The Reverse Bail-Out of Indebted Local Governments by Local Firms

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Overview

- Government Debt has been increasing rapidly in many countries in the recent decades, and there is a looming concern of default, especially in China.
- This paper adds to this research topic nicely by studying the pass-through of local government debt distress to local firms (i.e., “reverse bail-out”).
- Very nice paper with a very interesting contract-level data
  - Higher indebtnesses of local government lead to higher account receivables of hired contractors/firms.
  - Less prominent for firms with large size, state ownership, or in high tech industry.
- Comments on the contribution to the literature and empirical exercises

Comment 1: Literature Contribution

- The main economic message of the paper is to show how local government default (delayed payments) on their suppliers.
- It is not surprising that distressed borrowers would delay the payments to their creditors.
- I suggest the authors to highlight the selective default patterns (e.g., less likely to pass their debt distress to the SOEs).
  - The evidence on government strategic/selective default is still scant in the literature (e.g., Reinhart and Rogoff (2008 AER))
  - Cross default is not imposed in China, which is an ideal testing field.
  - Gao, Ru, and Tang (2021 JFE) documents that local governments in China prefer to default on less politically powerful lenders.
- In practice, the selective default in China is big issue in global financial markets.

Comment 1: Literature Contribution

Business / Banking & Finance

Sunac pays local bondholders after defaulting on dollar notes, showing that cash goes first to domestic creditors

- Sunac Real Estate Group sent an initial planned payment on 400 million yuan of notes due on May 15 to investors via the bond's trustee
- Sunac China will make the first principal payment on that date, according to an exchange filing on Friday night

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Comment 1: Literature Contribution

THE WALL STREET JOURNAL.

MARKETS

China Evergrande Revises Payment Plan for Wealth-Management Products

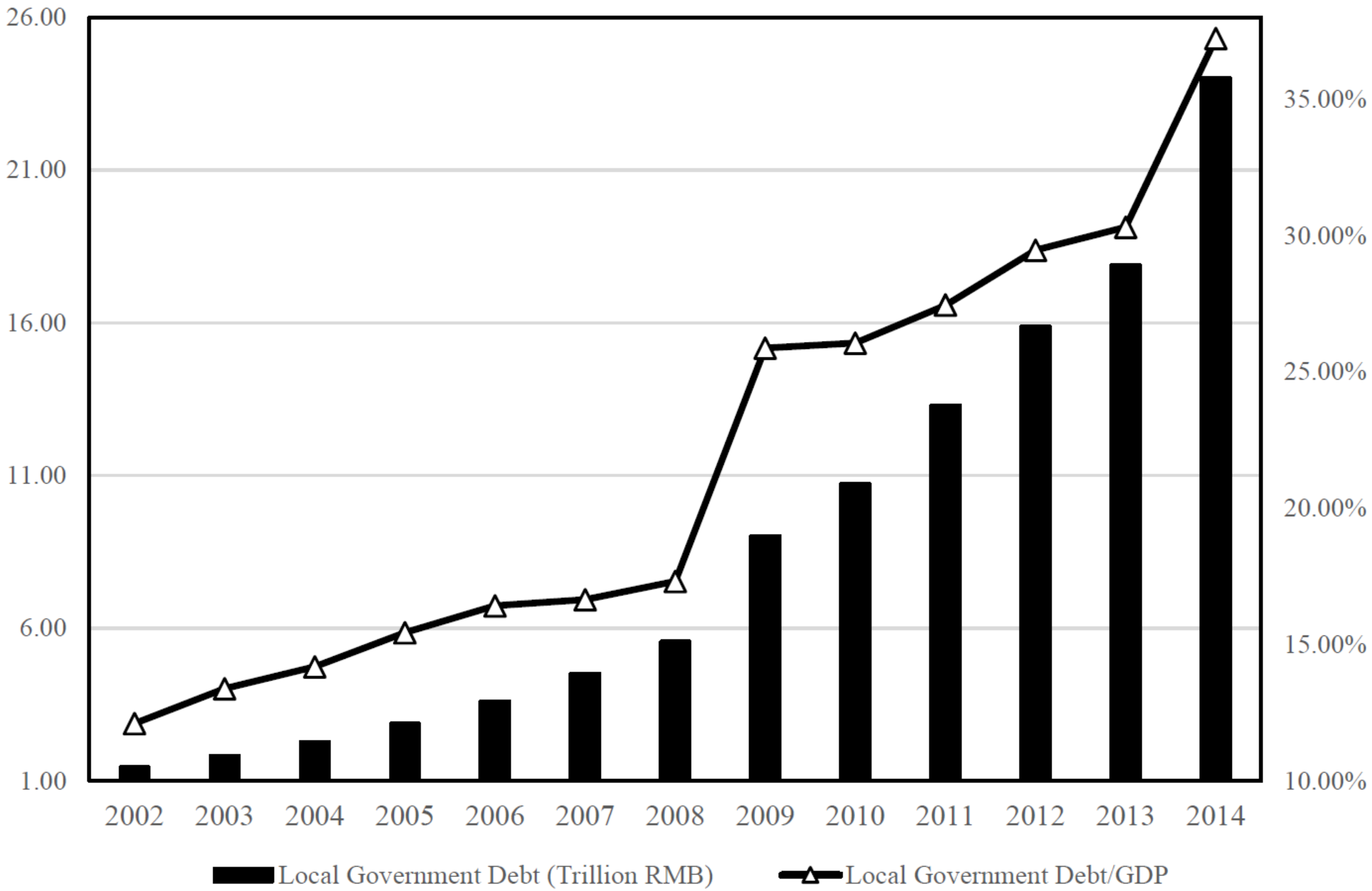
Unit proposes paying almost all product holders $1,255 a month from December to February

