CHINA’S 2022 BUDGET AND THE FATE OF LOCAL GOVERNMENT FINANCE

Christine WONG

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Executive Summary

1. At this year's *lianghui*, China's National People's Congress approved an expansionary budget. The headline deficit of RMB3.37 trillion is produced by bringing in RMB2.33 trillion from other fiscal resources to offset the general budget deficit of RMB5.65 trillion. The consolidated deficit of 7.1% of gross domestic product (GDP) is closer to 2020's 8.6% than the 4.4% last year.

2. The budget will mobilise "reserves", such as the RMB1.65 trillion in waived profit remittances from "designated" state-owned financial institutions and monopolies during COVID in 2020/2021, to finance increased spending. Another is the RMB1.5 trillion to be returned to taxpayers this year for value-added tax credits held up in intergovernmental disputes over divisions of financial responsibility.

3. If fully implemented, the budget could greatly boost the economy. In both 2020 and 2021, the intended stimulus fell short by almost three percentage points of GDP, mainly by local government underspending. While this year's budget has measures to boost local government resources, it is questionable whether a "three-peat" performance can be avoided.

4. In the past decade and especially since 2015, local government fiscal positions have deteriorated. Slower economic growth, fall in revenue buoyancy exacerbated by recent tax cuts and a decline in central transfers have all squeezed local government revenues.

5. Local governments faced two additional challenges in 2021. One was the intensive campaign to reduce financial risks in the economy, particularly local government debt. Since 2016 many rules for risk management have been issued, including a classification system for local government debt risks, tightened control over bank lending and assigning debt risks to officials' performance.

6. The housing downturn triggered by the Evergrande default has hit local tax receipts and led to a collapse in land lease sales. Even though only one local government has

been forced to undergo consolidation, reports of curbs on local spending and cuts or cancellation of bonuses and allowances, including in rich local governments in Shanghai, Guangdong and Zhejiang, are rife.

7. An analysis of local government spending in 2021 suggests that the remedies proposed in the 2022 budget are inadequate to prevent a repeat of the stimulus shortfall. While the deleveraging campaign can be put on hold, the authorities may not be able to reverse the housing sector downturn as it is beyond their control.

8. Given the resurgence of COVID and the likely adverse economic impact of the Ukraine war, fiscal support is crucial to avoid an economic downturn. In the short-term, it would require supporting local government spending such as fully funding the VAT rebate, increasing transfers and providing capital grants for good infrastructural investments with special project bonds.

9. In the longer term, the intergovernmental fiscal system (IFS) should be revamped to ensure local governments have sufficient resources and appropriate incentives to carry out their spending mandates efficiently. Until a more rational IFS has been built, local government underspending will persist to undermine national programmes.

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High Growth Target but Low Headline Budget Deficit

1.1 China's National People's Congress (NPC) meets annually to discuss and approve three documents: the government work report (GWR), budget report and planning report. These documents, especially the GWR and the budget report, are eagerly scrutinised for guidance on government policy directions and the macroeconomic landscape for the year ahead. This year's two reports generated some heated discussion because they not only each contained some surprises, but also seemed to pull in opposite directions. The 5.5% growth target set in the GWR is widely seen as higher than expected given the weak 4% growth in the fourth quarter of 2021 and the warnings of "three downward pressures" in the December Central Economic Work meeting. On the other hand, the headline budget deficit of 2.8% was smaller than the 3.2% last year – a surprise given the promise of more fiscal support from the December meeting.

1.2 If the elaborate layers of "plusses and minuses" scattered through the report were stripped away, the budget is more expansionary than indicated by the headline deficit figure. With a consolidated deficit of 7.1% of GDP, the stimulus is closer to the 8.6% provided in 2020 than the 4.4% last year (Table 1).[1]

[*] Christine Wong is Visiting Research Professor at the East Asian Institute, and Bank of America Merrill Lynch Visiting Chair Professor in International Finance, Schwarzman Scholars Programme, Tsinghua University.

[1] Unless otherwise noted, data in this background brief comes from the 2022 budget report to the National People's Congress, 5 March 2022.

TABLE 1 THE FOUR BUDGETS OF GOVERNMENT

(RMB billion unless otherwise noted)	2018	2019	2020	2021	2022
General Budget					
Revenues	**18,336**	**19,038**	**18,289**	**20,254**	**21,014**
Central government	8,546	8,931	8,277	9,146	9,488
Local government	9,790	10,108	10,014	11,108	11,526
Expenditures	**22,090**	**23,887**	**24,568**	**24,632**	**26,663**
Central government	3,271	3,512	3,510	3,505	3,557
Local government	18,820	20,376	21,058	21,127	23,106
General budget balance	**-3,754**	**-4,849**	**-6,277**	**-4,378**	**-5,649**
General budget balance (% of GDP)	*-4.1*	*-4.9*	*-6.2*	*-4.1*	*-4.6*
Government-managed Funds					
Revenues	**7,541**	**8,452**	**9,349**	**9,802**	**9,864**
Central government	403	404	356	409	422
Local government	7,137	8,048	8,993	9,394	9,442
Expenditures	**8,149**	**9,137**	**11,806**	**11,366**	**13,899**
Central government	402	311	1,044	400	718
Local government	7,747	8,825	11,534	11,046	13,181
State Capital Operating Budget					
Revenues	291	396	477	518	513
Expenditures	215	229	256	277	355
Social Security Fund Budget					
Revenues	7,900	8,084	7,586	9,473	10,027
Expenditures	6,738	7,499	7,837	8,788	9,241
Consolidated fiscal revenues	**34,067**	**35,970**	**35,702**	**40,048**	**41,418**
Consolidated fiscal expenditures	**37,193**	**40,752**	**44,467**	**45,062**	**50,158**
Consolidated fiscal balance (% of GDP)	*-3.4*	*-4.8*	*-8.6*	*-4.4*	*-7.1*
*Memo: Nominal GDP***	*91,928*	*99,087*	*101,357*	*115,218*	*123,880*

Source: MOF final accounts and 2022 budget report.

