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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT  
PROGRAM DOCUMENT FOR A PROPOSED LOAN  
IN THE AMOUNT EQUIVALENT TO US\$200 MILLION TO  
PEOPLE'S REPUBLIC OF CHINA  
FOR THE  
HUNAN FISCAL SUSTAINABILITY DEVELOPMENT POLICY FINANCING

December 12, 2016

Macroeconomics & Fiscal Management Global Practice  
& Governance Global Practice  
East Asia and Pacific Region

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**China-Government Fiscal Year**  
***January 1 – December 31***

**Currency Equivalents**

(Exchange rate effective as of December 2015)

Currency Unit	=	RMB
RMB1.00	=	US\$0.16
US\$1.00	=	RMB6.40

**ABBREVIATIONS AND ACRONYMS**

CAS	Country Assistance Strategy
CCP	Chinese Communist Party
CFAA	Country Financial Accountability Assessment
CNAO	China National Audit Office
DOF	Department of Finance
DPF	Development Policy Financing
DRC	Development and Reform Commission
DSA	Debt Sustainability Analysis
FAI	Fixed Asset Investment
FYP	Five Year Plan
GDP	Gross Domestic Product
GRS	Grievance Redress Service
HPFD	Hunan Provincial Finance Department
IBRD	International Bank for Reconstruction and Development
IFC	International Finance Corporation
IMF	International Monetary Fund
IPO	Initial Public Offering
JSAN	Joint Staff Advisory Note
LDP	Letter of Development Policy
LGFVs	Local Government Financing Vehicles
MDGs	Millennium Development Goals
MOF	Ministry of Finance
MTEF	Medium-Term Expenditure Framework
MTFS	Medium-Term Fiscal Strategy
NDRC	National Development and Reform Commission
NPC	National People's Congress
NPL	Non-performing Loan
OECD	Organization for Economic Cooperation and Development
PBOC	People's Bank of China
PBSOE	Public Benefit State Owned Enterprise

PEFA	Public Expenditure and Financial Accountability
PER	Public Expenditure Review
PFM	Public Financial Management
PPP	Public Private Partnership
SDR	Special Drawing Rights
SPV	Special Purpose Vehicle
TSA	Treasury Single Account
UDICs	Urban Development Investment Corporations
UNDP	United Nations Development Program
WBG	World Bank Group

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**CHINA**  
**HUNAN FISCAL SUSTAINABILITY DPF**

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**SUMMARY OF PROPOSED LOAN AND PROGRAM**

**PEOPLE'S REPUBLIC OF CHINA  
HUNAN FISCAL SUSTAINABILITY DPF PROGRAM**

Borrower	People's Republic of China
Implementing Agency	Hunan Province Finance Department
Financing Data	IBRD Loan Amount: US\$200 million Terms: 24-year maturity and 5-year grace period
Operation Type	Single tranche development policy operation
Pillars of the Operation And Program Development Objective(s)	This First Hunan Fiscal Sustainability Development Policy Financing supports the Hunan Provincial Government to achieve fiscal sustainability by developing a forward-looking, comprehensive and transparent public finance framework 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 Government Debt; and (d) Transparency.
Results Indicators	<p><b>A: Develop and employ a medium term fiscal / debt sustainability framework and budget for managing risks and achieving fiscal sustainability for Hunan Province</b></p> <p>A1: Share of Hunan Provincial Government public liabilities in Province GDP (Baseline: 14.1% in 2015; Target: &lt; 15% in 2016)</p> <p><b>B: Develop an integrated approach to capital budgeting to improve efficiency</b></p> <p>B1: Number of sectors covered in the integrated capital financing plan of Hunan Province (Baseline: 1 in 2015; Target: 3 in 2016)</p> <p>B2: Interagency Committee issues opinions on the Medium Term Fiscal Strategy and Three-Year Rolling Capital Financing Plan for Transportation, Water/Irrigation, and Social Housing for 2016-2018 (Baseline: Not applicable in 2015; Target: Opinions issued in 2016)</p> <p><b>C: Develop an effective system at the provincial level of government to monitor the financial health of local governments and incentivize them to pursue prudent debt management</b></p> <p>C1: Share of local governments satisfying annual disclosure of debt data online and fund use plans for new borrowing (Baseline: 0% in 2015; Target: &gt;40% in 2017)</p> <p>C2: Share of local governments classified as "red" for more than one year having not submitted a risk mitigation action plan to restore financial health (Baseline: 100% in 2015; Target: &lt;40% in 2017)</p> <p><b>D: Enhance transparency and accountability in the use of budget resources</b></p> <p>D1: Biannual comprehensive debt reports on the internet with less than four month lag</p>

	<p>from end-June 2016, end-December 2016 and end-June 2017  <u>(Baseline: 0 in 2015; Target: 3 reports on line on time by October 2017)</u></p> <p>D2: Number of local governments in Hunan Province having disclosed all debt and financial information in the template on the internet platform  (Baseline: 0 in 2015; Target: 10 in 2017)</p> <p>D3: Number of citizens' budget reports and budget performance reports disclosed online less than 6 months from year-end  (Baseline: No in 2015; Target: 2 reports on line on time by October 2017)</p>
Overall risk rating	Substantial
Climate and disaster risks	Not applicable
Operation ID	P157406

**IBRD PROGRAM DOCUMENT FOR A  
PROPOSED HUNAN FISCAL SUSTAINABILITY DPF  
TO  
THE PEOPLE’S REPUBLIC OF CHINA**

**1. INTRODUCTION AND COUNTRY CONTEXT**

1. **This single tranche stand-alone development policy financing (DPF) for the equivalent of US\$ 200 million supports the Hunan Provincial Government’s program focused on: (a) putting provincial finances on a fiscally sustainable path; (b) improving the efficiency and comprehensiveness of public investment planning; (c) better monitoring and regulating debt management of local governments in the Province; and (d) promoting transparency.** Hunan Province has long been a leader among Chinese provinces in reform, and is now piloting a program that could become a model of budget reform for other provinces in China.

2. **China is now a high middle-income country, and well positioned to become a high income country in the next decade.** The country’s economic transformation over the past three decades has raised living standards and made China the world’s largest manufacturer and exporter. Real per capita incomes increased 16 times over 1978–2014, and more than 750 million people have been lifted out of poverty. All Millennium Development goals have either been reached or are within reach.

3. **China’s exceptionally rapid growth and development in recent decades has served the country well, but can also be associated with economic, environmental and social imbalances.** China’s leadership recognizes that the transition to a high income country requires a qualitatively new growth strategy that is more balanced, based on productivity increases and innovation, as opposed to the mobilization of resources and cheap unskilled labor. Growth also needs to become more inclusive and environmentally sustainable.

4. **China’s growth has gradually slowed in this period of transition, signaling what President Xi Jinping has called the “new normal.”** Growth has moderated from the 10 percent average annual rate that China experienced for three consecutive decades, falling to 7.7 percent in 2013, 7.3 percent in 2014, and 6.9 percent in 2015. Against this backdrop, China’s economy is steadily rebalancing toward more consumption-led growth concentrated in the service sector.

5. **While growth in China still remains high by international standards, macroeconomic risks have increased, including in the form of rapidly rising debt.** To stimulate economic growth since the global financial crisis of 2008, subnational governments in China rapidly accumulated debt. 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 local government financing vehicles (LGFVs, mostly Urban Development Investment Corporations (UDICs)) that carried out public investments. Local governments effectively collateralized borrowing through LGFVs with land lease revenues. In recent years, a number of local governments have begun to experience financial difficulties due to this rapid build-up in LGFV debt against the backdrop of an economic slowdown, declining marginal returns from investment, and weaker land markets.

6. **The Chinese Government has recognized the seriousness of this problem, and has introduced a major reform in 2014 to bring subnational debt under control and reorient subnational officials and budgetary institutions toward fiscal / debt sustainability.** 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. Going forward, the reform prevents local governments from acquiring additional debt or issuing guarantees through LGFVs. At the same time, subnational governments have been granted the right to borrow explicitly through bond issues, albeit within strict limits. A bond swap program is addressing the stock problem of accumulated legacy debt in the LGFVs.

7. **Hunan Province and Chongqing Municipality were chosen as regions to pilot World Bank development policy financing operations focused on budget reforms to achieve fiscal sustainability at the subnational level.** The Chinese Government selected Chongqing and Hunan as the pilot regions for World Bank development policy operations for a number of reasons, including the strong reformist orientation of the municipal (provincial) leaderships and the strong demand in those regions for cooperation with the World Bank to accelerate reforms. To the degree that these initial subnational development policy financings are successful, they may be used subsequently as models for other regions in China. Important differences in context between the two pilot programs supported a decision to launch two separate operations. This particularly concerns differences between provincial-level finance in Hunan and district-level finance that is highlighted in the Chongqing operation.

8. **Hunan is a province of 67.4 million people (equivalent to the size of France), covering an area of 211.8 thousand square kilometers.** Hunan Province consists of 14 prefectural cities and 122 counties, with Changsha as its capital city. The Province Government directly supervises the public finance and debt management of all prefectural cities and counties. Despite high economic growth in the last decade at an annual rate of 12.6 percent, Hunan's GDP per capita is still only 86.5 percent of the China national average, and 6.4 million residents were estimated as living below the poverty line as of 2013.

9. **This World Bank Development Policy Financing for US\$ 200 million will assist the Hunan Province Government realize reforms to place its public finances on a sustainable path.** This includes the development of tools for debt / fiscal sustainability, a new integrated approach to medium-term capital budgeting, and improvements in the provincial-level monitoring and regulation of the financial health of local governments. The expectation is that Hunan can provide a model in China for subnational fiscal reform that can be scaled up to other provinces.

10. **This Development Policy Financing will support budget reform in Hunan Province in two primary ways:** (i) it will assist the Provincial Government directly in restructuring its budgets and capital investment plans toward fiscal sustainability and increased efficiency; (ii) it will support innovative approaches already underway in Hunan Province to use the new provincial allocation authority over new borrowing and debt swaps to incentivize local governments toward reforms and the disclosure of key information. The DPF program is strongly consistent with the current budget reform that includes the development of medium term budgetary plans, three-year rolling budgets, and an early warning system. Yet, as a pilot region, Hunan Province will go well beyond the current provisions of the budget reform in anchoring its policies to a comprehensive fiscal sustainability framework that accounts for contingent liabilities and risks from public investments involving state-owned enterprises, SPVs, or PPPs. The system being developed in Hunan Province to improve monitoring and regulation of local governments through incentivizing local officials is also novel. Finally, Hunan is setting standards in two other important areas: (i) a more integrated approach to capital budgeting and (ii) transparency (disclosure). Under the DPF program, Hunan Province will be afforded the opportunity to accelerate reforms in all of these areas, and solidify its status as a leader of fiscal reform in China.

11. **Several possible forms of assistance were discussed with the Chinese Government and Hunan Province before deciding on development policy financing.** The World Bank has already engaged at the subnational level in China on budgetary reforms through technical assistance in Shanghai. The Chinese Government and World Bank agreed that a Development Policy Financing would be an appropriate vehicle for a deeper engagement for two primary reasons. First, experience in other countries such as Brazil and Nigeria with development financing suggests that a DPF can be an effective instrument for World Bank support to a comprehensive policy / reform program consistent with fiscal sustainability at the subnational level that goes beyond a technical assistance program. As evidenced by the substance of this operation, the DPF has indeed provided a framework for a new level of World Bank engagement at the subnational level in China. A structured program built around prior actions and results indicators has served to focus energies and World Bank assistance on common ambitious objectives. Second, the deeper subnational engagement supported by this operation, as well as the simultaneous pilot in Chongqing Municipality, should also enable the Bank to expand its cooperation with the Central Government and other subnational governments in the areas of budget reform and fiscal sustainability.

12. **A multi-tranche operation was also considered.** Given that this operation supports institutional reforms that will take time to be realized, a programmatic engagement was naturally discussed. The Chinese Government decided that it would prefer to evaluate the results from this first DPF before considering options for further support which could be to Hunan or for expanding the program to other provinces. While this operation is a stand-alone single tranche operation, it is envisioned that cooperation between the World Bank and Hunan Province will continue beyond the initial DPF in one form or another.

13. **This operation is ambitious and will need to tackle significant implementation risks.** First, successful reform implementation requires close cooperation and the support of multiple ministries, particularly the Finance Department in charge of the budget, and the Development and Reform Commission (DRC) in charge of the investment plan and economic development targets. Given this DPF is the first conducted in China, there is limited experience to build on. The institutional changes envisioned in this operation require significant capacity building. Uncertainty over the future macroeconomic situation in China and the budget reform are other sources of risk. The determination of the Hunan Government to succeed, along with World Bank technical assistance, is the most important mitigating factor for these risks.

## 2. MACROECONOMIC POLICY FRAMEWORK

### 2.1 RECENT ECONOMIC DEVELOPMENTS IN CHINA

14. **China's economic growth has continued to moderate.** During the recent 12<sup>th</sup> Five Year Plan (FYP), GDP expanded by 7.8 percent per year on average, as compared to the 10 percent annual average growth rate that China experienced for three consecutive decades. Growth in 2016 is projected to be about 6.7 percent, in line with the government's indicative growth interval of 6.5 to 7.0 percent, but down from 6.9 percent in the previous year.

15. **The deceleration of growth reflects weaknesses in traditional industrial activity, as China rebalances to more service-oriented growth.** Excess capacity in manufacturing has been a drag on growth and investment across a wide range of sectors. The producer price index turned negative in 2014 and continued to decline until very recently, reflecting both lower commodity prices and considerable industrial overcapacity. At the same time, healthy growth of consumer spending and services has helped China maintain still strong growth rates, and is in line with the rebalancing sought by policymakers. The service sector continues to experience rapid growth of over 8 percent in recent years.

16. **Despite the deceleration of GDP, employment and income have exhibited robust growth.** More than 13 million new urban jobs were created in 2015, exceeding the 10 million annual target. Moreover, household real disposable income per capita grew by 7.4 percent. The World Bank poverty estimate for 2013 is 1.9 percent of the population, and it appears that the rate has fallen further in more recent years.<sup>1</sup>

17. **In the context of rebalancing, China's current account surplus has narrowed considerably, but strengthened again in 2015.** China's current account exhibited a surplus of 2.7 percent of GDP in 2015, which is much less than 10 percent of GDP in 2007, but stronger than 2 percent of GDP in 2013 and 2014. Weaker export and stronger import growth narrowed China's current account in recent years. In 2015, weaker commodity prices contributed to exceptionally low import growth, thus strengthening the trade balance and the current account. Exports declined by 2.9 percent in US\$ value terms, but imports fell by 14.2 percent.

18. **Despite a record trade surplus, significant capital outflows pushed China's external balance into deficit in 2015 and early 2016.** Gross capital outflows (excluding foreign direct investment) from China reached an estimated US\$ 760 billion in 2015, and significant outflows continued into early 2016. Consequently, despite the strong current account, gross foreign exchange reserves declined by US\$ 513 billion (20 percent) in 2015 and another US\$ 125 billion in the first half of 2016.

19. **Much of the recent strong capital outflows from China can be explained by temporary factors.** The real appreciation of the RMB attracted significant short term capital inflows to China through early 2014. Given that such real appreciation is no longer expected, much of this speculative capital left the country, in part through Chinese banks winding down their foreign exchange exposure. Second, uncertainty in markets around exchange rate policy in light of a depreciation of the RMB against the US dollar in the second half of 2015 encouraged some investors to reduce their exposure to RMB. Chinese authorities have moved away from the dollar to a trade-weighted basket of currencies for orienting exchange rate policy. While the RMB depreciated by 7 percent against the US dollar in the second half of 2015, it remained broadly stable against the relevant basket of currencies. Clearer communication from Chinese authorities on exchange rate policy has helped reduce volatility on the forex market and capital outflows may be stabilizing. This is reflected in a stabilization of China's gross foreign reserve position since the second quarter of 2016.

20. **Macroeconomic policy loosened in 2015 and early 2016 in an effort to prevent too rapid an economic slowdown.** The People's Bank of China (PBOC) continued to lower benchmark interest rates and required reserve ratios, while implementing new policies to facilitate refinancing for commercial banks. The fiscal deficit of the Government widened to a six-year high in 2015 of 2.3 percent of GDP (3.5 percent on a cash basis). This partly reflects accelerated infrastructure investment by the Central Government in the second half of the year to offset cutbacks by local governments related to falling land-lease revenues and new restrictions on off-budgetary investments imposed by the budget reform.

