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How Fiscal Risk May Constrain China's Geopolitical Ambitions

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How Fiscal Risk May Constrain China's Geopolitical Ambitions

Christopher F. Wurzel

Executive Summary

This paper focuses on questions surrounding the state of China's government finances and endeavors to identify the broad implications of the Chinese government's fiscal policy decisions. An apparently chronic diminution in China's headline economic growth rate, the disruptions emerging from its draconian approach to dealing with the COVID-19 pandemic, and its worsening political and economic relationships with many of the world's most developed countries both in East Asia and in the West, particularly the United States, have called into question prior assessments of China's ability to finance even basic government services, let alone realize its stated global ambitions. In recent years, the Chinese government itself has characterized its fiscal situation as "grave," even when the ostensible performance of China's economy, as expressed by increases in gross domestic product, has appeared relatively strong.

The study primarily relies on official Chinese government fiscal statistics to ascertain trends in overall revenues and expenditures that could affect China's national security and other goals. It also reviews various secondary sources in English and Chinese languages to provide historical and institutional background that can help explain the trends indicated by an examination of the available fiscal statistics. The available open source data indicates that fiscal pressure will inevitably inform and probably constrain China's domestic and foreign policy in terms both of goals and of implementation. A significant research opportunity exists to develop a better understanding of how China finances its national defense institutions, to include studies of the various institutions and procedures involved in translating government revenues into actual expenditures, of the dynamic through which public resources are allocated to the Communist Party's political priorities, and of the financial relationship between the Chinese civilian and military authorities.

The reason for the poor assessment of the Chinese government's fiscal state lies in the fact that revenues have been substantially less than expenditures at both the central and local levels because of slower economic growth and policy decisions that have reduced taxes and increased government spending, particularly at the local level. Most critically, local governments in China, which the central government denies formal authority to determine taxes and other revenues for political reasons but which account for over 85 percent of all government expenditures, have relied on income from sales of state-owned land to property developers along with transfers of revenue from the central government to meet their spending obligations (most of which are imposed by Beijing). The steady increase of these obligations combined with a significant decline in the real estate market

have led to a situation in which both the central government and the local governments must issue ever greater amounts of debt to finance government operations. This situation has caused spending on national defense, internal security, and interest on outstanding debt to account for over half of all central government expenditures. Also, it has led to reduced outlays for nearly all other central government agencies as China's leaders have endeavored to restrain debt service while steadily increasing national defense spending.

This growing reliance on debt to finance government spending has exacerbated stresses on China's financial system. The Chinese government funds its central and local government deficits through bond sales primarily to the country's banks, all of which are state-controlled and subject to political direction, and, at the local level, through "hidden debt" borrowed by companies established by local authorities. This system has resulted in inefficient use of capital, serious corruption, and proliferating defaults by both domestic and foreign borrowers, all of which are potential fiscal liabilities for China's central government.

China's political leaders have acknowledged the economic and political risk arising from the dependency on debt. The exigencies generated by the COVID-19 pandemic and China's response to that challenge, however, have undermined efforts to reduce overall debt while still maintaining economic growth. Internal and external shocks, such as a wave of debt defaults by domestic or foreign borrowers, a significant slowdown in global economic growth, disruption to global supply chains, and economic sanctions by China's leading economic partners that further reduce government revenues or shake confidence in the country's financial system, could have a large and immediate impact on the Chinese government's ability to fund even its highest priorities, including the military, which has enjoyed unbroken spending increases.

Further research should begin with the establishment of a more thorough understanding of China's overall public financial institutions: the interrelation of the four budgets, the structure of the tax system, the operation of the various funds that support government spending, and the legal and policy framework that underpins this system. The subsequent step could examine the nexus between the Communist Party and the key government institutions responsible for the collection and management of public funds. One possible approach would be to review the vast body of Chinese policy documents to map out the processes and authorities through which the different agencies interact. Finally, an effort to illuminate the civil-military financial relationship could focus on openly available Chinese government resource-related policy documents, court decisions, and reports involving both military and civilian authorities to establish a baseline understanding of this relationship.

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1. Introduction

After many years in which China's impressive economic performance led many observers to believe that the country had become an unstoppable juggernaut with nearly inexhaustible resources, questions have arisen as to whether this conclusion was fundamentally incorrect. An apparently chronic diminution in China's headline economic growth rate, the disruptions emerging from its draconian approach to dealing with the COVID-19 pandemic, and its worsening political and economic relationships with many of the world's most developed countries both in East Asia and in the West, particularly the United States, have called into question prior assessments of China's ability to finance even basic government services, let alone realize its stated global ambitions.

This paper focuses on questions surrounding the state of China's government finances. It begins with a discussion of the main materials on which the study is based and an assessment of the reliability of those sources. The subsequent section outlines the structure of China's public finance system and its fragmented nature in which responsibility for expenditures is divided between the central government and local authorities even though the central government dominates the collection of revenues. The following discussion provides an analysis of the way in which the central government has prioritized military spending as fiscal resources have become strained and examines the intimate relationship between China's government finances and its banking and financial institutions and the inherent systemic risk that has evolved through this dynamic. The paper then presents two cases of institutions that exemplify this risk.

The study continues with an account of Chinese government official policy statements highlighting longstanding concerns regarding the accumulation of on-budget and so-called "hidden" debt and provides an assessment of factors that could potentially exacerbate China's efforts to manage its public finances. The final sections give concluding thoughts and suggest potential lines of effort for additional research into China's fiscal system, in particular its relationship regarding support for the country's military development.

Both Chinese characters and pinyin romanization are provided for specific Chinese terms. The Chinese government fiscal statistics reflect the most current publicly available data as of September 2023. This paper refers to Chinese currency as *renminbi* (RMB), consistent with the nomenclature used by the International Monetary Fund (IMF) and other international financial institutions. Where equivalent values are expressed parenthetically in U.S. dollars, the Institute for Defense Analyses (IDA) applied the market exchange rate of \$1=RMB 7.3 prevailing in September 2023. Consequently, dollarized figures for years

prior to 2023 will not be consistent with citations of the same original Chinese statistics converted into dollars in other texts but calculated using different exchange rates. The dollarized figures in this study are provided primarily to give the reader a rough basis for comparison with non-Chinese equivalents and do not reflect any economic assumptions such as purchasing power parity.

2. Methodology

This study primarily examines official Chinese government fiscal statistics to ascertain trends in overall revenues and expenditures that could affect China's national security and other goals. The baseline assumption is that these statistics do reflect with reasonable accuracy real fiscal inflows and outflows for the Chinese government and can indicate the broader trends in China's overall fiscal health. That said, aggregate national data are obviously incomplete as they do not provide attribution for certain politically sensitive spending items such as prisons, Communist Party activities, and military research and development. Figures for those categories, however, are occasionally available in sub-national fiscal reports. Official fiscal data also do not cover "extra-budgetary" revenues and expenditures (such as the earnings and purchases of businesses affiliated with government agencies like many publishing houses), a longstanding feature of China's political economy of which the scale is largely unknown.

The study relies on data released to the general public and available on the websites of the Ministry of Finance of the People's Republic of China (PRC) and the financial agencies of various Chinese sub-national jurisdictions (provinces, municipalities, and counties). The main focus is the series of "final accounts" (决算 *juesuan*) that each Chinese government jurisdiction and agency must produce every year to report the execution of the official budget for the previous calendar year. These figures are normally released by the central government and local jurisdictions in July–August of the subsequent calendar year. These final account reports, which each jurisdiction submits to its relevant People's Congress (i.e., legislature) for review, appear to provide the most accurate, openly available data on public finances in the PRC. The audit offices that belong to the relative jurisdiction generally review and comment on these reports, which suggests that the figures may be somewhat less subject to manipulation than other Chinese government statistical data. In addition, because of the relatively lax fiscal discipline within China's political system, the final account data more accurately reflect real revenue and spending trends than the budgets (预算 *yusuan*) released by Chinese jurisdictions near the start of each calendar year at the annual sessions of their respective People's Congresses. Final account data can often vary wildly from the initially budgeted figures, and, therefore, supply a more accurate picture of China's fiscal condition.

