

# Empowering through Courts: Judicial Centralization and Municipal Financing in China

Jiayin Hu, Wenwei Peng, & Yang Su  
ABFER Webinar Series

Discussion by  
Jacopo Ponticelli  
Northwestern, CEPR and NBER

# Summary

- **Question:** impact of judicial independence on local government debt financing
- **Setting:** China
  - 2013 Judicial Reform (staggered rollout 2014-2020)
  - Transfer judicial authority from municipal → provincial governments

- **Empirical findings:**

judiciary ↓ win rate of LGFV in cases against suppliers (10%)

bond market ↓ issuance (10-15%), ↑ yields (0.25%)

real effects ↓ value of LGFV assets (9%), spending (20%), developed land quantity and price

# Comments

#1 Contribution to the literature

#2 Mechanisms

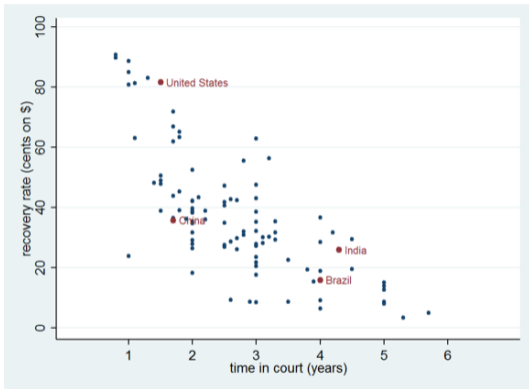
#3 Empirics

## Comment #1: Paper contribution to the literature

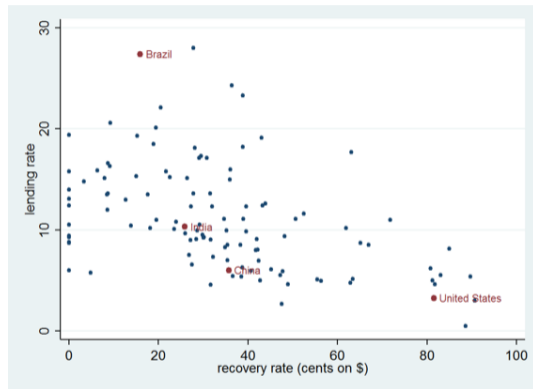
- Well-functioning judiciary: pillar of well-functioning institutions and markets
- Characteristics:
  1. efficient
  2. specialized
  3. independent (less studied)
- General implication for credit markets:
  - A judiciary that facilitates speedy and fair repossession by creditors (ex-post)
  - ... lowers borrowing costs for debtors (ex-ante)

# Comment #1: Paper contribution to the literature

slower courts lead to lower recovery



... lower recovery leads to higher interest rates



Source: WB Doing Business.

## Comment #1: Paper contribution to the literature

- Same reasoning should apply when governments borrow:
  - If government strategically defaults by using its influence on courts
  - Then it will likely face higher interest rate that undermine its borrowing capacity

# Serial defaulters

.... have hard time borrowing again

Spain: 1557, 1560, 1575, 1596      Argentina: 1982, 1989, 2001, 2014, 2020



## Comment #1: Paper contribution to the literature

- Same reasoning should apply when governments borrow:
  - If government strategically defaults by using its influence on courts
  - Then it will likely face higher interest rate that undermine its borrowing capacity
- Empirical evidence consistent with this argument at **sub-national level**:
  - Dove (2018, JCE):
    - studies changes in judicial selection of state courts of last resort in 19th century
    - higher independence leads to lower yields on local bonds



# Delays in payment of commercial transaction in Italy



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PRESS RELEASE | 7 December 2017 | Brussels | 2 min read

## Late payment: Commission refers Italy to Court of Justice for failing to ensure suppliers are paid on time

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Today, the European Commission decided to refer Italy to the Court of Justice of the EU due to systemic payments delay by the Italian public authorities in commercial transactions, thus breaching EU rules on payment arrangements (Late Payment Directive, Directive 2011/7/EU).

According to the [Late Payment Directive](#), public authorities have to pay for the goods and services they procure within 30 days or, in very exceptional circumstances, within 60 days of receiving the bill.

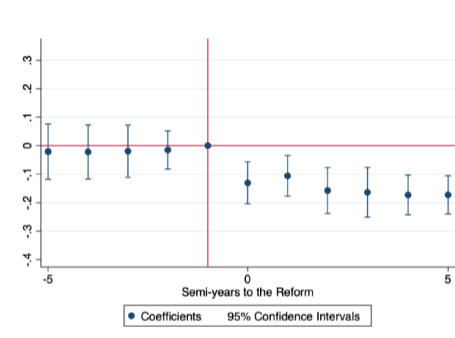
The Commission attaches great importance to addressing the issue of delayed payment by public authorities, which has also been identified in several Member States, and pursues a strict enforcement policy of the Late Payment Directive. Timely payments are particularly important for small- and medium-sized enterprises (SMEs), which count on a positive cash-flow to ensure their financial management, competitiveness and in many cases, their survival.

The Commission acknowledges the efforts made by the Italian government to improve the situation since the launch of the infringement procedure with a letter of formal notice in [June 2014](#) and the subsequent reasoned opinion sent in [February 2017](#).

