Morphing from ‘helping hand’ to ‘grabbing hand’ – local government fiscal incentives in the Xi era

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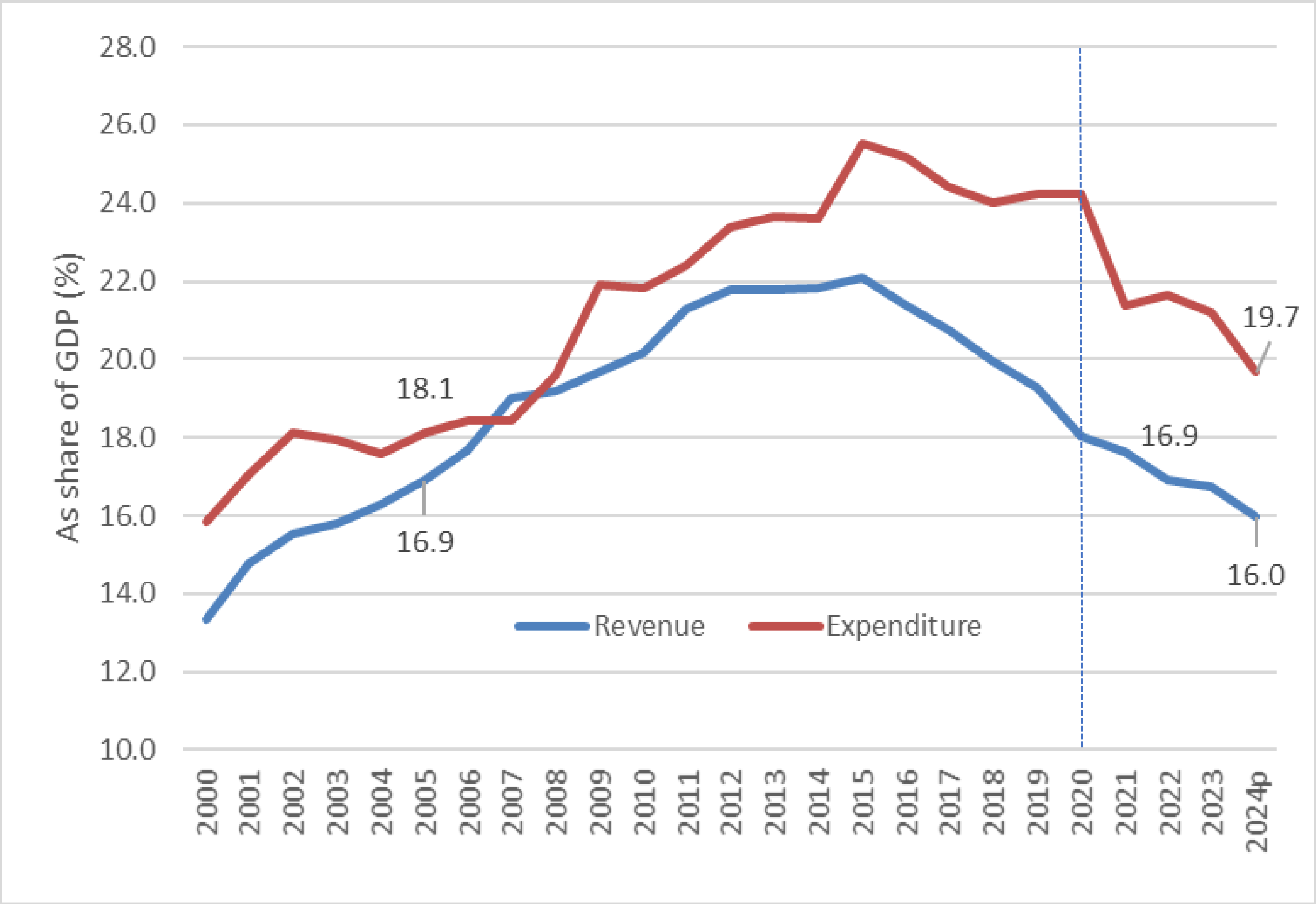
In China, policies are made in Beijing, but largely implemented by local governments

- Local governments provide the vast majority of public services, and account for 85-86% of national budget expenditures
- They also undertake and finance some 80% or more of public investments in infrastructure
- In 2020, they accounted for more than 80% of the RMB10.3 trillion in Government Industrial Guidance Funds (Naughton 2022).
- But their finances have been battered over the past few years, weakening their capacity to fund new initiatives or even meet spending mandates

Three sources of stress on local finance

- The collapse of land revenues that began in 2021 and deepened
- A looming local government debt crisis
- A long-term erosion of the aggregate fiscal position of government

Long-term erosion of the budget



From 2015 revenues have fallen steeply under a strategy of cutting taxes to stimulate economic growth

By 2022 revenues had fallen to the level reached in 2005, before the introduction of social welfare programs such as free compulsory education, basic residents' medical insurance and pension schemes, and minimum income guarantees (低保).

