

# Qualitative Analysis of the Risk Causes of Local Government Debt

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## Abstract

Under the influence of various factors such as the impact of the three-year epidemic, the pressure on debt repayment has increased in some places, and the debt risk has increased, and 2023 has also become a key year for local governments to resolve debt risks. From the meeting of the Political Bureau of the CPC Central Committee in July, which proposed to effectively prevent and resolve local debt risks and formulate and implement a package of debt reduction plans, to the subsequent financial and financial efforts to reduce debts, such as the issuance of special refinancing bonds of about 1.38 trillion yuan since the beginning of this year, from the central financial work conference at the end of October, which emphasized the establishment of a long-term mechanism for preventing and resolving local debt risks, to the introduction of a new mechanism for public-private partnership (PPP), and the implementation of the trillions of additional treasury bonds issued by the central government in December, the actions of debt conversion have been frequent during the year. This year, new breakthroughs have been made in measures to resolve the risk of local bonds, and the intensity is unprecedented, and the risk of local bonds has been significantly alleviated. One of the keys to the future of debt will be to coordinate the risk resolution and stable development of local bonds. It is expected that some special refinancing bonds will be issued next year, and financial institutions will continue to help localize bonds. Fiscal policy will be moderately strengthened, and the central government will bear more deficits, creating a favorable environment for localized debt.

## Keywords

Local Government Debt; Debt Risk; Risk Management.

## 1. Introduction

With the continuous development of social economy, the government has undertaken more functions such as ensuring people's livelihood and infrastructure construction. Earth as an important way of government financing, government bonds are important for the realization of government functions and the smooth operation of the bond market in the capital market will have an important impact, so it has received wide attention from all walks of life. According to data from the Ministry of Finance, as of at the end of 2022, the balance of China's government bonds was about 35,061.8 billion yuan, of which the general debt was about 14,389.6 billion yuan, which was earmarked the debt is about 20,672.2 billion yuan, and according to the issuance of government bonds in recent years, the total amount of issuance is on the rise government debt carries a high debt risk. This paper analyzes the problem and causes of debt risk, and discusses the causes the corresponding response mechanism is expected to provide a certain reference for resolving the risk of local government debt.

## 2. Literature Review

### 2.1. Classification and Formation of Local Government Debt

Local government bonds are subject to classified management, of which general bonds are included in the public budget management; Special bonds are included in the budget management of government funds. Some scholars divide local government debt into explicit debt and implicit debt on the basis of government responsibilities and obligations. There are also some scholars who divide local government debt into direct debt and contingent debt based on the certainty of the conditions for debt creation [1]. The study found that implicit debt is more likely to trigger the "gray rhinoceros" effect, which brings a crisis to the financial industry [2]. As for the causes of local government debt risk, most scholars believe that the local fiscal pressure caused by the mismatch between local government power and financial power has increased the demand for local financing [3]. In his study of Guangxi's local debt, Shiquan Lin pointed out that the direct cause of the increase in local debt risk is the construction of infrastructure and other projects, which are beyond the scope of the government's financial resources, resulting in large-scale government debt investment [4]. Due to the high cost and long cycle of these projects, it is difficult for the governments of some economically underdeveloped regions to realize, so it is a better choice to borrow for infrastructure and other public service construction. Liquan Pan and others believe that the soft budget constraints of higher levels of government on lower levels of government also contribute to local debt risks. Lower-level governments tend to assume that higher-level governments provide some kind of informal guarantee for their own government's debts, and this "back-up" expectation also exacerbates local debt risks [5].

### 2.2. Budgets and Other Mechanisms Lead to Local Government Debt

Hang Zhou et al. argue that the fiscal decentralization system has both advantages and disadvantages for local governments, and although it has increased the debt crisis to a certain extent, it has also stimulated the vitality of local markets and promoted the development of local economies [6]. Hui Zhang et al. argue that fiscal decentralization should be viewed dialectically, and even if it can bring debt risks, it can also be effectively curbed through policy actions such as structural optimization [7].

## 3. Analysis of the Causes of Local Government Debt Risk

### 3.1. Fiscal Decentralization Factors for the Formation of Local Government Debt Risks

The theory of fiscal decentralization calls for a reasonable separation of powers between the central and local governments. This theory was officially applied to China in 1994, but due to the incomplete decentralization reform, the mismatch between local government financial power and administrative power, soft budget constraints, and imperfect financing mechanism have become the fundamental reasons for the formation of debt risk.

