

## Local government debt

### Another bail-out job

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Recently, the Chinese media has warned of a looming local government debt crisis. Eye-catching headlines such as “Local government debts sound warning” and “Local government debts should not be ignored” have littered the tightly controlled official press. The spate of coverage indicates that the government is finally getting serious about a grave financial problem that it has long swept under the rug. So far, however, Beijing is addressing only the symptom – bad debts in rural credit cooperatives – and not the real disease, which is the effective bankruptcy of many local governments.

#### A trillion here...

The term “local government” commonly refers to county and township governments, which are the two lowest formal levels of administration. (Village committees that are below the township governments, though playing an important role in local implementation of government policies, are not a formal level of government.) Estimates of local government debt vary. A recent academic study suggests that in 2003 village committees owed a total of Rmb370bn, townships Rmb215bn and counties Rmb410bn, giving a combined local government debt of nearly Rmb1tn, or 7.3 percent of GDP. In other words, the average debt burden is Rmb500,000 for villages, Rmb5m for townships, Rmb150m for counties.\* Somewhat more conservatively, a nationwide inspection by the Ministry of Finance in 2001 indicated that the township and village levels’ combined debt was about Rmb370bn.\*\* These are at best preliminary reckonings, and they are likely to underestimate the actual magnitude of local governments’ liabilities. Much local government debt is latent or indirectly owed, and thus inherent difficult to measure.

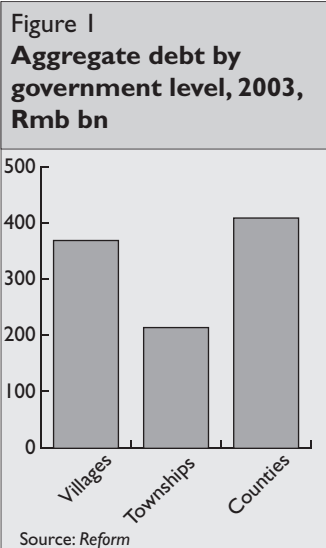
The emergence of local government debt is partly a product of increased fiscal responsibilities since the launch of economic reforms, and in particular the consequence of the 1994 tax reform that diverted a greater proportion of revenues to the central government, even as expenditure responsibilities of local governments increased. The central share of tax revenue rose from 22.0 percent in 1993 to 55.7 percent in the following year, while the local governments’ share of tax revenue fell from an average of 70.2 percent before 1994 to around 48 percent since.

One example of local fiscal pressure is basic education. Townships were originally responsible for running primary and junior secondary schools, under the nine-year compulsory education system. The townships’ inability to scrounge up funds to pay for education resulted in widespread arrears of teachers’ salaries, and paralysis of the basic education system across rural China. Consequently, the central government reassigned educational responsibility to county governments in 2003.

\*Fa Tian and Chenying Zhou, “Chongguo difang hengfu jian caizheng guanxi” (“Reconstruct Financial Relations among Local Governments”), *Gaige* (Reform), No. 2, (2004).

\*\*“Zhaiwu de kunrao – difang zhengfu zhaiwu wenti” (Bothered by Debt – Debt Problems of Local Governments), *Caijingjie*, 5 April 2004. Available at <http://finance.sina.com>.

#### Local loans



## Collective guilt

Financing of township and village enterprises (TVEs) is another major source of local government debt. Fiscal decentralisation policies in the 1980s encouraged townships and villages to set up TVEs (more formally known as rural collective enterprises), since tax revenues from these enterprises need not be shared with higher-level authorities. To finance these enterprises, township governments borrowed heavily from local financial institutions, notably rural credit cooperatives (*nongcun xinyong hezuoshe* or RCCs) and rural cooperative foundations (*nongcun hezuo jijinhui* or RCFs). Loans to township enterprises were often given on the basis of guarantees by the township government, without any physical collateral. In instances where collateral was present, the enterprise assets were grossly overvalued, so that in the event of non-repayment these financial institutions could not recover the loan amount even if the assets were liquidated. Since the late 1990s, many of these enterprises have folded: the number of TVEs fell to 802,000 in 2001 from a peak of 1.85m in 1985. These bankrupt enterprises leave behind sizeable debts for their guarantors – township governments.