With those programs, expenditures had grown by more than 7% of GDP

From 2020, sharp cuts in expenditure to hold down deficits

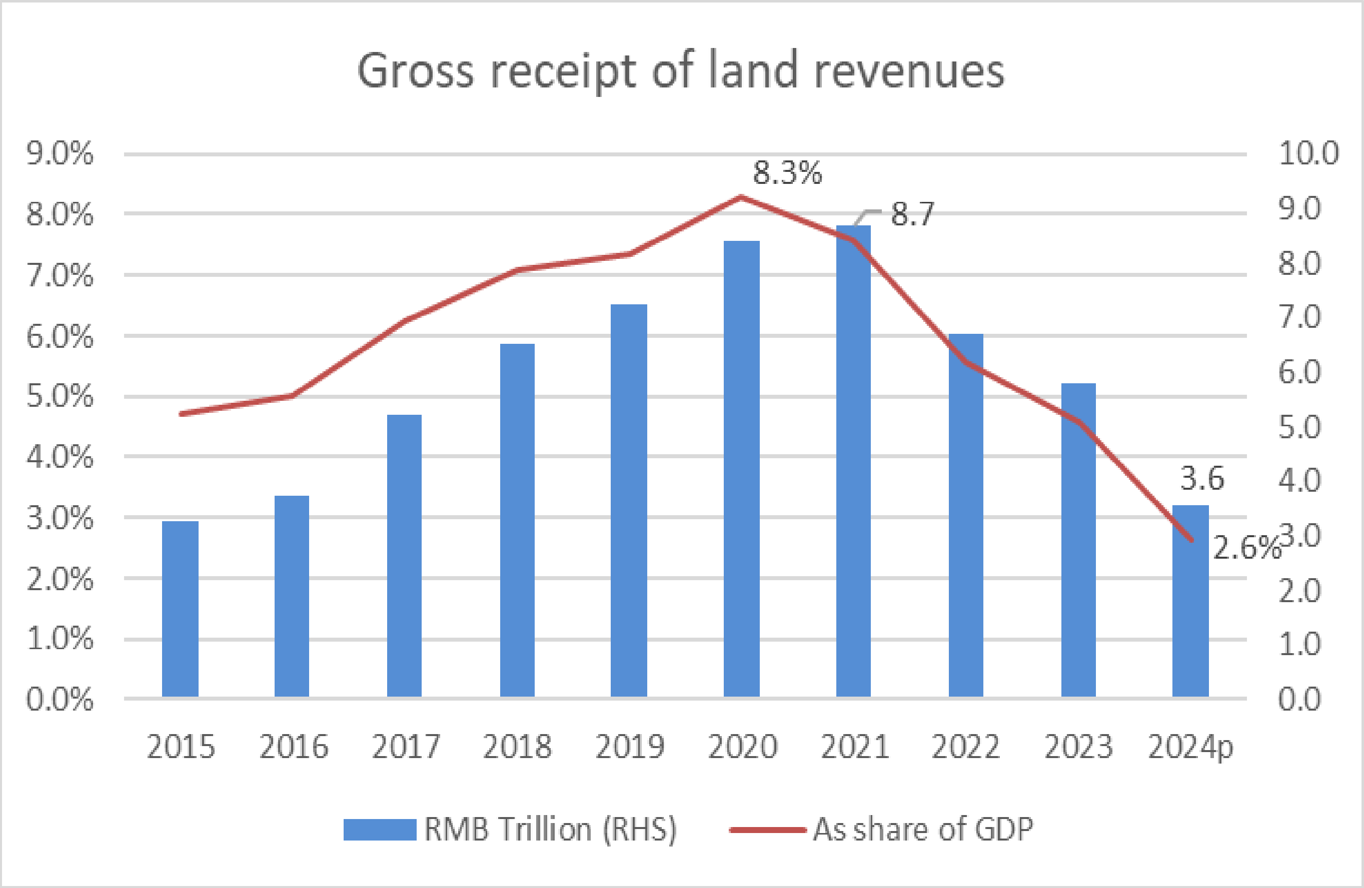
Across-the-board cuts have been imposed in main spending categories

