The Formation Mechanism and Resolution Path of Local Government Debt Risks from the Perspective of Fiscal Decentralization

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Abstract

Against the backdrop of fiscal decentralization, the risk of local government debt has been continuously escalating. The rapid expansion of debt scale poses a significant threat to regional economic development and fiscal stability. This paper analyzes the profound impact of the fiscal decentralization system on the formation of local government debt risks, and dissects the role of key factors such as the mismatch between administrative responsibilities and financial powers, the abnormal fiscal incentive mechanism, and the flawed local debt management system in driving debt expansion. Based on constructing an effective debt risk prevention and control mechanism, this paper proposes diversified measures, including optimizing fiscal decentralization arrangements, improving local debt management mechanisms, strengthening financial resource guarantees, and enhancing risk early-warning mechanisms, to effectively enhance the local government's debt management capabilities and risk prevention skills, and promote sustainable fiscal development.

Keywords

Fiscal Decentralization, Local Government Debt, Risk Formation Mechanism, Debt Management, Resolution Path

1. Introduction

The continuous expansion of local government debt and the gradual emergence of debt risks pose significant challenges to economic development and fiscal stability. While the fiscal decentralization system grants local governments the autonomy to allocate financial resources, it has objectively promoted debt accumulation, particularly in situations where administrative responsibilities and financial powers are mismatched. How to effectively prevent and resolve local debt risks within the fiscal decentralization framework has become a critical issue in fiscal management. A scientific analysis of the formation mechanism of debt risks and the exploration of reasonable resolution paths are of great practical significance for maintaining regional economic stability and government fiscal security.

1.1 Overview of Fiscal Decentralization Theory

Fiscal decentralization refers to a management model in which the central government transfers part of its fiscal authority to local governments, aiming to enhance local governments' autonomy in financial allocation and use to better meet the diverse needs of local economic development. Within the framework of fiscal decentralization, local governments enjoy certain autonomous decision-making powers in areas such as budget formulation, tax management, and expenditure arrangements. Fiscal decentralization is not a single concept; its core lies in the reasonable division and relative independence of fiscal revenue and expenditure between the central and local governments.

Fiscal decentralization has a dual impact on local governments' financial resources and debt management. It enhances local governments' autonomy in raising and allocating financial resources, thereby improving the supply of local public services. However, excessive decentralization may lead to a lack of constraints on local fiscal expenditures, especially in the absence of effective supervision, which may trigger a rapid expansion of local debt. Within the scope of fiscal autonomy, local governments often rely on borrowing to meet funding requirements for economic development, thereby exacerbating debt risks.

1.2 Characteristics and Current Status of Local Government Debt

Local government debt refers to the borrowing incurred by local governments to bridge fiscal gaps, support public project construction, etc., through issuing local bonds or using financing platforms. China's local government debt mainly consists of two parts: explicit debt and implicit debt. Explicit debt refers to local government bonds issued through legal channels, which are highly transparent and compliant; implicit debt is mainly formed through local financing platforms, state-owned enterprise guarantees, and other means, which are hidden and highly risky.

The scale of China's local government debt has been continuously expanding, with a significant increase in the growth rate of debt. In particular, in some underdeveloped regions, due to weak fiscal strength and heavy debt-servicing burdens, debt risks have become increasingly prominent. The main manifestations of local debt risks include large debt scale, unreasonable debt structure, and high debt concentration. Some local governments have fallen into difficulties in debt repayment, and even default risks have emerged. Especially when faced with weak growth in fiscal revenue and increasing pressure on fiscal expenditures, the potential crises caused by local debt accumulation have significantly intensified.

1.3 Impact Mechanism of Fiscal Decentralization System on Debt Risk Formation

Under the fiscal decentralization system, local governments have greater fiscal autonomy, which motivates their enthusiasm for economic development and project construction. However, excessive fiscal autonomy may lead to blind debt expansion by local governments, especially in the absence of effective supervision. Local governments often raise funds through various channels to meet local construction and economic development needs, leading to a rapid expansion of debt scale [1,2].