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<sup>1</sup> This estimate uses the new World Bank poverty line of US\$ 1.90/day and the new purchasing power parity exchange rates based on 2011 prices.

**Table 1: China / Selected Economic and Social Indicators, Projections 2013-2018**

	2013	2014	2015	2016 f	2017 f	2018 f
Real GDP Growth, at constant market prices	7.8	7.3	6.9	6.7	6.5	6.3
Private Consumption	6.8	7.9	7.6	7.5	7.4	7.3
Government Consumption	7.1	6.9	7.9	8.0	8.2	8.3
Gross Fixed Capital Investment	9.3	6.9	6.9	6.5	6.1	5.6
Net Exports (contribution to annual growth in percent)	-0.4	0.1	-0.1	-0.3	-0.4	-0.4
Export, Goods and Services	4.0	5.4	-2.0	1.2	2.3	3.0
Import, Goods and Services	4.6	4.0	-1.3	2.1	3.3	4.1
Real GDP Growth, at constant factor prices	7.8	7.3	6.9	6.7	6.5	6.3
Agriculture	3.8	4.1	3.9	3.7	3.6	3.5
Industry	8.0	7.4	6.1	5.8	5.5	5.2
Services	8.2	7.7	8.4	8.0	8.0	7.9
Consumer Prices (Consumer Price Index)	2.6	2.0	1.4	1.8	2.0	2.1
Aggregate Financing (growth)	17.5	14.3	14.0	...	...	...
Aggregate Financing (% of GDP)	182.7	193.2	204.1	...	...	...
Employment and Poverty						
Unemployment Rate	4.1	4.1	4.1	...	...	...
Poverty Line \$1.90 a day	1.9	1.5	1.1	0.8	0.6	0.5
Poverty Line \$3.10 a day	11.1	9.5	7.7	6.2	5.0	3.9
Balance of Payments (% of GDP)						
Current Account Balance	1.5	2.6	3.0	3.0	3.1	3.3
Financial and Capital Account	-0.9	-1.6	-1.6	-1.7	-1.9	-2.0
Net Foreign Direct Investment	2.3	1.4	1.4	1.4	1.3	1.3
Gross External Debt	9.0	8.5	12.9	...	...	...
Public Sector Finance (% of GDP)						
Fiscal Balance	-2.0	-2.1	-2.4	-3.0	-3.3	-3.3
Government Direct Debt	...	38.8	38.9	...	...	...
Real Effective Exchange Rate (end of period, annual growth in percent)	7.6	6.1	3.8	...	...	...

Sources: CEIC, Wind and World Bank staff estimates and projections

21. **Growth in aggregate financing—a broad measure of outstanding credit to the non-government sector—increased in the second half of 2015 and early 2016, reversing a recent trend of deceleration.** This has stimulated activity in the short-term, but arguably delayed the needed deleveraging of highly-indebted entities. Aggregate financing growth in 2015 registered at 14 percent, still well above nominal GDP growth, and is planned for 13 percent in 2016. Growth in aggregate financing accelerated to an estimated 13.4 percent in the first quarter of 2016 year on year. Credit to the non-government sector to GDP is now well over 200 percent of GDP, which is high by international comparisons. Government debt has also grown very quickly over the past decade. Consolidated direct government debt stood at 39.4 percent of GDP at the end of 2015.<sup>2</sup> Even adding contingent liabilities emanating from public-investment

<sup>2</sup> Using the latest revised GDP number by National Bureau of Statistics, the direct government debt to GDP ratio would be lowered to 38.9 percent.

related corporate liabilities, government debt to GDP is still not that high by international standards. However, the continued rapid expansion in credit is increasing macroeconomic risks in China.

## 2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY IN CHINA

22. **China's GDP growth rate should continue a gradual decline in the medium-term in the context of structural adjustments and policy efforts to address accumulated vulnerabilities (Table 1).** Growth is expected to decelerate to 6.7 percent per year in 2016. The average annual growth rate during the 13<sup>th</sup> Five Year Plan period (2016-2020) is projected to be about 6.5 percent. The rebalancing toward domestic demand will continue. Investment growth is expected to moderate from current very high levels, while consumption and employment growth will remain robust. On the supply side, the shift from capital and resource-intensive industries to services will continue, facilitated by policies to ease business regulations in the services sector and rationalize excess capacity in industrial sectors. Growth in services is expected to outpace that in manufacturing and contribute to more than half of GDP growth by 2020.

23. **There is considerable uncertainty around the baseline projections for China's economy.** First, a more rapid deceleration in economic growth is a distinct possibility. Second, risks from the credit expansion could potentially manifest themselves in some future financial instability. This could accelerate the slowdown in investment and the tightening of credit conditions, thus negatively affecting growth and rebalancing. The pace of reforms and policies in China to support economic rebalancing and bring the credit expansion under control will be important for mitigating these risks.

24. **China is confident that it still has significant buffers for conducting active macroeconomic policy.** These buffers include public debt at still less than 60 percent of GDP and gross foreign exchange reserves of US\$ 3.2 trillion at end-March 2016. However, these buffers could diminish over time, thereby increasing macroeconomic risks and reducing the degrees of freedom for policymakers.

25. **A debt sustainability analysis (DSA) conducted for China in 2016 by the IMF concluded that the risk of debt distress is low, given China's macroeconomic strength and favorable debt profile, although public debt according to a broad definition is on a rising path.** The IMF employs a broad measure that includes central government debt, debts of subnational governments, and the estimated debts of local government financing vehicles<sup>3</sup>. It is roughly equivalent to the concept of "government debt plus public benefit state owned enterprises' (PBSOEs) liabilities" used in section 2.3 below for the subnational debt sustainability analysis. It should be noted that this measure represents an upper bound for fiscal obligations of the government. Some of these contingent liabilities will likely not end up as government obligations. The focus on gross debt also ignores the fact that government in China has considerable state assets and sizeable equity holdings, many of which are listed on domestic and international stock exchanges.

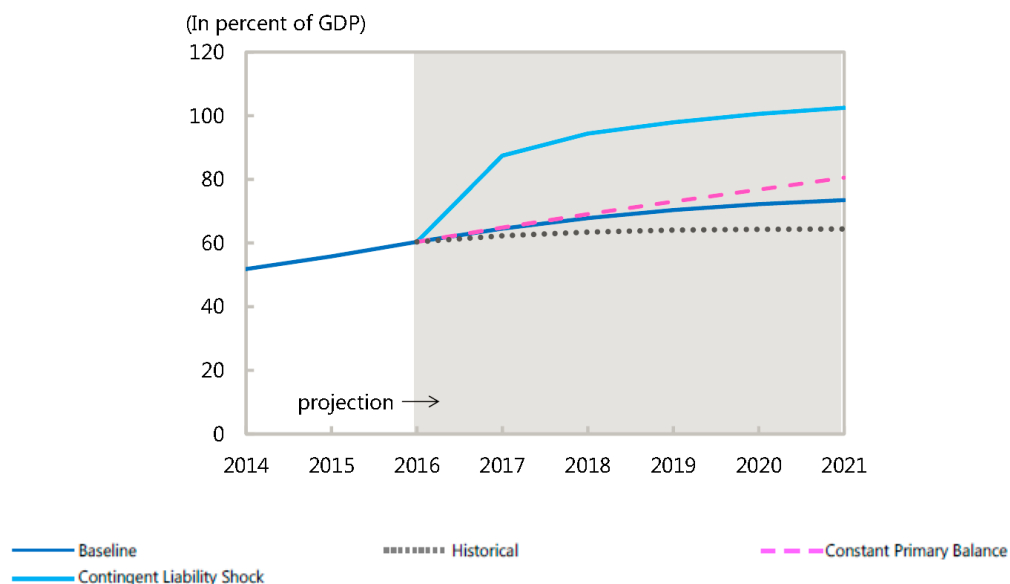
26. **In the baseline scenario, the IMF estimates that broadly-defined public debt is on a slightly rising path, and a contingent liability shock could adversely affect the picture.** The baseline scenario in the IMF debt sustainability analysis has annual GDP growth gradually declining and converging to about 6.0 percent in 2021. Growth in expenditures at the subnational level also gradually declines along with the implementation of the budget reform, thereby generating smaller deficits. In the baseline scenario, public sector debt edges upward from 55 percent of GDP in 2015 to 74 percent in 2020. The DSA found that

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<sup>3</sup> This IMF measure is controversial and not accepted by the Chinese government. Assessing the true implied contingent obligations for government from public investment related debts held by local government financing vehicles remains difficult.

these results are generally robust to small shocks to GDP growth, but a contingent liability shock that envisages 10 percent of banking sector assets becoming government liabilities, would push public debt almost as high as 100 percent of GDP by 2020 (Figure 1).

**Figure 1: IMF Debt Sustainability Analysis of Broadly Measured Public Sector Debt: 2016**



Source: IMF Country Report No. 16/270, 2016

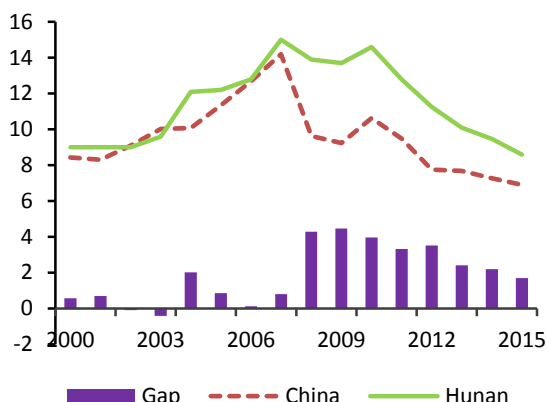
27. **On the basis of the above discussion, China’s macroeconomic policy framework is deemed adequate for the operation.** China has been conducting largely responsible fiscal and monetary policies. The upper bound on government obligations remains within a manageable range under baseline and stress tests. China’s overall debt profile is also favorable, as the vast majority of public debt is financed through a domestic investor base in the national currency. Over the medium and longer term, China will need to give attention to keeping debt in a manageable range, particularly given that non-government debt is quite high.

## 2.3 THE SUBNATIONAL CONTEXT

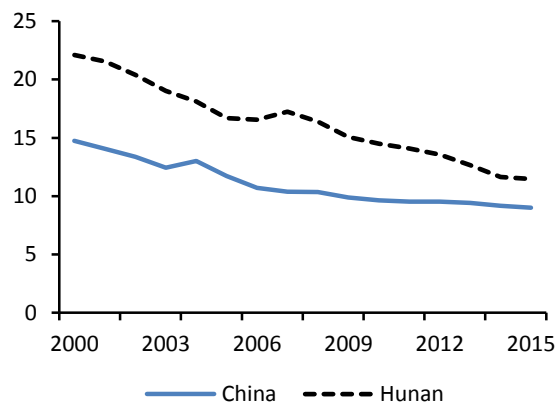
### 2.3.1 Recent Economic Developments in Hunan Province

28. **Hunan Province has grown very rapidly in recent years, with an average GDP growth rate of 10.4 percent in 2011-2015.** Hunan Province has a GDP of 2.9 trillion RMB (2015) and a population of 67.4 million (2014), with GDP per capita slightly below the Chinese average. Decomposing GDP by production sector, 44 percent of Hunan GDP (2015) is generated by the tertiary sector, making Hunan somewhat more reliant on agriculture and manufacturing than China as a whole. Economic growth in Hunan Province has been considerably higher than average in China in recent years, although it has been slowing and converging to this average since 2012 (Figure 2). A primary source of growth in Hunan Province has been a structural shift away from agriculture towards manufacturing and services. In this process, the share of agriculture in GDP has also been converging to the China average (Figure 3).

**Figure 2: Real GDP Growth in Hunan Province (%)**



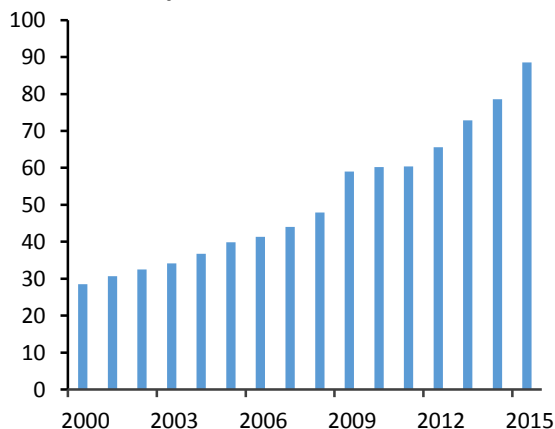
**Figure 3: Primary Sector Share of GDP in Hunan Province (%)**



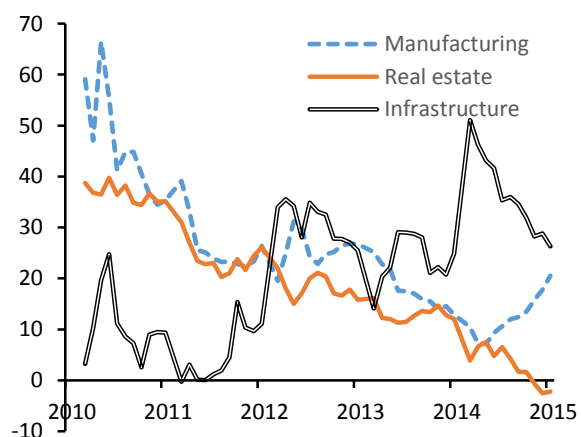
Source: staff calculation based on CEIC database.

29. **Hunan’s recent growth performance has been supported by a rapid increase in investment and credit activity.** Gross fixed capital formation makes up 58 percent of GDP (2014), compared to an already high 46 percent for China as a whole (2014). Fixed asset investment, a broad measure of investment that includes land leases and purchases of used capital, increased rapidly from 58 percent of regional GDP in 2011 to 89 percent in 2015 (Figure 4). Infrastructure investment grew particularly rapidly, which helped offset the weak domestic demand related to slowing real estate investment (Figure 5).

**Figure 4: Fixed Asset Investment in Hunan Province, as a percent of Province GDP**



**Figure 5: Fixed Asset Investment by Sector in Hunan Province, year-over-year growth (%)**



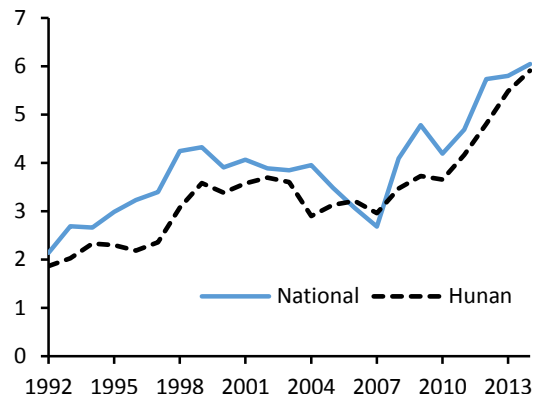
Source: staff calculation based on WIND database; Hunan Statistic Yearbook 2015

30. **A rapid credit expansion and rising incremental capital-output ratio mirror the recent acceleration of infrastructure investment growth in Hunan Province.** Both bank and non-bank credit accelerated sharply in recent years (Figure 6). Much of this credit has financed the expansion of investment. Increasing indebtedness (see below) and a rising incremental capital-output ratio (Figure 7) speak for growing risks in sustaining this investment-intensive model of growth. These trends are similar to national trends for China as a whole.

**Figure 6: Credit to Hunan Province, as a percent of Province GDP**



**Figure 7: Incremental Capital Output Ratio in China and Hunan Province**



Source: staff calculation based on CEIC database

31. **Overall, Hunan’s GDP growth is expected to continue converging towards the national trend as the Province undergoes its structural transformation.** The exceptionally rapid economic expansion from catch-up productivity growth and investment should continue to moderate, and consumption will need to play a larger role as a driver of growth in Hunan Province. There is a good base for the strong expansion of consumer demand. In urban areas, household real disposable income per capita grew by 8.5 percent in 2014, while in rural areas it grew by 12.5 percent. Unemployment remains stable at 4.2 percent of the active labor force. For the 13<sup>th</sup> 5-Year Plan, Hunan Authorities target annual average GDP growth of 8.5 percent.

