Journal of US-China Public Administration, May-June 2022, Vol. 19, No. 3, 95-107
doi: 10.17265/1548-6591/2022.03.002

Integrating Capacity and Autonomy in Evaluating the Quality of Governance: A Case of China's Capital Markets and Local Debt Crisis

Liguang Liu
Central University of Finance and Economics, Beijing, China
Heidi Jane M. Smith
Universidad Iberoamericana, Mexico City, Mexico

The quality of governance is an important concept in studying economic growth and social welfare in developing and transition countries. Although somewhat controversial, there are clearly defined broad approaches or interactions to evaluate the quality of government. Fukuyama proposes an ideal type of governance quality model that could illustrate optimal levels of autonomy for differing levels of capacity. Gaining insights from his perspective, this research examines China's experience with fiscal decentralization by focusing on the evolution of its current local government debt crisis. This research aims to explain the changing fiscal relationship between the central and local governments and analyze the roles and interactions of capacity, discretion, and accountability in China's local governments. Although the central government has shown proactiveness in promoting local capital markets and has exerted efforts in regulating the local debt financing, the paper argues that without advancing tax reform and local discretion while increasing ways to create accountability and improve capacity within local governments, the debt market will not operate as expected. As a result, local governments and residences still rely heavily on the center to support balancing their fiscal budgets.

Keywords: quality of governance, local government debt crisis, autonomy, China

Introduction

Intergovernmental relations represent "a series of financial, legal, political and administrative relationships established among all units of government that possess varying degrees of authority and jurisdictional autonomy" (Henry, 2018, p. 460). The past four decades have witnessed changes of the intergovernmental relationships in governments globally, no matter whether federal or unitary, generally done to accommodate political requirements and policy goals. Particularly in Western countries, since the 1970s, a number of trends of New Public Management—in particular through the mantra of devolution, decentralization, and privatization—accelerated an enormous change in government and its administration. The traditional bureaucratic government was required to relinquish its powers to lower levels, market actors, and non-profit organizations.

Liguang Liu, Ph.D., associate professor, School of Government, Central University of Finance and Economics, Beijing, China.
Heidi Jane M. Smith, Ph.D., research professor, Department of Economics, Universidad Iberoamericana, Mexico City, Mexico.

While decentralization within the field of public administration is believed to generate public policy innovation, greater transparency through citizen participation, and better delivery of public goods and services at the local level, research on how these factors have been used to help increase economic development has been contested (Davoodi & Zou, 1998). The casual mechanism to determine the relationship between decentralization and economic development is complex as it has proven in both theoretical and empirical studies (Bruechkner, 2006; Filippetti & Sacchi, 2015; Hernández-Trillo, 2016; Smith & Revell, 2016). For example, several large-scale quantitative studies on the relationship between fiscal decentralization and economic development find different outcomes (Davoodi & Zou, 1998; Glaeser, Scheinkman, & Shleifer, 1995). Scholars explain the mixture of outcomes by the variation that exists in terms of measures of autonomy, fiscal decentralization, and own-source revenue generation (Bahl & Bird, 2008; Bahl & Linn, 1994; Ebel & Yilmaz, 2002; Martinez-Vazquez & McNab, 2003; Zhang & Zou, 1998). The differences can be conceptual, for example how autonomy is defined or what economic development is, to more tangible, such as how budgets are calculated and organized.

Yet, for many decades, public administration scholars, development economists, and practitioners assumed that decentralization policies would improve efficiency in government activity and encouraged many emerging countries to shift political power and fiscal resources away from the national government towards sub-national governments. With the mixture of empirical results, recent public administration scholars suggest that countries that are still in the process of designing their institutions, legal systems, and human capital will fall behind others in the pursuit of economic development (Rodriguez-Pose & Krøijer, 2009). Yet, until recently, two factors are missing in scholarly literature: namely, (1) how to manage the relationship between discretion (autonomy) and accountability, and (2) how the decentralization process creates more local capacity in the long run. These assertions need to be studied further to distinguish how they may be of relevance for applications to public policy.

Decentralization of powers away from the central government is an important component of China’s transition to a market economy, although the extent is quite debatable. Over the past three decades, China has made a substantial effort to break down its highly centralized fiscal management system. This began with various public administration forms of fiscal contracting systems and later evolved into a tax sharing system reformed in 1994. These seemingly small fiscal reforms have contributed substantially to China’s economic growth and have rebuilt new relationships between the national and subnational governments, as well as other non-governmental actors.

Studies on China’s fiscal picture have shown that the 1994 tax sharing system improved the transparency and stability of the central-local fiscal relations but have also created a new trend of recentralization of fiscal power (Bird & Vaillancourt, 1998). While many subnational fiscal gaps have been filled by the operation of intergovernmental transfers, the stabilized situation was disrupted by the global financial crisis in the late 2000s and China’s anticipation of its potential devastating outcomes. Beginning in 2009, China set out large-scaled economic stimulus package-to stave off the impacts of economic collapse in the aftermath of the global financial crisis, in which local governments were permitted to finance local infrastructure projects. However, the local-government debt far outstripped own source revenues. Increasingly, this fiscal gap and upcoming repayments raised the question how the debts can be repaid. Many scholars have studied options for China to deal with the local government debt crisis (Goswami & Sharma, 2011; ADB, 2013; Feng, 2013).