#### 3.1.1. There is a Mismatch between Financial Rights and Administrative Rights

Fiscal decentralization refers to the division of expenditure responsibilities and tax administration powers between the central government and local governments on the basis of their respective powers and government functions. Before the reform and opening up, China practiced a financial system of unified revenue and expenditure, and all the revenues and expenditures of local governments were arranged by the central government, and financial power was highly concentrated in the central government. After 1978, in order to arouse the enthusiasm of local governments, the central government gradually delegated power to local governments, and at the same time delegated administrative powers, a series of changes began

to be carried out in the financial system. In 1994, in order to alleviate the dilemma of the weakening financial strength of the central government and strengthen the ability of macroeconomic regulation and control, China began to implement the reform of the tax-sharing system and re-divide the financial and administrative powers of the central government and local governments.

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### **3.1.2. The Problem of Soft Constraints on Local Government Budgets is Prominent**

Soft budget constraints were first coined by the Hungarian economist Kornai in his book *The Economics of Shortages*, and refer to an economic phenomenon in which economic organizations facing financial difficulties, such as state-owned enterprises, are able to survive with the help of government bailouts. Subsequently, this concept was introduced into the field of public finance, providing a strong theoretical basis for explaining the behavior of local governments in transition countries. Soft budget constraints can easily lead to excessive fiscal expenditure and irrational excessive borrowing behavior of local governments[8]. The theory of fiscal decentralization holds that reasonable fiscal decentralization is conducive to hardening the budgetary constraints of local governments, so that they can rationally arrange the scale of fiscal expenditure within the scope of their own financial resources. However, for a long time, due to the incomplete reform of fiscal decentralization and the imperfect budget management system in China, the problem of soft constraints on local government budgets has been prominent.

First, the central government's large-scale bailouts of local governments and financial institutions are the main manifestation of soft budget constraints. After the reform and opening up, China's central government carried out two large-scale bailouts: the establishment of an asset management company to divest the bank's non-performing assets after the outbreak of the Asian financial crisis in 1998 and the launch of a 4 trillion stimulus plan after the international financial crisis in 2008.

Second, the implicit subsidies imposed by the central government on local governments also reflect the problem of soft budget constraints. In order to alleviate the contradiction between local fiscal revenue and expenditure and stimulate the enthusiasm of local development, the central government has carried out large-scale implicit subsidies to local governments, such as transfer payments, tax reductions and exemptions, extra-budgetary revenues, etc., but these implicit subsidies have a negative incentive for local governments, and at the same time, they also promote excessive borrowing and fiscal undiscipline of local governments.

In addition, due to the lack of legal definition of the powers of governments at all levels, in practice, there is a complex situation of mutual power and shirking of responsibilities between governments at all levels, and local governments have room for discretion, which also provides a favorable environment for the problem of soft constraints on local budgets.

### **3.2. Political and Institutional Factors in the Formation of Local Government Debt Risk**

In the context of fiscal decentralization, political institutional factors are the internal driving force for the formation of China's debt risk. Due to factors such as GDP and other economic indicators in the performance evaluation of local government officials in China, the incomplete transformation of local government functions and the imperfect accountability mechanism for illegal debt borrowing by officials, the behavior of government officials taking the initiative to borrow and invest in order to obtain promotion regardless of financial resources is still repeatedly prohibited, resulting in the accumulation of local government debt risks.

#### **3.2.1. The Performance Evaluation Mechanism of Local Governments is not Perfect**

The governance structure of China's central government and local governments at all levels determines that the incentive and restraint mechanism of governments at all levels is transmitted vertically, and the higher-level governments mainly motivate and restrain the behavior of lower-level government officials through the performance appraisal system. Since the beginning of reform and opening up, the central authorities have decided to take economic construction as the central task, and at the same time, they have also continuously adjusted the performance appraisal standards for cadres, from the "Interim Regulations on the Evaluation of Party and Government Leading Cadres" to the "Opinions on Establishing an Evaluation and Evaluation Mechanism for Party and Government Leading Groups and Leading Cadres to Promote Scientific Development" and a number of cadre evaluation methods, and then to the "Regulations on the Selection and Appointment of Party and Government Leading Cadres." The central government's performance evaluation of local officials has been continuously refined, and now it has comprehensively covered the fields of economy, politics, culture, society, ecological civilization construction and party building, and the assessment indicators also cover various specific indicators such as labor and employment, residents' income, scientific and technological innovation, social security, environmental protection, and debt status. However, in the specific implementation, the weights of each indicator are different, there are strong and weak points, and there is a certain conflict between the indicators, and the performance appraisal system still needs to be improved.