Percent GDP	2015	2017	2019	2020	2021	2022	2023	2024p
General budget expenditure	25.5%	24.4%	24.2%	24.2%	21.4%	21.6%	21.2%	19.7%
Education	3.8%	3.6%	3.5%	3.6%	3.3%	3.3%	3.2%	2.9%
Health	1.7%	1.7%	1.7%	1.9%	1.7%	1.9%	1.7%	1.4%
Environmental protection	0.7%	0.7%	0.7%	0.6%	0.5%	0.4%	0.4%	0.4%
Urban and rural community affairs	2.3%	2.5%	2.5%	2.0%	1.7%	1.6%	1.6%	1.5%
Agriculture, forestry and water conservancy	2.5%	2.3%	2.3%	2.4%	1.9%	1.9%	1.9%	1.8%
Transport and shipping	1.8%	1.3%	1.2%	1.2%	1.0%	1.0%	0.9%	0.8%
Subtotal of listed categories	12.9%	12.1%	12.0%	11.6%	10.0%	10.1%	9.7%	8.8%

A 2022 survey of 521 counties and cities by the Chinese Academy of Fiscal Sciences found most local governments admitting to "leaving a considerable portion of policy mandates unmet" due to funding shortages.

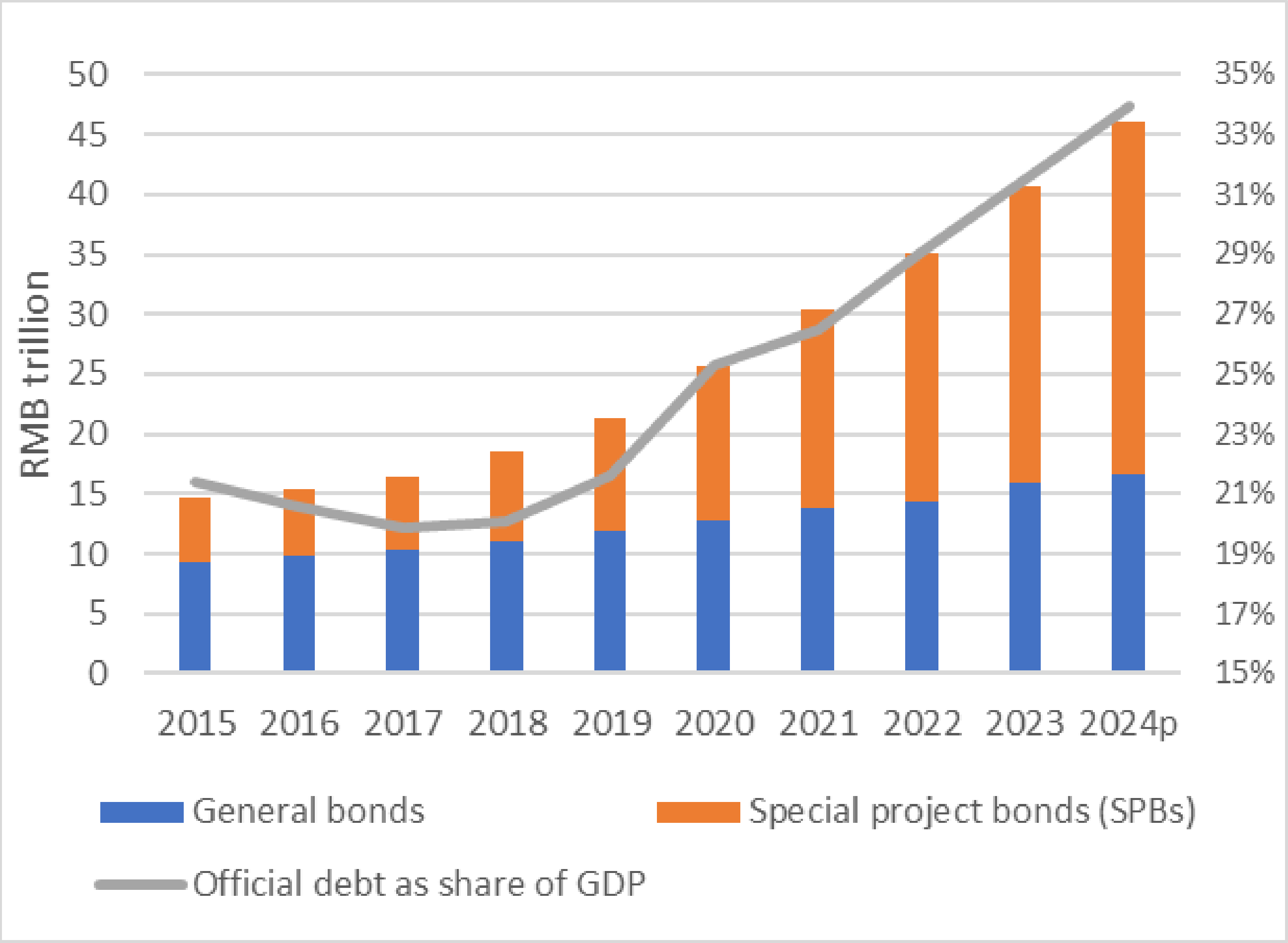
Local governments had grown more dependent on land revenues

