

Rethinking the Causes of Local Government Debt

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Abstract: In recent years, local government debt reduction and risk prevention have been the subjects of common concern to all parties. China's local government debt has different reasons in different historical periods, and the main line running through this is the development orientation of local governments. It is undeniable that local government debt has played an indelible role in China's rapid economic growth. However, due to historical restrictions, flood irrigation inevitably brought sediment all over the ground. Therefore, this paper intends to rethink the causes of local government debt from the perspective of the dual role of regional government and the main body of meso economics.

Keywords: Local government; Promotion incentive; Central-local relationship

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1. Introduction

In recent years, the acceleration and expansion of local government debt have been very obvious. By the end of October 2023, the outstanding debt of local governments had reached 4,01011 trillion yuan, and the local debt had exceeded 40 trillion yuan for the first time. Among them, the general debt is 15.7086 billion yuan, the special debt is 24.3925 billion yuan, the government bonds are 39.353 billion yuan, and the outstanding government debt in the form of non-government bonds is 165.8 billion yuan. Further, the remaining average life of local government bonds is 9.2 years, including 6.4 years for general bonds and 11.0 years for special bonds; the average interest rate is 3.28%, including 3.27% for general bonds and 3.28% for special bonds. China's local government debt is not highly transparent and highly hidden, quite difficult to monitor, and the causes are relatively complex, which poses a great challenge to the stable development of China's economy.

Since the reform and opening up, China's economy has developed rapidly and created many Chinese miracles, and local governments have played a very important role in this process. On the one hand, we cannot deny the role of local government debt; on the other hand, the expansion of local government debt, especially the quiet expansion of hidden debt, brings great challenges to economic stability. In China, local government debt funds are mainly derived from bank loans, and there are problems such as a single financing channel and serious maturity mismatch, which are easy to produce the risk of debt default. At the same time, as local governments at all levels rely too much on land transfer income in terms of fiscal revenue, in the case of the net income of land transfer gradually decreasing, all local governments are under huge pressure of debt repayment,

and the sustainability of local government debt is gradually prominent ^[1].

In October 2023, the first Central Financial Work Conference was held in Beijing. The meeting stressed the need to speed up the building of financial power, comprehensively strengthen financial supervision, improve the financial system, optimize financial services, prevent and defuse risks, unswervingly follow the path of financial development with Chinese characteristics, and promote the high-quality development of China's financial sector. At the level of local government debt, the meeting stressed the need to establish a long-term mechanism to prevent and defuse local government debt risks, establish a government debt management mechanism that is compatible with high-quality development, and optimize the debt structure of the central and local governments. It further shows that the mitigation and prevention of local government hidden debt risks is an important direction of China's steady economic growth in the future. To establish an effective local government debt resolution mechanism, the first task is to solve the mystery of the causes of local government debt.

2. Literature review

At present, the domestic scholars on local government debt research mainly focuses on the scale of local government debt calculation, the connotation and characteristics of local government debt risk, the main reason for the expansion of local government debt, the economic effect and social effect of local government debt, local government debt risk warning prevention, etc. In terms of the formation mechanism of local government debt, some scholars believe that it is mainly caused by the following main reasons:

(1) Budget soft constraints

Yang *et al.* pointed out that under China's political system, local governments have strong optimistic expectations about the central government and believe that the central government will not "die." However, due to resources and capacity restrictions, the central government often acquiesces in local governments to borrow for the reason of developing public services ^[2]. Li *et al.* pointed out that China's fiscal system showed significant vertical fiscal imbalance, aggravating the imbalance through the political stability needs of the central government and the unlimited responsibility governance model under the administrative decentralization system, thus enhancing the confidence of local governments in borrowing ^[3].

(2) Fiscal and tax systems

The financial decentralization system is an important factor leading to local government debt financing. Yang *et al.* believed that China's imperfect fiscal system and fiscal decentralization system are important factors leading to the risk of local government debt ^[4]. Tian *et al.* pointed out that since the beginning of economic transformation and development, the imperfect financial system has gradually become prominent, and local governments can only focus on local financing platforms to make up for the huge financial gap ^[5]. Some scholars have confirmed the impact of financial decentralization on local government debt risk based on empirical analysis. According to Chen *et al.*, the existing research indicates that financial decentralization will expand the scale of urban investment bonds of local government financing platforms. The empirical analysis results show that the main driving force for the doubling of the scale of urban investment bonds is the financial decentralization system ^[6]. Pang *et al.* used the two main indicators of the number of financing platforms and the estimated value of prefecture-level city debt to measure the level of local debt, taking this as the explained variable, and constructed a multiple regression model. The results showed that the formation of local government

debt lies in the financial gap caused by the current financial system ^[7].

