Local Government Debt Governance in China in the Past 70 Years: Review and Prospect

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This paper gives an overview of local government debt governance in China in the past 70 years and looks ahead to its strategic prospect in the new era based on a theoretical analysis of debt characteristics in the transition period. For this purpose, we divide the past 70 years into five stages: planned regulation, exploration, wide fluctuations, pilot expansion, and comprehensive transformation, which is a prudent trade-off process between "incentive" and "control" objectives to deal with the strategic financing game of local governments and striving to make debt governance regulated, transparent, and institutionalized. With the historic changes in social and economic development concepts in the new era, the debt governance mode needs to shift from the conventional GDP-based quantitative governance to performance governance which is oriented towards long-term benefits, with a focus on improving the quality and efficiency of debt financing. Guided by the new development concepts, debt governance in the new era can continue to unleash reform dividends and promote strategic adjustments at the institutional, structural, mode, and technical levels in an orderly manner, so as to lay a solid foundation for ensuring the security of fiscal operations and the sustainability of local government debt financing.
Keywords: local government, debt governance mode, debt financing

1. Introduction

In 2015, China lifted control over local government debt financing institutionally. This "ice-breaking" move signifies that after the provision on "balance of payments with no deficit" in the 1994 *Budget Law* had been in effect for 21 years,[1] the "front door" for local governments to make up for a budget deficit by issuing bonds has been officially opened, while the "back door" for expanding off-balance-sheet debts through local government financing vehicles (LGFVs) has been closed, ushering in a new era of regulated, transparent, and institutionalized debt governance. The transformation of

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[1] *Budget Law of the People's Republic of China*, adopted at the second session of the National People's Congress on March 22, 1994.

the local government debt governance mode is in line with the functional positioning of finance as the "foundation and important pillar of governance" as stated at the third plenary session of the 18th CPC Central Committee and is a necessary step for modernizing the governance system and governance capability.

The transformation of the debt governance mode is a landmark event for deepening reform leading up to the 70th anniversary of the founding of the People's Republic of China. In the past 70 years, China has upheld and solidified the overall leadership of the Party and given full play to the initiatives of the central and local governments, embarking on a path of decentralized governance with Chinese characteristics that combines fiscal decentralization and political centralization. Within the decentralized governance framework with Chinese characteristics, China has continuously explored its own mode of local government debt governance. On the one hand, through fiscal decentralization, local governments are encouraged to expand financing channels and vigorously drive economic development; on the other hand, local government debt growth is kept under control through discretionary administrative authority to prevent excessive debt from threatening financial security. In the past 70 years, local governments have actively engaged in "promoting economic development" through various debt financing channels and accumulated multitudinous public assets that could potentially deliver medium and long-term benefits, playing a historic role in helping the country create an economic miracle (Li and Zhang, 2015). However, there is no denying that local government debt financing has long been outside budget supervision, implying moral hazards associated with soft budget constraints (Gao, 2014). Although the "black swan" triggering a crisis had been out of sight in the phase of high-rate growth, the hidden "grey rhino" risk may come to the surface in areas with weak financial resources as the economy is transitioning to the new normal of medium-to-high speed of growth, posing a severe challenge to governance capability.

This paper tries to give an overview of local government debt governance in the past 70 years and shed light on the following questions. (1) After the founding of the People's Republic of China in 1949, what measures had been taken for local government debt governance in the planned economy period, and were there any lessons to be drawn? (2) After reform and opening-up was launched in 1978, under what circumstances did the central government decide to prohibit local governments from issuing bonds as a way of financing? (3) After the tax-sharing reform was launched in 1994, what governance problems did China encounter at different development stages, and what measures were taken to deal with them? (4) Why could local government debt financing be fully liberalized in 2015 and achieve a comprehensive transformation of the governance mode? We believe that a systematic review of the institutional background and evolution of local government debt governance in the past 70 years will help to reflect on the traditional mode, and map out the strategic blueprint for local government debt governance in the new era.

2. Review of Local Government Debt Governance in the Past 70 Years

The overarching principle of local government debt governance in the past 70 years is to seek a strategic balance between economic incentive and risk control based on the specific situations. Whether in the planned economy period or the market economy phase, China has prompted the transformation of the governance mode in seeking a strategic balance between "incentive" and "control", and this fundamental experience is still of great significance for debt governance in the new era.

