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Research on the Risk of Local Government Debt in China and the Path of Prevention and Control

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ABSTRACT

Over the past several years, the scale of local government debt in our country has rapidly expanded, sparking widespread societal concern over the escalating debt risks. As a critical component of fiscal expenditure, local government debt exerts a dual effect on economic development; it can stimulate local economic growth through investment but also pose a potential fiscal risk due to excessive borrowing. The accumulation of local government debt is attributable to deficiencies in the fiscal system and governance mechanisms, as well as the impact of changing external economic conditions. By analyzing the current state and causes of local government debt, clarifying the manifestations of risk, and drawing on international experiences, this paper proposes a series of preventive measures. This is not only crucial for safeguarding the fiscal health of local governments but also imperative for ensuring the long-term stable development of China's economy. Based on a review of the risks associated with local government debt, this article explores pathways for prevention and control, offering theoretical support and policy recommendations for optimizing local debt management in China.

KEYWORDS

Local Government; Debt Risk; Prevention and Control Path.

1. INTRODUCTION

The issue of local government debt has become a significant concern in our nation's economic sphere. As urbanization accelerates and the demand for infrastructure construction rises, the scale of local government debt continues to expand. However, this rapid growth in debt has also led to a series of problems, such as fiscal imbalances and low investment returns, raising concerns about debt sustainability. Local government debt is not merely an economic issue but also involves complex interactions between politics, society, and governance structures. Therefore, research into local government debt risks must not only examine its impact on economic stability from a macroeconomic perspective but also delve into the systemic causes of debt formation and potential long-term risks. Particularly in the current context of a complex and ever-changing global economic landscape, effectively preventing and controlling local government debt risks has become a crucial issue for safeguarding national economic security and promoting sustainable development.

2. DEFINITION AND CURRENT SITUATION OF LOCAL GOVERNMENT DEBT RISK

2.1. Definition and Classification of Local Government Debt

Local government debt refers to the borrowing activities undertaken by municipal authorities to fulfill public functions, provide services, and support infrastructure development. This debt is primarily categorized into two main types: general debt and special debt. General debt pertains to borrowings issued to meet routine fiscal expenditures, typically repaid through fiscal revenues. In contrast, special debt is raised for specific projects or public infrastructure, with repayment generally relying on the revenues generated by the project itself. The diversity of local government debt not only reflects the intense demand for capital in regional economic development but also highlights the challenges in management and control. Particularly, the use of special debt often involves complex interactions between the government and the market, with its success or failure directly impacting the effective allocation of public resources. As fiscal pressures on local governments intensify, the issues of transparency and sustainability in debt management become increasingly prominent. Clearly defining the categories and purposes of debt has become a crucial prerequisite for effectively mitigating debt risks. In the current economic climate, accurately identifying and appropriately delineating the nature of local government debt is essential for ensuring the sound operation of regional finances [1].

2.2. Current Situation of Local Government Debt

In recent years, the scale of local government debt in our country has continued to expand, displaying a trend of rapid growth. This phenomenon is driven by multiple factors, including substantial investment expenditures by local governments motivated by economic growth targets, infrastructure construction demands arising from urbanization processes, and the deceleration in fiscal revenue growth. Data indicates that local government debt is not only vast in scale but also increasingly complex in structure. Notably, the proportion of special bonds has risen, with repayment relying on future project revenues, thus facing significant uncertainty and potential risks. Furthermore, in some regions, the debt burden has surpassed warning levels, increasing repayment pressure and even leading to a vicious cycle of "borrowing new to repay old" debts. Mismanagement of debt and lack of transparency can easily trigger regional financial risks, thereby threatening overall economic stability. It is also concerning that some local governments exhibit issues such as data opacity and irregular borrowing channels, which not only heighten the fragility of the financial system but also potentially provoke deeper systemic risks. Against the backdrop of economic slowdown and worsening fiscal imbalances, effectively controlling the scale of local government debt and ensuring its healthy development has become a pressing issue that demands resolution.

