CHINA'S LOCAL GOVERNMENT DEBT

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The hidden debt of China's local governments, which is held by entities called local government financing vehicles (LGFVs), has rattled financial markets. Now some worry that it could threaten the entire economy. While there is no official data, one estimate of LGFVs debt puts it at 59 trillion yuan (US$8.25 trillion) at the end of 2022.[1] The International Monetary Fund estimates that the total might be even higher, more than 70 trillion yuan (US$9.79 trillion).[2] To put these numbers in perspective, another estimate puts local government debt held by LGFVs at nearly half of China's total GDP in 2021, or about twice the size of Germany's economy.[3] A more recent estimate has upped the number closer to US$10 trillion, which would be roughly double the GDP of Japan.[4] These off-the-books LGFV borrowings are almost the same size as official (on-the-books) central and local government debt combined.[5] While we do not know the precise figure, we do know that the prospects for local government finances are going to remain dire unless the real estate sector—the major source of local government financing—rebounds. The severe decline in the cash flow from the real estate sector to local government means that an increasing number of LGFVs will face liquidity risks, unable to pay their debts as they become due.

For most readers, the most puzzling thing about China's local government debt might be why it is considered 'hidden' and why local government financing vehicles (LGFVs) are holding the bag for local governments. To understand this, it is necessary to understand what LGFVs are and why the collapse of the real estate sector has created such problems for them. The bigger question is why China's powerful central government let this problem grow to this degree. Why didn't Beijing do something about it earlier? LGFV debt skyrocketed during the zero-COVID policies, so is the pandemic to blame? Finally, what is Beijing doing about this crisis, and is it enough to solve the problem?

LGFVs and 'hidden' debt

While local government debt is common in all countries, China's story is unique in several respects. First, if one looks at the on-the-books debt of local governments, the situation is manageable and relatively stable—one

would not know there was a debt problem. What makes the China case so curious but also worrisome for Beijing is that the local government debt that has skyrocketed is ‘hidden’. In this context, the adjective ‘hidden’ does not imply that the debt is illegal, but rather that it is off-the-books or unrecorded. Local governments do this off the books because Chinese law forbids them from bank borrowing. To circumvent this restriction, local governments were allowed by Beijing to create institutional middlemen to borrow on their behalf—these are the special purpose vehicles, called local government financing vehicles (LGFVs), which incur and hold this ‘hidden’ debt. It is these LGFVs that now are teetering on default. Hence, while this debt is technically ‘hidden’, it is an expected and condoned outcome of a deal made between Beijing and the localities.

To understand why and how LGFVs are left holding the bag of local government debt, one needs to go back to the early 1990s when Beijing reformed the fiscal system, which had been in place since 1980. The 1994 fiscal reform stemmed from the 1980 fiscal system, which was called a revenue sharing-system. The reason why that system proved to be such a potent incentive for local state-led development was that there was a category of taxes and fees, called extrabudgetary revenues, that localities did not have to share but could keep in their entirety. The most important and the fastest growing of these revenues was the collective and individual enterprise tax, which took off with the development of the township and village enterprises, the TVEs. It was these TVEs that allowed China’s economy to take off. The problem was that all the new revenue from this sector was staying in the localities. By the early 1990s, Beijing was only receiving less than a quarter of total revenues.

To grab a bigger share of total revenues, in 1994, Beijing restructured the fiscal system by dividing taxes into those that would go exclusively to the centre, those that would go to the localities, and those that would be shared; this is known as the ‘tax-sharing system’ 分税制. The hitch was that this 1994 fiscal reform would leave localities with insufficient tax revenues to meet their basic expenditures. Localities would face an annual fiscal gap—a shortfall between the amount of tax revenues left to them and their fiscal expenditures. The then vice premier of China, Zhu Rongji 朱镕基, and others,

including the then minister of finance Xiang Huaicheng 项怀诚, recognised the problem and knew that localities needed new incentives to pursue local state-led development to make up for the revenues that were taken away.

Zhu Rongji came up with a grand bargain that would allow Beijing to have its cake and eat it too. Beijing could recentralise tax revenues, and the localities would be given the rights and tools to raise new non-tax revenues that they could keep to replace the extra budgetary funds that were taken away. To make the bargain operable, localities were given the right to run local state banks and then establish LGFVs to circumvent the legal prohibition on government borrowing.[6]

The dependence of LGFVs and local governments on the real estate sector

Local governments established LGFVs as middlemen to borrow on their behalf. LGFVs were also tasked with selling land to real estate developers, who then paid land transaction fees to local governments. Using land to generate revenue is known as 'land finance' 土地财政. This strategy allowed localities to fill the fiscal gap left by the 1994 fiscal reforms, which recentralised taxes to Beijing. Yes, localities had to borrow and incur debt, but the steady stream of revenues from land transactions allowed them to repay debt and have funds to drive growth.