2.1. Local Government Debt Governance at the Stage of Planed Regulation (1950—1968)

In 1950, Northeast China, as a heavy industry base, was approved to issue the "Northeast China production and construction bonds" to raise funds for accelerating the recovery and development of local economy. Based on the experience in the issuance of the "people's victory bonds", the Northeast China bonds to some extent helped alleviate the shortage of financial resources on account of the highly centralized fiscal authority and represented a successful exploration in the issuance of bonds by local governments.

To increase the enthusiasm of local governments in raising funds to develop the economy, the State Council granted greater authority to local government over fiscal administration in 1957.[1] In 1958, the State Council adopted the decision to "delegate powers over revenues and expenditures to local governments", and allocated all funds for local capital construction and enterprise working capital to the provinces, municipalities directly under the central government, and autonomous regions.[2] During the Great Leap Forward period, however, various problems arose in the issuance of provincial-level bonds, such as excessively large scales and long term, forced apportionment, and low efficiency. In addition, in the face of the special domestic and international political environments, China suspended the issuance of all kinds of government bonds after paying off domestic and foreign debts in 1968 and had since then remained out of debt, internally or externally, for a long period.

During the planned economy period, a more severe local government debt risk came from bank borrowing. In the fiscal administration system of "centralized control over the revenues and expenditures", local governments acted as the local agencies of the central government, with virtually no independent fiscal power; the central government, as the entrusting party, became the de facto lender of last resort (Zhang, 2011). Especially, during the Great Leap Forward period, because of the malfunction

[1] The State Council. *Regulations on Improving the Fiscal Administration System*, November 8, 1957.

[2] The State Council. *Regulations on Further the Fiscal Administration System and Banking Credit Management System,* September 24, 1958.

of the national credit management system and financial supervision mechanism, local governments at all levels acquired enormous excess loans from banks, credit-supported projects generally faced problems such as repeated construction and low efficiency, and local investment enterprises were beset by debts, losses, and capital construction arrears. These "off-balance-sheet debt" accumulated from investment losses of local governments ultimately had to be repaid by central government. Therefore, special funds from the central finance were injected into state-owned banks to write off the debts in a bid to restore production and construction (Zhao, 2002).[1]

2.2. Local Government Debt Governance at the Stage of Exploration (1978—2007)

In 1980, China implemented the fiscal administrative system of "eating from different pots"[2] and expanded the fiscal power of local governments by "dividing central revenues and expenditures and allowing local governments at different levels to arrange revenues and expenditures as necessary". With the increase in disposable financial resources, investment enthusiasm ran high at the local level, and many local governments applied to the central government for approval to issue bonds. However, given that municipal bonds may expand the overheated fixed investment, the General Office of the State Council in 1985 explicitly banned local governments from debt financing.[3] Although prohibited from issuing bonds directly at the early stage of reform and opening-up, local governments resorted to off-balance-sheet financing methods such as policy-oriented loans, commercial loans, and inter-governmental loans. As a whole, the local government debt risk was controllable in this period given the relatively standard procedures and small scale of debt.

After the tax-sharing reform was launched in 1994, local governments began to establish urban construction investment companies to issue urban investment bonds to meet the demand for infrastructure investment and alleviate the severe shortage of construction funds within budget. Therefore, the tax-sharing reform marked that the business scope of locally owned investment companies had been extended from "investment" to "financing". Before issuing bonds, urban construction investment companies must apply to the State Development Planning Commission, People's Bank of China, China Securities Regulatory Commission (CBRC), and other government departments for approval and meet stringent requirements. As a result, the funds raised from urban construction bonds were still unable to meet the investment needs of local governments (especially basic-level governments).

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[1] For example, in 1962, the central government earmarked RMB 2 billion to China Construction Bank to clean up the debts that construction units owed to production enterprises.

[2] *Notice of the State Council on Implementing the Fiscal Administration System of Separate Revenues and Expenditures Between Central and Local Levels* (1980).

[3] General Office of the State Council. *Notice on Suspending the Issuance of Local Government Bonds*, September 9, 1985.

In 1998, China for the first time implemented a proactive fiscal policy aimed at closing funding gap by issuing an additional 100 billion RMB in treasury bonds to "expand domestic demand and ensure growth" and lending part of the proceeds from bond issues to provincial-level governments to support their economic and social development.[1] In practice, however, this arrangement was equivalent to the central government issuing bonds for the use of local governments, which was only reflected in the current account without being listed as deficit in central and local budgets, thus softening budget constraints. A lot of projects supported by this type of loans were launched hastily without sufficient demonstration, let alone those redundant projects; loan review and approval was not transparent, and funds were used in a scattered and inefficient way. Therefore, after the provincial regions received the last batch of such loans in 2007, this transitional arrangement was officially scrapped.

