The Debt Magnitude and Insolvency Risk of Local Financing Platforms in China

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Abstract

Policy makers and researchers have been debating the financial health of Chinese local government debt after the global financial crisis. However, the lack of transparency makes it difficult to full evaluate the risk of local debt in China. The paper uses the data of local financing platform to estimate the magnitude of the local debt and lays out several policy implications for Chinese governments.

Keywords: Local Public Finance, Local Financing Platform, Debt Magnitude, China, Local Government

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1. Introduction

State and local debt and debt of quasi-public agencies in the developing countries have been growing in importance and caught much more attentions after the global financial crisis. In China, although the state and local governments (the SNGs hereinafter) are forbidden to borrow,[1] debt incurred by the state and local government agencies has rise to an alarming scale in the last three years. These quasi-public agencies generally are incorporated as different investment companies in order to finance and invest as a commercial entity. The state and local governments backed these financing platforms by imputing hard assets, such as land, state-owned properties, and even revenue from fees and taxes. In other words, the state and local governments bear certain liabilities to pay for the debt if the financing platforms fail to meet their engagements. So these debts are considered to be the "hidden debt" of the SNGs although they are not included in the SNGs' balance sheet.

The worse problem is that no one even knows exactly how large these hidden debts are. Only the explicit fiscal debt, which is the result of expansionary fiscal policy, is reported by the governments. The borrowing scale by the local financing platforms that guaranteed by the state or local governments are out of supervision and control. Estimate of the size of the hidden debt vary dramatically from 4 trillion, to 5 trillion and to 11 trillion, with different components and different methods (Kang Jia, 2010; Victor Shi, 2010; etc.). Since 2011, the central government started to investigate the magnitude of debt incurred by the local financing platforms. The China Bank Regulation Commission estimated that there were approximately 9.4 trillion. However, according to the report of the Central Bank, the magnitude of local debt could reach 14.7 trillion. Most recently, the China Auditing Agency released the total debt of local government was 10.7 trillion. The big differences among these estimations made people more worried about the risk of local debt in China.

Three structural trends have contributed to the rising share of SNGs' hidden debt. First, the urbanization in China requires large-scale urban infrastructure financing to help absorb influxes of rural populations. The urbanization rate has increased from 29% in 1995 to 43.5% in 2005 and even greater to 47% in 2010.[2] The impressive progress of urbanization creates huge needs for infrastructure spending. However, the access to the financial market has been closed for the state and local governments for institutional and legal reasons. This dilemma pushes the SNGs to get off the beaten track.

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[1] According to the 28th paragraph of the Law of Budgeting, the local governments should not issue municipal bond, except as otherwise provided in the law and the state council.

[2] The Report of the National Bureau of Statistics, in 2006 and in 2010.

Second, the 1994 decentralization fiscal reform had given SNGs heavier spending responsibilities and less revenue-raising power. The 75% of VAT, the largest tax source of Chinese governments, was allocated to the central government. The income tax and some local taxes became sharing tax with larger share to the central government as well (Zhou Ye'an, 2000). On the other hand, the state and local governments are responsible for most local constructive expenditures, education expenditures and fiscal subsidies to social pension funds and SOE reforms. The expanding fiscal gap of SNGs had jumped from a small number to more than 2 trillion RMB in 2009. In order to meet their needs, the local governments have to exploit their control over land to generate both on- and off-budget revenue, including debt finance from the capital market.

Third, the revenue from land transfer provides popular collateral for the SNGs to borrow. As land is owned by the public in China, land is by far the most valuable asset for the state and local governments. In 1998, the Law of Land Administration centralized the right of approval and supervision of the use of the urban and rural land in the central and state governments, and decentralized the right of execution to the local governments (including the city level and county level). The net revenue incurred from the land transfer has become an important revenue source for SNGs. In some provinces, the share increased to more than half of the general budgetary revenue (Joyce, 2009). Scholars and policy makers have come to refer this phenomenon as 'land public finance'. The SNGs use land and other hard assets serving as collaterals for debt instruments such as bank loans and bonds.

