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 center-local fiscal reform is critical, and that it has a long way to go. The 2013 Third Plenum plans 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 "swap bond" program to compel local governments to swap all nonbond borrowing into lower-cost bonds. At the end of 2014, local governments had a reported 14.34 trillion RMB ($2.1 trillion) in official debt. As of October 2018, only 256.5 billion RMB ($37 billion) of this debt remained to be swapped. The program improved local fiscal transparency and reduced interest burdens for local governments and has been extended on a limited basis in 2019.

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

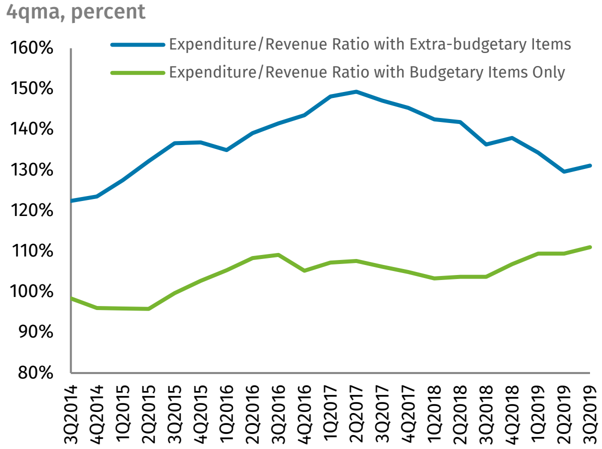
- Recognizing that the 2014 budget law had not succeeded in curtailing off-balance-sheet borrowing by local governments, in early 2018, Beijing required that local governments repay all associated contingent liabilities or implicit debt within three to five years. While the exact amount of local government implicit debt is unknown, credible estimates put the actual level at 30–45 trillion RMB ($4.3–$6.5 trillion) as of today. Since the heavy debt burden has been crippling for localities, 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 "extrabudgetary" 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.

- Fiscal affairs reform has progressed over time but remained flat this quarter. Local governments reported shrinking revenue, resulting in a larger fiscal gap. On the upside, Beijing is moving to allow more tax intake for local governments.

- The local government augmented fiscal gap widened slightly in 3Q2019 led by a decline in bond issuance and tax revenue, while spending expanded modestly.

- By increasing local government tax revenue, Beijing's proposed consumption tax reform is a step in the right direction but could slow momentum toward more impactful and necessary tax reforms in the near term.

This Quarter's Numbers

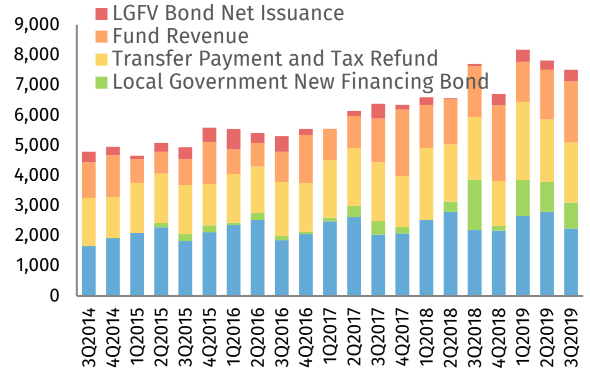
The gap between what local governments spend and what they take in expanded this quarter, contrary to the objective of fiscal affairs reform. The augmented **Local Expenditure-to-Revenue Ratio** increased slightly to 131% in 3Q2019 from 130% in the previous quarter, below 136% in 3Q2018. Declining revenue from both budgetary sources and local government bond issuance drove modest deterioration of the local fiscal balance. Net local bond issuance registered 13% lower than the previous quarter and 49% lower than the third quarter of 2018, as fiscal support was backloaded in 2018 and frontloaded in 2019 to offset weaker growth. Local issuance will be seasonally low in the fourth quarter, maintaining the pressure.

Tax revenue also took a hit in 3Q2019, plunging 20% quarter-on-quarter. Weaker economic growth drove the decline. The sharp fall in corporate income tax resulted from slowing cyclical momentum and heavy deflationary pressure that eroded corporate profitability. Individual income tax decreased following the implementation of 2019 changes that raised income tax thresholds and gave additional tax breaks, in hopes of spurring consumption.

An increase in land-related revenue prevented a sharper decline in local government resources. Local government fund revenue, most of which comes from land sales, rose 20% compared with 3Q2018 and was 10% higher than 2Q2019. With property developers reporting an 11.4% decline in land transactions in 2019, this pattern is unsustainable: collection of payments lags land transactions and is bound to fall in 2020.

