

# Local Government Debt in China: Development in Seven Decades, Current Situation, and Reform Suggestions

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Since 1949, local government debt in China has gone through the stages from scratch, then banned, and reintroduced, and then to the scale expansion, market construction and improvement under the system construction. In the past 70 years, although there have been twists and turns in its development, local government debt has undergone a “perfect transformation”. Based on a comprehensive review of the development of local government debt in China from 1949 to 2019, this paper refines its evolution logic, forecasts its development trend, and puts forward relevant policy recommendations for the future management and risk control of local government debt in China.

**Keywords:** local government debt, seven decades, development, current situation, reform suggestions

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With the founding of People’s Republic of China in 1949 as the starting point, and with the transition from the classical planned economy to the socialist market economy, the local government debt in China has experienced a tortuous process from scratch, to being forbidden and then being liberalized. As of July 2019, the balance of local government debt in China reached 21,065 trillion.<sup>1</sup> Local government bonds have become an important trading product in China’s bond market. In addition, local government debt management has also stepped into the track of standardization and legalization, with increasingly rich and perfect functions.

In fact, as one of the important sources of local government revenue, the development of local government debt is not an isolated economic phenomenon. Its evolution is not only restricted by the adjustment of the fiscal relations between the central government and the local governments, but also accompanied by the transformation and change of China’s society and economy. Or, to be more precise, its development by itself is an important embodiment of China’s fiscal system reform, and embedded in the background of the overall economic and social development and transition reform.

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## 1. Review of the Development of Local Government Debt in Seven Decades

### 1.1. Initial Exploration from 1949 to 1978

The local government bonds of the People's Republic of China originated in Northeast China, that is, the Northeast production and construction of parity bonds in 1950. At the end of 1948, the whole Northeast was liberated. After years of war, there was a great lack of funds to resume production and construction. At the same time, the War of Liberation continued in some areas. Even in 1950, the national defense expenditure accounted for 41% of the total fiscal expenditure. National finance could not support the economic and social development needs of all regions. To raise funds for construction and accelerate the recovery and development of the Northeast economy, with the approval of the then-Government Administrative Council, in February 1950, the Northeast People's Government issued *The Regulations on the Northeast Production and Construction Parity Bonds in 1950*. In March and November, two issues of Northeast production and construction parity bonds were issued respectively.

In the two issues, the planned issuance of construction bonds totaled 30.54 million cent (equivalent to RMB 35.4364 million yuan), 36.29 million cent (42.046 million yuan) was actually completed, and 18.69% of the total was exceeded. Among them, the proportion of employees' over subscription is the highest, reaching 37.9%. The smooth issuance of the Northeast construction parity bonds in 1950 became one example of the few cases of local government debt issuance at the founding of PRC, which made up for the lack of local fiscal resources caused by highly centralized planning and fiscal distribution system to a certain extent. It timely transformed the war supply-oriented finance into productive and constructive finance, and the large quantity of funds it raised in a short time restored the production and construction of Northeast China, as well as the economy and society, providing strong support for the recovery of the national economy. In 1950, the Northeast government budget, including the task of submitting to the central government, reached the balance of revenue and expenditure (Jiang, 2010), which also provided valuable experience for the subsequent issuance of "national economic construction bonds".

During the Second Five-Year Plan period, the central government suspended the issuance of government bonds for economic construction. Instead, for the first time in the history of PRC, local government bonds recognized in the legal sense appeared. In 1958, local government bonds were issued in the context of first large-scale administrative decentralization from the central government to local governments in the Great Leap Forward period. In fact, it was also an important part of decentralization.

In November 1957, the Standing Committee of the National People's Congress approved the provisions of the State Council on improving the fiscal system, clearly

defined the scope of revenue and expenditure of local finance, appropriately expanded the fiscal management authority of local governments, and increased local flexible fiscal resources on the premise of ensuring the key national construction. Different categories of fiscal revenue were divided between the central and local governments according to different proportions. The local fiscal revenue included the local fixed revenue, the shared revenue from the state-owned enterprises (that is, the revenue from the central state-owned enterprises and the public-private joint ventures shared by the local government according to a certain proportion) and the adjusted shared revenue. Revenue from government bonds was included in the adjusted shared revenue.

