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Insiders' insights

Promoting the Reform of Local Government Bonds in China

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Abstract: *In recent years, the issue of local government debt in China has grown into a major domestic and international concern, becoming a focus for research at the theoretical and policy-making levels. In fact, the proposal to grant debt autonomy to local governments through amendments to the* Budget Act *was again on the agenda at the end of 2011. In the long run, allowing local governments to issue bonds, similar to the municipal bonds in the Western market economy countries, is consistent with the direction of the fiscal, taxation, and financial systems. The significance of this issue will be analyzed in this article.*

In October 2011, the Ministry of Finance allowed the City of Shanghai, Zhejiang Province, Guangdong Province, and the City of Shenzhen to carry out pilot projects whereby these local governments could issue their own bonds, although the amount to be issued still had to be approved by the central government, and the Ministry of Finance was committed to repay capital with interest. Compared with local government bonds issued within the previous three years, the only difference was that these local governments acted on their own in issuing bonds. Although the existing local government bonds are not standard municipal bonds, it means that financial reforms are beginning to be enhanced. In this paper, the fiscal and financial aspects of this development will be analyzed.

I. The Fiscal Significance of Issuing Bonds by Local Governments

As a means of providing sustainable support for local governments in performing their public responsibilities, promoting the pilot project and policy reforms regarding local government bonds is of great fiscal significance, and is also conducive to changing the widely-criticized "land finance" policies.

1. Significant funding pressures caused by urbanization will be solved for local governments.

Due to the considerable controversy between statistical requirements and criteria, it is difficult to accurately estimate the local government debt balance, but its size has undoubtedly become an important part of the overall government debt structure. This is basically the result of the recent acceleration in the urbanization process which led to the rapid development of infrastructure, urban public utilities, booming real estate prices, urban consumption, and other elements, that gradually became the main driving force of the Chinese economy. During this process, local governments undertook too many responsibilities for economic development; changes in the urban "hard environment" became an important standard to measure administrative performance, so substantial funds were usually raised for various types of investment and construction activities. Fundamentally speaking, as long as the Chinese economy still needs investment as a main driving force, and if it is not to be transformed into a consumption-led economic model, then local governments must rely on a variety of tools, including financing platforms, to provide various forms of public facilities and public service products. Furthermore, as long as there are no changes in the characteristics of the government-led model, and the exuberance of private capital is not fully released, the financing pressures on local governments will continue to increase. Therefore, the troubles caused by local government debt are actually a reflection of the two basic contradictions in choosing between the driving force for economic growth and establishing boundaries between the government and the market.

2. The drawbacks caused by the fiscal decentralization between the central and local governments will be alleviated.

Since the 1980s, the principle for fiscal system reform in China has been "decentralization of power and allocation of profits", including allocating profits from governments to enterprises as well as decentralizing power from the central government to local governments. However, since the tax-sharing system reforms in 1994, improving the proportion of fiscal revenue in the GDP as well as the proportion of the central government fiscal revenue in the total national revenue has become the core principle of fiscal reform. Against this background, the "balance" between central and local fiscal decentralization showed a gradual tendency towards favoring the former; the local tax system is not stable as it lacks many forms of primary taxes and has an unclear tax base. At the same time, the responsibilities assumed by local governments have continued to expand, resulting in a contradiction regarding the separation of financial authority and the power of office.

Specifically, in 2010, central fiscal revenue accounted for 51.1% of the total for the whole country and central government expenditure accounted for 53.8% of the total. The central government's own spending accounted for only 17.8% of total national spending, as a significant sum of funds flowed to local governments through transfer payments or returned tax revenue. But, this process made it difficult to meet local funding requirements in a timely way, and the costs of transferring funds were found to be excessive. In addition, in 2010, central state-owned enterprises accounted for 67.5% of the profits realized by the state-owned enterprises nationwide and turned over 55.87 billion Yuan to the national capital operating budget; comparatively speaking, local state-owned enterprises showed low profitability, and local governments had no budget revenue for capital operations from these sources.

For the local levels of government, revenue sources are nothing more than regular income, capital income and debt income. As the first two sources are restricted, local governments have to focus on the development of debt as a source of income, as well as seeking extra-budgetary "land finance" support. For example, at the end of 2010, the central fiscal debt balance (including domestic and external debts) amounted to 6.8 trillion Yuan, the sovereign debt balance, borrowed by ministries and commissions of the State Council, was approximately 256.9 billion Yuan, and the total liabilities of the Ministry of Railways was 1.89 trillion Yuan, resulting in a central debt burden which totaled about 8.9 trillion Yuan. Even when taking into account potential debt obligations of policy banks, asset management companies, and the non-performing loans by banks, the overall debt burden is lower than the level generally accepted for local governments.

