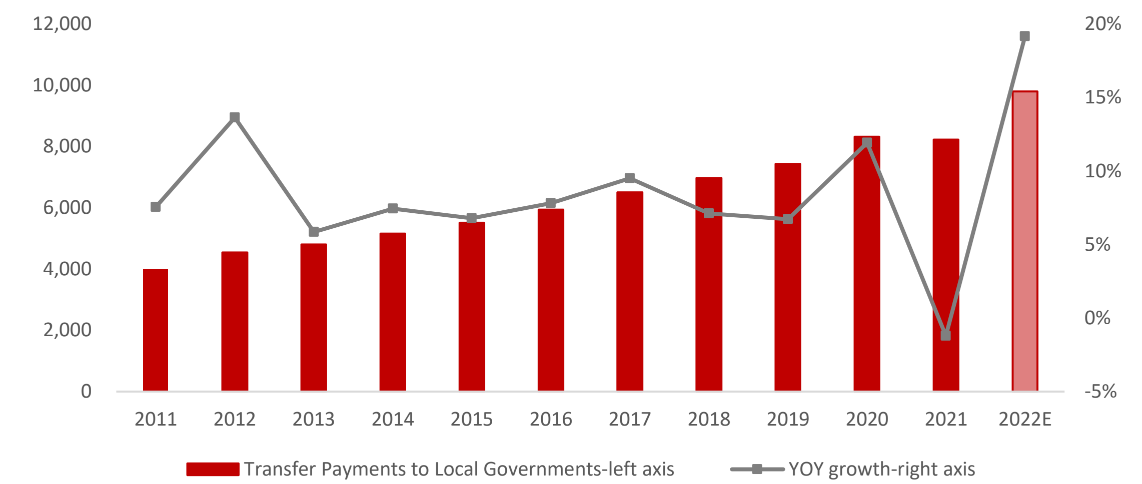
Non-rating Action Commentary: China strives to reduce fiscal strength discrepancies among local governments

The surging fiscal transfer from the central government is expected to bolster the budgetary revenue of local governments this year, particularly those with weaker fiscal self-sufficiency.

The central government has slated an incremental RMB1.5 trillion fiscal transfers to local governments in 2022, an increase of 19% compared to the fiscal implementation in 2021. This is viewed as an unprecedented growth over the past decade, when the average annual growth of the central government's fiscal transfers was at 7.6% (Exhibit 1).

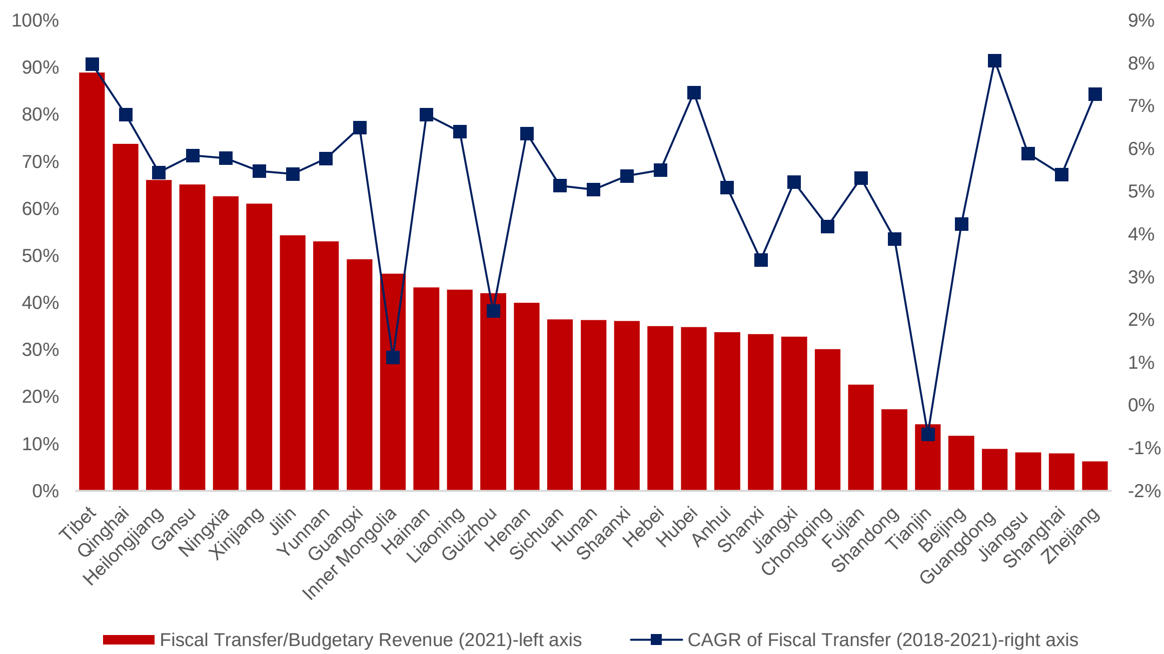
Exhibit 1: The transfer payments to local governments are set to surge in 2022 (RMB Billion)



Note: The fiscal transfer in 2022 is based on the budget plan of 2022, while those of the other years are based on the budget implementation.
Sources: MOF, Pengyuan International