Problems began with the Global Financial Crisis, when China implemented its stimulus package to keep the economy going. Nominally, the stimulus package provided RMB 4 trillion. In reality, however, the central government provided only 30 percent of that amount, and local governments were expected to find the rest.[7] All of that borrowing created a huge debt burden for local governments around 2013 when many of those loans started to come due. To help repay these debts, local governments started to issue bonds. Although debt was becoming more burdensome, it was manageable because land finance was still viable as the housing market continued to boom.

Construction sites have been left empty or half built since Beijing implemented the 'Three Red Lines' policy
Source: Markus Winkler, Unsplash

The current crisis stems from the collapse of the real estate sector, when the demand for land vaporised, rendering the land finance strategy inoperable. Because of their dependence on the real estate sector for revenues, its collapse left local government budgets with no incoming revenue stream. LGFVs must now borrow more on behalf of their local government to ensure the continued operation of public services and to service existing loans. Some localities have already had to cut back on social services or laid off government employees because of fiscal shortcomings. But the other options are also limited because there are now also restrictions on the ability of LGFVs to issue bonds if they are already holding too much debt.

COVID-19 and the current crisis

One might think that the current local government debt problem can be blamed on COVID-19. The costs of testing, isolating and treating COVID-19 was borne almost entirely by local governments. Yet COVID-19 does not sufficiently explain the problem. While COVID-19 certainly raised

expenditures for local governments, it was pandemic-era state policies, which enforced fiscal discipline and deleveraged the real estate sector, that triggered the crisis of local government debt. The mountains of debt facing local governments across China are largely an unintended byproduct of these policies. A few factors came together, including COVID-19, to create a perfect storm that then magnified and made intractable an institutional problem that had its origins in the mid-1990s.

Before COVID-19, starting in 2016, Beijing had already begun to tamp down the real estate sector with a deleveraging campaign that tried to limit the sector's borrowing and ensure that borrowers would have cash on hand to repay debt. The arrival of COVID-19 led Beijing to pause its efforts to enforce fiscal discipline. From about January to June of 2020, the central authorities provided substantial aid to localities to offset some of the costs to local governments during the initial phase of the pandemic, such as special low-interest COVID-19 bonds 抗疫特别国债.

Ironically, it was China's success in tackling COVID-19 during the first six months that set it on the road that led to the local government debt problems. After a rocky start in Wuhan, Beijing was highly rated by the Nikkei COVID-19 Recovery Index for its handling of COVID-19, as measured by case numbers, vaccination rates, mobility and functioning economic life.[8] Beijing became so confident that in the summer of 2020, the central government returned to its pre-COVID-19 economic agenda to try to enforce fiscal discipline on the real estate sector and curbing debt more generally, especially that of local governments.

Beijing implemented the 'Three Red Lines' policy 三条红线, which prohibited real estate firms from borrowing beyond set limits. Overnight, the developers' heretofore successful business model of borrowing to grow became inoperable. This left them with few or no new sources of funding to keep operating or repay debt, leaving many scrambling to sell assets for quick cash. Some stopped building, leaving construction sites empty or half built. Suppliers went unpaid. Some developers defaulted, but few were buying land from local governments. But the consequences did not stop with the developers not being able to get loans. Because homebuyers in China had

start making mortgage payments before construction was complete, once they realised what was happening to the real estate developers, they went on mortgage strikes, refusing to make further payments out of fear that they would never get a finished apartment.

Ultimately, the failures of the real estate companies meant that revenues from land sales and preparation sank to almost nothing, leaving local governments cut off from the source of non-tax revenue that made up the gaps in funding of their local budgets each year. The impact of the loss of land sales revenues was made worse by the decrease in tax revenues after central authorities cracked down on the tech and the afterschool tutoring sectors during this same period.

The final factor that contributed to the perfect storm was the arrival of a new COVID-19 variant, Omicron, in January 2022. The resulting lockdowns further cost local governments as COVID-related expenses for testing, quarantining, and treatment soared, while revenues plummeted due to the near halt of most economic activity. It became increasingly difficult, if not impossible, for local governments to repay their debts and cover rising expenditures. The real estate sector and housing market have yet to recover despite the end of zero-COVID restrictions at the end of 2022, as the economy—after a brief bump in activity—has remained in a slump.

