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China’s Local Governments

Can they pull the weight of the country’s economy?

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This document assesses the fiscal situation of China’s local governments. It highlights their growing fiscal imbalance owing to falling revenues and rising expenditures. It underlines that the accumulation local debt, including hidden debt, has drastically limited the fiscal space of the local governments. Finally, it argues that the measures undertaken by the central leadership to alleviate the misery of the local government have been ineffective.

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Executive Summary

China's economy has been undergoing a structural slowdown after witnessing four decades of near double-digit growth rates. For the third time in a row, China has set an annual growth target of around 5 per cent for 2025. And to a great extent, whether it achieves the target will be contingent on the performance of its local governments, which are responsible for around 88 per cent of the national expenditure. However, their fiscal situation continues to worsen. Not only has their general budgetary revenue as a percentage of GDP dropped, revenue from sale of land use rights has also sharply declined. To further compound their misery, local government debt, including hidden debt, has soared to over 50 percent of GDP. With the central leadership's crackdown on illegal debt, coupled with falling revenues, the fiscal space for the local governments has drastically reduced. However, their expenditure mandates continue to expand, thereby creating a structural fiscal imbalance. This has, in turn, severely limited the local governments' ability to keep the economy running.

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I. Introduction

In his annual Government Work Report delivered in March, Chinese Premier Li Qiang claimed that the country had successfully achieved the 2024 GDP growth target of 5 percent.[1] Subsequently, for the third time in succession, China set an annual growth target of around 5 percent in 2025 at the 'two sessions'.[2]

But much of China's economic future hinges on the performance of its local governments – an umbrella term for all four levels of government, from small counties to vast provinces, below the central government in Beijing. However, their worsening financial health – mounting debt along with dwindling revenues – limits their capability.

Taking cognisance of this fiscal imbalance plaguing local governments, the central leadership proposed plans to deepen tax and fiscal reforms at the Third Plenum in July 2024.[3] These were aimed at raising the local governments' income, increasing central transfers, and expanding the central government's share of spending to ease the pressure on local governments. While these plans were subsequently reiterated at the Central Economic Work Conference (CEWC) in December 2024 and then at the March 'two sessions', local governments await any meaningful outcome.[4]

II. Local Governments: The Expenditure Behemoth

Unlike virtually any other nation, China's local governments carry out the vast bulk of national expenditure. In 2024, China's local governments were responsible for more than 85 percent of the national general budgetary expenditure.[5] In aggregate numbers, China's total national government general budgetary expenditure in 2024 amounted to CNY 28.4 trillion (**$3.9 trillion**), and local government spending made up CNY 24.4 trillion of that. In contrast, local government expenditures in Brazil, often touted as the most fiscally federal country, account for roughly 50 percent of the national budgetary expenditure.[6]

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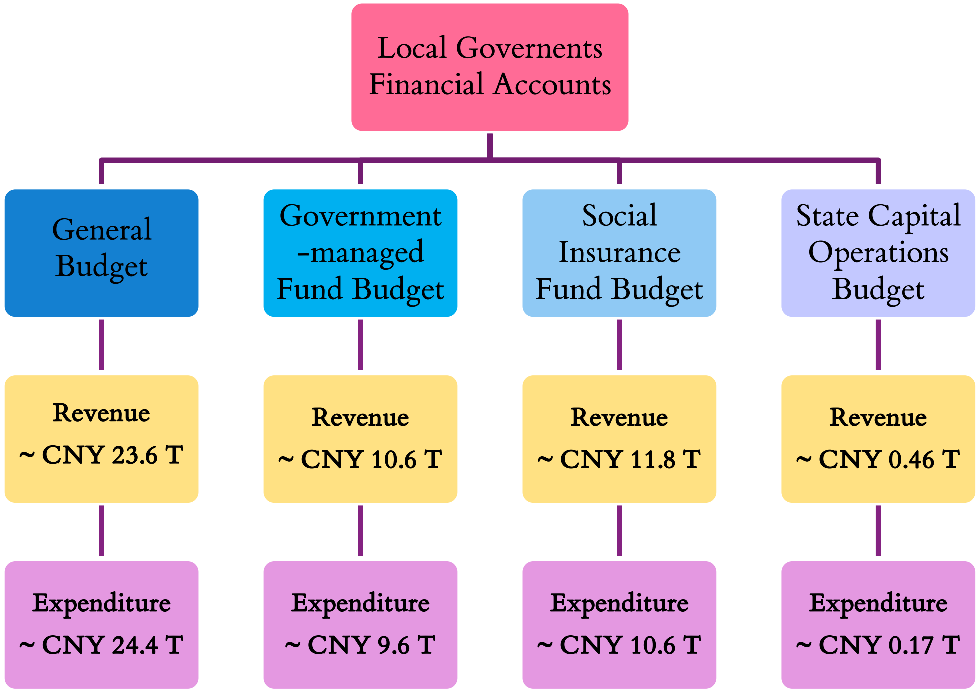
In contrast, local government expenditure in Brazil, often touted as the most fiscally federal country, account for roughly 50 percent of the national budgetary expenditure

