FISCAL AFFAIRS

THE STORY SO FAR

China's fiscal conditions are on an unsustainable path. Local governments spend much more than they take in, forcing them to rely on inefficient state-owned enterprises (SOEs), land sales, and risky debt-driven financing practices for revenue. This increases underlying risks and makes the economy less efficient. Leaders in Beijing acknowledge that fiscal reform is critical, and that it has a long way to go. The 2013 Third Plenum promised to close the gap between what the center commands local governments to spend and the resources available to them.

- Beijing passed a new budget law in August 2014 that allowed local governments to issue bonds while banning all other forms of local government borrowing and guarantees, including the use of local government financing vehicles (LGFVs) to borrow from banks and the shadow banking sector. The law was meant to limit quickly growing local government debt levels – particularly riskier "implicit debts," or contingent liabilities – that are not recorded on official balance sheets.

- In March 2015, Beijing initiated a three-year "bond swap" program to compel local governments to swap all non-bond borrowing into lower-cost bonds. At the end of 2014, local governments had a reported RMB 14.34 trillion ($2.1 trillion) in official debt. Only RMB 256.5 billion ($37 billion) of this remained to be swapped as of October 2018. The program, which has been extended in 2019, improved local fiscal transparency and reduced interest burdens for local governments.

- The central government initiated value-added tax (VAT) reform in 2012 in pilot form and officially rolled out VAT nationwide in 2016. The VAT replaced China's complex business tax with a more simplified scheme meant to cut corporate tax burdens. In practice, the VAT decreased local government tax revenue on net, given that it offered more tax deductions and was in many ways tax relief relative to the business tax scheme.

- Recognizing that the 2014 budget law had not succeeded in curtailing off–balance-sheet borrowing by local governments, in early 2018 Beijing required that local governments repay all associated contingent liabilities or implicit debt within 3 to 5 years. While the exact amount of local government implicit debt is unknown, credible estimates put it between RMB 30 and 45 trillion ($4.3–6.5 trillion). The heavy debt burden has been crippling for localities, and Beijing relaxed guidance on debt repayment in October 2018, allowing local governments to extend or renegotiate implicit debts.

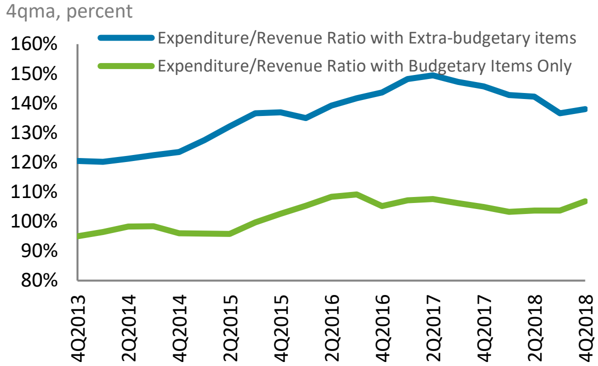
METHODOLOGY

To gauge fiscal reform progress, we watch the gap between local government expenditures and the financial resources available to pay for them, including central government transfers. Our primary indicator shows the official trend in blue and an augmented calculation of the gap including off–balance-sheet, or "extra-budgetary," expenses and revenues in green – thus covering the range of estimates. The higher the expenditure-to-revenue ratio, the more concerning the side effects, including local government debt burdens. Our supplemental fiscal indicators include local financing sources, the national official and augmented fiscal position, the move from indirect to direct taxes, and the share of expenditures on public goods.

QUARTERLY ASSESSMENT AND OUTLOOK

Primary Indicator: Local Governments Expenditure-to-Revenue Ratio

4qma, percent



Source: National Bureau of Statistics, Rhodium Group.

- We downgrade our assessment of fiscal affairs: local government expenditures are rising faster than revenues again as Beijing leans on infrastructure spending as a stimulus tool. This is a clear sign that Beijing is prioritizing stimulating a slowing economy over durable reform to its fiscal regime.

- Our primary indicator – the local fiscal gap – worsened as special revenue bond issuance and land sales slowed while mandates to spend on infrastructure piled up.

- Promised tax cuts and other easing will aggravate local debt this year; some proposed reforms are promising but are moving too slowly to be called real improvement.