On June 5, 1958, the 97th meeting of the Standing Committee of the National People's Congress approved *The Regulations of the People's Republic of China on Local Economic Construction Bonds* (hereinafter referred to as *The Regulations*), which initiated the exploration of the issuance of local government bonds in the period of planned economy. According to *The Regulations*, in general, the interest rate of government bonds should not exceed 2% and may be interest free if necessary; the period of amortization should not exceed five years generally, and the interest should be paid in one lump sum when the principal is repaid. The bonds were not allowed to circulate as currency and could not be freely traded. According to the data, the seven provinces of Sichuan, Heilongjiang, Anhui, Fujian, Liaoning, Jilin, and Jiangxi issued local economic construction bonds, raising a total of 337.235 million yuan of construction funds (Wan, 2017).

The local government bonds issued during the Great Leap Forward period were also marked with the “brand” of the special period, which not only had the distinct characteristics of planned economy, but also had the tint of excessive decentralization and rash advance. In the early 1960s, the issuance of public bonds in some provinces and cities was obviously affected by the “proneness to exaggeration”, and the expected issuance scale of public bonds was far beyond the capacity of each region. The issuance of public bonds failed to achieve the established goal repeatedly, which also became an important factor contributing to the subsequent suspension of local bonds.

Shortly after that, the special historical background made the decision-makers form a negative cognition of government bonds. In the report of the 10th National Congress of the Communist Party of China and a meeting of the 10th National People's Congress, it was regarded as “socialism superiority” that there was neither foreign debt nor domestic debt. Under this guidance, the issuance of government bonds, including local government bonds, was interrupted.

### *1.2. Local Government Debt Not Striking from 1978 to 1994*

Statistics about the local government debt during this period are less. In terms of laws and regulations, the central government rarely introduced policies and specific regulations

concerning local governments' borrowing. But in practice, some local governments tried to restart debt financing. However, in the context of the 1978 transformation reform with the theme of decentralization and interest concessions, the motivation of local governments to carry out large-scale debt financing was still insufficient.

According to the National Audit Office, local governments resumed borrowing debts that were to be repaid from 1979, which was roughly the same time as the central government of China restarted the foreign debt. In the same year, a total of eight counties and districts borrowed the debts that the governments were responsible for. From 1979 to 1980, four municipal governments borrowed, accounting for 1.02% of the total number of municipal governments, and 51 county governments borrowed, accounting for 1.84% of the total number of county governments. There is no record of borrowing at the provincial level. Since then, governments at all levels have been borrowing. The starting years for provincial governments (including municipalities with independent planning authority designated in the plan) to borrow debts with repayment or guarantee responsibilities were from 1981 to 1985. During this period, 77.78% of the provincial governments (28) began to borrow; the starting years of borrowing by municipal and county governments were from 1986 to 1996. During this period, 293 municipal and 2054 county governments began to borrow. By the end of 1996, all provincial governments, 353 municipal governments (90.05% of all municipal governments) and 2405 county governments (86.54% of all county governments) had borrowed (National Audit Office, 2011).

It is worth noting that, unlike the simple administrative decentralization, the decentralization of financial power in the 1970s was accompanied by the decentralization of other economic management, personnel management, legislative power, financial allocation and other multi-faceted powers, thus reducing the constraint of indicators from the "regulations" (from central ministries and commissions) and greatly weakening the constraints of central ministries and commissions on the freedom of local fiscal expenditure. Local governments could, in view of central policy, local fiscal resources and the needs of self-development and construction, arrange more flexible and independent expenditure (Zhou, 2018), forming a truly relatively independent interest subject, which is the necessary condition for independent local borrowing. Through the transformation reform of decentralization and interest concessions in 1978, the local government gradually obtained relatively independent autonomy in economy, investment and other aspects, confirmed and consolidated in the form of law, which laid the foundation for the subsequent rise of local government financing platform debt.

