

The Positive Role of Audit in Public Debt Management in China

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By Dr. DONG Dasheng, the first Deputy Auditor

Introduction

Since 2008, the financial crisis triggered by the US sub-prime crisis has swept the globe. Some countries have launched a large scale of economic stimulus plan to promote the economic growth through the use of appropriate fiscal and financial policies. However, as many economies are gradually recovering from the negative impacts of financial crisis, a new crisis is unnoticeably approaching us---the sovereign debt crisis. Recently, the US Congress and White House had a long-term debate on raising the debt ceiling. In order to cope with the sovereign debt crisis, the European Union also launched the second bailout plan of 159 billion Euros to Greece. From the global perspective, the potential risk of public debt still exists. This risk will inevitably spread fear and panic around the world, which will become a “hidden killer” to hamper the balance of global economy and sustainable recovery. As an emerging economy, China plays an important role in the sustained development of the world economy. Many experts and friends who have concerns about the economic development of the world and China are also interested to know the status quo of public debt in China. In particular, what’s going on with Chinese local government debt?

The Chinese government attaches great importance to the public debt management. From March to May 2011, the National Audit Office of the People’s Republic of China (to be abbreviated as the CNAO) organized the audit offices at all levels to have a comprehensive and unified audit over local government debt nationwide. In July 2011, the audit results released by the CNAO attracted great attention of the Chinese society as well as the world. Although the CNAO report was generally well received, a bit of doubt was also casted upon the report. I would like to

use this occasion to share with you the results of this audit over local government debt nationwide combining with the illumination of positive role and performance of the CNAO in public debt management.

I. A Summary of Chinese Public Debt and the Role of the CNAO in Public Debt Management

1. A Summary of Chinese Public Debt

Before the implementation of the policy of reform and opening-up, the Chinese government adopted the fiscal policy featured “zero foreign and domestic debt”. In 1981, the central government of China started to introduce the concept of government debt with the issuance of treasury bond. Meanwhile, the Chinese government also started to make borrowing from international financial organizations like the World Bank. The funds sourced from the public debt plays an important and active role in supplementing financial insufficiency, enhancing infrastructure construction, coping with international financial crisis, combating natural disasters, improving people’s livelihood and eco-environmental protection, and promoting the comprehensive and sustainable development of economy and society.

The central government debt mainly consists of national debt and loans from international financial institutions, which are issued and managed by the Ministry of Finance, and governed by the strict budgetary control under comprehensive systems and regulations with higher transparency. As of the end of 2010, the total outstanding central government debt was RMB 6.752691 trillion, including outstanding foreign debt of RMB 447.907 billion (equivalent to USD 67.63 billion).

But local government debt is rather complex. According to the present “Budget Law of the People’s Republic of China” and “Guarantee Law of the People's Republic of China”, the budgets of local governments shall not contain deficit, nor do they raise funds in form of direct borrowing or be guarantors for the debtors (except as otherwise prescribed by laws or the State Council). The legal-prescribed and regulated methods for local governments to borrow are few, mainly including government bonds issued by the central government on behalf of local governments, and foreign debt or national debt transferred from the Ministry of Finance to

local governments. However, a fast economic and social development was witnessed in recent years. In order to improve the investment environment and people's working and living conditions, local governments have made large investment in the infrastructure construction (e.g. highway, railway and subway) and municipal facility construction. Since 2008, local governments have also increased new investments as part of China's stimulus efforts to cope with the financial crisis. In order to meet the demand for funds, many local governments circumvent the legal restrictions and turned to Local Government Financing Vehicles (LGFVs) or by other measures to take on debt in a disguised form, resulting in a sharp increase of other forms of local government debt. This part of local government debt has been neither managed by the unified system nor included in the government budget. The result has been that the borrowing and use of local government debt becomes neither transparent nor visible. It is hard to estimate the actual size of debts and measure the potential risks of debt default, leading the central government, local governments at various levels and the whole society to be more concerned.