1.3 Since 2013 the government has presented four budget accounts in the annual budget report to the NPC. The accounts are controlled and managed by different authorities. The Ministry of Finance (MOF) controls the general budget, the State-owned Assets Supervision and Administration Commission (SASAC) the state capital operating budget (SCOB) and the Ministry of Human Resources and Social Security (MOHRSS) the social security funds (SSFs). The government-managed funds budget (GFB) contains numerous "funds", such as the Civil Aviation Development Fund, Railway Construction Fund, lottery funds and so on that are separately controlled by the recipient agencies. Local government-controlled revenues from land leases constitute by far the largest part of the GFB. Under the revised budget law, the MOF has since 2015 gradually extended greater control over the use of government-managed funds and the SCOB.[2] For now, the social security funds

[2] Since 2015 a number of government-managed funds have been abolished and their revenue streams moved to the general budget, while sunset clauses have been placed on balances in the remaining funds, with "expired" balances swept into the general budget and the share of the SCOB remitted to the general budget has been incrementally raised to 30% by 2020. The changes introduced a clearer delineation of scope that

remain under MOHRSS management and are not subject to reallocation under the budget, though not immune to encroachment by fiscal policies.[3]

1.4 This year's headline deficit of RMB3.37 trillion is produced by bringing in RMB2.33 trillion from government-managed funds, state capital operating budget funds, Budget Adjustment Fund (BSF) and carryovers to offset the RMB5.65 trillion deficit in the general budget. This has been the practice since 2015 (Table 2).

TABLE 2 TAPPING OTHER FISCAL RESOURCES TO OFFSET GENERAL BUDGET DEFICITS

(RMB Billion)	General budget deficit	Funds brought in from carryovers, BSF and other budgets	Funds returned to BSF	Official ("headline") deficit
2015	2,355	806	70	1,620
2016	2,829	727	78	2,180
2017	3,076	1,014	318	2,380
2018	3,755	1,477	102	2,380
2019	4,849	2,216	127	2,760
2020	6,277	2,613	104	3,767
2021	4,378	1,171	363	3,570
2022	5,649	2,329	50	3,370

Source: MOF, budget reports to the NPC, 2016-2022, CEIC.

1.5 The 2022 budget will increase expenditures by RMB2 trillion, an 8.2% increase over 2021. This is a welcomed change after two years of very slow growth, with 2021 expenditures only 4.5% higher than that in 2019. Anticipating slower revenue growth for local governments due to the downturn in real estate development, transfers will increase by 18% to help them fund the higher expenditures – also a big change from 2021 when transfers fell from the 2020 level.

1.6 Just as in past years, the stimulus efforts will remain focused on tax cuts and infrastructure investments. At a projected cost of RMB2.5 trillion, the programme of tax cuts and rebates is huge, compared to an estimated RMB500 billion in the 2021 budget.[4] The programme of special project bonds (SPBs) to assist local

moved recurrent expenditures to the general budget, leaving the GFB more clearly focused on capital expenditures.

3 For example, the waiver and deferral of social security contributions in the 2020 fiscal stimulus package reduced SSF receipts by more than RMB1.7 trillion and produced a current year deficit for the fund (Wong, Christine, "Uncovering China's Fiscal Stimulus Policies in the Budget Report", EAI commentary, 6 July 2020. https://research.nus.edu.sg/eai/wp-content/uploads/sites/2/2020/08/EAIC-16-20200706.pdf).

