

A Study on the Formation Mechanism and Risk Mitigation of China's Local Government Hidden Debt

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Abstract. This article focuses on the core issue of implicit debt of local governments in China, aiming to deeply analyze its complex formation mechanism and explore systematic risk resolution paths. The research first defines the connotation, characteristics, and main carriers of implicit debt through a review of existing literature. Subsequently, the article employs a case study approach to deeply investigate the formation process of implicit debt in a specific region. The core conclusion of the study is that the formation of implicit debt of local governments is not the isolated effect of a single factor, but a systemic product. The key lies in a trinity-driven framework of "fiscal incentives - promotion incentives - financial synergy": the mismatch of power and financial rights gives rise to the fundamental "demand" for off-budget financing; the performance evaluation system centered on economic growth amplifies this "demand"; and the financial system under soft budget constraints provides conditions for the realization of this "demand". This interlocking closed loop jointly drives the scale expansion of implicit debt. Finally, based on this formation mechanism, the article proposes systematic risk prevention and resolution suggestions from the aspects of rationalizing the fiscal relationship between the central and local governments, reforming the official assessment mechanism, promoting the market-oriented transformation of platforms, and strengthening financial penetration supervision. This research not only provides an integrated theoretical framework for understanding the debt issue of local governments in China, but also offers more targeted references for policymakers.

Keywords: Local government hidden debt; formation mechanism; risk mitigation; local government financing vehicles; fiscal risk.

1. Introduction

Local government debt constitutes a pivotal fiscal issue concerning China's macroeconomic stability. Despite the 2015 revised Budget Law aiming to establish a standardised management framework by 'opening legitimate channels while blocking illicit ones', local governments have accumulated substantial hidden debt through channels such as Local Government Financing Vehicles (LGFVs) under immense fiscal pressure and development demands. Its severity has drawn significant international and domestic attention, with multiple institutions estimating its total value could reach tens of trillions of renminbi [1, 2], posing a severe challenge to systemic financial stability [3]. However, existing research predominantly focuses on single-factor analyses, lacking an integrated systemic framework. In light of this, this study aims to delve into the systemic formation mechanisms of hidden debt and explore comprehensive resolution pathways that balance short-term disposal with long-term institutional development, thereby providing novel theoretical and practical references for addressing this issue. The research seeks to construct an integrated analytical framework to unravel the formation mechanisms of China's local government hidden debt, subsequently proposing risk governance solutions that combine theoretical depth with practical feasibility. Theoretically, by dissecting the hidden debt phenomenon, this study seeks to deepen understanding of government behaviour and intergovernmental fiscal relations within transition economies, providing empirical evidence to refine the applicability of relevant theories to the Chinese context. Practically, it offers Chinese policymakers a 'risk map' for resolving existing debt risks and recommendations for long-term mechanisms to curb new debt accumulation. Its lessons also hold relevance for other emerging market economies facing similar challenges.

The structure of this paper is as follows: Firstly, Section II presents a systematic literature review, synthesising existing theories and research findings on local government debt, fiscal federalism, and government behaviour both domestically and internationally. Secondly, Section III elaborates on the case study methodology adopted and its selection criteria. Thirdly, Section IV constitutes the core of this paper, offering an in-depth analysis of a representative regional case to meticulously deconstruct the formation process and evolutionary trajectory of its hidden debt. Finally, Section V will synthesise theoretical insights from the case study and propose systematic policy recommendations for risk mitigation and governance, integrating both short-term and long-term perspectives. Section VI presents the study's concluding findings.

2. Literature Review

2.1. Defining the Concept of Local Government and Hidden Debt

Local government hidden debt is not a term with a strict legal definition, but rather a consensus concept formed within academia and policy practice to describe specific debt phenomena. Its core characteristic lies in the fact that local governments bear direct or indirect repayment responsibilities for these debts, yet their formation and existence operate outside the statutory budget management and debt ceiling control systems. At the policy level, the Ministry of Finance defines it as ‘debts incurred by local governments beyond statutory government debt limits, either directly or through commitments to repay with fiscal funds, or by unlawfully providing guarantees’. This definition clarifies the fundamental distinction between hidden debt and statutory explicit debt: its ‘extra-budgetary’ and ‘over-limit’ attributes [4].