Comment 2: Measurement

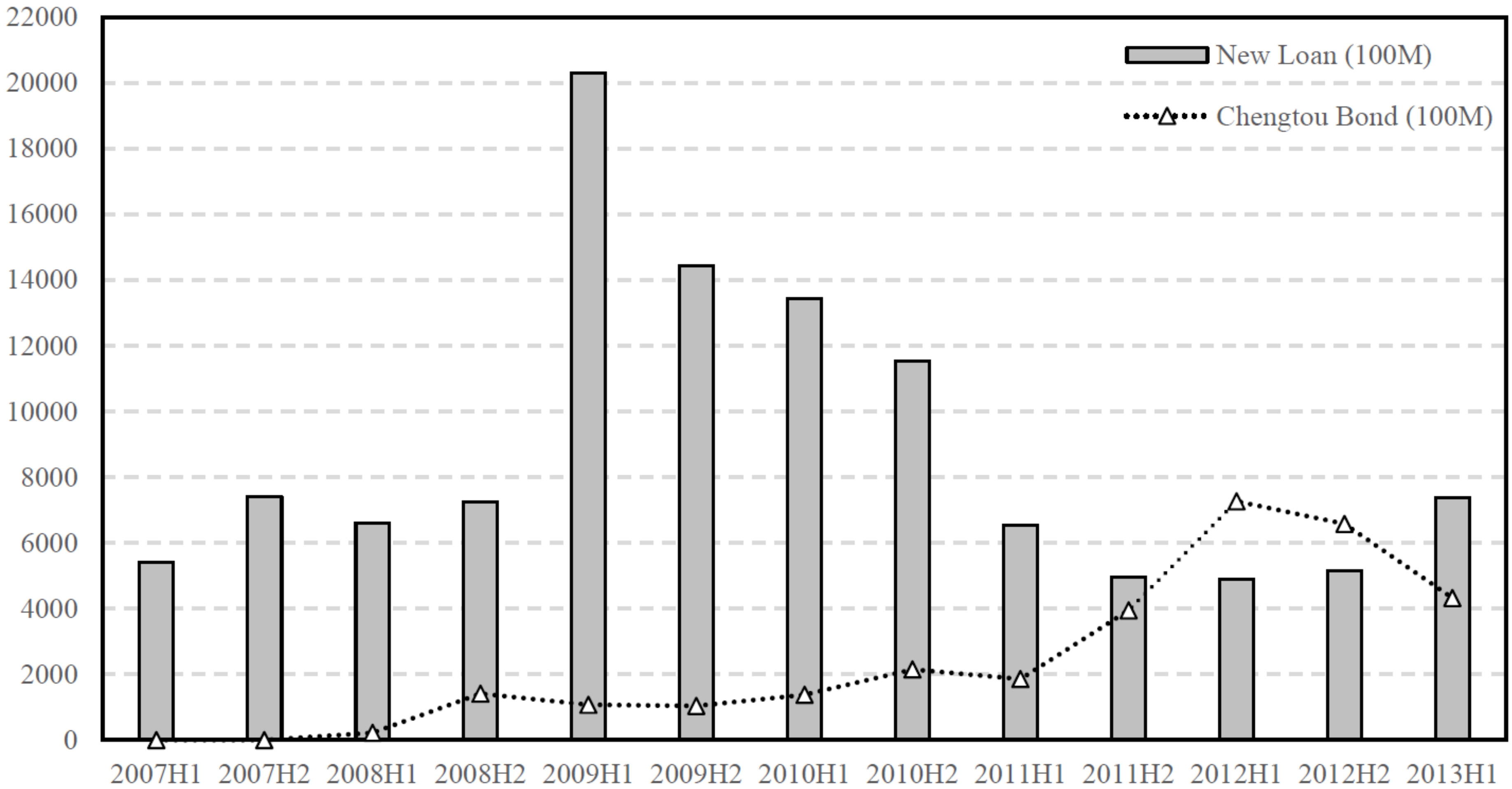
- Main variable to measure local government indebtness is dummy **[High pressure]**, which *"equals to 1 if the government has a higher-than-median government debt-to-income ratio or a higher-than-median debt interest premium".*

