

# **The Development of Implicit Debt of Local Government and the Countermeasures of Financial Institutions**

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**Abstract:** On the basis of explaining the meaning of local government's implicit debt, this paper reviews its progress diachronically, and quantitatively analyzes the forming mechanism of the development of local government's implicit debt by constructing a model and explaining its indicators, explaining the source of data and making statistical description of variables. When dealing with the hidden debts of local governments, we should resolutely curb the increase of the amount of hidden debts and actively start to solve the existing hidden debts. According to this, this paper puts forward the coping strategies of financial institutions, analyzes the operational opportunities they have under the fine-tuning policies, and improves the risky access conditions.

## **1. Introduction**

### **1.1 The Implication of Hidden Debts of Local Governments**

Local hidden debts are mainly based on morality or expected government department duties. The premise of their construction is not legal provisions or contracts, but the premise of public expectations and political oppression. Its types mainly include: Local government departments are responsible for debts and foreign debts, social security capital gaps, and local financial institutions' bad accounts and bad debts. In the event of liquidation of financial institutions, local government departments will assume responsibility for the loss of some assets.

### **1.2 Sorting out the Progress of Hidden Debts of Local Governments**

The first time that the concept of "hidden debts of local governments" was explicitly put forward was the politburo meeting held on July 24, 2017. However, it can be traced back to the implementation of the tax sharing reform scheme in 1994. Local governments are responsible for the pressure of expenditure, which has resulted in the division of powers and financial powers between local governments. At the same time, local governments have made demands for financing. Due to regulations such as "Guarantee Law", "General Provisions on Loans" and "Budget Law", local government debts based on local government financing platforms have gradually emerged. After the financial crisis broke out in 2008, the central government implemented the model of "paying on behalf of development" in 2009, and soon implemented the notice on strengthening the management of local government financing platform companies (issued by the state Council [2010] No.19) for rectification. In 2011, the model of "paying on behalf of development" was implemented, and in 2014, the revised budget law was promulgated to implement the model of "paying on behalf of development". As of March 25, 2019, except Sichuan and Yunnan, other provinces and regions have adopted the reporting method to show the result of resolving hidden debts. In 2020, the risks of hidden debts of local governments will be further resolved by means of asset disposal and replacement of hidden debts.

### **1.3 Quantitative Analysis of Forming Mechanism of Local Government Recessive Debt**

#### **1.3.1 Description of the Model and Its Indicators**

In order to better reveal the internal mechanism of the development of hidden debts of local governments, this section focuses on the data from 31 provincial panels in China during 2011-2018 to build panel regression models, as shown below:

$$\ln(d_{it}) = \alpha_0 + \alpha_1 Trans_{it} + \alpha_2 X_{it} + \mu_i + \gamma_t + \varepsilon_{it} \quad (1)$$

$$\ln(d_{it}) = \beta_0 + \beta_1 Self_{it} + \beta_2 X_{it} + \mu_i + \gamma_t + \varepsilon_{it} \quad (2)$$

$$\ln(d_{it}) = \gamma_0 + \gamma_1 Land_{i,t-1} + \gamma_2 X_{it} + \mu_i + \gamma_t + \varepsilon_{it} \quad (3)$$

$$\ln(d_{it}) = \varphi_0 + \varphi_1 Trans_{it} + \varphi_2 Self_{it} + \varphi_3 Land_{i,t-1} + \varphi_4 X_{it} + \mu_i + \gamma_t + \varepsilon_{it} \quad (4)$$

Among them,  $i$  and  $t$  in the above formula indicate the provincial, municipal and annual indexes in turn, and  $d_{it}$  represents the comprehensive debt rate index of local governments with hidden debts.  $Trans_{it}$  is an indicator of transfer payment rate.  $Self_{it}$  is an indicator of financial self-sufficiency.  $Land_{i,t-1}$  represents the financial index of land.  $X_{it}$  represents a series of control variable indexes.  $\mu_i$  represents the immobilization effect index of an individual;  $\gamma_t$  represents the time effect index;  $\varepsilon_{it}$  represents the index of random disturbance term.

