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

- We upgrade our assessment of fiscal affairs reform this quarter: local governments spent less, resulting in a smaller fiscal gap, but this will be short lived due to COVID-19.

- Local fund expenditure tied to costly land development declined. Revenue from stable, transparent sources like taxes increased modestly but will suffer in coming quarters due to the coronavirus.

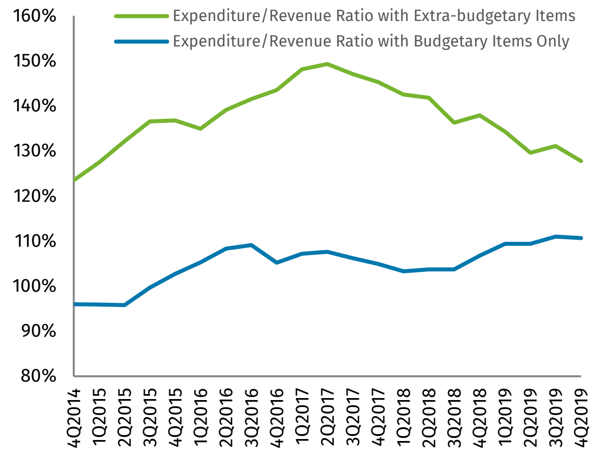
- The outbreak of COVID-19 darkens the fiscal outlook for 2020, with local tax and land revenue already falling sharply early in the year. Beijing will help bridge the revenue gap with special treasury bonds. Conditions could force localities to be more conservative with spending outside their budgets, positive for reform, but negative for growth.

This Quarter's Numbers

The fiscal gap between local governments' spending and what they take in narrowed this quarter, in line with fiscal reform objectives. The augmented **Local Expenditure-to-Revenue Ratio** narrowed to 128% in 4Q2019, the lowest in nearly four years, compared with 138% in 4Q2018. Lower expenditures in 4Q2019 drove this improvement, reversing a 15.8% increase in the third quarter.

Primary Indicator: Local Governments Expenditure-to-Revenue Ratio

4qma, percent



Source: National Bureau of Statistics, Rhodium Group.

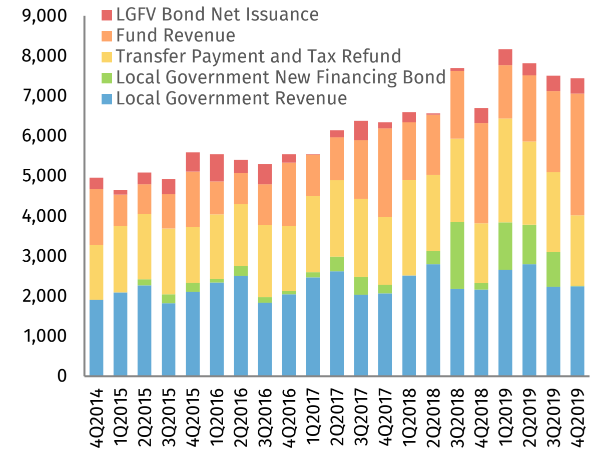
local funds spent 0.8 trillion yuan ($113 billion) *less* than their allowance for that year, which has not happened since 2015. Historically, land-related spending drives local government expenditure. Since 2019, however, the Ministry of Finance has stopped reporting land-spending data, making it impossible to see what is driving the present decline in fund expenditure.

More revenue from stable, transparent sources helped narrow local spending gaps. Both tax revenue and revenue earned by local government funds modestly improved in the fourth quarter, while central government transfers increased substantially, rising 13.8% from a 7.4% decline in the third quarter. Local bond issuance fell sharply to only 21 billion yuan in the last three months of 2019 (typical for this time of year).

Social expenditures accounted for a slightly bigger share of total spending in 4Q2019 due to increased environmental protection and social security expenditures (see **Government Social Expenditures**). In the coming quarters, we expect government social spending to increase in response to the COVID-19 outbreak, especially health-related spending. Social security expenses will also rise as governments step up payments to unemployed and low-income families impacted by the coronavirus and subsequent closure of economic activity. But in the aggregate, we do not expect that support to fully make up for faltering growth due to the coronavirus shock.