### *1.3. Local Government Debt Risks Became Evident from 1994 to 2012*

In the 1990s, China began to enter the stage of rapid development of urbanization

and industrialization, and the local financing represented by urban investment debt increased rapidly in disguised form. Taking the 1994 tax sharing system as a watershed, rapid urbanization and industrialization have put a huge pressure on local fiscal revenue and expenditure, and at the same time, they are subject to the limitations of local governments' debt financing by laws and regulations such as *Budget Law*, *Guarantee Law*, and *General Principles of Loans*. Local governments with relatively independent interests and resource regulation capabilities began to rely on financial innovation activities to seek local financing platform as the specific carrier of local government urbanization financing. Urban investment platform debt and trust debt have become diversified and disguised financing behaviors of local governments under the increasingly rigid constraints of financial discipline. While local governments obtain financial resources, they accumulate a lot of contingent liabilities outside the government system.

A proactive fiscal policy was adopted in response to the subprime crisis in 2008. With the purpose of arousing the enthusiasm of local governments, the central government's attitude towards local financing platform debt had changed from constraint and restriction to encouragement and development. The debt scale of local financing platform began to expand rapidly. The large scale of local government debt, which was free from budget management and supervision, aroused social concern. According to reports by the National Audit Office, as of 2009, the government debt of 18 provinces, 16 cities and 36 counties totaled 2.79 trillion yuan. Among them, the debt growth in 2009 was the fastest, with an increase of 1.04 trillion yuan in only one year, accounting for 37.28% of the debt. However, only 8.92% of the new debt was used as supporting funds for the new investment projects of the central government to expand domestic demand. This means that a considerable part of the debt financing was used for the transportation, municipal infrastructure and other infrastructures that had been started before 2008, or became an important means for local governments to borrow new funds to repay old ones and continue project financing. Especially in the aftermath of the subprime crisis and the resurgence of the European debt crisis, the risk of local government debt in China even aroused the concern of the international community about China's macroeconomic stability. At the same time, China began to evaluate and reflect on the follow-up effect of the stimulus package during the subprime crisis. Restriction and regulation began to be imposed on local government debt.

#### *1.4. The Establishment and Improvement of Local Government Debt Management System since the 18th CPC National Congress*

Marked by the 18th CPC National Congress, China's local government debt management bid farewell to piecemeal partial adjustment and carried out a new transformation. The decision of the third plenary session of the 18th CPC Central

Committee clearly proposed that standardized and reasonable debt management and early warning mechanisms of the central and local governments should be established. General Secretary Xi Jinping pointed out that the reform of the fiscal and taxation system was not a temporary solution, but a systematic reconstruction of the long-term mechanism at the meeting where *The Overall Plan for Deepening Reform of the Fiscal and Taxation System* was deliberated. In 2014, *Budget Law* was revised. In October of the same year, the State Council issued *Opinions of the State Council on Strengthening the Administration of Local Government Debt*. Since then, the management of local government debt in China has got rid of the “piecemeal” adjustment mode, clarified the management idea and mode, and established the institutional regulatory framework for regulating the local government debt. Local government debt management has stepped into the track of standardization and legalization.

On this basis, the central department has successively issued a number of local government debt management systems, involving debt issuance, emergency response, reward and punishment mechanism, negative list, etc., thus forming the whole-process supervision system of issuance, operation, repayment, punishment, etc., and the basic structure of the local government debt management system with the integration of borrowing, using and repayment.

At the same time, with the establishment of local governments’ bond issuance right, and the establishment of formal whole-process framework of local government bond issuance, circulation, and supervision, relying on the existing bond market, especially the treasury market, China has gradually built a relatively formed local government bond primary issuance and secondary circulation market. As a “silver-edged bond” with high security, the improvement and prosperity of local government bond market help local governments at all levels to obtain relatively stable and low interest construction funds, promote the construction of new urbanization, and reduce local dependence on implicit debt. At the same time, the increasingly perfect local government bond market and diversified products also provide investors with more safe investment options.

With the standardization and legalization of the local government debt management system, the local budget constraints are gradually hardening. However, the downward pressure of macro-economy and the concentrated digestion and repayment of the existing debts of local platforms have led the central government to adopt a gradually compromised approach. While accelerating the market-oriented transformation of financing platforms, local governments are encouraged to use PPP, government investment funds and other ways to attract and encourage market funds to participate in the investment and construction of public goods, so as to replace the supply model of government financing platforms in the transformation and reduce the debt ratio of the government. In the actual operation, some financing platforms facing survival and financing pressure borrow money in disguised form by means of PPP projects,

government investment funds, government purchase services, etc. The platform debt of local government is out of the balance sheet again, and a new round of recessive or contingent trend of local debt appears.