4 Ibid. The actual cost grew to RMB1.1 trillion after the scope of tax cuts was expanded in November.

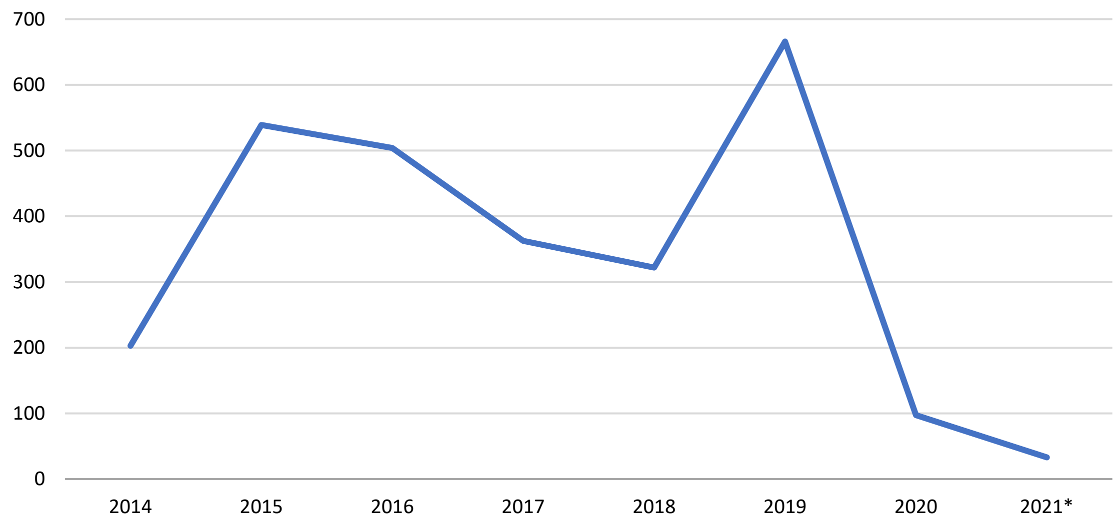
governments finance infrastructure will be continued at the same level as 2021, at RMB3.65 trillion. As before, all support is targeted at enterprises and "economic entities". Aside from a small allocation (RMB61.7 billion) for job training, there is no special provision for direct assistance to people. The subsidy provided to social assistance programmes will increase by 4.8%, less than overall expenditure growth. For all the talk of supporting the inclusion of rural migrants in urban public services, the amount of central funding to provide incentives for urban local governments to do so remains at a paltry RMB40 billion. Instead, the budget report warns that while being "committed to ensuring and improving public wellbeing in the process of development, (we must) refrain from setting our sights too high or getting ahead of ourselves".

1.7 Hewing firmly to this conservative spirit, the increased spending and transfers will be financed by "old" money that has been held in reserve, rather than from issuance of new government debt. What has attracted the most media attention is the RMB1.65 trillion collected from "designated" state-owned financial institutions and monopolies, of which RMB1 trillion will come from the central bank, and the remainder from China National Tobacco Corporation, China Investment Corporation and so on. The MOF has been at pains to explain that they are the deferred remittances of profits from the past two years when the obligation was waived during the COVID pandemic, rather than an extraordinary levy on these enterprises.[5] This explanation seems consistent with the level of central government receipts from profit remittances in recent years (Figure A).

1.8 In fact, there are two channels through which SOEs remit profits to the government. The better known channel is through SASAC, which reports the revenues in the state-owned capital operating budget, from which 30% is remitted to the general budget. The other channel – designated only for a select group of SOEs and financial institutions – is to remit directly to the government. These remittances are reported as nontax revenue in the general budget under the category of "state-owned capital operating income" that was first introduced in 2014.

5 http://www.news.cn/politics/2022lh/zb/zljzh/index.htm, accessed 11 March 2022.

FIGURE A PROFIT REMITTANCES IN THE CENTRAL GOVERNMENT BUDGET (RMB billion)



* budget.
Source: MOF final accounts, 2015-2020, and budget reports 2021 and 2022.

1.9 The treatment of this remittance in the 2022 budget, however, is highly unorthodox. This RMB1.65 trillion is reported neither in the general budget (where it belongs) nor the SCO budget. Instead, it is reported in the government-managed funds budget (Table 3), from where RMB900 billion is transferred to the general budget. Of the RMB750 billion remaining in the GFB, RMB89 billion is transferred to local government funds, leaving RMB661 billion in central government-managed funds where they will presumably be used to finance the central government's investment projects laid out in the planning report.[6]

TABLE 3 THE GOVERNMENT-MANAGED FUNDS BUDGET (2022)

Central government-managed funds	**RMB (billion)**	**Local government-managed funds**	**RMB (billion)**
Own revenues	422	Own revenues	9,442
Carryovers	35	Central fund transfers	89
Special remittance from financial and other institutions	1,650	Revenues from special project bonds (SPBs)	3,650
Total funds available	**2,107**	**Total funds available**	**13,181**
Own expenditures	**718**		
Transfers to local governments	89		
Transfer to general budget	900	**Own expenditures**	**13,181**
(unallocated surplus)	*400*		
Total expenditure (reported)	**13,899**		

6 Changes since 2016 have moved recurrent spending from the education surcharge and other funds to the general budget. The government-managed funds budget is now almost entirely used for capital spending.

1.10 The RMB1.65 trillion injection can be traced further in the general budget, which shows the RMB990 billion brought in from the GFB and the SCO budget to finance an additional RMB800 billion transfer to local governments on top of the "normal" RMB9 trillion transfer (Table 4). Acknowledging that "… a portion of local governments, especially at the prefecture and county levels, face pronounced gaps between revenue and expenditure, as well as increased pressure from expenditures for ensuring people's basic wellbeing, payment of salaries, and normal government functioning", this additional transfer is designated for grassroots local governments to enhance their fiscal capacity.[7]

TABLE 4 THE GENERAL BUDGET (2022)

Central government general budget	**RMB (billion)**	**Local government general budget**	**RMB (billion)**
Own revenues	**9,488**	**Own revenues**	**11,526**
Transfer from budget stabilisation fund (BSF)	276.5	Central transfers	9,797.5
Transfers from GF budget and SC operating budget	990	Transfers from GFB, SCOB, BSF and carryovers	1,062
Total funds available	**10,754.5**	**Total funds available**	**22,385.5**
Own expenditures	3,557		
Transfers to local governments	8,997.5		
One-time transfer to local governments from remitted profits of financial and other institutions	800		
Transfer to central BSF	50		
Total expenditures	**13,404.5**	**Total expenditures**	**23,105.5**
Central government budget balance	-2,650	Local government budget balance	-720
Total general budget balance	**-3,370**		

1.11 Since the central government is free to allocate its general revenues as it sees fit, this special treatment should be seen as a deliberate decision to set them aside from the normal budgeting process, for use in solving some urgent problem(s). The principal one appears to be funding local governments at the grassroots level.