2. The CNAO Continuously Paying Attention to Public Debt

In recent years, with the aim to safeguarding the national economic security, and disclosing the fiscal and financial risk inherent in public debt management, the CNAO has taken the following measures to exercise a comprehensive supervision upon public debt. First, the management and use of national and foreign debt has been listed as one of the priorities in the audit over central government budget implementation. In addition, special-purpose audits or investigations have been conducted over the use of national and foreign debt transferred from the central government to local governments. Second, with great attention paid to local government debt, the CNAO is one of the authorities who make the earliest warning to the State Council and the National People's Congress on the risk of local government debt. In recent years, local government debt has been listed as one of the priorities in both the audit over local government revenues and expenditures and the accountability audit over the provincial (municipal) governors. In 2010, the CNAO conducted a special audit over local government debt in 70 regions. Third, the CNAO requires that various forms of public debts should be included in the audit scope when

conducting the audits over such fields as enterprises, financial institutions, investment projects, environment protection, education and medical care. The audit offices at local levels also attach great importance to the supervision of public debt.

All these efforts taken by audit offices have been widely recognized by the society, and government debt has further come to the forefront with attention and concerns by the Congress, government and public at various levels.

II. The Introduction about the Audit over Local Government Debt Nationwide Carried out in This Year

1. Clear Audit Objectives

In view of the status quo of the management of local government debt, auditors set the following five-fold objectives: first, detailing the size, structure and development trend of local government debt for each government level and year; second, classifying local government debt by differing liabilities; third, analyzing the ability to serve the debt and revealing the potential risks; fourth, disclosing and reporting the prominent problems in the debt management; fifth, analyzing main causes of debt and proposing the opinions and suggestions on strengthening the debt management, mitigating and preventing risks.

2. Rational Classification of local government debt by Differing Liabilities

A rational classification of local government debt shall serve as a foundation to reasonably define the scope of government debt and accurately identify risks for serving debt. During the audit, local government debts are broken down into three categories according to the different payment obligations held by local governments: first, debts with a direct government obligation to pay back, namely, debts borrowed by local governments or government departments and to be paid back with government revenues; second, debts with a government guarantee, namely debts guaranteed or counter-guaranteed by local governments but not to be paid back with government revenues. For this type of debt, local governments, as the guarantors, were not liable for performing the debt

directly, but if the debtor defaults, shall perform the debts or bear the joint liability according to the agreement; third, other government-related debts (debts with a potential government obligation), namely debts borrowed by enterprises or public institutions for the non-profit projects and not guaranteed by local governments which were to be paid back by the revenues generated by the debtor or from the projects. For this type of debts, local governments were not held for any contractual obligations. However, if the debt default might occur to the debtor, local governments might need to offer bailout aids.

3. Huge Input of Audit Resources with Extensive Audit Scope

The total staff of audit offices nationwide at various levels totals around 80,000. In this year's audit over local government debts, 41,300 auditors from audit offices at various levels were mobilized for the audit. According to the principle of "examining the accounts, people and materials, and inspecting each debt and each item", the auditors inspected the debt situation of governments of 31 provinces (autonomous regions and municipalities directly under the central government), 5 cities with independent budgetary status, 392 cities and 2779 counties with the total number of debts amounting to 1.87 million. Only one county was skipped due to the occurrence of earthquake. The audit involved 25,590 government departments and institutions, 6,576 LGFVs, 15,721 units and 373,805 projects.

4. Elaborate Management and Implementation

First, the CNAO established a Task Force for leading the audit over local government debt nationwide to enhance the management and implementation of the audit, local audit offices also set up related leading groups with the heads of audit offices taking the leading responsibility. Second, it adopted the methods like "auditors at higher levels inspecting debts of governments at lower levels" and "cross inspection" to guarantee the independence of auditing. The resident offices of the CNAO were responsible for the audit over the provincial governments and governments of provincial capitals. The provincial audit offices organized the municipal and county audit offices to carry out audit with the manners such as "auditors at higher levels inspecting debts of governments at lower levels", "cross inspection" or "joint audit over

other cities and counties' debt. Third, the CNAO attached great importance to the training on the audit topic. It conducted 4 training programs on the audit over local government debt and IT, and local audit offices at various levels also provided multi-level trainings to ensure that over 40,000 auditors could be clear about auditing requirements and audit methodologies. Fourth, the CNAO reinforced the real-time management for the whole process of auditing. Audit Newsletter and other media were introduced to clarify the doubts and questions incurred in the audit process and correct the deviation in a timely manner. Fifth, the CNAO also provided the guidance to the field audit. Teams headed by the top management of the CNAO or experts were dispatched to the audit sites of 25 provinces (autonomous regions and municipalities directly under the central government) for investigation and supervision. The supervisory teams were also established in some places.