2.3. Local Government Debt Governance at the Stage of Wide Fluctuations (2008—2010)

In response to the impact of the 2008 international financial crisis, China again pursued a proactive fiscal policy and launched the "4 trillion RMB investment scheme" to prop up economic growth. From 2009, the Ministry of Finance issued a total of 600 billion RMB in municipal bonds as an agent for three consecutive years to address local financing problems. However, some problems arose in practice. As municipal bonds were issued and repaid by the central government, local governments, financial institutions, and capital markets, believing the central government would provide endorsements, together brought down the bond risk premium, resulting in problems such as excessive borrowing and overdraft by high-risk areas regardless of solvency.

In 2009, the People's Bank of China and the CBRC issued the opinions on adjusting the credit structure, encouraging local governments at all levels to establish LGFVs to support the central government's treasury bond programs.[2] However, this incentive policy triggered a surge in off-balance-sheet debts. According to the audit results of Announcement No.35 (2011) issued by the National Audit Office, outstanding local government debts in China soared 61.9% in 2009, 13 percentage points higher than in 1998 when a proactive fiscal policy was adopted, hitting a new record. By the end of 2010, 79.01% of outstanding local government debts came from bank loans, indicating a notable shift in local governments' off-balance-sheet financing mode from issuing urban construction investment bonds at the early stage of the tax-sharing reform to

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[1] Ministry of Finance. *Notice on Releasing the Administrative Measures for Treasure Bonds On-lending to Local Governments* (1998).

[2] People's Bank of China and CBRC. *Guiding Opinions on Further Strengthening Credit Structure Adjustment to Promote Stable and Fast Economic Development* (2009).

directly applying for bank loans through their LGFVs. For local officials, off-balance-sheet debt could expand financing channels and bring credit to them in performance appraisals, and when their term ended, the repayment responsibility could be shirked to their successors. From this perspective, the abnormal spike in local government debt in 2009 implied the fierce promotion game between local officials, and the scramble for debt driven by performance competition became a notable feature of the expansion of off-balance-sheet debt after the tax-sharing reform.

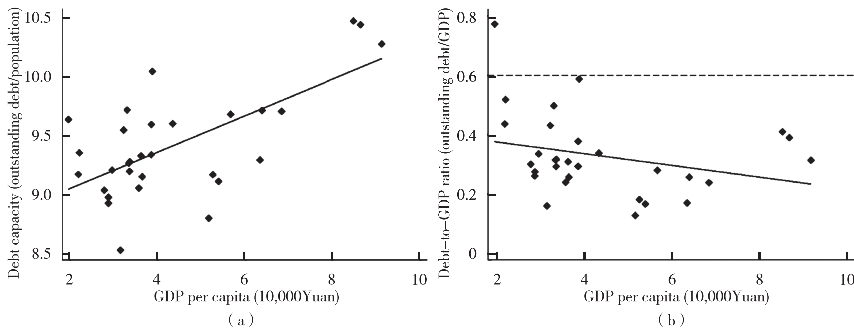

Figure 1. Debt Capacity and Debt-to-GDP Ratio by Province, 2012

Source: Wind Financial Terminal (WFT) and province-specific government debt audit announcements. The vertical axis in Figure 1 (a) indicates the natural log value of debt capacity (Yuan/person); the dotted line in Figure 1 (b) is the European Union's "warning line" of 60%.

Based on the province-specific audit data in 2012, the results of the debt financing from the perspective of "debt-bearing capacity" and "debt-to-GDP ratio" are shown in Figure 1. While Figure 1 (a) shows that debt per capita is positively correlated with economic size, Figure 1 (b) reflects an interesting phenomenon that the debt-to-GDP ratio and economic size go in different directions, that is, the economically underdeveloped provincial regions further away from the eastern coastal areas register a higher debt-to-GDP ratio and face more serious debt risk. This is because those regions, driven by stronger desires to develop the economy, can get access to credit support from local financial institutions by virtue of implicit contract, wishing to seeking help from the central government and transferring the repayment pressure to other regions through the "capital pool" when a risk event occurs.