1.12 The second big piece of "reserve" money is the RMB1.5 trillion rebate of value-added tax (VAT) credits in the RMB2.5 trillion programme of tax cuts, and it also stems from problems of intergovernmental fiscal arrangements. The tax cuts are a continuation of the programme, first introduced in 2020 and expanded in November 2021, to offer waivers of VAT and reduction of income tax for micro, small and

7 http://www.news.cn/politics/2022lh/zb/zljzh/index.htm, accessed 11 March 2022.

household businesses, and tax write-offs for R&D expenditures for small and medium-sized firms.

1.13 The rebate aims to resolve a problem that has dogged the administration of the VAT since 2016 when the tax was extended to sectors previously under the business tax. To compensate for their loss of business tax revenues, the sharing rate for local governments was raised from 25% to 50%. The transition brought a vast increase in the number of service sector entities to the rolls of VAT taxpayers and the increased sharing rate for local governments raised the stakes in determining how to share not only the revenues but also the rebates. Identifying local government shares in VAT credits has proven extremely problematic. Under current practice, VAT rebates are deducted from VAT payments. However, with VAT collected at different stages of production in different localities, disputes over who is responsible for funding have held up many rebates over the past few years. According to internal government information, "trillions of yuan" have accumulated in treasury accounts that should be returned to taxpayers.[8]

1.14 The rebate programme intends to put this money back into the economy. At the post-NPC press conference, Premier Li Keqiang explained that the goal is to complete the rebating of past credits to small and micro enterprises by the end of June, to manufacturing and R&D-intensive firms by the end of 2022, and to keep pace with new credits on a monthly basis. To clear up the logjam of disputed claims, the central government will pay for the bulk of the rebates, "with some local government contribution" that was later reported to be up to 18%.[9]

1.15 Finally, the budget report calls for implementation to be frontloaded this year, including to push through on VAT rebates for small and micro enterprises by mid-year, and to speed up the issuance and use of SPBs to get infrastructure investment underway.

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8 Interview information in Beijing, December 2021.

9 http://www.news.cn/politics/2022lh/zb/zljzh/index.htm, accessed 11 March 2022 and https://economy.caixin.com/2022-03-22/101859259.html, accessed 22 March 2022.

1.16 If successfully implemented, the budget would deliver a significant boost to the economy. However, optimism has to be tempered by a review of implementation of the past two budgets. In both 2020 and 2021, the intended stimulus fell short (Table 5). At year-end 2020, the consolidated deficit was 8.6% of GDP, 2.9 percentage points smaller than budgeted. In 2021 it was 4.4%, again nearly three percentage points smaller than budgeted. In each case the story was the same – outperformance on revenue collection combined with underspending – especially by local governments, that made fiscal policy tighter than intended. While the budget this year contains measures aimed at boosting local government resources, the question is whether these are enough to avoid the shortfall in stimulus.