Academic discourse on hidden debt further focuses on its realisation mechanisms. Existing research generally holds that local government hidden debt accumulates primarily through the following vehicles [5]:

2.1.1 Local Government Financing Vehicles (LGFVs)

This constitutes the most prevalent and traditional vehicle for hidden debt. Local governments establish financing platform companies by injecting assets such as land and state-owned equity [6]. Leveraging their status as independent market entities, these vehicles circumvent direct constraints under the Budget Law to borrow extensively from banks, trusts, and bond markets for infrastructure construction and public project investment.

2.1.2 Non-standard Public-Private Partnership (PPP) projects

When implementing PPP models, some local governments have shifted risks that should have been borne by private capital onto the government. This has been achieved through mechanisms such as establishing ‘equity in name, debt in substance’ arrangements, promising ‘minimum return guarantees,’ or implementing ‘buyback arrangements.’ Consequently, PPP projects have been distorted into a new, more covert form of local government debt.

2.1.3 Distortion of Government Procurement of Services

Some local governments exceed the legal scope of government service procurement, package engineering construction and services together, and through the “purchase first, pay later” approach, essentially form debts with deferred payment. This approach converts short-term budget expenditures into long-term debt repayment obligations and also constitutes part of implicit debts.

2.2. Causes of Local Government Hidden Debt Formation

Academic circles have conducted in-depth analyses of the root causes of hidden debt formation from multiple dimensions, yielding four representative explanatory perspectives.

The academic community has conducted an in-depth analysis of the root causes of implicit debt, revealing a complex picture of multiple intertwined factors. First, fiscal pressure is the structural root cause. Since the tax-sharing reform in 1994, the upward transfer of fiscal power and the downward

shift of administrative responsibilities have led to a widespread fiscal revenue and expenditure gap for local governments [7]. This institutional pressure compels them to seek off-budget financing to maintain operations and promote development. An unreasonable fiscal relationship between the central and local governments is considered the key to understanding their behavior [8]. On this basis, the promotion incentive centered on GDP growth plays the role of an "accelerator". Driven by the "political tournament", local officials have a strong motivation to promote large-scale investment projects to achieve political achievements [9]. When budgetary funds prove insufficient, advancing construction through hidden debt becomes a rational choice [10].

To translate this investment impulse into reality requires concrete implementation mechanisms, which brings us to the pivotal role of land finance. By injecting land into financing platforms, local governments not only secure substantial land transfer revenues but, more crucially, significantly enhance the platforms' asset scale and credit ratings. This enables them to obtain massive financing against such collateral, forming the material vehicle for hidden debt expansion. The final piece completing this closed-loop system is the financial sector's complicity. Given financing platforms' strong governmental affiliations, financial institutions widely succumb to the 'government credit illusion,' relaxing risk scrutiny and acting as financial 'facilitators.' This channels substantial financial resources towards local government-led projects under budgetary soft constraints. In summary, fiscal pressures generated demand, promotion incentives amplified it, land finance provided the tools, and financial synergy satisfied it. These four elements interlocked to form the complete chain of hidden debt expansion.

2.3. Risk Transmission Mechanisms of Hidden Debt

The accumulation of hidden debt not only poses a threat to local finances themselves, but its risks can also be transmitted and amplified through multiple channels, challenging macroeconomic stability.

Firstly, risks are transmitted to the financial system. Hidden debt is closely intertwined with financial markets through various financial instruments such as bank loans, trust products, and corporate bonds. Should local governments' fiscal conditions deteriorate to the point where they cannot repay debts on time, this may trigger defaults by financing platforms, potentially leading to regional and systemic financial risks. This transmission of local fiscal risks into financial risks represents one of the most concerning potential consequences of hidden debt [11].

Secondly, risks are transmitted within the fiscal system. When the pressure of repaying and servicing implicit debts becomes overwhelming, local governments may be forced to adopt various measures to cope, such as cutting expenditures on key public services like education and healthcare, encroaching on funds for other essential social welfare projects, or passing the burden onto society by increasing taxes and fees. This not only undermines the health and sustainability of the fiscal system but also has a negative impact on public welfare [12].

