



# Technical Assistance Consultant's Report

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Project Number: 45501-001  
December 2016

## People's Republic of China: Public Finance and Financial Management Reforms

### TA 7896: Output 3 Development of Local Government Bond Markets in the People's Republic of China

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**Asian Development Bank**

# Development of Local Government Bond Markets in the People's Republic of China

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## BACKGROUND

The 1995 Budget Law barred local governments from borrowing or issuing bonds without State Council approval. As a result, infrastructure investments were often funded with revenues from land leases or with indirect off-budget borrowings, through public utility companies, special-purpose vehicles, or urban development investment corporations. The Central Government recognized that granting local governments direct access to bond markets would provide them with more resources for infrastructure development and in the process introduce market discipline and reporting requirements. It was expected that this would encourage transparency and good governance. The central Government also expected considered that expanding local government borrowing would deepen financial markets.

## OBJECTIVES

Recognizing the potential benefits of giving local governments access to bond markets, the central government asked the Asian Development Bank (ADB) for technical assistance (TA) to undertake a study on the development of local government bond markets. The TA, which was approved in October 2011, provided for an in depth study of operating mechanisms and institutions for local government bond markets, and the transition to a nationwide system. The research was to be based on international good practice and the TA provided for a survey of the literature on local government bond markets in three developed countries. In addition, the TA selected five provinces, representing the various geographic regions of the PRC (eastern, central, southwestern, northeast, and northwestern), for an examination of the preconditions for the setting up of local government bond markets in different provinces. The research was to expand on studies by the budget department of MOF on the fiscal concerns connected with the issue of local government bonds. These had focused on the responsibilities of the treasury department and local finance bureaus and had covered investor relations, bond structure and yield curve, debt management, risk management, market liquidity, primary and secondary market development, information disclosure, and rating.

## FINDINGS

The study, which was undertaken by the TA consultants—China Central Depository and Clearing Company (CCDCC)—confirmed the importance of matching revenue raising powers with spending responsibilities. It found that while local governments are required to provide many services and facilities their official sources of revenue are limited. Local governments have had to rely heavily on off-budget revenues sources. A major source of off-budget revenues has been land transfer fees, which are unreliable and variable.

The lack of a consistent, reliable source of revenue has had serious consequences for the fiscal position of many local governments and in particular the poorer ones. These local governments have been forced to resort to “imaginative” and questionable practices in order meet their

expenditure obligations. Research suggested that there was a lack of transparency related to local government debt, that most local governments had incurred substantial contingent liabilities. and these liabilities were commonly difficult to identify and poorly understood. In many cases there is a real risk of default.

Overseas experience in financing of local government activities provides important lessons for PRC. A review of local government funding in Australia, France, Germany, Japan, the United States of America emphasized the importance of transparency, disclosure and accountability in local government financing and the importance of bonds as a source of revenue for local governments. It also emphasized the essential role that central governments have to play in establishing the legal framework for borrowing and setting limits on borrowings.

The TA has played a significant role in development of local government bond markets in the PRC. The report by the TA consultants and CCDCC provided a sound basis for initial reforms. Subsequently, under an extension of the TA, the consultants focussed on revenue bonds and this has supported government policies and regulations.

## **RECOMMENDATIONS**

Six major recommendations were made by the study:

- **Establish a clear system for management of municipal bonds**

A central authority should be established to oversee the municipal bond system in the PRC. The authority would have responsibility for such matters as: approval of bond issues to match the size of an issue to the capacity of local governments to repay; monitoring the use of funds from bonds to prevent misuse of funds, and supervising the repayment of principal and interest.

Local governments will be responsible for preparing a bond issuing plan and a repayment plan. They will also be required to improve their financial administration systems, and implement a comprehensive government financial reporting system in order to increase the transparency of local financial affairs.

- **Define issuers of municipal bonds and bond types**

The study recommended that authority to issue bonds be gradually expanded to local governments as they improve their financial administration and demonstrate their capacity to repay the borrowings. It further recommended rationalization of existing borrowing mechanisms. In line with these proposals, provincial governments have been allowed to issue bonds and in 2015 general obligation and revenue bonds were issued by all provinces. The total amount issued was CNY3,800 billion.

It was suggested that different bond types be issued depending on the use of the borrowed funds. General municipal bonds would be appropriate where funds were mainly used to finance projects without income, such as urban infrastructure, hospitals and schools. Repayment would be the responsibility of the local government. However, for projects with an income stream such as highways, airports and railways, Special municipal bonds would be issued. Repayment would be made from the project income stream and neither the local government nor the financing platform companies would be liable.

Newly instituted revenue bonds are backed by user revenue and commitments by governments to pay. Such government backing makes such bonds low risk and therefore low cost. This represents an innovative hybrid bond approach that lays the foundation for future, fully fledged revenue bonds. Around CNY1,900 billion of these bonds were issued in 2015. There is a close relationship between government policy and regulations and the consultant's reports on these bonds, with the reports playing a key role in helping senior officials formulate proposals.

- **Enhance the risk control mechanism for municipal bonds**

This was to have three components. First, an effective early warning mechanism should be established to provide information on the financial positions of local governments. This would use various indicators such as the debt service ratio and the debt service ratio of the local government. Secondly, local governments would be required to establish repayment guarantee mechanisms which would include sinking funds, external supervision and audit mechanisms, and strict repayment plans. Thirdly there would be an emergency response plan to address the possibility of default. This could involve increased taxes, sale of assets and debt deferral.

- **Establish market-oriented control mechanisms**

Local governments issuing bonds would be required to provide regular information on matters such as existing liabilities revenues, debt repayments, project income, project progress and other events that could have a significant impact on debt repayment and bond pricing. In addition, a credit rating system would be set up to provide potential investors with information on the credit risk relating to particular bonds. Finally, the study recommended the establishment of a guarantee fund administered by bond management departments.

- **Improve the operation of the municipal bond market**

The review emphasized the importance of adopting a market approach to the issuance of bonds. It was suggested that a tender system should be adopted for the issuance of municipal bonds. Although the institutions are currently the major holders of bonds the study argued that they should be made more accessible to individual investors through listing on regional markets. Further, it was argued that transactions costs would be reduced if there was a centralized, unified depository for municipal bonds and this would promote the formation of the bond market.

- **Improve supporting arrangements for municipal bonds**

The review also saw a need for changes to a number of supporting arrangements including: amendments to the Budget Act to define local government rights to issue bond; detail management requirements of local government debt; introduction of rules and regulations for the institutional management of debts of local governments; fiscal and taxation system reform to increase stable tax sources, simplify transfer payments; adoption of interest exemption for municipal bonds.