

**PROGRAM INFORMATION DOCUMENT (PID)
CONCEPT STAGE**

December 23, 2015
Report No.: AB7806

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| Operation Name | Chongqing-Dadukou Fiscal Sustainability DPF |
| Region | EAST ASIA AND PACIFIC |
| Country | China |
| Sector | Sub-national government administration (85%); Central government administration (15%) |
| Operation ID | P157404 |
| Lending Instrument | Development Policy Lending |
| Borrower(s) | PEOPLE'S REPUBLIC OF CHINA |
| Implementing Agency | Chongqing Municipality Finance Bureau (CMFB) and Dadukou District Government |
| Date PID Prepared | December 23, 2015 |
| Estimated Date of Appraisal | June 22, 2016 |
| Estimated Date of Board Approval | September 20, 2016 |
| Corporate Review Decision | Following the corporate review, the decision was taken to proceed with the preparation of the operation. |
| Other Decision <i>{Optional}</i> | <i>Teams can add more if they wish or delete this row if no other decisions are added</i> |

I. Key development issues and rationale for Bank involvement

China is now a higher middle-income country, well positioned to become a high income country in the next decade. China's economic transformation over the past three decades has increased incomes, raised living standards and made China the world's largest manufacturer and exporter. While in many aspects China's rapid growth in recent decades, China's leadership has recognized that to become a high income country requires a new growth model that is more balanced, based on productivity increases and innovations rather than on mobilization of resources, more equal in the distribution of the benefits of growth, and more sustainable in environmental outcomes.

While growth in China remains quite high by international standards, macroeconomic risks have increased in the form of rapidly rising debt. Subnational governments account for a good share of this new debt. From negligible levels only a decade ago, subnational debt in China reached an estimated 40 percent of Gross Domestic Product (GDP) by the end of 2014. Although subnational governments were not allowed to incur explicit deficits or borrow funds directly until 2015, they nevertheless accumulated debt quite rapidly in off-budget vehicles that carried out public investments. The most common form of implicit government borrowing was through Urban Development Infrastructure Companies (UDICs) that operated mostly at the local (sub-provincial) level of government.

The Chinese Government has recognized the seriousness of this problem, and introduced a major reform in 2014 to bring subnational debt under control and reorient subnational officials and budgetary institutions toward fiscal / debt sustainability. The Government has also requested that the World Bank work in two pilot regions to assist this transition: Chongqing Municipality and Hunan Province. Given the importance of local level finance for the success of this reform, Chongqing Municipality has chosen to concentrate this World Bank Programmatic Development Policy Financing (DPF) for US\$ 200 million in

a single pilot local government: Dadukou District. The expectation of the Chinese Government, Chongqing Municipality, and the district administration is that Dadukou can become a model for subnational fiscal reform that can be scaled up to other local governments in China.

The major budget reform that is currently underway in China provides the context for this operation. Strong incentives at the subnational level of government to promote growth and investment have been an important ingredient of China's successful economic development in recent decades. The budget reform seeks to alter the incentives and constraints of subnational governments toward the additional objective of fiscal sustainability, while also improving transparency in local finance. This reform has already transformed the stock of government debt in UDICs into explicit debt of subnational governments. A debt swap program is also converting these obligations into longer term (4-7 year) bonds at a lower interest rate (3 percent). Going forward, the reform prevents local governments from acquiring additional debt or issuing guarantees through UDICs. At the same time, subnational governments have been granted the right to borrow explicitly through bond issues, albeit within strict limits. The provincial level government regulates the distribution of new debt and bond-swap debt to local governments, and employs an early warning system to evaluate the financial health of localities. The budget reform also requires subnational governments to develop new budgetary institutions, including medium term budgetary plans and three-year rolling budgets.

China's macroeconomic policy framework is deemed adequate for the operation. The national government has been pursuing responsible fiscal and monetary policies, has a strong debt position, and sufficient reserve buffers. China's monetary and fiscal policy stance is expected to remain broadly accommodative. And there are sufficient policy buffers to address risks and prevent a sharp slowdown, for example, the fiscal space to apply stimulus in the event of a sharper than expected slowdown, if needed.

II. Proposed Objective(s)

This First Chongqing-Dadukou District Development Policy Financing (CDDDPF) supports Chongqing-Dadukou District Government to ensure its fiscal sustainability by developing a forward-looking, comprehensive and transparent public finance regime that integrates budget, public investment and debt management. The three pillars of the DPF are (a) Fiscal Sustainability, (b) Capital Financing Plan, and (c) Transparency.

III. Preliminary Description

The DPF program in Dadukou is divided into three pillars: fiscal sustainability, capital financing plan, and transparency. Under the first pillar, Dadukou will employ a medium term fiscal / debt sustainability framework for assessing its fiscal space to afford current and capital expenditures, managing risks, and ensuring the sustainability of its public finances. Under the second pillar, Dadukou will change the nature of capital investment planning by adopting an integrated approach that will coordinate the capital investment and budgetary planning for rationalizing public investments within appropriate ceilings. Under the third pillar, Dadukou will enhance transparency and accountability in the use of budgetary resources through the adoption of standards for disclosure and regular information reporting. A number of the prior actions for the first tranche of this operation focus on making the annual budget and the annual capital financing plan consistent with fiscal sustainability and a medium term budgetary framework. The triggers for the second tranche, in turn, focus on three-year rolling budgets and three-year capital financing plans.