To prevent moral hazards associated with the debt of LGFVs, the State Council issued a document urging all local government to sort through and regulate LGFVs, strengthen financing management over LGFVs and credit management over banking institutions, and properly handle the debt stock.[1] This came only one year after

[1] The State Council. *Circular on Several Issues on Strengthening the Management of Local Government Financing Platforms* (2010). In the planned economy period, administrative measures such as strengthening credit management were also taken to prevent and control off-balance-sheet risks caused by excessive investments and bank loans of local governments (Fan, 2006).

the People's Bank of China and CSRC jointly issued the opinions on adjusting the credit structure. The sharp tightening of policy caused the growth rate of local government debt to fall to a record low of 18.9% in 2010, so in less than two years, local government debt governance underwent a policy cycle from "expansion" to "tightening". This round of regulation and control demonstrates that a country's counter-cyclical measures should strike a balance between the objectives of "incentive" and "control"; otherwise, the interactions and game between micro-level entities may bring about unexpected negative impacts, resulting in a passive shift of subsequent policies to hedge against the relevant risks.

2.4. Local Government Debt Governance at the Stage of Pilot Expansion (2011—2014)

Given that off-balance-sheet debt borrowed via LGFVs involves moral hazards driven by the pursuit for political achievements, China carried out the pilot program on debt financing in selected regions from 2011, allowing local governments to issue bonds in the market economy. What has attracted attention from the academic community is that as more and more regions were added to the list, structural evolution involving explicit and implicit off-balance-sheet debt occurred. The mechanism behind this needs to be perceived in conjunction with the institutional background of the pilot expansion strategy.

2.4.1. Expansion of the Pilot On-Balance-Sheet Debt Program

In 2011, China gave a green light to the governments of Shanghai, Zhejiang, Guangdong, and Shenzhen to issue bonds on a pilot basis, so as to provide preliminary experiences for the full liberalization of local government debt issuance.[1] The four eastern coastal regions were selected on account of their strong economic and financial foundations and solvency, capable of accumulating bond regulation experiences on the premise of properly guiding market expectations to provide inspirational models for the full liberalization of local government debt issuance. However, to guard against regional risks, the central government restricted the total scale and term structure of bonds. In 2013, the pilot program was extended to Jiangsu and Shandong, two major provinces, increasing the total number of the pilot regions to nearly half of the eastern provinces and municipalities.[2] As shown in Table 1, all the pilot provinces and municipalities followed the same model, that is, local governments issued bonds and the Ministry of Finance handled the principal and interest payment for them. The

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[1] Ministry of Finance. *Notice on Issuing the Measures for the Pilot Program on Local Government Debt 2011*.

[2] Ministry of Finance. *Notice on Issuing the Measures for the Pilot Program on Local Government Debt 2013*.

intervention of the central government in the principal and interest payment to some extent made municipal bonds “quasi-treasury bonds”, leading market entities to believe that if local governments were unable to pay back, the central finance may step in as “lender of last resort”. Therefore, although the Ministry of Finance issued a document in 2013 encouraging the establishment of the credit rating system, it was still difficult for rating agencies to reasonably gauge the risk premium of municipal bonds, making some ratings overly high.

Table 1. Comparison in Local Government Debt Policies, 2011—2014

Year	Bond issue mode	Pilot areas	Debt service guarantee mechanism	Scale	Term structure	Pricing method
2011	Local government issued bonds and the Ministry of Finance handled repayment	4 eastern provinces/ municipalities	Special account of the central government	Quota management	3Y: 50%; 5Y: 50%	Single interest rate
2012	Ditto	4 eastern provinces/ municipalities	Ditto	Ditto	3Y/5Y/7Y: <50%	Single interest rate
2013	Ditto	6 eastern provinces/ municipalities	Ditto	Ditto	3Y/5Y/7Y: <50%	Single interest rate
2014	Ditto	10 provinces/ municipalities	Established by local governments	Ditto	3Y:5Y:7Y: 4:3:3	Single interest rate

Source: Documents issued by the Ministry of Finance (2011, 2012, 2013 and 2014).

In response to the institutional defects of the above bond issue mode, the pilot program was further extended to 10 provinces and municipalities in 2014, covering East China, Central China, and West China.[1] Different from the previous bond issuance mode, they organized underwriting and issuance, interest payment, and principal repayment by themselves, while the central government no longer intervened in the specific process. Limiting the scale and term structure could help control risks, but it ignored the differences in solvency between regions, making it difficult to distinguish the risk premium in different regions through interest spreads and even resulting in an inverted yield curve where the interest rate of municipal bonds was lower than that of treasury bonds with the same term (Wang, 2018). In this sense, the new bond issuance mode was still different from the market-oriented mode.

[1] Ministry of Finance. *Notice on Issuing the Measures for the Pilot Program on Local Government Debt 2014*.