The mismatch between administrative responsibilities and financial powers is one of the core causes of local debt risks. As local governments bear numerous public service obligations but have limited financial resources, fiscal revenue is often insufficient to cover expenditures, creating fiscal gaps. Against this backdrop, local governments often rely on borrowing to make up for funding shortages, leading to gradual debt accumulation.

While promoting regional balanced development, the fiscal transfer payment system has also indirectly contributed to debt risks. Due to the flexibility in the use of transfer payment funds, some local governments have invested them in non-productive expenditures or projects with unclear long-term returns, exacerbating debt accumulation. The imperfect fiscal transfer payment mechanism has led some local governments to become dependent on central subsidies. If subsidies are reduced or interrupted, their debt repayment capabilities will be severely affected.

While the fiscal decentralization system has energized local economic development, it has also become a key driver of debt risk accumulation. How to balance fiscal autonomy and debt management within the decentralization framework has become an urgent practical dilemma [1,2].

2. Root Causes Analysis of Local Government Debt Risk Formation

2.1 Dynamic Mechanism of Debt Expansion under Fiscal Decentralization

Under the fiscal decentralization system, local governments hold significant fiscal autonomy and expenditure authority. This institutional design has, to some extent, motivated local governments to accelerate economic development. However, due to the poor matching of financial powers and administrative responsibilities, local governments often face fiscal constraints when promoting economic construction and livelihood projects. As a result, local governments regard borrowing as a crucial means to bridge fiscal gaps and drive regional economic development.

The instability of local fiscal revenue and expenditure is one of the fundamental causes of debt expansion. Local governments bear a large number of social public service obligations, but their tax revenue is limited-especially in regions with weak economic foundations, where fiscal revenue struggles to cover expenditure gaps. Against this backdrop, local governments promote infrastructure construction and livelihood improvements through issuing bonds, bank loans, or attracting social capital, gradually leading to debt accumulation.

The proliferation of investment and financing platforms has further exacerbated the risk of local government debt expansion. To circumvent central government restrictions on local debt management, many local governments have established financing platform companies to carry out borrowing and fund-raising through these platforms, creating a dilemma of implicit debt. Although these financing platforms have some independence, their debts essentially rely on local government credit, forming implicit government guarantees. During economic booms, financing platforms can repay debts with project revenues, but if the economy declines or projects fail, these implicit debts will transform into government liabilities, triggering significant fiscal pressure.

2.2 External Factors Influencing Debt Risk Formation

In addition to the debt expansion driven by the internal mechanisms of the fiscal decentralization system, changes in the external economic environment play a significant role in shaping debt risks. Economic downward pressure directly affects local fiscal revenue, particularly in regions dependent on land transfer fees and local taxes. A slowdown in economic growth leads to a sluggish land market, prompting local governments to further intensify debt financing to bridge fiscal gaps and advance projects, causing debts to snowball [3].

Adjustments in central fiscal policies also significantly impact the formation of local debt risks. For example, when macroeconomic control policies tighten and deleveraging is promoted, local government financing channels are constrained, and financing costs rise significantly. Deteriorating financing conditions make it more difficult for local governments to refinance existing debts, sharply increasing the risk of debt default—especially for regions reliant on short-term loans and medium-term debts. Once the funding chain breaks, debt default becomes inevitable.

Regional economic disparities are another important external factor contributing to debt risks. In economically developed regions, reasonable industrial structures and stable fiscal revenue keep debt risks relatively manageable. In contrast, underdeveloped regions suffer from weak industrial foundations and limited fiscal resources, leading to a sudden decline in debt repayment capacity during economic fluctuations or unexpected shocks. These regional differences give rise to strong spatial concentration and regional characteristics of debt risks. In some cases, debt risks in a few regions can be contagious, triggering chain reactions that impact regional economic stability [4].

The internal mechanisms of the fiscal decentralization system drive the formation of local government debt risks, while external factors such as economic downturns, policy adjustments, and regional disparities also exert comprehensive influences. A thorough analysis of these root causes allows for more accurate identification of the evolution trajectory and potential hazards of debt risks, providing a scientific basis for formulating effective resolution strategies.