3. CAUSES OF LOCAL GOVERNMENT DEBT RISK

3.1. Unreasonable Structure of Fiscal Revenue

An important cause of the risk associated with local government debt in our country lies in the long-standing inefficiencies in the fiscal revenue structure. Local governments' finances are heavily reliant on land transfer fees and real estate-related taxes. This singular revenue structure not only results in an excessive dependence of local economic development on the real estate market but also exposes local governments to significant fiscal risks during fluctuations in the land market. When the real estate market is sluggish or land transfer income diminishes, local fiscal revenues experience a dramatic decline, leading to difficulties in timely debt repayment and consequently triggering debt risks. Furthermore, the lack of stable and continuous tax sources often forces local governments to resort to borrowing to fill fiscal gaps, particularly during economic downturns, exacerbating their reliance on debt. The inefficacy of this revenue structure also fosters short-sighted behavior in debt management, where investments and borrowing are indiscriminately expanded for short-term economic growth and fiscal gains, overlooking long-term financial sustainability. Compounding the issue, disparities in fiscal capacity between regions intensify debt risks, with economically developed areas leveraging borrowing to drive economic progress, while less developed regions, burdened by inadequate fiscal revenues and heavy debt loads, fall into debt traps. Thus, restructuring local fiscal revenues and reducing reliance on a singular income source become crucial steps in mitigating local government debt risks. Only through such reforms can we fundamentally alleviate debt pressures on local governments and foster the healthy development of regional economies [2].

3.2. Inadequate Debt Management System

The formation of local government debt risk is largely attributable to the flaws in the debt management system. In the current management framework, local governments possess significant autonomy and flexibility in borrowing but lack effective regulatory mechanisms, resulting in a deficiency of constraints and transparency in the process of debt expansion. This systemic flaw renders local governments susceptible to speculative behavior in financial management, where they may recklessly increase debt levels to achieve short-term economic growth or political gains, while neglecting long-term fiscal sustainability and risk management. Furthermore, the insufficient and untimely disclosure of local government debt information exacerbates the opacity and uncertainty in debt management. Some local governments, driven by self-interest, deliberately conceal the extent of their debt or evade central government oversight, thereby undermining the accuracy and completeness of debt data and destabilizing market and investor expectations regarding local debt risk, affecting financial market stability. More critically, the defects in the debt management system have intensified intergovernmental debt competition, with certain local governments engaging in irrational borrowing practices to secure additional funding and project resources, leading to the propagation and diffusion of debt risk across regions. Additionally, the lack of unified planning and coordination in local government borrowing, coupled with the absence of clear repayment plans and accountability, results in disorderly debt management and heightens systemic risk [3]. Therefore, optimizing and refining the debt management system and enhancing coordination and oversight between central and local governments are essential to effectively curb the accumulation and spread of local government debt risks.

3.3. Inefficient Use of Debt

A significant cause of the debt risk faced by local governments is the inefficiency in the utilization of debt. The root of this issue lies in the blindness and arbitrariness exhibited by local governments in project selection and fund allocation, coupled with a lack of a scientific and rational decision-making mechanism. In some regions, local governments, in pursuit of short-term achievements, tend to invest in large-scale infrastructure projects or so-called "achievement projects," which often lack thorough preliminary assessments and long-term economic returns, leading to suboptimal use of debt funds. This inefficiency not only fails to deliver the anticipated economic benefits but also exacerbates the fiscal burden on local governments. During project implementation, issues such as poor management and inadequate supervision often lead to cost overruns, extended timelines, and even instances of fund wastage and corruption. These factors further erode the efficiency of debt fund utilization, resulting in the intended developmental funds failing to yield the desired benefits and instead creating a heavy debt burden. More critically, the phenomenon of low debt utilization efficiency is widespread, causing numerous local governments to face a predicament of "high debt, low return." Inefficient use of funds not only fails to generate sufficient economic growth to support debt repayment but may also trigger a vicious cycle, leading to further accumulation of debt risk. Only by enhancing the efficiency of debt fund usage and ensuring that funds are directed towards projects with sustainable economic returns can local governments effectively control debt risk while achieving economic development and avoiding a debt crisis.