This research examines China's experiences with financial decentralization by focusing on the evolution of its recent local government debt crisis: how the debt issues emerged and how all levels of government work to address it. In particular, the research analyzes the roles and interactions of capacity, discretion, and accountability in improving the quality of governance. Arguably, the current financial stresses are symptoms of the underlying distortions of fiscal relationship between central government and localities, and without further reforms to reframe the fiscal system and improve local governance capacity; the fiscal stresses in local governments will be permanent and may get even worse.

The article is organized as follows. The first section reviews the public administration literature of decentralization, intergovernmental administration, and local autonomy with a special focus on the Chinese context. Then the article provides an overview of evolution of China's fiscal picture. Empirical observations are provided to describe which approaches were used by the Chinese national government to stave off the financial crisis. In addition, possible explanations are offered for why local government debt issues developed and more public administration reforms may be necessary. This is followed by conclusive thoughts on how China's fiscal system could be reformed for future using a local governance approach to financial decentralization.

Governmental Decentralization, Quality, and Local Autonomy

Decentralization in the inter-governmental administrative sphere is the process of redistributing or dispersing functions, powers, people, or things away from a central location or authority to other localities. In history, many countries have experienced cycles of centralization, then decentralization, and recentralization in their public administrations. Since the late 1970s, rising government expenditures, poor economic performance, and the rise of free market-influenced ideas have convinced governments to initiate so-called New Public Management reforms. This movement features decentralizing governmental operations, privatizing some governmental functions, contracting out competition within government and consumer orientation.

There are different types of governmental decentralization including political, administrative, financial, and economic reforms. Political decentralization aims to give citizens power to elect their own representatives. Administrative decentralization, in various forms of delegation, devolution, and privatization, transfers the powers of decision making and functions in policy implementation to local level authorities or private companies. Economic decentralization can be done through privatization of public owned functions and enterprises, but also done through deregulation, the abolition of restrictions on businesses competing with government services. Fiscal decentralization, similar to fiscal federalism, refers to the transfer of fiscal authority from central to subnational and local governments which could also include the management of financial outcomes (Bird & Vaillancourt, 1998).

China's fiscal decentralization process received significant academic attention because the process helps to explain the county's transition into market-based economy, which created rapid economic growth in the 2000s. Fiscal decentralization is among key components of the economic reforms. The reforms were achieved through increasing local participation in policy making, expanding local property and sales taxes, creating intergovernmental transfers of tax monies by central government to lower level of government, and authorizing municipal borrowing with national government loan guarantees. Historically, fiscal decentralization tends to enhance economic decentralization, which is taken as a major driving force toward market economy and privatization.

For example, Feltensteina and Iwata (2005) develop indicators to interpret the relationship between fiscal and economic decentralization. For them, the degree of economic decentralization is measured by the relative size of tax contributions, output, and sales volume of the non-state firms, while the degree of fiscal decentralization is measured through the relative size of expenditures and revenues of local governments as well as extra-budgetary. The empirical calculation shows they are highly correlated. However, fiscal decentralization is not always congruent with other reform measures. Hsu (2004) examines the linkage between two types of decentralization in China: fiscal decentralization and local autonomy (economic decentralization). He argues that local autonomy is not necessarily congruent with fiscal incentive in affecting local compliance with centrally imposed policy rules during policy implementation. When national mandates follow an internally consistent logic of decentralization as a whole, conflicting effects will arise. Whereas fiscal decentralization relates to linkages with other types of governmental decentralization, our study will be limited to financial decentralization.

Fiscal decentralization affects subnational governments in several ways. On the positive side, issues of fiscal federalism provide fiscal incentives to lower level governments. Closing the link between local government revenue and expenditure provides strong incentives for local governments to drive local economic development. But on the negative side, this may induce vertical and horizontal imbalances. In the case of vertical imbalances, the central government may allocate too much or too little transfers to the lower levels, thereby increasing central government control over lower levels of government, reshaping the central and local relationships. Horizontal imbalance is another possible outcome created when transfers are not created appropriately. Especially when cooperation among local governments is rare, financial decentralization reforms can give rise to fierce competition among local governments in China. This is because of the limited pool of national and international capital used to leverage local financing.

Typically governments go to international capital markets when local capital markets dry up. Also, local governments often times clean up their fiscal balance sheets in order to increase their rating for better terms for their credit. Krug and Libman (2015) analyze the conditions under which the political regimes are capable of making credible commitments to maintain a certain level of local autonomy and to incentivize local bureaucrats. Their research concludes that due to the competition between vertical elite networks that span across regional and central political arenas and the country's limited access to natural resources, China has been able to make credible commitments to local autonomy. Acts made by local administrations to improve their credible commitments to improve their public finances are valuable efforts to evaluate and study.

Decentralization offers significant opportunities to improve local discretion and accountability in order to achieve better governance. By analyzing four approaches of evaluating quality of governance, i.e. procedural measures, input measures, output measures, and measures of bureaucratic autonomy, Fukuyama (2013) suggests that quality of governance is ultimately a function of the interaction of capacity and autonomy, and that neither one will be independently an adequate measurement. He thus suggests adding discretion (autonomy) and capacity as components to measure quality of governance, in addition to the traditional use of output and procedural measurements (Bouckaert & Peters, 2002). Claiming bureaucratic autonomy is missing in the World Bank governance measures, Fukuyama suggests that states need to be disaggregated into their component parts, both by functional and regional levels of government, thus, allowing the appropriate type of government to be involved with increasing capacity and autonomy components as measures of executive branch quality (Busuioc & Lodge, 2016; Mohr, 2016). Discretion also links with accountability; ideally more discretion offers more opportunities to improve accountability, to the public (i.e. downward accountability) and citizens or to higher levels of government (i.e. upward accountability) (Yilmaz, Beris, & Serrano-Berthet, 2008).