The study also reviews various secondary sources in English and Chinese languages to provide historical and institutional background that can help explain the trends indicated by an examination of the available fiscal statistics. In most cases, however, neither the raw statistical data, the official Chinese government documents from which they are drawn, nor

the analyses of individuals inside or outside China provide fully satisfying explanations for the phenomena observed. Consequently, many conclusions in this study fall into the category of informed speculation.

Nevertheless, by focusing on publicly released Chinese official data, the hope is that this study can establish a baseline of knowledge regarding the present state of China's public finances and its related implications that further research may either support or disprove. Although confidence in much information originating from the Chinese authorities is weak, the official government figures, at a minimum, enjoy the imprimatur of the country's political leadership. In this respect, the numbers logically represent reality, at least in part, even if they may be somewhat inaccurate or incomplete. Officials at all levels of the political system must rely on these figures in the absence of other widely available alternative information. Too large a deviation from actual revenues and expenditures could lead to erroneous government actions with potentially dire consequences for the regime. As a result, the conclusions that flow from these data should provide some insight into Chinese government decision-making and policy priorities.

3. China's Fragmented Fiscal Structure

Conventional wisdom paints China as an emerging “superpower,” with the largest population of any country on the planet and the second-largest economy after the United States. Nevertheless, China faces many well-documented problems, including a rapidly aging population, ongoing environmental issues, and persistent corruption. An additional challenge that, until recently, has escaped widespread attention, especially outside China, is the state of its government finances. To quote the March 2022 annual budget report by China's Finance Ministry to the country's parliament, “On the whole, the outlook for government revenue and expenditure in 2022 remains quite grave.”¹ At the heart of this diagnosis are flaws inherent in China's governance structures and the policies the country's leaders have pursued, which have led to a chronic and massive expansion in the country's reliance on debt to finance public expenditures, to the extent that China's annual national budget deficit is roughly the same size as the cost of running the country's central government, including its armed forces. Servicing this debt not only has put increasing strain on China's fiscal resources but also threatens the viability of its financial system.

Technically, the PRC is a unitary state in which power is concentrated in the hands of the country's central government. It is not a federal system like the United States or Germany, in which subnational governments have clear, constitutionally defined independent powers, including to collect revenue and to spend it. In reality, however, because China is huge both in terms of population and land area with vastly different economic and social conditions from one part of the country to another, China's central government delegates tremendous authority—and responsibility—to the localities. The generally accepted figure is that local governments account for approximately 85 percent of “general government spending” (i.e., expenditures covered in the regular budgets of the respective government agencies and not part of a special purpose fund earmarked by the central government) in China each year.²

In fact, China officially has four national budgets that include revenues and expenditures both by China's central government and its local governments collectively, prepared in accordance with policy guidance from the ruling Communist Party of China (CPC) and approved annually by the National People's Congress (NPC), China's parliament. The “general budget,” which includes all central and local governmental operating expenditures as well as some critical investment items, is the largest and most important. The NPC also approves three other budgets covering the proceeds of sales of state property (notably the right to use public land for commercial development), the earnings from other state assets (mostly the retained earnings or dividends from companies

wholly or partially owned by the government), and a national social security fund, respectively. The assets of these funds tend to be earmarked for specific projects or activities, although their resources can be used to supplement the general budget. The NPC, which meets in plenary session for no more than 10 days each year in early March—over two months into the calendar year for which it will approve the budget—does not review a detailed budget proposal but only a report from the PRC’s Ministry of Finance that provides no more than top line figures on total spending and projected revenues for the current year. Delegates may comment on the Finance Ministry’s report but do not debate or amend its substance in terms of revenue or expenditures. The details are left to the numerous agencies and jurisdictions that constitute the PRC and the institutions that govern it.

China’s administrative structure further complicates this process. China has five levels of administration—central, provincial, municipal, county, and town/township—with the authorities at each level directly subordinate to the next higher level. Every jurisdiction below the central government is subsumed under the term “local” (地方 *difang*). Provincial leaders report to the central leaders, municipal leaders report to the provincial leadership, counties report to municipalities, and towns and townships (the successors of the Mao era “communes”) report to the county authorities. Each administrative level also has its own Communist Party organization and its own People’s Congress, which mirror their counterparts higher up the hierarchy.

The fiscal system follows this same pattern. Most critically, the central government transfers most of the revenue it collects every year to China’s provinces that, in turn, pass the money to municipal authorities, who ultimately divide the funds among their subordinate counties. (Towns and townships are incorporated into the county fiscal structure.) Leaders at each level of government also prepare their own budgets—ostensibly based on policy guidance from their superiors and rubber-stamped by the relevant local People’s Congress. Notably, one study, using 2012 data, found that counties, which serve as the front line in providing critical government services to China’s citizens, accounted for over 46 percent of total expenditures in China’s general budget but only raised about 26 percent of total revenue. As a result, counties also absorbed 60–80 percent of the central government’s transfers to the localities, once they had been passed level-by-level through the administrative pyramid.³

Based on national final fiscal accounts data for 2022 released by the Chinese Ministry of Finance in August 2023, China’s national (i.e., central and local combined) general government revenues totaled approximately RMB 20.4 trillion (roughly \$2.8 trillion). Taxes accounted for about 82 percent of this figure. “Non-tax revenues,” which include earnings from state-owned enterprises, sale of land-use rights and other assets, and miscellaneous fees, fines, and other charges collected at the central and local levels, constituted the remaining 18 percent of aggregate general revenues. On top of these

resources, however, governments at all levels drew on additional “transferred funds” (from the separate budgets covering sales of land and other state assets and state-owned enterprise earnings) and “carried over surpluses” amounting to nearly RMB 2.5 trillion (over \$340 billion). Issuance of central and local government bonds, totaling about RMB 3.4 trillion, completed the revenue side of the ledger to equal the overall national government expenditure for 2022 of approximately RMB 26.1 trillion (\$3.6 trillion). (As a comparison, the U.S. federal government alone—not counting expenditures by state and local governments—spent approximately \$6.5 trillion with revenues of \$5.0 billion and a deficit of \$1.45 trillion during Fiscal Year 2022.)⁴

Unlike the United States, where personal income tax is the single biggest source of government revenues (accounting for over half of U.S. federal revenue), indirect taxes provide the bulk of the PRC government’s tax receipts. In particular, China’s value-added tax (VAT), essentially a sales tax levied at each stage of production of a good, made up 24 percent of China’s 2022 general government revenues (a reduction of seven percentage points from the share VAT contributed in 2021, presumably due to constraints on economic activity resulting from China’s “zero-COVID” policy that was only lifted toward the end of the calendar year). Corporate income tax was the next largest tax revenue source at just over 21 percent of general revenues. Personal income tax in 2022 accounted for only about 7 percent of the total. The shares of corporate and personal income tax in general revenue during 2022 held steady with levels seen in 2021, unlike the dramatic drop in VAT.⁵

Also, in contrast to the United States, where the federal government does not legislate state and local taxes, the Chinese central government determines the types and rates for all taxes collected in China. China’s provinces and the sub-provincial units such as municipalities and counties technically have no independent authority to raise revenue whether through taxation or borrowing except as directed by the central government in Beijing. The central government also shares revenues from certain taxes with local authorities. For example, at present, the central government receives half of the revenue collected through the value-added tax while half goes to China’s provinces. Similarly, the central government retains 60 percent both of the corporate income tax and of the personal income tax.⁶ As a result, the central government kept about 47 percent of general revenue in 2022, and the local governments received 53 percent.⁷

Under this system, the central government draws nearly all of its revenue from taxes (97 percent as of 2021). Non-tax revenues, which are more volatile and less standardized than taxes, are not significant. Local governments, however, obtained only about 43 percent of their total fiscal resources from taxes paid directly to them in 2021. Local authorities obtained another 14 percent of revenues from non-tax sources, such as fees, earnings from state-owned assets, and compensation for the use of state assets (primarily land, which legally remains under full state ownership). Even so, these locally generated revenues—taxes and non-tax revenues combined—are generally insufficient to finance all

necessary local government expenditures. As a result, as of 2021, about 43 percent of the money spent by local governments consisted of funds transferred from the central government to the localities.⁸ In other words, local governments are heavily dependent on resources allocated by the central government in Beijing in order to operate. This situation provides tremendous leverage to China's national leaders over the localities, which must ascribe to the central government's political and economic priorities if they are to stay solvent.