The central government embarks on increasing the size of transfer payments, favoring regions with difficulties, underdeveloped areas, and regions with more tax and fee reductions. This is a strategic and rational approach, in our view, given that the economic slowdown, persistent tax cuts and the bleak land market are exacerbating the fiscal divergences among regions with different economic development stages. The significant enhancement of fiscal support from the central government should partially diminish the budgetary revenue gap between the wealthy and the poor regions, and most importantly, lift certain regions out of fiscal quagmire. We believe that this measure will benefit local governments with weaker budgetary self-sufficiency but a higher proportion of fiscal transfers in their budgetary revenue, increasing their reliance on the central government (Exhibit 2). For instance, over 50% of the budgetary revenues of the provinces of Qinghai, Gansu and Yunnan were derived from the central governments' fiscal support in 2021. The steadfast growth of the fiscal transfers has been the prime driver in their fiscal revenue over the past few years, so the furtherance of the fiscal support will boost their fiscal strength and alleviate their fiscal pressure, thereby improving their creditworthiness.

Exhibit 2: Poorer regions tend to have higher proportion of fiscal transfer in the budgetary revenue



Note: The fiscal transfers of Hebei, Shanxi, Inner Mongolia, Heilongjiang, Fujian, and Jiangxi are estimated based on the budget implementation of 2020; CAGR = compound annual growth rate
Sources: Local Governments, Pengyuan International.

The central government is walking a fine line between setting forth the proactive fiscal expansion and increasing the local governments' leverage.

The local governments' government fund revenues are budgeted flat in 2022, while the expenditures are budgeted to rise 19% year on year, generally in line with our projection. The gap between the revenue and expenditure is expected to be covered by the incremental special bond with a limit of RMB3.65 trillion. The ceiling is established at the same level as in 2021, showing that, while the central government is reinforcing its proactive fiscal measures, its willingness to rein in local governments' debt levels is strong, with undue debt raises not taken under consideration. However, because the real estate market has not yet recovered, many local governments may struggle to achieve flat land sales growth this year. Further loosening of property market restrictions may be necessary to rejuvenate the enthusiasm for land purchases. As the developers become more discreet and concentrate their land acquisition efforts on wealthier regions, the divergences in land sales between regions are widening. Nonetheless, the significant and prioritized increase in the central government fiscal transfers is expected to balance the regional fiscal diversities and thus effectively sustain the country's fiscal expansion.

Instead of ramping up debts, the central government has higher inclination to rely on the stated-owned assets and enterprises to meet its fiscal needs.

China's central bank announced on 8 March to transfer a total of more than RMB1 trillion in profit to the central government, substantially augmenting the central government's fiscal revenue base and facilitating its increase in transfer payments to local governments. The initiative is echoed with the national budget scheme for 2022, which stipulates that certain state-owned financial institutions and specialized institutions will pay RMB1.65 trillion of their profit to the central government in 2022. This indicates that the central government is becoming more active in utilizing its gargantuan state-owned enterprises and assets to fuel its fiscal revenue without incurring excessive debt. The initiative also shows the central government's capability to manage its deficit and debt levels, with its abundant revenue sources and realizable assets, while implementing a proactive fiscal strategy and, at the same time, revealing the tools available to the central government to fiscally support local governments.

ANALYST CONTACTS

Primary Analyst

Jameson Zuo, FRM

+852 3615 8341

jameson.zuo@pyrating.com

Secondary Analyst

Siqi Lin

+86 755 83210225

siqi.lin@pyrating.com

Media Contact

media@pyrating.com

Rating Services Contact

Mr. Allen Wei

+852 3615 8324

allen.wei@pyrating.com

Additional information is available on www.pyrating.com

****

DISCLAIMER

CREDIT RATINGS ARE EXPECTED TO BE TRAINED FOR INDEPENDENT ASSESSMENT OF INVESTMENT AND BUSINESS DECISIONS.

This research is based solely on the public data and information available to the authors at the time of publication of this research. For the purpose of this research, the Company obtains sufficient quality factual information from public sources believed by the Company to be reliable and accurate. The Company does not perform an audit and undertakes no duty of due diligence or third-party verification of any information it uses in the research. The Company is not responsible for any omissions, errors or inconsistencies of the public information used in the research.

NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS OR COMPLETENESS OF ANY INFORMATION GIVEN OR MADE BY THE COMPANY IN ANY FORM OR MANNER. In no event shall the Company, its directors, shareholders, employees, representatives be liable to any party for any damages, expenses, fees, or losses in connection with any use of the information published by the Company.

This research focuses on observing trends from the credit markets. This research has not been made available to any issuer prior its distribution to the public. The Company does not receive compensation for its research.

The Company reserves the right to disseminate its research through its website, the Company's social media pages and authorised third parties. No content published by the Company may be modified, reproduced, transferred, distributed or reverse engineered in any form by any means without the prior written consent of the Company.

The Company's research is not intended for distribution to, or use by, any person in a jurisdiction where such usage would infringe the law. If in doubt, please consult the relevant regulatory body or professional advisor and ensure compliance with applicable laws and regulations.

In the event of any dispute arising out of or in relation to our research, the Company shall have absolute discretion in all matters relating to resolving the dispute, including but not limited to the interpretation of disclaimers and policies.