2.4. Literature Review

To sum up, existing literature has explored local government implicit debt from multiple dimensions such as definition, causes and risks, and identified key driving variables such as fiscal pressure, promotion incentives and land finance, providing a solid theoretical foundation for this study. However, these studies mostly focus on in-depth analysis of single factors, presenting a "fragmented" feature, and have failed to reveal the systematic mechanism of interaction among various factors within a unified framework. Therefore, on this basis, this study will adopt an in-depth case analysis method to integrate these factors into a coherent analytical framework, with the aim of presenting a more complete formation chain and evolution path of implicit debt, thereby making up for the deficiencies of existing research.

3. Research Design and Case Selection

3.1. Research Methodology

The core objective of this study lies in thoroughly and systematically elucidating the formation mechanisms of local government implicit debt. This process involves intricate institutional contexts, diverse participating entities, and dynamic evolutionary pathways. Given these complexities, quantitative statistical analysis methods struggle to capture the underlying causal logic and complete narrative chains. Consequently, this paper primarily employs the qualitative method of single case study.

This single case study method aims to provide a holistic, panoramic examination of the complex social phenomenon of ‘local government hidden debt’, offering in-depth answers to questions such as “how” and ‘why’ it forms. This approach not only helps avoid oversimplifying intricate formation mechanisms but also permits researchers to cross-validate findings using multiple evidence sources, including government documents and corporate financial reports. Through the deep analysis of a representative case, it seeks to distil theoretically significant insights with broader applicability.

3.2. Case Selection

Case selection is paramount to achieving the research objectives. An ideal case should be typical and representative, concentrating on the core issues this study seeks to explore. After comprehensive consideration, Guizhou Province was selected as the subject of analysis.

This study selects Guizhou Province as a case study based on its comprehensive advantages in terms of typicality of the problem, representativeness of structure, availability of data, and relevance to policies. As a western province, Guizhou has a serious debt problem that has attracted much attention, making it a typical window for observing the accumulation of risks under fiscal pressure. At the same time, its complex financing structure, which is highly dependent on local government financing vehicles (LGFVs) and extensively uses non-standard tools such as trusts, provides a representative sample for understanding the diverse carriers of implicit debts. Although the data on implicit debts are concealed, the large number of bonds publicly issued by platform companies within the province and their financial reports provide a valuable data foundation for this study, ensuring the feasibility of the analysis. Finally, this case has drawn high attention from the central government and the market and has received policy intervention, providing a realistic basis for this paper to analyze the real risk response and resolution paths.

4. Case Study: Formation Mechanism of Local Government Hidden Debt in Guizhou Province

4.1. Case Background Introduction

Guizhou Province, situated in the heartland of southwest China, has long experienced relatively lagging economic development yet harbours formidable growth ambitions. For instance, during the 13th Five-Year Plan period (2016-2020), Guizhou's GDP achieved an average annual growth rate of 9.2%, exceeding the national average by 3.5 percentage points. Even amidst heightened economic headwinds in 2023, its GDP growth remained at 4.9%, standing out among China's major economic provinces. During this period, Guizhou vigorously implemented the ‘Industrial Strengthening’ and ‘Urbanisation-Driven Development’ strategies. Its regional GDP growth consistently ranked among the nation's highest for several consecutive years, while infrastructure development in transport, water conservancy, and energy achieved leapfrog progress. Most notably, it realised its ambitious goal of ‘expressway access for every county’.

However, this leapfrog development concealed a stark contradiction between immense capital demands and a fragile fiscal foundation. Official data indicates that in 2023, Guizhou's general public budget revenue stood at ¥206.7 billion, while expenditure soared to ¥673.6 billion. Its fiscal self-

sufficiency rate was a mere 30.7%, significantly below the national average of approximately 48% for local governments that year, with some cities and counties falling below 20%. Concurrently, mandatory expenditures in infrastructure development, poverty alleviation, and ecological conservation remained persistently high. This model of undertaking large-scale projects in a resource-constrained province has perpetually strained local finances to the point of precarious equilibrium or outright imbalance, sowing the seeds for the expansion of off-budget borrowing and hidden debt.

