Economics

China: Fiscal reforms to accelerate (2)

DBS Group Research

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- **Prompted by huge local government debts and inefficient investments, the Chinese government is allowing local governments to issue bonds and is encouraging public-private-partnership (PPP)**
- **More efficiency improvements could be achieved if the market is allowed to play a greater role**
- **Challenges in conducting fiscal reforms are mainly institutional**

The current tax sharing system, which was established in 1994, resulted in fiscal deficits for many local governments. While national revenues are almost equally divided between central and local governments, the latter are responsible for more than 80% of national government expenditures.

Up until 2015, local governments had limited autonomy to derive needed revenues, for example, by introducing new taxes or by issuing bonds. Instead, they make up for shortfalls through requesting transfer payments from the central government, selling land and borrowing from banks. These practices have created problems ranging from waste of resources through transfers, unfair land expropriation and associated over-investment in property, as well as large piles of opaque debts raised from local government financing vehicles. This debt buildup has prevented the use of more aggressive fiscal policy to arrest the economy's slide.

Faced with this, the Chinese government has embraced new strategies to fund public spending since the beginning of this year. These include allowing local governments to issue bonds and promoting public-private-partnership (PPP).

Strategy one - Local government bond issuance

For twenty years, local governments have been banned from issuing bonds. They are now facing a slew of challenges ranging from large debt accumulation, slower revenues from land sales and a prolonged economic slowdown. In a bid to increase their sources of funding in a sustainable manner, China's Ministry of Finance (MoF) allowed 10 local governments, including Beijing, Shanghai and Guangdong, to be included in a pilot scheme to issue bonds in mid-2014. It was only in March 2015 when MoF announced rules governing the issuance of CNY 500bn worth of general local government bonds [1]. Rules governing the issuance of CNY 100bn worth of special government bonds [2] were announced in April.

Government-directed debt swaps amount to CNY 2trn

Government-directed debt swap programs initiated in recent months quickened the issuance of local government bonds. In March 2015, MoF permitted local authorities to convert as much as CNY 1trn of high-yielding debt (out of CNY 1.86trn of estimated debts falling due this year) into lower-yielding municipal bonds. In June, a further CNY 1trn debt swap was initiated.

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Even though the exercise was government-directed, getting investors interested in refinancing these debts was an uneasy feat. A Jiangsu provincial bond auction set for April was delayed for a month after issuers failed to agree on a price with banks. The deal was finally settled on a yield of 3.41% for 10Y bonds, which was only 3bps higher than sovereign bond yields [3].

Yet, such low yields are achievable only because: 1) the government capped yields at no more than 30% above sovereign bond yields; 2) these debts come with explicit government guarantees; and 3) banks could use these bonds as collateral for medium term PBoC loans. Without such government support, yields are likely to be much higher. To compare, yields on existing high-yield local government debt are about 7%.

The conditions for issuing new local government debt (for purposes other than refinancing) are even more challenging. First and foremost, demand for this relatively new – and possibly risky – asset class may be limited. Many local governments are already heavily indebted, making it difficult to raise new funds at low interest rates. Besides, the debts may not come with explicit guarantees, and it is uncertain if these debts would be accepted as collateral for PBoC loans. The variation in yields would be much greater if the process was truly market-driven. Meanwhile, supporting mechanisms, such as a credible and transparent bond rating system, and adequate investor protection laws would take a while to establish.

State-directed issues vs. market-directed issues

The scale of market-directed debt is much smaller than those debts issued through government-directed debt swaps

It is important to distinguish between local government debt issued under the state-directed debt swap program (CNY 2trn) and market-directed debt issues (CNY 600bn allowed this year). Only truly market-driven issues can achieve the intended impacts of fiscal structural reform. Market-directed issuance – where the price is fully determined by the market and issuers are fully accountable to honoring payments – could help reinforce local governments' financial discipline and lower future debt accumulation. To secure cheap funding, they would be forced to make prudent investment decisions, keep risks in check and be transparent about their financial situation. In light of the challenges, actual issuances of market-driven local government debt may fall under the CNY 600bn quota set by MoF. State-directed refinancing debt dominates the market for now.

Strategy two – Promoting public-private-partnership (PPP)

In a public-private-partnership, the government and private companies engage in long-term cooperation in infrastructure or public services. In most cases, PPP projects are co-funded by both parties, operated by private companies and supervised by local governments. PPP has existed in China since the 1980s, but only took a minor role in public finance.

Lately, the central government – in particular, the MoF – has been championing this model. Since October 2014, MoF has issued at least 10 public notices supporting the PPP initiative. Local governments were quick to respond. A nationwide PPP project catalog, grouped by provinces, was made available on the government's website on 25 May 2015.

PPP decreases the government's financial outlays and spreads risks between the government and private companies

The promotion of PPP is timely as China is confronted with mounting local government debts and a need to fund urbanization projects. In a PPP model, the public and private sectors are jointly responsible for project funding – percentage of contribution differ case-by-case – and private companies may seek financing from commercial banks. The governments' key ongoing financial outlay is limited to paying operating subsidies to the private partner and rewarding the private partner based on project performance. As such, PPP greatly decreases the government's initial financial outlays and spreads risks between governments and private companies.

PPP may be used to finance projects along the "One Belt, One Road"

Additionally, to support the Chinese government's foreign policy objectives, PPP may be used to finance projects along the "One Belt, One Road", as well as other Asian infrastructure projects. According to the Asian Development Bank (ADB), around USD 8trn in investment will be needed in the Asia-Pacific region between 2010 and 2020 to improve infrastructure. However, the ADB is able to provide only about USD 10bn annually. There is immense potential for private Chinese enterprises to help fill this infrastructure gap, in collaboration with the Chinese government.

Besides the funding objective, private companies are often in a better position to provide expertise on localized projects. They may have already established a customer base and accumulated expertise in their field. In the most common form of PPP, private companies are required to design, build, and operate the project. Efficiency is likely to be higher than if the government owned and operated it.

PPP could also improve governmental efficiency by freeing up resources (including financial and human resources) to concentrate on government-specific tasks such as improving the regulatory framework and formulating fiscal policy. This creates a win-win-win situation for private enterprises, governments and citizens.

Institutional challenges remain

It has been more than three decades since PPP's inception in China, but many institutional challenges remain. An inadequate legal environment, frequent changes to regulations and incongruent central and local government statutes hinder the PPP's development.

Under this institutional background, private investors are sometimes unconvinced that their interests would be safeguarded throughout the length of the partnership. Overhauling the legal environment is easier said than done, as changes in laws and regulations will almost certainly upset certain interest groups.

It is difficult to draw the line between the state and the market

Another key challenge – common to both PPP and local government debt issuance – is drawing the line between the state and the market. Both initiatives infuse market elements into the realm of public finance, but there is a tendency for the government to dominate the scene in a planned-economy.

Too much government intervention could smother efficiency improvements and deter private investors. A guiding principle is that the market should have free discretion to make commercial decisions.

In the case of PPP, private companies should be given leeway to operate projects with minimum government intervention. In the case of local government debts, truly market-directed debt issues could rationalize governments' investment decisions and improve returns to investment, and so should be encouraged.

Meanwhile, the government's key role would be to nurture a favorable institutional and administrative environment – one that safeguards investors' interests and that clearly delineates the role of the government and the market.

Notes

[1] General government bonds are accounted for in public finance budgeting and must be used to minimize fiscal deficits

[2] Special government bonds are accounted for in governmental funds budgeting, mainly to raise funds for public infrastructure projects

[3] Average ten-year sovereign bond yields in the five trading days prior to the auction

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