### 2.3.2 Hunan Province Debt and Fiscal Sustainability

32. **The assessment of debt sustainability at the subnational level in China is complicated by the close relationship between government finance and corporations involved in public investment.** By identifying LGFV liabilities linked to financing of public investment and swapping these debts for subnational government bonds, the budget reform has helped enormously in clarifying the boundaries between government and market activities. Nevertheless, the transformation of the LGFVs into genuine commercial entities will take time. Most subnational governments are continuing to rely on public benefit state-owned enterprises (PBSOEs) for financing public investments, and typically support them through budget subsidies. Furthermore, going forward, Hunan and other Chinese provinces plan to expand the use of PPPs and SPVs for realizing public investments off budget. For this reason, the debt sustainability analysis in this section, as well as in the Medium Term Fiscal Strategy of Hunan Province, takes a broad approach that consolidates the finances of PBSOEs, PPPs, and SPVs related to public investment, together with explicit government budgets. It should be noted that the measure of public sector liabilities thus obtained likely exaggerates somewhat the true government debt situation in the province, as some of the commercial liabilities of PBSOEs, PPPs, and SPVs will likely not become liabilities for the government. In what follows, “direct government debt” refers to debts currently recognized as the sole liability of governments and “public sector liabilities” refers to the broader measure.



### **Box 1: Government Debt and Non-Government LGFV Debt in China**

Until 2015, subnational governments in China were not allowed to borrow themselves, and instead set up local government financing vehicles (LGFVs, mostly UDICs) to borrow for public projects with implicit government guarantees effectively collateralized by future expected land revenues. LGFVs typically finance themselves from budget transfers (often land revenues) and implement public projects. For the implementation of the budget reform, the Chinese Government carried out an inventory of the LGFV debt stock in 2014. Debts incurred for public projects without expected revenue sources were categorized as direct government debt. Other debts in the LGFVs were usually categorized as commercial (non-government) debt. In light of the budget reform of 2015 that prohibits governments from borrowing through corporate entities, LGFVs are to be dissolved or transformed into state owned enterprises (SOEs). All debts incurred by these firms since 2015 are categorized officially as strictly “commercial (non-government) debt” with no official repayment obligations for government. The successors of LGFVs that play a significant role in providing public benefit goods and services are recognized as public benefit SOEs (PBSOEs). They have continued to be very active in public projects in 2015 and early 2016, and have continued to borrow significantly. While this borrowing is no longer officially considered the liability or contingent liability of government, the fact that the finances of government and PBSOEs in many localities remain intertwined in complicated ways implies remaining risks. This is why the Hunan Provincial Government has taken a prudent approach to analyzing sustainability of its financial health that includes both government debt and all liabilities of the PBSOEs.

33. **Debts related to government finance in Hunan Province can be associated with the Provincial Government and 136 local governments.** The direct government debt of Hunan Province as a whole reached 613.3 billion RMB at end-2015 (21.1 percent of GDP), and the public liabilities totaled 1200.6 billion RMB (44.4 percent of GDP) in 2014. Given the currently dispersed nature of information on public investment activities in local governments, the public liabilities of Hunan Province at end-2015 needed to be estimated based on limited data. An estimate for total financing needs for public investment in 2015 was constructed from data on fixed asset investment in major infrastructure sectors and gross capital formation. Public liabilities were then projected based on the implied debt dynamics. Using this approach, public liabilities appear to have continued very rapid growth in Hunan Province in 2015, reaching 48.1 percent of GDP by the end of the year. Data on changes in PBSOE balance sheets are also consistent with this estimate.

34. **The pace of public investment growth in Hunan Province will need to slow down to achieve fiscal sustainability.** Table 2 below presents a debt sustainability scenario for consolidated public finance in Hunan Province under the assumption of a gradual slowdown of real GDP growth to 7.3 percent on average during 2016-2020 and 6.4 percent in 2021-2025, while the GDP deflator gradually recovers from current deflation and grows again at 1.5 percent in 2021-2025. Revenues and expenditures other than investment are assumed to grow at rates close to GDP. In the scenario for Table 2, public investment continues to grow, but at a much slower pace: its share in GDP will gradually decline from an estimated 12 percent in 2015 to 7.6 percent by 2025, a level still high by international standards. As can be seen in Table 2, under these assumptions, estimated public liabilities continue to grow as a share of GDP, but gradually stabilize at around 63 percent of GDP by 2025. This suggests that the objective of fiscal sustainability in Hunan Province will require phasing out public investment-driven stimulus policies in the near future. Keeping public investment above 10 percent of GDP under the assumptions in this scenario would not be consistent with debt sustainability.

**Table 2: Hunan Province Consolidated Debt Sustainability (Government and Public Service SOEs) Simulation, billion RMB**

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
	(Actual)		(Budget)				(Projection)					
<b>Annual net change in public liabilities [-A+B+C]</b>	<b>198.5</b>	<b>228.9</b>		<b>235.4</b>	<b>241.3</b>	<b>246.4</b>	<b>250.0</b>	<b>253.0</b>	<b>255.3</b>	<b>257.0</b>	<b>260.1</b>	<b>262.4</b>
<i>% change rel. to previous year</i>		16.5	16.4	14.5	12.9	11.7	10.6	9.7	8.9	8.3	7.7	7.2
<b>(A) Fiscal primary balance [I+II]</b>	<b>-62.1</b>	<b>-126.1</b>	<b>-141.1</b>	<b>-136.6</b>	<b>-131.0</b>	<b>-124.1</b>	<b>-115.5</b>	<b>-106.1</b>	<b>-96.0</b>	<b>-85.3</b>	<b>-73.9</b>	<b>-61.9</b>
(I) Budget primary balance (/1)	17.4	-2.2	-10.9	-11.2	-13.6	-16.3	-19.5	-23.2	-27.3	-32.0	-37.2	-43.2
(II) Estimated Off-budget primary balance	-79.5	-123.8	-130.2	-125.3	-117.5	-107.8	-95.9	-82.9	-68.7	-53.3	-36.6	-18.7
(+) Estimated transfers from budget (/2)	220.3	225.1	229.2	244.8	263.8	284.9	308.6	333.7	360.4	388.7	418.6	450.2
(-) Estimate of public investment (/3)	299.9	348.9	359.4	370.2	381.3	392.7	404.5	416.6	429.1	442.0	455.3	468.9
% growth		16.4	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
<b>(B) Interest</b>		<b>68.6</b>	<b>78.6</b>	<b>90.2</b>	<b>102.4</b>	<b>115.5</b>	<b>129.0</b>	<b>143.0</b>	<b>157.3</b>	<b>171.7</b>	<b>186.2</b>	<b>200.5</b>
(+) Direct Government debt		31.3	30.9	30.9	31.1	31.9	32.9	34.4	36.3	38.4	40.8	43.2
(+) Other public liabilities		37.3	47.8	59.3	71.3	83.6	96.1	108.5	121.0	133.3	145.4	157.3
<b>(C) Change in carry-over (/4)</b>		<b>3.7</b>	<b>9.2</b>	<b>8.6</b>	<b>7.8</b>	<b>6.8</b>	<b>5.5</b>	<b>3.9</b>	<b>1.9</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>
<b>Memo:</b>												
<b>Real GDP Growth</b>	9.5	8.6	8.0	7.6	7.3	7.0	6.8	6.7	6.5	6.4	6.2	6.1
<b>GDP Deflator Growth</b>	0.9	-1.2	-0.5	0.0	0.5	1.0	1.5	1.5	1.5	1.5	1.5	1.5
<b>Nominal GDP Growth</b>	10.4	7.4	7.5	7.6	7.8	8.0	8.3	8.2	8.0	7.9	7.7	7.6
<b>Estimated stock of public liabilities (/5)</b>	<b>1200.6</b>	<b>1399.0</b>	<b>1628.0</b>	<b>1863.4</b>	<b>2104.6</b>	<b>2351.1</b>	<b>2601.1</b>	<b>2854.0</b>	<b>3109.3</b>	<b>3366.3</b>	<b>3626.4</b>	<b>3888.8</b>
<i>% of GDP</i>	44.4	48.1	52.1	55.4	58.1	60.1	61.4	62.3	62.8	63.1	63.1	62.9

(/1) Budget primary balance excludes budget net borrowing & change in carry-over; includes the Social Security Funds balance

(/2) Estimated transfers based on discussions with Provincial Government staff

(/3) Public investment calibrated using FAI infrastructure investment data

(/4) Change in carry-over includes stabilization fund and segregated SSF carry-over

(/5) Public liabilities calibrated to 2014 reported total government debt

Source: staff projections

### 2.3.3 Hunan Provincial Government Debt and Fiscal Sustainability

35. **High public investment has led to the accumulation of significant liabilities at the level of the Hunan Provincial Government.** This reflects the historical high concentration of transport investment responsibilities of the Provincial Government. The Provincial Government carried out significant public investment projects in recent years through its UDICs concentrated in motorways, trunk roads, and railroads. Much of the motorways investment has been financed by debt in the expectation of future toll revenues from the new roads. Even with these expected toll revenues, the rapid accumulation of debt at the provincial level of government in the context of rather low revenues presents a particular challenge for achieving debt sustainability. The Hunan Provincial Government has analyzed the situation and is now carrying out an ambitious program aimed at fiscal sustainability that is supported by this operation.

36. **Hunan Province takes a prudent approach to debt sustainability that considers both government and provincial-level PBSOE liabilities related to public investment.** As is the case elsewhere in China, the finances of the Hunan Provincial government remain closely intertwined with those of its PBSOEs. Correspondingly, Hunan Province is gearing its Medium Term Strategy toward achieving the sustainability of both government and PBSOEs' public service finances.

37. **The Provincial Government of Hunan held direct government debt of 79.1 billion at end-2015.** This represents 2.7 percent of Province GDP or 20.5 percent of Provincial budget revenues. Public liabilities, including public investment-related liabilities of the PBSOEs, are estimated to have reached 409.8 billion RMB at end-2015 (14.1 percent of GDP). Of these public liabilities, more than half are held by the provincial-level motorway UDIC (M-UDIC). As of 2015, the responsibility for trunk roads was delegated to the local governments along with an increase in earmarked transfers from the Province.

38. **The Provincial Government continued a fiscal expansion in 2015, leading to an estimated 17.6 percent nominal increase in its public liabilities.** Large public investments from the three provincial level UDICs (PBSOEs) were responsible for this increase: M-UDIC carried out additional RMB 30.7 billion in investment in the motorway network (including over 3 billion in operating expenses), while toll revenues reached 9.9 billion. R-UDIC invested 5.8 billion in the railway network, while T-UDIC (trunk roads) incurred additional expenditures winding down its Provincial-Government level operations. Besides these three major infrastructure sectors, other significant expenditure items included airport and waterways investment. In addition, the budget alone generated net financing needs of 16.2 billion (before interest). Interest expenditures on the public liabilities of the Hunan Provincial Government are estimated to have reached 20.4 billion in 2015. Overall, provincial-level public liabilities are estimated to have increased from 348.6 billion in 2014 to 409.8 billion at end-2015.

39. **Recognizing the unsustainability of recent investment growth, the Provincial Government has developed a new Medium Term Fiscal Strategy for placing its finances on a fiscally sustainable path.** First, this program freezes the financing of public investment of the provincial government at its 2015 level. Given the small size of Provincial Government expenditures relative to the Province as a whole, as well as declining marginal returns from investment in transportation, the growth impact of this fiscal consolidation itself is judged to be limited. Second, the Hunan Provincial Government will increase the efficiency of its public expenditure budget, which consists almost entirely of civil service wages and operating costs, by growing ordinary expenditures at 1.8 percentage points below annual nominal GDP growth. This implies an average 6 percent nominal growth in 2016-2025. Third, transfers to local governments will be aligned to the level of transfers received by the Province from the Central Government (in contrast to the unusual year of 2015, when the Province transferred more revenues than it received from the Central Government). Fourth, the Province will aim to push forward reforms for the structural transformation of Hunan, ensuring economic growth and the growth of budget revenues. Fifth, the Provincial Government will also explore opportunities for early repayment of high interest rate loans, thereby reducing the Provincial Budget's debt burden.

40. **Under a baseline macroeconomic scenario, the Medium Term Fiscal Strategy program will gradually improve the provincial-level fiscal position** (Table 3). The baseline scenario assumes GDP growth slowing to 7.3 percent on average in 2016-2020 and 6.4 percent in 2021-2025, while the GDP deflator is expected to gradually recover from current deflation and grow again at 1.5 percent in 2021-2025. The projections also assume that transfers from Central Government to the Hunan Provincial Government will grow with GDP. In the short term, the Province will draw down on carry-over surplus funds accumulated in previous years to reduce the accumulation of interest-bearing liabilities.

**Table 3: Hunan Provincial-Level Debt Sustainability Under the Baseline Scenario, billion RMB**

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
	(Actual)	(Budget)	(Projection)								
<b>Annual net change in public liabilities (-A+B+C-D+E)</b>	<b>61.2</b>	<b>44.6</b>	<b>55.4</b>	<b>53.5</b>	<b>50.9</b>	<b>49.2</b>	<b>49.2</b>	<b>48.9</b>	<b>48.0</b>	<b>46.8</b>	<b>45.4</b>
<i>% change rel. to previous year</i>	17.6	10.9	12.2	10.5	9.0	8.0	7.4	6.9	6.3	5.8	5.3
<b>(A) Primary balance</b>	<b>-48.7</b>	<b>-36.9</b>	<b>-33.2</b>	<b>-28.9</b>	<b>-24.3</b>	<b>-20.5</b>	<b>-18.3</b>	<b>-15.8</b>	<b>-12.8</b>	<b>-9.5</b>	<b>-6.0</b>
<b>Fundamental Revenue Drivers</b>	<b>376.9</b>	<b>404.3</b>	<b>433.7</b>	<b>467.0</b>	<b>504.1</b>	<b>545.7</b>	<b>590.2</b>	<b>637.7</b>	<b>688.6</b>	<b>742.8</b>	<b>800.1</b>
Budget revenues (net of toll revenues and transfers)	69.8	72.0	77.1	82.6	88.8	95.6	103.0	110.9	119.4	128.5	138.3
Toll revenues	9.9	11.2	12.6	14.1	15.9	17.9	20.3	23.0	26.3	29.9	33.8
Transfers from Central Government	298.2	320.1	344.0	370.3	399.5	432.2	466.9	503.9	543.0	584.4	628.1
Delayed funds	-1.0	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Fundamental Expenditure Drivers</b>	<b>425.6</b>	<b>441.2</b>	<b>466.9</b>	<b>495.9</b>	<b>528.4</b>	<b>566.2</b>	<b>608.5</b>	<b>653.6</b>	<b>701.5</b>	<b>752.3</b>	<b>806.1</b>
Budget expenditures (net of transfers)	67.4	71.4	76.3	81.8	87.8	94.6	102.0	109.8	118.3	127.5	137.3
M-UDIC investment (/1)	30.7	30.8	31.0	31.2	31.4	31.5	31.7	31.9	32.0	32.2	32.4
R-UDIC investment	5.8	5.8	5.8	5.8	5.8	5.8	5.8	5.8	5.8	5.8	5.8
T-UDIC investment (/2)	7.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other investment	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2
Transfers to Local Governments	313.1	331.9	352.6	376.0	402.3	433.1	467.9	504.9	544.2	585.7	629.5
<b>(B) Interest expense</b>	<b>20.4</b>	<b>22.4</b>	<b>23.1</b>	<b>25.0</b>	<b>27.0</b>	<b>28.9</b>	<b>31.0</b>	<b>33.1</b>	<b>35.2</b>	<b>37.4</b>	<b>39.4</b>
<b>(C) Change in carry-over</b>	<b>-14.0</b>	<b>-6.3</b>	<b>-0.9</b>	<b>-0.4</b>	<b>-0.4</b>	<b>-0.2</b>	<b>-0.1</b>	<b>-0.1</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>
<b>(D) Delayed Debt Swap</b>	<b>-8.3</b>	<b>8.3</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>
<b>(E) Other</b>	<b>-2.2</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>
<b>Memo:</b>											
<b>Real GDP Growth</b>	8.6	8.0	7.6	7.3	7.0	6.8	6.7	6.5	6.4	6.2	6.1
<b>GDP Deflator Growth</b>	-1.2	-0.5	0.0	0.5	1.0	1.5	1.5	1.5	1.5	1.5	1.5
<b>Nominal GDP Growth</b>	7.4	7.5	7.6	7.8	8.0	8.3	8.2	8.0	7.9	7.7	7.6
<b>Stock of public liabilities</b>	<b>409.8</b>	<b>454.4</b>	<b>509.9</b>	<b>563.4</b>	<b>614.3</b>	<b>663.5</b>	<b>712.8</b>	<b>761.6</b>	<b>809.7</b>	<b>856.5</b>	<b>901.9</b>
<i>% of GDP</i>	14.1	14.5	15.2	15.6	15.7	15.7	15.6	15.4	15.2	14.9	14.6