In addition, a series of reforms in 2014 to standardize and to streamline the tax system reduced the aggregate tax burden, which fell from the equivalent of 18.5 percent of gross domestic product (GDP) in 2014 to 15.2 percent in 2020. Slowing economic growth, exacerbated by the effects of the COVID-19 pandemic, accelerated the trend toward lower tax receipts.⁹ These tax cuts disproportionately affected local governments, whose tax bases consist to a great extent of small and medium-sized firms, which the cuts have been designed to benefit. For example, in 2019, local revenues from the corporate income tax were nearly 7 percent below their budgeted levels. Consequently, the immediate result of the reforms, which were aimed at stimulating economic growth, has been to worsen the fiscal pressure on grassroots jurisdictions, which have the greatest spending obligations.¹⁰

This situation increased the importance of the "government-managed funds" to the finances of the Chinese state, particularly at the provincial and lower levels. In 2022, the authorities had expected that these funds (which, as noted above, are in addition to general tax and non-tax revenues) would generate nearly RMB 9.9 trillion (\$1.4 trillion) in resources for use by the central and local governments. Of this total, RMB 8.5 trillion (\$1.2 trillion) was to have consisted of proceeds from the sale of "use rights" for land. The Chinese government final accounts data for 2022, however, reveal that land rights sales only yielded RMB 6.5 trillion, leaving a gap of about RMB 2.0 trillion, nearly all of which would have gone to local government coffers. To address this shortfall, China's central government effected a "special submission of profits by central units" of RMB 1.8 trillion.¹¹ Over half of this amount (RMB 1.1 trillion) was a transfer of profits earned by the People's Bank of China (PBoC, China's central bank) on its holdings of foreign currency assets.¹² The other "central units" that participated in this operation are unclear but presumably consisted of other financial and non-financial state-owned corporations under the central government that had retained earnings that the authorities could tap in order to provide fiscal support to cash-strapped localities.

If funding for local governments is removed from the picture, however, the central government's own expenditures in 2022 were approximately RMB 3.6 trillion (\$490 billion), in contrast to RMB 9.5 trillion (\$1.3 trillion) in general revenues. Central government transfers to the localities amounted to approximately RMB 9.7 trillion (\$1.3 trillion). With contributions to the government's "budget stabilization fund" added to the amount transferred, China's central government needed to borrow over RMB 2.6 trillion

(\$360 billion)—the bulk of the total national deficit—to be serviced and ultimately repaid through the central government budget. On top of the central government deficit, local governments in 2022, even with transfers from the central government and other “government-managed funds,” still had a deficit of RMB 720 billion (\$99 billion) for which they would be responsible. With contributions from other government funds (such as the one for income from land sales) factored into the general budget, China’s official national (central and local combined) general budget deficit for 2022 was just under RMB 3.4 trillion (approximately \$470 billion)—in other words, *only slightly less than the total expenditures of the central government*.¹³ The Chinese government only achieved this result, however, through the massive injection of resources from the various funds outside the general public budget. In the case of the central government, the infusion of funds totaled nearly RMB 1.3 trillion (\$178 billion) in 2022, an extraordinary increase of 655.5 percent from the amount recorded in 2021 to make up for tax and non-tax revenues lost because of the economic shutdowns of many of China’s largest cities as a result of the “zero COVID” policy.¹⁴

A breakdown of the aggregate budget numbers illustrates the predominance of China’s localities in the spending of the country’s government resources (see Table 1 below). Final data for 2022 show that the central government only accounted for 13.6 percent of total government spending, according to China’s Ministry of Finance report on the implementation of the national budget. Local governments, per usual, made over 85 percent of all expenditures. The localities had responsibility for practically all the budget categories related to what would be considered entitlements or social benefits in the United States and most other countries: education, social security, health, and environmental protection. The central government, in contrast, accounted for nearly all (98.3 percent) of China’s official “national defense” spending, over half (57.5 percent) of the interest payments on government debt, and about one-third (32.1 percent) of all expenditures on “science and technology.” Direct central government spending in most other categories was under 10 percent of national total government expenditures for those functions, respectively.

Table 1. Chinese National and Central Government General Expenditures (2022)
(RMB billions unless otherwise indicated)

2022 Expenditure Type*	National (% of Total)	Central (% of Total)	Central/National (%)
National Defense	1475.2 (5.7)	1450.0 (40.8)	98.3
Interest on Public Debt	1135.3 (4.4)	652.4 (18.3)	57.5
Science & Technology	1003.2 (3.8)	321.6 (9.0)	32.1
Public Security**	1442.0 (5.5)	196.5 (5.5)	13.6
General Public Services***	2087.9 (8.0)	157.9 (4.4)	7.6
Transport and Communications	1204.4 (4.6)	63.5 (1.8)	5.3
Education	3944.8 (15.1)	152.4 (4.3)	3.9
Energy Saving & Environment	541.3 (2.1)	17.7 (0.5)	3.3
Social Security & Employment	3660.9 (14.1)	83.3 (2.3)	2.3
Agriculture, Forestry, and Water	2250.0 (8.6)	25.0 (0.7)	1.1
Health	2253.7 (8.6)	22.1 (0.6)	1.0
Urban & Rural Administration	1942.5 (7.5)	0.3 (less than 0.1)	less than 0.1
TOTAL	26055.2 (100)	3557.1 (100.0)	13.6

* Not all expenditure categories included.

** This category includes the paramilitary People's Armed Police (which is under the command of the Communist Party's Central Military Commission), regular public security (police) agencies, state security agencies (which focus primarily on foreign security and intelligence threats), the judicial system, the procuratorate, and the prison system, among other functions.

*** This category includes administrative expenditures for government agencies, the People's Congresses, the national and local Chinese People's Political Consultative Conferences (official advisory bodies), and the organs of the Communist Party of China and other officially permitted political parties.

Source: Data drawn from Ministry of Finance of the People's Republic of China 2022 final fiscal accounts: "National General Public Expenditure" (http://yss.mof.gov.cn/2022zyjs/202308/t20230825_3904170.htm); "Central Level General Public Budget Expenditure" (http://yss.mof.gov.cn/2020zyjs/202106/t20210629_3727246.htm) Accessed August 31, 2023.

4. Central Government Prioritization of Defense Spending

Analysts outside China continue to debate the actual size of China's defense spending and to speculate that the annual Ministry of Finance figure understates the funding the country applies to national defense.¹⁵ Nevertheless, the official figures—which never show any significant difference between the initially budgeted amount and the “actual” figure released in the final accounts for the fiscal year—indicate that military expenditures have been consuming a greater proportion of the central authorities' fiscal resources and have been forcing budget cuts on other elements of the central government. One study by the Center for Strategic and International Studies estimates that, from 2016 to 2019, national defense accounted for an average of 34.3 percent of central government expenditures. In 2020, however, that figure jumped to 36.2 percent, although the share of defense spending in the consolidated national budget, which includes all the local government expenditures as well, remained the same as in 2019 at 5.1 percent.¹⁶ Official national defense spending for 2021 matched the budgeted total and exceeded RMB 1.3 trillion (\$180 billion), a 6.8 percent increase over the previous year. Based on other data available in the Finance Ministry's 2021 report, that figure would account for 38.7 percent of total central government expenditures and slightly more than 5.4 percent of total national (i.e., central and local) expenditures.¹⁷

Table 2 draws on the official central government final fiscal accounts data published on the Chinese Ministry of Finance website for the years 2017–2022. This analysis shows not only the expenditures for the “national defense” (国防 *guofang*) functional category but also spending for the People's Armed Police (PAP), the internal paramilitary force that, like the People's Liberation Army, also falls under the command of the Communist Party's Central Military Commission (CMC). The table clearly indicates the expansion of the share of central government spending directly (and openly) subject to the authority of the CMC from 37.2 percent in 2019 to 44.8 percent in 2022. In addition, based on the figures budgeted for 2023, this share should reach 45.1 percent even as the overall level of central government spending is budgeted to grow by 6.5 percent, which would be the largest increase since 2019. Conversely, the proportion of the central government budget devoted to functional areas apart from “national defense,” the PAP, central government stockpiles of grain, edible oil, and strategically important materials, and debt service (i.e., most of the civilian operations of the central government) has declined over the same period from 46.4 percent of total central spending to only 33.4 percent in 2022, with a further proportional reduction budgeted for 2023. In other words, China's central civilian apparatus currently

only commands about one-third of all central government expenditures. Total central government civilian spending in 2022 was just under RMB 1.2 trillion (\$164 billion), the lowest figure since 2017.

