

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

April 19, 2016
Report No.: 109236

Operation Name	Hunan Fiscal Sustainability DPF
Region	EAST ASIA AND PACIFIC
Country	China
Sector	Sub-national government administration (85%); Central government administration (15%)
Operation ID	P157406
Lending Instrument	Development Policy Lending
Borrower(s)	PEOPLE'S REPUBLIC OF CHINA
Implementing Agency	Hunan Provincial Finance Bureau
Date PID Prepared	April 19, 2016
Estimated Date of Appraisal	May 6, 2016
Estimated Date of Board Approval	July 28, 2016
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of the operation.
Other Decision <i>{Optional}</i>	<i>Teams can add more if they wish or delete this row if no other decisions are added</i>

I. Key development issues and rationale for Bank involvement

While growth in China remains quite high by international standards, macroeconomic risks have increased in the form of rapidly rising debt. Subnational governments account for a good share of this new debt. From negligible levels in 2008, subnational debt in China reached close to 40 percent of Gross Domestic Product (GDP) by the end of 2014. Although subnational governments were not allowed to incur explicit deficits or borrow funds directly until 2015, they nevertheless accumulated debt quite rapidly in off-budget vehicles (Urban Development Investment Corporations (UDICs)) that carried out public investments. The Chinese Government has recognized the need to control this rapid increase in debt, particularly given the risks from a possible economic slowdown, declining marginal returns from investment, and weaker land markets.

The Chinese Government introduced a major reform in 2014 to bring subnational debt under control and reorient subnational officials and budgetary institutions toward fiscal / debt sustainability. The Government has also requested that the World Bank work in two pilot regions to assist this transition: Chongqing Municipality and Hunan Province. This World Bank Programmatic Development Policy Financing (DPF) for US\$ 200 million will assist the Hunan Province Government realize reforms to ensure that public finances are placed on a sustainable path. The expectation is that Hunan can provide a model in China for subnational fiscal reform that can be scaled up to other provinces.

II. Proposed Objective(s)

This First Hunan Province Development Policy Financing (HPDPF) supports Hunan Province Government to ensure its fiscal sustainability by developing a forward-looking, comprehensive and transparent public finance regime that integrates budget, public investment and debt management. An underlying key objective of this operation is to assist Hunan Province in placing itself on a fiscally sustainable path. The operation works at the level of the Provincial Government, developing a framework to assess the finances of the province from the angle of fiscal sustainability, and supporting measures to places finances of the Provincial Government on an immediate sustainable path, while strengthening the regulatory framework to move the finances of local governments in Hunan Province in the same direction. Another objective of the operation is to achieve greater efficiency in capital budgeting through an integrated 3-year rolling capital investment plan. Finally, Hunan Province promote the objective of greater transparency in public finance by preparing and publishing comprehensive debt reports on a biannual basis, and managing an internet portal where local governments are encouraged to disclose their individual debt data.

III. Preliminary Description

The DPF program in Hunan Province is divided into four pillars: (i) fiscal sustainability, (ii) capital budgeting, (iii) monitoring and regulating sub-provincial government debts, and (iv) transparency.

Under the first pillar, Hunan will employ a Debt Sustainability Analysis (DSA) framework for the preparation of a Medium Term Fiscal Strategy consistent with the fiscal sustainability of province-level finances. Under the second pillar, Hunan is introducing an integrated capital budgeting / financing framework that is critical for achieving fiscal sustainability and improving efficiency in public investment. Under the third pillar, Hunan will expand 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. 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. Under the fourth pillar, Hunan will enhance transparency and accountability in the use of budgetary resources through the adoption of higher standards for disclosure and regular information reporting to the public.

For **pillar 1**, Hunan Province is carrying out the following action:

- (a) *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

The results indicator for the pillar and prior action is that Provincial-level comprehensive liabilities relative to Province GDP remain under a critical threshold in 2016.

For pillar 2, Hunan Province is carrying out three prior actions:

- (a) *Prior action #2:* Hunan Provincial Government has issued a decree for the annual formulation of a three-year rolling capital financing plan for the provincial-level budget.
- (b) *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.
- (c) *Prior Action #4* Hunan Provincial Government has established the Interagency Committee for Public Investment Financing and Debt Risk Management

For **pillar 3**, Hunan Province is carrying out two prior actions:

- (a) *Prior action # 5:* Hunan Province has implemented an allocation scheme for bond swaps and new borrowing that rewards local governments for achieving better performance and early warning system indicators.
- (b) *Prior Action #6:* Hunan Provincial Government has strengthened its debt management framework 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” in the provincial early warning system; and (c) allocating new borrowing limits to local governments based on indicators set in the early warning system

For **pillar 4**, Hunan Province is carrying out three prior actions

- (a) *Prior action #8:* Beginning in year 2016, Hunan has started producing and publishing biannual debt reports, containing debt information for the provincial level, and consolidated information for sub-provincial governments.
- (b) *Prior Action #9:* Hunan has created an internet platform for local governments for the disclosure of subnational debt and financial data.

IV. Poverty and Social Impacts and Environment Aspects

Poverty and Social Impacts

The short run direct poverty and social impact of this operation is expected to be negligible, while the medium-longer term impact should be slightly positive. The operation addresses vulnerabilities that could potentially place the province in a very difficult financial position for public investments, which will contribute to poverty reduction and shared prosperity. Hunan is undergoing a significant fiscal consolidation effort. Public debt has now reached high levels and economic activity has been supported by unsustainable public investment growth. Going forward, the Province Government will need to severely constrain further growth of public expenditure. The proposed slower investment growth concerns mostly transportation and should not affect social spending. In the absence of the program supported by this operation, Hunan Province would nevertheless have been unable to sustain the high rates of growth in public investment in recent years, and a postponed adjustment might have been more disorderly, with a less certain impact on public welfare.

Spending with direct social implications is protected in 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 that 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 Medium Term Fiscal Strategy programs civil servant wage growth at higher than the rate of 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.

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 cuts in investment in major motorways. 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 by better informing this investment with local information, including social welfare considerations.

Environment Aspects

The DPF is expected to have a neutral environmental impacts. The reforms are designed to improve the institutional and policy framework of the Government as they relate to improving the fiscal sustainability and efficiency of public resources and, as such, have no direct bearing on the environment.

V. Tentative financing

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

VI. Contact point

World Bank

Contact:

Mr. John Litwack

Title: Lead Economist, GMF02

Tel: 010-5861 7650

Fax: 010-5861 7800

Email: jlitwack@worldbank.org

Location: China, Beijing (IBRD)

Ms. Min Zhao

Title: Senior Economist, GGO14

Tel: 010-5861 7656

Fax: 010-5861 7800

Email: mzhao1@worldbank.org

Location: China, Beijing (IBRD)

Borrower

Contact: Mr. Yuanjie Yang

Name: Government of People's Republic of China

Title: Director, IFI Div. I, International Economic and Financial Cooperation Department
Ministry of Finance

Tel: 010-6855 2471

Email: yuanjieyang@mof.gov.cn

VII. For more information contact:

The InfoShop

The World Bank

1818 H Street, NW

Washington, D.C. 20433

Telephone: (202) 458-4500

Fax: (202) 522-1500

Web: <http://www.worldbank.org/infoshop>