(/1) M-UDIC operating expenditures are assumed to grow proportionally with the motorway network

(/2) T-UDIC 2015 cash outflows include repayment of payables

Source: staff projections

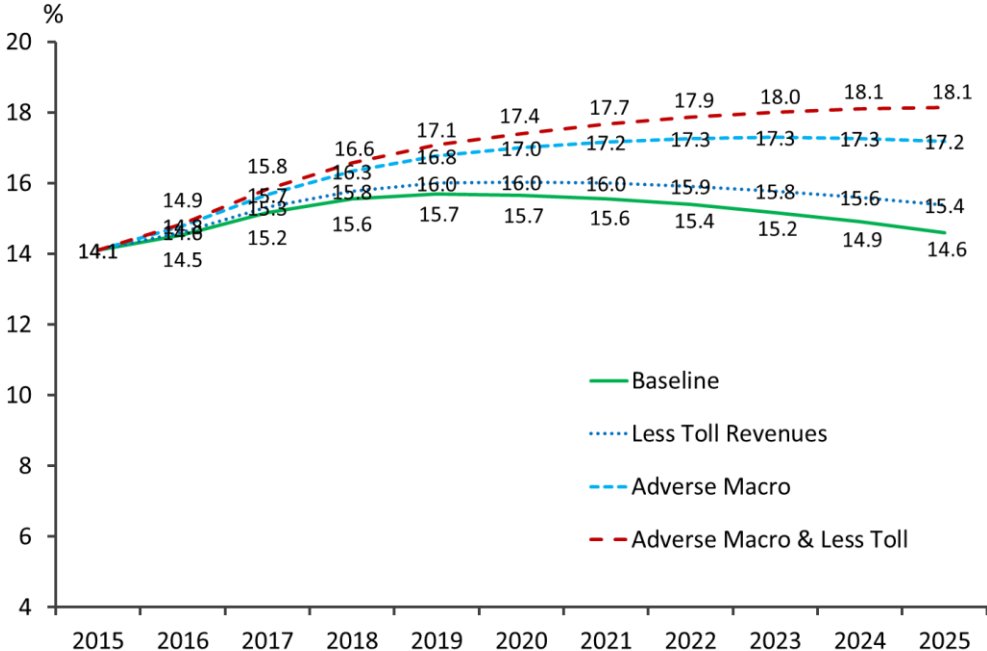
41. **The Medium Term Fiscal Strategy brings the public liabilities of the Hunan Provincial Government under control in the baseline scenario.** As Hunan's economic development continues apace and motorway traffic continues to expand, M-UDIC expects substantial growth in toll revenues in coming years. These revenues will play a critical role in servicing the large liabilities M-UDIC has accumulated in past years to grow Hunan's road network. Given a freeze on further growth of investment and subdued growth of budget expenditures, the growth of budget revenues will gradually reduce Hunan's budget deficit. The interest burden will be reduced, as the government swap program refinances UDIC liabilities declared as direct government debt for bonds issued by the Hunan Provincial Bureau of Finance at lower interest rates.<sup>4</sup> The UDICs are also expected to take advantage of the current low interest rate environment to refinance. Overall, given continued high expected GDP growth, the comprehensive measure of Hunan Provincial Government's public liabilities will peak at around 15.7 percent of GDP in 2019 and then start a declining path.

42. **Hunan's medium term fiscal framework is robust to a range of downside scenarios considered (Figure 8).** Given the current high level of uncertainty in the economic outlook for China and Hunan Province, the Medium Term Fiscal Strategy considers a significant range of downside risks from the baseline scenario. In an adverse macroeconomic scenario in which annual nominal GDP growth is

<sup>4</sup> It is assumed that the Central Government will continue to allocate the appropriate debt quotas to Hunan to make this strategy possible.

permanently 2 percentage points below the baseline projection, public finance expenditure growth would align itself to lower revenue growth. Public liabilities would peak at 17.3 percent of GDP in 2022 and then go on a declining path (Figure 8). Equally, the MTFF debt sustainability is robust to motorway toll revenues falling short by 20 percent of the strong growth expectations by M-UDIC and the Provincial Government.<sup>5</sup> A combined downside scenario of lower GDP growth and toll revenues would present more of a challenge, but would still be consistent with a stabilization of public liabilities at around 18 percent of Province GDP by 2022. Other sources of risk, including future higher than expected financing costs for the UDICs or the materialization of contingent liabilities related to local government finance, could also complicate debt sustainability. However, the Hunan Provincial Government is committed to further fiscal adjustments to preserve fiscal sustainability in the event that such risks materialize.

**Figure 8: Hunan Provincial Debt Sustainability: Baseline and Stress Scenarios (Public Liabilities as a Percentage of Province GDP)**



Source: staff projections

**2.4 INTERGOVERNMENTAL RELATIONS**

43. **China’s intergovernmental system is characterized by a high level of decentralization in revenues and expenditures, although tax rates and a high share of expenditure responsibilities are determined by the Central Government.** China’s inter-budgetary system consists of the central government and 34 province-level divisions. The provincial level also typically consists of several layers of authority, i.e. municipalities, districts and counties, and townships. Tax revenues are shared between different levels of governments. In addition, significant shares of revenues are transferred from the Central Government to Provinces, and from provinces to local governments, both in earmarked and general form. These transfers are generally adequate to cover the gap between revenues and current

<sup>5</sup> By year 2025, this adverse scenario for toll revenues implies that toll yields will be 27.0 billion a year, which is 6.8 billion less than under the baseline scenario.

expenditures at the subnational level. Subnational governments finance investment largely through borrowing and revenues from land. Until 2015, subnational governments could not borrow explicitly, but have borrowed significantly off budget through UDICs, effectively using future land revenues as collateral. Since 2015, the Budget Reform allows explicit subnational borrowing for the first time, while restricting the former off-budgetary schemes for investment finance.

44. **The 2014 reform of the Budget Law, effective as of January 1, 2015, as well as subsequent State Council decisions allow for subnational government bond issuance subject to annual quotas.** Only provincial level governments are allowed to borrow in this manner both for themselves and on behalf of local (sub-provincial) governments. The Golden Rule applies: such borrowing can only be used to finance capital expenditures. The Law also prohibits the Central Government from bailing out subnational governments. Quotas for the nation-wide aggregate outstanding subnational debt and net debt financing require the approval of the National Peoples' Congress. Within these aggregate limits, the Ministry of Finance sets a debt ceiling for each province and closely monitors compliance, while provinces set debt ceilings for local governments within the overall limit. In addition, subnational governments are authorized to issue bonds to swap LGFV debts that have now been made the explicit responsibility of subnational governments. To access the capital market, provinces must also follow regulations for information disclosure, obtain credit ratings, and follow market rules.

45. **Tax-sharing arrangements between the Central Government and subnational governments are stable,** and are governed by State Council Decrees (No 85, 1993 and No. 37, 2001). Subnational governments in China do not have the authority to set tax rates, but can collect and retain local taxes as authorized by the Central Government. Shared taxes are collected by the National Tax Administration to the National Single Treasury Account and disbursed to the Provinces. Starting from May 2016, the VAT (a major shared tax) replaced the former Business Tax (a major local tax) in all sectors. To compensate subnational governments for this change, the share of VAT revenues accruing to subnational governments was increased from 25 to 50 percent. These changes are expected to have only a limited adverse impact on Hunan Province, as potential losses should be covered by transfers from the Central Government.

46. **Intergovernmental transfers are mostly rule-based, and adequately cover the gap between Hunan's revenues and recurrent expenditures.** Intergovernmental transfers consist of general transfers and earmarked transfers. General transfers are mainly for equalization purposes, and fill the financing gap between standard revenues and standard expenditures. Earmarked transfers protect the funding for the Central Government's priority programs, mostly in education, public health, social housing and environmental protection.

47. **Going forward, the Chinese Government is examining reforms of the intergovernmental fiscal system that could make subnational finance more sustainable.** A primary challenge at the subnational level concerns lack of autonomy in taxation combined with a high dependence of local governments on land lease revenues. Given that subnational governments have little control over their revenues outside of land, and are constrained to realize most current expenditures according to centrally-determined norms and regulations, fiscal adjustment needs to focus almost entirely on public investment spending and (at the local level) land leases. Provinces can also adjust the share of central transfers passed down to local governments, but within limits dictated by expenditure assignments and central norms. A fundamental problem for long run sustainability at the local level going forward is that the supply of land is finite. Further investment spending could only be supported by expanding the share of commercial land or different financial arrangements. It is expected that new arrangements (interbudgetary reform) should come into effect over the next decade or so.

48. **In light of the above, intergovernmental relations in China are deemed adequate for this operation.** While subnational governments have limited degrees of freedom for pursuing fiscal sustainability, there are sufficient levers at least for the medium term. This concerns in particular the rate of growth of public investment, which has been quite high in China in recent years. Reforms to enable the continued sustainability of subnational finance will be needed for the longer run.

### 3. THE HUNAN PROVINCIAL GOVERNMENT'S PROGRAM

49. **In 2016, the Hunan Province Government adopted a 13<sup>th</sup> 5-Year Economic and Social Development Plan for 2016-2020.** The 5-Year Plan has the overarching goals of narrowing the development gap between Hunan and the average level of development in China, and for making Hunan Province a well-off society by 2020. To achieve these goals, Province gross domestic product and per capita household income should grow faster than the national average. The Hunan Province Government acknowledges the challenge of achieving such ambitious goals in the context of a weak global economy and economic slowdown in China. On the other hand, it recognizes great potential for successful development owing in part to its fortunate geography. Hunan is a part of the Yangtze River region, which still has major untapped commercial potential. It is also a major hub linking the South with the Northwest, and has close links to the southern coastal developed regions. This puts Hunan in an advantageous position to benefit from greater national market integration and to remain attractive for industrial investment in light of growing congestion in the coastal region. Hunan believes that its reputation as a leader in reforms and effective economic policies will also serve the Province well in competing for future business and investment. Hunan Province plans to pursue innovative, balanced, green, open and shared development strategies.

50. **Hunan's development strategy consists of four pillars.** The first pillar is for the promotion of innovation-driven economic growth: nurturing innovation culture; improving the support facilities for startups and venture capital; attracting high-end talent, enhancing the protection of property rights; promoting fair competition; streamlining public finance and administrative management; and deregulating / improving the business environment. The second pillar relates to spatial zoning policy aimed at achieving higher urban density (agglomeration), resource efficiency, and environmental improvements. The third pillar seeks to accelerate Hunan's economic transformation, including urbanization, the improvement of services in urban areas, the strengthening of environmental protection, promoting a low-carbon recycling model, the tourist industry, regional financial services, and the health industry. The fourth pillar is inclusiveness and ensuring development is appropriately shared among all citizens. This includes strengthening poverty reduction programs to better target the poor and lift the whole population above the poverty line. Pillar four is also focused on improving the accessibility of good quality education and health care, strengthening the social safety net, improving governance, and ensuring rule by law.

51. **Fiscal reform has been an integral crosscutting theme in Hunan's development strategy, and has become a particular priority in recent years.** The recent rapid build-up in public debt in Hunan Province described above, along with the budget reform initiative of the Central Government, have motivated Hunan Province to pursue reforms aimed at bringing government debt under control, improving the efficiency of investment financing, and advancing budget transparency. These reforms have provided a solid foundation for the present DPF Program. In this regard, some of the most important initiatives prior to 2016 concern the development of a debt early warning system for local governments, the preparation of a medium term investment financing plan that covers a strong majority of provincial-level investments, and initiatives for the disclosure of province finances to the public. In the context of the World Bank DPF program, Hunan is deepening reforms in these areas, while anchoring its economic

program to a Medium Term Strategy aimed at achieving and maintaining fiscal sustainability. The strategy for achieving fiscal sustainability for provincial-level finance is discussed and analyzed in section 2.3.3 above.

52. **Consistent with the guidelines of the Budget Reform, Hunan Province has put in place an early warning system to evaluate the fiscal and debt positions of local governments based on several indicators related to debt burden and distress.** Hunan Province has also gone beyond those guidelines in using these warning indicators for the allocation of debt swaps and new borrowing quotas to local governments in a manner that incentivizes them for responsible debt management. The scheme that was implemented in 2015 is elaborated in section 6.2.3 below.

53. **Hunan Province has taken the initiative to develop an integrated public investment financing plan for the sectors of transportation, water/irrigation, and social housing,** which together account for more than 90 percent of investment finance at the provincial government level. They will be extending this to all province-level public investment. As described above, the fragmented nature of public investment planning, much of which relies on off-budget finance, has been a key obstacle to budgetary efficiency and fiscal sustainability at the local level in China. Thus, institutions to support a more integrated capital budgeting process are central to efforts for ensuring fiscal sustainability in Hunan Province and getting better value for money from more moderate levels of investment finance going forward. The nature of the three-year rolling capital investment plan is described more fully in section 4.1.

54. **The introduction of an aggregate budget ceiling for the transport sector has motivated the Department of Transport of Hunan Province to improve the allocative efficiency of public investment.** In light of relatively higher perceived current economic returns in trunk/rural roads versus highways, Hunan Province has reallocated more limited investment resources toward trunk/rural roads. In addition, the responsibility for investment in trunk/rural roads has been decentralized to local governments in an effort to strengthen accountability and bring policy decisions closer to users. Earmarked transfers have accordingly increased to ensure that local governments have adequate resources to finance this new mandate. Hunan Province is also subjecting expenditures of the highway UDIC to increased scrutiny in an effort to increase returns.

55. **Hunan Province has also been pursuing a policy of greater budgetary transparency and disclosure to the population.** Budget transparency and disclosure – openness about policy intentions, formulation and implementation – is at the core of a good governance agenda, and instrumental for enhancing accountability of the government for performance. Hunan Province is playing a leading role in China through the preparation of the first Hunan Province Citizen’s Budget that contains valuable details on the Province’s public finance reform actions, government expenditure programs, sources of funding, government debt, and performance of public service delivery. Hunan is also publishing biannual comprehensive debt reports.

56. **Going forward, Hunan Province will continue to build on the current budgetary reforms, and will encourage an expansion of these reforms to the local level of government.** Hunan Province will expand its capacity in medium-term planning, budget reform, and debt sustainability analysis to build on progress achieved under this operation. Hunan Province gives particular importance to improving its ability to monitor and regulate effectively the finances of local governments. This includes critical budgetary reforms at the local level of government that will reveal a clearer picture of fiscal sustainability for individual entities and Hunan Province as a whole. Beginning with some of the larger and more advanced localities, Hunan local governments will also be encouraged to adopt integrated approaches to planning public investments, thereby generating valuable information for the assessment of fiscal



sustainability. Hunan Province will incorporate this information into its debt monitoring and Early Warning System. The Province is also cooperating with the World Bank on further regulations for managing the fiscal implications of an expansion in PPPs.

#### 4. PROPOSED OPERATION

##### 4.1 OPERATION DESCRIPTION AND LINK TO GOVERNMENT PROGRAM

57. **This First Hunan Fiscal Sustainability Development Policy Financing supports the Hunan Provincial Government to achieve fiscal sustainability by developing a forward-looking, comprehensive and transparent public finance framework that integrates budget, public investment and debt management.** The DPF program in Hunan Province is divided into four pillars: (i) fiscal sustainability; (ii) capital budgeting; (iii) monitoring and regulating sub-provincial government debts; and (iv) transparency. Under the first pillar, Hunan employs a Debt Sustainability Analysis (DSA) framework for the preparation of a Medium Term Fiscal Strategy consistent with the fiscal sustainability of provincial-level finances. Under the second pillar, Hunan has introduced an integrated capital budgeting / financing framework that is critical for assessing fiscal sustainability and improving efficiency in public investment. Under the third pillar, Hunan is expanding on its initiative in using authority over the allocation of debt swaps and new borrowing rights to incentivize local governments to manage their debts and contingent liabilities responsibly, and to gather and transfer key information for improvements in the monitoring and regulation of local government finance. Under the fourth pillar, Hunan Province is ensuring the timely disclosure to the public of key information on its finances.

58. **Hunan is 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 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 subnational government debt is a key goal for sustaining the rapid growth and development in China that has already brought millions of citizens out of poverty.