TABLE 5 THE 2022 BUDGET AND IMPLEMENTATION RESULTS IN 2020-2021

(RMB billion unless otherwise noted)	2020			2021			2022		
	Budget	Year-end outturn	Outturn compared to budget	Budget	Year-end outturn	Outturn compared to budget	Budget	Compared to 2021 outturn	Compared to 2019
General Budget									
Revenues	**18,027**	**18,289**	**1.5%**	**19,765**	**20,254**	**2.5%**	**21,014**	**3.8%**	**10.4%**
Central government	8,277	8,277	0.0%	8,945	9,146	2.2%	9,488	3.7%	6.2%
Local government	9,750	10,014	2.7%	10,820	11,108	2.7%	11,526	3.8%	14.0%
Expenditures	**24,785**	**24,568**	**-0.9%**	**24,962**	**24,632**	**-1.3%**	**26,663**	**8.2%**	**11.6%**
Central government	3,504	3,510	0.2%	3,502	3,505	0.1%	3,557	1.5%	1.3%
Local government	21,232	21,058	-0.8%	21,461	21,127	-1.6%	23,106	9.4%	13.4%
General budget balance	**-6,758**	**-6,277**	**481**	**-5,197**	**-4,378**	**819**	**-5,649**	**-1,270**	**-799**
As % of GDP	*-6.7*	*-6.2*	*+0.5*	*-4.5*	*-3.8*	*+0.7*	*-4.6*	*-1.0*	*-0.6*
Government Fund Budget									
Revenues	8,145	**9,349**	**14.8%**	**9,453**	**9,802**	**3.7%**	**9,864**	**0.6%**	**16.7%**
Central government	361	356	-1.4%	382	409	7.0%	422	3.2%	4.4%
Local government	7,783	8,993	15.5%	9,071	9,394	3.6%	9,442	0.5%	17.3%
Expenditures	12,612	**11,806**	**-6.4%**	**13,127**	**11,446**	**-12.8%**	**13,899**	**21.4%**	**52.1%**
Central government	278	1,044	275.4%	333	400	20.4%	718	79.4%	130.8%
Local government	12,334	11,534	-6.5%	12,794	11,046	-13.7%	13,181	19.3%	49.4%
Government Fund Budget Balance	**-4,468**	**-2,457**	**2,011**	**-3,674**	**-1,644**	**2,030**	**-4,035**	**-2,392**	**-3351**
As % of GDP	*-4.4*	*-2.4*	*+2.0*	*-3.2*	*-1.4*	*+1.8*	*-3.3*	*-1.9*	*-2.7*
State Capital Operating Budget									
Revenues	364	477	31.2%	388	518	33.6%	513	-1.0%	29.5%
Expenditures	261	256	-2.2%	265	277	4.4%	355	28.5%	55.4%
Social Security Fund Budget									
Revenues	7,729	7,586	-1.8%	8,918	9,473	6.2%	10,027	5.8%	24.0%
Expenditures	8,228	7,837	-4.8%	8,641	8,788	1.7%	9,241	5.2%	23.2%
Consolidated fiscal revenues	**34,264**	**35,702**	**1,438**	**38,523**	**40,048**	**1,524**	**41,418**	3.4%	15.1%
Consolidated fiscal expenditures	**45,887**	**44,467**	**-1,421**	**46,995**	**45,143**	**-1,852**	**50,158**	11.1%	23.1%
Consolidated fiscal revenues (% of GDP)	*33.8*	*35.2*	*1.4*	*33.4*	*34.8*	*1.3*	*33.4*	*-1.3*	*-2.9*
Consolidated fiscal expenditures (% of GDP)	*45.3*	*43.9*	*-1.4*	*40.8*	*39.2*	*-1.6*	*40.5*	*1.3*	*-0.6*
Consolidated balance (% of GDP)	***-11.5***	***-8.6***	***+2.9***	***-7.4***	***-4.4***	***+2.9***	***-7.1***	***-2.6***	***-2.2***
*Memo: Nominal GDP***	*101,357*	*101,357*	*101,357*	*115,218*	*115,218*	*115,218*	*123,880*	*123,880*	*123,880*

Source: Budget reports in 2020, 2021 and 2022.

Budget Implementation in 2021

2.1 The year 2021 was a year of fiscal contraction in China, but it did not start out that way. Riding on the post-COVID economic recovery from the second half of 2020, the National People's Congress approved a budget in March that envisioned the economy returning to its pre-COVID trajectory. Stimulus measures introduced in 2020 were largely withdrawn, leaving only two measures in place, namely the tax cuts for small and micro enterprises and tax credits for R&D expenditures. The budget also kept special project bond (SPB) issues for local governments at nearly the same level as in 2020.[10] The projected consolidated deficit of 7.4% of GDP was smaller than the 8.6% in 2020 but still significantly larger than the 4.8% in pre-COVID 2019.[11]

2.2 In the course of the year, revenues outperformed the budget, whereas spending fell short. Data released by the MOF in August revealed a surprise balanced budget through the first seven months, with revenues of RMB13.77 trillion and expenditures of RMB13.79 trillion. The unexpectedly strong economic recovery early in the year had brought nearly 20% more revenues than projected, but underspending was also a significant factor, with expenditures falling 5.3% below the budget. If continued through the year, the two trends would have brought a fiscal shortfall of RMB5.2 trillion (4.5% of GDP) compared to the budget and RMB6.23 trillion (6.2% of GDP) compared to that in 2020 (Table 6). Except for health, spending fell across sectors, with deep, double-digit cuts in major sectors such as environmental protection (-36%), urban and rural community affairs (-25%), agriculture, forestry and water (-17%), and so on compared to 2019.[12]

[10] The level was RMB100 billion less than the RMB3.75 trillion in 2020.

[11] For a discussion of the 2021 budget, see Wong, Christine (2021), "China's Post-COVID Goldilocks Budget – How Big Should It Be?" EAI Commentary, 18 March 2021 (https://research.nus.edu.sg/eai/wp-content/uploads/sites/2/2021/03/EAIC-27-20210318.pdf).

[12] These were discussed in detail in Wong, Christine, "What's up with China's fiscal policy? The puzzle of recent budget data", EAI Commentary, 7 September 2021 (https://research.nus.edu.sg/eai/wp-content/uploads/sites/2/2021/09/EAIC-34-20210907.pdf).

TABLE 6 THE SURPRISING FISCAL CONTRACTION

(RMB Billion)	Jan-July outturn	Projected for 2021	2021 Budget	Compared to budget	Compared to 2020
Revenue	**13,772**	**23,608**	**19,765**	**19.4%**	**29.1%**
central	6,466	11,084	8,945	23.9%	33.9%
local	7,306	12,524	10,820	15.8%	25.1%
Expenditure	**13,793**	**23,645**	**24,962**	**-5.3%**	**-3.7%**
central	1,793	3,073	3,502	-12.2%	-12.4%
local	12,000	20,572	21,461	-4.1%	-2.3%
General Budget Balance (RMB bn)	**-21**	**-36**	**-5197**	**5161**	**6233**
as Share of GDP	*0.0%*	*0.0%*	*-4.5%*	*+4.5%*	*+6.2%*

Source: http://gks.mof.gov.cn/tongjishuju/202109/t20210917_3753521.htm, accessed 19 September 2021 and 2021 budget report.