3.4. Impact of External Economic Environment

The emergence of local government debt risks is profoundly influenced by the external economic environment. Within the context of global economic integration, fluctuations in international economic conditions, intensified trade frictions, and uncertainties in external demand directly or indirectly impact the development of local economies, consequently affecting local government fiscal revenues and debt repayment capacities. Particularly during economic downturns, the contraction of external demand and reduced exports lead to diminished profits for local enterprises and decreased tax revenues, placing severe pressure on local government finances. Consequently, the substantial debt incurred previously to stimulate economic growth becomes challenging to service effectively. Such changes in the external economic environment are often beyond control, rendering local governments passive in their responses. To alleviate external economic pressures, some local governments may escalate debt financing efforts, hoping to invigorate local economies through large-scale investments. However, while such measures may yield certain economic benefits in the short term, they may exacerbate debt risks in the long run. Should the external economic environment fail to improve as anticipated, local governments' debt repayment abilities will be further weakened, potentially leading to debt defaults. Moreover, a deteriorating external economic environment can also destabilize financial markets, increasing the difficulty and cost of local government financing. Against the backdrop of heightened global financial market volatility, constrained financing channels and rising costs render local governments' capacity to manage debt pressures more fragile, increasing the risk of systemic financial instability. Therefore, local governments must exercise greater prudence in debt management when confronting external economic challenges, establishing more robust fiscal policies and risk warning mechanisms to address potential economic shocks and prevent possible debt crises.

4. PREVENTION AND CONTROL PATH OF LOCAL GOVERNMENT DEBT RISK IN CHINA

4.1. Improve the Debt Management System

Enhancing the debt management system of local governments is a crucial step in mitigating debt risks. This is not merely a technical adjustment of systems but a profound reform aimed at redefining the relationship between local governments and debt. Under the current framework, local governments' borrowing practices often lack transparency and effective oversight, leading to unchecked debt expansion and haphazard management. The persistence of such conditions not only undermines the fiscal stability of local governments but may also precipitate systemic financial risks. Therefore, establishing a scientifically sound, transparent, and efficient debt management system has become increasingly urgent. The primary task in perfecting the debt management system is to augment transparency, requiring local governments to comprehensively and timely disclose debt information, including the scale of debt, repayment plans, and usage. This not only aids the central government and the public in monitoring local debt but also enhances external constraints on local governments through market mechanisms. Furthermore, a stringent debt ceiling system should be established, setting reasonable debt limits based on the fiscal capacity and economic development level of local governments to prevent excessive debt expansion. In refining the management system, strengthening coordination and delineation of responsibilities between central and local governments is essential [4]. The central government should formulate unified debt management policies and standards, while local governments should adapt and implement these guidelines according to their specific circumstances. Throughout this process, it is crucial to reinforce central oversight and guidance on local debt to ensure regulatory consistency and prevent local governments from engaging in excessive borrowing in pursuit of short-term gains. Additionally, market-based mechanisms should be introduced to improve the efficiency and management of debt funds. For instance, market-oriented debt issuance and rating mechanisms could enhance the market's ability to price and assess risks associated with local debt, thereby establishing effective external constraints. Through these reform measures, the debt management system of local governments can be truly perfected, debt risks can be effectively controlled, and sustainable local economic development can be achieved.