Table 2. Central General Budget Expenditures (Total, Defense, and Debt Interest) Compared to Central Revenues, Transfers, and the Total National Deficit (2017–2023)
(RMB billions unless otherwise indicated)

	2017	2018	2019	2020	2021	2022	2023 (budgeted)
Total Central Government Expenditure	2985.7	3270.8	3511.5	3509.6	3505.0	3557.1	3789.0
– Increase/Decrease over Previous Year (Percent)	7.5	8.8	6.0	–0.1	–0.1	3.9	6.5
<i>Of Which:</i>							
• National Defense and People's Armed Police	1162.4	1260.5	1305.7	1391.0	1488.2	1593.9	1708.4
– Increase/Decrease over Previous Year (Percent)	7.7	8.4	3.4	6.5	7.0	7.1	7.2
– Share of Total Central Government Expenditure (Percent)	38.9	38.5	37.2	39.6	42.5	44.8	45.1
<i>Of Which:</i>							
• National Defense	1022.6	1107.0	1189.7	1268.0	1355.8	1450.0	1553.7
– Increase/Decrease over Previous Year (Percent)	7.1	8.1	7.5	6.6	6.8	7.0	7.2
• People's Armed Police	139.8	153.5	116.0*	123.0	132.4	143.9	154.7
– Increase/Decrease over Previous Year (Percent)	7.6	9.7	18.4*	7.8	7.5	8.7	7.5
• Central Government Grain, Edible Oil, and Materials Reserves	159.7	137.6	120.4	122.5	111.2	116.9	132.9 [152.9]**
– Increase/Decrease over Previous Year (Percent)	10.0	–13.9	–12.3	1.7	–9.2	5.3	13.6 [30.7]**
– Share of Total Central Government Expenditure (Percent)	5.3	4.2	3.4	3.5	3.2	3.3	3.5
<i>Of Which:</i>							
• Grain and Edible Oil Reserves	115.5	103.9	85.7	83.7	59.9	78.3	67.9
– Increase/Decrease over Previous Year (Percent)	17.3	–10.0	–17.5	–2.4	–28.5	30.8	–13.3
• Interest Payment on Central Government Debt	377.8	416.2	456.7	553.9	586.8	652.4	728.6
– Increase/Decrease over Previous Year (Percent)	11.9	10.2	9.7	21.3	5.9	11.2	10.9
– Share of Total Central Government Expenditure (Percent)	12.7	12.7	13.0	15.8	16.7	18.3	19.2
• All Other Central Government Expenditures	1285.8	1456.5	1628.7	1442.2	1318.8	1189.5	1199.1**
– Increase/Decrease over Previous Year (Percent)	9.6	13.3	11.8	–11.5	–8.6	–9.8	2.5

	2017	2018	2019	2020	2021	2022	2023 (budgeted)
– Share of Total Central Government Expenditures (Percent)	43.0	44.5	46.4	41.1	37.6	33.4	31.6

* Reflects transfer of People's Armed Police (PAP) units involved in economic activities to other central government agencies. The denominator for the reported increase is only the expenditures for those units retained in the People's Armed Police following the transfer of its command from the Ministry of Public Security to the Central Military Commission, presumably plus the China Coast Guard, which was administratively moved to the PAP in 2018.

** The bracketed figure is provided as a total for "expenditures on central reserves" (中央储备支出 *zhongyang chubei zhichu*) in the 2023 budget chart. It does not match the total in the 2023 budget chart for "grain, edible oil, and materials reserves," which is the figure without brackets. The unattributed portion of these expenditures, which accounts for a large part of the budgeted increase of over 30 percent, has not been identified. The total for "expenditures on central reserves" in the 2022 final accounts chart, however, does match the total for "grain, edible oil, and materials reserves, and the figures from that expenditure line have been used for prior years.

Sources: Ministry of Finance of the People's Republic of China, final budget accounts for 2017, 2018, 2019, 2020, 2021, and 2022. Available at <http://yss.mof.gov.cn>. Ministry of Finance of the People's Republic of China, "2023 Central Fiscal Budget" (2023 年中央财政预算 2023 *nian zhongyang caizheng yusuan*), <http://yss.mof.gov.cn/2023zyczys/>. Accessed August 13, 2023.

In contrast, debt service, which had been holding steady at about 13 percent of central government spending up through 2019, reached 18.2 percent in 2022 and is budgeted to take up a marginally greater (about one percentage point) share of the total in 2023. Annual increases in central government debt service had been between 9 percent and 11 percent through 2019, but ballooned by 21.3 percent in 2020, presumably to address spending requirements generated by the onset of the COVID pandemic. The central government then sought to rein in debt growth in 2021, allowing only a 5.9 percent increase in 2022. The fiscal demands of “zero COVID” in 2022, however, led to another double-digit (11.2 percent) jump in total debt service, with a similar increase (10.9 percent) budgeted for 2023. Meanwhile, national defense spending (to include the PAP) has risen steadily at a rate of 6–7 percent throughout the period of the pandemic.

These figures indicate that as government revenues have become more strained, especially at the local levels, China’s national leaders have continued to prioritize military spending over practically all other expenditure categories which they control directly. Most notably, the exigencies emerging from the COVID-19 pandemic clearly forced a sharp reversal in the funding trend for the central government’s civilian agencies, which have borne the primary burden of fiscal austerity to compensate for the decision to maintain steady increases in military expenditures. Even then, squeezing the finances of non-military agencies has proven insufficient to reverse the growing debt service obligation of the central government as it has confronted both diminishing tax revenues and urgent requirements from sub-national authorities for financial support. China’s leaders, however, have struggled to contain the growth of the central government’s balance sheet, despite the pressure on its civilian agencies, not simply because of a penchant for fiscal conservatism. Excessive expansion of central government debt could severely erode the central government’s capacity to address the already worrisome situation with respect to debt that has evolved as a result of China’s investment-driven economic growth model and the inherent risk to the country’s financial system that it entails.

