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Why China's 2022 Fiscal Stimulus Will Fall Short

By Christine WONG

Data released by China's Ministry of Finance on 16 June 2022 offer a glimpse of the economic damage caused by the spread of the omicron variant and the containment policies adopted since late March. They also point to trouble ahead in the government's plans for reviving the economy.

Fiscal data for May showed some improvement over April, reflecting recovery after easing of the COVID-19 related lockdowns in major cities. Revenues and expenditures in the general budget account rose by 1.6% and 4.5%, respectively, over April. Compared to the monthly average of the first three months of 2022, however, May revenues were still down 40%. Much of the decline was due to the more than RMB500 billion in value-added tax (VAT) credit refunds provided during the month.[1] The decline in spending revealed the economic stress more clearly: May spending was 14% lower than the first quarter monthly average, with local government spending 18% lower. This decline runs counter to the finance ministry's call to frontload spending in the fiscal year and weakens the intended fiscal stimulus.[2] Spending in the first quarter was boosted by revenues carried over from 2021,[3] but this effect had faded by April-May. Year-to-date total spending for the first five months was 10.8% below budget and 9.9% for local governments (Table 1).

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[1] A total of RMB1.34 trillion was refunded during April and May. http://www.mof.gov.cn/zhengwuxinxi/caijingshidian/jjrb/202206/t20220617_3818737.htm, accessed 17 June 2022.

[2] Report on the implementation of the 2021 central and local budgets and the draft 2022 central and local budgets, presented on 5 March 2022 at the Fifth Session of the 13th National People's Congress, 5 March 2022. http://www.mof.gov.cn/zhengwuxinxi/caizhengxinwen/202203/t20220314_3794760.htm, accessed 15 June 2022. Hereafter referred to as the "2022 budget report".

[3] Finance Minister Liu Kun explained in an interview on 5 March 2022 that due to slow spending in 2021, RMB1.27 trillion was rolled over to 2022 on the central government budget alone. http://www.mof.gov.cn/zhengwuxinxi/caizhengxinwen/202203/t202203053792838.htm, accessed 6 March 2022.

TABLE 1 BUDGET IMPLEMENTATION THROUGH MAY 2022

RMB (billion)	2022 budget	2022 (Jan-May)	May only	May compared to April	May compared to avg for Q1	Ytd projected over budget
General Budget						
Revenue	21014	8673.9	1244.6	1.6%	-40%	-0.9%
Central	9488	4053.4	596.3	6.1%	-38%	2.5%
Local	11526	4620.5	648.3	-2.3%	-41%	-3.8%
Expenditure	26663	9905.9	1812.6	4.5%	-14%	-10.8%
Central	3557	1229.1	265.5	-6.3%	17%	-17.1%
Local	23106	8676.8	1547.1	6.6%	-18%	-9.9%
Government Fund Budget						
Revenue	9864	2194.8	438.3	17.7%	-5%	-46.6%
Central	422	146.9	35.9	39.7%	26%	-16.4%
Local	9442	2047.9	402.4	16.1%	-7%	-47.9%
Expenditure	13899	3932.9	784.1	17.0%	-5%	-32.1%
Central	718	162.0	66.4	-5.5%	687%	-45.9%
Local	13181	3770.9	717.7	19.7%	-12%	-31.3%

Source: Ministry of Finance fiscal reports and 2022 budget report.

Figures in the government fund budget, which include land revenues and infrastructure spending, raise further concerns. Year-to-date revenues in May were running 47% behind the pace set in the budget and expenditures were 32% behind. For local governments, the shortfalls were 48% and 31%, respectively. This portends trouble ahead. The government fund budget constitutes one-quarter of the consolidated government budget and one-third of fiscal resources excluding social security funds (Table 2) and is therefore an important component of government spending. Moreover, the underperformance is largely attributable to the collapse in land revenues, which were, through April, running 48% below the 2021 level.[4] Since land revenues are the main financing source for local infrastructure, the shortfall poses a huge problem for the government's stimulus measures, which rely heavily on infrastructure investment to drive economic growth.

TABLE 2 THE FOUR BUDGETS OF GOVERNMENT (per cent share)

Consolidated Revenues	2018	2019	2020	2021	2022
General Budget	53.8	52.9	51.2	50.6	50.7
Government Fund Budget	22.1	23.5	26.2	24.5	23.8
State Capital Operating Budget	0.9	1.1	1.3	1.3	1.2
Social Security Fund Budget	23.2	22.5	21.2	23.7	24.2
Consolidated Expenditures					
General Budget	59.4	58.6	55.3	54.7	53.2
Government Fund Budget	21.9	22.4	26.5	25.2	27.7
State Capital Operating Budget	0.6	0.6	0.6	0.6	0.7
Social Security Fund Budget	18.1	18.4	17.6	19.5	18.4

Source: Ministry of Finance final accounts and 2022 budget report.