4.2. Optimize the Structure of Fiscal Revenue

Optimizing the structure of fiscal revenues is a crucial strategy for mitigating local government debt risks. Currently, some local governments excessively rely on land finance and central government transfers, resulting in a narrow and fragile revenue base that is susceptible to market fluctuations and policy adjustments. This vulnerability not only exacerbates fiscal pressures but also makes local governments more prone to debt crises during economic downturns and policy shifts. Therefore, it is imperative to adjust and refine the fiscal revenue structure to enhance local governments' financial autonomy. Firstly, promoting diversified local economic development and supporting emerging industries and service sectors are essential to broadening the revenue sources of local governments. By cultivating a varied tax base and reducing dependence on single industries or resources, the stability of local fiscal revenues can be improved. This will not only enhance fiscal independence but also ensure a relatively stable revenue level amidst economic fluctuations, thereby reducing reliance on debt financing. Moreover, optimizing the fiscal revenue structure requires reforming the local tax system. Adjusting the tax structure to increase the proportion of direct taxes will improve the fairness and sustainability of local tax revenues. Concurrently, strengthening tax administration to prevent revenue loss is crucial for ensuring genuine growth in fiscal income. Particularly in economically advanced regions, exploring additional local taxes tailored to regional economic characteristics can better reflect economic development and fiscal needs. Furthermore, local governments should consider leveraging public-private partnerships (PPP) and other mechanisms to attract private capital for investing in local public projects, thereby alleviating fiscal burdens. By refining the fiscal revenue structure, local governments can bolster their financial resilience and manage debt pressures more effectively during economic downturns, fundamentally reducing debt risks and fostering the long-term healthy development of local economies.

4.3. Enhancing the Efficiency of Debt Utilization

Enhancing the efficiency of debt utilization is an indispensable core element for local governments in managing debt risk. Currently, some local governments face issues such as improper project selection and irrational fund allocation, which result in public funds failing to achieve their intended economic and social benefits. Such inefficient debt management not only exacerbates local fiscal pressure but also undermines the sustainable development of the regional economy. In practice, local governments should adhere to scientific and rational standards when evaluating and selecting debt projects, ensuring that funds are directed towards areas that genuinely offer long-term economic benefits and social value. Excessive pursuit of short-term gains or vanity projects often leads to resource wastage, thereby increasing the fiscal burden. Therefore, optimizing the direction of debt funds should prioritize projects that promote regional economic growth, improve people's livelihoods, and enhance the quality of public services [5].

4.4. Enhancing Risk Early Warning and Response Mechanisms

Enhancing risk warning and response mechanisms is crucial for local governments in effectively managing and controlling debt risks. Local government debt risks are often characterized by their latent and cumulative nature, and once they materialize, they can easily trigger systemic risks.

Therefore, establishing a robust and scientifically grounded risk warning mechanism, along with developing flexible and efficient response plans, is essential for mitigating debt risks. The risk warning system should leverage big data analytics and artificial intelligence technologies to monitor the debt conditions and economic trends of local governments in real-time. By conducting comprehensive analyses of economic indicators, fiscal revenues, debt scale, and its structure, potential risk factors can be identified in advance, with timely warning signals issued. This enables local governments to implement effective measures at the early signs of risk, thereby preventing further escalation. However, having a warning mechanism alone is insufficient. The refinement of response mechanisms is equally crucial. Local governments must devise a set of effective contingency plans to address potential debt crises. The response strategies should encompass both short-term measures, such as fund allocation and debt restructuring, and long-term structural reforms to gradually alleviate debt risks.

5. CONCLUSION

The risk of local government debt is a multifaceted and multi-dimensional issue, necessitating not only institutional reforms but also a focus on enhancing management and efficiency in practical operations. Currently, the scale of local government debt in our country has reached a historic peak. In the face of potential risks and hidden dangers, there is an urgent need for efforts in several areas, such as improving management systems, optimizing fiscal structures, and increasing the efficiency of fund utilization, to ensure the sustainable development of local finances. At the same time, strengthening early warning and response mechanisms for debt risks to enhance local governments' capacity to handle external shocks is a crucial direction for future policy-making. Effective debt management not only pertains to the health of local finances but also to the stability and security of the national economy. Only through systematic reforms and precise risk control can a virtuous cycle of local government debt be truly achieved, thereby fostering the long-term healthy development of our economy.

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