2.3 The size of fiscal contraction moderated somewhat in the second half year when the weakening economy slowed down revenue growth. This was reinforced when the government expanded the scope of tax and fee cuts to offer more support to enterprises. In October the government announced a three-month deferment of 50% of their corporate income tax and VAT for small and medium-sized manufacturers from November 2021 through January 2022, and 100% deferment for those with annual sales of less than RMB20 million.[13] However, spending cuts continued to deepen. Through November, general budget expenditures were falling 6.5% below budget, with local expenditures 6.8% lower.[14]

2.4 Adding to the contraction was a 24% shortfall in government fund expenditures (GFE), driven partly by a steep fall in land revenues set off by the Evergrande debacle. With revenues from land leases accounting for 85%-90% of government fund revenues (GFR), receipts of GFR fell 12% short of the budget. Another factor causing the shortfall in GFE was the slow pace of special project bond issuance and utilisation. By mid-October only RMB2.34 trillion of the SPBs had been issued, less than two-thirds of the RMB3.65 trillion allocated, putting in doubt the full utilisation of the funds by year end.[15] With the steep fall in government fund expenditures, the

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

14 http://gks.mof.gov.cn/tongjishuju/202112/t20211217_3775786.htm, accessed 19 December 2021.

15 In past years local bond issuance would have been largely completed by October. In 2020, for example, they were 95% sold, https://www.caixinglobal.com/2021-10-23/china-wants-local-governments-to-speed-up-annual-special-bond-borrowing-101790757.html, accessed 24 October 2021.

pace set through November was on course to shrink the consolidated deficit by 4.2% of GDP compared to the budget approved in March, and a contraction of 5.1 % from the 2020 level and 2.1 % from even the pre-COVID 2019 level.

2.5 This scenario was averted at year-end with a burst of spending in December that added RMB3.24 trillion to bring on-budget expenditures to within 1.3% of the budgeted level. Even so, budget expenditures were only 0.3% higher than that in 2020 and 3.1% higher than that in 2019. With revenues slowing markedly during the final quarter, the budget outturn for 2021 ended with a general budget deficit of 3.8% of GDP, only 0.7% of GDP smaller than budgeted. As government fund expenditures remained substantially below projection, the combined spending on the general budget and GFB shrank by RMB2.1 trillion compared to the budget, and the combined deficit shrank by 2.5 percentage of GDP to 5.2% of GDP (Table 7). In the end, fiscal policy was tighter not just compared to 2020 but even more so than 2019.

TABLE 7 YEAR-END BUDGET OUTTURN FOR 2021

(RMB Billion)	2021 Budget	2021 outturn	Compared to approved budget	Compared to 2020	Compared to 2019
Revenue	**19,765**	**20,254**	**2.5%**	**10.7%**	**6.4%**
central	8,945	9,146	2.2%	10.5%	2.4%
local	10,820	11,108	2.7%	10.9%	9.9%
Expenditure	**24,962**	**24,632**	**-1.3%**	**0.3%**	**3.1%**
central	3,502	3,505	0.1%	-0.1%	-0.2%
local	21,461	21,127	-1.6%	0.4%	3.7%
General Budget Balance(RMB bn)	**-5,197**	**-4,378**	**+819**	**+1,891**	**+471**
As Share of GDP	*0*	*0*	*+0.7%*	*+2.4%*	*+1.1%*
Government Fund Revenue	**9,453**	**9,802**	**3.7%**	**4.8%**	**16.0%**
Central	382	409	7.0%	14.8%	1.2%
Local	9,071	9,394	3.6%	4.5%	16.7%
Government Fund Expenditure	**13,127**	**11,366**	**-13.4%**	**-3.7%**	**24.4%**
Central	333	400	-3.8%	17.9%	2.8%
Local	12,794	11,046	-13.7%	-4.2%	25.2%
Government Fund Budget Balance	**-3,674**	**-1,564**	**+2,110**	**+893**	**-879**
Consolidated fiscal revenues(RMB bn)*	29,218	30,056	839	2,418	2,566
Consolidated fiscal expenditures(RMB bn)*	38,089	35,998	-2,090	-375	2,974
Consolidated Balance (RMB bn)*	**-8,871**	**-5,942**	**+2,929**	**+2,791**	**-408**
As Share of GDP	*-7.7%*	*-5.2%*	*+2.5%*	*+3.5%*	*+0.4%*

* General and government fund budgets only.
Source: MOF final accounts, budget reports 2021 and 2022.

Causes of the 2021 Contraction and Prospects for 2022

3.1 Since 2015, local government fiscal positions have deteriorated, with pressures growing on all sides.[16] On the expenditure side, the rapid build-up of social welfare programmes under the Hu Jintao-Wen Jiabao administration (2002-2012) had vastly increased social spending. These programmes are overwhelmingly implemented by local governments, especially those at the county and township levels.[17] As a result of these policies, the subnational share of budgetary spending rose from 65% in 2000 to 85% in 2012 and the share of counties from 26% to 45%. In the absence of adjustments in revenue-sharing, transfers grew to account for nearly 40% of local spending by 2012, but the share had since fallen to 31% in 2019. This combination of slower economic growth, declining revenue buoyancy exacerbated by recent tax cuts and a waning of central government willingness to provide transfers have squeezed local government revenues, and caused social spending as a share of GDP to decline since 2016.[18] Over the past two years, the local fiscal position has worsened further during the pandemic (Table 8).

