Creating Institutional Systems to Keep Local Government Debt in Check

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China's local government debt once again has captured public attention. At the end of May 2019, according to official information, the balance of China's local government debt hit 19.89 trillion yuan, a net increase of 1.5 trillion yuan over the end of 2018, or up 8% in five months. In December 2018, the Central Economic Work Conference decided on policy arrangements for "significantly increasing the size of special debt for local governments."

China's local government debt is rooted in its fiscal system. Local governments play a pivotal role in propelling China's economic growth, but their spending responsibilities are not matched by sufficient fiscal power. This institutional conundrum gives rise to China's local debt, presenting a major financial risk. Despite its vital importance to the economy, the problem of local government debt is often discussed in negative ways whenever it arises without a careful analysis of its institutional root cause.

Based on China's reality and international practice, we should recognize the status of local government debt in the fiscal and financial systems, and keep local government debt in check. Managing local government debt is key to mitigating financial risks in China.

I. Local Government Debt: An Institutional Phenomenon

China's local governments are incentivized to compete with each other in spurring local growth. As most economists would agree, local competition has played a key role in China's growth miracle. China's economic history over the past seven decades shows a strong correlation between local government initiative and growth. When local governments played an active role, growth would accelerate; government inaction was invariably followed by slowing growth.

The reason is that apart from actively intervening in the economy, China's local governments also operate as quasi-companies. They set up financing platforms like city investment companies, take stakes in financial institutions, and develop local enterprises, infrastructure, and real estate. By regulating land price and offering disguised forms of tax rebates and guarantees, local governments influence investment decisions of economic entities in their jurisdictions and attract external investment to develop the local economy.

Since 1949, investment and other economic activities toward the industrialization and urbanization involving China all the seven decades have mostly taken place at the local level. Yet both China's fiscal and financial funds are concentrated at the central level. **Due to lack of funds, local governments depend on transfer payments from upper-level governments, particularly the central government, and look to financial institutions and financing platforms for funds.**

In a speech on February 23, 2019, General Secretary Xi Jinping called for "promoting the pivotal role of investment" when he mentioned financial supply-side structural reforms. In this important speech, he listed a swathe of sectors for investment. Except for manufacturing upgrade, 5G, AI, industrial internet, and internet of things (IOT), other sectors such as transportation, logistics, infrastructure, public services, and natural disaster mitigation require public investment. The bulk of the investment will be made by local governments, which play an important role in shoring up the economy by providing financing for these projects.

Since 1979, China's local governments have run debts to set up enterprises, build infrastructure, and support national macroeconomic regulation. With changing central-local fiscal relations, local governments financed such activities in different ways across various stages. Before the tax reform of 1994, they offered excessive tax breaks to attract capital and develop the local economy. After 1994, they offered fee deductions as policy preferences and incentives to raise capital. When these measures no longer worked after 2008, local governments looked to financing platforms, which continue to thrive today despite policy restrictions. **When China's economy dipped and required a countercyclical boost, the role of local governments always came into play.** According to our analysis, about 40% of China's local government debt, to the tune of tens of trillions of yuan, was passively incurred by their responses to national macroeconomic regulation.

Local government debt reflects a mismatch between spending responsibilities and fiscal powers at the local level. Yet local government debt has been interpreted negatively without recognizing the necessity of proactive local fiscal interventions. Since 2015, the central government took makeshift measures to curb local government debts **without offering legal assurance on local government financing and debt, which is vital to the stability of China's socialist market economy.**

In our view, it is essential to make **a set of institutional arrangements to keep local government debt in check.** The central government must identify spending responsibilities of local governments, offer financial support to local governments to meet their spending needs, and write such arrangements into law for enforcement.

II. Managing Local Government Debt: Japan's Three-Decade Experience

Japan's reaction to its local government problem offers food for thought.

The burst of the housing bubble in the 1990s was followed by a deep recession of the Japanese economy, known as the "lost three decades." Economic recession led to a serious shortfall of spending in Japan's private sector, including firms and households, giving rise to a stockpile of savings not converted into investment. As a leakage from the economic flow, savings in the private sector must be reinjected into the economic flow in order to prevent a long-term recession and even contraction of the economy.