THE STIMULUS PROGRAMME AND INFRASTRUCTURE FINANCE

China's a remarkable recovery from the initial COVID-19 wave started from the second half of 2020. The recovery was interrupted in mid-2021 by a downturn in the real estate sector and

[4] This estimate is based on land revenues of RMB1.5 trillion during 2022 (i-iv), compared to the RMB8.71 trillion for the whole year of 2021. 2022 budget report and http://gks.mof.gov.cn/tongjishuju/202205/t20220517_3810958.htm, accessed 18 May 2022.

sporadic outbreaks of COVID-19 and subsequent lockdowns. With growth slowing to 4.9% in the third quarter, the government responded with more tax and fee cuts in October.[5] In December the annual Central Economic Work meeting warned of "three downward pressures" (shrinking demand, supply shocks and weakening expectations) and vowed to provide more support to the economy.[6]

Against this backdrop, a sizeable fiscal stimulus was built into the 2022 budget approved at the National People's Congress meeting in March. The consolidated deficit of RMB8.74 trillion, or 7.1% of gross domestic product (GDP), is nearly 3% of GDP larger than the 2021 deficit, and close in size to the 2020 deficit of 8.6%.[7] At the heart of the stimulus programme are RMB2.5 trillion in tax cuts and refunds, which include RMB1.5 trillion in VAT credit refunds. The budget also includes RMB3.65 trillion in special-purpose bonds (SPBs) for local government infrastructure investments. In addition, the budget increases spending by RMB2 trillion and central transfers to local government by 18%, including a one-time special allocation of RMB800 billion for grassroots governments. To provide a quick boost to the economy, the finance minister also called for spending to be frontloaded, including disbursing all VAT rebates for small and micro enterprises by mid-year, and fast-tracking the issuance and use of SPBs to get infrastructure investments underway.

After the presentation of the budget, the economy slowed down sharply in April and May as a result of the COVID lockdowns in major cities including Shanghai and the Russian invasion of Ukraine. In response to the slowdown an additional programme of stimulus measures was rolled out on 23 May.[8] The urgency was underscored by Premier Li Keqiang in a teleconference on 25 May with more than 100,000 local officials when he called for an all-out effort to stabilise the economy and "get (it) back on a normal track".[9]

Despite the high profile meeting, the 33-point stimulus programme contained surprisingly few additional measures. They include an additional RMB140 billion in VAT credit rebates to cover more industries, prolonging the deferral of pension premium payments for hard-hit sectors (at a cost of RMB300 billion), a 50% cut in the car purchase tax and relaxation of restrictions on purchases, and a doubling of the support facility for loans to micro and small businesses. At the 23 May teleconference, Premier Li reminded local officials that the 2022 budget already contained "the largest ever transfers" and that the central government has no more left to give. "I want to tell everyone the bottom line: except for an extraordinary natural disaster, for which there is a premier's reserve fund, all other money will have to come from you (local governments)", Li asserted.[10]

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5 https://www.scmp.com/economy/china-economy/article/3153993/chinas-small-manufacturers-see-taxes-deferred-beijing-vows, accessed 23 March 2022.

6 http://www.news.cn/english/2021-12/10/c_1310364779.htm, accessed 21 June 2022.

7 For details of the 2022 budget and stimulus programme, see Wong, Christine (2022). "China's 2022 Budget And The Fate Of Local Government Finance", *EAI Background Brief*, No 1644, 7 April 2022.

8 https://www.scmp.com/economy/china-economy/article/3178989/china-has-33-ways-get-economy-back-track-critics-say?module=lead_hero_story&pgtype=homepage, accessed 25 May 2022.

9 https://webcache.googleusercontent.com/search?q=cache:hnv4PGhH-68J:https://longbridgeapp.com/topics/2660738+&cd=1&hl=zh-CN&ct=clnk&gl=us, accessed 30 May 2022.

10 https://webcache.googleusercontent.com/search?q=cache:hnv4PGhH-68J:https://longbridgeapp.com/topics/2660738+&cd=1&hl=zh-CN&ct=clnk&gl=us, accessed 30 May 2022.