To make matters worse for local governments, Beijing pushed aside concerns about curbing local debt. In an about-face, it instructed LGFVs to take up the slack from the demise of the real estate sector and make land purchases, even if it mean going into more debt, to provide revenues for local government coffers. It remains unclear what LGFVs are doing with this land. Reports suggest that few have actually used that land for new development. Recent reports reveal that although some LGFVs did buy land, others faked these transactions to comply with upper-level directives.[9] These must have decided that they simply did not have the funds to do so, nor did they want to assume more debt. We await details of how local governments dealt with these directives, which are simply trying to make the on-the-books local government budgets look stronger even if the off-the-books borrowing skyrockets even further.

Why did Beijing not stop this hidden debt problem earlier?

Since 2014, when the costs of the stimulus package loans became evident, Beijing has been trying to rein in local government debt. This included Beijing swapping out the LGFV bonds, which were most costly in terms of interest with shorter maturity dates, to longer maturing, lower-cost, centrally approved and guaranteed local government municipal bonds that could be more easily repaid. Importantly, these municipal bonds were strictly limited in the amounts issued and required approval by the upper levels. The assumption was that if they cleaned up these existing bonds and required approval for the municipal bonds, the centre could control local government debt. After the bond swaps, in 2018 another campaign was started to get rid of hidden debt, including having local governments sell assets or stakes in state-owned enterprises (SOEs). But none of the many attempts were successful because none addressed the root of the problem: the flawed fiscal system instituted in 1994 that left localities with a fiscal gap. The approved municipal bonds were insufficient to cover local fiscal needs.

Banks such as ICBC are now offering 25-year loans
Source: Adrian-Grycuk, Wikimedia Commons

The point that must be understood is that LGFVs and their borrowing on behalf of local government was an expected outcome of the grand bargain to mobilise support from the localities for its 1994 fiscal reforms. Beijing even assured localities that they should not fear upper-level intervention in revenue-generating activities, as long as they sent up the requisite tax revenues. This also explains why Beijing had no official accounting of local government debt until 2011. Beijing had agreed that it would not seek to know the details.

What Beijing is doing to resolve the crisis

Allowing the establishment of LGFVs was an effective short-term workaround for local government borrowing. As indicated in the introduction, the terms 'legal' or 'illegal' are useless in understanding their actions because they were condoned and created to get around official prohibitions against local governments borrowing from banks. But the grand bargain between the centre and the localities that allowed their creation also has created ambiguity around who is responsible for repaying LGFV debt and allows Beijing to pretend that local government finances are not in jeopardy.

As financial analysts around the world have become more rattled by the sheer size of this hidden debt and the possible consequences for the larger economy, Beijing has tried to calm markets by describing it as enterprise debt (LGFVs are state-owned enterprises) and denying that it counts as local government debt. As China's Ministry of Finance has said, the liability for LGFV debt 'lies with the entity that issued it'.[10] It added, 'local governments do not bear the responsibility to repay the debt of LGFVs and other state-owned enterprises', citing the amended Budget Law in 2014. That means, however, that there is no explicit guarantee of payment; that is, local governments never promised to pay this debt. This ignores the fact that local governments also have what is called implicit debt, which is debt that they may pay if the original borrowing cannot pay. To thwart any hope of a central government

rescue, the ministry has explicitly said: 'If it's your baby, you own it. There will be no bailout from the central government.'[11] Such statements seem at least implicitly to recognise that the problem will be the local governments'.

At the same time, Beijing has taken steps to buy more time for LGFVs and local governments to repay their debt. Banks have been asked to give LGFVs new loans with 'ultra-long maturities and temporary interest relief to prevent a credit crunch'. Instead of the ten-year loans previously given to LGFVs, banks, including some of the big four such as ICBC and China Construction Bank, are now offering 25-year loans.[12] But this strategy has moved huge risks onto the banks. As a result, Goldman Sachs downgraded its rating of China's big banks,[13] which led to a rout in bank stocks on foreign exchanges.[14]

None of the above strategies solves the institutional problem of local government debt in China. The state can formally separate local governments from their LGFVs, but at the end of the day, somebody must take responsibility for their debts. But even if someone takes over existing LGFV debt, more local debt will reappear each year because of how the fiscal system is structured. Beijing must reconfigure the system or find an alternative source of revenue to plug the fiscal gap.

China realises that a property tax like that in the United States where the revenue would belong to the localities is a solution. A few cities have limited pilot programs, but Beijing keeps delaying its implementation. Such a tax would alienate a rising middle class, and in the current context it would further hurt a depressed housing market.

Ultimately, to end hidden debt, Beijing must address the fundamental flaws in the system established by the 1994 fiscal reforms. Without thorough fiscal reform, the problem of local government debt, hidden or not, will persist. It might be time for Chinese leadership to stop kicking the can down the road. There is no other sustainable solution.

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