
Article

**Binding Leviathan: Credible Commitment
in an Authoritarian Regime**

Roderick M. Hills, Jr.[†] & Shitong Qiao^{††}

INTRODUCTION

Suppose that you are the ambitious mayor of a mid-size Chinese city striving to win a promotion to a more prestigious position. You do not have a lot of time to make your mark. The Chinese Communist Party (CCP) will likely move you to a new and better post in three to four years—if it is going to promote you at all. You therefore need to make a splash quickly in a way that conforms to the CCP’s promotion criteria. Here comes the challenge: how can you assure prospective beneficiaries of your long-range plans that those plans will ever yield fruit? After all, your successor would want to impress her superiors with her own projects, not stand in the shadow of your achievements. And, if you cannot give them such assurance, how can you induce them to make the investments you need to achieve your plans?

This problem of credible commitment dogs every government, whether democratic or authoritarian. Governments that

[†] William T. Comfort III Professor of Law, New York University Law School.

^{††} Assistant Professor, The University of Hong Kong Faculty of Law; Global Associate Professor of Law, New York University (Fall 2017); JSD (Yale). Many thanks for comments on an early draft to the participants of the conference on Decentralization and Development sponsored by New York University’s Classical Liberalism Institute and the University of Hong Kong Faculty of Law on March 13–15, 2017 in Hong Kong. Both authors gratefully acknowledge research assistance provided by Junye Guo and Yawen Li. Rick Hills and Shitong Qiao gratefully acknowledge the generous support from the Filomen D’Agostino Research Fund at New York University School of Law and the University of Hong Kong Strategic Research Theme on China Business and Economics respectively. Copyright © 2018 by Roderick M. Hills and Shitong Qiao.

have sufficient power to begin a project can always change their minds but, paradoxically, their power to change their plans makes them less powerful.¹ Omnipotence can be crippling. If lenders cannot be assured that a current mayor's successors will repay loans, then they may charge him or her extortionate interest rates.² If homebuyers suspect that a mayor's touted plans to improve the schools, police, environment, or any other long-term project will be abandoned by her successor, they will discount their bids on the city's land, reducing the capitalization of good government and discouraging the current mayor from even attempting such long-term improvements in the first place.³ The bankruptcies of Detroit and Puerto Rico are testaments to the potentially short-term horizons of elected politicians, even in constitutional democracies.

Authoritarian bureaucracies, however, face special credible commitment problems that may further exacerbate the ability of local officials to pursue long-term goals. Fear that local officials will build up a local power base that could be used to rebel against the center has historically induced the leadership of China, Imperial and Communist alike, to transfer local officials

1. For a general account of the problem of credible commitment and sovereign debt, see CARMEN M. REINHART & KENNETH S. ROGOFF, *THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY* (2009) (explaining how large-scale buildups of debt pose risks because they make an economy vulnerable to crises of confidence, particularly when debt is short-term and needs to be constantly refinanced). For a general overview of the tension between democratic accountability and credibility of governmental commitments, see PETER H. SCHUCK, *WHY GOVERNMENT FAILS SO OFTEN: AND HOW IT CAN DO BETTER 182–90* (2014) (noting that the “demands of democratic legitimacy and accountability require government to respond to changed conditions . . . in ways that will impair its credibility”). For a theoretical examination of how democratic elections can increase the problem of credible commitment, see Steven A. Block & Paul M. Vaaler, *The Price of Democracy: Sovereign Risk Ratings, Bond Spreads and Political Business Cycles in Developing Countries*, 23 *J. INT'L MONEY & FIN.* 917 (2004) (finding that agencies and bondholders view elections negatively, increasing the cost of capital to developing democracies). For one empirical test of the effects of political structures on ability to make credible commitments to repay sovereign debt, see Michael Breen & Iain McMenamin, *Political Institutions, Credible Commitment, and Sovereign Debt in Advanced Economies*, 57 *INT'L STUD. Q.* 842 (2013) (arguing that power-sharing and party system polarization have important effects on long-term interest rates). The article then finds that, where collective responsibility is high and polarization is low, markets perceive more credible commitments on the part of sovereign debtors.

2. See Breen & McMenamin, *supra* note 1, at 843.

3. See PIERRE F. LANDRY, *DECENTRALIZED AUTHORITARIANISM IN CHINA: THE COMMUNIST PARTY'S CONTROL OF LOCAL ELITES IN THE POST-MAO ERA* 263 (2008).

among subnational jurisdictions.⁴ Such frequent transfers undermine those officials' capacity to make the credible commitments that officials with stable tenure can make with ease. Robert Moses, a mid-level bureaucrat in a constitutional democracy, was a mighty power broker because he stuck to one city, New York, for his entire career.⁵ Ironically, a mayor in Communist China, albeit untrammelled by democratic elections or local rivals with formal powers to dismiss him or her, lacks the same tenure and, therefore, the same power.⁶

Moreover, authoritarian regimes discourage the development of institutions that are independent from the central and local governments and that might otherwise act as monitors and enforcers of long-term commitments.⁷ Consider, for instance, the role of lenders as monitors of fiscal probity. By dividing powers over decisions such as debt repayment and the bailout of defaulting governments among rival institutions, liberal democracies are able to make credible commitments to both hard budget constraints against the bailout of unlawfully profligate governments and the repayment of lawfully incurred debt.⁸ China's state-controlled banks, by contrast, face constant political pressure to bail out failing state-owned enterprises and extend credit to dubious city projects, resulting in ballooning municipal debt of dubious legality.⁹ Similarly, the power of homeowners in liberal democracies to elect local officials gives those officials a powerful weapon with which to entrench long-term investments in education, land-use regulation, parks, or other municipal improvements, a weapon their counterparts in authoritarian regimes lack.¹⁰

4. See WILLIAM T. ROWE, CHINA'S LAST EMPIRE: THE GREAT QING 37–39 (2012).

5. See ROBERT A. CARO, THE POWER BROKER: ROBERT MOSES AND THE FALL OF NEW YORK (1974) (examining the creation and use of power in local and state politics, through the story of Moses's use of unelected positions to radically reshape New York City).

6. See *id.*

7. Luo Dang Lun (罗党论) & She Guo Man (佘国满), *Di Fang Guan Yuan Bing Geng yu Di Fang Zhai Fa Xing* (地方官员变更与地方债发行) [*Change of Local Officials and the Issuance of Local Debts*], (经济研究) 6 ECON. RESEARCH J. 131.

8. See WILLIAM A. FISCHER, THE HOMEVOTER HYPOTHESIS: HOW HOME VALUES INFLUENCE LOCAL GOVERNMENT TAXATION, SCHOOL FINANCE, AND LAND-USE POLICIES 39–72 (2005).

9. See Breen & McMenamin, *supra* note 1, at 843–84.

10. See FISCHER, *supra* note 8, at 39–72 (2005).

In Part I, we describe the special problems for credible commitment posed by China's cadre transfer policy and, more generally, the CCP's distrust of divided power. Then, in Part II, we examine whether the country's current housing and financial markets effectively discipline local politicians. Part III is devoted to an evaluation of the existing solutions that national authorities apply to local government debt, a typical symptom of the short-term behavior exhibited by local politicians. Finally, Part IV proposes three new institutional solutions for resolving the credible commitment problem of China's authoritarian regime. In the end, we conclude that there is no magical solution that can reassure stakeholders, such as lenders or homebuyers, that an autocratic mayor will follow through on her promises. All of our proposed solutions, however, trade on the intuition that even modest institutional limits on power can mitigate the problem of powerlessness that is ironically created by authoritarian power.

I. THE PROBLEM OF CREDIBLE COMMITMENT

The problem of credible commitment is usefully illustrated by the tales of two Chinese mayors, both of whom racked up immense amounts of municipal debt through socially dubious demolitions. As will become clear below, far from being particularly pernicious, these mayors were actually admirable in terms of their activism and ambition. However, they were crippled by poor incentives and bad institutions. Because they lacked mechanisms by which to entrench long-term governance reforms, they rationally cast their lot with debt accumulation and large-scale demolition rather than making slower, less-visible improvements in local governance.