THIS QUARTER'S NUMBERS

Our primary fiscal indicator, the augmented **Local Expenditure-to-Revenue Ratio**, worsened for the first time since 2Q2017, with the ratio edging up from 136.6% in 3Q2018 to 138.1% in 4Q2018. This means a larger gap between what local governments take in and what they have to spend – the exact opposite of what fiscal reform should accomplish. Local governments spent 38.1% more than they collected in the fourth quarter, even after accounting for off-budget financing activities. This could get worse before it gets better, at least through the second half of 2019, as Beijing attempts to boost a slowing economy through traditional channels.

A plunge in local government special revenue bond issuance was the main cause, with only RMB 159 billion ($24 billion) issued in 4Q2018, compared with a massive RMB 1.68 trillion ($250 billion) in the previous quarter (see **Sources of Local Government Financing**). This is not surprising as special revenue bond issuance is usually concentrated in the middle quarters of the year, while slowing at the end of the year as annual quotas set by the central government are exhausted.

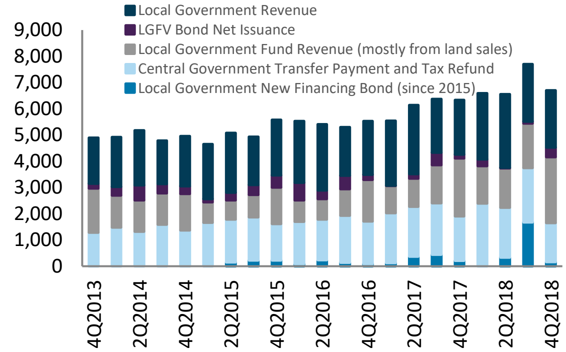
A more surprising development with worrying fiscal implications is slowing revenue growth from land sales. Growth slowed to a two-year low of 13.8% year-on-year (yoy), down from an average pace of 31.8% in the previous three quarters. This causes many analysts to think that property troubles will loom large this year, given declining sales momentum and weakening financing conditions for developers. Data from China's National Bureau of Statistics (NBS) show that growth in land transaction values in 2018 slowed to 18% from 49% in 2017 and has fallen sharply so far in 2019. Since Chinese developers have a full year to pay for land purchased at auctions, land sales revenue for localities will probably slow this year, consistent with the declining trend in purchases.

The national-level augmented fiscal deficit (see **National Fiscal Deficit Measures**) ticked up slightly in 4Q2018, from 13.8% to 14.0% of GDP, while the official fiscal deficit also rose to 4.2% of GDP from 3.5% in the previous quarter. Rising infrastructure spending to support the economy was the cause. At the National People's Congress (NPC) in March, the central government pledged RMB 2 trillion ($300 billion) in tax and fee cuts for 2019, which will also reduce local government tax intake, unless the cuts kickstart a consumer boom.

Looking ahead, local government bond issuance took off in the first quarter of 2019, as leaders authorized local governments to start selling bonds in January to reverse the fourth-quarter fiscal drought. Resulting revenue will offset some spending increases and weaker tax revenues in the short term, and increased bond issuance is an important structural improvement; however, the volume of current issuance is insufficient to forestall local fiscal risks given high existing implicit debt levels.

Supplemental 1: Sources of Local Government Financing

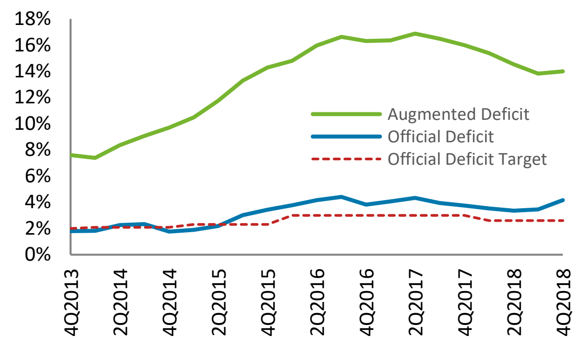
RMB billions



Ministry of Finance, National Bureau of Statistics, International Monetary Fund, Rhodium Group.

Supplemental 2: Fiscal Deficit Measures

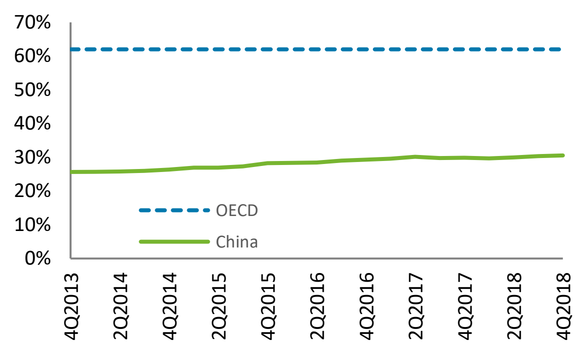
4qma, percent



Source: Ministry of Finance, Rhodium Group.