5. China's Domestic Debt Trap

One key reason that China's leaders are reluctant to use debt to finance greater central government spending lies in the intimate relationship between the Chinese state and the country's financial system. The fact that China's government finances have come to rely increasingly on debt does not automatically equate to a fiscal crisis. The IMF has estimated that all but one of the G7 countries (Canada, France, Germany [the exception], Italy, Japan, the United Kingdom, and the United States) had gross government debt in excess of 100 percent of GDP in 2021. In the case of Japan, the total was over 250 percent of GDP, while the United States' figure was 133 percent. China's official total debt-to-GDP ratio was about 69 percent, similar to that of Germany (72 percent).¹⁸

The G7 countries, however, all have highly developed, law-based fiscal systems, which provide transparent and effective control over revenue and expenditures, and deep, well-regulated financial markets, through which any deficit can be financed. In contrast, China relies almost exclusively on its state-controlled banking system to finance both central and local government debt, as well as to provide credit for businesses and consumers. Moreover, although the level of China's official debt seems reasonable, the official statistics, by the government's own admission, do not capture a tremendous amount of borrowing that, in many cases, has an implicit or explicit government guarantee, including lending to firms and industries that are confronting imminent default. Consequently, the risk for China lies not as much in the size of the country's debt relative to its economy but in how the debt was used and whether China's relevant institutions can service it effectively.¹⁹

As in most other countries, China's central and local governments finance their deficits by issuing bonds. In China, as elsewhere, the issuing jurisdiction has the responsibility to repay the bonds with interest. Although China's central government has been issuing bonds for decades, local governments have only been allowed to do so since 2014, and even then, the central government determines the volume of official debt the localities can assume. According to the IMF, China's official outstanding central government debt at the end of 2020 was about RMB 20.9 trillion (\$3.3 trillion), with explicit local government debt reaching RMB 25.7 trillion (\$4.1 trillion), equivalent to approximately 20 percent and 25 percent, respectively, of China's GDP that year.²⁰

The official figures, however, fail to reflect the actual amount of outstanding debt at the local levels. The problem is rooted in the basic structure of China's fiscal system, which, as noted earlier, concentrates resources in the central government and does not

provide adequate funding—either through transfers or taxes exclusively designated for local use—for local authorities to meet the social welfare and economic development mandates imposed by the CPC and its leaders.²¹

The 2014 decision by China’s central government to allow the issuance of bonds by local governments was fundamentally an attempt to stem the phenomenon of localities borrowing money through so-called “local government financing vehicles” (LGFVs). These entities were companies, owned by local governments, that, because of their legal status as profit-earning enterprises, could legally borrow from China’s commercial banks, often with an implicit commitment from the local government to repay the loan. This borrowing would then be used for economic development and other projects sponsored by the government of the jurisdiction in question. Despite the conversion of about RMB 14 trillion (\$1.9 trillion) of LGFV debts into local government bonds and a central government prohibition on local authorities raising additional capital through LGFVs, borrowing by local governments through this mechanism has continued to grow, with investments by these entities expanding beyond just infrastructure investment into areas such as real estate and financial instruments.²²

China’s central government, which has had little or no visibility into the operation of the LGFVs, has repeatedly endeavored to dissociate itself from the expanding local debt, much of which has been guaranteed by local authorities using land under their jurisdiction as collateral.²³ Ultimately, though, the fiscal dependence of local governments on the central authorities means that local government debt, whether open (in the case of bonds) or “hidden” (as bank loans to LGFVs), could become Beijing’s responsibility. Based on IMF calculations incorporating LGFV debt along with other special purpose official borrowing, China’s total volume of outstanding government debt exceeded 93 percent of the country’s GDP at the end of 2020, topped 100 percent of GDP in 2021, and is estimated to have reached nearly 110 percent of GDP in 2022.²⁴

Even more serious, growing government debt in China has a direct impact on the health of the country’s banks and other commercial financial institutions. In most economies, government bonds are just one financial asset among many in which individuals and institutions may invest. In China, however, the government compels the commercial banks to buy the bonds that fund central and local deficits. As of 2016, for example, Chinese domestic commercial banks held about 75 percent of all government bonds that had been issued. In addition, government bonds accounted for 20–27 percent of the official assets of the country’s four largest central government-controlled commercial banks; by way of contrast, most U.S. commercial banks keep less than 5 percent of their total assets in government securities.²⁵ The government bonds held by the PRC’s commercial banks (or any other investor) also tend to be illiquid, with little trading to establish a clear market price or to factor in risk.²⁶

China's commercial banks, though, have little choice but to purchase central and local government debt. China, in essence, has no fully private domestic banks.²⁷ Six major banks, all of which are under formal ownership by China's central government, dominate the country's banking sector and, as of 2020, accounted for approximately 40 percent of all China's banking assets.²⁸ In addition, many other entities and jurisdictions have been allowed to establish commercial banks since China began its transition away from a Soviet-model economy in the late 1970s. Most notably, China's provinces and cities have formed local commercial banks out of the state-owned urban and rural "credit cooperatives" of the pre-reform era. Both the major central government-controlled banks and the local banks continue to suffer interference in their commercial operations from the political leadership of the jurisdiction to which they belong. In addition to full or partial formal ownership by the relevant government authorities, all commercial banks have elements of the CPC embedded within their staff and management structures to ensure adherence to the Communist Party's policies and goals.²⁹

China's central and local governments, though, are not the only institutions heavily indebted to the country's banks. Based on IMF calculations, China's overall outstanding total non-financial debt, which includes the funds owed by households, enterprises, and government entities, will reach 300 percent of the country's GDP at the end of 2023—in other words, roughly three times the value of every good and service produced in China during the year.³⁰ In comparison, the total outstanding U.S. national debt, which only covers the obligations of the federal government, is about 120 percent of GDP.³¹ A key difference is that the U.S. federal government has no direct financial responsibility for states, localities, or commercial entities. In contrast, China's local government, state-owned firms, and, most importantly, the country's commercial banks themselves—whether belonging to the central authorities or a local jurisdiction—all enjoy an implicit guarantee that the state, ultimately China's central government, will make good on their liabilities if they should run into financial trouble.

In fact, the chief stress on China's financial system remains the high number of nonperforming commercial loans that many banks carry on their books. Large portfolios of such loans have plagued Chinese banks since the reintroduction of commercial banking in the 1980s. The Chinese government endeavored to clean up the problem—at least in the case of the major central government-controlled banks—in the late 1990s and early 2000s by transferring the banks' nonperforming loans to "asset management companies" that were technically separate corporate entities (but organizationally related to the major state-owned commercial banks) to liquidate or to restructure the bad debts. This maneuver gave the banking system some breathing room at a time when China's economic growth strengthened significantly following its entry to the World Trade Organization at the end of 2001.³² Nevertheless, Chinese commercial banks, still subject to substantial political pressure to lend to unprofitable projects, continued to accumulate bad loans. Although

Chinese official sources put the overall amount of nonperforming loans at less than 2 percent of all lending, that figure is suspect, and many observers estimate the volume of nonperforming debt is much higher, with lending to LGFVs accounting for a large portion of the total.³³

“Shadow banking,” where China’s banks endeavor to skirt the country’s increasingly vigilant and strict bank regulators in order to provide credit “off the books” to politically (or criminally) favored ventures, also remains a major problem as these measures, which may once have helped to fuel China’s rapid economic growth, now seem only to promote overbuilding in the country’s real estate industry.³⁴ Many local banks have connections not only with political elites but also with major Chinese corporations and high-profile business figures, prompting the central government banking regulators to crack down on “problem shareholders” in these institutions.³⁵ Capital flows not to the ventures that have the highest rate of return but to projects that serve the immediate political interests of the relevant authorities. This intimate relationship between the government and the financial sector has created a network of vested interests that not only inhibits progress toward a new model of economic growth but that also threatens to undermine the governing capacity of the Chinese state and the ruling Communist Party.

6. China Development Bank and Evergrande: Examples of Political-Financial-Fiscal Risk

A prime example of the convoluted and precarious relationship between China's financial and fiscal systems is the China Development Bank (CDB). China's central government created the CDB in 1994 to act as a "policy bank" that would focus on long-term infrastructure projects and other development ventures, in contrast to the state-owned commercial banks that service consumers and profit-making companies. Unlike the commercial banks, the CDB does not take deposits but borrows the funds it uses through bonds (sold primarily to the commercial banks) and must pay interest at the commercial loan rate, albeit with an explicit central government guarantee to service the bonds if the CDB's own earnings prove insufficient. The CDB initially was designed to focus on domestic projects, but over time, it expanded its operations overseas, becoming a key actor in China's overseas development assistance program, most notably the so-called Belt and Road Initiative to foster China's economic ties across Eurasia.³⁶ The CDB also obtains foreign currency to lend outside China either through borrowing from the reserves held by China's central bank or by issuing its own foreign currency bonds.³⁷ To ensure an adequate return for servicing its bonds, most of the CDB's loans, in particular those for overseas projects, are not concessional but are provided at commercial interest rates.³⁸ To put the central government's commitment to the CDB in perspective, as of the end of 2020, the CDB's liabilities (i.e., the outstanding bonds it has issued) totaled RMB 15.6 trillion (about \$2.1 trillion), equivalent to roughly three-quarters of total central and local government revenue in China in 2021.³⁹