A. A TALE OF TWO MAYORS

Geng Yanbo was the mayor of Datong, a prefecture-level city in Shanxi province, from January 2008 to February 2013.¹¹ After becoming mayor of Datong, Geng demolished all contemporary buildings in the old city for the purpose of restoring its historical features, an urban development plan requiring the relocation of over 40,000 households to a new city to be con-

11. *Geng Yan Bo Shi Zhang Da Tong 5 Nian: Huan Jing Pai Ming Cuan Sheng 81 Wei GDP Xia Die 3 Wei* (耿彦波市长大同5年: 环境排名蹿升81位 GDP 下跌3位) [*Mayor Yanbo Geng's Five Years in Datong City: Environmental Ranking Jumped 81 Places While GDP Fell 3 Places*], IFENG (凤凰网) (Feb. 28, 2013), http://news.ifeng.com/mainland/detail_2013_02/28/22563990_0.shtml.

structed across the river¹² and an investment totaling RMB 50 billion.¹³ During Geng's five-year term, the city's land-sale revenue totaled about RMB 25 billion.¹⁴ The mayor also received loans from two banks, the China Development Bank and Rural Development Bank, both of which were policy-based banks offering RMB 14 billion in loans at relatively low interest rates for long terms.¹⁵ By 2012, Datong's total debt stood at roughly RMB 20 billion, one billion more than its total revenue of RMB 19 billion in that year.¹⁶ Although Geng's energy and charisma might have led to a successful project, Geng did not stick around. He was promoted to mayor of Taiyuan, the capital city of Shanxi province, in February 2013.¹⁷ Suddenly, the clock stopped on Geng's project: the new mayor of Datong was reluctant to continue Geng's plans.¹⁸ As a result, construction companies received no further payments from the government, and numerous projects were suspended.¹⁹

Although he is now in prison after being convicted of corruption, Qiu He is another legendary Chinese city leader who built a reputation on mammoth construction projects that did not outlast his tenure as mayor.²⁰ As party secretary of Kunming, the capital city of Yunnan province, from December 2007

12. Shu Taifeng (舒泰峰), *Da Tong Zao Cheng zhi Shang: Ri Tou 5500 Wan, Li Kai 1 Yue Zhao Bu Dao Hui Jia Lu* (大同造城之殇: 日投5500万 离家1月找不到回家路) [*The Ache of Datong's Urban Construction: Daily Investment Costs 55 Million Unable To Find Home After a Month's Leave*], SOHU (搜狐网) (Sept. 24, 2013), <http://business.sohu.com/20130924/n387104682.shtml>.

13. Geng Yan Bo: *Gui Liu Shi Zhang Bei Hou de Min Yi An Liu* (耿彦波: 跪留市长背后的民意暗流) [*Yanbo Geng: The Public Opinion Undercurrent Behind the Scene of People's Knelling for the Stay of Their Mayor*], SOHU (搜狐网) (Feb. 21, 2017), <http://news.sohu.com/s2013/newsmaker157>.

14. *Id.*

15. *Id.*

16. *Id.*

17. Geng Yan Bo *Shi Zhang Da Tong 5 Nian*, *supra* note 11.

18. Wu Gang (武刚), *Da Tong Bai Yi Zao Cheng Lan Wei: Cai Zheng Chi Jin Wai Di Da Gong Si Che Li* (大同百亿造城烂尾: 财政吃紧 外地大公司撤离) [*Ten-Billion City-Making Project Going Nowhere: Fiscal Austerity and Big Companies Evacuating*], ORIENTAL OUTLOOK WEEKLY (瞭望东方周刊) (Dec. 16, 2013), http://news.ifeng.com/shendu/lwdfzk/detail_2013_12/16/32160228_0.shtml.

19. *Id.*

20. Yun Nan Yuan Sheng Wei Shu Ji Qiu He *Shou Hui 2000 Duo Wan Huo Xing 14 Nian 6 Ge Yue* (云南原省委副书记仇和受贿2000多万 获刑14年6个月) [*The Previous Deputy Secretary of CPC Yunnan Provincial Committee He Qiu Was Found Bribe-taking for Over 20 Million and Was Sentenced for 14 Years and 6 Months' Imprisonment*], CHINANNEWS (中国新闻网) (Dec. 15, 2016), <http://www.chinanews.com/gn/2016/12-15/8095143.shtml>.

to November 2011, Qiu launched plans for a nine-line subway system that would require a RMB 300 billion investment.²¹ The massive size of this investment was puzzling in a city whose total revenue in 2009 stood at RMB 37.8 billion.²² To make up the revenue gap, the Kunming city government under Qiu's leadership set up forty-eight finance platform corporations and provided government guarantees for them to borrow money from various financial institutions.²³ For the subway construction, it signed credit agreements with the China Development Bank and Bank of China.²⁴ Financial institutions are generally not particularly enthusiastic about subway construction because of the long time frame involved, but the Kunming city government's guarantee was adequate assurance for these lenders. As with Geng's project in Datong, Qiu's huge investment in infrastructure also saw land-sale revenues rise rapidly. In 2011 alone, the city government's land sale revenues totaled RMB 55.8 billion.²⁵ Again, Qiu's gamble might have paid off had he remained longer in Kunming. However, he was promoted to vice governor of Yunnan in November 2011,²⁶ and his successor did not buy into his ideas about urban development.²⁷ Qiu's legacy is numerous unfinished projects in Kunming and a huge amount of city government debt.²⁸

B. "TEA BECOMES COLD AFTER HE LEAVES": CADRE TRANSFER POLICY AS AN OBSTACLE TO CREDIBLE COMMITMENT

The short mayoral terms of Qiu and Geng are not exceptional. It is well-established practice for Chinese mayors and party secretaries to have short tenures in any single local gov-

21. *Id.*

22. Song Jia Yan (宋佳燕), *Kun Ming Fu Zhai Lu Chao 100% 3000 Yi Di Tie Xiang Mu Xi Gan Shi Nian Cai Zheng* (昆明负债超100% 3000亿地铁项目吸干十年财政) [*Debt of Kunming City Surpasses 100% the 30 Billion Metro Program Used up Ten Years' Fiscal Revenue*], SOHU (搜狐网) (Aug. 12, 2013), <http://business.sohu.com/20130812/n383914651.shtml>.

23. *Id.*

24. *Id.*

25. *Id.*

26. People's Daily, *supra* note 20.

27. Yin Hongwei (尹鸿伟), *Zi Liao: Kun Ming Gao Bie "Qiu He Shi Dai" Fa Zhan yu Wei Quan Shuang Xian Bing Xing* (资料: 昆明告别"仇和时代"发展与维权双线并行) [*Document: Kunming City Bids Farewell to the "Era of He Qiu" Development and Rights-Protection Walk in Parallel*], IFENG (凤凰网) (Mar. 15, 2015), http://news.ifeng.com/a/20150315/43343686_0.shtml.

28. *Id.*

ernment.²⁹ After proving themselves for a few years, the principle of cadre transfer requires that the CCP transfer them to new assignments.³⁰ Legally, local government leaders serve five-year terms, but in reality their rotation and promotion occur much more frequently.³¹

The cadre transfer policy is by no means a recent innovation. It is in fact the contemporary manifestation of an ancient method of insuring that local officials do not build up a local power base capable of resisting central government commands.³² The rotations imposed by the Qing Dynasty system of bureaucratic assignments were strikingly similar to those currently imposed by the CCP. As William Rowe notes, “as everyone knew, the throne was trading off independent initiative on the part of its officials for the sake of central control.”³³

Centuries later, that tradeoff remains the same. It is intuitively plausible that such rapid rotation results in cadres systematically undervaluing long-term investments, the ultimate value of which is difficult to ascertain at the time of investment. If cadres expect to be promoted in three to five years, then they may rationally opt for investments that produce smaller but more easily measured and immediate value for which they can take credit. Empirical research suggests that short terms for local leaders have a number of negative consequences, and economists have found that enterprises postpone investments and banks are reluctant to loan money to local governments during a leadership turnover period.³⁴

C. DEBT AS A CONSEQUENCE OF SHORT-TERM BEHAVIOR

Geng’s and Qiu’s leaving giant municipal debts for their successors is not atypical. The National People’s Congress (NPC) recently reported that “incurring debt often brings performance credit to the current government while the obligation to pay is left to the next government or upper-level government. This mismatch between the right to incur debt and the

29. See LANDRY, *supra* note 3, at 263 (2008).

30. Zheng Yong Nian (郑永年), *Zhong Guo Di Fang Zheng Fu Zhi Li Wei Ji ji Qi Ti Zhi Gen Yuan* (中国地方政府治理危机及其体制根源) [*China’s Local Governance Crisis and Its Institutional Roots*], LIAN HE ZAO BAO (联合早报) (Nov. 22, 2016), <http://www.zaobao.com.sg/zopinions/views/story20161122-693309>.

31. *Id.*

32. ROWE, *supra* note 4.

33. *Id.* at 39.