But those figures alone are not the complete story of China's local finances. Neither does it encapsulate the sheer scale of China's local governments' spending.

China's local governments, like the centre, maintain four separate budgets, and the general budget is only one among them. The other three budgets are the government-managed funds budget, the state capital operations budget and the social insurance fund budget, each with their own streams of revenue and separate expenditures.

Figure 1: Local Governments Financial Accounts



Note: Revenue and Expenditure figures from 2024 Budget.

China's local governments maintain four different budgets: general budget, managed fund budget, social insurance fund budget and state capital operations budget.

Put together, China's local governments combined budgetary expenditure shoots to 88 percent of the national expenditure (2024 figures).

The government-managed fund is the second-most important of the four budgets after the general budget. This fund earns an overwhelming majority of its revenue from just two sources: the sale of land use rights and special purpose bonds. At its peak in 2021, these two made up for around 94 percent of the fund's total revenue. The expenditures from the fund (~CNY 10 trillion, 2024) mostly relates to compensation for land procurement, land preparation, interest payments and infrastructure development.

The social insurance fund budget earns revenue largely through various insurance premiums, and the expenditure (~CNY 10 trillion, 2024) from the fund is solely reserved for social security payouts.

The government managed fund budget is the second-most important of the four budgets. It earns an overwhelming majority of its revenue from sale of land use rights and special purpose bonds. At its peak in 2021, these two sources made up for around 94 percent of the fund's total revenue.

The state capital operations budget, the smallest of all, includes revenue (~CNY 0.45 trillion, 2024) from profits from State-owned enterprises, dividends, liquidation, property transfer, and central transfers. The budget maintains a small surplus (~CNY 0.3 trillion, 2024) after SOE-related expenditures, such as subsidies and capital infusion, which is then transferred to the local general budget.

Put together, China's local governments' combined budgetary expenditure shoots to ~88% (CNY 44.7 trillion, 2024) of the national expenditure (CNY 50.6 trillion, 2024). While this arrangement has worked wonders for Beijing in the past, mounting pressure on China's local government finances – increasing expenditure amidst shrinking revenue - has become a drag on an already slowing economy.