Overall, as industrialization, urbanization, and agricultural modernization advance in China, the contradiction between the sustained rapid growth in funding demand for public utilities and the relatively inadequate financial capabilities of local governments will continue to exist for some time to come. Therefore, efforts must be made to regulate and clean up the debts from local government's financing platforms, and to explore institutional arrangements for local government financing in a market-oriented manner, especially through standardized pilot projects for municipal bonds, so that debt financing by local governments will receive a wider range of market supervision.

II. The Financial Significance of Issuing Bonds by Local Governments

In terms of financial reform and development, local government bonds are equally important.

1. Bond products will be diversified and the healthy development of the bond market will be promoted

Among the developed market economies in the world, municipal bonds are an important product in the bond market. For example, in the United States, the financial crisis did not change the growth trend for municipal bonds issued since the 1990s, and there was a noticeable increase in their share of government revenue at all levels. In addition, the crisis also stimulated the innovation of new municipal bond products, for example, the main municipal bodies in the United States began to issue a new municipal bond, the "Build America Bonds", in order to raise funds for municipal infrastructure and create jobs. Viewing the bond market as the most promising and dynamic field among the capital markets, the development of municipal bonds can make up for the drawbacks of other bond market products and stimulate the bond market to more effectively serve the economic and social development goals.

2. Financial structures will be optimized

In China's current bank-dominated social financial structure, there is a mismatch between "short-period deposits" and "long-period loans", and a lack of long-term stable funding. As the stock market cannot meet this need in the short term, issuing local government bonds is an important measure to provide a stable funding source for urban infrastructure construction in order to improve the structure of financial terms. Furthermore, China has long put too much emphasis on indirect financing; the proportion of direct financing has not shown a substantial increase, which is not consistent with the modernization process for the Chinese financial system, so the introduction of local government bonds will alleviate this phenomenon.

3. Core financial markets and a marketized interest rate will be

promoted

The standardized development of financial markets must rely on the coordination of government debt policies. The national debt serves as the benchmark for pricing all other financial assets, and is also the basis for derivative financial product innovation and a major tool for financial risk hedging. Municipal bonds, as "silver edge bonds", have formed a core financial market along with the national debt, and play an important role in the formation of market benchmark interest rates and equilibrium interest rates. Local bonds recently issued independently by Shanghai and other places had lower interest rates than national bonds; although this phenomenon was interpreted as meaning that the banks and other institutions hoped to maintain good potential relationships with the local governments through their participation, the bonds were popular because the institutions that issued the bonds had good financial standing; in addition, this autonomous issuance of bonds was a new "scarce" product. But it was also a reflection of the fact that the local bonds had more complex effects on market interest rates. So, in the future, with an expansion in its scale and product standardization, local bonds will surely play a more important role in the marketization of interest rates.

4. The local financing structure will be changed and systemic risks in the banking system reduced

The reason for concern about the debt of local financing platforms is that potential financial risks may be transferred to the banking system. Especially in the local commercial banks, a large proportion of loans are related to financing platforms, and this poses a challenge for the healthy development of the banking industry and financial stability. Promoting the development of standardized local government bonds can provide an exit mechanism for implicit government liabilities in local financing platforms and is conducive to the reform of commercial banks; in addition, it can help reduce the over-reliance of local financing on bank loans, and thus more effectively achieve risk diversification through strengthening bond financing.

5. Investment products will increase and private financial capital will be attracted

In the global capital markets, municipal bonds are very attractive to investors. In China, due to a lack of financial innovation, a considerable amount of private capital lacks effective investment tools and methods; furthermore, some traditional industries have become unproductive, so private capital eventually begins to pursue speculative opportunities. Therefore, standardized local government bonds can not only provide an important financial investment opportunity and a means for private capital to participate in the real economy, but they can also help to meet the wealth management and asset allocation needs of various types of investors.

In conclusion, the reform of local government bonds is a systematic project which has far-reaching significance for economic development, fiscal reform and financial optimization. The experience of the evolution of municipal bonds in developed countries should be studied to promote improvements in related laws and regulatory mechanisms for the future. The existing local government bonds should be gradually developed into standardized general obligation bonds, while corporate bonds issued by all urban investment companies will be gradually transformed into safe revenue bonds. Meanwhile, the rating assessment, market transactions and circulation, investor protection, and other related aspects of reform will be encouraged. In this way local government bonds can become an important impetus for strengthening fiscal and financial sustainability in China.

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