59. **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 by other types of operations in China.** The World Bank has been accumulating experience from subnational development policy operations in several countries, including Brazil, India, and Nigeria. Some of these operations also focused on achieving or maintaining fiscal sustainability. Experience has confirmed that strong ownership is particularly critical to the success of development policy operations. 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 are carrying out the prior actions as genuine steps toward lasting budgetary reforms. Hunan is institutionalizing medium term integrated capital budgeting and debt sustainability analysis, and will continue to refine these institutions going forward.

60. **The basic approach of comprehensive debt sustainability analysis combined with integrated capital budgeting can be scaled up at the local level in Hunan and other provinces.** An important next step in Hunan Province will be the implementation of this approach in local governments, beginning with some of the most important for the regional economy. Hunan Province plans to pilot the approach in a few local governments, including the capital city of Changsha, in the near future. The anticipated scaling

up of medium term fiscal strategies and integrated capital financing plans to the local level of government in Hunan should provide additional valuable information to the Province Government for the effective monitoring and regulation of local debt. They are anticipating further close cooperation with the World Bank in this endeavor.

## 4.2 PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

**Table 4: DPF Prior Actions and Analytical Underpinnings**

Prior actions	Analytical Underpinnings
<b>Operation Pillar 1: Fiscal sustainability</b>	
<p>Prior action #1: Hunan Provincial Government has adopted and published a Medium Term Fiscal Strategy, grounded in a debt sustainability analysis, which sets a target for provincial-level public investment financing that is consistent with fiscal sustainability.</p>	<p>Urban China Flagship Report (2014), World Bank Technical Note on Managing Transitional Risks (2015), World Bank cooperation with Hunan Province on debt sustainability analysis (2015), Beyond Annual Budget Report (2013), China 2030 (2012), World Bank Policy Note on China MTEF (2013), World Bank cooperation with Hunan Province on MTEF (2015).</p>
<b>Operation Pillar 2: Capital budgeting</b>	
<p>Prior action #2: Hunan Provincial Government has instituted the annual formulation of three-year rolling capital financing plans for the provincial-level budget.</p>	<p>Urban China Flagship Report (2014), World Bank Technical Note on Municipal Infrastructure Planning and Budgeting (2013).</p>
<p>Prior action #3: Hunan Provincial Government has adopted a three-year rolling capital financing plan for the provincial-level budget for transportation, water/irrigation, and social housing for the calendar years 2016-2018, itemizing project by project.</p>	<p>World Bank cooperation with Hunan Province on capital financing plan (2015).</p>
<p>Prior Action #4 Hunan Provincial Government has established the Interagency Committee for Public Investment Financing and Debt Risk Management.</p>	<p>World Bank cooperation with Hunan Province on gate-keeping function and interagency committee (2016).</p>
<b>Operation Pillar 3: Monitoring and regulating sub-provincial government debts</b>	
<p>Prior action # 5: Hunan has implemented an allocation scheme for bond swaps and new borrowings that rewards local governments for achieving better performance and early warning system indicators.</p>	<p>World Bank cooperation with Hunan Province on early warning system (2015), Papers of the International Subnational Debt Forum held in Nanning, China in October (2016).</p>
<p>Prior Action #6: Hunan Provincial Government has approved its Debt Management Framework to strengthen regulations by, inter alia: (a) establishing informational requirements for local governments, including submission and disclosure of a fund use plan for new borrowing and basic debt data; (b) requiring the submission of risk mitigation action</p>	<p>Urban China Study (2014), World Bank Policy Note on Subnational Debt Regulatory Framework (2011), World Bank Policy Note on fiscal rules and indicators (2011).</p>

plans from local governments classified as “red” or “orange” in the provincial early warning system; and (c) allocating new borrowing limits to local governments based on indicators set in the early warning system.	
<b>Operation Pillar 4: Transparency</b>	
Prior action # 7: Beginning in year 2016, Hunan Provincial Government has started publishing annual Citizens’ Budget Reports and Budget Performance Reports, and has set up an internet platform which allows an open engagement with citizens.	Urban China Flagship Report (2014), World Bank Policy Note on Transparency (2013).
Prior action #8: Beginning in year 2016, Hunan has (a) started producing and publishing biannual debt reports, containing debt information for the provincial level, and consolidated information for sub-provincial governments, and (b) created an internet platform for local governments for the disclosure of subnational debt and financial data.	World Bank cooperation with Chinese Treasury Department on subnational debt monitoring and reporting (2015), Revised Guidelines for Public Debt Management (World Bank-IMF, 2014), Debt Management performance Assessment (DeMPA) Methodology (2015).

#### 4.2.1 Pillar 1: Fiscal Sustainability

61. **This pillar corresponds to a fundamental goal of the operation:** putting in place institutions that will allow Hunan Province to assess its expected financial position under various circumstances and adopt a Medium Term Fiscal Strategy that is consistent with the fiscal sustainability of province-level finance under a range of plausible scenarios for growth, revenues, and other variables.

***Prior action #1:** Hunan Provincial Government has adopted and published a Medium Term Fiscal Strategy, grounded in a debt sustainability analysis, which sets a target for provincial-level public investment financing that is consistent with fiscal sustainability.*

***Evidence:** Hunan Finance Department’s Decree [Xiangcaiyu, 2016, No. 53] on Hunan Provincial Government Medium-term Fiscal Strategy dated April 29, 2016. The full report is published on the government official website.*

*[http://www.hnczt.gov.cn/xxqk/tzqg/201606/t20160614\\_3071039.html](http://www.hnczt.gov.cn/xxqk/tzqg/201606/t20160614_3071039.html)*

62. **The first step, facilitated by the World Bank team, is the development of a debt sustainability framework** that includes the explicit Hunan budget and other sources of finance for public investments such as public benefit state owned enterprises, public-private partnerships, and special purpose vehicles. Distinguishing between true government liabilities, contingent liabilities, and purely commercial liabilities in this context is a rather difficult task. Hunan Province has taken a prudent approach to including a comprehensive measure of public liabilities (and assets) for the conduct of its debt sustainability analysis. This is also consistent with the goal of Hunan Province of strengthening provincial managerial control and responsibility over the UDICs that are involved in provincial level public investment. Thus, for example, for the UDIC that builds motorways in Hunan and expects future revenues from tolls, both the expected liabilities (debts) and future revenues of this UDIC are included in the DSA analysis. A similar approach is taken for PPPs.

63. Hunan Province has agreed with the World Bank on a working definition of “fiscal sustainability” for a medium term fiscal strategy: Hunan provincial-level public liabilities as a share of province GDP must stabilize over time under baseline assumptions (official projections) and under a stress test where GDP growth is two percentage points lower and revenues from toll roads are 20 percent lower. GDP growth and toll roads are two primary sources of fiscal risk for Hunan provincial finances. As indicated above, the Medium Term Strategy that Hunan Province is adopting satisfies this definition of fiscal sustainability. Fiscal sustainability is achieved by essentially freezing aggregate province level public investment for five years at the level of 2015, while keeping growth in current expenditures at moderate levels. Within the investment finance envelope, there are plans for a reallocation toward higher priorities, including an expansion of investment in trunk roads and airports relative to motorways. The details of the debt sustainability properties of the Medium Term Fiscal Strategy program can be found in the section on debt sustainability above. Its basic properties are summarized in Table 5.

**Table 5: Key Directions of the Medium Term Fiscal Strategy of the Hunan Provincial Government**

	Objectives	Measures
1	Sustainability	Rationalize public investment while maintaining aggregate outlays at the level of 2015.
2		Improve the debt profile by redemption of high cost debts.
3		Enhance transparency and disclosure.
4	Inclusiveness	Allocate a higher share of investment to trunk/rural roads, while decentralizing the finance and responsibility to local governments.
5		Enhance accountability through improved engagement with citizens (citizens’ budget).
6	Efficiency	Increase the efficiency of public expenditures, keeping their growth slightly lower than that of nominal GDP.
7		Align revenues with expenditures, and ensure sufficient transfers to local governments to cover delegated expenditures.
8		Improve public investment project evaluation and management.

64. The Medium Term Fiscal Strategy developed under Prior Action #1 employs a MTF-DSA framework developed jointly with the World Bank, and is consistent with fiscal sustainability as defined above. Follow-up actions from this operation will extend the MTF-DSA framework to local governments in Hunan Province, beginning with those that either account for a large share of finance in the province or have experienced particular debt distress.

65. The proposed results indicator for Pillar 1 is public liabilities as a share of Province GDP. As Hunan’s debt sustainability framework focuses on this measure, it is a natural indicator of progress in achieving this aim of the program. As indicated in section 2.3.3 above, the nature of the debt situation in Hunan Province is such that public liabilities should continue to increase as a share of GDP before leveling off in 2019-2020 (in the baseline scenario) and declining thereafter. This is despite the fact that the needed fiscal adjustment for debt sustainability is being done immediately. The initial increase is due to the high burden of debt service on outstanding obligations. The targets in the baseline are 14.5 percent in 2016 and 15.2 percent in 2017. However, under the adverse macro scenario of lower growth and toll revenues, these numbers would increase to 14.9 percent and 15.8 percent, respectively, and public liabilities as a share of GDP would not stabilize until 2024-2025. Given that the assumptions for the

baseline are optimistic and Hunan authorities have little control over the external macroeconomic environment, a logical results indicator for Hunan remaining on a sustainable path is that public liabilities as a share of GDP remain below 15 percent in 2016. This maximum increase of 0.8 percent of GDP expected in the adverse scenario would still be less than the 1.2 percent actual increase in 2015.

#### **4.2.2 Pillar 2: Capital Budgeting**

66. **As discussed above, public investment financing at the subnational level in China goes well beyond the explicit government budget.** Hunan province is implementing a multi-year capital budgeting framework to ensure that priority public infrastructure needs are addressed at lower cost and risk, and are consistent with fiscal sustainability. This is a purely provincial initiative, as the national budget reform does not yet prescribe the preparation of multiyear aggregate investment programs, project level capital budgeting, or investment financing plans. This direction of reform is critical for achieving two primary goals in subnational finance in China: (a) fiscal sustainability and (b) greater efficiency in public investment. The recent rapid rise in local government debt in China can be associated almost entirely with the financing of public investment programs that are commonly realized in a rather fragmented manner, including numerous planning and implementing bodies and (usually) off-budget financing sources. The current Budget Reform has required moving much of this investment explicitly on budget, although an important role remains for off-budget sources in the form of PPPs and SPVs. A key task going forward for subnational governments will therefore be the conduct of public investment planning and finance in a more integrated way that allows for a clear assessment of its implications for debt sustainability as well as key cost-benefit tradeoffs. Hunan Province is achieving this goal through reforms in public investment planning and the creation of an Interagency Committee that will have a gatekeeping function for assessing public investment projects and plans from the points of view of fiscal risk, and costs / benefits.

***Prior action #2:** Hunan Provincial Government has instituted the annual formulation of three-year rolling capital financing plans for the provincial-level budget.*

***Evidence:** Hunan Finance Department's Decree (Xiangcaiyu, 2016, No. 51) on the Compilation of Medium-term Financing Plan for Hunan Provincial Government's Public-Benefit Projects dated February 29, 2016.*

67. **Hunan Province is a leader in China with respect to the integrated planning of public investment finance.** The Hunan Province Department of Finance introduced a multi-year integrated capital budgeting process in 2014 involving selected PBSOEs in the areas of rail, roads, and water/irrigation. This was prescribed in the 2014 Budget Circular for Provincial Major Public Infrastructure Investments (No. 121, 2014). The piloted PBSOEs are required to submit 3 year rolling budget requests based on medium-term projections of revenues, recurrent expenditures (headcount and operations / maintenance), and costed implementation plans for priority investment projects. With explicit equity and/or operational subsidies from government budgets, PBSOEs are required to achieve targets for financial viability and other performance objectives. Investment projects that receive budget resources should be consistent with government development plans, be of public nature, obtain approval of sponsoring government agency(s), have completed feasibility studies, and have passed environment assessments. PBSOEs are required to maintain their liability to asset ratio below 60 percent (75 percent in exceptional cases). An early warning system is developed in each PBSOE based on a dynamic financial analysis over a time span of 5-10 years. PBSOEs require prior review from the Province Department of Finance before borrowing, and additional approval from the Province Governor for projects financed with an interest rate beyond a threshold of 7 percent.

68. **The Decree developed under Prior Action #2 in 2016 institutionalized the annual formulation of a three-year rolling capital budget plan.** It clarifies a timetable, responsibilities, processes, and relevant deadlines for the annual formulation of a three-year rolling capital financing plan for the provincial level budget. Hunan Province plans for gradually expanding the sector coverage of the capital budgeting plan, and is now moving toward the preparation of a three-year capital investment financing plan that will cover 100 percent of provincial-level public investment by 2017.

*Prior action #3: Hunan Provincial Government has adopted a three-year rolling capital financing plan for the provincial-level budget for transportation, water/irrigation, and social housing for the calendar years 2016-2018, itemizing project by project.*

*Evidence: Hunan Finance Department's Decree (Xiangcaiyu, 2016, No. 86) on the Circular of Medium-term Financing Plan for the Hunan Provincial-level Government's Major Public Benefit Projects for the years of 2016-2018, dated on August 17, 2016*

69. **In 2015, the Hunan Province Department of Finance extended the three-year rolling capital budgeting plan (2016-2018) requirement to all agencies involved in major public infrastructure projects in the area of rail, roads, airports and water/irrigation.** (Province Budget Circular No.6, 2015). This capital budgeting plan is inclusive of both explicit budgetary and other forms of finance for public investments, including UDICs, PPPs and SPVs, and accounts for the vast majority of provincial-level investment. The three-year rolling capital investment financing plan for 2016-2018 has been extended again to include social housing. This comprises well over 90 percent of province level public investment. The actual adoption of the three-year rolling capital budgeting plan for the years 2016-2018 was postponed to May 2016, so as to synchronize with the adoption of the Medium Term Fiscal Strategy. The Medium Term Fiscal Strategy determined overall ceilings on infrastructure investment for the prioritization and selection of projects.

70. **As with the prior action under pillar one, it is expected that the integrated medium-term planning approach for public investment will be gradually scaled up to local governments in Hunan Province following this operation.** The World Bank should remain engaged with Hunan Province on this endeavor. Once local governments have clear integrated public investment finance plans, this will facilitate greatly the assessment of fiscal sustainability in these localities and the tasks of pillar 3 of this operation: the effective monitoring and regulation by the Province of the financial health of localities.

*Prior Action #4: Hunan Provincial Government has established the Interagency Committee for Public Investment Financing and Debt Risk Management.*

*Evidence: Hunan Province Government's Act [XiangZhengHan, 2016, No. 5], "Hunan Province Government's Reply on Agreeing to Establish an Inter-agency Committee for Province-level Government Debt Budget Management and Risk Control", dated January 6, 2016.*

71. **The effectiveness of integrated capital investment planning depends on the continual systematic review of the planning, execution, and fiscal implications of projects.** This challenge is particularly acute in the Chinese institutional context, where capital investment planning has been rather disjoint from budget planning. The Provincial DRC reviews all capital investment projects with the main objectives to promote economic growth and ensure timely project implementation. The Department of Finance manages the budget, but the majority of capital spending typically occurs off budget.

72. **In its leading role as a reformer in China, Hunan Province recognizes the need to institutionalize a gatekeeping function for capital projects to promote fiscal sustainability and greater efficiency.** International experience suggests the importance of creating an explicit “gatekeeping” body assigned with the task of examining and scrutinizing proposals and public projects from the points of view of fiscal sustainability and project efficiency. Given the past experience in China, an interagency body of this type could also solidify the new integrated approach toward public investment planning and finance.

73. **Hunan Province has put in place an interagency committee (IAC) to strengthen sustainable financing aspects of the capital investment program (“debt budgeting”).** This IAC was approved by Hunan Province Government, and reports directly to the Province Governor. The Interagency Committee is chaired by the Director General of the Department of Finance, and includes high level representation from the Finance Department, the Provincial Development and Reform Commission, the Transport Department, the Audit Office and the Finance Office. Close interaction with selected line departments is to be conducted as appropriate.