First, the GDP-oriented evaluation system has not been fundamentally reversed. In the process of high competition, local officials must stand out in the performance appraisal in order to get the opportunity to be promoted, which determines that the performance appraisal system has a strong guiding and guiding role in the behavior of local officials[9]. In the current performance evaluation index system, GDP and other economic development indicators are more explicit, intuitive and easy to measure than other evaluation indicators, and China is still a developing country, and economic development is still the first priority of governments at all levels in China. Therefore, under China's centralized "pressure" assessment and appointment system, economic development indicators have naturally become the main assessment indicators,

which have greater weight than people's livelihood improvement and scientific and technological innovation, and local officials, as rational economic persons, will also choose this index that is easy to produce results and easy to be recognized by superiors to guide their own behavior.

Second, there is a conflict between the diversity indicators of performance measurement. For example, there is a certain conflict between stable growth and deleveraging, because in the case of local government financial difficulties, deleveraging will lead to a decrease in local fiscal resources, and the reduction of fiscal resources will reduce the ability of local governments to stabilize growth. Another example is that there is a certain conflict between promoting development and benefiting people's livelihood, because no matter how much investment is made in education, medical care and other areas of people's livelihood, it is difficult to achieve results in the short term, and it will reduce fiscal expenditure for economic development.

### **3.2.2. The Transformation of Local Government Functions is Lagging Behind**

First, the relationship between the government and the market, between the government and society, and between the central government and local governments has not yet been straightened out. The core of changing the functions of the government lies in straightening out these three relationships. However, in practice, there is a lack of clear and systematic theoretical definition of how these three relationships should be divided into their respective management powers. For a long time, the Chinese government has taken the decisive role of the market in allocating resources to itself, and its functions almost cover major macro and micro affairs such as economic, political, social, cultural, and ecological construction, thus forming a pattern in which the management power of the whole society is concentrated in the government, and social organizations and enterprises are dependent on the government power, and the lower level government is dependent on the higher level government. This pattern not only increases the government's fiscal expenditure, aggravates the contradiction between local government's fiscal revenue and expenditure, but also leads to the failure to give full play to the role of the market and the low efficiency of resource allocation.

Second, the transformation of the government's economic construction functions has not yet been completed, and the reform of social management and public service functions is lagging behind. Under the GDP-oriented performance appraisal system, local governments are still concerned about the function of economic construction due to the inertia of the local "development-oriented government" model, and many local governments even take the initiative to put forward the growth concept of leapfrog development, ignoring the actual large-scale debt investment in the region, and various image projects and over-standard projects emerge in an endless stream, and often intervene in the market beyond the scope of their authority, resulting in serious distortion of resource allocation and a serious mismatch between the supply of public goods and social demand. At the same time, the unreasonable division of powers between the central government and local governments has led to the increasing social management and public service functions of local governments (such as rural compulsory education funds), which has also increased the pressure on local governments' fiscal expenditures.

### **3.3. Macro Policy Factors for the Formation of Local Government Debt Risk**

Behind the passive debt and active leverage of local governments, macro policy factors are the external driving force for the formation of debt risk. On the one hand, the continuous advancement of urbanization and the implementation of active fiscal policies have increased the demand for local governments to borrow money, and on the other hand, the implementation of expansionary monetary policy has provided a favorable financing environment for local governments to borrow a large amount of money.

### 3.3.1. The Impact of Accelerated Urbanization

Since the beginning of reform and opening up, with the establishment of China's socialist market economic system and the continuous deepening of the reform of rural areas, urbanization has become an inevitable trend and an inherent requirement of socialist modernization. In recent years, China's central government has made a series of decisions and arrangements to further promote urbanization, and the level of urbanization has been rapidly improved. With the continuous acceleration of urbanization, the demand for supporting inputs such as municipal construction, land acquisition and storage, and transportation is also increasing. Although in recent years, China has vigorously promoted PPP and other government-market cooperation models, and the investment in public infrastructure projects in the process of urbanization has begun to show marketization, but due to the characteristics of large investment scale, long construction period and low return on funds, it is difficult to truly attract social capital investment, and the main position of local government investment has not changed, and it is still the leader of the urbanization process, which has become an important reason for the rapid growth of local government debt.