- The authors use Wind database for local government debt (i.e.,**bond**), which might significantly underestimate the actual debt level.
  - Tax Sharing Reform in 1994
  - Local governments in China receive only around 30% of the tax revenue
  - Budget Law in 1994 prohibited local government to incur debts
  - Local governments cannot directly borrow or issue bonds until 2015
  - Off-Balance sheet borrowing: local government financing vehicles (LGFVs/SPV), which are fully state-owned corporations which can legally borrow and issue bonds.

Comment 2: Measurement



Comment 2: Measurement



Comment 2: Measurement

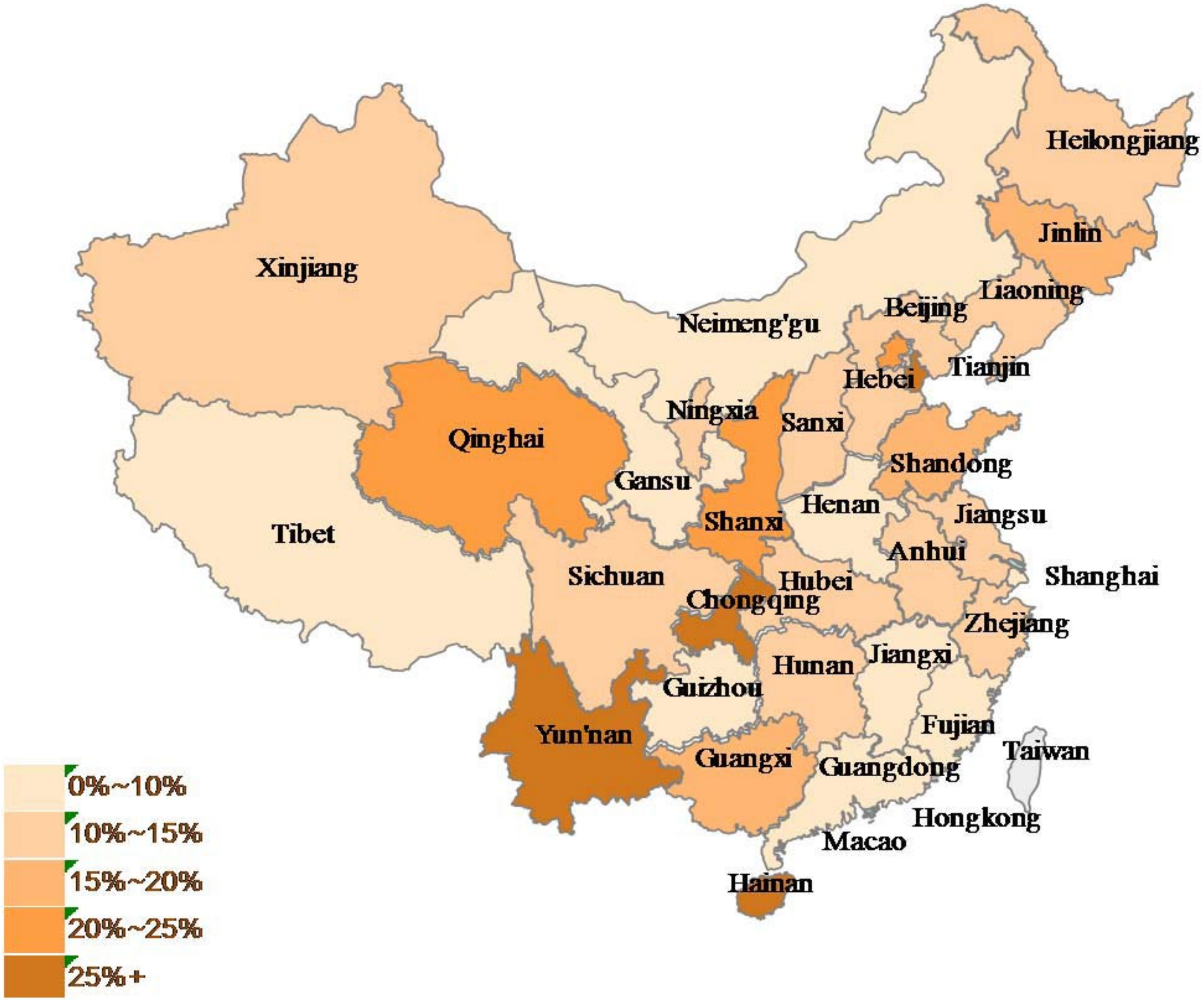
- In addition, I suggest the authors to have a super clear description on how they measure the bond level.

- The dummy [High pressure] is measured at the city-year level by using only the SPV bond issuances.

- Following 2015 new budget law, the provincial government can directly issue bonds, part of these funding would follow to municipal governments.

- Why use median as the cut off?

Loan to GDP Ratio in 2012



Comment 3: Identification

- The authors use the prior political connections of the city political leaders (mayor or secretary) to the provincial governments as the IV for dummy **[High pressure]**
- The authors argue that **"the political connection of the previous city leaders can hardly have affected current economic conditions in channels other than debt."**