### 1.3.2 Interpretation of Data Sources and Statistical Description of Variables

The implicit debt information of local government is based on the research paradigm of reference risk probability in the financial field, assuming the following indicators to carry out inductive estimation: (1) coefficients of various debt risks; (2) contingent debt conversion rate; (3) the proportion of government departments' burden. Among them, the calculation rule of the second index value is: the total amount of all kinds of contingent liabilities, the conversion rate of contingent liabilities, and the ratio of government departments. Whether contingent debts will be converted in the form of actual debts, especially the specific time and scale involved in conversion, mainly depends on the occurrence of certain events, and its conversion rate ranges from [0,1]. From the academic point of view, the conversion rate of contingent debts of local governments is generally 0.5. In addition, this paper also adds the asset-liability ratio of state-owned companies and the GDP ratio occupied by their debts as the contingent conversion rate control coefficient corresponding to the contingent hidden debts of state-owned companies, and adds the local government debt ratio as the contingent hidden debts or conversion rate control coefficient of local financing platforms. Based on the relevant contents in the Notice of the Ministry of Finance on Issuing the "Guidelines for Classified Disposal of Local Government Debt Risks" (Ministry of Finance Forecast [2016] No.152), the proportion of government departments' responsibilities for contingent debts is 50%, which is taken as a frame of reference and the high and low values of government departments' responsibilities are set to be 0.5 and 0.25 respectively.

The calculation of the predicted value of the direct hidden debt scale is generally obtained by the product of the total amount of the direct hidden debt source and the debt proportion, the coefficient of the risk of the debt and the proportion borne by the government department. It should be noted that when predicting the hidden debts of government departments under PPP paradigm, the proportion of debts is estimated based on the lowest capital requirements of various industries in the PPP center project bank of the financial department. The debt risk coefficient is based on the ratio of all risk-bearing costs less than or equal to 20% as stipulated in the Letter on Soliciting Opinions on "Guidelines for Value-for-Money Evaluation of Cooperation between Government and Social Capital" (General Office of the Ministry of Finance [2016] No.118). The proportion of government departments is 15% for user-paid PPP projects and 100% for government department-paid and gap-subsidized PPP projects. See Table 1 below for details.

Table 1 Table of Predicted Scale of Hidden Debts of Local Governments

| Type of debt                             | Origin of debt                                  | Source scale in 2019 | Debt proportion | Risk factor of direct debt/conversion rate of contingent debt | High proportion of government departments | Government departments bear a low proportion | Estimate of hidden debt scale of government departments in 2019 |
|------------------------------------------|-------------------------------------------------|----------------------|-----------------|---------------------------------------------------------------|-------------------------------------------|----------------------------------------------|-----------------------------------------------------------------|
| Direct hidden debts of local governments | In response to the project materials            | -                    | 1               | 1                                                             | 1                                         | 1                                            | -                                                               |
|                                          | Gaps in medical insurance                       | -                    | 1               | 1                                                             | 1                                         | 1                                            | -                                                               |
|                                          | Pension gap                                     | 11,411               | 1               | 1                                                             | 1                                         | 1                                            | 11,411                                                          |
|                                          | Gap subsidy PPP debt financing                  | 84,121               | 0.8-0.75        | 0.2                                                           | 1                                         | 1                                            | 10,111                                                          |
|                                          | Government departments pay PPP debt financing   | 33,333               | 0.8-0.75        | 0.2                                                           | 1                                         | 1                                            | 5,131                                                           |
|                                          | The application pays PPP debt financing         | 10,542               | 0.8-0.75        | 0.2                                                           | 0.15                                      | 0.15                                         | 202                                                             |
| Contingent hidden debt                   | Debt of local state-owned companies             | 601,123              | 1               | 0.5x regulation coefficient a                                 | 0.5                                       | 0.25                                         | 119,345                                                         |
|                                          | Bad loans from commercial banks                 | 17,313               | 1               | 0.5                                                           | 0.5                                       | 0.25                                         | 5,194                                                           |
|                                          | Illegal guarantee and disguised financing, etc. | 2,091                | 1               | 1                                                             | 1                                         | 1                                            | 2,091                                                           |
|                                          | Debt of local financing platforms               | 604,513              | 1               | 0.5x regulation coefficient b                                 | 0.5                                       | 0.25                                         | 19,234                                                          |
| Total                                    |                                                 |                      |                 |                                                               |                                           |                                              | 185,223                                                         |

Source of data: The source of non-performing loan information of commercial banks is the Annual Report of China Banking Regulatory Commission issued by CBRC official website. The source of debt information of local state-owned enterprises is “China Financial Statistics Yearbook”. In 2019, based on the comprehensive report on the management of state-owned assets in 2019 published by the State Council, the total amount of assets and liabilities of local state-owned enterprises are obtained by spreading out the proportion of shares based on the base in 2018. The information source of financing platform debt is Wind database; Information in PPP debt financing is obtained through calculation based on the specific investment amount and minimum capital conditions of the government departments of the Ministry of Finance and the Social Capital Cooperation Center for various industries in the PPP project bank. The implicit pension debt is calculated based on the product of the total amount of employees of companies in all provinces and cities and the 8% contribution proportion listed in the system. The source of employee salary information is China Statistical Yearbook. Illegal implicit debt information is obtained based on the publicity of each audit published by the National Audit Office, the information accountability

content in the bulletin of the official website of the Ministry of Finance, and the audit circulars of various provincial, municipal and district audit offices (bureaus) on budgets and replies to implicit debt bulletins.