### 3.3.2. The Impact of Expansionary Fiscal Policy

Fiscal policy is an important means for the government to perform its macroeconomic regulation and control functions to iron out the economic cycle and maintain stable economic growth. Judging from the specific practice of China's fiscal policy, when it is hit by macroeconomic shocks, China's central government will also give local governments a large number of economic stability responsibilities while adopting expansionary fiscal policies. Since the reform of the tax-sharing system, in order to cope with the two financial crises and increase the aggregate demand of society, China's central government has launched two rounds of proactive fiscal policies focusing on "increasing expenditure" and "increasing expenditure + reducing taxes".

The implementation of the proactive fiscal policy has not only effectively stimulated aggregate social demand and promoted social and economic development, but also increased the pressure on local fiscal expenditure, resulting in a widening gap between local fiscal revenue and expenditure, thus stimulating the growth of local government debt. On the one hand, the proactive fiscal policy requires local governments to expand spending, which directly leads to an increase in local government debt. For example, in 1998, in response to the Asian financial crisis, the central government issued 990 billion yuan of long-term construction bond investment funds, of which one-third of which was borne by the local governments to repay the principal and interest. On the other hand, in the process of implementing a proactive fiscal policy, the central government often requires local governments to provide matching funds to expand investment in infrastructure and key projects, which leads to increased pressure on local government fiscal expenditure and indirectly forms local government debt. For example, in 2008, in response to the international financial crisis, China introduced a total investment plan of 4 trillion yuan, of which 1.18 trillion yuan was included in the central government budget, and most of the remaining funds were solved by local support.

## 3.4. Factors of the Debt Management System Formed by the Risk of Local Government Debt

The imperfection of the debt management system is the technical reason for the formation of debt risk. Due to the lack of a strong professional debt risk management institution in China, the low efficiency of debt use and management, and the lack of stable debt repayment funds, local governments have prominent problems such as blind and disorderly debt borrowing, repeated and inefficient investment, resulting in the continuous accumulation of debt risks.

### 3.4.1. Lack of a Strong Debt Risk Management Institution

At present, only the central government has re-lent loans for various professional projects and treasury bonds in the local areas under unified management by the financial departments, and the management of most of the other debts is still very chaotic. Although China's current management system stipulates that the financial sector is the centralized management department of local government debt, and the budget department of the Ministry of Finance in 2008 has also set up a "local government debt management office" to manage local government debt, but the current management authority of the agency is still limited, and it is difficult to achieve the requirements of supervision and management of local government debt risk nationwide. In addition, although the main person in charge of the local government is stipulated to be the first person responsible for the management of local government debt and the prevention and resolution of fiscal and financial risks, the supervision is still a formality and lacks a specific implementation mechanism, resulting in a lack of supervision over the implementation of responsibilities.

On the one hand, the multi-departmental decentralized management of government debt risk has led to the lack of scientific and reasonable planning for local government debt behavior, and it is difficult to establish a set of standardized debt borrowing, debt use and debt repayment mechanisms. For example, when carrying out debt financing, many local governments often ignore the actual social and economic development of the region and their own debt repayment ability, blindly borrow money for projects based on their political performance, and even violate laws and regulations beyond the legal limit or set up projects in disguised debt, leaving hidden debt risks. On the other hand, China has not yet established a standardized local government debt statistics and risk early warning mechanism, and various departments lack a unified debt statistical caliber and confirmation standards, resulting in some local governments taking advantage of system loopholes to conceal or falsely report debt data, and it is difficult to accurately assess local government debt risks. In addition, this disorderly state of debt management strengthens the soft constraints of budget management, creates conditions for the wanton expansion of local government contingent debt and the accumulation of hidden debt risks, and increases the difficulty of systematic management and control of local government debt risks.