34. Lun & Man, *supra* note 7.

responsibility to pay leads to the weak consciousness of local government debt risk.”³⁵ The NPC’s comprehensive 2015 report on local-government debt revealed that, at the end of 2014, a few local governments had already carried overdue debt for several consecutive years.³⁶ Some local governments had even incurred new debt just to pay the interest on their old debt.³⁷ A 2014 audit of local governments found that more than 20% of recent loans had been used to pay older debts.³⁸ The interest rates on local government debts are actually quite high, ranging from 7% to 20%.³⁹ “In general, local governments are paying interest rates that are 4–5 percentage points above the prevailing treasury yield (about 3.5% on ten-year bonds)”⁴⁰ Short-term mayors’ inability to commit to completing long-term projects is probably a main reason for the high interest rates of local-government debt.

The rapid expansion of local government debt is raising concerns over the possibility of a debt crisis in China.⁴¹ Although scholars and policymakers have yet to reach consensus concerning the likelihood of such an event,⁴² it is clear that local-government debt is a major challenge for China’s financial

35. *Yi Xie Di Fang Zheng Fu Reng Ran Wei Gui Ju Zhai Shen Zhi Ju Zhai Fa Fang Yang Lao Jin* (一些地方政府仍然违规举债，甚至举债发放养老金) [*Some Local Governments Still Borrow Illegally, or Even Pay Pensions out of Such Illegal Borrowings*], BEIJING NEWS (新京报) (Dec. 23, 2015), http://big5.xinhuanet.com/gate/big5/news.xinhuanet.com/politics/2015-12/23/c_128557588.htm.

36. The Research Office of the Budgetary Affairs Comm. for the Nat’l People’s Cong. of the People’s Republic of China (全国人大常委会预算工作委员会调研组), *Guan Yu Gui Fan Di Fang Zheng Fu Zhai Wu Guan Li Gong Zuo Qing Kuang de Diao Yan Bao Gao* (关于规范地方政府债务管理工作情况的报告), [*The Report on the Work Progress Regarding the Regulation of Local Government Debt Management*], NAT’L PEOPLE’S CONG. (中国人大杂志) (2016), http://www.npc.gov.cn/npc/zgrdzz/2016-03/29/content_1986294.htm.

37. *Id.*

38. Richard Dobbs, Susan Lund, Jonathan Woetzel & Mina Mutafchieva, *Debt and (Not Much) Deleveraging* 76, MCKINSEY GLOBAL INST., Feb. 2015, at 76.

39. *Yi Xie Di Fang Zheng Fu Reng Ran Wei Gui Ju Zhai Shen Zhi Ju Zhai Fa Fang Yang Lao Jin*, *supra* note 35.

40. Xiaowei Huang, Chen Song & Yi David Wang, *Does China’s Debt-for-Bond Swap Reduce Banks’ Risk*, CHINA INT’L CONF. IN FIN. 3 (Feb. 7, 2017), https://editorialexpress.com/cgi-bin/conference/download.cgi?db_name=CICF2017&paper_id=329.

41. Richard Partington, *China’s Credit Rating Cut to A+ by S&P Over Rising Debt Fears*, GUARDIAN (Sept. 21, 2017), <https://www.theguardian.com/business/2017/sep/21/sp-cuts-chinas-credit-rating-to-a-over-rising-debt-fears>.

42. See Huang et al., *supra* note 40, at 2–3.

system.⁴³ China's rising debt and slowdown in economic growth prompted Moody's Investors Service to downgrade the country's credit rating in July 2017, cutting its long-term currency issuer rating to A1 from Aa3.⁴⁴ The last time Moody's cut China's sovereign rating was in 1989, when the country's economic momentum was halted by the government's violent reaction to the Tiananmen Square protests.⁴⁵ Two months after Moody's downgrade, and less than a month before the Communist Party's Nineteenth Party Congress, Standard & Poor's Global Ratings followed suit by down-grading Chinese debt from AAA to A+ on September 21, 2017.⁴⁶

II. DO MARKETS DISCIPLINE SHORT-TERM OFFICIALS?

If the central government cannot monitor or discipline local governments effectively, can markets do so? Here, we examine whether the current housing and financial markets can effectively discipline short-term officials. As explained below, Chinese cities lack two mechanisms for making credible commitments that American cities enjoy: home-owning residents' electoral power and independent lenders' financial incentives.⁴⁷

A. CAPITALIZATION, HOMEVOTERS, AND CREDIBLE COMMITMENT TO LOCAL AMENITIES

If long-term and value-adding reforms could be reliably entrenched, then local officials would have powerful and immediate incentives to provide local amenities that are attractive to homebuyers, because such amenities increase local land values and thereby also increase the local governments' revenues from selling ground leases.⁴⁸ It is a familiar point that homebuyers are willing to pay more for houses located in jurisdictions with better schools, cleaner air, lower crime or other amenities com-

43. See Partington, *supra* note 41.

44. Shen Hong, *Moody's Cuts Its China Rating for the First Time Since 1989*, WALL ST. J. (May 24, 2017), <https://www.wsj.com/articles/moodys-cuts-its-china-rating-citing-risks-from-rising-debt-1495590160>.

45. *Id.*

46. Partington, *supra* note 41.

47. See *infra* Parts II.A, II.B.

48. For a more complete explanation of the process by which capitalization of local amenities into housing prices can give local officials revenue-based incentives to provide amenities that foot-voting citizens desire, see Roderick M. Hills, Jr. & Shitong Qiao, *Voice and Exit as Accountability Mechanisms: Can Foot-Voting Be Made Safe for the Chinese Communist Party?*, 48 COLUM. HUM. RTS. L. REV. 158, 180–83 (2017).

pared to competing jurisdictions.⁴⁹ By “capitalizing” such improvements into housing prices, markets increase the revenue of the local governments that are most successful in attracting homebuyers.⁵⁰ To the extent that local officials are evaluated according to their ability to raise revenue, such capitalization gives local officials with short tenures an incentive to take the long view.⁵¹

Capitalization, however, depends on local officials’ ability to make a credible commitment to prospective homebuyers that the reforms they value will be durable. Promises to create excellent schools, cleaner air, or an honest police force will increase bids on lots only if those promises are believed.⁵² Rational bidders will reduce their bids on local real estate by the amount necessary to insure themselves against the risk that the mayor’s successors will renege on the promises (implied or express) he or she has made.

William Fischel’s “homevoter hypothesis” shows how liberal democracies can address the problem of credible commitment through local elections that enable homebuyers to protect their investments at the ballot box.⁵³ Once homebuyers invest in a community, they become what Fischel calls homevoters—that is, people whose undiversified investment in local real estate gives them powerful incentives to monitor local politics.⁵⁴ Homevoters’ incentives to closely monitor politics give them power over the local legislature, ensuring that individual legislators pay close attention to the opinions of homeowners about developments in their neighborhoods.⁵⁵ Knowing that their purchase of real estate gives them control over the local legislature sufficient to protect their investment from future changes in zoning or fiscal policy, American homebuyers are prepared to pay more for such amenities as restrictive zoning and good schools.⁵⁶

49. See Anup Malani, *Valuing Laws as Local Amenities*, 121 HARV. L. REV. 1273, 1275 (2008).

50. See FISCHEL, *supra* note 8, at 39–71.

51. Hills & Qiao, *supra* note 48, at 185.

52. FISCHEL, *supra* note 8, at 49–51 (describing incomplete capitalization of temporary tax relief in land values in Massachusetts).

53. *Id.* at 74–97.

54. *Id.* at 72–97 (describing median voters’ control over local politics).

55. *Id.* at 96–97.

56. Roderick M. Hills, Jr. & David Schleicher, *Planning an Affordable City*, 101 IOWA L. REV. 91, 112–15 (2015).

Chinese officials, by contrast, have weak electoral mechanisms for locking in value-enhancing programs, a weakness that limits homebuyers' ability to reward local leaders who protect those programs. Although local people's congresses at the level of urban district and town are directly elected, the rules for nominating candidates and norms for campaigning dampen the power of delegates to determine policy.⁵⁷ In indirect elections, where directly elected local congresses select delegates for the level of government above them, party leaders rather than the local congress play the leading role in setting quotas for different social groups and choosing the delegation.⁵⁸ The capacity for local landowners to control the congress, therefore, is limited: party leaders might decide to emphasize entirely different industries based on their own policy priorities.⁵⁹ Mayors and party secretaries of cities are, in theory, selected by the local congresses; but in reality, they are chosen by the party leadership of the next higher level of government, further weakening the capacity of the local congress to lock in reforms of an outgoing mayor.⁶⁰

Far from empowering mayors, this lack of an electoral connection actually weakens them by depriving them of an important method of making credible commitments through an electoral coalition of program beneficiaries, which would bind their successors to respecting the incumbent's programs. In the absence of such a tool, Chinese mayors rationally favor infrastructure investments. Unlike investments in such long-term and intangible goods as administrative fairness and educational and environmental quality, investments in infrastructure provide quick and easily verifiable benefits to buyers. A road, once built, will always be there, whereas investments in schools

57. BARRETT L. MCCORMICK, POLITICAL REFORM IN POST-MAO CHINA: DEMOCRACY AND BUREAUCRACY IN A LENINIST STATE 130–56 (1990) (describing local elections in the wake of the 1979 election law reform and noting various Leninist impediments to local voters' electing candidates independent from the local party secretary).