5. Making Full Use of the Advanced Information Technology

To effectively manage and supervise this large-scale audit and ensure audit quality, the CNAO and local audit offices at various levels have made full use of advanced information technology. First, a dynamic interacting information platform was established on the Audit Office Network to realize the real-time, interactive communicating between the task force of the CNAO and the field audit sites to ensure the efficiency and effectiveness of unified management. Second, a number of audit tool software for data verification, data analysis systems and analysis models were developed. The databases of local government debts nationwide were also established to ensure that audit data were recorded, totaled and analyzed in an integrated, regulated and standard manner, resulting in a full set of complete, accurate and reliable audit data.

III. The Results of the Audit over Local Government Debt Nationwide in This Year

1. Fully Identifying the Situation of Local Government Debt

As of the end of 2010, the total outstanding local government debt stood at RMB 10.717491 trillion. Among them, debts with a direct government obligation to pay back were RMB 6.710951 trillion, accounting for 62.62% of total amount. Contingent Debts with a government guarantee

was RMB 2.336974 trillion, accounting for 21.8% of the total amount. The amount of other government-related debts (debts with a potential government obligation to offer bailout aids) amounted to RMB 1.669566 trillion or 15.58% of total amount. The bank loans were the main source of local government debt. By the end of 2010, of total outstanding local government debt, approximately 79.01% (RMB 8.4679998.5 trillion) is in the form of bank loans.

As of the end of 2010, of outstanding local government debt, a total amount of RMB 9.613044 trillion has been taken out by local governments and used to finance the following projects: transportation, municipal infrastructure and energy development (RMB 5.946689 trillion, or 61.86%); land purchase and reserve (RMB 1.020883 trillion, or 10.62%); people's livelihood such as education, medical care, science and culture, low-income housing, agriculture, forestry and water conservation (RMB 1.375312 trillion, or 14.31%); energy conservation, emission reduction, ecological development and industrial development (RMB 401.602 billion, or 4.18%); and other areas (RMB 868.558 billion, or 9.03%).

2. Objectively Reflecting the Positive Role of Local Government Debt

First, the use of local government debt to finance and accelerate the construction of infrastructure development projects such as local road, railway and airport, as well as municipal facilities projects like urban rail transit, city road and bridge, has formed a large number of high-quality assets, and laid a foundation for the sustainable economic and social development of China. Second, the use of local government debt provides an important support for the improvement of people's livelihood and eco-environmental protection and promotes the eco-environmental development and transformation of the pattern of economic development. Third, the use of local government debt provides financial support for combating crisis and natural disasters. Local governments provide financial support for implementing a series of economic stimulus plans and coping with international financial crisis through multiple financing methods such as the LGFVs. Sichuan and Gansu provinces have also managed to promote successful implementation of post-earthquake reconstruction plans through financing by local government debt.