The fundamental objective of the operation is to make Dadukou a pilot for local government fiscal reform in China through assisting the District Government in achieving fiscal sustainability by developing a forward-looking, comprehensive and transparent public finance regime that integrates budget, public

investment and debt management. Achieving fiscal sustainability by means of debt reduction is a primary goal in the current development and fiscal program of Dadukou District described above. If the District can become a successful pilot, this would have implications for the budget reform in China that go beyond Dadukou and Chongqing. Developing appropriate institutions to ensure local governments' fiscal sustainability is a key goal for sustaining the growth and development in China that brought millions of citizens out of poverty in recent decades.

While this is the first subnational development policy operation in China, the project design is informed by the experience of such subnational operations in other countries, as well as other types of operations in China. Experience has confirmed that strong ownership of the operation is particularly critical to the success of development policy lending. The program being supported will have little meaning or impact if it is discontinued after the operation is over. In this regard, the operation is encouraged by the pride and determination of Dadukou District to transform itself from one of many fiscally distressed local governments in China into a positive example of a fiscal turnaround that could be followed by other localities. The technical assistance that accompanies this operation is focused, first and foremost, on transferring knowledge to Dadukou officials, who will carry out the prior actions as genuine steps toward a permanent budgetary reform in the locality.

IV. Poverty and Social Impacts and Environment Aspects

Chongqing-Dadukou is undergoing a significant fiscal consolidation effort. The local economy has suffered from the closure of an important steel plant in 2012. Public debt has now reached high levels and economic activity has been supported by unsustainable public investment growth. Going forward, the District will need to severely constrain further growth of public expenditure. While Chongqing-Dadukou aims to attract private investment to support economic growth despite a tight fiscal stance, the nature of Chongqing-Dadukou's current economic and fiscal situation breeds significant risks for local progress on poverty and social indicators.

The prior actions for this operation set in place a best-practice budgetary system to (i) minimize the short-term social cost of this fiscal consolidation effort and (ii) to maximize the probability that the adjustment plan will lead to sustainable local public finances and growth. The prior actions and triggers aim to support a budget planning framework that takes a holistic and forward-looking perspective. Three-year budgeting, subject to debt sustainability analysis, means that the full consequences of individual fiscal consolidation measures are taken into account when designing the adjustment program, including the impact of policies on future growth and living conditions. A credible upfront medium-term adjustment plan also reduces current policy uncertainty, potentially helping to attract new private investors to the District. A capital budgeting framework ensures that fiscal risks from the entire Chongqing-Dadukou investment plan are evaluated, including contingent liabilities from projects that are not currently consolidated in the official Chongqing-Dadukou budget.

The provision of many basic social services is protected. A range of services are provided by the national and provincial level governments [...]. National and provincial regulation also ensure minimum standards on [...] services that Dadukou needs to provide for its citizens. Finally, the small scale of Dadukou District creates strong incentives to maintain a basic level of public services: many residents can respond to a sharp cut-back in local public services by relocating to neighboring districts. This creates a natural safeguard against measures with strong poverty and social impact.

The operation supports the introduction of modern capital budgeting to ensure efficient public investment decisions. Given many budget expenditures and revenues that are outside of the control of the District, the public investment budget is likely to be a key margin for fiscal adjustment in the coming years. A formal capital budgeting process will help ensure that any adjustment will be tailored to rationalize high-cost and

low-return projects first. [To anchor this principle in the program, the incremental capital-output ratio is identified as key results indicator for the operation.] However, this may not prevent the need to reduce Chongqing-Dadukou expenditure on some investment projects with high impact on poverty and social indicators. In this case, mitigating measures should be put in place. For instance, a forward-looking budget analysis may conclude that the social housing construction projects of the District need to be cut back. To minimize the poverty and social impact of such policies, a reassignment of expenditure responsibilities to the Chongqing Provincial Authorities could be discussed, given the Municipality as a whole may benefit from local social housing. Given social housing construction is cut back, families in need could also be allocated rent subsidies to move into existing vacant residential units in Chongqing-Dadukou District.

Environment Aspects

The proposed CDDDPF will not entail direct environmental impacts as its main focus is essentially to enhance budget management of the Government. There are clear signs that the Dadukou District Government has given a higher priority to the environment, and seeks a transition to green growth. With this polluted steel factory relocated out of Dadukou in 2011, the District Government aims to rebuild its economic base and develop emerging industries including environmentally-friendly advanced manufacturing. As part of the implementation of the proposed development policy support operation, the introduction of modern capital budgeting to ensure efficient public investment decisions will help strengthen the environmental integrity and sustainability of investment projects financed by the budget.

V. Tentative financing

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| Source: | (\$m.) |
| Borrower: | 0 |
| International Bank for Reconstruction and Development Borrower/Recipient | 200 |
| Total | 200 |

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