Hence, the Japanese government adopted a proactive fiscal policy to ramp up investment. **Central and local governments at all levels introduced hefty public investments funded by treasury bonds purchased with household savings.** For more than two decades, the Japanese economy showed a peculiar equilibrium: Government fiscal deficits and debts climbed, yet the private sector, including households and firms, maintained a high savings rate and invested their savings in government bonds. Figure 1 shows Japan's central and local government debt since the 1990s.

No matter under which system, the amount of taxes and fees at the disposal of the local government is limited. Without the power to issue money, their debt growth is subject to a rigid budgetary constraint, beyond which the government will face a fiscal crisis. In extreme circumstances, such a fiscal crisis may lead to a local government bankruptcy, as Japan learned to its cost at the dawn of the new century in the aftermath of an investment and credit binge in the 1990s.

To prevent a broader crisis, in April 2009, Japan enacted the *Law Relating to the Financial Soundness of Local Governments* after extensive deliberations. The law **specifies local financial indicators, classifies local financial status, and identifies measures that can be taken under different financial conditions.** The law tamed the raging local government debt crisis. Debt risks facing Japan's central and local governments peaked, with leverage ratios starting to fall since 2015 (see Figure 1).

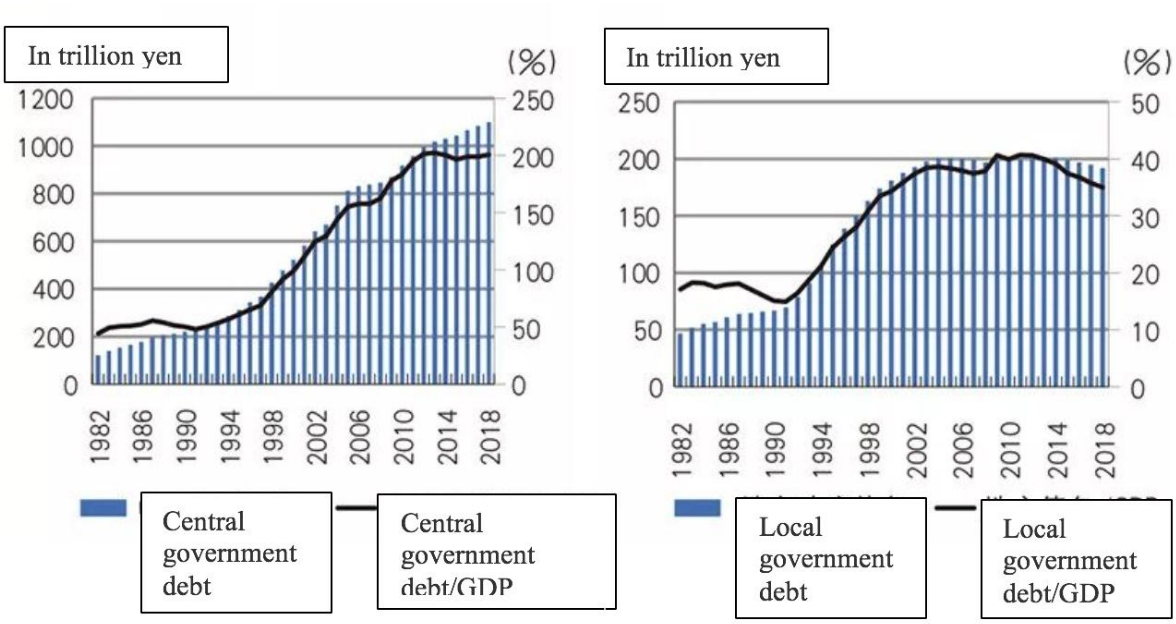

Figure 1: Japan's Central/Local Government Debt and Share in GDP

The law enables Japan's local governments to raise debt from sources such as **fiscal financing funds of the central government, funds from the Japan Finance Organization for Municipalities (JFM), public market issue funds, and bank acceptance funds.**

Fiscal financing funds of the central government refers to treasury bonds issued by the Ministry of Finance to raise funds on behalf of local governments. In 2018, fiscal financing funds accounted for 24.1% of local government financing. As a financial institution funded by local governments, the Japan Finance Organization for Municipalities (JFM) issues institutional bonds to raise funds from the market and lends money to local governments. In 2018, JFM made up 15.3% of local government financing. Public market issue funds refers to funds raised from local government bonds directly issued to the market, which accounted for 32.8% of local government financing in 2018. The acceptance funds of banks and other financial institutions refer to loans borrowed by local governments from designated financial institutions, which accounted for 27.8% of local government financing in 2018 (see Figure 2).