Figure 1 shows the relationship between bureaucratic autonomy and quality of governance and can be used to draw hypothesis for research. All these curves are inverted-U shaped. In general, the higher capacity of government, the higher discretion the government can mobilize. Notably too much discretion or too much subordination can damage the governance quality (Fukuyama, 2013). At one extreme of complete subordination, the bureaucracy has no room for discretion, management, or independent judgment and is completely bound by detailed rules; and at the other end of complete autonomy, governance outcomes would also be disappointing, because the bureaucracy has escaped all political control and pursued its own interests. For this research, we hypothesize that China, through its efforts to promote fiscal decentralization, has created more discretion for local governments to make decisions to take out debt, but at the same time has not associated these decisions with the capacity of government to mobilize local capital to pay for that issuance.

According to Fukuyama's arguments, if all the inflection points of these inverted U curves can be linked, we get optimal levels of autonomy for the given levels of capacity. In general, the higher the capacity of a bureaucracy, the more autonomy one would want to grant them. We can theoretically draw on the government institutions to the left side of this sloping line. They are bounded by excessive rules and the proposed solution is to add more discretion to manage financial decisions, for example, while the institutions to the right need to limit their excessive discretion, in order to fully exert their capacities. Thus, as shown in Figure 1, red arrows provide directions to enhance governance quality. Due to the differences of the capacity, government institutions, at different levels of government, vary in their optimal points. In addition, there is relationship between discretion and accountability. The desired goal is generally higher degree of discretion and higher degree of accountability. In a given capacity level, once the governance reaches its sweet spot zone, the desired target is then to enhance accountability (Yilmaz, et al., 2008).

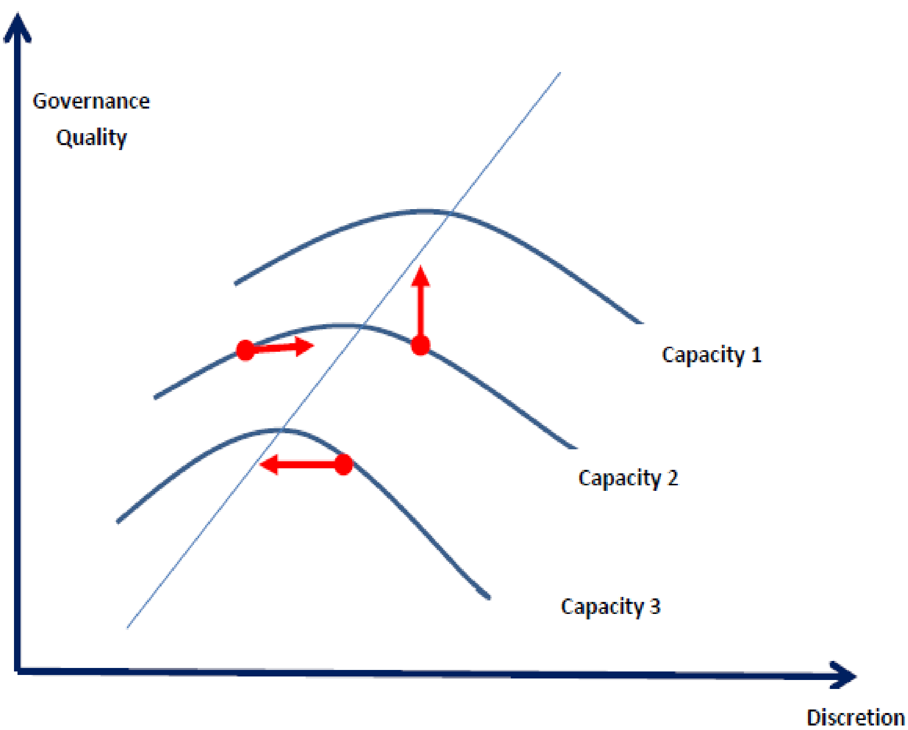

Figure 1. Quality of governance and optimal levels of autonomy developed by Fukuyama (2013).

Development of Local Capital Markets and Debt Crisis in China

This section provides a case study of the development of China's local capital markets and debt crisis and how China has coped with it. China's debt finance issue is seen as a component of the country's finance structure, which also consists of other elements such as own-source revenues, expenditures, and intergovernmental transfers. Local debt finance is a policy option that allows subnational government to borrow from banks or issue domestic bonds. The fiscal structure to seek out finances is shaped by the intergovernmental context in which different types of decentralization policymaking and implementation take place. The fiscal discretion, accountability, and management capacity are concepts to evaluate performance of intergovernmental system and are influenced by the decentralization context and finance structure.

Fiscal Structural Between Central Government and Localities

Although China remains a unitary political system, the Chinese public finance system has many of the features of fiscal federalism (Bahl, 1998). The main organs of state power are the National People's Congress (NPC), the highest legislative branch, and the State Council, the highest executive branch. Since the Communist Party of China (CPC) is the founding and ruling political party, the Politburo and its Standing Committee play the most significant roles in policy decisions. The subnational (provincial) government in China exercises jurisdiction over 22 provinces, five autonomous regions, four municipalities under the central government (Beijing, Tianjin, Shanghai, and Chongqing), and two mostly self-governing special administrative regions (Hong Kong and Macau). Under the provincial-level government, there is a three-level administrative network of prefectures: counties, and cities and townships and districts.