2. The Subnational Borrowing in China

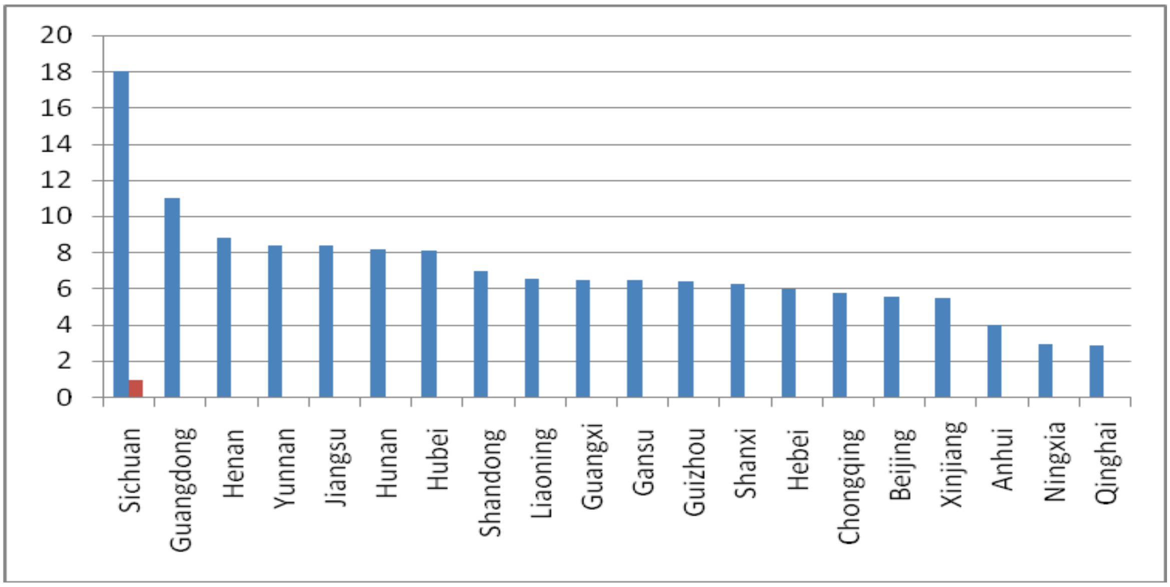
Historically, the SNGs in China only have rare record of bond issue shortly after the Civil War in 1950. The Dongbei Province (in the north part of China) issued a five-year bond with payment in kind. Such government loan was not exactly a municipal bond and the security market had been closed for more than twenty years.

Until 1981, the door of the security market finally opened, and the Treasure Bond issued by the central government has become the dominant way in domestic debt. Furthermore, the Budget Law which was promulgated in 1995 prohibited the right of SNGs to issue bonds.

So far, the SNGs have only two approaches to raise money from the credit market. The first one is the Proxy Treasure Bond issued by the central government. In order to alleviate the fiscal stress of SNGs during Asia Financial Crisis in 1998, the central government started to issue bonds in the name of SNGs. The issue process of such bond is exactly the same as the Treasure Bond and the distribution of the revenue raised by such bond depended on the negotiations among the central government with each provincial government. More importantly, the central government is the payer of last for these bonds though the SNGs have the nominal obligation to pay the principles and interests. The amount of these bonds decreased from 40 billion RMB in 1998 to 10 billion in 2005, and then increased dramatically to 200 billion in 2009 due to the global financial crisis. According to the hearing of the

Department of Finance, the western provinces had gained more shares of these bonds, such as Ningxia 3 billion, Xinjiang 5.5 billion, Guizhou 6.4 billion and Shan'xi 6 billion. In other words, this distribution of proxy treasure bond is more like transfer other than market financing. In 2010, the size of the Proxy Treasure Bond kept the same number as 200 billion.

Figure 1. The distribution of the proxy treasure bond in 2009 (partly)



Unit: billion Yuan

The second one is the corporate bonds issued by SNGs owned companies, which are known as city investment bonds. Some of these companies also have their own commercial assets, such as highways. They can manage joint venture projects with government agencies and raise money from foreign investors, commercial banks or the security market. The money raised by these companies mostly was used in the local infrastructure projects.

The local financing platforms were originally established to finance the city construction spending at the early 1990s and only centralized in a few big cities at that time, such as Shanghai. The financing activities through the platforms had started to expand to other provinces since the fiscal stimulate plan after 1998 Asian financial crisis. The number of platforms significantly boomed in the 2008 global financial crisis. In order to support the 4 trillion investment program of the central government, the state and local governments were encouraged to expand financing channels.[3] By the end of June 2009, there showed up 8221 platform companies including 4907 county-level companies (Century Weekly, 2010). Most of these companies were set up in a short time and the local governments transferred their land or other hard asset to the companies to make them have capacity to raise money.

[3] See the Guideline to Promote the Restructuring of Credit Structure and the Stable Development of National Economy by the Central Bank and the China Bank Regulation Commission, March 23, 2009.