In line with President Xi Jinping's call in April for an "all-out" campaign to boost construction of infrastructure, much hope is pinned on the RMB3.65 trillion in SPBs. To fast track their use, the government has prioritised allocation to provinces with strong repayment capacity and projects ready to go. To date, Guangdong, Beijing, Zhejiang and Shandong have taken the lead.[11]

THE ROLE OF SPECIAL-PURPOSE BONDS

SPBs (专项债) were first introduced in 2015 when the newly promulgated budget law permitted local governments to borrow directly for the first time. To create a transparent and regulated framework for local government debt, Article 35 of the budget law stipulated that local governments can borrow only for capital spending, supervised by the local people's congress. Borrowing must be done through bond issuance by the provinces, under a national cap set annually by the National People's Congress, with quotas distributed by the State Council.[12] Provinces are responsible for allocating bond proceeds and monitoring debt that is on-lent to lower level governments.

Local governments borrow for two reasons. First, local governments finance most of infrastructure investment in China. Over the past two decades, local governments have accounted for up to 90% of China's massive investments in infrastructure.[13] In 2017, the last year for which data are available, the general budget covered 17% of total infrastructure investment, with the rest financed through debt, government funds and other non-budgetary resources.[14] Second, all levels of government consider promoting economic growth and development to be the most important part of their mission, and investment in infrastructure is widely seen as a key driver of growth.

Prior to the new budget law, to provide the infrastructure needed, local governments circumvented the prohibition on borrowing by reaching outside the budget to draw on land revenues and borrowing through a variety of entities often called 'local government financial vehicles' (LGFVs) that undertake financing, construction and operation of the infrastructure.[15] By 2015, when the central government finally conferred on local governments the legal right to borrow, they had already accumulated sizeable debt, estimated to be as much as RMB30 trillion (or more than 40% of GDP) when guaranteed and partially guaranteed debts were included.

To transition to a regulated framework for local government borrowing, in 2014-2015 the Ministry of Finance required classification of existing debt into three categories: those

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[11] http://www.gov.cn/zhengce/2022-03/31/content_5682739.htm, accessed 22 June 2022.

[12] Aside from the 31 provincial level units, the five cities with deputy provincial status can also issue local government bonds.

[13] Wong, Christine. (2014). "China: Public Investment Management under Reform and Decentralization", World Bank, *The Power of Public Investment Management: Transforming Resources into Assets for Growth*, Washington, DC: World Bank.

Wong, Christine. 2013. "Paying for Urbanization: Challenges for China's Municipal Finance in the 21st Century", In *Metropolitan Government Finances in Developing Countries*, edited by Roy W Bahl, Johannes F Linn and Deborah L Wetzel, 273-308. Cambridge, MA: Lincoln Institute for Land Policy.

[14] Calculated from data in *China Statistical Yearbook 2018*. This figure includes investments in education and health. These investments are not included in the calculations for infrastructure in Chinese official data, which exclude social sectors.

[15] Wong, Christine. 2013. "Paying for Urbanization: Challenges for China's Municipal Finance in the 21st Century".

stemming from public infrastructure projects with no revenue generation (e.g. schools and village roads) would be classified as government debt and brought into the local government budget. Those for public infrastructure with revenue generation (e.g. toll roads and urban water systems) would be classified as specific-purpose (SP) debt and included in the government fund budget, and revenues generated by the projects would be booked as government fund revenues and used for debt servicing. Those for commercial projects would be classified as enterprise debt and not be included in the government accounts.

After some negotiation and compromise,[16] in 2016 the Ministry of Finance accepted on the official account a total of RMB15.3 trillion in local government debt, with RMB9.8 trillion in general debt and RMB5.5trillion in SP debt. Together, they equalled an estimated 80.5% of local government "consolidated fiscal resources" (综合财力).[17] The remainder of the debt and contingent liabilities were attributed to LGFVs and other entities and excluded from local government finances.

This classification scheme created two types of local government debt and bonds. Local government general debt (financed with general bonds) is to be repaid from general (budget) revenues and SPBs are to be repaid from the government fund budget.

Given the long history of off-budget borrowing and the potentially large liabilities that lurk outside the government debt registry (and therefore beyond the Ministry of Finance's purview), the central government has been conservative in setting the annual borrowing quotas, especially for general government debt (Figure A). At 3-4% of budget expenditures, borrowing quotas remain far below the needs for local capital expenditures, especially since the bond quotas should also finance approved deficits in the regular budget.