Supplemental 1: Sources of Local Government Financing

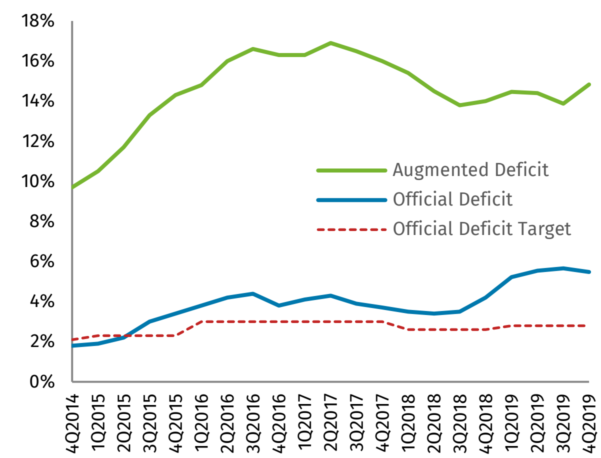
Billion RMB



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

Supplemental 2: Fiscal Deficit Measures

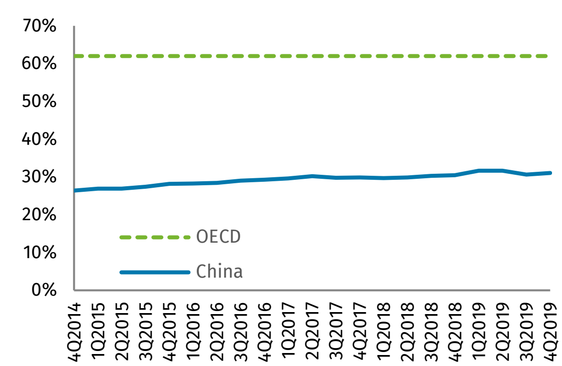
4qma, share of GDP



Source: Ministry of Finance, Rhodium Group.

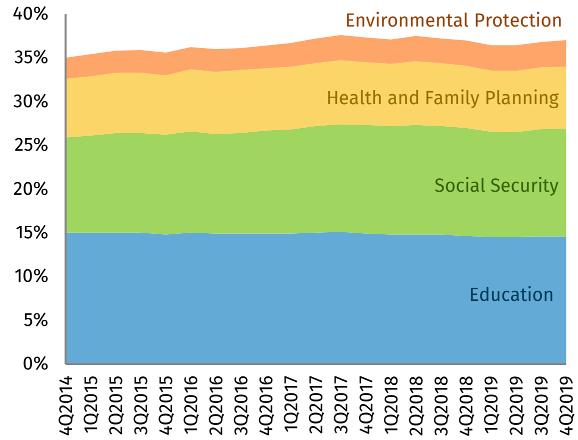
Supplemental 3: Direct Taxation Ratio

4qma, percent



Source: OECD, Ministry of Finance, Rhodium Group.

Supplemental 4: Government Social Expenditures
4qma, percent



Source: Ministry of Finance, Rhodium Group.

Policy Analysis

Years of putting off financial system and state-owned enterprise reforms have left China fiscally constrained in the present crisis. Early 2020 data show a painful COVID-19 impact on local fiscal balances. Localities are reining in extra-budgetary spending to avoid default and must continue to do so to sustain fiscal solvency.

The major sources of local fiscal intake, taxes and land sales revenue, will both fall sharply as tax breaks are extended and payment collections are postponed to help firms, while property developers cut land purchases to preserve cash amid slowing sales. Evergrande Group, the country's largest property developer, plans to reduce its land reserves by 30 million square meters per year for three years by cutting land purchases from local governments. Budgetary income fell 8.6% in the first two months of 2020, and land sales revenue dropped 16.4% year-on-year.

Some help is on the way. Beijing has raised local bond issuance quotas even though the official 2020 budget target announcement has been delayed. Local government net bond issuance in 1Q2020 exceeded that in 1Q2019 by 200 billion yuan, an effort to fill the gap left by shrinking tax and land revenue.

This means local governments are cutting spending to maintain fiscal balances amid falling revenue. With little room to cut mandatory expenditures, localities will probably reduce land development spending (for instance, anticipatory investment in clearing land and installing infrastructure to attract developers). Regulations limit use of new bond sales proceeds for these purposes: Beijing banned the use of "frontloaded" special revenue bond (SRB) issuance to fund housing and land development in 2019. In March, this ban was extended to all 2020 SRB issuance. This shows Beijing is winding down support for "shantytown redevelopment" programs, which had greatly added to local spending burdens in 2015–2019.

Fiscal support in the form of special treasury bonds is also forthcoming, with unclear implications for the long-term fiscal reform outlook. A March 2020 Politburo meeting announced that these bond sales would combat the COVID-19 impact, but without details. Special treasury bonds have been employed twice before: to recapitalize banks in 1998 and to establish the China Investment Corporation (the sovereign wealth fund) in 2007. In those instances, issuance did not impact local fiscal balances. This time, bond proceeds will likely be used to support local fiscal balances hit by the coronavirus.

The proceeds could be used to fund countercyclical infrastructure spending performed through local government financing vehicles (LGFVs). In the response to the global financial crisis in 2008–2009, LGFVs were encouraged to obtain funding from the murky shadow banking system, rather than official funds. This created the misleading appearance that the Chinese government's fiscal position was more sound than it really was, while abetting the buildup of quasi-official obligations out of the light of day—obligations now causing banks to fail. More direct lending from the central government to LGFVs this time would make the reality more transparent and ultimately provide the funding at much lower cost than shadow banking, reducing future debt-servicing problems.