TABLE 8 RECENT CHANGES IN REVENUE, EXPENDITURE AND TRANSFERS (annual growth)

	Revenues			Expenditures			Net
	Total	**Central**	**Local**	**Total**	**central**	**Local**	**transfers**
2000-2010	20.0%	19.8%	20.3%	18.9%	11.2%	21.7%	26.8%
2010-2015	12.9%	10.3%	15.4%	14.4%	9.8%	15.3%	12.9%
2015-2019	5.7%	6.6%	5.0%	8.0%	8.3%	7.9%	5.9%
2019-2021	**3.1%**	**1.2%**	**4.8%**	**1.6%**	**-0.1%**	**1.8%**	**NA**

Source: Author's calculations from NBS data.

3.2 Against this backdrop, local governments faced two additional challenges in 2021. One was the campaign to reduce financial risks in the economy, of which a principal

16 Wong, Christine (2021). Plus ça Change: Three Decades of Fiscal Policy and Central–Local Relations in China, *China: An International Journal*, Volume 19, Number 4, November 2021, pp. 1-31, https://muse.jhu.edu/article/839228, accessed 5 April 2022.

17 In this background brief, "county" will be used as a shorthand to include counties, county level cities and urban districts. After about 2003-2004, townships ceased to be an independent level of budgeting and the county became the lowest level of budget accounting.

18 The sum of budgetary expenditure on education, health and social security and employment had fallen from 8.5% of GDP in 2016 to 7.6% in 2019 despite the government's vow to protect expenditures on "people's livelihood services" (*minsheng zhichu*).

target is local government debt, especially off-balance sheet debt. This began quietly in October 2016 when the State Council ordered a classification system for local governments debt risks. The order stipulates, among others, that ".. a fiscal consolidation plan must be initiated if the annual general debt interest payment expenditure of the city or county government exceeds 10 percent of the general public budget expenditure, or if the interest payment expenditure for special project debt exceeds 10 percent of the government fund budget expenditure in the current year".[19] Once consolidation is triggered, harsh conditions apply, including severe cost-cutting, stops to new investment projects, downsizing of staff, and freezing or cessation of all bonus pay and allowances that make up a large portion of take-home pay for civil servants and public employees.

3.3 This was followed by tighter control over bank lending and imposition of rules assigning responsibilities for direct and contingent debt to leading officials and tying them to their personnel records.[20] In 2017 the National Audit Office (NAO), along with the MOF, began to audit local government debt and publicising violations.[21] In August 2018 the Party central committee (with the State Council) called on provinces to formulate plans for eliminating hidden debt within a 5-10 year period.[22] County level governments in the coastal province of Zhejiang are reportedly expected to complete the task of eliminating hidden debts by the end of 2022.[23]

3.4 Even without full enforcement of these debt consolidation rules, the multi-pronged campaign had succeeded in slowing the growth of hidden local government debt, with local government financing vehicle (LGFV) debt shrinking through 2019, until

[19] State Council Plan for Emergency Response to Local Government Debt Risks, Office of the State Council Letter No 88, 2016, http://www.gov.cn/zhengce/content/2016-11/14/content_5132244.htm, accessed 21 March 2022.

[20] See, for example, https://economy.caixin.com/2018-03-30/101228976.html?sourceEntityId=101320485, accessed 1 March 2022.

[21] Jiang Chao and Zhu Zhengxing, "From assigning accountability to resolution of local debt" (in Chinese), September 2018, https://www.sohu.com/a/255041679_480400, accessed 14 February 2022.

[22] *Opinions of the Central Committee of the Communist Party of China and the State Council on Preventing and Resolving the Hidden Debt Risks of Local Governments*, CCPCC and State Council Document 27, 2018, https://m.21jingji.com/article/20190817/5568ce8242d30032e203b30fd030b2e8.html, accessed 21 March 2022.

[23] Fieldwork information, January 2022.

the COVID pandemic interrupted the momentum and reversed some of the gains.[24] In 2021 the campaign was resumed, with the MOF calling on local governments to improve their financial health by paying down and restructuring their hidden debt.[25] In two articles in *People's Daily*, Finance Minister Liu Kun urged local governments to establish market-based legal mechanisms for resolving their LGFV debt, through bankruptcy if warranted.[26] In July, following an NAO report enumerating problems in the use of SPBs, the party central committee also called on local people's congresses to heighten monitoring of local government debt.[27]

3.5 Amidst the intensifying pressure to deleverage came the housing downturn triggered by the Evergrande default, which delivered a large hit on tax receipts from construction and real estate-related activities that account for one-third or more of local tax revenues. The slowdown in housing construction also led to a collapse in land lease sales, the principal source of revenue for government-managed funds on which local governments have grown increasingly dependent as pressures grew on the general budget (Figure B). While the decline in land revenues was not fully reflected in the 2021 data given the lag between auctions and payment, its knock-on effect had already caused transfers from the GFB to the general budget to fall some 30% short of the RMB1.68 trillion budgeted, with the shortfall mostly hitting local government budgets.[28]

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24 Sun Binbin and Tan Yiming, 2020, "How to resolve hidden debts and how is the progress?" (in Chinese) Tianfeng Research. 4 September 2021, https://zhuanlan.zhihu.com/p/215419428, accessed 4 January 2021. See also He, Wei, 2021, "The Next Steps on Hidden Local Debt", GaveKal Dragonomics, 16 February 2021.