III. Falling Revenues

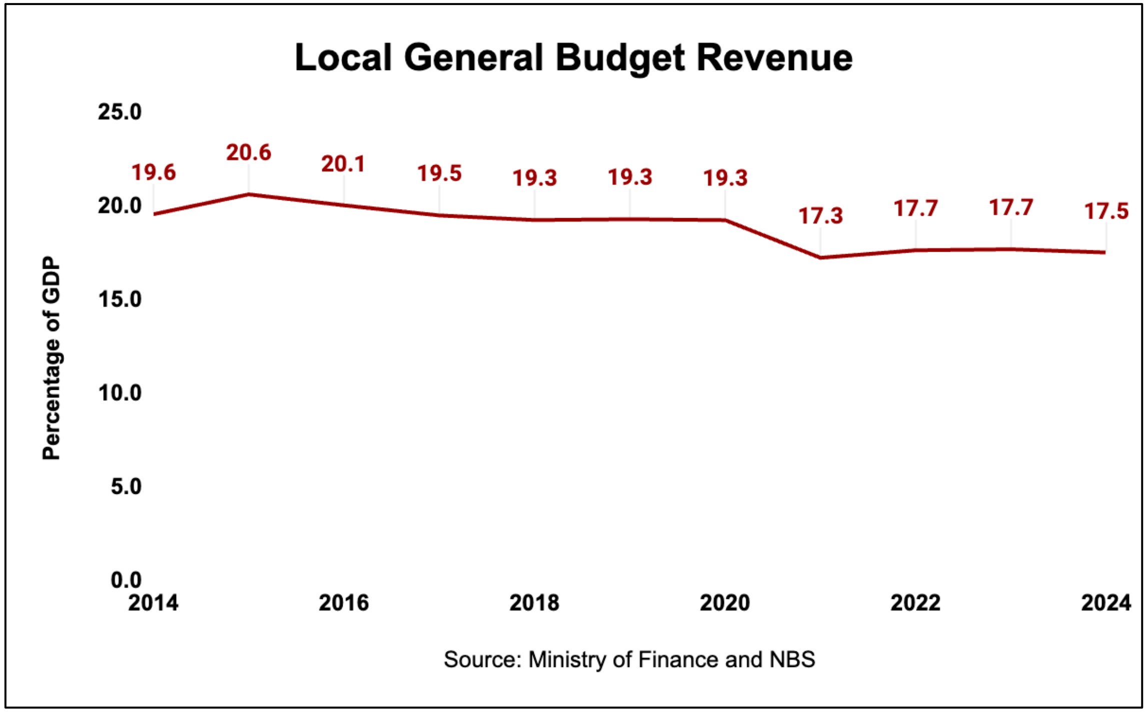
The general budget and the managed funds budget are the two primary financial accounts of local governments. And both these budgets have witnessed a sustained decline in their revenue pool. Local general budgetary revenue has declined from a high of 20 percent of the GDP in 2015 to 17.5 in 2024.

China's two primary budgets have witnessed a downfall in revenue.

Local general budgetary revenue has declined from a high of 20 percent of the GDP in 2015 to 17.5 in 2024.

Revenue from sale of land use rights have also dropped from a high of CNY 8.7 trillion in 2021 to CNY 4.9 trillion in 2024.

Figure 2: Local Government General Budget Revenue (%GDP)