4.2. Analysis of the Formation Chain and Key Nodes of Hidden Debt

4.2.1 Starting Point: Fiscal Pressure and Development Impulse

As previously noted, Guizhou Province faced a typical ‘fiscal development’ dilemma during the Twelfth and Thirteenth Five-Year Plans. On one hand, it grappled with an extremely low fiscal self-sufficiency rate and heavy pressures from public welfare expenditures; on the other, it experienced a strong investment impulse and the political imperative to drive GDP growth through infrastructure development. Public budgetary funds and central transfer payments proved wholly inadequate to sustain its extensive construction programme. For instance, to achieve the goal of ‘expressway access for every county,’ Guizhou's expressway construction investment reached hundreds of billions of yuan. This colossal funding gap compelled local governments to seek financing channels beyond the budget, thereby opening the floodgates for hidden debt.

4.2.2 Core Vehicle: The Rise and Expansion of Financing Platforms

To shoulder the massive infrastructure financing burden, governments at all levels in Guizhou established numerous local government financing vehicles (LGFVs). Provincial-level entities included the Guizhou Expressway Group Co., Ltd. and the Guizhou Transportation Construction Group Co., Ltd., while municipal and county-level authorities set up various ‘urban development,’ ‘transportation development,’ and ‘construction development’ companies. These platforms operated under highly homogeneous models:

Government Capital Injections and Credit Endorsements: Local governments injected assets such as toll collection rights, land, and state-owned equity into platform companies, rapidly expanding their balance sheets. They leveraged their position as controlling shareholders to provide strong implicit credit endorsements [13].

Project Undertaking and Large-Scale Financing: Platform companies acted as project legal entities, responsible for investing in, constructing, and operating major infrastructure projects. Under this guise, they circumvent direct constraints of the Budget Law, securing substantial financing from various financial institutions as corporate entities. Public data indicates that Guizhou's primary financing platforms carry an exceptionally large volume of interest-bearing debt, constituting the most significant component of local government implicit liabilities.

4.2.3 Critical Link: Land Finance and Financial Support

In Guizhou's case, land finance also plays a crucial role, though its mechanism differs slightly from that in other eastern provinces. Constrained by mountainous terrain and limited industrialisation, land transfer revenues themselves make a relatively modest direct contribution to the fiscal balance. However, the core function of land as collateral for financing has been maximised. Local governments transfer or inject land use rights from their reserves into financing platforms, which then use these as security to apply for bank loans or as credit enhancement measures for bond issuance.

Simultaneously, local financial institutions have formed close ‘government-bank-enterprise’ cooperative relationships with local governments and financing platforms. Under local government coordination and implicit guarantees, commercial banks, trust companies and other financial institutions provided continuous funding support to these platform companies. Notably, Guizhou Province exhibited a high reliance on costly ‘non-standard’ financing methods such as trusts and financial leasing. While this addressed short-term funding needs, it resulted in persistently high debt costs, sowing deeper seeds of risk accumulation for the future.

4.2.4 Catalysts: Irregular Industrial Funds and Government Procurement of Services

Beyond the traditional financing platform model, Guizhou Province has employed industrial investment funds and government procurement of services in certain regions as disguised financing methods. For instance, the establishment of government-led industrial funds, which introduce social capital through the "equity but debt-like" approach and promise a fixed rate of return, essentially creates an obligation for the government to guarantee repayment. Additionally, in some regions, engineering and construction projects that do not fall within the scope of government-purchased services are packaged as service projects for procurement, extending the payment cycle to smooth out the current fiscal expenditure pressure. However, this also transforms short-term funding gaps into long-term hidden debts.

