanization, China is only experiencing aging similar to developed countries, while urbanization and industrialization still have considerable room for development; fourth, the central government's management authority over local governments is different. In China, the central government has the power to appoint and dismiss local government leaders, while in the United States, the federal government cannot remove state governors, let alone city mayors. This personnel control is the least costly yet can lead to mistakes.

On the other hand, compared to the West, there are two unfavourable factors for local debt development in China: first, the management model of small to medium-sized cities in China has a significantly larger number of public employees relative to similarly sized western cities. For example, the management models of major cities in the West, such as New York and Boston, are similar to those in Chinese cities, characterized as "strong government." However, cities in the West with populations of 200,000 to 300,000 are managed by urban manager agencies, without the burden of city government staff. Generally, a city management committee member is elected from a few tens of thousands of residents, and they meet twice a year to vote and select one member as the mayor, who receives only a $300 monthly transportation allowance. In the other meeting, they decide which urban manager agency to hire for city services like sanitation, security, landscaping, and water supply and drainage, which is comparable to an expanded version of property management in Chinese communities. Both the United States and Europe have standardized management quality systems for urban managers, and city management committees can replace ineffective managers at any time, making management costs in small to medium-sized western cities much lower than in China.

Second, the main decision-makers in Chinese cities tend to have short tenures and are often from outside the locality. This "eating the grain of the next year" motivation is much stronger than that of their western counterparts. For instance, the average tenure of a city mayor in China is about three years, whereas the mayor of Chicago has served for 13 years, aiming to surpass the 15-year record set by his father. Additionally, candidates must meet residency requirements to run for city mayor in western cities, which adds another layer of stability to their leadership.

4. Who Should Leverage More: Central or Local Finance?

First, the central government's finances serve as the last line of defines against unprecedented risks; thus, it is not advisable for it to significantly increase leverage for several reasons. First, the central government's deficit rate is comparable internationally, while local financial situations are not. Second, if the central government's deficit rate rises too quickly, Western rating agencies will likely overreact and react negatively. Third, given the massive scale of China’s finances, it is unlikely that international organizations would provide assistance in the event of a crisis, similar to the principle that "the grain bowl must be held in our own hands" regarding food production.

Secondly, different entities have varying levels of risk when leveraging. The resilience against risks ranges from weak (private enterprises, families, small and medium banks/local state-owned enterprises) to strong (central state-owned enterprises/four major banks, central finance, and local finance). I believe that local finance can withstand leverage better than central finance. Although some local finances are already heavily indebted, government operations can still continue because they have the ‘backing’ of the central government, which can provide emergency assistance in critical situations. However, if central government debt were to rise to the same extent as local government debt, many functions of state agencies might no longer operate normally. Hence, under the same debt ratio, local finance exhibits greater debt resilience than central finance.

Additionally, two important points should be emphasized: first, while deleveraging is challenging, transferring leverage between different entities is easier. In the past, we have made the mistake of overly focusing on deleveraging, which led to a substantial contraction in various investments and consumption, ultimately forcing us to declare a policy of "stabilizing leverage"--a lesson learned from history. Second, it is easier for leverage to transfer from the bottom up than from the top down. For instance, if the central government increases leverage to absorb local government debt, the effects can be almost immediate; however, the opposite is much more difficult.

Third, the ultimate risks of local finance are manageable. When I served as the county party secretary in the early 1980s, the county had a population of 1 million with only one jeep, and many police stations lacked telephones. At that time, local finances were far more challenging than those of any current city. Based on practices in numerous localities, current local government employees can temporarily adjust salaries and benefits downward by 25-33% without causing a mass exodus that would paralyze the government. Central and provincial finances can focus on ensuring the operation of essential services, such as pensions for retirees, public goods, health, education, vital engineering projects, and social welfare expenditures. Excess personnel in government agencies can be reassigned or temporarily suspended, as long as essential services like water and electricity are maintained to support the public’s daily lives and production activities.

Importantly, due to competitive relationships among cities, potential financial risks from over-investment can be easily identified, and accountability is clearer. Many investment projects undertaken by local governments are economically and socially inefficient, and similar issues exist within central government investment initiatives. However, due to competition among cities, a poor choice of projects for the same amount of money in one city becomes immediately evident compared to others. When central ministries make errors in project investment decisions, other ministries may not become aware of them due to differences in professional specialization and industry focus; the consequences of erroneous investments can be concealed or even misrepresented as positive outcomes.

5. Comprehensive Solutions for Resolving Local Debt Risks

Provincial Level: It is essential to factor in the state-owned assets and potential realizable assets held by provincial governments when assessing the risk levels of local debt. Asset disposal companies should be entrusted with handling debts through market-oriented approaches, such as auctions, viewing debts as misallocated assets. Additionally, it is important to enhance the oversight of local budgets by local people's congresses. Strengthening the supervision of lower-level financial departments by higher-level ones is also crucial, with local financial budgets prepared according to a "full-caliber budget" approach. Simplification and reduction of staffing should be based on the actual service population, as seen in Hunan Province, which has begun to reduce the number of civil servants in declining population counties and cities.