Decentralization of power away from central government is an important component of China's transition to a market economy, although the extent is quite debatable. The 1980s has seen various contracting reforms to break down its highly centralized fiscal system. As a result, the "two ratios" experienced continued a sharp decline: the budgetary revenue to GDP went down from 22.91% in 1984 to 12.56% in 1993 (Figure 2) and the central to total budgetary revenue declined from 40.5% in 1984 to 22% in 1993.

In response, China introduced the "tax sharing system" in 1994 under which each type of tax is shared by the central and subnational governments according to a stated percentage. The new fiscally re-centralized system achieved immediate impact on the division of revenue sources between the central and subnational governments, and finally ended the central government's reliance on the local remittance. The budgetary revenue to GDP percentage reversed the declining trend and instead began to grow. For example, during 2011-2016, the share stabilized at 21%-23%. Figure 3 shows the percentage change of subnational government revenue and expenditures. As shown in this figure, the percentage of subnational revenue dropped below 50% in 1994 and remained at this level until 2010. The figure also shows that the tax sharing system did not significantly influence the expenditures by subnational governments. The percentage of the subnational government expenditures had fluctuated between 67% and 72% during the 1990s and the early 2000s. However, China has kept increasing its fiscal federalist system since 2004 until stabilizing at around 85% in 2011.

The 1994 tax-sharing reform improved the transparency and stability of the central-local fiscal relations, but it also shows a new trend of recentralization of fiscal power. The subnational fiscal gaps have been mainly filled in by the operation of intergovernmental transfers. In fact, central-provincial transfer accounts for 67% of provincial needs and provincial-local fiscal transfer accounts for more than half of local fiscal resources (Shen, Jin, & Zhou, 2012). The central-subnational transfers in China can be classified into two broad categories:

general purpose (e.g. tax rebate and equalization transfer) and specific purpose transfers (e.g. grants, earmarked funds for projects). In 2012, the central-subnational government transfer reached to 4023.4 billion yuan, doubled the number of 2008, including 2143 billion as general-purpose transfers and 1880.4 billion as specific transfers (MOF, 2013). This total transfer reached to 6521.8 billion yuan in 2017.

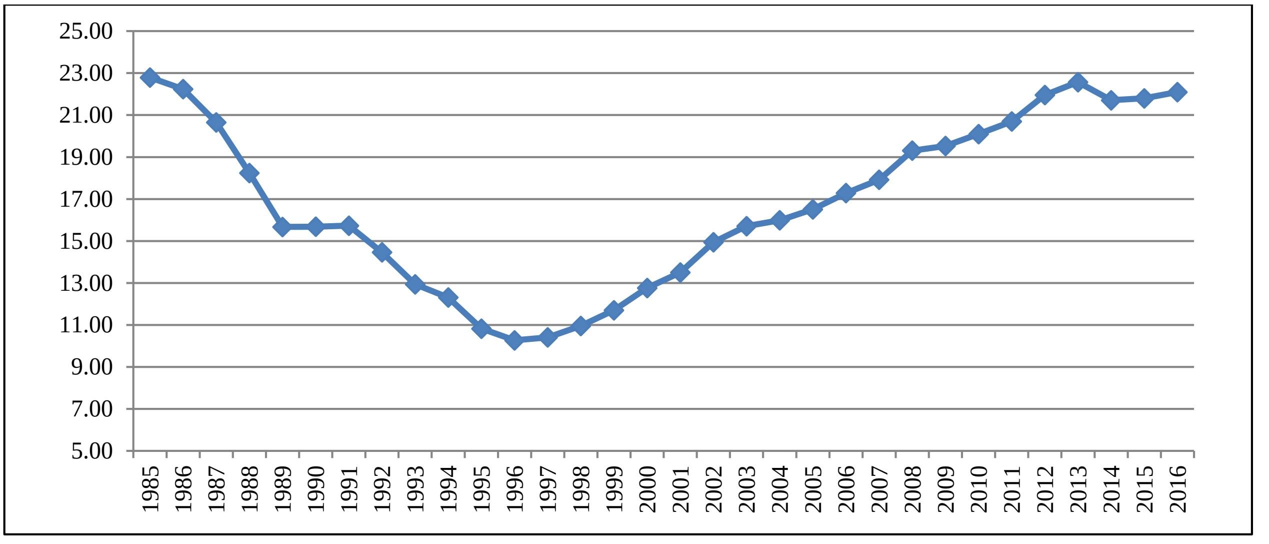

Figure 2. Budgetary revenue to GDP percentage in China.