2.4.2. Structural Substitution of New Off-Balance-Sheet Debt

Another problem that arose at the stage of pilot expansion was the co-existence of explicit and implicit off-balance-sheet debt. After the State Council tightened credit management over financial institutions in 2010, loans from financial institutions to local LGFVs should be directly benchmarked against projects and conform to macro-control policies, development plans, industrial policies, and industry thresholds, effectively containing the disordered credit expansion of LGFVs. However, audit results show that local governments invented financing methods of shadow banking such as entrusted loans, trust financing, and financial leasing, which gives rise to the structural substitution of "bank loans" with "shadow banking".[1] Compared with bank loans, financing channels of shadow banking are more hidden, making it more difficult to clarify the debtors, accurately determine the actual scale of debt, and identify the debt repayment responsibility of the government and enterprises.

Given that local LGFVs were used by local governments as a tool to play off-balance-sheet strategic games with the central government and weaken disciplinary constraints, the State Council issued a document in 2014 vowing to completely strip the government financing function away from LGFVs, transform LGFVs into market-oriented entities, and strengthen statistical analysis and risk prevention and control of off-balance-sheet debt of local governments. This document signifies that the "back door" of local government debt financing would be officially closed and replaced by the standardized and transparent mode of on-balance-sheet debt financing, marking the beginning of a new era of modernizing debt governance in an all-round way.

2.5. Local Government Debt Governance at the Stage of Comprehensive Transformation (from 2015)

In 2015, the central government fully lifted control over bond issuance in all provinces and municipalities, realizing the institutional transformation after only four years of policy experimentation. As shown in Figure 2, the framework of local government debt governance at the central level include the National People's Congress, the State Council, the Ministry of Finance, and other highest authorities and administrative organs, and a well-structured institutional system has been formed by introducing relevant policies.

First, the *Budget Law* revised in 2015 by the National People's Congress and the No.43 document issued by the State Council in 2014 provide the basic institutional framework for debt governance in the transition period. The new *Budget Law* requires

[1] *Opinions of the State Council on Strengthening Local Government Debt Management* (2014).

that all local government debts shall be incorporated in budget management in order to control the scale; the State Council empowers provincial-level governments to issue municipal bonds in place of the debt stock included in budget management, so as to slowly release the pressure of debt repayment and reduce the costs. Another important reform measure put forward in the State Council's document is to require that local governments should take responsibility for their debts and the central government will not come to their rescue, sending a signal of "no bailout" within the framework of vertical decentralization. The signal of "no bailout" is aimed at tightening local budget constraints and cracking rigid payments by the central government, and is set to have far-reaching institutional impacts.

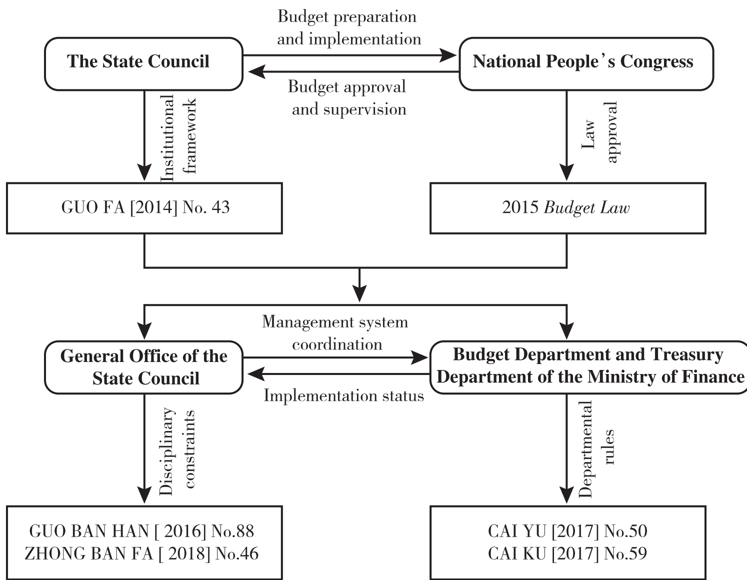

Figure 2. Organizational Framework and Institutional System of Local Government Debt Governance

Second, based on the new *Budget Law* and the institutional framework provided by the State Council's documents, the General Office of the State Council issued guiding opinions on debt governance, with a focus on strengthening financial discipline and controlling moral hazards of debt. In Document No.88 in 2016 issued by the General Office of the State Council and Document No.46 in 2018 by the State Council,[1] the central government explicitly pledged to change the performance appraisal mechanism of local officials, emphasizing that those who allowed excessive borrowing, misused debts, and shrugged off responsibility for debts should be held accountable for their whole life. This indicates that the long-time local official performance appraisal