The 19th National Congress of CPC put forward that China has entered the new era, which is a directional judgment for the major historical changes in the stage of China's social and economic development. The report of the 19th National Congress of CPC also pointed out that in order to win the victory of building a moderately prosperous society in all respects, we must fight three key battles, namely, preventing and resolving major risks, targeted poverty alleviation, and preventing and controlling pollution. Among them, how to resolve the financial risks caused by the continuous expansion of the scale of local government debt, especially the scale of implicit debt, has become a key content of China's comprehensive deepening reform.

## **2. Existing Problems and Challenges of Local Government Debt**

Throughout the development of local government debt in the past 70 years, “Empowering—prohibiting—re-empowering” has been repeated, but it has always been “embedded” in the relations between the central government and the local government. In essence, the distribution of creditor's rights between the central and local governments is an important part of the central and local power structure arrangement. It is not only related to the stages and trends of a country's economic and social development, but also deeply influenced by the institutional inertia between central and local governments and the distribution pattern of power and responsibility. Therefore, it is necessary to think about and solve the problems and challenges of local government debt in this context.

### *2.1. The Economic New Normal Will Have a Sustained Impact on Local Government Borrowing*

With China's economy entering the new normal, the main social contradiction has been transformed into the contradiction between the people's ever-growing needs for a better life and the unbalanced and inadequate development. China's economic development model, population structure, social composition and many other aspects show drastic changes, which will also affect and reflect on the fiscal revenue and expenditure of governments at all levels, and have an impact on the local government's fiscal revenue and expenditure and borrowing based on the central-local fiscal relations and the division of power and responsibility pattern.

From the perspective of revenue side, in 2016, the “replacing business tax with value-added tax” was comprehensively promoted, and the revenue growth pattern of the central and local governments was further divided. In the process of economic

structure transformation and upgrading, the impact of the transformation of new and old economic growth drivers on local industries and government revenue will continue, which may cause the continuous debt liquidity pressure in some regions with heavy rigid expenditure pressure and large local debt stock. On the other hand, new changes in social and economic development will have a profound impact on local fiscal expenditure and local debt structure. With China's post-industrialization and post-urbanization, the proportion of demand for urban roads, highways, bridges and other facilities, water, electricity, heat and other public infrastructure will decrease in some areas. At the same time, driven by consumption upgrading, people's demands for pension, education, medical care, health care, law, information and other aspects are gradually increasing. Accordingly, the proportion of government expenditure on medical care, pension, education and Internet infrastructure will increase. This expenditure pressure will increase with social and economic development and the aging of population. The hidden expenditure gap of pension and medical care will gradually become explicit. It can be predicted that the local finance, which bears the main responsibility of expenditure in the central and local fiscal expenditure arrangements, will be further under pressure.

## *2.2. There Are Many Uncertain Factors in the Reform of Fiscal and Taxation System*

In 2016, the comprehensive implementation of "replacing business tax with value-added tax" brought about fundamental changes in local revenue sources. Local governments lost the business tax which has been under their independent control and has great influence on the local finance. The autonomy of local fiscal revenue is further damaged, which will undoubtedly affect the freedom of provincial and local governments to arrange fiscal revenue and expenditure, and further increase the local dependence on central finance.

The State Council has issued *Notice on Issuing the Transitional Plan on Adjusting the Distribution of the Value-Added Tax between the Central Government and Local Governments after the Comprehensive Promotion of the Pilot Program of Replacing Business Tax with Value-Added Tax* and *Notice on Issuing the Plan for Advancing the Reform of Adjusting the Division of Revenue between the Central and Local Governments after the Implementation of Larger-Scale Tax and Fee Cuts*. But these are just administrative regulations to continue to ensure the overall 50:50 distribution pattern of value-added tax between the central and local governments, there are no fundamental laws to define the specific division of revenue and detailed arrangements of expenditure. This also makes the distribution pattern of the central and local governments face great uncertainty in the subsequent central-local game, thus affecting the expectations and behaviors of all levels of government.