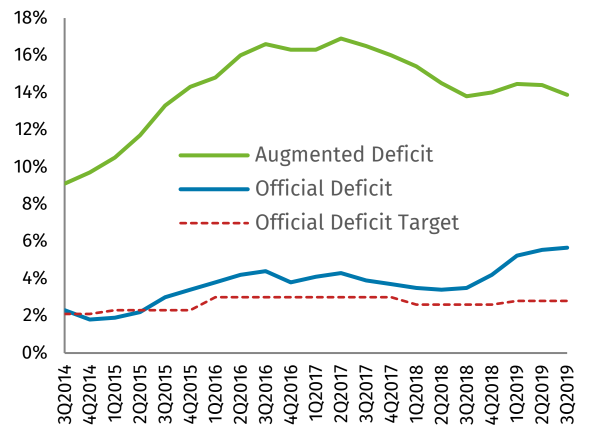
Local spending on social services as a share of total expenditure reported a modest uptick in the third quarter with improvement mainly from social security expenditure, money spent on paying salaries and subsidies to retired and unemployed persons (see **Government Social Expenditures**).

Supplemental 1: Sources of Local Government Financing
Billion RMB



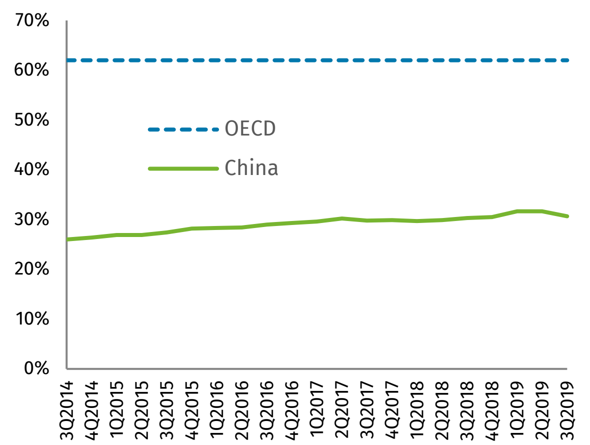
Source: Ministry of Finance, National Bureau of Statistics, International Monetary Fund, Rhodium Group.

Supplemental 2: Fiscal Deficit Measures
4qma, share of GDP



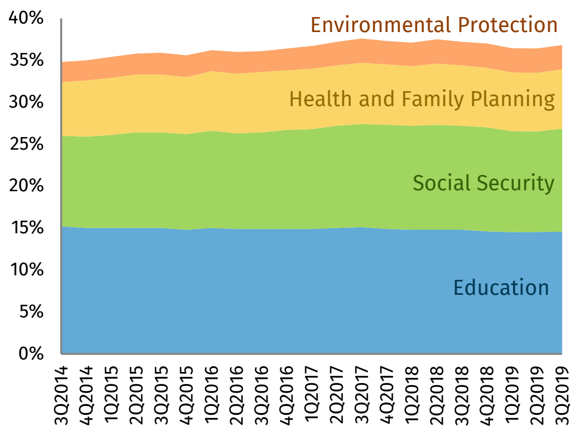
Source: Ministry of Finance, Rhodium Group.

Supplemental 3: Direct Taxation Ratio
4qma, percent



Source: OECD, Ministry of Finance, Rhodium Group.

Supplemental 4: Government Social Expenditures
4qma, percent



Source: Ministry of Finance, Rhodium Group.

Policy Analysis

The most important development in late 2019 was the central government's proposed consumption tax reform, which will expand the tax base and increase central revenue sharing with local governments. The Ministry of Finance named this as a 2020 priority; the new draft law will undergo several rounds of legislative review and likely be approved as early as 2020. If implemented, the change would increase local governments' intake and relieve some of the fiscal pressures they face amid shrinking land sales revenue.

Currently, the central government collects consumption taxes and disperses a portion back to localities via transfers. The proposed reform will shift consumption tax collection from producers and wholesalers to the consumer-facing retail side. While the central government will continue to collect a base tax at the current level, local governments would retain marginal revenue collected above the base level. The consumption tax accounts for 8% of total tax revenue; in the first 11 months of 2019, consumption tax revenue rose 19.4% year-on-year, bucking the 0.5% slowdown in overall tax intake growth.

Consumption tax reform is one step toward fixing the uneven status quo wherein local spending responsibilities exceed permitted fiscal intake, as the central government takes the lion's share of tax revenues. As a result, although local governments have historically relied on land sales revenues, the deteriorating property outlook makes it unrealistic to count on this going forward. Land sales revenue only grew 8.1% for the January-November 2019 period, compared with a 25% rise in 2018 and a 40.7% increase in 2017. Localities urgently need new sources of revenue to narrow the gap.

So once again, policymakers are left with the alternative to tax and redistribution: running up debt. Beijing's budget will determine localities' fiscal balance – including how much local governments are allowed to issue in special revenue bonds (SRBs), which have been the main support for fiscal balances in recent quarters. In 2019, local governments' SRB quotas increased by 800 billion yuan ($114 billion) to 2.15 trillion yuan ($305 billion), sharply higher than the 550 billion yuan increase reported in 2018. Chinese media reported a 2020 SRB quota of 3 trillion yuan, another 850 billion yuan increase over 2019. The official quota will be announced ahead of the March "Two Sessions" gathering of policymakers.

All of this – including whether there is a March congress – depends on the course of the coronavirus pandemic sweeping the nation. As we look ahead, it is likely that the need for outlays will boom and the size of tax revenues will shrink greatly.