Development of township enterprises is closely related to local financial organisations, particularly the RCFs which were established by the township authorities in the mid-1980s, and shut down by the central government in late 1990s. Because the RCFs – unlike the RCCs – were “informal” financial organisations, they could offer interest rates higher than the official level, which helped to absorb households’ savings. The RCFs were managed by the township agricultural economic management stations, and since these stations came under direct control of the township governments, they had enormous influence over loan allocations. Furthermore, since the RCFs were not officially regulated by the central bank, the local authorities could borrow directly from them. (The Budget Law stipulates that local governments may not borrow from any formal financial organisations.)

As a result, local authorities siphoned RCF funds to their own coffers. The consolidated accounts of the RCFs in Sichuan where they were very active suggests that more than half of their loans went to the local governments and government-related units. These funds were used for official fiscal expenditures, township enterprises, or simply for local officials’ cars and banquets – earning the RCFs the sobriquet of “little cash boxes” (*xiaojinku*). When the central government closed down all the RCFs in 1999, audits uncovered widespread misuse of funds by local officials, and a high level of debt owed by local authorities.

## Where the money went

There are few comprehensive studies on the sources of local government debt. A study by Zhao Shukai of the State Council’s Development Research Centre (DRC), based on investigations in 20 townships in ten provinces, suggests that amounts owed to RCFs are a major component of township government debt, accounting for 17 percent of the total. The other major sources of indebtedness are funding of education, construction projects and wage arrears (see Table 1).

Construction projects, such as plush government buildings and investment parks that host few enterprises, which showcase their “political achievements” are one of the favourite pastimes of local authorities. For local officials eager to impress their political superiors, extravagant spending on easy-to-spot physical infrastructure is rife, even in the poorest parts of the country. Despite recent efforts by the central government

## Flexible foundations

Table 1  
Applications of township debts, 2003  
%

Township enterprises	12
Construction projects	15
Education	17
RCFs	17
Wage arrears & borrowing from private individuals	15
Daily expenses	10
Previous loan interests	9
Meet tax targets	5

Source: Development Research Centre

Saved in the country,  
spent in the city

## Reverse Robin Hood

The function of rural credit cooperatives (RCCs) is demonstrated by the aggregate balance sheet shown in Table 3. They collect deposits from farmers and other individuals (95 percent of the total) and redistribute the funds to enterprises and other, largely local-government controlled organisations (65 percent of total loans). This is not unreasonable if the enterprises are productive ones creating off-farm employment opportunities for rural folk.

However, it appears that many enterprises are unproductive. The value of enterprise deposits in the RCCs at the end of 2004 was just 19 percent of the value of outstanding enterprise loans; for China's financial sector as a whole the ratio is over 50 percent. It is likely, of course, that some local enterprises borrow from RCCs but have deposit accounts at commercial banks. But all this means is that rural household funds are being drained away to finance construction and real-estate speculation in the cities.

The PBoC has instituted a variety of measures to repair RCC balance sheets and make them viable financial institutions. The biggest ongoing aid programme is an interest-rate subsidy, under which RCCs can borrow funds from the central bank at around one percent – yielding a fat profit when the money is on-lent to farmers at market rates of 7-9 percent. In June 2003, PBoC outlined additional subsidies to aid RCC restructuring:

- Rmb30bn in subsidies to RCCs that suffered financial losses due to the central government's 1994-97 interest-guarantee policy.
- For RCCs undergoing reform in the central and western regions, a reduction in operating tax (*yingyeshui*) on RCCs from 5 percent to 3 percent, valid from 1 January 2004 to end of 2006, and full exemption from corporate income tax.
- PBoC would take over RCC non-performing loan in exchange for PBoC earmarked on-lending (*zhuanxiang zai daikuan*) or earmarked central bank bills (*zhuangxiang zhongyang yinhang piaoju*). The bills have a tenor of two years and an annual interest rate of 1.89%.