- Political connections can affect local economic activities in many ways not only in China (e.g., Fisman and Wang (2014 RES); Jia et al. (2015 JEEA)) but also in many other countries (e.g., Fisman (2001 AER); Khwaja and Mian (2005 QJE); Faccio (2006 AER)).

Comment 3: Identification

- Ru and Zou (RF forthcoming) find the discontinuities in economic activities across connected top politicians’ age (i.e., seven up and eight down).

- Focus on the debt swap program in 2015 under the new budget law (e.g., Chen, He, and Liu (2020 JFE)).

- Policy shocks to the real estate industries, given that local governments in China heavily rely on revenues from land sale.

Other comments

- Provide more evidence on how to link local government delayed payments to firms' account receivables.
  - "Statistics show that the total overdue repayments to government procurement by the end of 2018 were at least 890 billion RMB, most of the suppliers are SMEs. By the end of August 2018, 480 local governments in China appear on the "Dishonest debtor" name list, meaning that they default on the procurement at least once."
- Dummy supplier switch from 0 to 1 when the firm becomes a government supplier. What happened when they finish the job and never take any new ones?
- For all 2SLS, report the weak identification test stats.
- Move up the Table of Variable Definition to the main manuscript.

Conclusion

Very good paper to add to the literature!

Good luck!