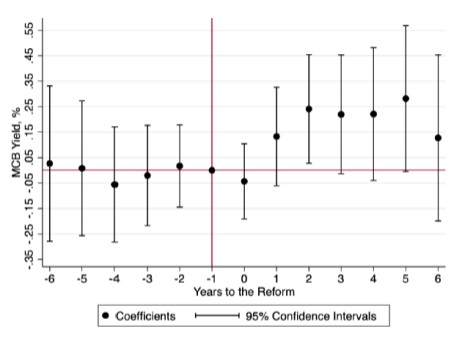
However, more than three years after the launch of the infringement procedure, the Italian public authorities still take on average 100 days to settle their invoices, with peaks which can considerably exceed this figure.

## Comment #1: Paper contribution to the literature

- This paper: more independent judiciary → higher yields, lower debt capacity



(a) Local Government Win Rates



(b) Municipal Corporate Bond Yield, %

- Why?
- Crucial to understand the mechanism

## Comment #2: Mechanism

Key mechanisms: ↑ judicial independence:

### 1. **Increases expenditure:** local governments have to pay suppliers

- Question: isn't that reassuring for perspective creditors?
- Implicit assumption: **selective default**, gov defaults on suppliers to pay bond holders

### 2. **Reveals credit risk** of local governments

- Question: what information does the ruling reveal exactly?
  - Implicit assumption about use of courts by different types of local governments:
    - non-liquidity constraint → only if contract violated by supplier (wins always)
    - liquidity constraint → to strategically default (wins before, loses after)
    - Thus: after reform, loss in court signals liquidity constraint
- this is only true if this is the correct model of the world!

## Comment #2: Mechanism

- Throughout the paper, authors mention how local courts “have to respect contract terms” and have little room to “nullify debt obligations”.
  - In that case, we would not expect a large impact of increased judicial independence
  - Important to clarify:
    - How does political influence over local courts facilitate default in the pre-reform?
    - Any way to ascertain pro-government bias in rulings? E.g. violations of the letter of the contract to benefit government
- Large effects imply local courts do not respect contract terms!

# Comment #3: Empirics

## identification strategy

Figure: Staggered roll out of judicial reform

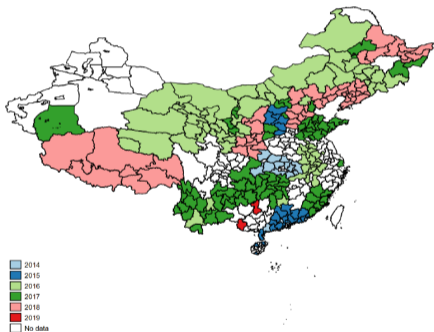


Figure 2: Timeline of the Reform

- Transfer appointment/budget decisions to provincial courts
- Introduced in 238/336 cities between 2014-2020
- **What drives selection into treatment vs control?** This needs more discussion.
- Check balance in
  1. levels at baseline ✓
  2. growth rates pre-reform ×
  3. exposure to potential confounders ×

# Comment #3: Empirics

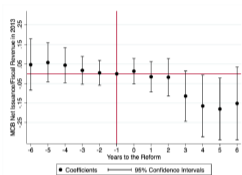
## Magnitudes

- Magnitudes indicate large negative shock (or cumulative effect of multiple shocks)
  - debt downgrade
  - net issuance of MCB declines 10 to 15 %
  - total assets of LGFV decline 9%
  - local gov spending declines 20%
- Dynamic confounders? Contemporaneous push to lower sub-national debt
  - 2014 Revision of budget law
    - emphasize budget transparency, disclosure of existing debt
    - authorize local governments to borrow directly
  - 2014 State Council Document 43
    - curb borrowing via LGFV

# Comment #3: Empirics

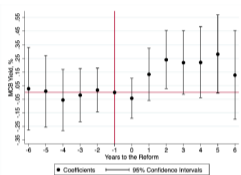
## Timing of the effects

### debt net issuance



(a) Net Issuance/Budgetary Revenue

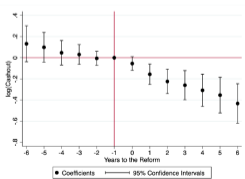
### yields



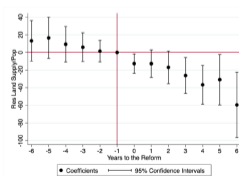
(b) Average Yield, %

Figure 4: MCB Issuance and Yield after the judicial reform

### investment



### developed land area



- Causal chain: independence → lower debt capacity → lower ability to invest/spend
- Negative impact on debt issuance from year 3 post reform
- However, spending cuts and real effects materialize from year 1 post reform

## Comment #3: Empirics

### Composition effects

- Paper aggregates all bonds issued at the city-year level
- Alternative approach: use bond-level variation in pricing over time, controlling for time invariant bond and city characteristics (via bond or issuer fixed effect)
- Concern with current approach: change in issuance leads to change in composition of bonds used to study effect on yields



# Summary

- Important research question. Early stage, but great potential.
- Nudge authors to:
  1. Clarify contribution
  2. Clarify mechanisms and assumptions needed for such mechanisms to be at work
  3. Discuss dynamic confounders and timing
- Looking forward to read new version, encourage authors to keep working on this promising agenda.