To mitigate this, the SPBs provide an extrabudgetary instrument to allow for more borrowing space for local governments. In a sense, this is a centrally controlled continuation of the practice prior to 2015 when local governments borrowed off budget and relied on extrabudgetary resources, especially land revenues, to repay

The use of SPBs is a work in progress. To minimise fiscal risks, SPBs are required to be self-financing—i.e. finance projects that generate sufficient funds for repayment. The 2015 document on their issuance specified that SPBs are "government bonds whose principal and interest are repaid from the government fund or earmarked income corresponding to the project within a certain period of time".[18] Each project is reportedly required to show expected income equal to at least 1.2 times the value of the SPB used to finance it.[19]

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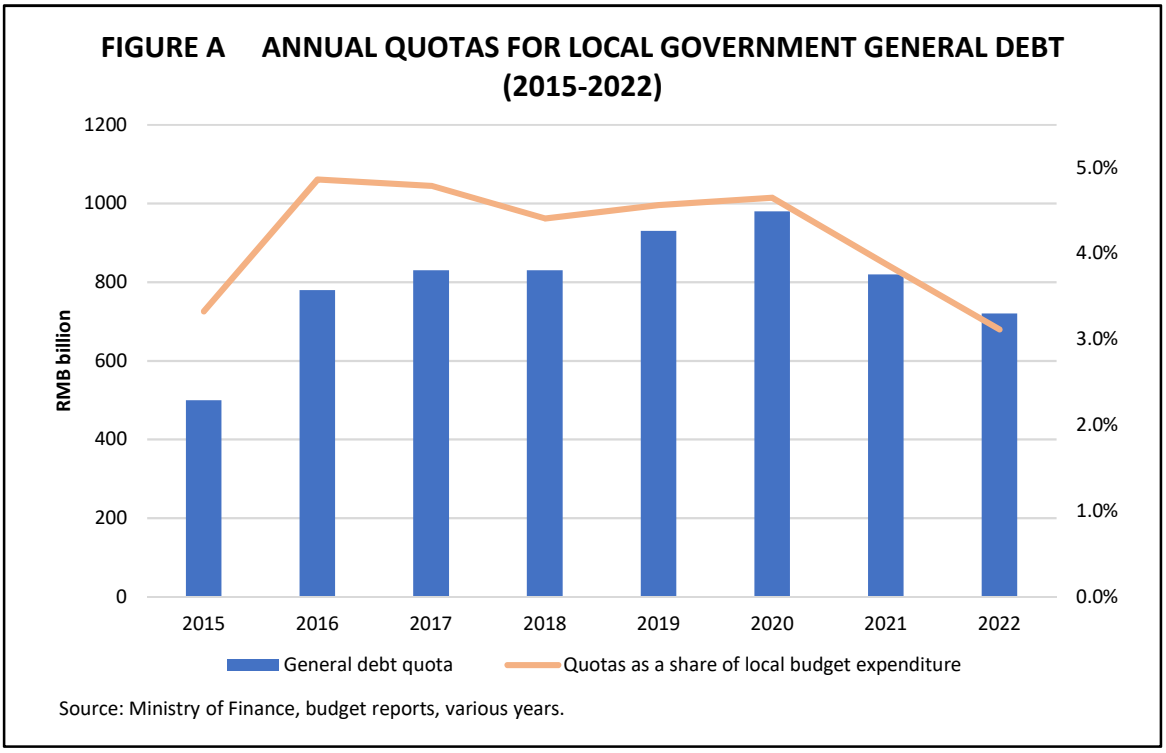
[16] For a recounting of the back-and-forth between the Ministry of Finance and local governments, see Naughton, Barry (2015). "Local Debt Restructuring: A Case of Ongoing Authoritarian Reform", *China Leadership Monitor*, no. 47.

