PROGRAM INFORMATION DOCUMENT (PID)
CONCEPT STAGE

December 23, 2015
Report No.: AB7808

Operation Name	Hunan Fiscal Sustainability DPF
Region	EAST ASIA AND PACIFIC
Country	China
Sector	Sub-national government administration (85%); Central government administration (15%)
Operation ID	P157406
Lending Instrument	Development Policy Lending
Borrower(s)	PEOPLE'S REPUBLIC OF CHINA
Implementing Agency	Hunan Provincial Finance Bureau
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 *{Optional}*	*Teams can add more if they wish or delete this row if no other decisions are added*

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: Hunan Province and Chongqing Municipality. This World Bank Programmatic Development Policy Financing (DPF) for US$ 200 million will assist the Hunan Province Government and two local governments within Hunan Province realize reforms to ensure that public finances are placed on a sustainable path. The expectation is that Hunan can provide a model in China for subnational fiscal reform that can be scaled up to other provinces.

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 perusing 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 Hunan Province Development Policy Financing (HPDPF) supports Hunan Province 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 four pillars of the DPF are (a) Fiscal Sustainability, (b) Capital Budgeting, (c) Monitoring and Regulating Sub-provincial Governments' Debt, and (d) Transparency.

III. Preliminary Description

The DPF program in Hunan Province is divided into four pillars: (i) fiscal sustainability, (ii) capital budgeting, (iii) monitoring and regulating sub-provincial debt, and (iv) transparency. Under the first pillar, Hunan 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. Province officials will then partner with the World Bank to work with local governments in the same areas. Under the second pillar, Hunan is introducing a capital budgeting framework that is tailored to the context of Hunan Province, adopting an integrated approach within appropriate ceilings that will improve efficiency and sustainability. Under the third pillar, Hunan will introduce policies to induce local governments to reduce debts, and to gather and reveal valuable information for financial monitoring and supervision. Under the fourth pillar, Hunan will enhance transparency and accountability in the use of budget resources through the adoption of enhanced 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 capital budgeting consistent with fiscal sustainability and a medium term capital budget framework at the provincial level, while the triggers focus on achieving similar results at the local level, together with progress in the development of three-year rolling budgets and three-year capital budgets.

The fundamental objective of the operation is to make Hunan a pilot for subnational fiscal reform in China. Achieving fiscal sustainability through strengthened institutions, debt reduction and greater budgetary efficiency is a primary goal in the current development and fiscal program of Hunan described above. If the pilot is successful, this operation would have implications for the budget reform in China that go beyond Hunan Province. Containing the growth of local government debt is a key goal for sustaining the growth and development in the country 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 that this DPF supports 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 the Hunan Provincial Government to play a leading role in budget reform in China. The technical assistance that accompanies this operation is focused, first and foremost, on transferring knowledge to provincial and local officials in Hunan, who will carry out the prior actions as genuine steps toward a permanent budgetary transition.

IV. Poverty and Social Impacts and Environment Aspects

Poverty and Social Impacts

Hunan is undergoing a significant fiscal consolidation effort. Public debt has now reached high levels and economic activity has been supported by unsustainable public investment growth. Going forward, the subnational government will need to severely constrain further growth of public expenditure. While Hunan province aims to attract private investment to support economic growth despite a tight fiscal stance, the nature of Hunan'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 Hunan province. A capital budgeting framework ensures that fiscal risks from the entire Hunan investment plan are evaluated, including contingent liabilities from projects that are not currently consolidated in the official subnational 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 Hunan needs to provide for its citizens. 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 subnational government, 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 fiscal expenditure on some investment projects with high impact on poverty and social indicators. In this case, mitigating measures should be put in place.

Environment Aspects

The proposed DPF is expected to have positive environmental impacts. The Hunan Province has given a high priority to green development. The medium-term capital budgeting framework supported in the pillar 2 of this DPF will strengthen the environment integrity by requiring all budget supported projects to pass environment assessment.

V. Tentative financing

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

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