3. Impacts of Local Government Debt Risks in the Context of Fiscal Decentralization

3.1 Impacts on Fiscal Risks and Social Stability

If local government debt risks spiral out of control, they first trigger dual shocks to fiscal stability and social order. Local governments bear significant responsibilities for public services, such as infrastructure projects, public health security, and educational resource allocation. Debt defaults or fiscal distress will inevitably disrupt the normal provision of these services. When fiscal austerity intensifies or debt repayment pressures mount, local governments often have to cut public spending and reduce investments in livelihood projects, directly undermining social welfare and residents' quality of life. This can give rise to social conflicts and instability.

Local debt risks also pose a major threat to financial market stability. Local governments raise funds through financing platform companies or local bonds, and their debt repayment capacity is directly linked to local economic performance and fiscal revenue. In the event of debt defaults, the banking system and bond markets would suffer heavy blows, eroding investor confidence and tightening financial market liquidity. When local financing platform debts are highly intertwined with financial institutions' loans, a local debt crisis could even trigger regional financial risks, potentially destabilizing the national financial system. Thus, local debt risks are not merely fiscal challenges but also significant hazards to financial market stability [5].

3.2 Impacts on Economic Development and Local Investment Environment

The continuous expansion of local government debt has increasingly revealed negative effects on regional economic development. Excessive borrowing exacerbates fiscal burdens, diverting financial resources from economic development and public projects to debt principal and interest repayments. This misallocation of resources directly stifles local investment vitality and weakens economic growth momentum. Under debt pressure, local governments may resort to raising taxes or expanding fee collections to boost fiscal revenue, further burdening enterprises and residents and running counter to the path of sustainable local economic development.

Debt crises also affect local governments' credit ratings. A downgrade in credit ratings leads to higher financing costs, greater borrowing difficulties, and even the risk of narrowed financing channels. In regions with pronounced economic disparities, low credit ratings often make it harder to issue local bonds and reduce market subscription rates. A decline in credit ratings not only impacts local governments themselves but may also undermine the financing capabilities of regional enterprises and financial institutions, triggering chain reactions that sap regional economic vitality.

3.3 Impacts on Social Credit and Public Well-Being

Beyond fiscal and economic consequences, local government debt risks exert profound effects on the social credit system and public welfare. When local governments suffer credit damage due to debt defaults or fiscal hardships, market confidence in their debt repayment and governance capabilities plummets. Such a credit crisis may trigger market panic, causing sharp declines in local bond prices or even sell-offs. Public and corporate skepticism about local governments' governance capabilities could lead to investment withdrawal and capital outflows.

Increasing debt burdens directly squeeze local fiscal expenditure structures, diverting more budgetary funds to debt repayment rather than social welfare. To meet repayment obligations, local governments may cut investments in education, healthcare, and social security, degrading the quality of livelihood services. During periods of severe economic downturn and fiscal revenue shortages, the priority given to debt repayment often marginalizes livelihood expenditures, worsening local fiscal conditions. Such austerity policies not only reduce the level of public service provision but may also spark social dissatisfaction and erode local governments' public credibility.

Against the backdrop of fiscal decentralization, local government debt risks threaten not only local fiscal stability and economic growth but also social credit and public well-being. How to effectively prevent and address debt risks while expanding local fiscal autonomy has become a critical challenge in the field of public governance.

4. Resolution Paths for Local Government Debt Risks from the Perspective of Fiscal Decentralization

4.1 Improving the Fiscal Decentralization System and Strengthening the Matching of Administrative Responsibilities and Financial Powers

Fiscal decentralization plays a positive role in enhancing local governments' autonomy and fiscal management capabilities. However, in practice, the mismatch between administrative responsibilities and financial powers is widespread, leading local governments to borrow blindly to bridge fiscal gaps. Improving the fiscal decentralization mechanism and promoting the precise matching of administrative responsibilities and financial powers have become a top priority for resolving local debt risks.