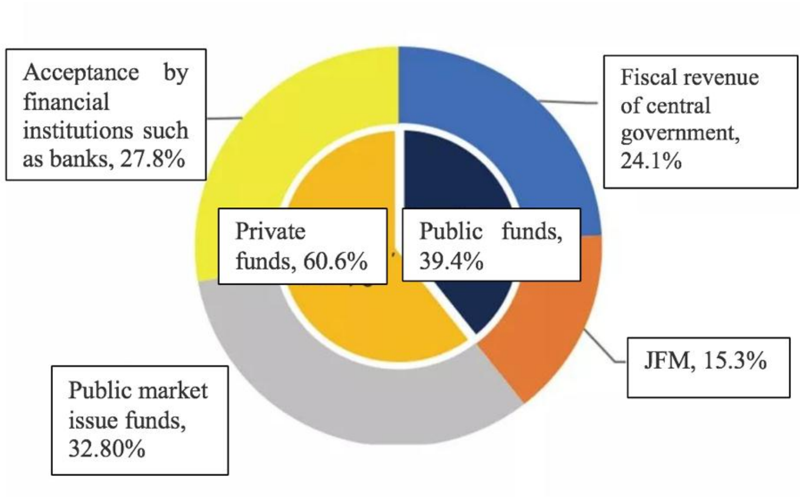

Figure 2: Financing Structure of Japan's Local Governments (2018)

Unlike other advanced economies, Japan's local governments' debt financing was mainly indirect financing. While financial institutions such as banks provide financing for local governments through acceptance, Japan also created a unique institution to facilitate local government financing - the Japan Finance Organization for Municipalities (JFM). Jointly funded by local governments, JFM offers cheap financing to local governments and operates similarly like a policy bank. On the liability side, JFM raises funds from bond issuance. On the asset side, it offers loans to local governments (see Figure 3).

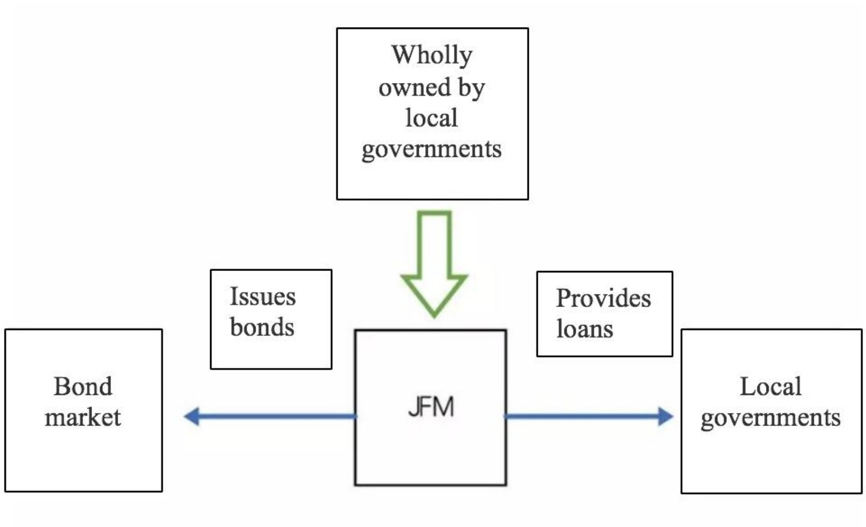

Figure 3: JFM's Operating Model

III. Learning from Japan's Experience

We believe that **the financing arrangements of Japan's local governments are worth referencing for China** for the following reasons:

(1) Similar to Japan in the 1990s, China's economy is also troubled by a lack of corporate confidence, flagging domestic demand, and a high savings rate in the private sector;

(2) Similar to Japan, China's central and local governments are obliged to make hefty public investments

to make up for scant demand in the private sector.

(3) Both countries used to keep a lid on local government deficits. However, once local governments stepped in to shore up the economy, the size of local government financing swelled beyond control.

(4) Unlike advanced economies in Europe and North America, both China and Japan are unitary states. This enables them to seek a national solution rather than rely on decentralized local governments at all levels.