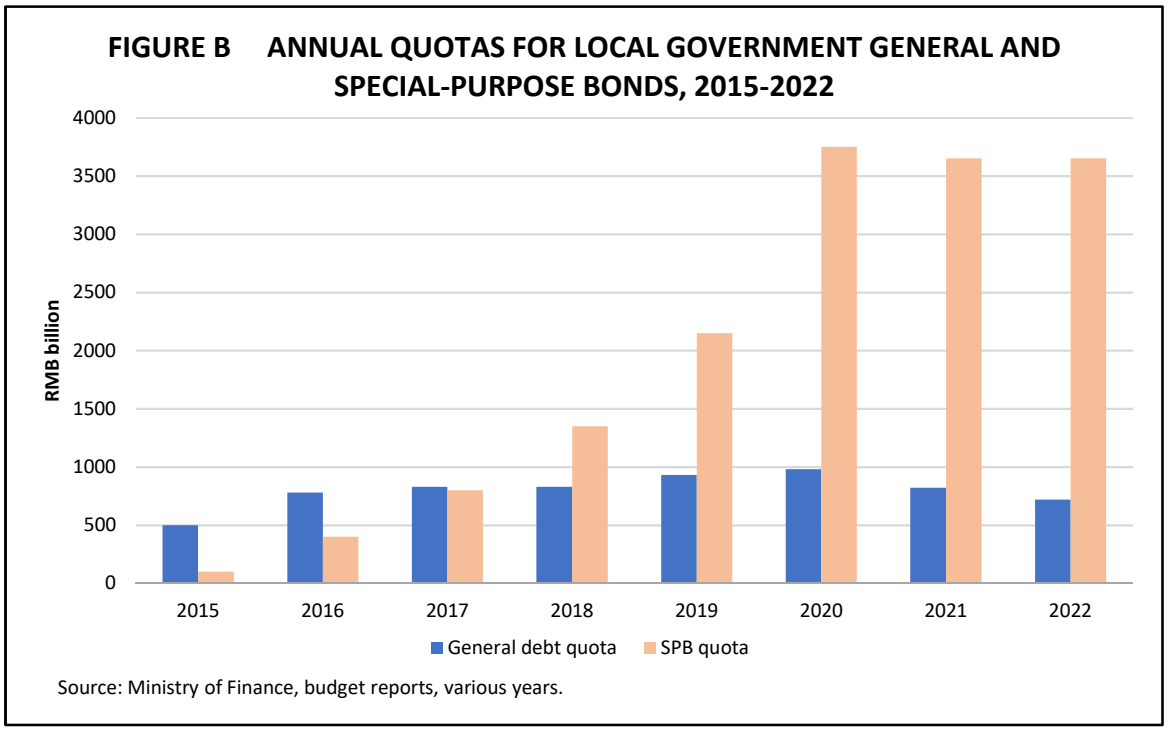
[17] Ministry of Finance (2017). Report of the Ministry of Finance on Resolutely Stopping Local Governments Illegally Raising Debt. December 2017. https://www.audit.gov.cn/n5/n26/c118298/content.html, accessed 14 June 2022.

[18] Interim Measures for the Administration of Issuance of Special Bonds by Local Governments, Ministry of Finance Treasury Department Document No. 83, 2015. Interim Measures for the Administration of Issuance of Special Bonds by Local Governments, Ministry of Finance Treasury Department Document No. 83, 2015. http://www.gov.cn/gongbao/content/2015/content_2883246.htm, accessed 26 June 2022.

[19] Reported in Zhenfa Li, Fulong Wu and Fangzhu Zhang (2021): A multi-scalar view of urban financialization: urban development and local government bonds in China, Regional Studies, DOI: 10.1080/00343404.2021.1998419, accessed 22 June 2022.