From the perspective of expenditure side, up to now, although reform plans on

the division of respective fiscal powers and expenditure responsibilities in health care, science and technology, and basic public services between the central and local governments have been successively introduced, there are still problems such as the refinement of basic public service cost standards and the calculation of project sharing proportion. In addition, how to standardize and steadily promote the reform of the fiscal system and the division of revenue and expenditure below the provincial level? Issues including the basic standards of basic public services at provincial level, cost calculation, etc. are yet to be refined and implemented.

Reform is both a top-down and a bottom-up process. Therefore, if the intergovernmental powers and expenditure responsibilities are not divided into specific items, and the sharing proportion and standard are not fully detailed in this two-way interaction, then the matching of intergovernmental powers and expenditure responsibilities still cannot be achieved. The local governments will still have the impulse and inertia to borrow because of the gap between revenue and expenditure.

### *2.3. Lower Level of Laws Regulating Local Government Debt*

At present, many laws and regulations have been issued concerning local government debt, involving the whole process of local borrowing, repayment, emergency aid and punishment. However, as far as the legal system of local government debt is concerned, there still lacks a system design based on long-term considerations or guidance of a comprehensive and fundamental law. The legal level of laws regulating local government debt is relatively low, which is not conducive to the coordination of claims and liabilities of local government debt.

### *2.4. Reform of Government Accounting and Budget Lags Behind*

With local government debt getting explicit, legalized, and standardized, the biggest risk of government debt system is the uncertainty brought by government contingent liabilities and implicit liabilities. Given the current government budget and accounting system in China, it is difficult to fully reflect the cost and risk of government liabilities, especially contingent liabilities and implicit liabilities, resulting in the lack of micro level data. As a result, the scale of local government debt including implicit debt cannot be calculated comprehensively and accurately at the macro level, and it is difficult to judge the real risk level. The lack of debt statistics and supervision (caused by implicit guarantee) directly leads to the local government's easy transfer of debt from on-balance-sheet to off-balance-sheet, which promotes fiscal opportunism and the moral hazard of blind borrowing.

### 3. Policy Suggestions for Future Reform

#### *3.1. Steadily Advancing the Reform of Intergovernmental Fiscal and Taxation System*

The pressure of huge local financial gap is considered to be one of the important factors that lead to local over-borrowing. International experience also shows that local expenditures' great reliance on transfer payments from higher authorities will lead to soft budget constraints, and implicit guarantee has a strong expectation of relief. Therefore, on the basis of the long-term layout and overall plan of the relations between the central government and local governments, reconstructing intergovernmental fiscal relations and hardening fiscal constraints will be the focus of deepening the reform of the fiscal and taxation system at present and in the future, as well as the important premise of realizing the unity of powers and responsibilities and relieving the pressure of local governments' borrowing. The specific contents of the reform include:

—Promote the division of powers and expenditure responsibilities. The expenditure responsibilities, especially the expenditure responsibilities shared by governments, should be comprehensively sorted out. Based on the consideration of the medium and long-term development of China's economy and society, in basic public service fields, the principle, mode and proportion of public cost sharing between the central and local governments, and the conditions triggering the adjustment should be adjusted and set. National basic standards, provincial standards and indexation methods for basic public services should be formulated to consolidate the expenditure responsibilities undertaken by the central government and local governments, measure the real gap, evaluate the matching of revenues and expenditures of central government and local governments, and pave the way for the subsequent reform.

—Stabilize the local tax system. In the medium and long term, it is necessary to establish and improve the local tax system matching the expenditure responsibilities, stabilize the local revenue pattern, and guide the local government to rationally borrow.

In order to eliminate the risk of revenue uncertainty and debt maturity mismatch, it is necessary to break the path dependence of local high dependence on land transfer fees for economic construction.

At the same time of reducing indirect tax and income tax, the pilot area and collection scope of real estate tax can be expanded, the impact of the piloting on the real estate industry, land market, finance and regional economy should be tracked and evaluated, so as to provide a practical template for the final plan. China should emphasize the revenue function of real estate tax, gradually build it into a local main tax, create a stable revenue flow for public welfare project financing, and form a benign borrowing mode.