### 3.4.2. Inefficient Use of Debts

For a long time, due to China's lax use and management of local government debt funds, local governments at all levels have generally focused on project construction and neglected debt management, and there are serious problems such as duplicate construction and inefficient investment. On the one hand, under the constraints of the lack of an effective accountability mechanism, the promotion mechanism of local government officials, which uses GDP and other economic growth indicators as the main assessment criteria, stimulates the impulse of local governments to invest in infrastructure construction. However, due to the law of marginal diminishing capital factors, the driving effect of investment on economic growth has gradually weakened.

On the other hand, in order to win the "competitive competition" with GDP as the main goal, some local governments blindly borrow to increase investment in infrastructure and fixed assets, and many projects are rushed into operation without scientific demonstration and democratic decision-making.

## 4. Related Recommendations

### 4.1. Handle the Relationship between Debt Risk Management and Economic Development

There is no doubt that debt financing is an important way for local governments in China to promote economic growth. On the one hand, government debt, as a means of financing public expenditure, is more in line with the principle of intergenerational equity and more economically efficient than taxation. On the other hand, debt funds are mainly used for public infrastructure construction, forming a large number of high-quality assets, and improving the regional investment environment, which is conducive to attracting investment and stimulating economic growth. However, there is a threshold effect on government debt, and a large number of studies at home and abroad have confirmed this view: when the scale of local government debt is small, debt can promote local economic development, but when it exceeds a certain size, it will hinder economic growth. Therefore, from the perspective of preventing and resolving local government debt risks, it is necessary to maintain a certain economic growth rate; At the same time, it is necessary to earnestly change the fixed thinking of using debt to promote growth, and it is necessary to stabilize growth and guard against risks.

### 4.2. Handle the Relationship between Debt Risk Management and Urbanization

With the continuous acceleration of urbanization, the demand for supporting inputs such as municipal construction, land acquisition and storage, transportation, and education has been increasing, and the financial expenditure of local governments has also put forward a huge demand, thus indirectly generating a relatively large scale of government debt. However, the general law of economic development shows that urbanization is the inevitable consequence of development and a sign of modernization. For China, urbanization is still the biggest potential for domestic demand and development momentum [10]. According to the National Bureau of Statistics, at the current level of China's economic development, direct consumption from every 1 percentage point increase in the urbanization rate can promote an increase in GDP growth rate by 0.5 percentage points [11]. Therefore, the role of local government debt should not be completely denied because of the debt risk generated in the process of urbanization, and the management of local government debt risk should be placed in the context of the urbanization process.

### 4.3. Improve the Evaluation Mechanism for Local Officials

The accumulation of local government debt risk in China is largely due to the lack of transformation of government functions and the lack of clarification of the relationship between the government and the market. Under the conditions of market economy, the positioning of local governments in China should be service-oriented government, that is, the modern government governance model of "taking social development and the common interests of the people as the starting point, serving the people as the purpose and undertaking corresponding service responsibilities" [12]. In 2018, Premier Keqiang Li summarized the achievements of China in recent years in streamlining administration and delegating powers, combining decentralization and decentralization, and optimizing service reforms, and analyzed the existing problems, which has important guiding significance for accelerating the profound transformation of China's government functions.

Performance appraisal has a guiding and guiding effect on the behavior of local government officials. Judging from the setting of the current assessment index system, the indicators of economic development are still dominant. In order to win the promotion competition, local government officials tend to expand investment by blindly borrowing, resulting in the accumulation of local government debt risks. Therefore, the central government must optimize the existing performance evaluation standards. From the perspective of local government debt

risk management, it is necessary to increase the weight of the evaluation indicators of the debt borrowing situation of officials during their tenure of office, and include the scale of debt, the direction of capital investment, and debt repayment in the scope of examination of the work performance of leading cadres.

#### 4.4. Establish a Local Government Debt Risk Management Institution

At present, China has not established a professional local government debt risk management institution, which is not conducive to the control and prevention of debt risks to a certain extent. International experience also shows that in countries that can effectively manage the risk of local government debt and scientifically regulate the borrowing behavior of local governments, local government debt is indeed an effective way to develop the local economy. Although China also has some debt management departments, it is difficult to effectively supervise and manage the debt risks of local governments nationwide. Therefore, the central government should speed up the establishment of a unified professional debt risk management agency, and at the same time set up branches or offices under local governments at all levels, so as to change the situation of multiple management, unclear powers and responsibilities, and ineffective regulation and control of debt management.

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