

The Local Government Crisis 2007-2014: When China's Financial Management Faltered

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Summary

The direct impact of the 2007-09 global financial crisis on China was very limited. However, its USD586 billion economic stimulus package launched in 2008 to protect the economy from imported recession led to a surge in bank lending to local governments which threatened the stability of the financial system. Local government debt almost doubled between 2009 and 2013 (reaching 30 per cent of GDP). This paper investigates what triggered this crisis and why it proved so difficult to halt these borrowings, most of which were neither legal nor creditworthy.

Local administrations and their dysfunctional funding had been a source of mounting anxiety since the 1990s. They were responsible for the bulk of the nation's expenditure on economic and social development but economic reforms had left them with inadequate tax and other legitimate revenue sources. To cover their budget deficits, local governments relied increasingly on bank loans and property transactions in defiance of legislation and repeated national directives. Ideological resistance to land reform and the absence of a comprehensive land registration system allowed local officials to exploit the burgeoning property market.

A local government environment of wholesale fiscal insubordination was facilitated by the absence of modern budgetary, accounting, taxation and administrative systems, this paper reveals. The banking system had little choice but to collaborate as local officials could use their Chinese Communist Party rank to penalise the careers of recalcitrant bankers. In addition, financing local governments was often highly profitable.

The national leadership launched a vigorous campaign in 2010 to end the long-standing abuses. Initial progress was slow because the available data grossly underestimated total borrowings, leading to premature claims of success. The paper argues that the Government's plans for restructuring local government finances through the use of bond issues will face considerable delay because of what the World Bank described as the lack of the necessary fiscal transparency, financial oversight, land legislation and institutional framework.