Table 3  
RCC aggregate balance sheets, 2002-04  
Year end figures, Rmb bn

		2002	2003	2004	2004 % of total
<b>Deposits</b>		1,988	2,371	2,729	100.0
Enterprise		81	102	114	4.2
Government		6	8	12	0.4
Households		1,555	1,800	2,077	76.1
Rural and other	346	460	526	19.3	
<b>Loans</b>		1,394	1,698	1,924	100.0
To farmers		424	559	677	35.2
Agricultural economic organisations		133	146	168	8.7
Township enterprises		514	570	599	31.1
Other		322	423	479	24.9

Source: PBoC

to crack down on meddling by local authorities in the banking system, local officials still lend to their favoured enterprises, such as those set up to manage local infrastructure projects. This behaviour is often hard to detect since – on the books – loans are provided to companies. On further investigation, however, it often turns out that the authorities are not able to pay the contractors or construction companies, and

the latter in turn owe wages to migrant workers; this has become a major cause of the nationwide migrant workers' wage arrears.

Another cause of local government debt is sheer waste, which is rampant because the local government budgeting process is neither open nor subject to any supervision. A common problem is the excessive number of officials, sometimes exceeding the officially sanctioned numbers by two or three fold. Borrowing to pay the salaries of these redundant officials is a major source of local government debt. Even so, salary arrears remain commonplace. In Sichuan and Hebei provinces, where I have conducted field studies, local officials often complain that they receive salaries for only six to nine months out of every twelve.

Local government's fiscal plight has worsened thanks to Beijing's efforts to boost rural incomes. Since 2001 a number of reforms – including a crackdown on arbitrary fees and the abolition of agricultural taxes – have taken a significant bite out of local revenues. Collection of arbitrary taxes and fees, such as education surcharges, broadcasting fees, and labour fees was especially pervasive in the middle and western parts of China. While their abolition has been good news for rural residents, fiscal revenue of local authorities continues to dwindle. The phase-out of agricultural taxes is even more dramatic: originally slated for complete elimination by 2009, agricultural taxes will probably all be gone by the end of this year.

### *Worsening plight*

#### **Solution: another bailout**

One way of dealing with the local government debt crisis would be to attack its fiscal roots – by restructuring the tax system to balance local revenue and expenditure, and by forcing local governments to trim the fat. Politically, however, this would be impossible. The government has instead focused on a related issue: cleaning up the RCCs, whose parlous financial condition stems in large measure from the debts owed to them by local governments. The RCC clean-up is mainly seen as part of the wider rural welfare programme begun in 2003, but it indirectly affects local government finance as well.

The precise amount of debt owed by local governments to the RCCs is hard to know, not least because such borrowings are illegal. Based on interviews with more than two dozen local financial institutions in prosperous, middle-income and poor areas of rural China, I estimate that roughly 60-70 percent of the non-performing loans (NPLs) of the RCCs were owed by township enterprises, or local government-related projects. According to official figures, at least half of RCCs' aggregate NPLs of Rmb515bn in 2002 were debts of local governments. The likelihood of local governments ever repaying these loans is scant: in Sichuan, my data show that township debts to RCCs range from 1.4 times to 40 times the townships' annual fiscal revenues.

After years of dithering, Beijing moved aggressively to recapitalise the RCCs in 2004, via transfers from the PBoC. Between late 2004 and the end of 2005, the PBoC injected Rmb98.5bn yuan into the RCCs; the cooperatives then wrote off Rmb17.4bn in loan losses and transferred another Rmb81.1bn in NPLs to the central bank. Further such capital injections, to the tune of Rmb70bn, are budgeted for 2006. In principle, the injections were conditional upon the RCCs meeting criteria including improvements in corporate governance and profitability, but the actual extent of such improvements is far from clear.

	2003	2004	2005*
<b>Official</b>			
NPLs, rmb bn	504.9	451.4	385.1
NPL ratio, %	29.7	23.1	17.5
<b>Excluding NPL swaps</b>			
NPLs, rmb bn	504.9	483.3	466.2
NPL ratio, %	29.7	24.7	21.2

Source: CBRC, CEQ estimates \*As of June 30

This engineering superficially improved the RCCs' balance sheets, but, as Table 2 shows, the improvement is more apparent than real, once the effect of the NPL transfers is stripped out. Moreover, the RCC rescue may have created an expectation among local governments that they too will be bailed out in the future – meaning they have little incentive to cut back on their wasteful spending habits. Until the fiscal system is reformed to achieve a better balance between local government revenue and expenditure – and to discourage waste by localities – the underlying problem will endure.