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4.3. Risk Accumulation and Policy Responses

4.3.1 Risk Accumulation and Manifestation

Following nearly a decade of rapid development and debt expansion, Guizhou Province's debt risks have gradually surfaced since 2020. The manifestation of these risks has unfolded through an interlinked process: first, a large volume of high-cost non-standardised debt and short-term debt reached maturity simultaneously, placing local finances and platform companies under immense pressure to repay principal and interest. This resulted in severely strained cash flows and an exceptionally urgent need for refinancing. However, this coincided with central government policies tightening restrictions on 'curbing the growth of hidden debt'. Simultaneously, the market conducted a credit reassessment of high-risk regions, resulting in a cooling of bond issuance by some Guizhou financing platforms in the public market. Banks also tightened credit lines, making the 'borrowing new to repay old' chain increasingly fragile. Ultimately, when internal pressures could no longer be alleviated through external financing, risks became public. Some municipal and county-level platforms experienced technical defaults or openly sought assistance. The most emblematic case occurred in early 2023 when Zunyi Road and Bridge Construction Group announced a 20-year extension for its ¥15.6 billion bank loans, signaling the severity of local debt risks had been brought into the open [14].

4.3.2 Countermeasures and Preliminary Assessment

Confronted with this severe debt situation, Guizhou Province has implemented a series of countermeasures in recent years:

Seeking Central Government Support: Actively communicating difficulties to the central authorities. In 2022, the State Council issued a document supporting Guizhou in forging new paths for the Western Development Strategy in the new era. This explicitly called for 'researching support measures to help Guizhou resolve its debt risks,' providing a policy basis for securing higher-level backing.

Promoting Debt Restructuring and Replacement: Exemplified by Zunyi Road and Bridge, local governments have proactively negotiated with major creditors such as banks to restructure debts through loan extensions and interest rate reductions. This approach buys time by sacrificing flexibility, alleviating short-term liquidity crises. Concurrently, efforts are underway to utilise policy tools like special refinancing bonds to replace portions of hidden debt.

Platform Consolidation and Transformation: Provincial financing platforms are being consolidated to reduce their number, driving their transition towards market-oriented and substantive operations while attempting to divest government financing functions. Furthermore, efforts include revitalising state-owned assets and injecting high-quality resources (such as liquor and tourism assets) to enhance the platforms' self-sustaining capabilities.

Preliminary Assessment: These measures have mitigated Guizhou's short-term debt default risks to some extent, averting systemic risk outbreaks. As one of China's twelve key debt-resolution provinces, Guizhou effectively controlled the growth rate of its interest-bearing liabilities in the first half of 2024, maintaining it at a relatively low national level [15]. More encouragingly, following a series of debt restructuring and high-interest debt replacement efforts, financing costs for Guizhou's urban investment platforms saw a significant decline in the first half of 2024 [15]. However, debt restructuring and extensions essentially defer problems rather than reducing total debt. Concurrently, the report indicates that Guizhou's urban investment platforms continue to face tight cash reserves, with cash holdings growing at a rate below -10% in the first half of 2024, signaling persistent short-term liquidity pressures [15]. Moreover, the market-oriented transformation of these financing platforms cannot be achieved overnight. In the long term, Guizhou Province faces a considerable challenge in resolving its debt burden. The fundamental solution lies in identifying new, sustainable economic growth drivers and fundamentally restructuring the local government's investment and financing model.

5. Theoretical Summary and Policy Recommendations

5.1. Theoretical Summary of the Formation Mechanism of Hidden Debt

Through an in-depth analysis of the Guizhou Province case study, combined with the literature review in Part II, this research concludes that the formation of local government hidden debt is not the isolated effect of a single factor such as fiscal pressure, promotion incentives, land finance, or financial support. Rather, it is a systemic product of multiple factors that are intertwined and mutually reinforcing. This can be summarised as a tripartite driving framework comprising fiscal incentives, promotion incentives, and financial accommodation.

5.1.1 Fiscal Incentives as the Logical Starting Point

The mismatch between administrative responsibilities and fiscal authority constitutes the fundamental, institutional incentive for local governments to seek extra-budgetary financing. The Guizhou case clearly demonstrates that, under the dual pressures of insufficient self-sustaining capacity and substantial rigid expenditures on development and public welfare, local governments inevitably seek ways to circumvent budgetary constraints and open new financing channels. This represents the structural breeding ground for hidden debt.