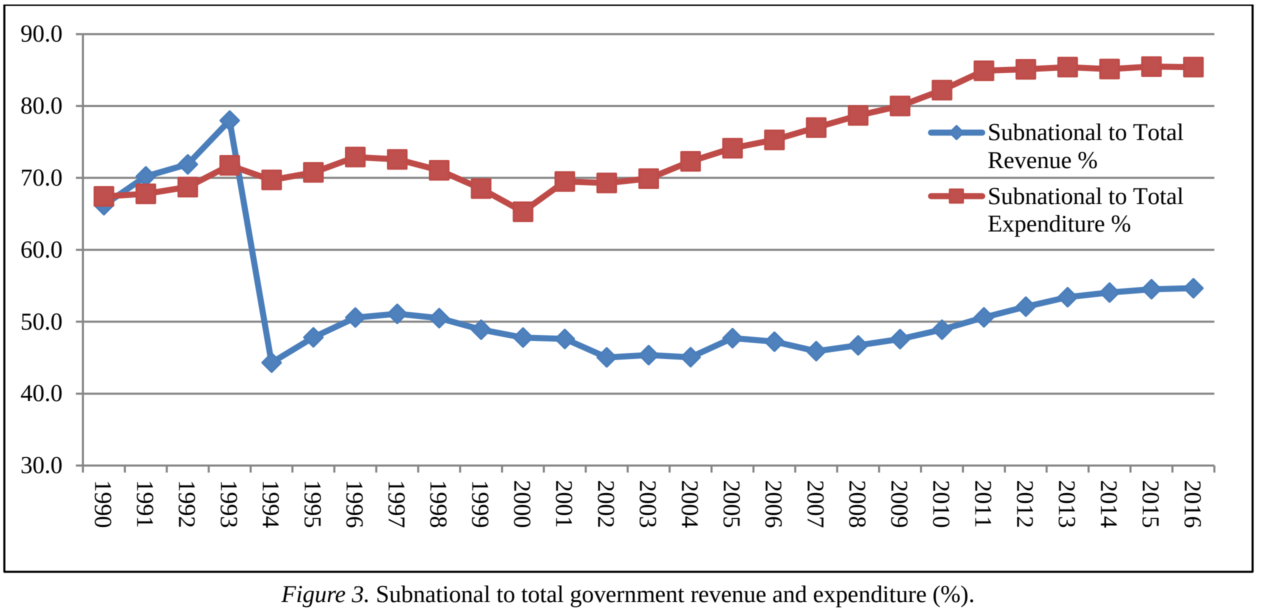

Figure 3. Subnational to total government revenue and expenditure (%).

Emerging of Subnational Government Debt

The 1994 tax reform gave birth to the Budget Law of China. Under the Budget Law, subnational governments are forbidden to obtain domestic or foreign debt issuances. When a local government needed an investment which surpassed their revenues, the central government would take a comprehensive approach to analyze the fiscal situation and if needed specific transfers are made to meet these requests for distribution.

In 1998, to stave off impacts of Asian financial crisis, the central government acted as debtor and issued 108 billion Yuan of treasury bonds and transferred the loans to local governments. In addition, the local governments were indirectly allowed independent decision-making powers regarding debt financing and the expenditure of public investment by means of the local state-owned enterprise (Xu, 2012). There has been circuitous route of debts that local governments are able to manage such as direct borrowing, loan guarantee, borrowing from commercial banks, indirect borrowing from local-owned enterprises or Trust and Investment Companies (TICs). The total local borrowing was estimated to be over US$120 billion by the end of 2004, some local governments were actually on the verge of bankruptcy due to debt services; however, there were lack of legal procedures for resolving local government insolvency.

As a result, the Chinese central government put forward an economic stimulus package of four trillion yuan (586 billion USD). This was a deliberate state-driven stimulus program to mitigate potential economic collapse in the aftermath of the 2008 global financial crisis. The funding would be transferred within three years and included 1.18 trillion yuan from central government and the rest as matching grants from local governments. The stimulus opened the door for local governments to seek new additional financing channels, which made the local government debt issues worse.

How can local government finance local projects with its already tight budgetary situation and how did the central government supervise their performance? The first approach was through bond issuance. From 2009-2011, the Finance Ministry issued 200 billion yuan each year on behalf of the local governments. Realizing the necessity to ensure local government is accountable for the quality and quantity of the loans, in April 2009, a team by the Finance Ministry was formed to revise the national Budget Law. After three-year pilot program, which included bond issuance experimentation in six local provinces and municipalities and four rounds of reviews, the new Budget Law was finally passed in 2014. The revised Budget Law makes local government debt more transparent and accountable by granting local government the right to issue bonds on their own (Dong, 2014).

The second approach is through the establishment of the Local Government Financing Vehicles (LGFVs). LGFVs are state-owned enterprises set up by local governments to conduct infrastructure projects that would normally be undertaken directly by the governments themselves. Local governments support the LGFVs by injecting cash into or transferring state land to them, which the LGFVs are used as collateral to borrow from banks and capital markets. The number of projects funded through LGFVs increased rapidly. The total reached to 6576 projects by 2010. Fearing the LGFVs aggravating the overheat of economic growth, the State Council began to discipline the LGFVs by imposing curbs on bank loans and tightening the promotional controls of lower-level officials.

In addition to the LGFVs, local governments also borrow through the less transparent shadow-banking system. The lenders are nonbank financing agencies in which the borrowing is not regularly disclosed. Funds borrowing from shadow banks grew from 360 billion USD in 2011 audit to almost 1.2 trillion USD in June 2013 (Huang & Bolser, 2014). Foreseeing a potential crisis due to lack of regulation, the State Council sent orders to clean up the market and enhance supervisory responsibility in late 2013.

In September 2014, China announced its new Budget Law after four rounds of reviews, which was finally enacted in 2015. The new Budget Law ensures local government debt be more transparent and accountable by granting local governments the right to issue their own debt. In addition, the law required local governments to report these debts on their budgets and operate expenses. The process mandated tight monitoring and supervision by local and central authorities. It also drove many local governments to compete for limited funds.