—Improve the intergovernmental transfer payment system. Fiscal resources can be

prioritized to the local governments by giving full consideration to the inter-regional cost of basic public service expenditure and the change of permanent population, and combining with the reform of expenditure responsibility division. The proportion of general transfer payments should be increased to promote the equalization of public services in all regions. At the same time, in line with the division of shared responsibility, the scale, standard and proportion of shared special projects should be defined based on the factors of public welfare and externality, for example, the budget performance management of transfer payment should be strengthened to improve the use efficiency of fiscal funds.

—Timely issue the law on intergovernmental fiscal relations. On the premise of the completion of the three major tasks of the reform of the fiscal and taxation system and the relative stability of the new round of adjustment of the pattern of intergovernmental revenue and expenditure, the intergovernmental fiscal relations law can be timely promoted and promulgated to clarify the power and responsibility relation and distribution pattern between the central government and the local governments, as well as the local governments below the provincial level, standardize the government's behavior, and form a hard constraint on the governments at all levels.

### *3.2. Steadily Advancing Financial Reform and Strengthen Supervision of Financial Innovation*

#### *3.2.1. Promoting the Development of the Medium-and Long-Term Bond Market*

Efforts should be made to develop medium-and long-term bond markets and enrich and improve the variety of local government bonds. Based on the principle of intergenerational compensation, the term of local government bonds can be extended to match the debt term with the actual income term of the project. The scope of issuance and trading of local bonds can be further expanded, and preferential tax policies for local government bonds be implemented to attract long-term investors such as social security funds, enterprise annuities, occupational annuities and commercial insurance, gradually expand the participation of foreign financial institutions, at the same time, encourage individual investors within the region to purchase, so as to spread risks by changing the structure with state-owned commercial banks as the main holders.

#### *3.2.2. Strengthening the Supervision of Financial Innovation*

After the subprime crisis, all countries have a comprehensive reflection on financial innovation activities under the wave of financial liberalization. Financial innovation not only creates liquidity and reduces transaction costs, but also creates new risks and instability. In China, financial innovation has played a role of “booster” in breaking the

ban on local governments' borrowing or borrowing limit. Therefore, while guiding and developing financial innovation orderly, it is necessary to prevent financial innovation from alienating and getting out of control by strengthening supervision and controlling risks.

### 3.2.3. Regulating Local Financial Supervision

The financial supervision system should be improved to rationally define the boundaries of financial power between central and local governments. In keeping with the bottom line of no systemic financial risk, we should make clear the responsibility of local authorities in maintaining regional economic and financial stability. In particular, it is necessary to put the local government in the right position as "financial demander, regulator and owner", with clearly defined powers and responsibilities and relative independence, so as to establish a modern financial supervision system with incentive compatibility, and finally ensure appropriations in place and finance in its right position.

## 3.3. *Strengthening the Basic System Construction of Local Debt Management*

### 3.3.1. Systematic Construction of the Legal System Framework of Local Debts

In the medium and long term, we can refer to international practices, follow the principle of "government debt legalization", and issue a special public debt law under the guidance of the constitution. The government's borrowing will be restricted and regulated by different levels of laws and regulations such as budget law, government debt law and securities law, and the patching governance mode of continuous pressure by administrative means should be abandoned. The rights and responsibilities of stakeholders of government debt (including local debt) will be defined in the form of "law" to impose legal constraints on the relevant elements of debt (scale, structure, etc.) and the whole process of debt raising (risk control, etc.).

With the help of the People's Congress as a platform for consultation, the government debt stakeholders can be widely involved in the discussion to obtain the greatest common divisor of social interests; at the same time, positive public opinion guidance can be formed through publicity to stabilize market and social expectations.