5.1.2 Promotion incentives are the core engine

The 'political tournament' centred on GDP growth provides powerful and direct political motivation for local officials to undertake large-scale debt-financed investment. Guizhou's pursuit of ambitious goals like 'leapfrog development' and 'expressway access for every county' during specific periods epitomises this promotion incentive. It transforms latent financing needs into tangible, large-scale debt-taking behaviour, serving as the core driver behind the rapid expansion of hidden debt.

5.1.3 Financial Synergy as Enabling Condition

An off-budget financing system centred on government credit, underpinned by land as key collateral, and actively involving financial institutions, rendered the aforementioned incentives and motivations feasible. Within this framework, Local Government Financing Vehicles (LGFVs) serve as the core organisational vehicles, land finance constitutes the fundamental credit base, while financial institutions, operating under soft budget constraints and the expectation that 'the government will not default,' assume the role of capital providers. Together, these three elements form the financial ecosystem enabling hidden debt to materialise.

In summary, this tripartite framework reveals the complete chain of hidden debt formation: fiscal pressure generates the 'demand' for financing, promotion incentives amplify this 'demand', and financial synergy satisfies it. These elements are interlinked, forming a self-reinforcing cycle that leads to the continuous accumulation of hidden debt outside legal channels until risks are exposed.

5.2. Pathways for Risk Mitigation

Based on a systematic analysis of the underlying mechanisms, resolving local government hidden debt risks necessitates adhering to the principle of addressing both symptoms and root causes, combining short-term risk management with long-term institutional restructuring.

At the short-term symptomatic level, the primary task is to contain risk propagation through orderly ‘de-risking’ measures, thereby securing time for long-term reforms. This necessitates a combination of emergency measures: on the one hand, existing implicit debts must undergo thorough identification and categorisation for tailored approaches. Projects generating operational cash flow should be resolved through market-based mechanisms, while purely public welfare projects should be gradually absorbed by the government via budgetary allocations and asset monetisation; Concurrently, proactive negotiations with creditors such as banks must be pursued to restructure debt through extensions and interest rate reductions, thereby buying time. Prudent use of policy tools like special refinancing bonds should be employed to replace existing debt, optimising structures and reducing costs – as demonstrated by the successful case of Zunyi Road and Bridge in Guizhou.

At the fundamental, long-term level, the ultimate solution lies in institutional restructuring to decisively break the ‘triple-driver’ cycle that generates debt. This requires systematic reform: Firstly, rationalise central-local fiscal relations by granting local governments stable revenue sources commensurate with their responsibilities, thereby diminishing their fundamental need for off-budget financing. Second, and most crucially, budgetary constraints must be strengthened and the performance appraisal system for officials reformed. A lifetime accountability system for non-compliant borrowing must be established to transform behavioural incentives. Thirdly, resolutely advance the market-oriented transformation of financing platforms, stripping them of their government financing functions to organisationally sever the primary source of hidden debt. Finally, strengthen ‘penetrative’ financial supervision, reinforce financial institutions’ risk assessment responsibilities, and fortify the ‘firewall’ preventing the financial system from being hijacked by local governments’ soft budget constraints.

6. Conclusion

Through a systematic examination of China’s local government hidden debt issue, this study arrives at the following core conclusions: Local government hidden debt is not an isolated phenomenon driven by a single factor, but rather a systemic product of multiple factors long intertwined and mutually reinforcing within China’s specific institutional context. Its core mechanism can be summarised as an off-budget financing cycle centred on land and government credit.

This study constructs and demonstrates a tripartite driving framework of “fiscal incentives-promotion incentives-financial synergy”, revealing how fiscal pressures, promotion motivations, and financial support interlock to form a closed loop of hidden debt expansion.

This study has two primary limitations: firstly, owing to the non-public nature and complexity of hidden debt data, it relies on publicly available information for qualitative analysis, with room for improvement in quantitative precision; secondly, while the single-case study method offers depth, its conclusions warrant caution when generalised nationally, given substantial regional variations. To address these limitations, future research may deepen in two directions: methodologically, employing cutting-edge econometric techniques such as text analysis and big data mining to measure implicit guarantees and debt risks more precisely; conceptually, conducting comparative multi-case studies (e.g., contrasting eastern and western provinces) to explore regional patterns and provide richer empirical evidence for formulating differentiated policies.

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