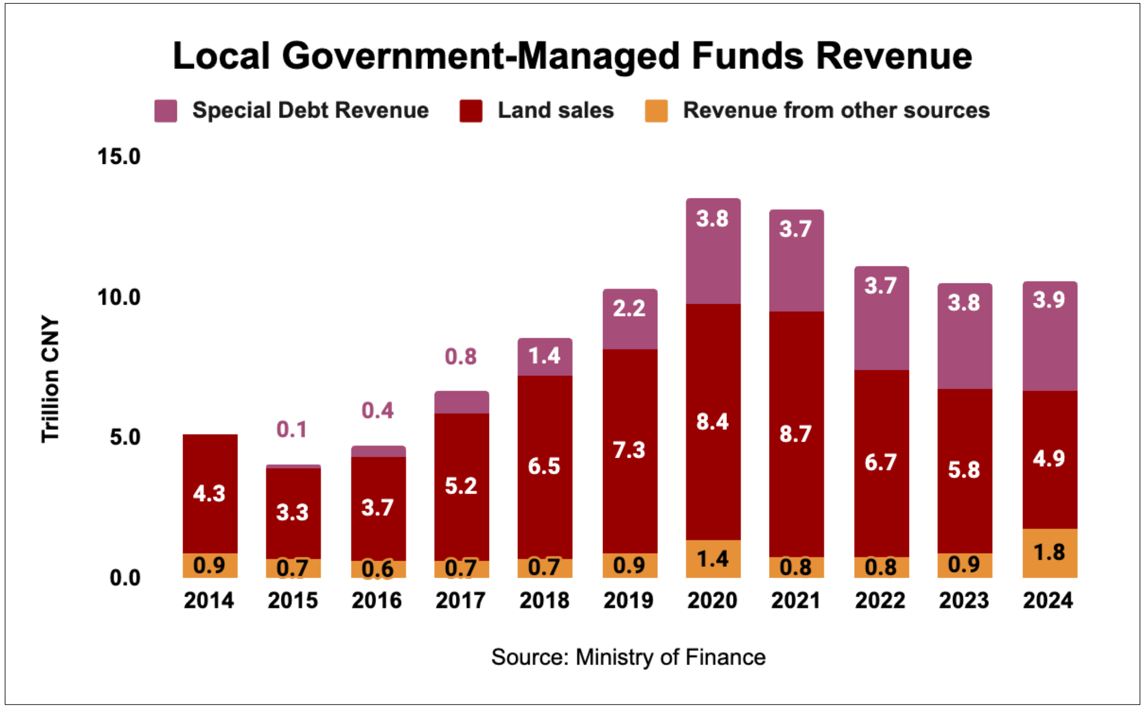


The development is in line with a sustained fall in China's national general budgetary revenue (tax and non-tax revenue) as a percentage of GDP. It has also declined from 29 percent in 2018 to just 22.1 in 2024. China's national tax receipts in 2024 fell by 3.4% year-on-year.

To make matters worse, dwindling land sales revenue owing to the collapse of the real estate bubble has exacerbated the problem for local governments.

China's national general budgetary revenue (tax and non-tax revenue) as a percentage of GDP has declined from 29 percent in 2018 to just 22.1 in 2024.

Figure 3: Local Government-managed Funds Revenue



Revenue from the sale of land use rights dropped from an all-time high of CNY 8.7 trillion in 2021 to CNY 4.9 trillion in 2024.[7] This has severely constrained China's local governments' finances as land sales is the single largest source of revenue for the local governments across the four budgets. As revenue has shrunk, the residual pool for capital expenditure has also shrunk.

Local governments' primary budget was never fully equipped to shoulder the requisite expenses. However, the falling revenue has further restricted their already limited capability to fulfil their mandates. With the off-budget financing model already under scrutiny, falling general budgetary revenues and lack of taxing powers have compounded their misery.

Signs of stress have been showing up for a while now. In November last year, several medical staff members of a public hospital in the Chinese city of Shanwei in Guangdong province, gathered to protest against unpaid wages and bonuses.[8] Around the same time, retired employees of Yichuan city protested missing pension payouts. The local authorities in China's city of Liuzhou, had to halt the construction of the light-rail system last year owing to a cash crunch, leaving behind half-built tracks.[9] Even China's civil servants could not escape the consequences as reports of months-long delays in salaries surfaced last year.[10]

IV. China's Accounting Practices Obscure part of the Problem

However, a preliminary reading of China's local governments' budgets doesn't suggest an immediate crisis. For instance, local governments' total general budgetary revenue receipts in 2024 stood at CNY 22 trillion, of which CNY 10 trillion were received as central government transfers.[11] Adding the funds from local budget stabilisation fund, local government-managed funds budget, local government state capital operations fund, and carryovers, the gross budgetary revenue for local governments reached CNY 23.6 trillion.

Money raised through special purpose bond constitutes the second-largest source of revenue for the local government-managed fund budget.

However, money raised through this route is technically debt masquerading as revenue, which must be paid back with interest.

With a general budgetary expenditure of CNY 24.4 trillion in 2024, a budget deficit of CNY 2.5 trillion for China's local governments (discounting local budget stabilisation fund, inter-budgetary transfers, and carryovers) is well under global standards.[12] Consequently, the local governments' fiscal deficit for 2024 comes out to be 1.8% of the GDP. After accounting for the three additional budgets, which run a surplus account, the local governments' fiscal deficit further reduces.

The puzzle remains. If indeed local governments' finances are in a dire state, why isn't it showing up in the official figures? The answer to the question lies in China's accounting practices. The figure of 1.85 percent was arrived at by subtracting the total revenue from total expenditure and then expressing it as a percentage of the GDP. While this method is correct, there is an error in accounting. It regards the money raised through the special purpose bonds as revenue.