The critical collateral for the local financing platforms to borrow is their land related assets. The land transfer fee has been not only an important part of out-budget revenue source of local governments, but also a popular tool for local governments to finance. Joyce (2008) indicated the importance of land public finance for local governments. The ratio of land related revenue share of local fiscal revenue and expenditure was 9.3% and 5.8% respectively; the number has increased to 19.4% and 11.9% in 2007.

Obviously, the largest resource is the state-owned commercial banks and the money from security market is quite small (Peterson, 2004). However, local governments have been exploring capital market for mobilizing financing during the crisis period. The size of bond financing had sharply increased in 2009 by the incentives of central government. The data we obtained from the bond market could reveal some of the facts that how much the local financing platforms have borrowed.

3. The Debt Magnitude of Local Financing Platforms

We use the data from the bond market to estimate the magnitude of local debt in China since no official information disclosed by local governments.

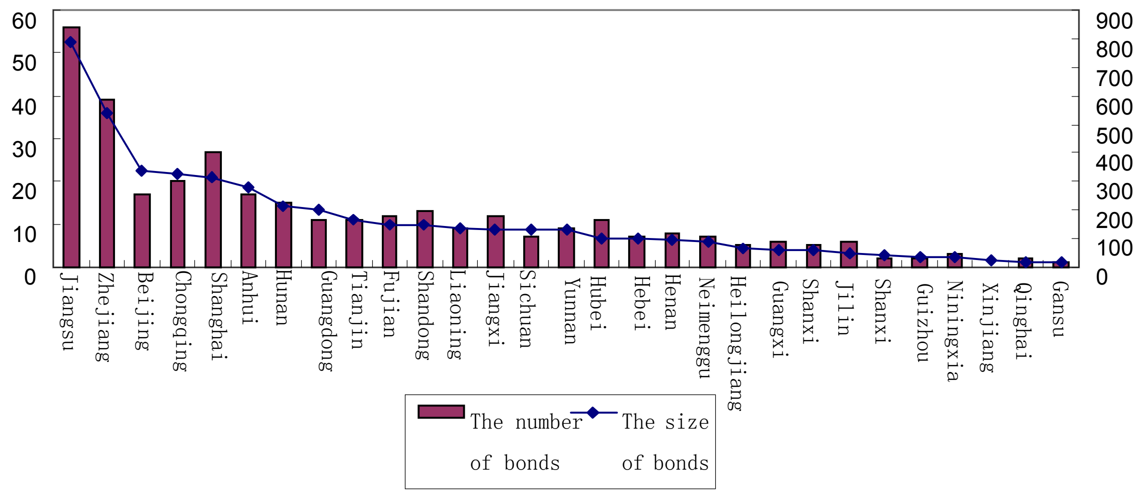
The definition of the local financing platforms is generalized, including city construction companies, developing zone platforms, transportation financing platforms, public facility financing platforms, land reserve centers and state-owned asset management centers. As long as its investment objective is to pay for any public interest project and the payment source is from government revenue or government guaranteed assets, we include it as a local financing platform. Our final data set includes 340 local financing platform companies which has publicly issued bonds in the security market in 2002–2010.[4] The companies come from 29 provinces and municipal cities. We can have following preliminary findings based on these data.

3.1 The Regional Differences

The first category has issued more than 20 bonds or raised more than 20 billion by security market. They mainly include four municipalities and four southern provinces. Jiangsu Province has reached the highest record, which are 56 bonds and 78.9 billion. The least number is in Gansu, only issuing one bond. Moreover, the Xinjiang and Hainan have not issued any bond.

[4] It includes the corporate bond, midterm notes, and short-term financing bills.

Figure 2. The size and number of bonds



3.2 The Collateral of Borrowing

Although the money raised by the financing platforms is used in the infrastructure constructions, the guarantee by the local government is not clear. The collateral of the bonds takes different forms, such as the guarantee by the national development banks or state-owned commercial banks. The more popular collateral is the land or hard asset owned by the local governments, accounted as 47% of total collateral.[5] The upswing in the value of hard assets in economic boom times can lead to excessive borrowing; and the volatility of land and real estate markets creates risks for nonperforming loans, which can become a liability of the national government and create macroeconomic risks (Canuto and Lily, 2010).