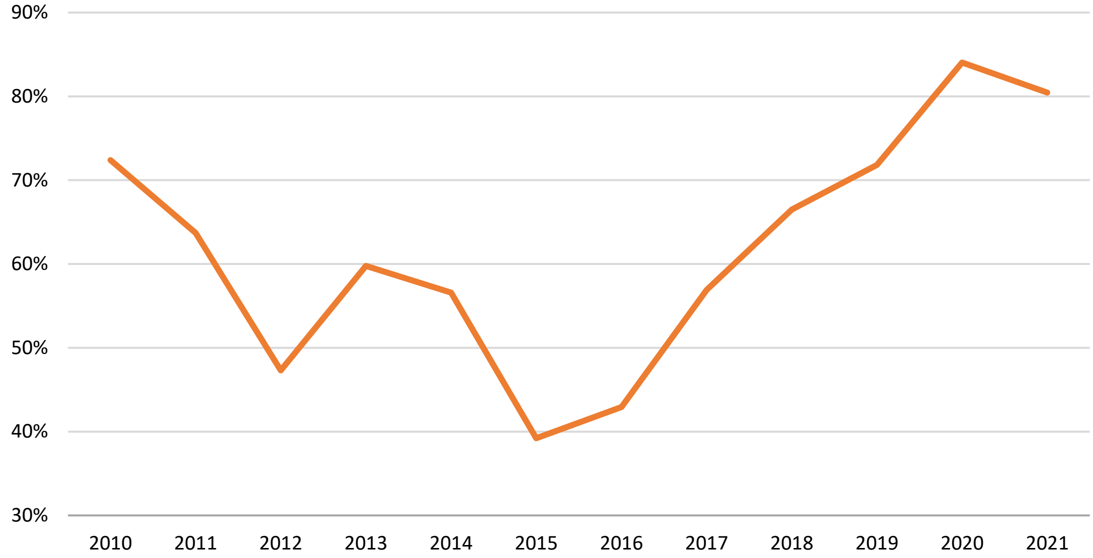
25 State Council, 2021, *Opinions of the State Council on Further Deepening the Reform of the Budget Management System*, Document #5. Issued 7 March 2021, http://www.gov.cn/zhengce/content/2021-04/13/content_5599346.htm, accessed 14 April 2021.

26 Wang Dehua, "The resolution of local hidden debt enters critical period" (in Chinese), *Caixin Weekly*, No. 17, 3 May 2021, https://weekly.caixin.com/2021-05-01/101704803.html, accessed 7 June 2021.

27 http://www.audit.gov.cn/n4/n19/c145358/part/75592.pdf, accessed 24 March 2022 and http://www.npc.gov.cn/npc/kgfb/202107/92e8ae5d96e242a784b83b8e2b0b096e.shtml?mc_cid=cff8748702&mc_eid=70bc029764, accessed 23 February 2022.

28 2021 and 2022 budget reports.

FIGURE B THE RATIO OF LAND REVENUES TO LOCAL GOVERNMENT BUDGET REVENUES



Source: CEIC and author's calculations.

3.6 For many local governments, the downturn in the housing sector has reduced their principal source of funding for debt servicing and raised the threat of default. Even though to date only one local government has been forced to undergo consolidation – the high-profile case of Hegang in Heilongjiang – evidence of curbs on local spending is rife, with widespread reports of cuts or cancellation of bonuses and allowances, including in rich local governments in Shanghai, Guangdong and Zhejiang.[29]

More Support Needed

4.1 The analysis of the factors that led to the slowdown in local government spending in 2021 suggests that the remedies proposed in the 2022 budget are too small to prevent a repeat of a shortfall in stimulus this year. While the central government can put the deleveraging campaign on hold, reversing the housing sector downturn will be harder as it is in part outside the control of the government.

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[29] Fieldwork information, December 2021 – January 2022. See also, for example, https://asia.nikkei.com/Editor-s-Picks/China-up-close/Analysis-China-s-mandarins-face-25-pay-cut-as-alchemy-fades. 4 April 2022.

4.2 Given the resurgence of COVID and the likely adverse economic impact from the war in Ukraine, the government has to do all it can to provide fiscal support to avoid an economic downturn. In the short-term this means doing whatever it takes to support local government spending. Some measures to consider include fully funding the VAT rebate, providing additional transfers to fund local fiscal gaps should local revenues slip in a housing/economic slowdown, and issuing capital grants to enable local governments to take up good infrastructural investments with special project bonds.

4.3 In the longer term the government must push forward on revamping the intergovernmental fiscal system to ensure that local governments have sufficient resources and appropriate incentives to carry out their spending mandates efficiently and equitably. In some respects, the problem has been most acute for capital spending, for which the lack of adequate provision of fiscal resources and, until 2015, legal channels for local government borrowing, have created the present local debt risks. Until a more rational IFS has been built, local government underspending will persist to undermine national programmes.