

From Fiscal Black Holes to Rent-Free Havens: An Institutional Analysis of China's Local Governance

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Abstract: This paper performs an institutional analysis of the escalating fiscal distress and aggressive competitive strategies observed among China's local governments. Drawing on the principles of New Institutional Economics (NIE), I argue that these phenomena are direct and predictable outcomes of the fundamental institutional clash established by the 1994 fiscal decentralization and the accompanying growth-oriented official promotion system. Specifically, the paper analyzes the causal link between the structural fiscal gap (the 'fiscal black hole') and local authorities' recourse to informal, off-balance-sheet mechanisms, such as Local Government Financing Vehicles (LGFVs) and, more recently, non-transparent subsidies like 'zero-rent' policies. The essay demonstrates that informal institutions—primarily the career incentives tied to GDP growth—effectively override formal rules (the Budget Law), forcing local governments into a 'race to the bottom' where fiscal health is sacrificed for short-term investment attraction. The central government's attempts to impose formal discipline (zero-based budgeting) only prompt local actors to innovate new, riskier informal workarounds, creating an unsustainable institutional equilibrium. This analysis contributes to understanding the inherent tensions in China's development model and suggests that sustainable stability requires a fundamental realignment of fiscal responsibilities and performance metrics.

Keywords: China; Local Governance; Institutional Economics; Fiscal Decentralization; Local Government Debt; LGFVs; Regional Competition; Zero-Rent Policy

Online publication: August 31, 2026

1. Introduction

This essay is about the money problems and competitive strategies of local governments in China. I argue these are predictable outcomes of its institutional framework. Using New Institutional Economics, I will show how informal bargains and growth incentives override formal rules, shaping the long-term sustainability of China's economic model and its inherent tensions. My analysis centers on the interaction between Beijing's fiscal policy and the localized actions of municipal and county-level governments, illustrating how rational behavior at the local level can lead to collective irrationality for the entire system. Understanding this

structural tension is key to grasping the trajectory of China's economic reforms and the challenges it faces in transitioning to a high-quality, sustainable growth model. The framework of NIE distinguishes clearly between formal institutions (laws, regulations, contracts) and informal institutions (norms, customs, culture, and, critically, internal political incentives). This essay demonstrates that in the Chinese context, the informal incentives of the cadre evaluation system have systematically dominated the formal constraints of the fiscal budget law. The persistence of these debt and competition issues, despite numerous central government mandates, highlights the deep resilience of informal institutions over formal policy announcements.

2. Comparison of two media articles

2.1. AI-assisted comparison and its evaluation

To begin, I prompted an AI to compare The Economist's "China's local governments are approaching a fiscal black hole" and Caixin's "China's Cities Offer Rent-Free Industrial Parks in Battle to Lure Startups." The AI gave back a pretty good basic summary. It correctly said that The Economist's piece is about debt and budgets, with the central government pushing "zero-based budgeting." It also figured out that the Caixin article was about cities trying to win over businesses with stuff like free rent.

But the AI's analysis didn't go very deep. It basically talked about the two articles as if they were separate stories and didn't explain how one problem causes the other, which is a big part of institutional analysis^[1].

The core failing of the AI's comparative summary was its inability to articulate the institutional causality. It recognized the dual problems—the money crisis and the intense competition—but treated them as parallel news items instead of recognizing the 'fiscal black hole' as the structural cause and the 'city war' as the strategic consequence. This limitation is typical of current AI: it sorts information but struggles with the deep causal thinking required by institutional analysis^[1]. It missed the main idea: that the 'city war' is a desperate result of the debt problem, driven by a structural mandate for growth that conflicts with a lack of revenue. For an institutional economist, the relationship is a closed loop: the fiscal structure demands growth; the promotion system rewards growth; restricted formal financing forces the creation of new informal strategies, like 'zero-rent,' to achieve that growth.

2.2. My own evaluation of the articles

The Economist and Caixin articles are two sides of the same institutional coin, together illustrating a core problem in China's local governance. The Economist portrays local governments as fiscally distressed actors, now facing the formal solution of "zero-based budgeting" from the central authority. Conversely, Caixin depicts these same governments as aggressive, entrepreneurial agents in a 'city war' for survival, devising the informal workaround of 'zero-rent' policies to attract investment when traditional incentives are banned. The profound connection is that the fiscal black hole is the cause, and the city war is the consequence. This causal link is explained by the post-1994 "grand bargain" between central and local governments^[2].