Table 1: China's Fiscal Deficit (% GDP)

Financial Accounts	Local	Central	National
General Budget	-1.8	-2.9	-4.7
Managed-funds	-2.9	0.0	-2.9
Social Insurance	1.0	0.0	1.0
State Capital Operations	0.2	0.1	0.3
Consolidated	-3.5	-2.9	-6.4

Source: Author's calculation based on Ministry of Finance Report (2025) on Execution of the Central and Local Budgets for 2024

Between 2020-23, the local governments raised ~CNY 3.8 trillion each year through special purpose bonds.[13] This constitutes the second-largest source of revenue for the local government-managed fund budget. However, money raised through this route is technically debt masquerading as revenue, which must be paid back with interest. However, the managed funds budget lists this amount as special debt revenue. This explains the error.

Thus, adding the CNY 3.9 trillion debt raised through special purpose bonds, and subtracting the surpluses recorded by social insurance funds and state capital operation funds, the effective budget deficit of the local governments stood at ~CNY 5 trillion in 2024. This raises their fiscal deficit to 3.6 percent of the GDP, higher than the 3 percent national fiscal deficit limit set for 2024. If one adds the central government's fiscal deficit numbers, the national fiscal deficit breaches the 6.5 percent mark.

V. Off-budget Financing and Hidden Debt

Yet, this doesn't capture the true extent of the local governments' fiscal woes. The primary reason why local governments' balance sheets do not show signs of an impending crisis is the extra-budgetary nature of their finances. Since the early 1990s, local government's budgets have never matched up to what the central government demands of them, or their own self-proclaimed annual targets. That gap has been filled by debt-raising schemes that are now coming back to bite.

The current Tax Sharing System (TSS), introduced in 1994, boosted the central government's share of national revenues at the cost of the local governments. Consequently, the central government's revenue (tax and non-tax) share soared from a mere 22 percent in 1993 to over 46 percent.[14] At present, 53 percent of the tax proceeds go to the central pool, while 47 percent is collected in the local pool.[15] At the same time, the local governments were asked to spend more, with their share of the general budgetary expenditures having increased from over 70 percent in 1993 to 85 percent today.[16]

The leadership also barred the local governments from imposing new taxes, as the central government alone possessed that power.[17] Neither can they raise

The current Tax Sharing System (TSS), introduced in 1994, led to a decline in local governments' share of national general budgetary revenue.

At present 53 percent of the tax proceeds go to the central pool, while 47 percent is collected in the local pool.

Further, local governments' share of general budgetary revenue (tax and non-tax) dropped from 78 percent in 1993 to 54 percent after the introduction of the TSS.

At the same time, the share of local governments' budgetary expenditure has risen from 70 percent in 1993 to 85 percent in 2024.

tax rates beyond a certain range set by the central leadership. These restrictions continue to plague the local governments' finances.

Furthermore, the Budget Law of 1994 prevented the local governments from directly raising money from the banks or the market, blocking off a major borrowing source for the local governments to finance their overreaching expenditure mandates.[18] Although the central government amended the Budget Law in 2014, the damage was already done. Even now, local governments cannot issue bonds beyond a quota allotted to them by the central government.[19] Not surprisingly, the quota system offers only limited fiscal space to local governments.

This left local governments with a permanent shortfall, which they made up by the meteoric rise of the Local Government Financing Vehicles (LGFVs). These were enterprises and corporations set up by the local governments to raise capital from the market to finance infrastructure and development projects. It allowed the local governments to run a significant part of their expenditure off the books.

LGFVs rapidly became an indispensable tool for local governments to sustain their finances. The central government, too, encouraged local governments to use the LGFVs to step up their investments in the aftermath of the Global Financial Crisis of 2008.[20]

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Neither can they raise tax rates beyond a certain range set by the central leadership.

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The Budget Law was amended in 2014 to allow local governments to issue special purpose bonds. However, local governments cannot issue bonds beyond a quota allotted to them by the central government.