[1] *Contingency Plan Against Local Government Debt Risks* (2016); *Opinions of the State Council on Guarding Against Implicit Local Government Debt Risks* (2018).

mechanism "based on GDP" would gradually give way to a new performance appraisal mechanism that highlights the development concept of "improving quality and efficiency". The document issued by the General Office of the State Council further stresses that in case of a debt repayment crisis, local governments should take responsibility for debt repayment on their own by collecting taxes, reducing expenditures, and even liquidizing assets.

Finally, the Budget Department and the Treasury Department of the Ministry of Finance introduced specific rules and administrative measures and followed the guiding opinions of the State Council to urge local governments to set local regulations. For example, the Budget Department's Document No.50 in 2017 put forward specific requirements for regulating local government debt financing, and the Treasury Department's Document No.59 in 2017 specified the issuance mode, scale and progress of municipal bonds.[1] After being informed of the implementation status of various regions by the Ministry of Finance, the General Office of the State Council may coordinate with the Ministry of Finance and issue new guiding opinion to manage and control risks as necessary.

3. Evolvement Characteristics of Debt in the Period of Debt Governance Mode Transformation: Observations and Enlightenment

In the new era of socialism with Chinese characteristics, the concepts of economic and social development have undergone profound changes. Specifically, in terms of economic development, China no longer takes "GDP as the yardstick" but instead emphasizes the quality and efficiency of growth; as for social development, it highlights the "people-oriented" values and recognizes the principal contradiction between unbalanced and inadequate development and the people's ever-growing needs for a better life" (Xi, 2017). Such changes in economic situations and development concepts, coupled with the new-type performance standard that no longer takes GDP as the sole yardstick, provide the necessary institutional background for examining the evolvement characteristics of debt in the period of governance mode transformation.

3.1. Evolvement Characteristics of Debt in the Transition Period

In view of the reform path of local government debt governance since the launch of reform and opening-up and the changes in economic situations and development concepts in the new era, local government debt in the transition period will show new

[1] *Notice on Further Regulating Local Government Debt Financing* (2017); *Notice on Ensuring Good Work in Municipal Bond Issuance in 2017.*

characteristics in terms of type, debt repayment pressure, risk bearers, and allocation of rights and responsibilities, requiring close attention from the decision-makers and immediate efforts to adjust the governance strategy.

3.1.1. Typological Characteristics: Clarified Debt Ownership

After the tax-sharing reform, local government debts mainly accumulate off-balance-sheet debt via LGFVs, leading to the overlapping between government leverage and enterprise leverage and the mismatch between debt repayment pressure and payback period, making it difficult to clearly define the risk responsibility in a system of soft constraints similar to a “big pot” (Liu, 2004). The ambiguity of debt ownership is reflected in the fact that before control over municipal bonds was lifted in 2015, government borrowings via local LGFVs were defined as “local government-related debt” rather than “local government debt” in a strict sense.

Since the comprehensive transformation of the debt governance mode, the central government has taken a range of regulatory measures. Through these measures, the rights and responsibilities of governments, enterprises, and officials have been gradually clarified, so that “local government-related debt” that originated from government audits are replaced with “local government debt”, which is defined as debt that was included in budget management at the end of 2014 and is to be repaid by local governments or debt that was incurred from bond issuance after 2015 and need to be repaid by them on their own (Liu, 2018). With the clarification of debt ownership boundaries, “auditability” and “accountability” will become the important directions of debt governance, urging local governments to make careful arguments and prudent decisions regarding debts, and work to improve quality and efficiency.

3.1.2. Institutional Characteristics: Explicit Repayment Pressure

Since the launch of reform and opening-up, debt repayment pressure, no matter in high-risk or low-risk regions, has been implicit in the institutional environment of soft budget constraints, with no observable debt crisis exposed. With LGFVs as the intermediary, local governments and financial institutions regard revenue from land leasing as a guarantee for debt rating. Even if land leasing revenue is insufficient to repay maturing debts, local governments can still obtain additional loans by virtue of implicit contract with financial institutions, transferring the debt repayment pressure to enterprises and banks.

