

# The Research on the Characteristics of China's Local Government Debt Situation and Governance Development

## Strategies

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**Abstract:** This article examines various factors such as political structure, economic framework, and fiscal system to reveal distinctive characteristics exhibited by local governments in different countries. Through analyses encompassing risk entities, local government behavior, fiscal insolvency, and a comparison of diverse bondholders, financing constraints, and credit ratings, the heterogeneous attributes of China's local government debt are synthesized. Building upon these findings, a novel theory framework of local government debt is formulated, bearing Chinese characteristics, thereby offering policy recommendations for resolving local government debt issues in our country.

**Keywords:** Local Government Debt; Heterogeneous Attributes; Policy Recommendations

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## 1. Introduction

Local government debt plays a significant role as a supplementary source of local finances in China's processes of industrialization and urbanization. However, as the scale of local government debt continues to expand, issues related to debt management and debt risk have become increasingly prominent, attracting attention from various sectors of society. In the study of local government debt issues, the current focus primarily lies in understanding the relationship between local government debt and economic growth, as well as the management and mitigation of debt risks, with relatively less exploration of the heterogeneous attributes of Chinese local government debt. Nevertheless, comprehending the characteristic differences in local government debt holds crucial significance for the efficient utilization of debt resources and the formulation of appropriate policies.<sup>[1]</sup>

Existing research predominantly posits that government debt has short-term positive effects on economic growth but may lead to negative consequences in the long term. The risk of local government debt is considered one of the greatest threats to the Chinese economy, necessitating the careful management of relations between central and local governments.<sup>[2-3]</sup> Therefore, under the guidance of an overarching national security perspective, it is essential to systematically advance the governance of local government debt, reinforcing debt performance management within the context of the new development paradigm.

However, the existing literature lacks a comparative study of the disparities between the characteristics of Chinese local government debt and those of other countries. Hence, this article aims to contrast the development of local government debt in China with the attributes of other nations, providing valuable insights for optimizing the utilization of debt resources and policy direction.<sup>[4]</sup>

## 2. Current Status and Characteristics of China's Local Government Debt

The development of China's local government debt reveals that since 2015, the level of explicit local government debt has generally remained within a manageable range, with the average local fiscal debt ratio staying below the globally recognized caution line of 60%. The government has implemented quota management measures to restrain the growth of

debt, controlling the risk of local government liabilities. As of 2021, the balance of local government debt stood at 30.47 trillion yuan, slightly surpassing the approved limit of 33.28 trillion yuan set by the National People's Congress. Looking at the scale of bonds issued by local governments, the issuance of local government bonds gradually increased from 2018 to 2022, with a total issuance of 7.49898 trillion yuan in 2021, marking a 16.23% increase from 2020. Impacted by the COVID-19 pandemic, China's economy faced significant pressure, prompting the government to take proactive measures to alleviate downward economic pressure. This included a notable increase in the issuance of special bonds, which were used to invest in key sectors and support small and medium-sized enterprises, but also added pressure to reduce the overall debt burden. It is projected that the scale of special bonds will increase by 59% for the entire year of 2022. The characteristics and development trends of local government debt require attention, necessitating a reasonable limitation of government debt, the full utilization of special bonds, and the safeguarding of stable economic operations. Rational management and resolution of local government debt risks hold significant importance.

In addition to explicit local government debt in China, there also exists implicit debt in various complex forms. Implicit debt refers to forms of debt that are not included in budget management and are not easily monitored or controlled by higher-level governments. The lower the level of local government, the more diverse and difficult to fully comprehend these implicit debts become.

These implicit debts primarily include the following forms:

1.State-owned enterprises, financing platform companies, and others borrowing on behalf of local governments, with guarantees or financial support from the government for repayment.

2.Debt expenditures incurred through agreements between the government and equity capital providers in government investment funds, government and social capital cooperation, and government service procurement processes, often involving "equity-for-debt" arrangements through capital buybacks and guaranteed minimum returns.

3.Novel financing models where local public institutions collaborate with financial institutions, resulting in a new form of government-backed financing with repayment obligations.

The presence of implicit debt increases the debt risk of local governments. If not promptly controlled and resolved, it may lead to a continuous rise in local fiscal risks, ultimately endangering the overall fiscal security of the country. Therefore, it is necessary to gradually uncover the details of implicit debt, ensure its inclusion within budget management, strengthen fiscal oversight and transparency, transform implicit debt into explicit debt for better management, and prevent the generation of new implicit debt through the standardization of fiscal and administrative powers. This approach helps safeguard the soundness and sustainable development of the national finances.

