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Disclosure of government financial information and the cost of local government's debt financing—Empirical evidence from provincial investment bonds for urban construction ☆

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ABSTRACT

China's slowing economic growth and rapid urbanization have made local government debt financing a significant issue. This study uses a sample of China's provincial government data for the 2006–2012 period to examine the effect of the disclosure of financial information by local governments on their debt financing costs. The results show that financial information disclosure is conducive to public supervision and enhances government credibility, leading to a decrease in the cost of debt financing. Furthermore, increased government economic intervention increases the strength of the association between financial information disclosure and the cost of debt financing. Increased government audit prevention function weakens the strength of the association between financial information disclosure and the cost of debt financing.

1. Introduction

In recent years, local government debt has increased. Deputy finance minister Wang Baoan says: "The contradiction between tardiness of financial growth of revenue and strong rigidity of expenditure will further

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intensify the pressure on local government debt." A 2013 report by the national government's Audit Department states that the government's direct liability for repayment of debt increased by 62.44% between 2010 and June 2013. As the expansion of debt is often accompanied by an increase in financial risk, the Third Plenary Session of the 18th session of the Central Committee of the Communist Party of China has announced that the relevant departments should establish a reasonable early warning mechanism to control government debt risk and to enhance management. For example, *The State Council on Strengthening the Opinions of the Local Government Debt Management* was issued by the State Council in 2014. However, a government without debt financing is not a government with no risk. Debt risk, to a large extent, is related to the ability to pay off debt (Liu, 2014), and blindness about debt financing combined with ignorance about the lending rate leads to huge risks for governments (Luo and She, 2014).

Previous studies of the cost of debt focus on corporate debt, financing scale and risk factors, such as accounting information and debt contracts (Sun et al., 2006; Lu et al., 2008; Deng, 2014), information disclosure and debt financing (Hu and Tang, 2007; Lu et al., 2013), control of local government debt scale (Azuma and Kurihara, 2011), municipal bonds and local government debt risk (Mikesell, 2002; Liu and Zhao, 2005; Han et al., 2005), government performance and cost of financing (Wilson and Howard, 1984). These previous studies, especially those examining financial disclosure, suggest that the cost of debt financing is less for local governments. Therefore, this study uses a sample of urban construction investment bonds[1] issued at the provincial level to explore how financial information transparency affects the cost of local government debt financing. The results show that a high degree of government financial information disclosure is associated with a low cost of local government debt financing. A higher government intervention index and more effective government auditing are also associated with a lower cost of local government debt financing, although these factors also weaken the negative relationship between local government financial information disclosure and government debt financing costs.

The rest of this paper is organized as follows. The second section discusses the institutional background. The third section presents the theoretical analysis and research hypotheses, and the fourth section presents the research design. The fifth section presents the empirical testing and results. The final section discusses the results and presents the conclusions.

2. Institutional background

Since its 1993 reforms of its fiscal and taxation system policy, the Chinese government has allocated more capital to regional infrastructure construction. However, these reforms have caused some problems at the local level, such as the mismatch of government fiscal power and responsibility, leading to a lack of financial resources. To meet the demands of economic development and political competition, local governments have financed their regional investment and financing platforms[2] (Mei, 2011) through bank loans and by issuing Quasi-municipal bonds (also called urban construction investment bonds, hereinafter referred to as "UCID").[3] Originally, the central government allowed the Shanghai government to issue bonds to raise money for urban construction in the new Pudong area. In 2005, with the support of state policy, the use of UCIDs spread rapidly. In 2008, in response to the global subprime mortgage crisis, the central government implemented the "four trillion plan" to stimulate economic growth, and this provided further opportunities for the development of UCIDs. The issuers of UCIDs are regional investment and financing platforms established by local governments and the aim is to raise money. The buyers are mainly institutional investors, and the money is used to make loan payments, pay for infrastructure construction and provide day-to-day

[1] These instruments originated in the Shanghai Pudong construction bonds at the beginning of 1992 and have developed relatively slowly. However, the 2008 financial crisis and the "four trillion plan" launched by the government stimulated their development. Due to concerns about the out of control local financing behavior, since 2013, the Chinese government has begun macro control of bonds. As document No. 43 [2014] indicates: "local government debt is facing full clear screening, issuing bonds is the only way to raise funds for provincial governments."

[2] According to the 1994 regulations, "The local government shall not issue bonds."

[3] The local government debt financing may also include forms of trust-financing, finance-leasing and BT-financing, but they are adopted at a very low rate, due to the relatively high cost of financing.