Structure of Debt Portfolios and Management

The Chinese National Audit Office (NAO) categorizes government debts into three types: government direct debt, government guaranteed, and other contingent liabilities. In 2010 and 2013, the NAO (2013) published auditing reports that unveiled the China's government debt situation. According to the 2013 NAO report, by the mid-2013, the total local liabilities amounted to 17.89 trillion yuan, 66.9% higher than the figure in 2010 (10.7 trillion yuan). During those four years, GDP had expanded 42%, which was at a slower rate than the real increase of the local government debt. China's subnational debt to GDP percentage has increased from 26.7% to 31.5% from 2010 to 2013. If adding the central government's debt in 2013 of 12.38 trillion yuan (21.77% of GDP), the total government debt would bring a total of 53.2% of GDP. The increasing local government debt has been taken as risky, especially when tax revenues are on a downward trend due to pressures from a declining economy.

The 2013 NAO report also publicized the percentages of direct debts by each level of subnational government were as follows: 16.3% provincial, 44.5% prefectural, 36.4% county level, and 2.82% at the township level. Similar to other countries, the prefectural and country level governments are the main debtors. The subnational debts are mainly borrowed for investment. More than 37% of the direct debt financed municipal building works. Besides, 16.7% was used for land overhaul and preservation, 13.8% paid for transportation infrastructure, and 7% paid for affordable housing. Many of these investments have not yet started to generate returns, which decreases the risk of default because the investment becomes self-sustaining into the future.

The local governments are the most indebted public institutions. It is estimated that the local government debt has doubled from less than 20% of GDP in 2007 to nearly 32% in 2013. The challenge is who will pay back these debts mostly incurred after 2009, by local governments themselves or by central government? In March 2015, a clean-up refinancing program was introduced to restructure the liabilities by the Ministry of Finance. The logic was to promote a debt swap policy to roll the loans over and shrink debt's ratio to the economy. Consequently, to rein in local government debt, caps on the debt quota were set by the central government. In 2015, local governments, with the permission of central government, issued 1.6 trillion-yuan worth of bonds, in which 1 trillion was used to swap existing high-interest for lower cost bonds and 600 billion yuan used as new bonds for making up deficits and financing public projects.

In August 2015, the bond-for-debt swap program was readjusted. The National People's Congress (NPC), China's top legislature imposed a ceiling of 16 trillion yuan ($2.51 trillion) for liable local government debt in 2015. The 16-trillion-yuan local government debt consists of two parts: 15.4 trillion yuan of debt balance owned by local governments by the end of 2014, and 0.6 trillion as the maximum size of debt local governments is allowed to run up in 2015 (China Daily, 2015).

Such ceiling approach continues as part of efforts to control debt booming and contain systemic financial risk. The Chinese central government has set a ceiling of 21 trillion yuan for local government debt in 2018. As of May 2018, local government debt accounted for 16.6 trillion yuan, including 15.6 trillion yuan as local bonds. The Ministry of Finance also outlined measures to crackdown illicit hidden growth of local government debts by "opening the front door" of fund-raising via municipal bond issuance, while "shutting the back door" to illicit forms of financing (CBN, 2018). In general, the increasing trend of local government debt has been curbed with the ceiling control approach.

Discussion

After three decades of rapid economic growth, China's GDP growth has begun to slowdown. The low growth rates could aggravate the municipal debt crisis of the repayments, especially after the COVID-19 pandemic. If no effective public administration reforms are taken, the local government debt could continue to grow at a rate higher than the GDP. The efforts by the Chinese government in auditing its subnational government debts are the basis for seeking policy solutions to the crisis. In effect, with the hypothesis that China has created more discretion for local governments to make decisions to take out debt, at the same time has not associated these decisions with the capacity of government to mobilize local capital to pay for that issuance may be correct, these efforts at finical decentralization is leading to a local debt crisis.

To deal with the local government debt crisis, the Chinese government could promote a series of policies to facilitate local governments to repay the debts by themselves. At the same time, the adaptation of the new Budget Law provided a solid legal basis for the repayment requirements. The Law insures that local government authorities must seek permission if they issue bonds for local development by the central government. This recruitment alone eliminates the local government financial discretions to manage their local businesses. After two decades of tax-sharing system reform from Beijing's tight controlling of economic policymaking, does permission of bond issuance by local governments implicate a reemerging of fiscal decentralization?

It is true that the new version of the Budget Law moves forward in relinquishing central government's exclusive authority in issuing bonds. Yet the law is far from its initial goal to allow local governments to independently finance their local development projects. If the tax-sharing system does not change alongside this law, the fiscal imbalance will still remain. For a typical local government, if their budgetary revenues do not meet expenditures, there is still a dependence on the central authority for an implicit bailout (see this example in Mexico, Hernández-Trillo, 2018). In addition, large-scaled local government debts are caused by the indiscriminate investment and spending through LGFVs. These loans are backed by inter-governmental transfers in part and therefore do not have complete autonomy, since some of them resulted from the national stimulus plans or local incentives. The adoption of a local debt management system is necessary to obligate local governments to be responsible for local financial affairs and clarify that the central government will not bailout local governments when their expenditures have exceeded the incomes.