74. **The committee works under the guidance of the Province Governor and performs regular review functions aligned to the budget process.** According to the Province Government directive, the roles and responsibilities of this IAC are as follows:

- Review the policy framework for debt management policies and regimes
- Review medium term fiscal planning and capital budgeting
- Receive information about provincial and sub-provincial debt/contingent liabilities and capital financing
- Provide endorsement subject to review of the Governor for any capital projects with major financing and/or contingent risk

75. **A Secretariat of this IAC is based in the Department of Finance and the Deputy Director General of Finance heads the Secretariat.** The secretariat has the tasks of scheduling meetings in line with the preparation calendar and special requests from the Governor or member departments, and preparing minutes of the meetings. The minutes shall be transmitted to all relevant departments in a timely fashion upon the approval of the Province Governor.

76. The results indicators for Pillar 2 concern the sector coverage of the integrated capital financing plan, expanding from only transportation sector in 2015 to including water/irrigation and social housing by 2016 and all province level public investment in 2017. The second results indicator corresponds to the official release of opinions by the Interagency Committee on the Medium Term Fiscal Strategy and the three-year rolling capital financing plan for 2016-2018. This indicates that the IAC is operating as envisioned in the program.

#### **4.2.3 Pillar 3: Monitoring and Regulating Sub-provincial Government Debt**

77. **Under the Budget Reform, provincial governments have the task of developing an effective system for monitoring and regulating sub-provincial debt.** Since the sub-provincial level has been responsible for the majority of (mostly off-budget) accumulation in government debt in China, Hunan Province faces some difficult challenges in this regard. Hunan Province has been working actively to build an effective system to monitor and regulate local government debt, including innovations that go well beyond central guidelines. The key innovation has been incentivizing local governments to manage their finances prudently through the allocation of debt swaps and new borrowing rights under the authority of the Province administration. The DPF supports the efforts of Hunan Province in creating and expanding

this monitoring and regulatory framework. This framework will be gradually improved as reforms proceed in local governments in Hunan Province and better information is gathered to reveal the full picture of local finance.

78. **The Budget Reform requires Chinese provinces to set up early warning systems to monitor and regulate local governments.** Hunan Province set up an early warning system ahead of many other provinces, and has extended the early warning system in an important and innovative manner. The early warning system divides local governments into categories of red, orange, yellow, and green according to fiscal risks measured by the ratio of government debt to the disposable revenues of local governments. Hunan Province is also using early warning indicators as inputs for formulating debt limits, the allocation of bond swaps, and new borrowing quotas for sub-provincial governments. (Decree\_XiangCaiJin No. 50, 2015)

*Prior action # 5: Hunan has implemented an allocation scheme for bond swaps and new borrowings that rewards local governments for achieving better performance and early warning system indicators.*

*Evidence: Hunan Province Finance Department's Decree [XiangCaiJin, No.50, 2015] on Notification of Government Debt Risk Early Warning for 2015 dated on December 14, 2015; Hunan Province Finance Department's Decree [XiangCaiYu, No. 132, 2015] on Subnational Government's Debt Limit dated on December 4, 2015.*

79. **Hunan Province implemented distinct allocation schemes in 2015 for both bond swaps and new borrowing quotas.** Hunan Province received a bond swap quota of 122.2 billion RMB for swapping maturing UDIC debt and putting this debt explicitly on government books. It also received a bond quota for new borrowing of 18.1 billion RMB designated for new investment projects. The Provincial Government took 27.98 billion RMB of debt swap bonds and 7.1 billion RMB in bonds for new borrowing for its own finance. This left 94.2 billion RMB and 11 billion RMB to be allocated to local governments for debt swaps and new borrowing, respectively. Two different schemes were introduced to reward more prudent local governments.

80. **An adopted formula allocated a larger share of debt swaps to local governments with lower shares of non-standard debts and lower debt to revenue ratios.** The size of the quota for debt swaps given to Hunan Province was based on the expected size of maturing legacy debt in 2015. The standard practice would be for a province to swap out all of this maturing debt in a passive manner as the debts came due for repayment. Instead, Hunan Province first applied a discount factor of 70 percent in counting debts in the form of build-transfer obligations, payables, or medium term notes that are considered to be sub-standard. It then applied a second coefficient for allocation between 0.8 and 1.2. Local governments with lower debt to revenue ratios received a higher number. Thus, local governments with lower debt to revenue ratios and little non-standard debt could swap more than just maturing legacy debt, while more poorly performing local governments had less than all of their maturing debt swapped. The relative shares of legacy debt swapped varied from 62.5 percent to 118.9 percent.

81. **Quotas for new borrowing were allocated by formula based on indicators in Hunan Province's early warning system.** Of the 11 billion RMB in new borrowing quotas allocated to local governments in 2015, 1.57 billion RMB were earmarked for local projects of particularly high priority for the province and the remaining sum was divided in a manner that accounts for a number of the primary indicators in the early warning system (debt, debt servicing, debt servicing capacity, projected growth in revenues, etc), with a significantly larger share going to local governments that have achieved the higher green or orange ratings.



**Prior Action #6:** Hunan Provincial Government has approved its Debt Management Framework to strengthen regulations by, *inter alia*:

(a) *establishing informational requirements for local governments, including submission and disclosure of a fund use plan for new borrowing and basic debt data;*

(b) *requiring the submission of risk mitigation action plans from local governments classified as “red” and “orange” in the provincial early warning system; and*

(c) *allocating new borrowing limits to local governments based on indicators set in the early warning system.*

**Evidence:** The official summary of Hunan Provincial Government’s meeting No. 78 on June 17, 2016 during which the debt management framework was duly approved ([http://www.hunan.gov.cn/zw/hnyw/zfhy\\_59077/201606/t20160621\\_3073869.html](http://www.hunan.gov.cn/zw/hnyw/zfhy_59077/201606/t20160621_3073869.html)), as well as by the government’s confirmation letter addressed to the Bank, dated September 5, 2016.

82. **A new Decree of Hunan Province on the debt management framework, already approved by the Provincial Government, will expand the early warning system in a manner that solidifies Hunan’s role as a primary innovator in building fiscal institutions.** The indicators of the fiscal risk monitoring system are being expanded to account for contingent liabilities associated with the current expansion of PPP and SPV schemes. Furthermore, the Province will now use its authority over the allocation of new borrowing rights to incentivize further local governments to undertake necessary reforms and transfer information to the provincial level for more effective monitoring. The tool of linking the allocation of borrowing quotas to information requirements will be key to the success of Hunan’s quest to obtain a clear picture of the finances of the entire province with implications for fiscal sustainability. Once all local governments compile and disclose integrated public investment programs and land revenue projections, the capacity of the Province will be notably strengthened in this regard. This is a follow-up goal of Hunan Province to this operation. As a first step, all local governments will be encouraged to submit to the Provincial Department of Finance fund use plans for new borrowing, and to publish these plans as well as basic debt data in the public domain. Going forward, special attention is also being given to adjustment programs for debt distressed and particularly high risk (red or orange) localities. In some cases, local governments may not have the means to manage the fiscal adjustment by themselves. For example, there are cases of local government distress in Hunan Province that are clearly related to an imbalance of expenditure responsibilities and revenue sources. Thus, work out programs may require the joint cooperation of the province, the local administration in question, and (perhaps) other higher-level local governments.

83. **All three components of prior action #6 represent areas where Hunan is taking the lead for reforms that go beyond national guidelines.** Fund use plans, risk mitigation action plans, and the allocation of borrowing quotas based on early warning indicators are not a part of national guidelines. Hunan Province recognizes the fact that it is substituting for market discipline when it borrows in its own name on behalf of local governments, and should therefore ensure due diligence.

84. **Pillar 3 has two results indicators.** A first results indicator for pillar 3 is the share of local governments satisfying the annual disclosure of debt data and fund use plans for new borrowing. The Provincial Government can encourage, but not force, local governments to disclose this information. However, given its control over allocating new borrowing quotas, the Provincial Government is confident that at least 40 percent of local governments will comply with this request by 2017. The second indicator

is the number of local governments classified as “red” in the early warning system for more than a year that still have not submitted risk mitigation action plans to the Provincial Government for restoring their financial health. From 100% in 2015, Hunan Province is determined to reduce this indicator to 40 percent by 2017.

85. **The World Bank will continue to cooperate with Hunan Province on the development of monitoring and regulation of local governments in debt management following this DPF.** It is anticipated that the institution of an integrated capital financing plan will be scaled up to local governments, and this information will be used for debt sustainability analysis, therefore providing a more comprehensive and forward-looking informational basis for monitoring and regulation. The allocation of new borrowing quotas will continue to be a primary mechanism for incentivizing local governments toward these reforms. Follow-up actions to the operation should also include capacity building training to formulate a medium-term debt management strategy, aligned with the medium term budget framework, that includes an assessment of the costs and risks of the debt portfolio.

#### 4.2.4 Pillar 4: Transparency

86. **Transparency is increasingly at the heart of accountable, representative, and well performing government.** The Chinese national government recognizes transparency as a cornerstone of clean and modern government, and requests local governments to disclose all government activities, except for those related to State secrets, business secrets and individual privacy. Under the budget reform, Chinese provinces are instructed to improve their monitoring and disclosure of the financial information of local governments. The successful implementation of this transparency policy, however, relies on the cooperation of local governments. At present, China’s de facto very high degree of fiscal decentralization finds reflection in significant informational decentralization. While local governments in China are responsible for the majority of budgetary expenditures, public investments, and debt accumulation, the information available to the public and higher levels of government remains limited. Improved information dissemination on fiscal and debt sustainability of local governments will become especially important, as debt markets develop in China and play an increasingly important role in the allocation of credit.

***Prior action # 7:** Beginning in year 2016, Hunan Provincial Government has started publishing annual Citizens’ Budget Reports and Budget Performance Reports, and has set up an internet platform which allows an open engagement with citizens.*

***Evidence:** HPCD published on internet its first Citizen Budget Report and Budget Performance Report, and set up an internet platform for engaging with citizens in May 2016. The respective websites are listed below:*

[http://www.hnczt.gov.cn/ztl/hnczysgk/gzdt\\_79130/201605/t20160505\\_3053693.html](http://www.hnczt.gov.cn/ztl/hnczysgk/gzdt_79130/201605/t20160505_3053693.html)

[http://czt.hunan.gov.cn/xxgk/gzdt/gzdt/201512/t20151227\\_2725133.html](http://czt.hunan.gov.cn/xxgk/gzdt/gzdt/201512/t20151227_2725133.html)

<http://czt.hunan.gov.cn/ztl/hnczysgk/>

87. **With the publication of Citizen’s Budget Report along with additional Budget Performance Reports, Hunan Province further advanced its leading role among all provinces in terms of the richness and timeliness of information disclosure, and has also innovated new approaches to reaching out and engaging with citizens.** Approved aggregated budget and budgetary outcomes are regularly published on the official website. Through its Citizen’s Report, Hunan Province is now taking initiative and communicates this fiscal information in a plain language that the general public can easily understand. This information has been provided on an internet platform that allows for engagement with citizens. In

doing this, the Provincial Government is providing a model that can also be implemented at the local level of government. Given that service delivery is the primary responsibility of local level governments in China, such a platform likely has the most potential at the local level.

**Prior action #8:** Beginning in year 2016, Hunan has (a) started producing and publishing biannual debt reports, containing debt information for the provincial level, and consolidated information for sub-provincial governments and (b) created an internet platform for local governments for the disclosure of subnational debt and financial data.

**Evidence:** HPFD published on internet its first debt report of the provincial level ([http://czt.hunan.gov.cn/ztl/zwxqk/201605/t20160506\\_3053745.html](http://czt.hunan.gov.cn/ztl/zwxqk/201605/t20160506_3053745.html)), and consolidated debt report for sub-provincial governments in May 2016 ([http://czt.hunan.gov.cn/ztl/zwxqk/201605/t20160506\\_3053746.html](http://czt.hunan.gov.cn/ztl/zwxqk/201605/t20160506_3053746.html)). An internet platform (<http://www.hnczt.gov.cn/ztl/zwxqk/index.html>) for local government disclosure has been created as of May 2016.

88. **Hunan Province pioneered the biannual publication of comprehensive debt reports for Provincial level and consolidated province finance.** The publication of this report in an agreed best practice template further boosted Hunan's position as a leader in China in disclosure and transparency. Publishing comprehensive debt information reinforces the credibility of the early warning system supported in pillar 3, while also strengthening the creditworthiness of Hunan Province, thus lowering the cost of government borrowing—the objective supported in pillar 2. Pertinent information on debt composition and risk indicators should be periodically disseminated on a biannual basis to inform citizens and minimize uncertainty amongst market players, thereby ensuring more stable financing and efficient pricing.

89. **The Comprehensive Debt Report will be published with a lag no greater than four months and include information on the outstanding stock and composition of debt, including contingent liabilities.** The timeliness of the debt report release will eliminate a common problem in China of long delays before the release of subnational debt data. The template includes indicators for debt burden, repayment, solvency and liquidity. The debt report will cover (i) Hunan Provincial Government and (ii) consolidated debt of all local governments in Hunan province. This will thus establish a landmark system of transparency that permeates across the provincial and sub-provincial administrations, and also builds on the envisaged best-practice reforms in the budgetary system. The Department of Finance will benefit by establishing a focal point that deals regularly with the main debt stakeholders and produces these debt statistics and other relevant information.

90. **The internet platform for local government debt created a one-stop shop for accessing debt data in Hunan Province.** This is part of an effort by Hunan Province to encourage the public disclosure of debt information by individual local governments. As the Provincial Government borrows on behalf of local governments, it should naturally play a disciplining role to ensure adequate transparency and information disclosure at the local level. This includes not only information submitted to the Province, but that disclosed by local governments to the public. For this purpose, the Provincial Government set up an internet platform with a template that can be used by local governments for the public disclosure of information relevant to debt. In the time frame of this operation, Hunan will pilot this template for 10 local governments. Thus, these local governments will be expected to populate fully the template in the internet platform.

91. **Three results indicators will be used for this pillar.** A first results indicator concerns the actual publication of the proposed biannual comprehensive debt reports within the proposed time frame of less than four months past the end of period. Given the special efforts involved in preparing the first Report for the year 2015, this four month deadline will not be met. However, it is expected that subsequent reports will be published on schedule. This will amount to three more reports by October, 2017. A second results indicator measures the number of local governments that populate the template in the internet platform that Hunan Province is piloting. As indicated above, it is expected that 10 local governments will populate this platform immediately. A third results indicator measures the number of citizens' budget reports and budget performance reports disclosed online with less than 6 months lag. To achieve this, there will be 2 citizen reports and 2 budget performance reports on internet by October 2017.

#### **4.3 LINK TO CPS, OTHER BANK OPERATIONS AND THE WBG STRATEGY**

92. **This operation is strongly linked to the Country Partnership Strategy's (FY2013-FY2016) theme 2: promoting more inclusive development.** In particular, the CPS (Report No. 67566-CN) notes the importance going forward for "integrating policies and program administration" for China's future developmental success. The China Performance and Learning Review (Report No. 95709-CN) of January, 2016 noted that future IBRD lending in China may include PforR and DPO instruments. The operation also corresponds to the objective in the CPS for deepening direct cooperation at the subnational level. Given the increase in subnational borrowing recorded in recent years and the 2014 reform of the budget law, there is now significant need and interest for a systematic reform of subnational budgeting practices. This operation will be a pilot that can act as possible blueprint for the eventual roll-out of subnational fiscal reform across provinces and local governments in the whole of China. By thereby promoting modern and best-practice debt management systems at local governments, this operation contributes to safeguarding sustainable growth in China, and hence achieving the twin goals of ending extreme poverty and promoting shared prosperity. The operation also supports the Chinese government's overarching objective to establish a comprehensive, transparent and efficient fiscal system by 2020.

93. **This subnational fiscal reform DPF in Hunan Province (P157406) is complemented by a subnational fiscal reform DPF in Chongqing-Dadukou District (P157404).** Together, these pilot projects aim to bring best practice debt management frameworks to both provincial and sub-provincial governments in China.

94. **These DPFs also complement a fiscal technical assistance operation at the national level (P154694),** which includes the following activities:

- Facilitate formulation, design and implementation of policies, institutional modifications required to support a modern fiscal system in China with due consideration to changing economic structures domestically and internationally;
- Develop a pool of skilled management talent and broaden international knowledge exchange and dialogue on fiscal issues based on generally accepted international rules to facilitate reform implementation.