Financial scandal, however, has haunted the CDB. Former CDB Chairman Hu Huaibang, who enjoyed ministerial-level political rank in China's central government, came under investigation in 2019 and was sentenced to life imprisonment in 2021 for having received approximately \$13 million in bribes.⁴⁰ Several other CDB executives have been removed on corruption charges.⁴¹ During the 2000s, the CDB, in fact, played a pivotal role in the creation of the local government financing vehicles that have driven the growing debt of China's provinces and municipalities.⁴² Despite efforts by the Chinese government to convert the CDB into a more commercially viable entity, politics have sustained the guarantee of full state support for its securities—funds that ultimately originated with the multitude of China's citizens whose savings in the commercial banking system were utilized to buy CDB bonds.⁴³

Most prominent among the risky borrowers that have blossomed under the development model promoted by the CDB (and embraced by China's localities) have been real estate developers, who, by some measures, have contributed as much as 30 percent of the country's GDP in recent years.⁴⁴ In an effort to control the expansion of the debt-fueled property market, China's central government in 2020 instituted a policy labeled the "three red lines" that limited the amount of new debt property developers could assume.⁴⁵ Under the new policy, property firms' liabilities could not be more than 70 percent of assets, net debt could not exceed equity, and short-term borrowing would need to be less than available cash. These measures quickly led to a liquidity crisis in the property sector as companies, unable to take on new loans, found themselves without the resources to service their existing liabilities.⁴⁶

The recent situation of Evergrande, a property developer based in Guangdong Province but with projects all around China, exemplifies the extent of the problem. Technically a private firm, Evergrande has enjoyed a close relationship to the Guangdong provincial authorities. It funded its expansion through both domestic and foreign debt, amassing a total of over \$300 billion in liabilities as of 2021, including both bonds and prepayments by individual Chinese citizens for unbuilt housing. By September 2021, the firm was acknowledging that it might not be able to meet its debt service obligations.⁴⁷ In December, Fitch Ratings declared the firm to be in "restricted default," which signaled that the company had fundamentally defaulted on its obligations but had yet to initiate formal bankruptcy or restructuring procedures.⁴⁸ The creation of a "risk management committee" in the company, consisting of representatives from other Guangdong-based state-owned enterprises and from a central government-owned asset management company, to oversee Evergrande's efforts to deal with creditors demonstrated both Evergrande's local government connection and central-level concern about the firm's condition.⁴⁹ With government acquiescence, Evergrande, in February 2022, sold a portion of its assets to two Chinese state-owned trust companies, themselves considered to be part of the country's "shadow banking" network.⁵⁰

None of these measures stopped the erosion of confidence in the company. At the end of August 2023, Evergrande reported losses of RMB 33 billion (\$4.53 billion) for the first half of the year. This figure, nevertheless, represented an improvement over the RMB 66.4 billion loss during the same period in 2022, when "zero COVID" lockdowns paralyzed the Chinese economy. Evergrande's shares still declined 79 percent when they started trading again on August 28, 2023, after a 17-month suspension. The result was a reduction of an estimated \$2.2 billion of the company's market value.⁵¹

Evergrande has not been the only major property developer at risk. The real estate firm Country Garden, also based in Guangdong, was the largest Chinese developer by sales until recently and had been thought to be much more financially sound than Evergrande. According to a report by the Reuters news agency, Country Garden's liabilities are only 59

percent of those held by Evergrande. Country Garden, however, has nearly four times as many projects—3,103 to 800 for Evergrande. In August 2023, the company missed two dollar-coupon payments totaling \$22.5 million and has dollar coupon payments on its other offshore bonds coming due each month for the rest of 2023 on top of onshore bond payments of RMB 12.6 billion (\$1.7 billion) coming due before the end of the year.⁵²

China's financial regulators, for their part, remain acutely conscious of the risks to the country's financial system and endeavor to maintain public confidence in it. For example, a January 2022 press conference by the PBoC, the country's central bank, conspicuously avoided any reference to the term "default" and declared success in efforts to "defuse" concerns about the property sector.⁵³ Other PBoC statements, however, have indicated that problems persist. A media report on a meeting laying out the central bank's work for 2022 put the spotlight on real estate speculation as an area for continued attention and specifically called for efforts to address default risk in China's securities markets.⁵⁴ Another item put out by the PBoC to highlight its achievements in managing the financial sector also (perhaps inadvertently) listed a number of the chronic issues that have confronted the system—such as highly leveraged companies and financial firms, unregulated activities like peer-to-peer (P2P) transactions, pervasive shadow banking, challenges in financial market regulation, and serious corruption—while asserting that the situation was steadily improving.⁵⁵

Somewhat surprisingly in light of these issues, China's debt, particularly government debt, had remained extremely popular with foreign investors. Chinese sources indicate that non-Chinese entities held about RMB 2.5 trillion (\$340 billion) in Chinese government bonds, including those issued by CDB and local authorities, as of the end of January 2022.⁵⁶ Although some analysts have acknowledged the relatively high risk associated with Chinese corporate debt,⁵⁷ CDB bonds have enjoyed a reputation as essentially a "zero-risk" asset among international ratings agencies.⁵⁸ In 2020, even with the onset of the COVID pandemic, foreign investors doubled their holdings of Chinese government and policy bank bonds both because of higher interest rates (3 percent per annum on Chinese debt in contrast to roughly 1 percent on U.S. Treasury bonds at the time) and because of the 2019 inclusion of Chinese official debt in two influential indices, the Bloomberg Barclays Global Aggregate Index and the J.P. Morgan Emerging Market Global Bond Index.⁵⁹ By 2023, however, the perception of foreign investors had shifted significantly. The lockdown of much of the Chinese economy slowed foreign investment in 2022, and despite hopes that the Chinese economy would recover strongly following the lifting of the draconian "zero COVID" regime at the end of that year, China's sluggish economic growth, connected in large part to the woes of the property sector, had led to foreign investors reducing their exposure to Chinese stocks and bonds by the summer months of 2023.⁶⁰

The CDB and Evergrande represent only two of the more egregious examples of the linkages between China's government and its financial institutions and the contribution of

that relationship to the investment-focused development model that has fueled much of the country's economic growth, particularly over the past two decades. The collapse of this debt-financed approach has led to the fiscal pressures described earlier, as local governments can no longer rely on land sales and property development to provide revenues, and the central government, which has already squeezed its civilian spending in order to protect the expansion of the military, refuses to take more debt onto its own balance sheet.

7. The Central Government's Struggle to Control Debt

China's national leadership recognizes the dangers inherent in the high level of indebtedness, particularly of "hidden debt." One important piece of evidence is a 2019 "central document," the most authoritative policy instrument in China's political system because it is approved by the Political Bureau of the CPC; its main topic is local government debt. The document, entitled "The Opinion of the Chinese Communist Party Central Committee and State Council on Preventing and Resolving the Risk of Local Government Hidden Debt" (中共中央国务院关于防范化解地方政府隐性债务风险的意见 *zhonggong zhongyang guowuyuan guanyu fangfan huajie difang zhengfu yinxing zhaiwu fengxian de yijian*), has not been made public in full but is mentioned in open-source materials that refer to it by its serial number, Document No. 27. According to a Chinese press report, Document No. 27, at two to three times the length of previous policy instructions on the topic, provided comprehensive guidance to Chinese officials on ways to reduce hidden debt. The document reportedly yielded some progress in putting once hidden debts onto the formal accounts of local governments by the conversion of LGFVs' bank debt to bonds but created confusion regarding which assets would go directly to the government and which could remain the LGFVs.⁶¹