What are the obstacles that impede the enthusiasm of local governments to take a proactive approach to defuse the current debt crisis and for a long term to learn to exercise their discretion for local development? Analyzing from the case above, challenges confronting Chinese governments at all levels are still serious and full of uncertainties. In other words, how do we promote financial sustainability and autonomous decision-making capacities at the local level in China?

The first challenge is the weak capacity of local governments to repay debts with their own income. Due to the slower fiscal revenue growth and declines in the land sale revenue, the local debt servicing ability has been weakened. There are already some provinces and municipalities whose government debt-revenue ratio is above 100%. The local governments are in dilemma: if their own income is used to repay the debts, the expenditures for infrastructure will be squeezed and local economic growth and employment will be damaged, which runs at odds with central government's effort of stabilizing growth. However, if the debt repayment plan is defaulted, the debts are accumulating at a faster pace that has been destroying the banking system. The bond-for debt swap plan is just sheer expediency. Although the central government expanded the size of new bonds in the program to 3.2 trillion yuan in 2015, the market had a low acceptance to absorb local governments’ massive low-yielding bonds (Zheng, 2015).

The second challenge is to seek a policy change with a view of rebalancing the authorities and responsibilities between central government and localities in China. The 1994 tax sharing system has shaped the structure of fiscal revenues among all levels of government. The tax structure has been stabilized for quite a while, while the local expenditures have expanded to meet the local needs. This fiscal imbalance definitely may impel local governments to try to keep expenditures within the limits of income, while simultaneously adding incentives that the local governments seek supports from central government to meet their fiscal ends through inter-state competition. As unitary or centralization being its main features, supports and dependence on the central government seems perfectly justified, and the central government is ready to play as a patriarchal authority. Therefore, the question for China which also aims to improve its governance is to make a decision. If the central government expects and trusts the localities to self-govern their affairs, more fiscal autonomous measures should be provided to local government to manage their own affairs. Certainly, this calls for policy reforms. But if the central government will remain its current allocation format, it has to overcome the challenge of well balancing the interests of localities and normalizing all localities’ behaviors towards center’s objectives.

The third challenge relates the accountability of government behaviors. The local governments have been following the central government’s commands and directives for local development. The current local government debt issues mainly came out of the central government’s expansion directives to address the global financing crisis, followed by the excessive investment impulses of local governments, which are far beyond their capacities. However, neither levels of government would assume accountability for the outcomes. They are in the same boat. To seek permanent and effective solutions, policy reviews should be conducted to examine the whole policy-making processes: what contextual factors are shaping the policies, how the decisions have been made and why. These definitely call for remaking its political system, which the government administration is imbedded in.

A capable government should be accountable. This is a lessen China has learned from past experience. In recent years, Chinese leadership paid great attention to “fight against corruption”, to “streamline administration and delegate power to societies and lower-level government”, to promote “rule of law” establishment. All these measures are to make the government more accountable for their action and seek the balance between authority and responsibility. These should not be the mandates to the governments of lower levels but should be obeyed by the higher-levels. Fukuyama argues that the relationship between autonomy and quality of government would look like an inverted U curve. Both complete subordination and excessive autonomy lead to poor performance of government, as shown in Figure 1. If we agree that the inflection point of optimal governance level exists, it can be boldly argued that in China, the central government is located at the right side of the governance quality curve, while the local governments, with many lower capacities, at the opposite side. This means to ensure a better governance quality, both local governments and central government should move towards the middle sweet spot. It is time to make reinventions to make reform and reboot its competence.

Conclusion

China’s adoption of a set of large-scaled economic stimulus package in response to the global financial crisis has incurred serious local government debt issues. This has attracted wide attention since the debts are coming to their maturity period and local fiscal conditions are still insufficient. Although China has issued the New Budget Law to streamline the local bonding business and legalize the behaviors of local government in issuing bonds, although the law mandates locality to take more responsibilities in minimizing gaps between local revenues and expenditures, it is far from a signal of fiscal decentralization. The research argues that without advancing tax reform and creating appropriate levels of discretion, accountability, and capacity, local debt market will not be able to operate as expected. Thus, subnational governments and localities still will rely heavily on the central government to solve the debt crisis. This leaves the debt issuance unsustainable in the long run.

The degree of fiscal decentralization must harmonize with other types of decentralization. As political and economic issues arrive or depart from the government's agenda, the pendulum of autonomy thus swings back and forth. The challenge for China dealing with intergovernmental relationships is to seek a better degree of autonomy that can permit more local innovation, risk-taking, and experimentation, rather than lacking discretion in local affairs. All these issues are critical in resolving the local government debt crisis and reinvigorating China's sagging growth momentum.

References

Asian Development Bank (ADB). (2013). *Local debt in the People's Republic of China: Local government financing vehicle's debt management and risk control*. Mandaluyong, Philippines: Asian Development Bank.

Bahl, R. M. (1998). China: Evaluating the impact of intergovernmental fiscal reform. In Bird and Vaillancourt (Eds.), *Fiscal decentralization in developing countries*. Cambridge: Cambridge University Press.

Bahl, R. W., & Bird, R. M. (2008). Tax policy in developing countries: Looking back—And forward. *National Tax Journal, 61*(2), 279-301.

Bahl, R. W., & Linn, J. F. (1994). Fiscal decentralization and intergovernmental transfers in less developed countries. *Publius: The Journal of Federalism, 24*, 1-19.