(3) Promotion championship

Promotion incentives will strengthen the motivation of local government debt financing and induce debt risks. Chen *et al.* pointed out that China's fiscal decentralization system and promotion incentive mechanism will increase the impulse of local governments to borrow money and increase the debt burden of local governments ^[8,9]. Some scholars have confirmed the influence of promotion motivation on the scale of local government debt and debt risk based on empirical analysis. Zhang *et al.* added the variable of characteristics of provincial officials to the empirical model, and the results showed that under the strong role of the financial decentralization system, political promotion and economic growth incentives will accelerate this impact and further expand the scale of local debt ^[10]. Zheng, through empirical analysis, found that although local governments still have certain debt space, in recent years, local debt, persistent downward trend and differentiation trend, and the official appraisal system reform is conducive to curb officials borrowing impulse from source and ease the downward trend ^[11,12].

(4) Other factors

In addition to the three main factors mentioned above, many scholars have suggested that there are other incentives for local government debt. Miao *et al.* pointed out that the real reason for the risk of local government debt is that the local government is not a real "responsible government," due to China's unique political system, China's local government presents a time and space separation between debt right and debt repayment responsibility. In other words, local governments can borrow by themselves, but they do not have the responsibility to repay the debt when it is due. This separation worsens the risk of local government debt ^[13]. Yang pointed out that the excessive intervention of the government in the economy may increase the distortion degree of the economy, allocating funds flow to more government-led economic activities. If the government-led economic activities have no return or low return, the corresponding debt may form the hidden debt of local governments ^[14].

3. The system logic of the generation of local government debt risk

3.1. The relationship between the central government and the local governments

In China, finance is the foundation of national governance and important pillar, so all previous involving fiscal decentralization or fiscal relations between the government system reform is destined to be the process of the central and local government participation and consultation, the typical approach is the central rules or tacit local first exploration, place under the guidance of the central to explore suitable for local specific practices ^[15]. This kind of fiscal decentralization with Chinese characteristics on the one hand is conducive to overall planning, "concentrate resources to do big things," but on the other hand from the reality, the central and local there are various aspects of information asymmetry, blurred legal boundary, in economic growth of this abstract and broad goals prone to vicious competition, fraud conceal, local government debt is also affected by expanding scale, the term structure mismatch, not sustainability, and many other problems..

3.2. Competition between governments

As early as in the planned economy period, there was competition and games between local governments in China. After the reform and opening up, the power of local government has been expanded, and "territorial management" and "local competition" constitute the basic mode of intergovernmental competition. Chen *et al.* pointed out that although the regional government competition brought by economic incentive and promotion incentive has a driving role in economic development, it also brings the side effects of "independent

governance,” which restricts the free flow of resources, distorts the allocation of resources, causes market segmentation and hinders the construction of a unified national market^[16]. Understanding the field of regional government competition is the first step to standardizing the regional government competition behavior and promoting the construction of a unified national market. That is to say, in the process of regional government competition, the “officialdom + market” system around “economic construction as the center” has a far-reaching and complex impact on the scale expansion and risk accumulation of local government debt.

3.3. The relationship between the government and the market

Since China’s economic development has entered the new normal, the good combination of the government and the effective market has become more and more important. In meso economics, some scholars have put forward new resource fields: Quasi-operational resources. Quasi-profit resources is given priority to with the regional urban resources, it is mainly used to ensure the normal national or regional social and economic activities, the public service system, and provide public services for social production, residents life of hardware and software infrastructure, education, science and technology, culture, health, sports city utilities facilities and public life service facilities. The dual attribute that quasi-operational resources can be allocated by both the government and the market determines that the key to the long-term benign interaction between the competent government and the effective market is to clarify the boundary between the two, that is, the mastery of local government in the allocation of operational resources. One of the risk accumulation of local government debt is the local government debt on operational resources allocation appeared a certain degree of distortion, such as part of the elements of a strong correlation with the market is firmly control in the hands of local government, but the local government is not following the principle of market allocation in the market rationing, caused the loss of the efficiency of the market, local debt unsustainable. Therefore, finding out the optimal boundary between the government and the market is also a key step in controlling the local government debt.

4. Conclusion

According to the existing studies, in the study of local government debt risks, there is no lack of suggestions and criticisms on the existing fiscal and tax system and official assessment mechanism that should be reformed. We cannot deny that the current system indeed has many deficiencies due to its historical limitations, and it fails to keep up with the pace of social and economic development in time. But nothing can be achieved overnight. Just as China’s progress is always on the way, the reform and development of the economic system is also a protracted battle. There is still a long way to go from discovering problems and understanding distortion to solving problems and correcting distortion. The use of funds and the structure of debt are the main directions of efforts to control the increment and curb the stock in the future. The key point is that local governments will continue to adapt to their changing roles as the economy develops. Ideally, a promising government can follow economic development and adjust policies and development goals in real time and dynamically based on the usage of operational resources to serve the city.

The effective operation of the field to create a basic framework, two-way incentive development. In other words, the local government to find their positioning, to adapt to their role from “developmental government” to “service government,” improve the allocation of operational resources, combine with the market, realize the sustainable development of local government debt, maintain macroeconomic stability, to achieve the great rejuvenation of the Chinese nation in the struggle.

Disclosure statement

The author declares no conflict of interest.

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