95. **Chinese authorities have indicated that the capacity building component of the Fiscal Technical Assistance Operation should be used for training subnational officials as well as cadres of the Central**

**Government.** This suggests natural synergies with scaling up subnational reforms informed by the DPF pilots.

96. **The World Bank is coordinating analytical work around subnational finance and intergovernmental relations.** This includes the Fiscal Policy Analysis Program (P158478) and the Institutions for Public Sector Performance Program (P157831), which will be closely coordinated with this DPF and the operation in Chongqing-Dadukou. It will feed into a continued engagement at the subnational level, including policy advice and technical assistance.

#### **4.4 CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS**

97. **This operation contributes to the achievement of the Government’s overarching fiscal objectives set at annual plenary sessions of the Chinese People’s Congress after broad consultation with stakeholders.** Specifically, this project supports the government’s implementation of the fiscal reforms. The Hunan Province Finance Department has broadly consulted with the Central MOF, NDRC, and key stakeholders, including Hunan Province DRC and the Transportation Department through the mechanism of the Inter-agency Committee, and now has an open engagement with citizens through the internet platform established under this operation.

98. **Various other development partners are supporting China’s fiscal reforms.** These include the IMF, which supports fiscal reform through its regular Article IV monitoring missions and technical assistance. The Asian Development Bank is also running related technical assistance operations on fiscal reforms and development policy financing in China. The OECD has prepared various analytical reports. This operation of the World Bank complements these initiatives through a fiscal reform lending operation at the subnational level. It is anticipated that the operation will profit from regular interactions with these other institutions.

99. **Consultations have been held with the IMF.** The IMF has a strong interest in fiscal sustainability issues at the subnational level in China and is fully supportive of this direction of World Bank engagement in China. The IMF is providing technical assistance to the Central Government MOF on formulating medium-term fiscal plans, reconciling the cash-based budget classification with an accrual-based chart of accounts, and on improving cash management. It is envisioned that close cooperation with the IMF on budget reforms will continue following this operation. IMF Article IV Consultation Mission Statement is attached. (Annex 3)

### **5. OTHER DESIGN AND APPRAISAL ISSUES**

#### **5.1 POVERTY AND SOCIAL IMPACT**

100. **The short run direct poverty and social impacts of this operation are expected to be negligible, while the medium and longer term impacts should be slightly positive.** The operation addresses vulnerabilities that, if not addressed in a timely manner, could potentially place the province in a very difficult financial position regarding public investments in a few years. Public debt has now reached high levels and economic activity has been supported by unsustainable public investment growth. A postponed adjustment would likely be disorderly and with greater impact on public welfare. Given this counterfactual, the orderly and gradual fiscal consolidation program supported by the Program can be viewed as contributing to poverty reduction and shared prosperity. The proposed slower investment growth concerns mostly transportation, an area in which Hunan has already built substantial capacity. The adjustment should not affect social spending.

101. **Spending with direct social implications is protected under the fiscal adjustment plan.** A range of services including compulsory education, health care, community services and public utilities are provided by sub-provincial governments. The fiscal adjustment of this operation concerns only the finances of the Provincial Government, which cover primarily transportation, irrigation, operating costs and civil servant wages. While the Provincial Government does have projects in social housing, the Medium Term Fiscal Strategy does not focus on reducing investment in this area. The civil servant wage bill still grows faster than projected inflation. National and provincial regulations also ensure minimum standards for education, public health services and social protection. This creates a natural safeguard against measures with strong poverty and social impact.

102. **While freezing aggregate provincial-level public investment in transportation at 2015 levels, the MTFS maintains significant growth in trunk/rural roads.** This will be financed through reducing investment on major motorways, given the Province has already established a significant motorway network. Empirical studies provide evidence for the higher impact of trunk/rural roads investment on the poor relative to major motorways. The Provincial Government is also further decentralizing trunk/rural road construction to the local level of government, and is financing this investment through earmarked transfers. This will potentially increase the efficiency of trunk/rural road investment, better aligning funds with local information and social welfare considerations.

103. **More moderate levels of province-level public investment should have little impact on employment in the province.** Province-level public investment accounts for a small share (12.9 Percent in 2015) of public investment in Hunan Province as a whole. In addition, the labor market in Hunan Province remains quite vibrant in line with the exceptionally rapid growth that the Province has experienced in recent years. The registered unemployment rate in urban areas in Hunan Province has been on a steady declining path, moving from 4.20 percent in 2013 to 4.14 percent in 2014 and 4.09 percent in 2015. All this considered, the impact of a somewhat slower pace of growth of only provincial-level investment in the medium term should have an only slight impact on employment. As indicated in section 2.3.2, fiscal sustainability of the Province as a whole, including local government finance, will also likely require a somewhat slower pace of public investment growth than has been the case in the recent past. The impact on employment growth over the medium term from a province-wide slowdown in infrastructure investment could be a bit more significant.

104. **The operation supports the introduction of more strategic medium term budgeting that can increase the efficiency and impact of public spending in Hunan Province.** The 3-year rolling capital financing plan and the debt sustainability analysis supported by this program are the beginning of a process that will place all of Hunan's finances on a strategic forward-looking planning basis. This is due to be rolled out at the provincial and sub-provincial levels of government, and should thus improve the efficiency of social spending, as well as public investment in the medium and longer term.

## 5.2 ENVIRONMENTAL ASPECTS

105. **The DPF is expected to have a neutral environmental impact.** The reforms are designed to improve the institutional and policy framework of the Government, and relate to improving fiscal sustainability and efficiency in the use of public resources, as well as information disclosure of government finances. As such, these actions have no direct bearing on the environment. Indirectly, the capital budgeting institutions could have a positive environmental impact by creating a more integrated and strategic framework for prioritizing projects by expected impact, including implications for the

environment. Green growth is a development priority in Hunan Province. Hunan province has a comprehensive environmental policy framework derived from the national one, and well-defined provisions and a sound institutional capacity to internalize environmental and social considerations during the policies implementation. Hunan's policy framework, institutions, and capacity to monitor and manage environmental issues are considered adequate for this operation.

### **5.3 PFM, DISBURSEMENT, AND AUDITING ASPECTS**

#### **Public Finance Management and Disbursement**

106. **Important progress has been made in recent years in both the national public financial management (PFM) regulatory environment and the way that Hunan Province manages its public finances.** National PFM laws and regulations in key areas such as budget, debt, financial reporting, audit and others influence provincial PFM performance. Hunan province adheres to these PFM regulations and directives but has autonomy in their implementation. In recent years, national PFM regulations have been strengthened. Notably, the 2014 Budget Law established significantly better control over subnational debt. MOF is also leading a national transition to accrual accounting. MOF's provision of budget execution software, a financial application support program, and other software, has strengthened and standardizes to some extent local government PFM.

107. **Hunan Province's PFM Reform seeks to modernize provincial governance by adopting best practices and has three pillars:** 1) budget reform; 2) tax reform; and 3) reform of intergovernmental roles and responsibilities. Budget reform started first and is most advanced. The scope of the budget reform is to: a) strengthen integration of the provinces four budgets (general budget, government fund budget, state owned capital income budget and social security fund budget); b) increase budget transparency; c) reform earmarked funds; and d) reform debt management. These reforms are producing tangible results such as budget documents prepared in simple, non-technical, easy-to-understand language. The treasury single account reform, begun in 2003, and completed in 2014, centralized most payments and significantly reduced bank accounts province-wide. Hunan Province is also one of the first batch to pilot the accrual based government comprehensive financial report. The World Bank Financial Management review of Hunan's PFM systems (no national or subnational Public Expenditure and Financial Accountability (PEFA) reviews have been carried out in China) noted that these ongoing reforms are addressing important PFM development needs. Work remains to be done but Hunan's vision is to complete the three pillars of its ongoing PFM reform by 2020. The goal for completion of reform in the accrual based government comprehensive financial report is similarly slated for 2020. Some of the provincial debt reform objectives, activities and timelines are embodied in this DPF program.

108. **National procurement laws and regulations, implementation rules and procedures for supervision and procurement oversight systems, complaint handling mechanisms, anti-corruption laws, administrative regulations and enforcement measures establish a well-functioning national procurement framework.** In Hunan province, the government has put in place a well-functioning procurement system and platform including procurement transaction centers, a procurement website for publication of bidding opportunities, a bid evaluation expert pool, bid award notices, supervision and oversight, complaint handling and anticorruption, bidder's credit management, and other institutions. The Hunan Province procurement system provides reasonable assurance for the economy, effectiveness, efficiency, fairness and openness of procurement activities executed with budget resources.

109. **The Bank has reasonable assurance that the control environment for foreign exchange in the People's Bank of China (PBOC) is satisfactory for the purposes of this operation.** China's foreign

exchange reserves reported by PBOC were USD3.22 trillion in April 2016. The International Monetary Fund (IMF) does not carry out a Safeguards Assessment of the PBOC. However, the IMF's November 2015 Policy Paper on valuation of the SDR noted that Chinese authorities have made notable strides in enhancing data disclosures that include China's reserves. The PBOC is audited by the China National Audit Office (CNAO), China's supreme audit institution (SAI). CNAO's audit of PBOC is largely compliance in nature and it therefore does not issue an audit opinion on PBOC's financial statements. PBOC's 2014 Annual Report noted the following foreign exchange control activities: It maintained its diversified investment strategy, optimized the allocation of currencies and assets, and ensured the safety, liquidity, maintenance and appreciation of the value of the foreign exchange reserve. It further improved the risk management framework, intensified the early warning and judgment of risks, perfected the contingency plan and enhanced its capacity of withstanding the impact of crises.

**110. The overall fiduciary risk to this operation arising from Hunan's PFM system, the use of budget resources and its foreign exchange environment as controlled by the Central Bank is assessed to be moderate.**

#### **Disbursement Arrangements**

**111. The Borrower is the People's Republic of China.** This operation is an IBRD loan of US\$ 200 million. The World Bank loan agreement will be signed between the World Bank and MOF, the on-lending agreement will be signed between MOF and the Hunan Province Finance Department (HPFD). The on-lending currency is in US dollar and the terms are the same as stipulated in the loan agreement between the World Bank and MOF. The Hunan Province Finance Department will be responsible for repaying the World Bank loan.

**112. The proposed Bank loan will follow the Bank's disbursement procedures for development policy lending.** The loan proceeds will be disbursed once evidence of fulfillment with prior actions has been accepted and an adequate macroeconomic framework has been maintained. Upon the withdrawal application submitted by the Borrower, the Bank would disburse the loan proceeds, denominated in US dollars, into a designated foreign currency account held by HPFD in a commercial bank acceptable to the Bank. The USD loan proceeds will be immediately translated into equivalent Renminbi and transmitted into the treasury single account (TSA) of HPFD to finance budgeted expenditures.

**113. Within 30 days after the Bank loan disbursement, the Borrower (or MOF via HPFD) will accordingly provide the Bank with a written confirmation of the USD amount received, the amount of RMB transferred to the TSA to finance budgeted expenditures, and the exchange rate used for converting USD into RMB.**

#### **5.4 MONITORING, EVALUATION AND ACCOUNTABILITY**

**114. The development policy operation, including the development of the program objectives and results indicators, has been prepared through intensive policy dialogue with the Government.** The main counterparts are the Finance Department of Hunan Province as well as the Development and Reform Commission of Hunan Province. The projects are also supported and coordinated by the national MOF and the NDRC. Some indicators will be publicly available; some are part of internal monitoring in the Ministry of Finance.

**115. The Hunan Provincial Finance Department will have the main responsibility of the day-to-day monitoring on implementation and progress in the DPF Program.** Other government bodies, including the Province Development and Reform Commission and the Interagency Committee, will contribute to



this process in line with the functional responsibilities in the DPF program. The results indicators are already being tracked by the associated institutions. The operation builds on the existing monitoring and evaluation systems of the Government, which should ensure that program performance is monitored at no additional burden to the institutions.

116. **Grievance Redress.** Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the World Bank's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the World Bank's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of World Bank non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit <http://www.worldbank.org/GRS>. For information on how to submit complaints to the World Bank Inspection Panel, please visit [www.inspectionpanel.org](http://www.inspectionpanel.org). "

## 6. SUMMARY OF RISKS AND MITIGATION

117. **The overall risk rating for this subnational operation is substantial.** The main risks include: (i) limited implementation capacity at the subnational level; (ii) required close cooperation between government departments at the provincial and national level; (iii) further substantial adjustments to the national budget framework; and (iv) macroeconomic uncertainty. Materialization of any of these risks could imperil the ability and willingness to implement the modern and best-practice debt management framework supported by this operation. Beyond passage of the appropriate decrees and circulars, the success of the budgetary reforms envisaged by this operation requires the new framework to become ingrained over several budget cycles.

118. **Implementation capacity:** Limited implementation capacity at the subnational level represents the main risk faced by this operation. The budgetary reforms envisaged are ambitious at any level of government in China – but particularly for the limited resources available at the subnational level. For instance, performing a full debt sustainability analysis for multi-year comprehensive budget planning requires a substantial data collection effort, the need to build appropriate analytical capacity and the integration of such analysis into the work-streams that feed into the budget preparation process. Given the tight fiscal situation faced by the Hunan province, local staff are likely to be especially stretched. Risk mitigation will include support from World Bank staff on the implementation of the reforms.

119. **Cooperation between departments across levels of government:** A new more integrated approach to capital budgeting, as well as setting up and operating the new debt management system will require close cooperation and the support of multiple departments, particularly the Finance Bureau in charge for the budget and the Province Development and Reform Commission in charge of the investment plan and setting economic development targets, at the subnational level. It also requires support from these Departments' counterparts at the level of the national government. Given this DPF is the first conducted in China, it faces particular challenges, as the engagement needs to be tailored to the Chinese context. In this sense, this DPF covers new ground. As a mitigating factor, prior action 4 of this operation creates an Interagency Committee that can institutionalize part of the much needed cooperation.

120. **Further changes to the national fiscal framework:** the 2014 reform of the Budget Law is probable, and certain adjustments described above have already been made in 2015 through a series of State Council decisions. Budgetary reforms at the subnational level may need to be recalibrated dynamically in line with upstream changes. This could require changes to some of the content of the operation.

121. **Macroeconomic risks:** a sudden deterioration of the economic environment can imperil the achievement of the result indicators set for this operation. Budgetary pressures may also undermine, or at least delay, implementation of the institutional reforms supported by the program, particularly if local administrators see the need for greater short-term budgetary flexibility.