Bird, R. M., & Vaillancourt, F. (1998). Fiscal decentralization in developing countries: An overview. In Bird and Vaillancourt (Eds.), *Fiscal decentralization in developing countries*. Cambridge: Cambridge University Press.

Bouckaert, G., & Peters, B. G. (2002). Performance measurement and management: The Achilles' heel in administrative modernization. *Performance & Management Review, 25*(4), 359-362.

Bruechkner, J. K. (2006). Fiscal federalism and economic growth. *Journal of Public Economics, 90*, 2107-2120.

Busuioc, M., & Lodge, M. (2016). Reputation and accountability relationships: Managing accountability expectations through reputation. *Public Administration Review, 77*(1), 91-100.

CBN. (2018). 21 trillion yuan ceiling on Chinese local government debt set for 2018. Retrieved from http://www.chinabankingnews.com/2018/03/28/21-trillion-yuan-ceiling-chinese-local-government-debt-set-2018/

China Daily. (2015). China adopts local government debt ceiling. Retrieved from http://www.chinadaily.com.cn/china/2015-08/30/content_21741565.htm

Davoodi, H., & Zou, H.-F. (1998). Fiscal decentralization and economic growth: A cross-country study. *Journal of Urban Economics, 43*(2), 244-257.

Dong, T. (2014). Budget law changes to rein in local government debt. *Global Times*, 2014-09-03. Retrieved from http://www.globaltimes.cn/content/879754.shtml

Ebel, R. D., & Yilmaz, S. (2002). On measurement and impact of fiscal decentralization. *Policy Research Working Paper No. 2809*. Banco Mundial.

Feltenstein, A., & Iwata, S. (2005). Decentralization and macroeconomic performance in China: Regional autonomy has its costs. *Journal of Development Economics, 76*, 481-501. Retrieved from http://down.cenet.org.cn/upfile/94/200512712545165.pdf

Feng, X. (2013). Local government debt and municipal bonds in China: Problems and a framework of rules. *The Copenhagen Journal of Asian Studies, 31*(2), 23-53.

Filippetti, A., & Sacchi, A. (2016). Decentralization and economic growth reconsidered: The role of regional authority. *Environment and Planning C: Government and Policy, 34*(8), 1793-1824.

Fukuyama, F. (2013). What is governance? *Governance, 26*, 347-368.

Glaeser, E. L., Scheinkman, J. A., & Shleifer, A. (1995). Economic growth in a cross-section of cities. *Journal of Monetary Economics 36* (1), 117-143.

Goswami, M., & Sharma, S. (2011). The development of local debt markets in Asia. *IMF Working Paper*. Retrieved from www.imf.org/external/pubs/ft/wp/2011/wp11132.pdf

Henry, N. (2018). *Public administration and public affairs* (9th ed.). London: Pearson Education Inc.

Hernández-Trillo. F. (2016). Poverty alleviation in federal systems: The case of México. *World Development, 87*, 204-214.

Hernández-Trillo, F. (2018). When lack of accountability allows observing unobservables: Moral hazard in sub-national government credit markets in Mexico. *Applied Economics Letters, 25*(5), 326-330.

Hsu, P. (2004). Deconstructing decentralization in China: Fiscal incentive versus local autonomy in policy implementation. *Journal of Contemporary China, 14*(40), 567-599.

Huang, Y., & Bosler, C. (2014). *China's debt dilemma: Deleveraging while generating growth*. Washington DC: Carnegie Endowment for International Peace.

Krug, B., & Libman, A. (2015). Commitment to local autonomy in non-democracies: Russia and China compared. *Constitutional Political Economy, 26*(2), 221-245.

Martínez-Vázquez, J., & McNab, R. M. (2003). Fiscal decentralization and economic growth. *World Development, 31*(9), 1597-1616.

MOF. (2003). The situation of the central—Subnational government transfer. Retrieved from http://yss.mof.gov.cn/zhengwuxinxi/gongzuodongtai/201311/t20131129_1018397.html

Mohr, Z. T. (2016). Performance measurement and cost accounting: Are they complementary or competing systems of control? *Public Administration Review, 76*(4), 616-625.

National Audit Office (NAO). (2013). *Audit report of national government debt.* Beijing: National Audit Office.

Rodriguez-Pose, A., & Kröijer, A. (2009). Fiscal decentralization and economic growth in central and eastern Europe. *Growth and Change, 40*(3), 387-417.

Shen, C., Jin, J., & Zhou, H. (2012). Fiscal decentralization in China: History, impact, challenges and next steps. *Annals of Economics and Finance, 13*(1), 1-51.

Smith, H. J. M., & Revell, K. (2016). Micro-incentives and municipal behavior: Political decentralization and fiscal federalism in Argentina and Mexico. *World Development, 77*(1), 231-248.

Xu, J. (2012). Local fiscal autonomy under the background of decentralization reform. *Chinese Journal of Law, 34*(3), 43-58.

Yilmaz, S., Beris, Y., & Serrano-Berthet, R. (2008). Local government discretion and accountability: A diagnostic framework for local governance. *Social Development Working Papers, Local Governance and Accountability Series 46552*. World Bank.

Zhang, T., & Zou, H. F. (1998). Fiscal decentralization, public spending, and economic growth in China. *Journal of Public Economics, 67*(2), 221-240.

Zheng, Y. (August 26, 2015). Caps on local government debt quota pose more questions than answers. *China Daily*. Retrieved from http://www.chinadaily.com.cn/business/2015-08/26/content_21706980.htm