58. Ying Sun, *Municipal People's Congress Elections in the PRC: A Process of Co-Option*, 23 J. CONTEMP. CHINA 183, 186–88 (2014) (describing process of delegate quota setting and selection of delegates).

59. *Id.* at 189 (quoting city party leaders who emphasized selection of members of "four pillar industries in our city, i.e. the high and new technology sector, the modern service industry, the finance business, and the cultural industry" as delegates).

60. LANDRY, *supra* note 3, at 80–115 (describing appointment process of mayors and party secretaries).

or a polite police force may well disappear once a mayor or party secretary has moved on to greener pastures.

That local officials across China are ignoring what homebuyers plainly want suggests that the incentives of the two parties are not well aligned. One possible reason for this misalignment is that local officials are not systematically evaluated on the basis of their comparative success in raising the aggregate value of real estate within their jurisdictions.⁶¹ Another is that even if they were assessed on the basis of indicators keyed to real estate values, they have no mechanism by which to lock in reforms that promote such values over the long haul.

B. INDEPENDENT LENDERS AND CREDIBLE COMMITMENT TO HARD BUDGET CONSTRAINTS

Might the lenders themselves be a force for reining in local borrowing? After all, most are themselves governmental officials running state-owned enterprises.⁶² Could bankers' incentives to win promotion induce them to play the heavy with wayward localities?

State-owned banks, however, face the same credible commitment problem as local officials: as noted below, the very omnipotence of the CCP undermines the reliability of bankers as CCP agents for fiscal discipline. The CEOs of state-owned banks move up the bureaucratic ladder like other officials, and their portfolios do not follow them to their next post.⁶³ Accordingly, if the loans they extend to mayors to cultivate political alliances turn out to be nonperforming, that is a problem for their successors, not for them.⁶⁴ The leaders of some banks may

61. *Id.* at 114–15 (describing pros and cons associated with appointment process of local officials).

62. Ing. Jan Bejtkovský, *State Capitalism in China: The Case of the Banking Sector*, PROC. OF THE INT'L ACAD. RES. CONF. ON SMALL & MEDIUM ENTERPRISES, at 7 (Aug. 2–4, 2016), http://globalbizresearch.org/IAR16_Vietnam_Conference_2016_Aug/docs/doc/PDF/VS611.pdf (cataloguing different types of banks in China and concluding that “the vast majority of assets in China’s banking sector is under state control”).

63. For a survey of the rules governing the appointment and promotion of executives at state-owned banks, see Li-Wen Lin, *Reforming China’s State-Owned Enterprises: From Structure to People*, 229 CHINA Q. 107 (2017). For the Chinese Communist Party rules on promotion of executives, see Dangzheng Lingdao Ganbu Xuanba Renyong Gongzuo Tiaoli (党政领导干部选拔任用工作条例) [Rules on the Selection and Appointment of Party and Government Leaders] (Jan. 16, 2014), <http://renshi.people.com.cn/n/2014/0116/c139617-24132485.html>.

64. We discuss the career incentives of Chinese officials *infra* in Part III.C. See also Hills & Qiao, *supra* note 48, at 178–79 (discussing how officials

enjoy the political clout to force a mayor to make a settlement.⁶⁵ For example, evidence suggests that local officials pay off loans from the politically weighty China Development Bank more quickly than those issued by commercial banks.⁶⁶ However, even the most powerful bank bosses lack strong incentives to limit loans to creditworthy municipalities, particularly as local government balance sheets are hardly models of transparency.⁶⁷ The actual track record of municipalities in racking up extraordinary levels of debt to build ghost cities and zombie firms provides an anecdotal illustration of bank-imposed discipline being less than ideal.⁶⁸ The recent wave of bank swaps of local government financing vehicle (LGFV) debt for municipal bonds suggests that bankers are relying on the central government's implicit guarantee of those bonds to improve bank portfolios.⁶⁹

III. EVALUATING CURRENT SOLUTIONS

In the face of its emerging debt crisis, China's national government has taken multiple measures to avoid it, including swapping mature debt for bonds to avoid debt default, signaling

behave when they are evaluated on the basis of their jurisdiction's GDP and revenue).

65. On the general tendency of state-owned banks to extend loans for reasons other than the borrower's credit-worthiness, see Paolo Sapienza, *The Effects of Government Ownership on Bank Lending*, 72 J. FIN. ECON. 357 (2004) (concluding from empirical analysis that "state-owned banks are a mechanism for supplying political patronage"). These general incentives of executives at state-owned banks seem to operate in China. See Minxin Pei, *How Rotten Politics Feeds a Bad Loan Crunch in China*, FIN. TIMES (May 7, 2006), <http://carnegieendowment.org/2006/05/07/how-rotten-politics-feeds-bad-loan-crunch-in-china-pub-18308> (summarizing survey evidence that bank executives at state-owned banks are not disciplined for their banks' nonperforming loans).

66. See Haoyu Gao, Hong Ru, & Dragon Yongjun Tang, *Subnational Debt of China: The Politics-Finance Nexus*, (2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2783125.

67. See *Counting Ghosts: China Opens the Books of Its Big-Spending Local Governments*, ECONOMIST (Jan. 4, 2014), <http://www.economist.com/news/china/21592628-china-opens-books-its-big-spending-local-governments-counting-ghosts> (discussing challenges auditing local government debt).

68. For some of the numerous stories about Chinese cities' investments in apparently non-productive physical infrastructure, see Frank Langfitt, *China's White Elephants: Ghost Cities, Lonely Airports, Desolate Factories*, NPR (Oct. 15, 2015), <http://www.npr.org/sections/parallels/2015/10/15/446297838/chinas-white-elephants-ghost-cities-lonely-airports-desolate-factories>.

69. See Shirley Yam, *Chinese Banks Swap Transparency for Debt*, S. CHINA MORNING POST (Apr. 22, 2016), <http://www.scmp.com/business/banking-finance/article/1937649/chinese-banks-swap-transparency-debt>.

a no-bailout principle, threatening to impose lifetime responsibilities on local officials, and using local people's congresses to supervise local governments' borrowing and spending behaviors. After detailed examination we argue that the debt-bond swaps worsen the moral hazard of short-term behaviors, that the no-bailout principle does not really exist due to the systemic risk posed by local governments, and we point out the challenges to imposing lifetime responsibilities and empowering local people's congresses.

A. DEBT-BOND SWAPS?

High rates of local-government debt mean that debts are compounding at an alarming rate. To ease the repayment pressure on local governments and reduce the risk of default, the national government introduced a bond-for-debt swap program for local-government debt in March 2015.⁷⁰ After the initial RMB 1 trillion target set in March had been reached, a second swap in the same amount was launched in June of the same year.⁷¹ The program was then further expanded to reach RMB 3.2 trillion in August, and is slated to total RMB 15 trillion by 2018.⁷² The goal of the debt-for-bond swap program is to lower debt-servicing costs and extend maturities by converting short-term, high-interest bank loans into low-interest, long-term municipal bonds.⁷³

The debt-bond swap, however, is impeded by the same problems of credible commitment plaguing municipal governments. Put simply, leaders of state-owned banks, like leaders of cities, have institutional incentives to favor short-term benefits over long-term health of their banks' balance sheets.⁷⁴ The interest rate for local government debt stands above 7%, whereas the swap program extends that debt into the future with interest rates under 4%.⁷⁵ Because the leaders of state-owned banks are evaluated by their banks' profits and balance sheets, the

70. See Gabriel Wildau, *China Imposes \$160bn Municipal-Bonds-for-Debt Swap*, CNBC (May 13, 2015), <https://www.cnbc.com/2015/05/13/china-imposes-160bn-municipal-bonds-for-debt-swap.html>.