Table 1: Scale of Local Government Bond Issuance (2018-2022)

Unite: 100 million yuan

Classify	Year2018	Year 2019	Year 2020	Year 2022	January to June 2022
Total amount of local government bond issuance for the year	41652	43624	64437	74898	52503
Issuance of general bonds	22192	17742	23033	25669	13318
Issuance of special bonds	19460	25882	41404	49229	39185

Data Source: Ministry of Finance of the People's Republic of China Financial Data

### 3. Analysis of Heterogeneous Characteristics of Local Government Debt in China

#### 3.1 Local Government Debt Risk Dominates China's Fiscal Risk

The heterogeneity of China's local government debt is primarily manifested in the dominance of local government debt risk as the main component of China's fiscal risk. Compared to developed countries, the risk of local government debt in

China is more pronounced, as sustained borrowing has led to local fiscal expenditures consistently exceeding revenues, resulting in significant fiscal risk. The absence of government bankruptcy-related systems, along with challenges in the local government fiscal framework, coupled with temporal and spatial separation of responsibilities, prevent local budgetary entities from autonomously addressing debt issues. Despite the central government's emphasis on no bailouts, local governments still engage in irregular borrowing, making the task of resolving implicit debt risks daunting. Unrepayable local government debts at maturity can only be swapped for long-term, low-interest debt. If local finances cannot service the interest on long-term debt, it may be transferred to higher-level finances, posing a threat to national fiscal security. Therefore, effectively addressing local government debt issues holds significant importance for ensuring fiscal stability and security.

## **3.2 Corporate Characteristics Enable Local Governments to Leverage Debt Resources**

Reforms in the fiscal distribution system and land management have expanded economic and resource management powers of local governments in China, resulting in corporate-like characteristics. Chinese local government's function akin to "corporations," driving economic activities, maximizing local GDP and fiscal revenue. To achieve the goal of a proactive government, leveraging debt resources becomes a crucial tool. In comparison to local governments in developed countries, China's local governments have a more pronounced administrative role and a dominant position in utilizing debt resources.

## **3.3 Lack of Relevant Insolvency Systems for Chinese Local Governments**

The case of Orange County, USA, is a classic example of local government fiscal insolvency. China has yet to establish relevant systems but has introduced measures to prevent debt risks. The first municipal-level city, Hegang City, underwent fiscal restructuring based on relevant measures. China's local governments need to continually refine their systems to address debt risks and ensure prudent fiscal operations.

# **4. Strategic Considerations for Improving China's Local Government Debt Management**

## **4.1 Constructing a New Theory of Local Government Debt with Chinese Characteristics**

The construction of a new theory of local government debt in China aims to optimize the utilization of debt resources, enhance the efficiency of fund allocation, stabilize the macro economy, and prevent systemic financial risks.<sup>[8]</sup> This theory differs from the operation of municipal bonds abroad and embodies the fundamental characteristics of China's socialist market economy. It encompasses various aspects such as fiscal management driven by local governments' development, the coordination between fiscal and financial policies, and reflections on modern monetary theory, providing a governance path for optimizing the issues of local government debt in China. The key features of this theory include:

**Systematic openness and balance:** The management of China's local government debt is a progressive and continuously adjusting process. Policies are timely and reasonably fine-tuned based on the development changes in the economic and social situation.<sup>[9]</sup> Debt issuance and management reflect characteristics of systematic balance, expanding or strengthening control over debt based on economic development needs to achieve economic stability and balance.

**Management rules of "establishing regulations, setting limits, enhancing efficiency, and breaking rigidity":** China is forming standardized rules for public debt management, such as limits on local government debt and performance-based management of bond projects, to address debt issues. This process has gradually embraced the idea of breaking rigid redemption, which is important in solving debt problems.

## **5. Enhancing the Path of Local Debt Management in China**

Considering the heterogeneous characteristics of local government debt in China and combining with the new theory of local government debt, focus on the intrinsic nature of China's local government debt to provide reasonable policy recommendations for its management.

Advancing fiscal restructuring and improving risk response measures: Drawing from foreign experience, encourage fiscal restructuring through legal means, implement fiscal deficit monetization, and promote fiscal consolidation through revenue generation and expenditure reduction. This will contribute to local government fiscal recovery and debt risk management.

Seeking diversification of debt holders: Promote the development of multi-tiered capital markets, enrich the types of debt holders, increase the proportion of market-making by debt holders, and activate the market. This will reduce local governments' excessive reliance on banks, attract more non-bank institutional investors, and avoid crowding out private investment.

Exploring a debt budget management system: Formulate a debt budget management system suitable for China's national conditions, incorporate it into medium- and long-term fiscal plans and local investment plans, specify the responsibilities of chief fiscal officers in regions, and establish risk supplementation mechanisms. This will standardize local government debt and ensure its reasonable operation.

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