3.3 The Insolvency Risk

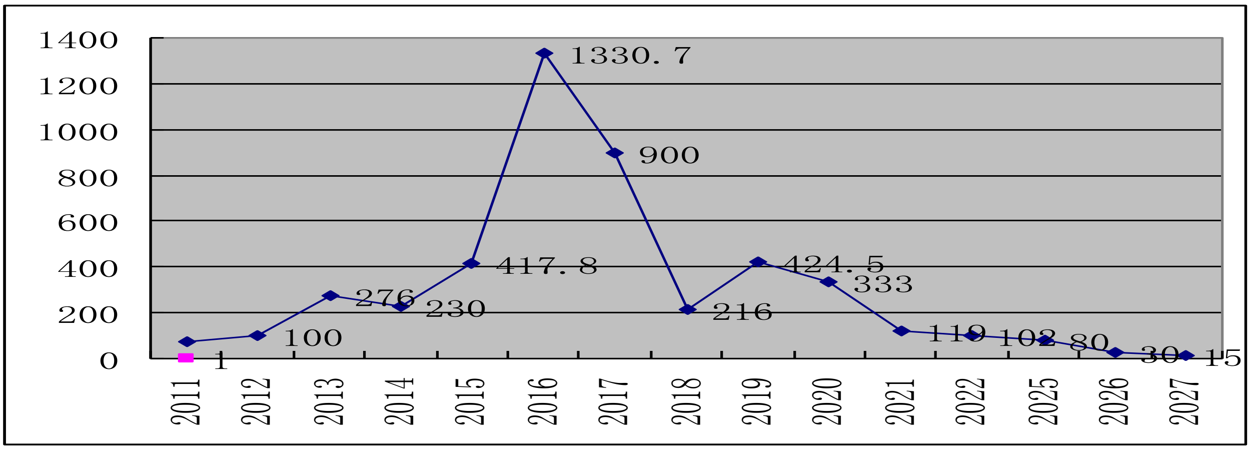
The insolvency risk of these local financing platforms comes from three trends. Firstly, the administration level of borrowing entity has come down. There are mainly provincial financing platforms before 2007. The municipal financing platforms successfully issued 14 bonds in 2008 as well as one bond by a county level financing platform. The number of issued bonds by municipal and county level financing platforms accounted for 45.5% of total bonds issued by governmental financing platforms. The share increased to 64.9% in 2009, including 60 bonds by municipal financing platforms and 14 county level financing platforms. By 2010, this share grows to 70.3% with 66 bonds by municipal financing platforms and 5 county level financing platforms. As is known to all, the lower government has less own revenue and relies heavier on transfer in China's fiscal system. Therefore, the falling of financing level has moved the debt obligation to the lower government with weaker financial capacity.

[5] 史进峰，财政担保近五成 地方平台贷款清理年末攻坚，21 世纪经济报道，2010 年 11 月 1 日。
http://www.21cbh.com/HTML/2010-11-2/2MMDAwMDIwNDA2Mg_2.html

Secondly, the finance costs of local financing platforms are higher than corporate bond issuer. The average yield spread of bonds issued by financing platforms steadily increased in last three years and generally 0.2% higher than corporate bonds.

Thirdly, the maturity exhibited a fluctuating trend in next twenty years. The rising spread was driven mainly by the rising spread of bonds with maturity of less than seven years. The bonds will be concentrated due from 2015 to 2017, particularly in 2016 with 97 matured claims (figure 3).

Figure 3. The mature period of bond issued by local financing platforms



3.4 The Size of Overall Debt

We also use of financial data disclosed by the financing platform companies to shed the lights on how large their debt are. We calculate their interest-bearing debt from 2006 to 2009, including long term loan, short term loan, accrued interest payable and bond payable. So the overall debt comprises the paying liabilities for both banks and capital market.

The interest-bearing debt of local financing platforms was approximately 2.04 trillion in 2006 and slightly increased to 2.62 trillion in 2007. The debt number had doubled to 4.49 trillion in 2009 and sharply increased to 7.66 billion. Adding the amount raised from the bond market, the overall debt in 2009 was more than 7.83 trillion. This number is close to but higher than the number estimated by China Banking Regulatory Commission in 2010.

Among different provinces, the debt of financing platforms in Jiangsu province was the highest (table 1). This demonstrated the strong financing capacity of its platform companies. The debt of China's four municipal cities, including capital Beijing, is all on the top. On the contrast, the less developed provinces, such as Gansu and Guizhou, are at the bottom of the list.