## **2. Ways to Deal with Implicit Debt of Local Government**

### **2.1 Resolutely Curb the Increase of Hidden Debt**

When “suppressing the increment”, we should resolutely curb the phenomenon of illegal secured financing and prohibit borrowing by means of government purchase of services or investment fund projects and PPP. In addition, we should strengthen the management and control of the sources of risks, harden budget constraints, do a good job in reviewing projects, manage the “gate” of control number finance, and prohibit the acquisition of new projects through new hidden debt means.

### **2.2 Actively Set about Solving the Hidden Debts in Stock**

When the stock is dissolved, it should be solved through various ways of capital, and it is required that high-debt areas should greatly reduce the project's construction expenses, the “three public funds” and other general expenses. Based on the stock of debt to resolve the case and its current policies, it is suggested that repayment and conversion can be implemented. According to the way of repayment, it is suggested to implement a series of financial capital such as over-collection, carry-over and balance to pay off debts.

## **3. Countermeasures of Financial Institutions**

From the analysis in the previous article, we can see that the hidden debts of local governments have their own progress and their mechanism form a model dose analysis, and there are corresponding ways to resolve them. There are also corresponding coping strategies for financial institutions.

### **3.1 Operational Opportunities for Financial Institutions under Fine-Tuned Policies**

As the hidden debts of government departments are kept in a state of continuous elimination, it has a negative impact on infrastructure investment and economic development. From 2012 to 2019, the annual growth rate of infrastructure investment will remain at about 20%. However, in 2018, the growth rate of infrastructure construction will show a cliff pattern, with its proportion reduced to 3.8%. During the period when the work was biased towards “deleveraging”, the Chinese government emphasized the importance of “mending the short board” and promoted economic development by means of infrastructure investment. The general office of the State Council issued the “Guiding Opinions on Maintaining Efforts to Supplement Shortage in Infrastructure” (No.101 [2018] issued by the general office of the State Council), pointing out that: Financial institutions should first implement the premise that risks must be mitigated, and ensure that financing platform enterprises meet the needs of reasonable financing based on relevant principles of marketization. They are not allowed to blindly process loans or withdraw, press or stop loans, so as to avoid the risk consequences of chain breakage of existing hidden debt capital. Later, the executive meeting of the State Council (2019) also pointed out: reduce the proportion of minimum capital for some infrastructure projects; The scope of basic facilities and funded projects in other regions can raise capital through the issuance of equity and equity-based financial instruments. Such mechanisms will ensure that the economy is in a steady and increasing state for subsequent government departments to implement investment and construction of larger-scale basic facilities.

According to this, because most of the local infrastructure facilities highlight the financing platform's function in financing, at the same time, most of the funds of many city investment enterprises are currently stored for the purpose of repayment of due debts, but the proportion of investment in the new round of investment or projects under construction is not enough. Therefore, if the proportion of infrastructure construction is increased, it will certainly open up new space for local financing, which will be a new opportunity for financial institutions.

In terms of market performance, the fine-tuned policies will provide opportunities for local government departments to build financing platforms. City Investment Platform Enterprises have gradually improved their financing, and at the same time changed the previous negative attitude of the market towards city investment. For example, the spread meaning of AA+ city investment bonds issued after 2015 refers to the overall downward trend of the figures from August 2018 to now, which shows that the prudent attitude of the market towards AA+ city investment platforms has been eased to a certain extent.

### **3.2 Financial Institutions Should Improve the Access Conditions for Risks**

As the restraint of hidden debts has not been fully released, financial institutions are still cautious in their subsequent infrastructure construction and capital investment. Also, due to the constraints of platform financing channels, the risks that may exist in the credit of the city investment may be continuously exposed, and at the same time, it will be more or less affected by market conditions. After improving the financing structure of the platform, the market-oriented transformation of the city investment enterprises still maintains the momentum of advancement, which will promote the differentiation of the internal qualifications of the main bodies of each city investment platform. After the promulgation of various regulatory policies, the limits of borrowing by local government departments have become more and more clear, thus accelerating the progress of separating the financing platform from the nature of “gilt-edged”, which will increase the risk probability of liquidity in urban investment. Therefore, in the future, we should consciously avoid the lack of cash flow and the phenomenon of “shell” platform built by essential projects.

According to this, in the process of implementing specific strategies, financial institutions should choose regions with good economic development, good coverage of marketing assets, relatively sufficient cash flow and reasonable proportion of liabilities. It can shoulder the core responsibility of public welfare or quasi-public welfare projects of local government departments based on compliance. The credit rating of the main body of city investment is not low, and it can avoid projects with too long operation cycle.

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