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Can America Avoid China's Local-Government Debt Trap?

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Although far from perfect, U.S. state- and local-government financial conditions are far better than those in China. Aside from heavy debt loads, Chinese public-sector entities have opaque financial-reporting practices that reduce investor confidence. By contrast, U.S. borrowers now have an opportunity to improve their world-leading transparency standards — an opportunity that they would be wise to take.

As of early 2023, U.S. state and local debt securities only amounted to 12 percent of GDP according to Federal Reserve data. The Fed also estimates total state- and local-government liabilities including those for public-employee pensions. This amount, currently 34 percent of GDP, represents something of an undercount because retiree health-care obligations and some other items are not included. Even if the Fed was able to capture the true extent of total liabilities, they would probably not exceed 40 percent of GDP.

By contrast, the International Monetary Fund (IMF) estimates China's local government debt at 32 percent of GDP. But this excludes debt issued by Local Government Financing Vehicles (LGFV). IMF estimates this category of debt at 53 percent of GDP. There do not appear to be estimates of pension obligations or other provincial liabilities.

It is only possible for the IMF and others to estimate LGFV debt because it is excluded from government balance sheets and not centrally tabulated. This hidden debt is now proving to be unsustainable in several parts of the country. According to S&P Global, LFGV debt in at least three provinces (Yunnan, Guizhou, and Gansu) and one independent municipality (Tianjin) faces heightened risk of restructuring and maturity extensions.

Guizhou Province appears to be in the worst shape, but bond investors and the public are being denied the full story. On April 11, an official provincial think tank concluded that due to "limited financial resources, debt relief work has been extremely difficult, and it is impossible to effectively solve it on our own." But the article was quickly taken down.

The following month, the finance bureau of Guiyang, the capital city of Guizhou, offered a similar assessment on its website, and, once again, the post was quickly removed. And even if these warnings were reposted, their general findings would tell us relatively little about each of the dozens of LGFVs in the province.

In the U.S., by contrast, we can determine which public-sector entities have issued debt, and we can obtain some level of information about their financial status. But the availability of financial information in the U.S. municipal-bond market is inferior to that of corporate securities markets.

We lack freely available identifiers for government-securities issuers and the instruments they have issued. Instead, we have an antiquated system of CUSIP numbers, which do not uniquely identify government-bond issuers and cannot be freely redistributed. CUSIP (Committee on Uniform Security Identification Procedures) numbers are licensed by the American Bankers Association and FactSet under highly restrictive terms. On the U.S.'s municipal-bond information website, CUSIP numbers are displayed as images that cannot be readily copied and pasted, and their republication is prohibited by strict terms and conditions.

Financial data for U.S. government-bond issuers are more readily available than they are for their Chinese counterparts, but they also lag corporate-disclosure practices. Public-sector audited financial statements appear months or even years after the end of the entity's fiscal year. And because these reports are published as PDFs with non-standard table formats, their financial statistics are hard to extract.

This latter problem could be solved if the Securities and Exchange Commission properly implements the Financial Data Transparency Act (FDTA). This legislation requires a transition away from PDFs to open (i.e., royalty-free), structured text-reporting formats such as eXtensible Business Reporting Language (XBRL), used by publicly listed companies since 2009.

FDTA also addresses the problems with municipal issuer identifiers mentioned earlier by mandating the use of unique, freely redistributable Legal Entity Identifiers (LEIs) by each entity issuing municipal securities.

But unfortunately, these reforms are not welcomed by many leaders in the municipal securities markets. At a May 2023 SEC disclosure conference, public-finance leaders from Florida and Michigan told attendees that CUSIPs were perfectly fine, perhaps unaware of their technical, legal, and transparency limitations.

They were also critical of a transition away from PDFs on the grounds that structured text filings were too onerous for local governments. This ignores the existence of many low-cost as well as premium solutions already in use by tens of thousands of companies to prepare their machine-readable financial reports. And it further portrays an unfounded pessimism in the ability of private companies, non-profits, and even government information-technology groups to develop tools that will further ease the transition and insulate non-technical users from the complexities of creating machine-readable reports.

China's further development is now greatly impeded by an accumulation of unsustainable and poorly understood local-government debt. FDTA provides an opportunity for the U.S. to double down on our transparency advantage. Rather than oppose such obvious modernization, the SEC and municipal market leaders should embrace the opportunity to advance local-government debt and financial-disclosure standards.

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