Supplemental 3: Direct Taxation Ratio

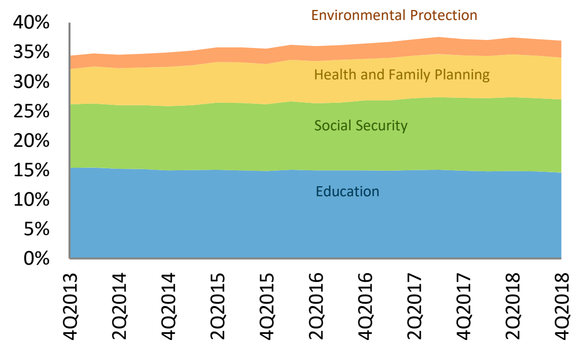
4qma, percent



Source: Ministry of Finance, Rhodium Group.

Supplemental 4: Government Social Expenditures

4qma, percent



Source: Ministry of Finance, Rhodium Group.

POLICY ANALYSIS

Fiscal reform has seen some recent experimentation, but our net assessment is still negative: while some important structural reforms have been proposed, on balance Beijing's turn toward stimulus will aggravate local debt risks this year. Fiscal reforms are not moving fast enough to turn this around. For example, while Beijing is encouraging local governments to bring in more revenues via bond issuance, new political promises of tax cuts to stimulate activity add equivalent if not larger revenue burdens. The clear focus of policy is *managing*, not *reducing,* the local debt burden.

Premier Li Keqiang announced RMB 2 trillion ($300 billion) in tax and fee cuts at the NPC on March 5 and reduced the top VAT bracket to 13% (from 16%) and the middle bracket to 9% (from 10%). In theory, leaving profit with firms to reinvest efficiently is better than taxing them or driving government investment in low-return infrastructure projects. But for the short term, growth still depends on these types of government spending. Financing that traditional investment-led growth with more debt rather than taxes will only extend financial and fiscal risks.

On the surface, policymakers understand these trade-offs and promise to reduce fiscal risks by opening wider "front-door" channels for local governments to raise new funds like bond issuance, while keeping closed "back-door" channels like riskier shadow banking and off–balance-sheet financing vehicles. Local government bond issuance (a front door) is clearly opening: at the March NPC, leaders approved RMB 2.15 trillion ($320 billion) in local government special revenue bonds for 2019 and also extended a bond swap program that allows local governments to exchange explicit debt into lower interest rate bonds.

These policies would mark marginal improvement by forcing local governments to improve the structure of their debts and take on financing more transparently. But they will not address the most worrisome part of China's local fiscal debt morass, which is the level of contingent liabilities, or hidden debts, owed by local governments. Early last year, it appeared probable that Beijing would force localities to tackle this issue head on by writing down or paying off their hidden debts; instead, in late October 2018 the State Council allowed localities to renegotiate or extend the terms of these debts. This freed up additional spending room for local governments, while leaving existing debt levels untouched and reinforcing moral hazard around these types of borrowing activities.

There are some bright spots in fiscal policy rhetoric, but new policies are not being implemented quickly. The NPC featured some discussion of a pilot program to reduce local government implicit debt, first in a few provinces and cities, by having central government policy banks play a bigger role. Zheng Zhijie, president of the China Development Bank (CDB), told reporters on the sidelines of the NPC that his bank had already provided around RMB 250 billion ($37 billion) in low-interest loans to the Shanxi provincial government the past December to replace some of the province's implicit debt. Media reports said CDB also lent to Zhenjiang, a city in Jiangsu province, and Xiangtan in Hunan province, under a similar program. If this CDB loan swap for local government debt is limited to only a few localities, the impact is likely to be fairly small. However, over time it creates a potential vehicle for a bigger absorption of local government debt by the central government.

Reformers have also long argued that imposing a property tax on existing homes would be a more sustainable revenue source for local governments than continuing to rely on land sales to developers (as discussed in This Quarter's Numbers above). Li Zhanshu, head of the NPC, pledged during the March 2019 legislature meetings that the Congress would work on a property tax law this year, suggesting possible progress despite weakening real estate market conditions. However, even if the legislation moves fairly quickly, the law will most likely only be implemented starting in 2020.