A review of the annual reports by China's Finance Ministry to the NPC on the implementation of the previous year's budget and the budget for the current year from 2018 through 2021 also reveals progressively stronger rhetoric and frustration from Beijing on the persistent risk posed, in particular, by hidden local government debt. The Finance Ministry's 2018 report only made passing reference to "hidden debt" and stressed the prohibition on increasing local debt through the "back door" (i.e., via LGFVs), but otherwise did not highlight the issue.⁶² In 2019, the Ministry cited the problem of local government debt in several sections of the report, noting expressly that "The debt burden of some local governments is relatively heavy, and the risk of hidden debt cannot be ignored" (有的地方政府债务负担较重, 隐性债务风险不容忽视 *youde difang zhengfu zhaiwu fudan jiaozhong, yinxing zhaiwu fengxian burong hushi*).⁶³ The 2020 annual budget report to the NPC, which focused on efforts to meet the economic and social targets of the soon-to-be-completed 13th Five-year Plan, acknowledged the local debt problem, exhorted officials to "open the front door and close the back door" (i.e., raise funds through local government bonds and not through financing vehicles), and warned against false reporting on local indebtedness.⁶⁴

In contrast to the relatively limited emphasis on local debt in previous years, the Finance Ministry's 2021 annual budget report spotlighted the growth in government debt at several points in the text and framed the issue as relevant to the "nation's comprehensive security." More importantly, the Ministry's report explicitly characterized any increase in hidden debt as a "red line" and charged provincial CPC committees and governments with the responsibility of addressing the risks from debt in their jurisdictions.⁶⁵ To tackle the problem, the Ministry explicitly stated that the central government budget would pursue overall austerity so as to increase fiscal support for China's localities and stressed that, while the overall central budget would decline slightly, transfers to the provinces for shared central-local responsibilities like education and social security would grow 6.1 percent and funds purely to support local governments would increase 9.4 percent.⁶⁶

Data for the first months of 2021 confirmed that China did pursue a highly restrictive fiscal policy, mostly at the central level, as the Finance Ministry had outlined, but with reduced spending at the local levels as well. Through July 2021, China actually spent significantly less than the approved budget levels, with local and central expenditures 4.1 percent and 12.2 percent below their respective authorized totals. As of mid-2021, one observer noted that China was on track to underspend its approved national budget by as much as 5 percent even though weakening economic growth would suggest the need for more government spending.⁶⁷ Preliminary year-end 2021 data released by the Ministry of Finance in January 2022 showed spending increases in comparison to the previous year only for education (3.5 percent), science and technology (7.2 percent), social security and employment (3.4 percent), and interest on government debt (6.6 percent). Spending in all other reported categories declined—by double digits in some cases. (Figures on spending for defense and public security were omitted from the preliminary report.)⁶⁸

Measures announced at the 2022 session of the NPC further highlighted the dilemmas confronting China's leadership. At a time when revenues could not cover existing expenditures, particularly at the local levels, the central government committed to pursuing a number of competing policy priorities that might actually slow economic growth and reduce revenues needed to service the government's outstanding debt. For example, Chinese Premier Li Keqiang, in his press conference following the annual NPC session, suggested that the overall GDP growth rate of 5.5 percent targeted for the year was not excessively ambitious and, based on the economy's performance in 2021, might even be exceeded. Nevertheless, he indicated that proposed increases in government spending—financed largely through unspent funds from 2021 and one-time boosts like the collection of deferred dividend payments from state-owned firms—would actually just fill the gaps left by tax cuts and rebates for companies in the expectation that the reductions would generate more economic activity and ultimately greater revenue. Li also highlighted a sharp increase in transfer payments from the central government to local authorities and stressed that the funds would be targeted to support sub-provincial jurisdictions. In his remarks to

the press, Li noted that the consolidated national budget for 2022 reduced the target ratio of the annual deficit to GDP to 2.8 percent, an assertion viewed by some observers as the result of budgetary sleight-of-hand.⁶⁹

Premier Li's prognosis for the country's government finances, however, centered on China achieving its planned growth rate for the year. As noted earlier, 2022 did not turn out as expected. In its July 2023 update of the World Economic Outlook, the IMF, based on the Chinese government's own figures, estimated that China's GDP only grew 3.0 percent in real terms in 2022, substantially below the Chinese government's announced target for the year.⁷⁰

As of mid-2023, the Chinese government was still wrestling with significant economic challenges, driven by the problems in the property market and continued weakness in household consumption. According to an August 28, 2023, report to the NPC by Chinese Finance Minister Liu Kun, tax and regular non-tax revenue for the general budget more or less recovered as strict lockdowns no longer inhibited economic activity and tax rebate programs implemented in 2022 to support the economy ended. Nevertheless, January–July 2023 total revenues from the sale of land-use rights, which are vital to local government finances, were just under RMB 2.9 trillion (about \$400 billion), a 14.3 percent decrease from the same period in 2022. Nearly all of the decline was the result of a 19.1 percent drop in revenue from the sale of land-use rights.⁷¹ Liu indicated that the central government, as of the end of July, had already transferred RMB 9.2 trillion (approximately \$1.3 trillion) of a planned RMB 10.1 trillion (\$1.4 trillion) in central revenues to the localities and, in addition, had approved an RMB 3.7 trillion (over \$500 billion) quota for local government bond issuances to support cash-strapped local authorities.⁷² The report did not suggest, however, that the central government would be willing to expand its own balance sheet to assist local government finances.

8. Potential Exacerbating Factors

Looking further into the future, a number of factors seem likely to impose additional fiscal stress on China's government. Most of these items relate to ongoing domestic issues within China, including failure to reform the financial system and policy priorities that lead to lower revenues or higher government spending. External factors, however, could also play a significant role, especially as a result of China's increased exposure to the global economy as one of the world's leading creditor countries. Additional disruption in the international economy, such as that currently arising from Russia's military action against Ukraine, could sour many of the investments China's official and commercial entities, like the CDB, have made around the world. The result might be defaults by the borrowers, which, at least in the near term, would require action by China's central government to protect the financial soundness of its domestic institutions.

China's government does not provide comprehensive public data on its lending to other countries. One estimate, however, put the amount of total external lending by China at over 5 percent of global GDP in early 2020. In a key difference from other major economies, where private financial institutions are the funding source, China's external lending, estimated at about \$1.5 trillion, has mostly originated with elements tied to China's government, such as the CDB. Half of these loans appear not to have been captured in the global debt statistics kept by international organizations like the World Bank or the Organization for Economic Cooperation and Development (OECD).⁷³ A recent World Bank-sponsored study, relying on various sources to estimate the volume and performance of China's overseas loans concluded that, as has been the case with many credit booms in the past, many of the loans made by entities from China have had to be restructured or were subject to "hidden defaults" by the borrowers.⁷⁴

Of particular note, in light of recent events, is the exposure of China's financial institutions to Russia, which has received massive amounts of credit from China, notably for oil and gas projects. One recent study estimated Russia's "hidden debt" to China to be as high as 8 percent of the former's GDP, with much of the funding in loans to Russian entities now subject to the sweeping sanctions imposed after Russia launched military action against Ukraine in February 2022.⁷⁵ The study found that, between the years 2000 and 2017, Russia was the largest recipient of "other official flows"—the term applied by the Development Assistance Committee of the OECD to loans and export credits priced at or near commercial terms—from China, totaling over \$125 billion and frequently using oil and gas sales to China as collateral.⁷⁶

China also has significant financial exposure to Ukraine. For example, prior to Russia's military action against Ukraine in February 2022, Ukraine's government was looking to restructure a \$3 billion loan from the China Export-Import Bank, a central government policy bank like CDB, that had been used to support the State Food and Grain Corporation of Ukraine.⁷⁷ Similarly, a Chinese company, using financing from China, also won a \$1.3 billion contract in 2017 to build a new subway line in the Ukrainian capital Kyiv.⁷⁸ Obviously, Ukraine's capacity and willingness to service these debts and other similar commitments to lenders in China are now in doubt. The conflict in Europe will negatively affect other countries, notably in Central Asia, whose economies have depended on trade with and remittances from Russia.⁷⁹ Kyrgyzstan, notably, was having trouble servicing its large debt to China even before the start of major conflict between Russia and Ukraine.⁸⁰ The result could be a cascade of defaults on loans from financial institutions in China, which would add to the stress on the country's financial system.