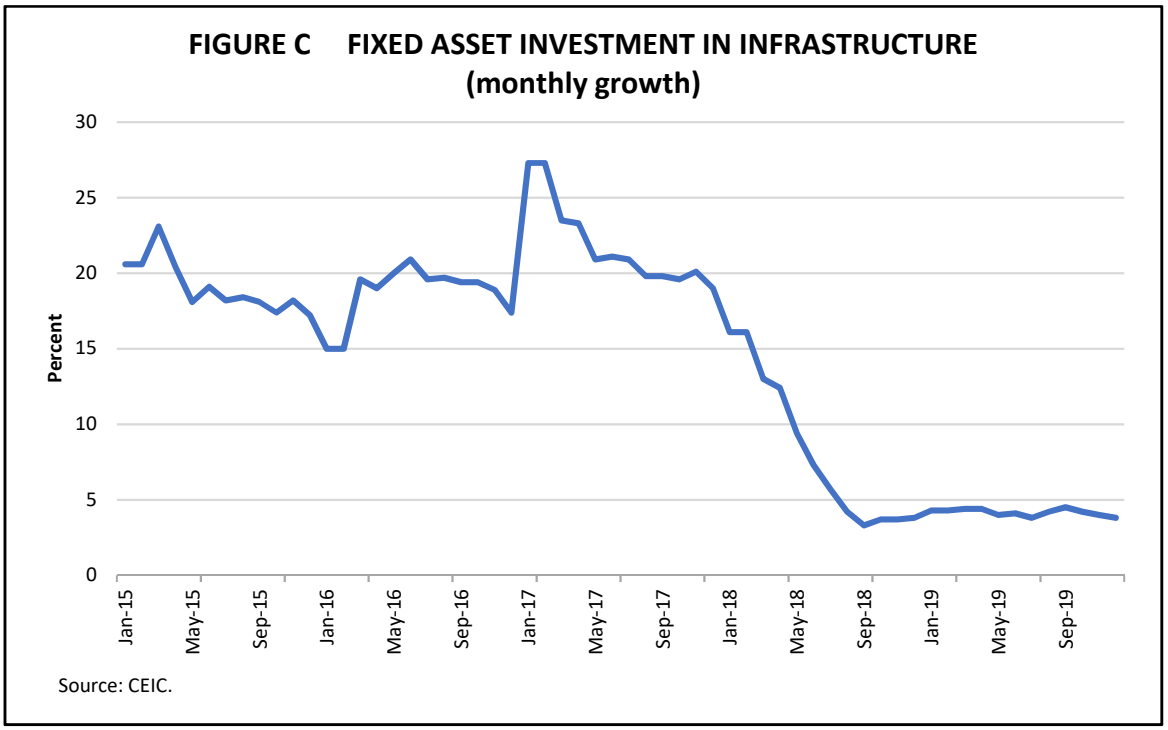
The programme began with a quota of RMB100 billion in 2015 and RMB400 billion in 2016 but has grown quickly, especially after 2018 (Figure B).



However, the increase in SPBs did not lead to a corresponding increase in infrastructure investment, even before the disruptions of COVID (Figure C).[20] Instead, 70% of the bonds

[20] On an annualised basis, the growth in infrastructure investment fell further to 0.9% and 0.4% in 2020 and 2021, respectively (http://www.cf40.com/en/news_detail/12351.html?_isa=1, accessed 19 February 2022).

had gone into land reserves and slum redevelopment in 2018 and the first 10 months of 2019.[21] In September 2019, in an attempt to stem housing price inflation, the State Council banned the use of SPBs for land reserves and other real estate investments, while it expanded the scope of eligible projects and encouraged investment in urban infrastructure such as underground pipeline networks, parking garages, cold chain logistics and other "new infrastructure".[22]



The expanded scope for SPBs should help to boost infrastructure investment, but the short term effects are likely to be limited. The reason for this is the weak fiscal position of local governments, whose revenues are falling as much as RMB5 trillion below budget for the year.[23] As most public infrastructure does not generate sufficient revenues to cover even interest payments on SPBs, they are rarely used as stand-alone financing for projects and require co-financing from the budget and project debt raised by LGFVs.[24] As noted earlier, land revenues play a key role, both directly as supplementary finance and indirectly as collateral for LGFV debt. Even as the economy reopens, a quick recovery in the housing market looks unlikely in 2022. In 2021, fully one-third of the SPB quota was left unused because of local fiscal problems and more stringent supervision of projects amidst an intensifying campaign to curb hidden local government debt through LGFVs. The same problems may beset SPB-utilisation this year.

With growth projected to fall well below the 5.5% target set for the year, a fiscal stimulus is much needed. Boosting infrastructure spending is a tried-and-true countercyclical instrument used around the world, and China has proven especially effective in mobilising and building infrastructure quickly. Moreover, many areas and sectors in China face urgent needs for investment, among them urban drainage systems. The recent flooding in Guangdong, Guangxi

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21 Rosealea Yao, "The Back Door Is Still Closed", Gavekal Dragonomics, 3 December 2019. https://research.gavekal.com/article/back-door-still-closed/, accessed 11 June 2022.

22 http://finance.sina.com.cn/roll/2019-09-05/doc-iicezueu3586890.shtml, accessed 11 June 2022.

23 Estimated from data through end of May, with projected shortfalls of more than RMB400 billion in general revenues and RMB4.5 trillion in government fund revenues.

24 See https://m.yicai.com/news/101391794.html, accessed 13 June 2022.

and Jiangxi serves as a reminder that, with climate change bringing more heavy rains, improved drainage systems would reduce economic losses and prevent the recurrence of tragedies such as that in Zhengzhou in 2021. These investments cannot be financed with SPBs alone as local governments will need help from the central government in the form of transfers or capital grants, which can be financed by treasury bonds.

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