**Table 6: Summary Risk Ratings**

<b>Risk Categories</b>	<b>Rating (H, S, M or L)</b>
1. Political and governance	S
2. Macroeconomic	S
3. Sector strategies and policies	M
4. Technical design of project or program	M
5. Institutional capacity for implementation and sustainability	S
6. Fiduciary	M
7. Environment and social	L
8. Stakeholders	M
9. Other	n/a
<b>Overall</b>	S

## ANNEX 1: POLICY AND RESULTS MATRIX

Prior Actions	Results Indicators (Baseline and Target)
<b>Pillar 1 – Fiscal sustainability</b>	
<b>Objective A: Develop and employ a medium term fiscal / debt sustainability framework for managing risks and promoting the fiscal sustainability of Hunan Province</b>	
<p>Prior action #1: Hunan Provincial Government has adopted and published a Medium Term Fiscal Strategy, grounded in a debt sustainability analysis, which sets a target for provincial-level public investment financing that is consistent with fiscal sustainability.</p>	<p>A1: Share of Hunan Provincial-Government’s public liabilities in the Province GDP  <u>Baseline: 14.1% (2015)</u>  <u>Target: &lt; 15 % (2016)</u></p>
<b>Pillar 2 - Capital budgeting</b>	
<b>Objective B: Develop an integrated approach to capital budgeting to improve efficiency</b>	
<p>Prior action #2: Hunan Provincial Government has instituted the annual formulation of three-year rolling capital financing plans for the provincial-level budget.</p> <p>Prior action #3: Hunan Provincial Government has adopted a three-year rolling capital financing plan for the provincial-level budget for transportation, water/irrigation, and social housing for the calendar years 2016-2018, itemizing project by project.</p> <p>Prior Action #4 Hunan Provincial Government has established the Interagency Committee for Public Investment Financing and Debt Risk Management.</p>	<p>B1: Number of sectors covered in the integrated capital financing plan of Hunan Province  <u>Baseline: 1 (2015)</u>  <u>Target: 3 (2016)</u></p> <p>B2: Interagency Committee issues opinions on the Medium Term Fiscal Strategy and Three-Year Rolling Capital Financing Plan for Transportation, Water/Irrigation, and Social Housing for 2016-2018  <u>Baseline: Not applicable (2015)</u>  <u>Target: Opinions issued (2016)</u></p>
<b>Pillar 3 - Monitoring and regulating sub-provincial government debts</b>	
<b>Objective C: Develop an effective system at the provincial level of government to monitor the financial health of local governments and incentivize them to pursue prudent debt management</b>	
<p>Prior action # 5: Hunan has implemented an allocation scheme for bond swaps and new borrowings that rewards local governments for achieving better performance and early warning system indicators.</p> <p>Prior Action #6: Hunan Provincial Government has approved its Debt Management Framework to strengthen regulations by, inter alia: (a) establishing informational requirements for local governments, including submission and disclosure of a fund use plan for new borrowing and basic debt data (b) requiring the submission of risk mitigation action plans from local governments classified as “red” or “orange” in the provincial early warning system; and (c) allocating new borrowing limits to local governments based on indicators set in the early warning system.</p>	<p>C1: Share of local governments satisfying annual disclosure of debt data online and fund use plans for new borrowing  <u>Baseline: 0 (2015)</u>  <u>Target: &gt;40% (2017)</u></p> <p>C2: Share of local governments classified as “red” for more than one year having not submitted a risk mitigation action plan to restore financial health  <u>Baseline: 100% (2015)</u>  <u>Target: &lt;40% (2017)</u></p>

Prior Actions	Results Indicators (Baseline and Target)
<b>Pillar 4 – Transparency</b>	
<b>Objective D: Enhance transparency and accountability in the use of budget resources</b>	
<p>Prior action # 7: Beginning in year 2016, Hunan Provincial Government has started publishing annual Citizens' Budget Reports and Budget Performance Reports, and has set up an internet platform which allows an open engagement with citizens.</p> <p>Prior action #8: Beginning in year 2016, Hunan has (a) started producing and publishing biannual debt reports, containing debt information for the provincial level, and consolidated information for sub-provincial governments, and (b) created an internet platform for local governments for the disclosure of subnational debt and financial data.</p>	<p>D1: Biannual comprehensive debt reports on the internet with less than four month lag from end-June 2016, end-December 2016 and end-June 2017.  <u>Baseline: No (2015)</u>  <u>Target: 3 reports on line on time (October 2017)</u></p> <p>D2: Number of local governments in Hunan Province having disclosed all debt and financial information in the template on the internet platform.  <u>Baseline: 0 (2015)</u>  <u>Target: 10 (2017)</u></p> <p>D3: Number of citizens' budget reports and budget performance reports disclosed online less than 6 months from year end.  <u>Baseline: No (2015)</u>  <u>Target: 2 reports on line on time (October 2017)</u></p>

# 湖南省人民政府

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## 湖南省 DPL 项目发展政策信函

尊敬的金墉行长：

首先，我谨代表湖南人民，衷心感谢您和贵行一直以来对湖南的支持和帮助！发展政策贷款项目通过向湖南省提供无指定用途、可纳入预算统筹安排长期低息贷款，帮助我们通过深化改革来提升现代治理能力，一旦贵行批准发放，我们将有效运用贷款资金，充分借鉴国际经验，努力提升全省政府性债务的预算管理水平和风险防控能力。

湖南省地处中国中部，面积 21.18 万平方公里，2015 年末全省常住人口 6783 万人，全省 GDP29047 亿元，一般公共预算收入 4008.1 亿元。“十二五”期间，我们主动适应经济发展新常态，克服多重困难和挑战，以改革创新增强发展动力，保持了稳中趋优、稳中向好的发展态势，2013-2015 年 GDP 分别增长 10.1%、9.5%、8.6%。“十三五”期间，湖南省 GDP 年均增长率预计为 8.5%左右。

湖南省属于中部欠发达省份，基础设施建设投入任务比较

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重。特别是我省地处中部腹地，在全国交通网络中处于连接南北、承东启西的重要位置，为完善全国路网承担了大量的铁路、普通公路、高速公路等交通基础设施建设任务，目前我省高速公路通车里程达 5649 公里，居全国第 6 位；国省干线达 3.1 万公里，居全国第 3 位，相应也形成了规模较大的债务。截至 2015 年末，全省政府性债务 12007.1 亿元，其中，政府负有偿还责任的债务 6121.7 亿元，或有债务 5885.4 亿元；省本级政府性债务 3131.5 亿元，其中，高速公路债务 2089.6 亿元，占 67%。受宏观经济增幅放缓影响，我省财政收入增速也步入中速增长，因此，合理控制政府投资规模，防范债务风险，实现财政可持续发展是当前我们改革的重点。据此，世界银行发展政策贷款项目不仅契合了当前财政改革方向，也为实现我省财政可持续发展提供了新的思路和办法。

2013 年以来，中国进入全面深化改革的新时期。随着新预算法、《国务院关于加强地方政府性债务管理的意见》（国发〔2014〕43 号）、《国务院关于实行中期财政规划管理的意见》（国发〔2015〕3 号）等法规制度的实施，政府预算管理、公共工程建设融资制度等正在发生着深刻变革。在这一轮改革中，湖南把政府债务改革作为重中之重，按照中央部署，结合省情实际，采取了一系列既利当前、又管长远的债务改革举措，取得了初步成果，得到了财政部的高度肯定，并作为典型经验向全国推介。经报国务院批准，我们申报世界银

行发展政策贷款（DPL 项目），希望将湖南改革实践与世行成熟经验结合起来，进一步提升我省政府性债务管理水平，探索一条有效控制债务风险、实现可持续发展的道路。

几个月来，世行专家和我们反复研究探讨和磋商沟通，确定了我省 DPL 贷款项目的先期行动计划，我们将严格按照约定组织实施好各项先期行动计划：一是建立跨部门的政府性债务管控机制，成立由省财政厅、省发改委、省审计厅、省交通厅、省政府金融办等部门参加的省级政府性债务预算管理和风险控制联席会议制度；二是制定加强政府性债务管理的制度办法，对市县政府债务信息公开、化解债务风险作出明确要求；三是在省级政府性债务可持续性分析（DSA）的基础上，制定可持续的中期财政战略，并将这一战略应用到我们正在编制的省级重大基础设施建设项目债务预算（2016-2018 年）中去，确保省级债务整体可控，实现可持续；四是编制包括交通运输、水利、保障性住房建设等方面的省级重大基础设施建设项目债务预算（2016-2018 年）；五是完善政府债务风险预警办法，并将债务预警结果应用到债券配额的分配中，以激励市县加强债务管控，防范债务风险；六是提升政府预算和债务信息透明度，我们将在互联网上公开省本级的预算报告和预算绩效报告，并根据与贵行约定的模板，在互联网上公开省本级及市县的相关债务信息。

最后，感谢世行在项目申报过程中给予我们的技术援助，世行专家的专业水准、敬业精神给我们留下了深刻印象。

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希望世行能够批准我省这一贷款项目，这将创下中国地方政府运用现代治理手段管控政府性债务风险的范例。

湖南省人民政府省长



2016年5月20日



# The People's Government of Hunan Province

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## Letter on DPL Project Development Policy of Hunan Province

Respected President Jim Yong Kim,

First of all, on behalf of the people of Hunan, I would like to extend my sincere appreciation to you and the World Bank (WB) for your consistent support and assistance. By providing to Hunan Province long-term and low-interest loans which require no earmarking and which support the general budget, the DPL Project aims to help us in promoting modern debt management capability and deepening reform. Upon approval and disbursement, we will use the loan funds effectively, take full advantage of international experience, and make all efforts to improve our budget management capacity and risk control ability in handling provincial government debt.

Located in central China, Hunan Province covers an area of 211,800 m<sup>2</sup>. At the end of 2015, the province's permanent population reached 67.83 million, with a total GDP of RMB 2904.7 billion and general public budget income of RMB 400.81 billion. During the "Twelfth Five-year Plan" period, we have taken the initiative to adapt to China's transition towards a "new normal" path of economic development and overcome various difficulties and challenges, so as to enhance growth thrust through reform and innovation, and maintain stable and high development momentum. From 2013 to 2015, Hunan Province achieved GDP growth of 10.1 percent, 9.5 percent and 8.6 percent respectively each year. During the "Thirteenth Five-year Plan" period, Hunan's annual GDP growth rate is projected at around 8.5 percent.

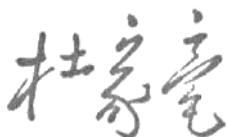
Hunan is an underdeveloped province in central China, facing the heavy task of investing in infrastructure construction. Located in the hinterland of China, Hunan plays an important role in the national transportation network, connecting the north to the south and linking the west and the east. It has undertaken a large amount of work establishing railways, highways and expressways as well as other transport infrastructure construction in an effort to improve this network. At present, the length of highways in operation in our province has reached 5649 km, ranking sixth in China; the length of provincial trunk roads stretches 31,000 km, ranking third in our country. These investments have accordingly resulted in a relatively large debt. As of the end of 2015, the province as a whole had total government debt of RMB1200.71 billion, of which RMB612.17 billion were government obligation and RMB588.54 billion were government contingent liability. The government debt of the provincial government alone reached RMB 313.15 billion, of which 67 percent, or RMB 208.96 billion, are linked to the construction of Hunan's motorways. At the same time, given slowing macroeconomic growth, our province has entered a period of medium-speed growth in fiscal revenues. Therefore, our current reform program focuses on controlling the size of further government investments and preventing the further build-up of fiscal vulnerabilities and debt. This WB DPL project not only fits well the current direction of ongoing fiscal reforms, but also provides new ideas and methods for addressing the province's problems regarding fiscal sustainability.

Since 2013, China has entered a new era of deepening a comprehensive reform. With implementation of the New Budget Law, *The State Council's View on Strengthening the Local Government Debt Management*(Guo Fa No.43, 2014), *The State Council's View on Implementing the Medium-term Fiscal Planning Management*(Guo Fa No.3, 2015) and other regulations, profound reform has taken place in government budget management, financing systems for public infrastructure investment projects and

other areas. In this latest round of reform, Hunan attached top priority to government debt management, and adopted a series of debt reform measures that are conducive to both the current situation and long-term developments. In doing so, Hunan has taken into account both the guidance from the central government and the reality in the province. The reforms have achieved preliminary results, which have won high praise from the Ministry of Finance and have been introduced to local governments across the nation as leading examples. We have submitted the application for a development policy loan from the WB (DPL project) to the State Council for approval. We hope to integrate Hunan's reform practices with the experience of the WB to further improve government debt management in our province and explore an effective way to control debt risk and realize sustainable development.

After repeated study, discussion of and consultation on this project over the last few months, experts from the WB and we have worked out a set of prior actions for the DPL project of our province. We will make sure that all prior actions will be strictly carried out as agreed: Firstly, establish a cross-department government debt control and management mechanism, by setting up a provincial government debt budget management and risk control interagency committee, which consists of the Provincial Department of Finance, the Provincial Development and Reform Commission, the Provincial Audit Office, the Provincial Department of Communications, and the Provincial Government Financial Office; secondly, formulate a framework for strengthening government debt management, making explicit requirements regarding city and county government debt information transparency and fiscal adjustment plans for highly-indebted local governments; thirdly, develop a sustainable medium-term fiscal strategy on basis of the government Debt Sustainability Analysis at the provincial level, and ensure that the public investment capital financing plan of the Provincial Government (2016-2018) is consistent with this fiscal strategy; fourthly, develop a capital financing plan (2016-2018) for all major public investment sectors, including transportation, water conservation and social housing; fifthly, improve Hunan government's debt risk early-warning system for Local Governments, incentivizing fiscal prudence by offering high-performing cities and counties higher borrowing quotas; sixthly, increase transparency in government budget and debt information, release budget report and budget performance report of the provincial level on the Internet, and release relevant debt information of the provincial, city and county level on the Internet in the template agreed by WB experts and us.

At last, we would like to thank the WB for their technological assistance during the process of our project application. We are deeply impressed by professional level and dedication of experts from the WB. We look forward to the WB's approval of our DPL project, and believe this will set an outstanding example for Chinese local governments in how to control and manage government debt risk with modern management approach.



(Signature)

Governor of the People's Government of Hunan Province

May 20, 2016

### **Annex 3: IMF Article IV Consultation Mission Statement**

IMF Press Release No. 16/374

On July 27, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation 1 with China.

China continues its transition to sustainable growth, with progress on many fronts yet also many challenges. Growth slowed to 6.9 percent in 2015 and is projected to moderate to 6.6 percent this year owing to slower private investment and weak external demand. The economy is advancing on many dimensions of rebalancing, particularly switching from industry to services and from investment to consumption. But other aspects are lagging, such as strengthening SOE and financial governance and containing rapid credit growth.

Inflation dipped below 1.5 percent in 2015 and is expected to pick up to around 2 percent this year, reflecting the rebound in commodity prices and the exchange rate depreciation since mid-2015.

Infrastructure spending picked up and credit growth accelerated in the second half of 2015. Accommodative macro policies are projected to continue supporting activity over the remainder of 2016.

The current account surplus is projected to decline to 2.5 percent of GDP this year (from 3 percent of GDP in 2015) as imports increase and the services deficit widens with continued outbound tourism. The balance of payments came under pressure in 2015 due to large capital outflows, mainly related to repayment of external debt. The volume of outflows is expected to moderate this year. After appreciating 10 percent in real effective terms through mid-2015, the renminbi has depreciated some 4.5 percent since then and remains broadly in line with fundamentals.

#### **Executive Board Assessment**

Executive Directors commended the Chinese authorities for their strong determination to achieve more balanced, sustainable growth. They noted that economic growth continues to moderate and is driven increasingly by services and consumption. Directors welcomed the impressive progress on structural reforms in many areas, notably interest rate liberalization, internationalization of the renminbi, and urbanization. They also welcomed the 13th Five-Year Plan, with its ambitious goals centered on economic rebalancing.

Directors noted that China's economic transition will continue to be complex, challenging, and potentially bumpy, against the backdrop of heightened downside risks and eroding buffers. They stressed the need for decisive action to tackle rising vulnerabilities; reduce the reliance on credit-financed, state-led investment; and improve governance, risk pricing, and resource allocation in the state-owned enterprise (SOE) and financial sectors. Directors emphasized that consistent, well-coordinated, and clearly-communicated policies are key to a smooth, successful transition, which will eventually benefit the global economy.

Directors highlighted the urgency of addressing the corporate debt problem through a comprehensive approach. They encouraged the authorities to harden budget constraints on SOEs; triage and restructure or liquidate over-indebted firms; and recognize losses and share them among relevant parties, including the government if necessary. Piloting a few SOEs would make a strong start to the process. Directors

recommended that the authorities complement these measures with targeted social assistance for displaced workers, and initiatives to facilitate entry of new, dynamic private firms.

Directors concurred that macroeconomic policies should be geared at lowering vulnerabilities, which would likely entail somewhat slower growth in the short term. They welcomed the authorities' intention to rely on fiscal support if growth falls sharply in the near term. To this end, they saw merit in using on-budget, pro-consumption measures, which would help promote internal and external rebalancing. Measures could include raising pensions; increasing social, education and health spending; providing restructuring funds; and cutting minimum social security contributions. Continued efforts are also needed to ensure full implementation of the new budget law, improve fiscal transparency, and modernize the tax system.

Directors underscored the importance of further enhancing financial stability. Priorities include encouraging banks to proactively recognize loan losses and strengthen capital ratios; enhancing supervisory focus on liquidity risk management and funding stability risks; and addressing vulnerabilities in shadow products. Directors also recommended a major upgrade of the supervisory framework to foster cross-agency information sharing and policy coordination, reduce the scope for regulatory arbitrage, and enhance crisis management capabilities. They looked forward to the forthcoming Financial Sector Assessment Program Update.

Directors noted the staff's assessment that the renminbi is broadly in line with fundamentals, although the external position in 2015 was moderately stronger than consistent with fundamentals. They welcomed steps toward an effectively floating exchange rate regime and encouraged the authorities to build on this progress while carefully managing the transition, and with the support of a more market-based monetary framework. Directors supported a cautious approach to capital account liberalization that is carefully sequenced with the progress on exchange rate flexibility and financial sector reforms.

Directors encouraged the authorities to continue to improve data quality and policy communications, which would help reduce uncertainty, align expectations, and guard against market turbulence.

*Source:* <https://www.imf.org/en/News/Articles/2016/08/11/20/37/PR16374-China-IMF-Executive-Board-Concludes-2016-Article-IV-Consultation>