71. *China Expands Debt-for-Bond Swap Plan to 3.2 Trillion Yuan: Xinhua*, CNBC (Aug. 27, 2015), <https://www.cnbc.com/2015/08/27/china-expands-debt-for-bond-swap-plan-to-32-trillion-yuan-xinhua.html>.

72. *Id.*; see also Huang et al., *supra* note 40, at 3.

73. See *supra* note 71.

74. See JAMES STENT, *CHINA'S BANKING TRANSFORMATION: THE UNTOLD STORY* (2017).

75. Huang et al., *supra* note 40, at 3.

potential loss of interest would impose an immediate loss during the current leaders' tenure.⁷⁶ As the swap program prioritizes debts that have already matured or will mature in the current fiscal year, some banks have voluntarily extended the repayment deadline to keep interest rates high rather than swapping local-government debts for bonds.⁷⁷ In one case, a state-owned bank offered a LGFV a high-interest loan to pay off matured debt, encouraging the LGFV to avoid the swap to protect future cooperation with the bank.⁷⁸ In short, the leaders of state-owned banks pass off bad municipal debt to their successors—just like local government leaders.⁷⁹

Credible commitment issues impede the debt-bond swap in a second sense. Precisely because the risk of excessive municipal debt is systemic in nature, state-owned bank leaders do not believe the national government will allow it to happen.⁸⁰ Hoping for an eventual bailout of excessively indebted local governments, creditors blithely accept municipal debt to avoid the immediate costs of lower interest rates.⁸¹ This mindset has resulted in two publicly reported cases in which swap plans were canceled under investor pressure.⁸² As one NPC report points out: "According to our investigation, because most swapped debt will not be repaid in five years, some local governments has no immediate pressure anymore and want to swap all their existing debt. They even think that local debt is not a problem anymore."⁸³

76. See STENT, *supra* note 74.

77. Zhong Yuan (钟源), Zhao Jing (赵婧), *Zhi Huan Zhai Gui Mo Pan Sheng Yin Hang He Di Fang Zheng Fu Bo Yi Jiang Sheng Ji* (置换债规模攀升银行和地方政府博弈将升级) [*As the Scale of Swept Debts Increases, the Game Between Banks and Local Governments Will Escalate*], PEOPLE.CN (人民网) (Feb. 2, 2016), <http://money.people.com.cn/n1/2016/0202/c42877-28102860.html>.

78. *Id.*

79. *Id.*

80. See Peter S. Jeffrey, *The Chinese Municipal Debt Crisis and Central Government Response* (Dec. 17, 2015) (unpublished thesis, University of Pennsylvania) (on file with Penn Libraries Social Impact Research Experience, University of Pennsylvania) (noting that current levels of local government debt are unsustainable, and the national government may need to bailout the local governments to maintain current levels of development).

81. *Id.*

82. *Cheng Tou Zhai Fa Zhan Li Shi Zhuan Ti Yan Jiu* (城投债发展历史专题研究) [*Research on the Development History of Urban Investment Bonds*], JRJ (金融界) (Jun. 9, 2017), <http://bond.jrj.com.cn/2017/06/09081922590656.shtml>.

83. Committee of Budget Affairs of the National People's Congress Stand-

To conclude, the debt-bond swaps imposed by the central government are not particularly welcome by investors who rely on the central government's implicit guarantee of local debt, and more importantly, they worsen the moral hazard of short-term local government officials rather than solving it.

B. NO-BAILOUT PRINCIPLE?

In theory, because the Party controls the tenure of local officials,⁸⁴ the CCP's omnipotent leadership could forbid local officials from incurring too much debt. Indeed, as a matter of legal theory, local governments lack the power to incur bonded indebtedness.⁸⁵ As early as 2014, the national government instituted the principle of no bailouts in dealing with local government debt.⁸⁶

This theoretical power to curb debt, however, is weakened by the absence of a mechanism through which the central government can make credible commitments to enforce hard budget constraints against local officials. Chinese cities (like American cities⁸⁷) can evade formal legal limits on city debt through the establishment of LGFVs—separate corporations that are

ing Committee (全国人民代表大会常务委员会预算工作委员会), *Quan Guo Ren Da Di Fang Zhai Diao Yan Bao Gao Shi Da Wen Ti Qiao Xiang Zhai Wu Jing Zhong* (全国人大地方债调研报告 十大问题敲响债务警钟) [*National People's Congress Local Debt Research Report's Top Ten Questions Raise the Debt Alarm*], SINA (新浪网) (Dec. 26, 2015), <http://finance.sina.com.cn/money/bond/market/2015-12-26/doc-ifxmxxsp7010714.shtml>.

84. See generally LANDRY, *supra* note 3 (exploring how the CCP manages local officials in order to meet its goals).

85. Zhong Hua Ren Min Gong He Guo Yu Suan Fa (中华人民共和国预算法) [Budget Law of the People's Republic of China] (promulgated by Order No. 21 of the President of the People's Republic of China on Mar. 22, 1994, effective Jan. 1, 1995), art. 28, *translated in* 1994 P.R.C. Laws; Huang et al., *supra* note 40, at 6–7. For an exploration of the ambiguities in these limits on the power to incur debt, see Donald Clarke & Fang Lu, *The Law of China's Local Government Debt Crisis: Local Government Financing Vehicles and Their Bonds* 7–15 (George Wash. Univ. Law Sch. Pub. Law Research, Paper No. 2016-31, 2016), <http://ssrn.com/abstract=2821331> (describing legally ambiguous restrictions on local governments' issuing debt and creation of LGFVs to circumvent these restrictions).

86. The State Council of the People's Republic of China, *Guo Wu Yuan Guan Yu Jia Qiang Di Fang Zheng Fu Xing Zhai Wu Guan Li de Yi Jian* (国务院关于加强地方政府性债务管理的意见) [*The State Council's Opinions on Strengthening the Management of Local Government Debt*], GOV.CN (中华人民共和国中央人民政府网站) (Sept. 21, 2014), http://www.gov.cn/zhengce/content/2014-10/02/content_9111.htm.

87. LYNN A. BAKER & CLAYTON P. GILLETTE, *LOCAL GOVERNMENT LAW* 618 (4th ed. 2010) (describing techniques for avoiding debt limits including the creation of special authorities with separate debt-issuing capacity).

not formally part of the local government itself—which then borrow money secured by real estate turned over to them.⁸⁸

In theory, the central government could force lenders who make risky loans to LGFVs to internalize the risk by committing to not bailing out lenders or LGFVs that get in over their heads. In practice, however, lenders might not regard such a commitment as credible.

The central government's actual "no-bailout principle" turned out to be precisely such a weak and noncredible constraint. On investigation, it actually allowed bailouts.⁸⁹ Lower-level governments can still apply for financial assistance from upper-level governments in the event of a debt crisis.⁹⁰ In the highest-level crises, such as a situation in which a provincial-level government defaults on its debt or more than fifteen percent of the cities in a province default on their debt, the provincial-level government is obligated to report to the Ministry of Finance, and the State Council can decide to transfer money to that government to make debt payments and to set up a working group to supervise and coordinate all crisis-related work.⁹¹

In short, local governments are simply too big to fail. If a provincial government or the national government decided not to take any measure to contain the crisis and spread of panic, the likely result would be systemic financial crisis.⁹² The national government simply cannot afford to take such a risk, which is why the aforementioned debt plan incorporates financial assistance measures despite the declaration of "no bailouts."⁹³ National or provincial financial assistance comes

88. See Clarke & Lu, *supra* note 85, at 13–29 (providing a detailed overview of LGFVs' operation, liabilities, and monitoring by central government).

89. Wang Chang Yong (王常勇), *Guo Wu Yuan Ding Gui Di Fang Zhai: Zhong Yang Tui Bu Jiu Zhu Yuan Ze* (国务院定规地方债：中央推不救助原则) [*The State Council Rules on Local Debt: The Central Government Introduces the Principle of Non-assistance*], CAIXIN (财新网) (Oct. 2, 2014), <http://economy.caixin.com/2014-10-02/100735206.html>.

90. *Id.*

91. *Guo Wu Yuan Ban Gong Ting Guan Yu Yin Fa Di Fang Zheng Fu Xing Zhai Wu Feng Xian Ying Ji Chu Zhi Yu An de Tong Zhi* (国务院办公厅关于印发地方政府性债务风险应急处置预案的通知) [*Notice of the General Office of the State Council on Issuing the Emergency Response Plan for Local Government Debt Risks*], MINISTRY OF FIN. OF THE PEOPLE'S REPUBLIC OF CHINA (Oct. 27, 2016), http://www.mof.gov.cn/zhengwuxinxi/zhengcefabu/201611/t20161114_2457914.htm [hereinafter Ministry of Finance Notice].