VI. Legacy Issues Continue to Plague Local Governments

Over time, these LGFVs accumulated massive debt. And since this debt was backed by local government guarantees (with land as collateral), off-budget financing threatened to turn into a macroeconomic problem for China. A central government audit in 2013 disclosed CNY 17.9 trillion in outstanding local debt.[21] Thereafter, the central government rushed to contain the impending crisis in a process described as "opening the front door while closing the back door."[22] Under this policy, the Budget Law was amended in 2014 to allow local governments to directly raise money from the market through special purpose bonds. The local governments could also swap the off-budget debt with local government bonds, albeit within the set quota. This allowed the transfer of hidden debt into official records. The central government also directed that a distinction be made between 'government debt' and 'enterprise debt'. Additionally, the central government directed that, henceforth, no new LGFV debt can be added as government debt.[23] It also barred the local governments from giving guarantees to LGFV debt. Accordingly, all new debts incurred by LGFVs since 2015 are categorised as enterprise debt.

Local governments turned to LGFVs to make up for the revenue shortfall. LGFVs rapidly became an indispensable tool for local governments to sustain their finances.

The central government, too, encouraged use the LGFVs to step up their investment in the aftermath of the Global Financial Crisis of 2008.

Overtime, LGFVs accumulated massive debt. Since this debt were backed by local government guarantees, off-budget financing threatened to turn into a macroeconomic crisis.

This, however, has not solved the crisis. According to official estimates, China's local governments' total outstanding debt stood at ~CNY 47 trillion at the end of 2024.[24] This does not include the hidden debt accumulated by the local governments. While the official figures quote an additional CNY 14.3 trillion in 'hidden debt', independent assessments place China's LGFVs debt alone in the range of CNY 50-100 trillion in 2023.[25]

In November 2024, the Chinese leadership announced a CNY 10 trillion package to address hidden debt. But this does very little to alleviate the situation. Firstly, the scheme is not a bailout plan. Instead, it allows the local governments to replace up to CNY 6 trillion of their hidden debt with government bonds over three years.[26] The remaining CNY 4 trillion will be available to the local governments in the form of additional special purpose bonds quota over the next five years, i.e., CNY 800 billion every year.[27] Thus, while the measure could save some CNY 600 billion in interest payments,[28] as per the central government, it is hardly a reprieve given the scale of hidden debt.

The scale of China's local debt, official and hidden, means that the fiscal space for the local governments is fast shrinking. With the central leadership's crackdown on 'illegal debt',[29] the LGFVs that have long been instrumental in the country's urban development and infrastructure expansion are struggling to shift from a land-based finance model to a new revenue model.

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China's CNY 10 trillion debt-relief package, unveiled in November 2024, does very little to alleviate the situation.

Moreover, the "front door" of centrally-sanctioned debt is too small for local governments. Local governments cannot issue bonds beyond the quota allotted to them, and a significant portion of that quota is spent towards debt replacement or swapping of debt – an accounting exercise to bring hidden debts into official records. Thus, that debt raised through swapping or replacement is not used towards capital expenditure.

Even Beijing's proposed tax and fiscal reforms, unveiled at the Third Plenum last year to alleviate the local governments' fiscal difficulties, face several challenges. To begin with, the proposal to increase central transfer payments to the local governments doesn't seem plausible in the current situation. In 2024, the central government's total general budgetary revenue amounted to CNY 10.8 trillion, of which CNY 10.03 trillion (~93 percent) were given away in transfers to the local governments.[30] Thus, unless the central government raises its share of debt, or its general budgetary revenue increases substantially, the room for increased central transfers is limited. This is evident in the fact that 2024 witnessed a decline of CNY 0.23 trillion in transfers from 2023.[31]

Secondly, the proposed plan to increase local governments' tax receipts faces similar challenges. Local governments would need to either raise the current tax rates or find new tax sources to expand their revenue pool. However, this could adversely impact Beijing's efforts to boost domestic consumption. The only other way that the local governments' tax revenues can increase is if the domestic consumption itself expands substantially, something China continues to struggle with.

Finally, raising the central government's share of national expenditure can relieve the pressure on the local governments. But given that the former already transfers ~93% of its budgetary revenue to the latter, this measure can only materialise if the central government expands its tax base, which seems difficult at present, or raises additional debt, which will further complicate the national debt situation.

VII. Conclusion

China’s local governments’ seem to be caught in a difficult situation. They cannot raise debt. They cannot generate revenue. But they must spend, and continue to bear the momentous task of powering the world’s second largest economy. In times of a sustained economic slowdown, the only question to answer is “how.”

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