3. Objectively Disclosing the Risks of Local Government Debt

Through the audit, the CNAO summarized the following opinions about public debt situation in China: First, the overall debt burden was not heavy. As of the end of 2010, local debts with a direct obligation to pay back by the provincial, municipal and county level governments reached the amount of RMB 6.710951 trillion, equivalent to 16.86% of China's 2010 GDP (RMB 39.79833 trillion), while total debt figure was put at 33.83% of 2010 GDP after accounting for outstanding central government treasury bond of RMB 6.752691 trillion. Both figures were lower than 60%, the European control ratio for debt-to-GDP. In terms of the ratio of outstanding local government debt against local government's comprehensive financial resources (debt to financial resources ratio), if we calculate the amount of debt by the debts with a direct obligation to pay back by the provincial, municipal and county governments, the ratio would be at 52.25%; but if also accounting for contingent debts with the guarantee held by local governments, the ratio was 70.45%. Second, both ratios of overdue debts in the contingent debts with the guarantee held by local governments and other government-related debts with a potential government obligation to offer bailout aids were not high, equivalent to 2.23% and 1.28% respectively in 2010. Third, the maturity profile of local government debts is mixed (some coming due soon and others not due until years later) with relatively even distribution in years onward. It would be less possible for the peak year of serving the debt to come. Out of the outstanding local government debts by the end of 2010, 24.49% and 17.17% of debts would come due in 2011 and 2012 respectively, while 28.13% of them would mature between 2013 and 2015 and 30.21% not due until after 2016.

In addition, indeed some individual localities and institutions may be faced with crippling debt burdens and potential risk of debt default. As of the end of 2010, For 78 cities and 99 counties, the ratio of debt with direct obligation to repay to financial resources of local governments is higher than 100%. Some LGFVs are running with a loss and some localities have been relying on land sale revenues to perform the debt repayment.

4. Proposing Constructive Opinions on Preventing Debt Default Risks and Strengthening Management of Local Government Debt

Based on the audit findings, the CNAO has made the audit recommendations on the following three aspects. First, the outstanding debt should be actively and prudently dealt with on the merits of each case. For the debts incurred due to the need to finance projects with market-competitive power or non-profit projects with revenue-generating power, or the debts of enterprises with market-competitive ability, revenues generated from the projects or enterprises should be taken as main channel of performing the debt, while local government should be exempted from the direct liability to repay and may only provide some proper financial subsidy if necessary. For the debts incurred due to the need to finance non-profit projects without revenue-generating power, and local government held liable for repayment, a plan of performing the debt should be instituted by local governments to ensure the budgetary funds arranged for the repayment.

Second, the LGFVs should be further straightened out and standardized and the act of providing guarantee in violation of laws or regulations by local governments should be strictly prohibited. The LGFVs shall be integrated and regulated by local governments through various measures including reorganization and transformation of the LGFVs and the introduction of private investments, with the aim to promoting the diversification of investors for the LGFVs and improving the corporate governance. The act of providing guarantee in violation of laws or regulations by local governments for the debts of LGFVs and other institutions should be strictly prohibited. The launch of new projects should also be strictly controlled to prevent the risk of failing to accomplish the project under construction.

Third, a standardized financing mechanism through debts by local governments should be established and a dynamic supervision for all dimensions of local government debts should be realized. The granting of the right for local governments to raise funds in form of debts on a rational scale should be considered, provided that the plan to raise the debts should be examined and approved by the State Council, and the budget of local debts should be compiled and included in the local budget, and submitted to the local People's Congress at the corresponding level for examination and approval. A strict procedure for examining and approving other government-related debts that governments are not liable for performing the debt directly should be introduced and implemented,

with the aim to controlling the size of this type of debt. The assessment upon debt situation should be included in the performance evaluation upon local government in order to prevent the acts of raising debts in violation of laws and regulations or in an excessive manner.

5. Providing a Reliable Foundation for Decision-making of the Central Government

With the provision of instructive classification of local government debts by differing liabilities, and full set of relevant basic data, the audit has laid a solid foundation both for the enhancement of local government debt management and decision-making of the central government. The State Council and the Standing Committee of the National People's Congress attach great importance to the audit recommendations which shall be used for promoting the improvement of financing mechanism through debts by local governments. For the problems disclosed in the audit, the related departments and local authorities are studying and formulating the systems and measures to reinforce and improve the management of local government debt.

To conclude, the results of this audit has responded to the public concerns and provided a foundation for strengthening local government debt management. The immunity-building function of auditing in the governance at national level has been fully played, and it shall produce a significant and far-reaching influence on the management of public debt in China. The CNAO will continuously exert further efforts to establish a standardized, transparent and effective management system of public debt.