92. Wang, *supra* note 89.

93. For the challenges of imposing a hard budget constraint *ex ante* on local officials in China, see Jing Jin & Heng-fu Zou, *Soft-Budget Constraints and Local Government in China*, in *FISCAL DECENTRALIZATION AND THE*

with a catch: that is, the disciplining and punishment of local government leaders, who are thereafter disqualified from promotion.⁹⁴ The distant prospect of being punished for a later local bankruptcy, however, is apparently an insufficient incentive for an official to avoid current debt,⁹⁵ perhaps because that official likely will not hold office in the bankrupt jurisdiction at the moment of systemic crisis.

C. LIFETIME RESPONSIBILITY?

How then can we change local officials' incentives? Like politicians everywhere, Chinese officials care about their careers.⁹⁶ In China, an authoritarian regime without democratic elections, the national government has implemented a cadre evaluation system based on GDP growth.⁹⁷ The cadre evaluation system, however, presents a dilemma: as criteria become more complex, local officials' misreporting can defeat the central government's capacity to monitor whether the criteria have been satisfied.⁹⁸ The central government's evaluation of local debt poses precisely this dilemma of balancing accuracy of in-

CHALLENGE OF HARD BUDGET CONSTRAINTS 289 (Jonathan Rodden, Gunnar S. Eskeland & Jennie Litvack eds., 2003).

94. See Ministry of Finance Notice, *supra* note 91 (detailing the procedures available for holding local government officials accountable for managing provincial debt).

95. According to multiple sources, debt is growing rather than shrinking. See, e.g., Wu Hong Yu Ran (吴红毓然), *Jin Rong Gong Zuo Hui Yi Ding Diao Di Fang Zhai Shou Ti Zhong Shen Wen Ze Zhi* (金融工作会议定调地方债 首提终身问责制) [*The Financial Work Conference Sets Tone for Local Government Debts: First Time Mentioning Lifelong Accountability Institutions*], CAIXIN (财新网) (July 16, 2017), <http://finance.caixin.com/2017-07-16/101116483.html>. It now amounts to RMB 35 trillion, far exceeding the RMB 16 trillion debt limit approved by the NPC Standing Committee. Dong Jing (董兢), *Zhong Cai Ban Fu Zhu Ren: Xia Ban Nian Jiang Xian Zhi Di Fang Zhai Feng Xian* (中财办副主任: 下半年将限制地方债风险) [*Deputy Director of China Financial Affairs Office: Will Limit the Risk of Local Debt in the Second Half of the Year*], CAIXIN (财新网) (July 27, 2017), <http://finance.caixin.com/2017-07-27/101122968.html>.

96. Hills & Qiao, *supra* note 48, at 177–79 (discussing the use of promotion as a feedback mechanism encouraging government officials to take certain actions).

97. Zong Wen (宗文), *Gan Bu Bu Zuo Wei Ye Shi Yi Zhong Fu Bai* (干部不作为也是一种腐败) [*Cadre Inaction Is Also a Kind of Corruption*], PEOPLE.CN (人民网) (Feb. 2, 2010), <http://fanfu.people.com.cn/GB/10913536.html>.

98. See Hills & Qiao, *supra* note 48, at 168–71. For evidence of such local circumvention of the one-child policy through local misreporting of data, see JUAN CARLOS SUÁREZ SERRATO, XIAO YU WANG, & SHUANG ZHANG, THE ONE CHILD POLICY AND PROMOTION OF MAYORS IN CHINA (Feb. 3, 2016), https://www.gsb.stanford.edu/sites/gsb/files/pe_04_16_wang.pdf.

formation about true debt capacity with simplicity of measures sufficient to allow monitoring of that information.

In the face of a burgeoning debt risk, the national government decided as early as December 2013 to incorporate debt risk into the cadre evaluation system.⁹⁹ Recently Chinese President Xi Jinping proposed lifetime responsibility as a way of constraining local officials' short-term behavior.¹⁰⁰ President Xi's proposal mentioned lifetime responsibility and looking into responsibilities retrospectively. Lifetime responsibility differs from the no-bailout principle in terms of the underlying assumption about the relationship between the national government and local governments. In proposing the concept of lifetime responsibility, the national government is demonstrating that it is taking responsibility for disciplining local officials, which is consistent with China's centralized regime.¹⁰¹ The proposal sends a clear signal to local officials that the national government is very serious about combating local government debt, and may well exert a major impact on their decisions.¹⁰²

The challenge lies, however, in implementing the proposal. Top-down evaluation systems pose a dilemma: central officials can evaluate local officials with simple criteria that are easy to verify but that ignore relevant aspects of local officials' performance, or they can use a comprehensive evaluation system requiring information too difficult to collect and verify.¹⁰³ Assessing the optimal level of local debt poses precisely this dilemma: despite worries about excessive debt, the central government still seeks to encourage a certain degree of economic development.¹⁰⁴ It is difficult for the central government to tell where the ideal balance lies, and it is also difficult to establish whether a default on debt is the fault of an initial blameworthy decision to incur debt or later mismanagement of the

99. Di Yi Cai Jing (第一财经), *Di Fang Zhai Feng Xian Fang Kong Sheng Ji: Wen Ze Shou Ti "Zhong Shen, Dao Cha"* (地方债风险防控升级: 问责首提"终身、倒查") [*The Upgrade of Local Debt Risk Prevention and Control: The First Mention of "Lifetime Responsibility" and "Reversed Investigation"*], CHINA.COM (中国网) (July 16, 2017), <http://finance.china.com/news/11173316/20170716/30973768.html>.

100. *Id.*; Sidney Leng, *Hold Local Governments Accountable for Their Debt, Chinese President Says*, S. CHINA MORNING POST (July 18, 2017), <http://www.scmp.com/news/china/economy/article/2103008/hold-local-governments-accountable-their-debt-chinese-president>.

101. *See* Di Yi, *supra* note 99.

102. *See id.*

103. *See supra* note 98 and accompanying text.

104. Zong, *supra* note 97.

debt-created asset.¹⁰⁵ Without a simple metric balancing these rival values accurately, any lifetime-responsibility system will fail at selecting the right officials to reward and punish.¹⁰⁶

D. LOCAL PEOPLE'S CONGRESSES?

Local legislatures are supposed to control the power of the purse, that is, local-government spending. Local governments are in charge of drafting their own budgets, which they then send to their Local People's Congress (LPC) for review and approval.¹⁰⁷ The review and approval process constitutes a short session during the annual meeting held by the local congresses.¹⁰⁸

In theory, the LPCs could have good incentives to curb excessive debt. Although LPCs differ from city councils in democratic countries, they constitute a collection of local elites, including intellectual, economic, and political elites.¹⁰⁹ Government officials who are nearing retirement age and have no prospects of promotion often become members of the standing committees of LPCs.¹¹⁰ These local elites have both the motivation and expertise to contain the short-term behavior of local administrative leaders. First, although they were not democratically elected, most are from the local area and have a long-term interest in sound local governance.¹¹¹ They may be local college professors, investors, or, as noted, former senior

105. Hills & Qiao, *supra* note 48, at 166–71 (discussing the challenges of supervising local government officials).

106. *Id.*

107. See, e.g., Yang Huayun (杨华云) & Bao Zhen (鲍征), *Ren Da Dai Biao Jian Yi She Yu Suan Xiu Zheng An Yi Cheng She Li Biao Jue Ji Zhi* (人大代表建议设预算修正案议程 设立表决机制) [*People's Congress Deputy Proposed Budget Amendment Agenda and To Set up a Voting System*], QQ.COM (腾讯网) (Mar. 13, 2011), <https://news.qq.com/a/20110313/000144.htm>.

108. *Id.*

109. Zhao Xiao Li (赵晓力), *Lun Quan Guo Ren Da Dai Biao de "Jing Ying" Gou Cheng yu Zhi Ben zhi Ce* (论全国人大代表的“精英”构成与治本之策) [*On the "Elite" Constitution of National People's Congress Deputies and Its Fundamental Solutions*], ZHONG WAI FA XUE (中外法学) (Sept. 20, 2016), <http://www.cwzg.cn/theory/201609/31102.html>.