### 3.3.2. Strengthening the Coordinated and Optimized Management of Government Bonds (National Debt and Local Debt)

In 2013, the National Audit Office reviewed the local government debt together with the national debt for the first time; in 2015, the Ministry of Finance incorporated the local government debt in the same balance sheet with the national debt, the two

together recorded and reflected as “government debt”. As an important component of aggregate demand, local government debt may have spillover effects on regional economic, social development and macro-financial stability, thus weakening the macroeconomic adjustment ability of the central government. Therefore, it is necessary to further strengthen the coordination between local government debt and national debt policy. The government debt (national debt and local government debt) should be managed uniformly with the concept of public debt, and the impact of public debt issuance and repayment on government investment, private investment, macro aggregate demand, monetary policy and social capital should be assessed. The scale, structure and risk management of national debt issuance and new local government debt should be reasonably determined by comprehensively considering the government debt service rate and debt service ability control.

### 3.3.3. Accelerating the Reform of Budget and Government Accounting System

Measures should be taken to speed up the improvement of government accounting system, especially the establishment and improvement of government contingent and implicit debt information quantification and disclosure regulations. Efforts can be made to bring guarantee cost and risk into debt supervision. Revisions of relevant laws can be made to include the contingent and implicit debt cost into the debt limit framework, considered the same as the direct debt cost, so as to comprehensively reflect the real cost, optimize the government debt structure, and guide local governments to rectify the off-budget borrowing.

Efforts can be made to separate the general public budget and capital budget of the government, clearly measure the operation cost and investment cost of the local government, and objectively evaluate the administrative efficiency and investment behavior of the government. The preparation of the government’s balance sheet should be accelerated to make a comprehensive survey of local assets, liabilities and solvency. The construction of risk early-warning system should be strengthened to further promote the openness and transparency of government financial information, fully disclose the government’s solvency and risk information, and strengthen market constraints.

### 3.3.4. Effectively Strengthening the Supervision and Responsibility of the Provincial Government for the Local Debts

The provincial government’s responsibility to manage and control the debts of governments at and below the provincial level should be strengthened. The central government reserves the right to supervise and examine local debts. The audit and fiscal departments track and supervise the risk points and high-risk areas, and the review results can be used as indicators to assess the performance of provincial

government debt management. At the same time, the local debt risk accountability mechanism should be further improved, so that the evaluation can be operated, rewards and punishments can be implemented. Punishments should be linked to local officials, the civil servant system and the interests of residents.

### 3.3.5. Effectively Strengthening the Tracking and Evaluation of the Whole Process of Government Investment

Good economic and social benefits are the key to the sustainability of the project and its debt. Through strengthening the whole process tracking of project pre-screening, in-process supervision and post evaluation, the government's investment performance will be improved, and the project evaluation (including debt risk) will be closely linked with the performance of decision-making officials, so as to truly fulfill the responsibility and prevent new risks.

## 3.4. *Establishing a Long-Term Institutional Framework to Prevent Local Government Debt Risk*

### 3.4.1. Exploring the Economic Transformation to a Low Debt Density Growth Mode

Efforts should be made to deepen market-oriented reform and rationally define the functions of the market and the government, the central government and local governments. While there are certain things the government should do, there are certain things the government should avoid doing. The vitality of private economy will be stimulated, and the decisive role of market in resource allocation will be given full play to by encouraging innovation, promoting new technology revolution, cultivating market forces. By effectively promoting the transformation of government functions, and strengthening government public functions, the economic growth mode that relies heavily on government investment will be gradually broken. Further measures should be taken to boost domestic consumption, promote supply-side reforms in healthcare, pension and education, tap, nurture and rely on increasingly domestic demand markets, reduce the deep dependence of the macro economy on real estate and other industries, and explore the transformation of the economy to a low debt density growth model.

### 3.4.2. Reconstructing and Perfecting the Incentive and Restraint Framework of Local Government

As an important participant and contributor of China's economic development, the initiative of local government innovation is very important. After breaking the GDP-oriented and evaluation criteria, there is still a lack of clear signal and quantifiable

guidance for local government evaluation and incentive. In the long run, there is the need for a comprehensive assessment and evaluation mechanism for high-quality development, which pays attention to the balanced development of economy, society, environment and humanity, including a good business environment, open, transparent and efficient public governance, high-quality public services, excellent environment, etc., prevents political performance projects and vanity projects under the guidance of GDP, and establishes a comprehensive and sustainable development concept.

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