Table 1 The Interest-bearing Debt of Local Financing Platforms

	2006	2007	2008	2009
Jiangsu	3812.01	4738.72	17410.56	38901.14
Zhejiang	3086.84	3646.09	4397.91	5645.57
Beijing	2209.58	2576.92	3887.5	5308.3
Tianjin	1350.37	2301.55	3165.85	5296.17
Shanghai	2583.28	3377.71	3913.71	5132.42
Chongqing	1471.08	1508.77	1819.22	2560.12
Hubei	964.56	1268.75	1603.84	2280.2
Anhui	545.25	524.95	990.15	1879.69
Hunan	784.25	932.27	1168.5	1760.59
Guangdong	1103.75	1506.58	1707.56	1701.8
Fujian	725.54	925.38	1360.4	1608.02
Sichuan	460.09	1163.29	1457.29	1282.66
Guangxi	402.21	594.22	792.29	1164.22
Shanxi	446.78	541.64	622.2	880.17
Shandong	173.17	261.71	387.47	603.28
Yunnan	183.34	249	333.81	565.36
Liaoning	89.95	199.59	235.84	469.97
Neimenggu	39.91	123.97	199.24	366.17
Jilin	129.16	148.72	173.51	359.01
Henan	432.45	645.92	805.57	358.63
Hebei	108.71	122.02	153.98	309.1
Jiangxi	55.14	124.5	164.54	246.39
Xinjiang	62.36	70.41	120.92	234.76
Qinghai	104.63	125.13	186.79	227.53
Heilongjiang	32.4	36.47	49.98	183.22
Ningxia	423.2	512.59	603.63	110.61
Shanxi	94.7	97.38	74.51	110.08
Gansu	64.35	66.98	71.44	107.54
Guizhou	3.7	26.92	30.03	44.27

Unit: billion yuan

The growth rate of debt in different provinces has almost all kept high. The growth rate of debt of Heilongjiang in 2009 was 266 percent and of Jiangsu, Jilin and Hebei provinces were all over 100 percent.

We use the ratio of interest-bearing debt and general budgetary revenue of local government to measure the debt burden. This ratio has increased significantly after 2009. In Jiangsu, the interest-bearing debt was 12.42 times of the general budgetary revenue. In more than 9 provinces, the debt was double of the general budgetary revenue, including Beijing, Tianjin and Chongqing.

The direct responsibility of those hidden debt is the interest payment every year. We use the benchmark interest rate 6 percent to calculate the yearly interest payment. As those hidden debt is out of balance sheet, the local governments have to use out-budget revenue to pay for them. Presently, the land transfer fee is the most important out-budget revenue of local governments. Many local governments highly reply on the land transfer fee to pay for interest payment. However, we find out that the land transfer fees have already been short to pay for the interest in some provinces at this land market boom time. At 2006, the debt interests have exceeded double or triple of land transfer fees. At 2007, the land transfer fees several provinces could not cover the interest payment neither. Take Ningxia province for example, the interest payment was 5.56 times of land transfer fee at that year. The situation became better at 2008 because of the sharply increase of the land price. The housing bubble was attributed to this rising price of land. However, the soaring demand of capital by local governments after the global financial crisis urged the crazy growth of the financial platforms. The land price was still kept at a high level but could not cover the interest payments in some provinces anymore at 2009. This situation has warned the potential risks if the housing and land price going down. Some financial platforms would not have enough capability to pay for the interests, not to mention the maturity debt.

4. Concluding Remarks

The issue of subnational borrowing is an important and widely debated topic. Yet, relatively little is known about the magnitude of and the factors driving the debt of local financing platforms in China. The main reason is that the available data is limited in terms of both quality and quantity. In this study, we try to use the financial data revealed in the bond market to see the tip of the iceberg.

The results obtained from estimation undertaken by this study help us to understand the underlying effect factors and potential risks of the local borrowing by the financial platforms. The potential risk is generated from the mixture of public assets and commercial assets in these platform companies and the unclear guarantee of local governments behind these platform companies. We admit the contributions of the financing platforms in the regional development. However, the risk could not been efficiently controlled if the debt incurred by the financial platforms is out of budgetary and administrative supervision. The ‘land public finance’ plays active role in the local borrowing scheme. The revenue generated from land has become a key revenue source of local governments and also leverage for them to borrow. As a result, the fluctuation of land market would not only affect the fiscal situation of local governments but also the subnational insolvency and finance stability in China.

We reach several policy implications based on above analysis. Firstly, the Chinese government should provide more reliable and sustainable revenue source for the local governments, such as property tax. The ‘land public finance’ has created unstable social events in some provinces. The open of credit market for the local governments also need the borrowing entity have more stable revenue source. Secondly, build institutional and legal systems for the local governments to borrow. The local governments could only guarantee and make the payments for the public interest projects, while the commercial assets should be managed by the market rules.

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