110. Tian Bi Yao (田必耀), *Jie Du Ren Da Dai Biao yu Tong Ji Ren Da Chang Wei Hui de Si Ge Fa Lu Guan Xi* (解读人大代表与同级人大常委会的四个法律关系) [*To Interpret the Four Legal Relations Between People's Congress Deputies and the Standing Committee of People's Congress at the Respective Level*], PEOPLE.CN (人民网) (Feb. 17, 2004), <http://www.people.com.cn/GB/14576/14841/2343959.html>.

111. See Zhao, *supra* note 109.

government employees.¹¹² They do not move as often as ambitious mayors and thus have no motivation or appetite for capital projects that would burnish the mayor's reputation at the expense of plunging the city into a debt crisis.¹¹³ Second, local elites have the local knowledge and expertise needed to supervise local governments.¹¹⁴ For example, standing committee members who previously worked for a long time in various government agencies understand how government works and possess the inside knowledge needed to supervise local government finances.¹¹⁵ What LPCs lack, however, is power.¹¹⁶

In particular, land-sale revenues and the debts incurred by LGFVs are excluded even from this limited review process.¹¹⁷ In other words, a large portion of local-government debt lies outside the review remit of LPCs.¹¹⁸ Accordingly, local govern-

112. *See id.*

113. *See id.*

114. *See id.*

115. *See id.*

116. People's congresses at the national and local levels used to be called rubber stamps. *See The National People's Congress: What Makes a Rubber Stamp?*, *ECONOMIST* (Mar. 5, 2012), <https://www.economist.com/blogs/analects/2012/03/national-peoples-congress>; *see also* Lucy Hornby, *Inside China's National People's Congress*, *FIN. TIMES* (Mar. 3, 2016), <https://www.ft.com/content/c4eddaf6-e108-11e5-9217-6ae3733a2cd1?mhq5j=e7>; Zhu Jian Zhang (朱建璋), *Ren Da Cai Zheng Yu Suan Jian Du de Nan Dian ji Kun Jing* (人大财政预算监督的难点及困境) [*Obstacles and Difficulties in the Supervision of the Fiscal Budget of the People's Congress*], *PEOPLE.CN* (人民网) (May 24, 2006), <http://theory.people.com.cn/GB/40537/4398096.html>. However there is evidence that they have become more active in national and local politics. *See* Tomoki Kamo & Hiroki Takeuchi, *Representation and Local People's Congresses in China: A Case Study of the Yangzhou Municipal People's Congress*, 18 *J. CHINESE POL. SCI.* 41, 42 (2013); Rory Truex, *Representation Within Bounds* (2014) (unpublished Ph.D. dissertation, Yale University), <http://www.rorytruex.com/s/rtruex-Writing-Sample-Dissertation-Chapters-1-4-7.pdf> (analyzing original data showing that local and national representatives are increasingly being held accountable by those they represent). Despite this increased activity, people's congresses' power in controlling the government's budget is still quite weak. *See generally* SHUJIAN ZHANG, *BUDGETARY SUPERVISION IN CHINA: AN INSTITUTIONAL PERSPECTIVE OF PROVINCIAL PEOPLE'S CONGRESS* (2015) (providing analysis on LPCs and budgetary supervision).

117. Wang Wei Guo (王卫国) & Liu Jia (刘佳), *Zhuan Jia Jian Yi Pei Zhi Zhuan Ren Shi Xian Ren Da Dui Zheng Fu Yu Suan Jue Suan Jing Chang Xing Jian Du* (专家建议配置专人实现人大对政府预算决算经常性监督) [*Experts Suggest Allocations of Specially-Assigned Person To Account for Regular Supervisions on Government Budgets*], *IFENG* (凤凰网) (Nov. 13, 2012), http://news.ifeng.com/mainland/special/zhonggong18da/content-2/detail_2012_11/13/19091066_0.shtml.

118. *Id.*

ments decide whether and how much to borrow with little public input.¹¹⁹

Granting LPCs greater power to supervise local-government finances could well motivate local elites to utilize their local knowledge and expertise to check short-term government leaders, thereby serving as the national government's ally in controlling local governments.¹²⁰ The emergence of a potential local-government debt crisis in the past five years has prompted calls for greater LPC power from LPC members,¹²¹ the Ministry of Finance,¹²² and the NPC.¹²³ As we explain below,¹²⁴ these proposals are promising, especially if they are tied to strengthening the representation of local real estate owners in LPCs.

IV. STEPS TOWARD AN INSTITUTIONAL SOLUTION: PROMOTING FORESIGHT BY MAKING COMMITMENTS STICK

The problems with the current proposals are not necessarily insurmountable. Modest reforms might indeed improve local officials' incentives to incur debt responsibly. Here, we propose several reforms that might plausibly promote such institutions. The proposals we offer are intended to be realistic by being compatible with China's current system of one-party rule and democratic centralism. Assuming the existence of independent courts, municipal elections, and separate powers would be like

119. *Id.*

120. Xu Jun Zuo (徐俊作), *Na Ru Yu Suan Guan Li Shi Xing Gui Mo Kong Zhi Di Fang Zhai Jiao Ting "Pai Nao Dai Jie Qian"* (纳入预算管理实行规模控制 叫停“拍脑袋借钱”) [*Incorporate Budget Management To Implement Scale Control Stop "Borrowing out of Head-tapping"*], PEOPLE.CN (人民网) (Jan. 12, 2015), <http://finance.people.com.cn/2015/0112/c1004-26365494.html>.

121. Nan Fang Du Shi Bao (南方都市报), *Guang Zhou Cheng Jian Fu Zhai Yu Qian Yi Di Fang Rong Zi Ping Tai Ying Na Ru Ren Da Jian Du* (广州城建负债逾千亿 地方融资平台应纳入人大监督) [*Guangzhou City's Urban Construction Has More Than 100 Billion Debts: Local Financing Platforms Shall Be Included Under the Supervision of the People's Congress*], SINA (新浪网) (Jan. 11, 2012), <http://finance.sina.com.cn/china/dfjj/20120111/112411176981.shtml>.

122. Xu, *supra* note 120.

123. The Research Office of the Budgetary Affairs Comm. for the Nat'l People's Cong. of the People's Republic of China, *supra* note 36; Xiaohui Liang (梁晓辉) & Haiyan Ma (马海燕), *Lou Jiwei: Di Fang Zheng Fu Zhai Wu Qing Kuang Yao Ding Qi Xiang She Hui Gong Kai* (楼继伟: 地方政府债务情况要定期向社会公开) [*Jiwei Lou: Local Government Debts Should Be Made Public on a Regular Basis*], CHINANEWS (中国新闻网) (June 29, 2016), <http://www.chinanews.com/gn/2016/06-29/7922006.shtml>.

124. See *infra* Part IV.B.

assuming the proverbial ladder to escape from a pit. Instead, we suggest that buried within China's actual political traditions and current system of government lie the resources necessary to defeat the crippling effects of theoretical omnipotence.

A. USING LAND VALUES AS A LAGGING INDICATOR OF LOCAL OFFICIALS' PERFORMANCE

To induce local governments to care about the future, performance indicators that take the future into account would be helpful. Local officials are currently evaluated by a plethora of conflicting indicators of varying weight that are difficult to aggregate and bear an uncertain relationship to the welfare of the people they govern.¹²⁵ As we argued in a previous paper,¹²⁶ central party authorities could simplify their task if they focused on local real-estate values as the measure of local cadres' performance. By promoting cadres based on their success in raising real-estate values, the CCP would give local officials stronger incentives to advance social welfare to compete to attract mobile homebuyers. Homebuyers, in turn, have powerful incentives to balance the rival benefits of different types of local amenities.¹²⁷ Because homeowners' bids on land take the likely net future value of those amenities into account, local officials who compete to increase land values relative to other jurisdictions in the same metropolitan area would likely compete for the amenities most attractive to homebuyers.¹²⁸ In effect, they would be competing to win "election" by foot-voting households. Evaluating local officials based on the comparative change in the value of the real estate within their jurisdictions would therefore focus their minds on the future via a metric sufficiently complex to take into account the multiple ways in which a municipality can be well- or ill-governed yet simple enough to be read at a glance by their evaluators.¹²⁹ Because the officials tasked with the general supervision of local governments within a given metropolitan area are all subject to the same set of provincial and national laws, any differences in the real-estate

125. On the complexity of cadre evaluation systems that balance economic with social welfare indicators and local officials' varied responses to such criteria, see Cai (Vera) Zuo, *Promoting City Leaders: The Structure of Political Incentives in China*, 224 CHINA Q. 955 (2015).

126. See Hills & Qiao, *supra* note 48.

127. *Id.* at 180–83.