- As tax revenue collection weakened and fiscal pressures grew, local governments stepped up land revenue ‘creation’
- The collapse of land revenue has been especially damaging since they are the principal source of funds for capital spending and debt-servicing
- In 2019-2020 land revenues were also tapped to fund 8-9% of spending on public services

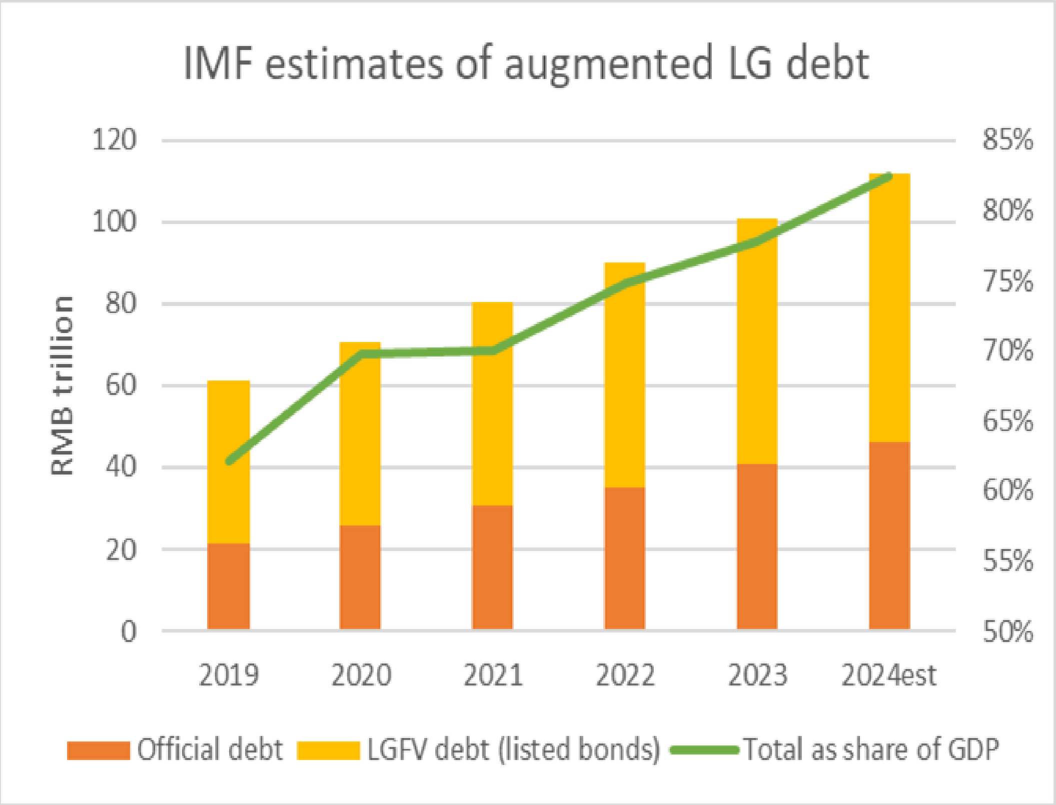


The local government debt problem: starting with on balance sheet, official debt

- Central government has used infrastructure investment for fiscal stimulus – resulting in a steep rise in local government debt since 2020
- Devolving budget deficit to local governments – while keeping 'headline' deficits around 3%, the deficit on Gov Fund Budget has grown to 3.7% in 2024 (budget)



But off-balance sheet debt has also grown alongside the official debt of local governments



This financing structure shows that infrastructure is also the main driver of off-balance sheet debt of LGs

(RMB Billion)	LG infrastructure investment*	Quotas for general bonds	Quotas for SPBs	Funding gap
2016	9,510	780	400	8330
2017	11,200	830	800	9570
2018	11,626	830	1350	9446
2019	12,068	930	2150	8988
2020	12,176	980	3750	7446
2021	12,225	820	3650	7755

* Estimated as 80% of total.

While fiscal incentives remain strong for LGs to promote and support local enterprises, they no longer have capacity

- Instead, cash-starved local governments are increasingly trying to extract resources from businesses and citizens through fines and penalties
- In 2021 Ministry of Public Security issued the “Seven Provisions on Prohibiting Profit-Driven Law Enforcement by Public Security Organs” in attempt to rein in excessive inspections and tax audits
- It seems the famous entrepreneurial energies of local governments are being engaged in “distant-water fishing” expeditions to target businesses in other jurisdictions