After the transformation of the debt governance mode, off-balance-sheet debt owed by local governments via LGFVs has been gradually included in the balance sheet, subject to standard budget management at the provincial level; the central government emphasizes the “no bailout” principle in case of a local government debt crisis, whose costs would

be borne by local governments themselves. These institutional measures will break the implicit cycle chain of debt repayment pressure and make the debt repayment pressure of local governments manifest, causing risks to be first revealed in some economically underdeveloped areas with financial deficiencies. On the premise of safeguarding the bottom line of regional systematic risk, allowing risks to be exposed in certain areas can help filter inefficient financing, alleviate the distortion caused by the pursuit of political accomplishments, and conform to the development concepts for the new era.

3.1.3. Risk Characteristics: Dispersed Micro-Level Entities

Driven by the traditional performance appraisal mechanism, local governments play a strategic game against the central government, mainly leveraging LGFVs to expand financing channels and accumulate off-balance-sheet debts. As risks are concentrated in local LGFVs, the central government can draw up macro-control measures for LGFVs to seek a balance between the objectives of "incentive" and "control" in the debt governance strategy.

Since the transformation of the governance mode, financial discipline and constraints have been tightened, and LGFVs' behaviors such as implicit endorsement, non-compliant credit granting, and ineffective risk control have been incorporated into the accountability mechanism, which greatly restricts the leeway of local government debt financing. However, audits find that in terms of off-balance-sheet debts, local governments have shifted from relying on LGFVs to break through financial discipline constraints to taking a project accounting approach involving more dispersed entities in the transition period, adding difficulty to risk supervision. Some financing methods take the form of equity investments, which, however, are transformed into debtor and creditor relationships with fixed income through the design of transaction structures and essentially become debt investments that allow local governments to expand off-balance-sheet debts, posing a threat to financial security.

3.1.4. Decentralization Characteristics: Diversified Leverage Transfer

Looking at the allocation of rights and responsibilities in local government debt financing from the perspective of decentralization, we can see that in the traditional governance mode, debt leverage only moved down at a single dimension below the provincial level. In the decentralized governance mode of "centralizing fiscal power and delegating administrative power", the responsibility for debt financing moves downward; the further the local governments are from the central government, the bigger the investment and financing gap for economic development, and the stronger their debt financing impulse. As a result, the implicit liquidity risk underlying high leverage may have accumulated at the basic level for a long time, on the verge of

breaking out in some high-risk regions.

After the comprehensive transformation of the debt governance mode, the central government has promoted the debt swap strategy at the provincial level, making the debt leverage presenting a more diversified tranifer trend. On the one hand, with the full liberalization of bond issuance in all provincial regions and the swap and recovery of debts at the municipal and county levels, the stock leverage moves upward to the provincial level, so as to realize full-caliber budget management of explicit debts and prevent and control on-balance-sheet debt risk in a coordinated manner. On the other hand, before the local tax system is put in place, local governments will still face the mismatch between financial strength and administrative power; Governments, especially basic-level governments, still have the impulse to expand implicit debts in disguised ways to make up the difference between revenue and expenditure, leaving room for the incremental leverage to move down. This kind of risk cannot be ignored.

3.2. Strategic Enlightenment

Based on the theoretical analysis of the evolvement characteristics of debt in the transition period, a close look at their logical relationships finds that these four types of evolvement characteristics are closely interrelated. It is precisely because the ownership boundaries of local government debt between governments, enterprises, and banks are gradually clarified, making it impossible to continue to eat from the "big pot of risk" and pass the buck, that the debt repayment risk may be revealed first in some regions and the areas of weaknesses and distortion of the traditional governance mode can come to light. As the government financing function is stripped from LGFVs and replaced with the bond issuance mode, which is subject to provincial-level quota management, local governments in turn resort to the more implicit and decentralized approach of debt investments under the cover of equity investments to fill the investment and financing gap within the province, diversifying leverage transfer and the allocation of rights and responsibilities.

It can be seen from the analysis of the evolvement characteristics that debt governance in the transition period is a systematic project where a light move in one part may affect the situation as a whole. Therefore, it is necessary to curb the local governments' debt financing impulse in all forms, rectify allocation distortions, and stick to the bottom line of risk management; moreover, a one-size-fits-all approach of rigid control should be avoided to maintain appropriate liquidity and give some leeway in incentive policies in an effort to advance structural adjustment. With the deepening of reform, the strategic choice under the constraints of the above-mentioned diversified objectives will pose a major challenge in decision-making to local government debt governance.