128. *Id.*

129. *Id.*

value changes in their respective jurisdictions could plausibly be tied to the policy choices of individual officials.¹³⁰

Real-estate values provide a solid basis for President Xi's proposed system of lifetime responsibility.¹³¹ As we explained in more detail in our earlier article, we recommend that local officials be evaluated on the basis of their city's real estate performance over a multi-year average, including the years following their move to a new jurisdiction. By holding officials accountable for their past jurisdictions' performance, such a system of rolling averages would insure that such officials do not hand off a soon-to-pop real estate bubble to their successors: a collapse in real-estate prices soon after an official's departure would thus mean the collapse of his or her career prospects under our proposed system. Because our version of lifetime responsibility relies on a simple variable that nevertheless captures what homebuyers value most about local jurisdictions, we avoid the dilemma of criteria too complex to allow comparisons among cadres or too simple to capture citizen welfare.

B. USING HOMEVOTERS AS LOCAL GOVERNMENT MONITORS

To render LPCs more representative and more resistant to pressure from short-term mayors, we suggest expanding the presence of real-estate interests—that is, the real-estate industry, related financial industry, and homeowner and condominium associations—therein. The real estate and financial industries already have representatives in LPCs. Hence, the focus should be on incorporating more local homeowner representatives. As previously discussed, once homebuyers invest in a community, their undiversified investment in local real estate gives them powerful incentives to monitor local politics.¹³² Granting them due power and a voice in local governance could counteract and constrain local government leaders' short-term behavior. Recent years have witnessed increasing numbers of protests by middle-income homeowners in China's big cities.¹³³ These protests are often triggered by policies that jeopardize

130. Kevin E. Davis, *Data and Decentralization: Measuring the Performance of Legal Institutions in Multilevel Systems of Governance*, 102 MINN. L. REV. 1621, 1635 (2018).

131. Hills & Qiao, *supra* note 48 at 185–87.

132. See FISCHER, *supra* note 8, at 72–97.

133. Zhengxu Wang, Long Sun, Liuqing Xu, & Dragan Pavličević, *Leadership in China's Urban Middle Class Protest: The Movement To Protect Homeowners' Rights in Beijing*, 214 CHINA Q. 411, 414 (2013).

property values, evidence that homeowners constitute a population that is highly motivated to shape local governance.¹³⁴ At the same time, they are usually not ideologically motivated and make no abstract political claims, rendering their petitions relatively acceptable to the government.¹³⁵ Adding homeowner representatives to LPCs would provide this population with an institutional channel for reflecting their concerns, thereby keeping them off the streets and, in turn, reducing the pressure on the government to maintain social stability through force.

Expanding the power of LPCs is essential to balance local politicians' short-term behavior with long-term localized interests. To achieve this purpose we need only rely on what is already in the Chinese constitution, according to which LPCs control their governments' budgets.¹³⁶ Such mechanisms would include giving LPCs more substantive power and resources in approving government budgets and monitoring their implementation. Precisely because the incentives of real-estate interests are narrow, adding homeowners to LPCs also does not threaten the CCP with multi-party democracy inconsistent with the principle of the Communist Party's primacy. To the contrary, the inclusion of real-estate interests insures that LPCs will support the *status quo* by counteracting incoming party secretaries' short-term behavior with long-term localized interests. While inclusion of other social groups in local politics is necessary to insure true democratic equality, focusing on owners of real estate is a necessary and politically safe first step.¹³⁷

C. EX-ANTE AND EX-POST RESTRICTIONS ON STATE-OWNED BANK LENDING TO LOCAL GOVERNMENTS

The institutional problem the central government confronts with respect to state-owned banks is the mirror image of the problem faced by local governments: unable to credibly commit to refraining from bailing out defaulting cities and their lenders, the central government cannot control bank lending to those cities. A general solution must therefore address the

134. *Id.* at 420–21 (describing the views of prominent political activists in Beijing, including one leader who believed that policies were “based on the wrong values”).

135. *Id.* at 413 (explaining that homeowners often express their frustrations at particular policies rather than abstract ideas).

136. XIANFA art. 99, § 2 (1982) (China).

137. Wendell Pritchett & Shitong Qiao, *Exclusionary Megacities*, 91 S. CAL. L. REV. (forthcoming 2018).

problem of credible commitment by allowing the central government to lock in promises to force local governments to rely on their own-source revenue. The usual mechanisms for preventing either defaults or bailouts for European and American governments are the separation of powers or partisan conflict that impedes the central government from taking swift action that unravels an earlier bargain.¹³⁸ Democratic centralism, however, poses an ideological obstacle to these conventional solutions. The CCP leadership is unlikely to tolerate the introduction of separate powers in name or in fact.¹³⁹ In any case, the shadow of such conflict in the hidden, internecine fights between factions within the CCP seems like a thin reed on which to hang China's financial policy.¹⁴⁰

A more promising strategy would be to limit the powers of state-owned banks, rather than the central government, by tying the promotion chances of bank leaders to their track record of issuing dubious loans. The Ministry of Finance could require municipalities to produce debt-to-property-valuation ratios to assess the degree to which outstanding municipal bonds are supported by underlying real-estate values. Under this sort of precommitment device, officials who extend credit to over-extended municipalities would be in a disadvantaged position vis-à-vis promotion even after moving on to new posts if the own-source revenue of the debtor governments proved insufficient to cover their debts. To strengthen the hand of state-owned banks, the central government could reassign taxation powers from over-indebted municipalities to the banks themselves, thereby allowing the latter to impose or maintain local taxation levels within those municipalities in proportion to the

138. As David Stasavage has argued, early modern England could borrow at much lower interest rates than Louis XIV's France, because divided powers and partisan conflict in the English Parliament made default on the Bank of England's loans exceedingly difficult. DAVID STASAVAGE, *PUBLIC DEBT AND THE BIRTH OF THE DEMOCRATIC STATE: FRANCE AND GREAT BRITAIN, 1688–1789*, at 68–69 (2003). Likewise, partisan and constitutional divisions in Jacksonian America made credible the federal government's commitment not to bailout out defaulting debtor states after the Panic of 1837, imposing a hard budget constraint on all subnational jurisdictions that made credible their state constitutional commitments to balanced budgets. JONATHAN A. RODDEN, *HAMILTON'S PARADOX: THE PROMISE AND PERIL OF FISCAL FEDERALISM* 64 (2006).

139. See Hills & Qiao, *supra* note 48, at 163–66.

140. See VICTOR C. SHIH, *FACTIONS AND FINANCE IN CHINA: ELITE CONFLICT AND INFLATION* 47–63 (2008).

scope of the likely default.¹⁴¹ The advantage of such a system is that it has the possibility of becoming self-enforcing through introduction of an element of competition between lenders and local governments, thereby providing the former with an incentive to compete rather than collude with the former.¹⁴² On the other hand, leaders of state-owned banks are also politicians and prone to short-term incentives. To completely overcome the short-term incentives requires furthering market-oriented reforms in the financial sector.¹⁴³

CONCLUSION

We are under no illusion that the prescriptions outlined above will magically transform Chinese local officials into far-sighted caretakers of local fiscal responsibility. We suggest only that these are examples of the sorts of steps necessary to liberate local officials from the irony of crippling omnipotence, by giving them the incentives and capability to make credible commitments. Until local officials have the motives and means by which to bind themselves and their successors to long-term and gradual reforms, those officials will always gamble on investments that have certain short-term benefits but uncertain future costs. Promotion criteria rooted in land values can supply the motives, while local decision-making processes like LPCs can supply the means. By giving each local official the power to tie the hands of his or her successor, those processes seem to weaken officials. Paradoxically, such limits on power make them more powerful, by enabling them to pursue projects that transcend the local officials' short time in office.

141. An analogous system for regulating default on public debt was attempted in the Ming Dynasty, when the Imperial government defaulted on debt owed to salt merchants but assigned to them the collection of the salt tax, converting a governmental debt into a system of tax farming. WING-KIN PUK, *THE RISE AND FALL OF A PUBLIC DEBT MARKET IN 16TH-CENTURY CHINA: THE STORY OF THE MING SALT CERTIFICATE* 40–47 (2015).

142. For an argument about the competing incentives of the leaders of state-owned banks and municipalities, see *supra* Parts II.B, IV.C.

143. Fareed Zakaria, *China's Coming Challenges*, WASH. POST (Nov. 7, 2013), https://www.washingtonpost.com/opinions/fareed-zakaria-chinas-coming-challenges/2013/11/07/2cecc11e-47d0-11e3-b6f8-3782ff6cb769_story.html.