As noted earlier, the chronic slowdown in China's economic growth threatens the flow of revenues and limits the government's leeway to increase spending to meet domestic or foreign contingencies without further expanding its borrowing at all levels of the system. Even before the rigorous lockdowns during 2022, both the World Bank's December 2021 quarterly report on China's economy and the IMF's annual Article IV report released at the end of January 2022 noted that China's economic growth had started to slip toward the end of 2021 despite showing some recovery in the first half of the year, due in part to the central government's austerity measures. Both institutions also cited weak consumer demand and a sharp reduction of investment, particularly in the property sector, as causes of the tapering economy.⁸¹ They observed that China had pursued "fiscal consolidation," reducing government spending even as revenues increased, which slowed the increase in public debt but reduced economic growth.⁸² China's annual statistical communique, released in February 2022, reported that the country's GDP had grown 8.1 percent in 2021 in real terms over the previous year but noted that the combined growth rate for 2020 and 2021 had been only 5.1 percent over the figure for 2019 because of the low increase of only 2.2 percent in 2020, reaffirming the long-term slowing of China's economy.⁸³ Growth, in fact, was only about 4 percent year-on-year toward the end of 2021.⁸⁴ Subsequently, as noted above, China only realized a real GDP growth rate of 3.0 percent in 2022, bearing out the concerns voiced prior to the imposition of the harsh "zero COVID" regime.

Looking at the long term, a study by the Lowy Institute, an Australian think tank, estimated that China's annual GDP growth would likely average only 2–3 percent per year to the year 2050, a rate much slower than many other economists' earlier forecasts.⁸⁵ An August 2023 paper by the Rhodium Group consultancy, drawing primarily on China's 2021 fiscal statistics, estimates that China's fiscal deficits have grown to about 6.5 percent of GDP in the past 3 years with no indication they will diminish and suggests that the country

no longer has the “fiscal space” to achieve many of the Communist Party’s ambitions, including a stronger military.⁸⁶

Finally, the risk exists that China, which has already seen sanctions placed on specific companies and individuals, could become subject to significant sectoral economic sanctions, whether the result of international actions (such as support for Russian aggression in Ukraine) or reactions to measures undertaken by China’s authorities domestically (additional repression in Hong Kong, for example). Trade restrictions, financial prohibitions (including exclusion to U.S. and other foreign capital markets), and travel and transportation bans on Chinese nationals and Chinese carriers all could restrain the country’s economic growth, thus reducing tax and other revenues as well as blocking China’s central and local governments from tapping external sources to finance their expanding debt. The impact on China’s economy would depend on the mix and extent of sanctions imposed. Nevertheless, such measures could have a rapid negative effect on China’s fiscal condition and force difficult choices on the country’s leaders. Even the potential for sanctions could reduce the interest of foreign investors in China, many of whom have already suffered losses from ventures in Russia.⁸⁷

9. Conclusions: Debt Burden Constrains China's Policy Options

Although popular discourse frequently references the size of China's economy as an indicator of its national power, that is only part of the story. An equally important factor is how the resources produced by China's economy are translated into national power through state institutions. The fiscal system is the chief mechanism by which China's government mobilizes the resources of the economy to support the instruments of national power, including its armed forces. The evidence indicates that China's fiscal system, which concentrates revenue in the central government but leaves most expenditures to the localities, is highly inefficient and, as spending has grown, has become increasingly imbalanced and dependent on debt to finance government operations at both the central and local levels.

China has been able to pursue this course because of a domestic financial system that remains tethered to the political authorities and that cannot freely allocate capital efficiently on a purely commercial basis. In essence, the Chinese government has been able to issue a limitless string of IOUs to its citizens, whose savings it has appropriated from the commercial banking system. Because of the size both of China's economy and of its population, this practice can conceivably continue indefinitely but not infinitely. Eventually, some contingency is likely to undermine confidence in the solvency of China's financial system, and that loss of confidence will directly affect the government's own finances. The expanding requirement to service the liabilities already on the books has diminished the resources available to the PRC's central government, especially as China's leaders insist on annual increases in spending on national defense, while, not unjustifiably, endeavoring to hold down the debt burden of the central government itself.

Consequently, although political figures in China and outside observers tout the country's impressive GDP figures, China's government has far less leeway in terms of the resources it has available to address the many challenges it faces than the size of the economy would suggest. During the period of high economic growth, a steady and robust flow of taxes and other revenues could compensate for the inefficiencies and weaknesses in China's fiscal system. Slower growth and unexpected crises, like the COVID-19 pandemic, have revealed the fragility of the country's government finances to the point that the problem cannot be ignored or dismissed. Hence, the PRC Finance Ministry's assessment of the situation as "grave." China's leaders confront increasingly stark policy tradeoffs as external factors, like the Russia-Ukraine conflict, create a more uncertain

global environment even as chronic domestic problems like the aging population, environmental degradation, and widening economic inequality demand attention. Of course, China's party-state retains an almost unparalleled capacity for mobilization to face a near-term crisis, but the sustainability of any effort to address further pressures on the system (e.g., resurgent pandemic, military conflict, global recession, economic sanctions) is questionable. The country's fiscal weakness urges China's leaders to be cautious as they consider foreign and domestic policy initiatives.

10. Areas for Further Research

Studies of China's fiscal condition have proliferated recently when the country's slowing economy and global disruptions caused by the COVID pandemic and by Russia's full-scale invasion of Ukraine raised the question of whether the Chinese economic model is sustainable. In addition, intensifying geopolitical tensions with the United States have added a new urgency to the perennial puzzle of ascertaining accurately the volume of financial resources China devotes to its military. What has been notably lacking in the available open-source literature has been research that explains the linkages between the two issues.

The reason for this omission is likely the differing interests of the research institutions and scholars concerned. Economists and social scientists in academia, in international financial institutions, and in private research firms and consultancies have produced the best work on Chinese government finances. The audience for these works tends to be academics, financial and non-financial businesses, and government officials in charge of economic policy. These consumers have relatively little interest in military affairs, a bias supported by the fact that most openly available Chinese fiscal statistics provide little to no detail on the financing of China's military. Conversely, those scholars and research institutions focused on the Chinese military, while interested in the national resources devoted to China's armed forces and military industries, tend to ignore the origin of those resources and the bureaucratic processes through which they are amassed and allocated. They concentrate their attention on the outcome of this system, not on the mechanisms by which it operates.

Consequently, a significant research opportunity exists to develop a better understanding on how China finances its national defense institutions in the context of the myriad of demands on the resources of the Chinese state. Such an effort should begin with the establishment of a more thorough understanding of China's overall public financial institutions: the interrelation of the four budgets, the structure of the tax system, the operation of the various funds that support government spending, and the legal and policy framework that underpins this system. Much of this information should be publicly available in Chinese-language instructional materials aimed at officials involved in public finance as well as in specialty publications produced by China's Ministry of Finance and its local counterparts.

The subsequent step could be an examination of the political dynamic through which public resources are allocated. This study would necessarily center on the nexus between

the Communist Party and the key government institutions responsible for the collection and management of public funds. At the central government level, these institutions include the Ministry of Finance, the State Administration of Taxation, and the National Development and Reform Commission. To encompass the full dynamic, however, it would also be necessary to investigate the relationship between the central government agencies and the Party and government bodies at the provincial and lower levels of the Chinese state. One possible approach to these questions would be to review the vast body of policy documents issued by the relevant authorities at all levels of the system in order to map out the processes and authorities through which the different agencies interact.

A third, and probably the most challenging, research endeavor could center on the financial relationship between the Chinese civilian and military authorities. Although much of the Chinese-language literature on the working of China's armed forces is either restricted or classified, one starting point could be to identify openly available Chinese government resource-related policy documents, court decisions, and reports involving both military and civilian authorities to establish a baseline understanding of this relationship. Additional research utilizing all-source U.S. government materials could build on this initial study to form a more complete picture both of the fiscal relationship between the military and civilian elements of the Chinese government and the resources available to it.

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