Local Level: First, platform companies should undergo shareholding reforms to independently bear operational risks. Jiangsu Province has announced that the shareholding reform of 400 platform companies has been completed and is requesting that the central government allow failed platform companies to declare bankruptcy like normal enterprises. Second, promoting the temporary suspension of salaries for surplus civil servants and staff can reduce budget expenditure by about one-third, facilitating coordination among financial, fiscal, state-owned, and private enterprises for joint debt resolution and balance sheet expansion. Third, implementing a "zero-based budget" approach will help cut down on inefficient budgets inflated by land finance and pandemic-related expenditures in recent years, aligning with the central government's repeated calls for "tightening the belt." Local government departments often strive to maximize annual budget allocations, leading to excessive expenditures--many cities renovate their streets nearly every two years, a practice that exceeds national standards. Some urban parks are sprayed with pesticides almost daily during the summer and fall, driven by a desire to exhaust this year's budget to secure a similar allocation for the following year. Therefore, it is recommended that all regions adopt a "zero-based budget" approach, establishing expenditure budgets based on essential needs.

Finally, new investment projects should prioritize anticipated return analyses. The effectiveness of investments is far more critical than the debt ratio. For example, in rural Zhejiang, if someone is accepted into Tsinghua University, the entire community is willing to lend money to that family, regardless of their debt ratio being as high as 1000%, because they perceive this as a beneficial debt with expected returns. This illustrates that debt is fundamentally neutral; the focus should be on the projects being financed and their potential returns. Take Hefei City as an example; in recent years, the city has emphasized analysing the expected returns of science and innovation projects, successfully investing in many high-quality new projects, resulting in significant economic growth compared to other cities.

6. Recommendations for the Central Government to Facilitate the Healthy Resolution of Local Debt

First, the central government can moderately delegate the authority to issue local government debt, which is beneficial for replacing high-interest loans and constraining debt expansion through autonomous financial management. The creditworthiness of local governments is highly sensitive in the debt market, and sometimes it is more effective than dispatching central personnel for investigations. Provincial debt assessments should deduct the net assets of provincial state-owned assets and public institutions; the central government can provide special bonds to replace high-interest local debts.

Second, the central government can moderately incorporate social welfare responsibilities from provinces and municipalities, which will facilitate the cross-regional storage of social insurance and housing fund benefits for mobile populations.

Third, a national asset disposal trading platform should be established, as debt, in a certain sense, represents misallocated assets that need increased liquidity to help localities resolve their debts.

Fourth, state-owned enterprises (SOEs) should temporarily take control of large private real estate companies to achieve low-cost "protection of main entities" and ensure project completions. This approach can be learned from the United States, where, during the 2008 financial crisis, the government funded the temporary nationalization of some major corporations facing financial crises, allowing the government to exit with substantial profits after the risks had subsided.

Fifth, strict adherence to the "five thresholds" should be enforced, focusing on results and seriously addressing decisions by local governments that blindly raise salaries and benefits, engage in image projects, wasteful spending, arbitrarily increase penalties, and delay payments to private enterprises. This should not be limited to punishing grassroots officials for expanding hidden debts to prevent reversing priorities.

Sixth, regulations for local debt management should be established, strengthening audits for local leaders upon departure. Those who recklessly open the "five thresholds" should be held accountable for life. Local platform companies in provinces and municipalities should undergo market-oriented transformations, and once qualified, their debts should not be considered as hidden debts of the government. Allowing local platform companies to declare bankruptcy would be beneficial for the development of local science and technology enterprises and autonomous debt resolution.

Seventh, for local governments in the "green zone" of debt, the scope and limits of special bond usage should be relaxed. The scope of special bond usage should be dynamically adjusted according to the risk level of local debts; currently, Shenzhen and Guizhou are managed under the same model for special bonds, which is unreasonable.

In summary, resolving local debt is an unprecedented challenge and essentially a comprehensive transformation. In the long run, it is inevitable that China’s overall fiscal leverage will expand investments; once local governments autonomously resolve debts, proactively increasing leverage can be more beneficial than harmful, and accountability for investment project failures is easier to ascertain. The central government can increase leverage selectively, primarily for systemic and inter-provincial projects, with strict analyses of the return rates on new government projects. Investing in the right projects is far more important than merely reducing debts; encouraging local governments to increase revenue and optimize expenditures while scientifically and rationally expanding investments is essential. It is important to effectively incentivize local governments to creatively manage their finances, preventing a one-sided pursuit of deleveraging that could lead the economy into prolonged deflation.

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