4. Strategic Prospect of Local Government Debt Governance in the New Era

Generally speaking, local government debt governance in the past 70 years is a prudent trade-off process between the two objectives of “incentive” and “control” to deal with the strategic financing game of local governments and making debt governance regulated, transparent, and institutionalized. looking ahead, we think that guided by the new development concepts, strategic adjustments to local government debt governance can be advanced in an orderly manner to unleash reform dividends at the institutional, structural, mode, and technical levels.

First, at the institutional level, to adjust the framework of rights and responsibilities will fundamentally curb local governments’ impulse for off-balance-sheet financing and solidify the foundation for improving the quality and efficiency of debt governance. The State Council proposed lately to “strengthen the fiscal power of the central government” and to align local governments’ administrative power with their expenditure responsibility, which is an important measure to improve the vertical division of rights and responsibilities.[1] With regard to fiscal strength, however, the mismatch between local governments’ fiscal strength and administrative power has remained serious especially since replacing business tax with VAT reform, putting local governments under great institutional pressure to fill the on-balance-sheet gap with off-balance-sheet financing and to undertake the administrative matters entrusted by higher-level governments. To contain local governments’ off-balance-sheet financing impulse, it is necessary to accelerate the construction of the local tax system or appropriately increase the proportion of shared tax revenues that can be retained by local governments, so that they can obtain stable and predictable on-balance-sheet revenues. When their fiscal strength is better aligned with their administrative power, local governments will direct debt financing towards long and mid-term objectives such as strengthening the areas of weakness in local development and providing externality for industrial development, and in this way, the inherent moral hazard associated with debt in the “pressure system” will be reduced accordingly.

Second, at the structural level, guided by the new development concepts, the fields where local governments utilize their debts will be extended from the demand side to the supply side. In the new era, the economy has been transitioning from high-speed growth to high-quality development, and the fields where local government debts are used should be extended from the demand side to the supply side accordingly, that is, more funds should be channeled towards livelihood fields such as education, healthcare, and affordable housing, as well as social undertakings such as energy conservation and emission reduction, agriculture, forestry, and water conservancy,

[1] *Guiding Opinions of the State Council on Promoting the Reform of the Division of Fiscal Power and Expenditure Responsibility Between the Central and Local Governments* (2016).

and ecological progress, so as to foster new drivers of growth and promote the strategic adjustment of industrial structure. The changes in the fields of spending will extend the capital accumulation direction from material capital to broad-sense capital including human capital and ecological capital, reflecting the new people-oriented development concept. Although investments in livelihood fields and social undertakings take a long period before they can generate returns, the repayment period of municipal bonds is longer than that of negotiated loans. Hence, local governments can schedule investments more properly and for the purpose of expanding effective supply and nurturing long and mid-term tax revenue sources. They need to shift the implementation mode of the proactive fiscal policy from driving the demand side to pursuing innovation-driven, coordinated, green, and shared development in the supply side, thereby promoting the virtuous circle of local government debt financing and sustainable economic and social development.

Third, as for governance mode, debt financing efficiency should be improved, and refined as well as project-based governance centering on micro-level entities should be implemented. In the new era, given the more implicit and dispersed risk bearers, qualitative governance on the demand side should be replaced with performance-based governance on the supply side, and the governance mode should be shifted from macro-control to micro-level audit. Specifically, for one thing, project audits can be carried out to prudently examine the shadow value and investment performance of government debts based on micro-level financing metrics, and an exit mechanism directed at low-efficiency projects should be established. For another, responsibility audits can be conducted to replace the GDP-based appraisal mechanism for local officials with a performance-based mechanism so as to reduce the moral hazard that local officials shirk responsibility for debts. The performance-based mechanism can also prevent local officials from being sluggish and neglectful of their duties and will eliminate underperforming officials while providing space of promotion and incentives for those who are diligent and do a good job.

Fourth, with the strategic adjustments in institution, structure, and mode, it is necessary to shift traditional risk-based regulation to "guiding contingency plans" at the technical level and to establish a local government debt risk monitoring and warning mechanism. In the new era, for local governments, the only debt financing channel is to issue bonds in a regulated and transparent manner and accordingly, the debt risk monitoring and warning mechanism can be implemented at the very start for debt monitoring and warning. To do this, a big data monitoring platform covering the five-level administrative framework should be established, so that debt data at the basic level can be reported to the decision makers to help them analyze the warning signals and guide high-risk regions to identify and respond to the risks. To improve the monitoring and warning effects, debt information can be made public step by step, and credit ratings agencies, research institutes, and university think tanks can be organized

to conduct independent assessments and compare their results with the government's monitoring results to help ensure the security of fiscal operations.

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