(5) Unlike advanced economies in Europe and North America, China's and Japan's financial systems are both dominated by indirect financing. Namely, banks play an active role in almost all financial arrangements, and particularly government financing arrangements, of both countries.

We believe that China may learn from Japan in three aspects of their local government financing system:

(1) For China as a unitary state, its local governments are under the leadership of the central government, which is responsible for the final payment of local government liabilities. Unlike Europe and North America, we cannot create a hierarchical system based on a high degree of local autonomy. Instead, we should learn from Japan's nationally unified system where the central government is in charge of policy coordination and supervision. Given this system, local governments can be given a growing degree of autonomy.

(2) China's financial system is dominated by indirect financing through banks. Thus, local governments cannot get around banks and other financial institutions for debt financing. Nominally, China's local government debts were no longer supported by bank capital by the end of 2017 (see Figure 4). Below the surface, however, 86% of local government debts are still held by financial institutions, which is far above the level of Japan and other countries. Barred from borrowing directly from financial institutions such as banks, local governments have resorted to local government financing platforms (LGFPs), which are inefficient, murky, and fraught with risks. In light of Japan's experience, we should allow banks and other financial institutions to provide financing to local governments. With their risk management system, banks will regulate local government debts more rigorously and transparently.

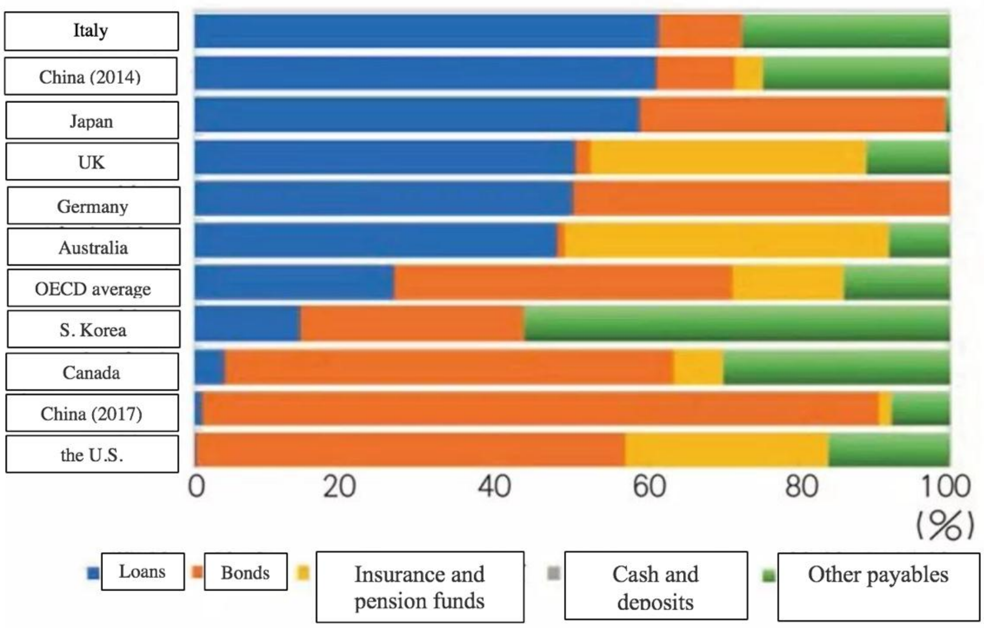

Figure 4: Financing Structure of Local Government Debts by Country/Region

(3) We may set up a specialized financial policy institution like Japan's JFM to bring local government debt under transparent management. An alternative to creating a new institution is to reform existing agencies or endow them with new functions to achieve a similar institutional arrangement.

This institution has the following benefits: (1) **It diversifies local government debt financing.** It offers local governments a stable source of cheap capital. It may also provide the bond market with long-term bonds backed by the central government, thus promoting capital market deepening. (2) **It offers local governments long-term loans by issuing institutional bonds, thus addressing the financial balance sheet maturity mismatch**, which will stem systemic risks in China's financial system. (3) **Part of local government bonds should be supplanted by institutional bonds more enticing to investors.** Whether the proposed institution is funded by the central government, local governments or both, it is backed by the government and therefore reduces the risk of local government debt.