It is necessary to reasonably adjust the fiscal sharing ratio between the central and local governments and enhance local fiscal self-sufficiency. When formulating tax-sharing reform plans, comprehensive consideration should be given to local economic development conditions, fiscal revenue structures, and public service expenditure needs to ensure that local governments can achieve fiscal balance autonomously within a reasonable range. Clarifying local governments' responsibilities and authorities in different public service areas—especially in infrastructure construction, education, and healthcare—can avoid the problems of empty administrative responsibility rotation and unclear duty division, fundamentally reducing local governments' irrational borrowing behaviors [6].

4.2 Strengthening Local Government Debt Management and Risk Prevention Mechanisms

The core of local government debt management lies in advance risk prevention and process supervision. A set of local government debt risk assessment systems should be established, covering multiple dimensions such as debt origination, debt composition, and debt repayment capabilities. Through risk early-warning tools, regular scientific assessments of local debt conditions should be conducted to promptly identify potential risks. Promoting the transparency of debt monitoring and information disclosure ensures the authenticity and integrity of debt data.

Implementing debt ceiling management and debt list regulations can strictly control the overall level of local debt, especially the accumulation of implicit debt. Debt ceilings should be comprehensively calculated based on local fiscal capacity and economic development levels, with expenditures reasonably arranged in annual budgets. Debt list management measures should be formulated to categorize local government debts in detail by type, term, interest rate, etc., ensuring traceable debt management. Scientifically setting debt ceilings and standardizing debt list management can help slow down debt accumulation and reduce systemic risks caused by blind debt expansion.

4.3 Optimizing Local Government Financing Platforms and Debt Structures

Financing platform companies are a key channel for expanding local government debt. To resolve local debt risks, these companies should be guided toward market-oriented transformations, gradually divesting their public welfare-related functions and completing market-oriented operational shifts. With policy guidance, financing platforms should increasingly rely on market credit and operational efficiency for financing rather than implicit government guarantees. Through corporatization reforms, enhancing the self-sustaining capabilities of these platforms can reduce the ripple effects of their debt risks on local finances.

Strengthening local debt structure adjustment is also an effective way to optimize debt management. Local governments should prioritize repaying high-risk debts, especially those with high costs and short terms, to prevent liquidity crises caused by refinancing failures. Debt swaps and restructurings can reduce debt costs and extend repayment terms, alleviating short-term debt repayment pressures. During debt structure adjustments, attention should also be paid to optimizing debt usage, guiding debt funds toward public projects with long-term stable returns, and ensuring the sustainability of debt investments.

4.4 Establishing Transparent and Socially Supervised Mechanisms for Local Government Debt

Implementing transparent management of local government debt provides a safeguard against the spread of debt risks. A sound information disclosure system should be established, requiring local governments to periodically publish debt reports covering details such as debt balances, repayment arrangements, debt structures, and risk assessments, enabling the public to fully understand local debt conditions. A transparent information disclosure mechanism can enhance public credibility in debt management and prevent social panic caused by debt loss of control.

Strengthening social supervision and building diversified oversight frameworks, such as using third-party audit institutions to independently evaluate local government debt management, ensures the objectivity and accuracy of debt data. Guiding the public and social organizations to participate in debt supervision-through forms like NPC deliberations and public hearings-can enhance public participation in the debt management process. Social supervision not only effectively prevents irregularities in local government debt but also improves the scientificity and rationality of debt management.

5. Conclusion

Against the backdrop of fiscal decentralization, the formation of local government debt risks exhibits complex and diverse characteristics, driven by both internal institutional mechanisms and external economic environments. Appropriately improving the fiscal decentralization system, enhancing the matching of administrative responsibilities and financial powers, and strengthening debt management and risk prevention systems can effectively reduce the scale of fiscal risks arising from debt expansion. By promoting the market-oriented transformation of financing platforms, optimizing debt structures, improving the efficiency of debt fund utilization, and reducing the accumulation of implicit debt, while simultaneously improving mechanisms for transparent debt management and social supervision, it is possible to enhance local governments' debt management capabilities, eliminate debt-related hidden dangers, and safeguard sustained local economic development and social stability. Building a scientific, standardized, and effective local debt management system has thus become a critical task for preventing fiscal crises.

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