The structural origin of the 'fiscal black hole' lies in the 1994 tax-sharing system reform. This formal institutional change recentralized the most lucrative tax revenues (like VAT) away from local hands, while local governments were simultaneously left with the majority of expenditure responsibilities, including education, healthcare, and infrastructure necessary for economic growth. This created a profound and chronic

vertical fiscal gap—a structural imbalance between revenue and expenditure at the local level.

This imbalance essentially forced localities to find off-the-books ways to pay for everything, creating a system dependent on debt from the very beginning. The center’s tacit approval of “backdoor financing” mechanisms—such as Local Government Financing Vehicles (LGFVs)—was the unspoken deal. Since the formal Budget Law prohibits local governments from directly borrowing, they established LGFVs (nominally independent SOEs) to borrow massive amounts from banks by pledging land revenue. Crucially, the sustainability of this model was intrinsically tied to the land finance system. Revenue from local land leases, considered ‘extra-budgetary’ and easily funneled through LGFVs, became the largest source of discretionary income. This dependency created a perverse institutional incentive: officials had to continuously push up land prices and rapid urbanization to keep the LGFV-based financing machine running, prioritizing real estate expansion over sustainable industrial development. This reliance on land as collateral not only inflated the property bubble but also led to massive misallocation of capital, crowding out productive private sector investment in favor of often-redundant infrastructure projects. This inefficient debt-driven model generated high GDP numbers but eroded the long-term productivity and genuine tax base required for sustainable fiscal health.

This institutional innovation transformed operational deficits into hidden investment debt, shifting the liability off the government’s official balance sheet. The sheer scale of LGFV debt, estimated in the tens of trillions of RMB, blurs the lines between sovereign and corporate risk, representing a significant systemic threat.

As Beijing attempts to close these backdoors—by imposing “zero-based budgeting” and restricting LGFV debt—local governments, still under immense pressure for official promotion via growth, are simply innovating new informal strategies. The “zero-rent” policy is a prime example: a non-transparent, off-balance-sheet subsidy designed to lure mobile capital. By offering free or subsidized land and space, the government absorbs a non-cash operational cost that avoids direct budgetary expenditure. This subsidy is a direct institutional substitute for the old debt-for-growth model, revealing the fundamental contradiction in central policy: demanding fiscal consolidation while maintaining intense, promotion-driven pressure for economic performance. This dynamic confirms the NIE principle that economic actors (the local governments) will always find innovative ways to overcome institutional constraints to maximize their utility (career advancement).

3. Analysis in broader academic context

The dynamics in the media articles are powerfully illuminated by the institution-based view of strategy^[3]. A core proposition of New Institutional Economics (NIE), central to the Week 3 lecture, is that where formal constraints are weak or contradictory, informal constraints—such as unwritten rules and career incentives—play a larger role in shaping behavior. In China’s case, these informal rules are often more important than the official laws.

The formal rule is the 1994 Budget Law. The informal, overriding institution is the official promotion system that links career advancement to GDP growth. The “zero-based budgeting” plan strengthens the formal rule, while “zero-rent” deals represent local governments’ new informal strategies for survival^[3]. When the formal rule says “you cannot borrow,” but the informal rule says “you must grow to be promoted,”

the local official rationally prioritizes the informal rule, which has direct career consequences.

The institutional competition is further refined by NIE's focus on transaction costs^[1]. Firms in centralized systems often face high transaction costs related to opaque bureaucracy and weak legal protection. The "zero-rent" policy is a mechanism explicitly designed to lower these costs, specifically reducing the private firm's bargaining costs and governance costs. By offering a concrete, immediate subsidy, the local government signals commitment and reduces the firm's uncertainty about future policy stability^[5]. For firms, this "zero-rent" package significantly lowers search costs by simplifying the location decision and enforcement costs by bypassing slow, bureaucratic processes often required to secure government support or tax breaks. The subsidy essentially becomes a political guarantee, streamlining the business entry process in exchange for future tax revenue and job creation. This strategic move is a localized 'market design' adjustment, attempting to generate economic activity despite restrictive national rules.

Xu's (2011) ^[4]theory of "regionally decentralized authoritarianism" suggests that the competitive relationship between regions, institutionalized by the promotion tournament model based on GDP growth, is the engine of China's expansion. This provides officials with a strong personal reason to focus on rapid economic growth and infrastructure spending over long-term financial health. This focus incentivizes officials to engage in competitive deregulation and subsidized investment. As seen in the Caixin article, officials are scrambling to "boost jobs and tax revenues" by any means necessary, a rational response to the institutional incentive structure.

However, this push for growth, combined with the 1994 fiscal shortfall, has caused severe structural problems, leading to what Oi, Luo, and Xu (2025) call a "perfect storm." The system was only manageable during periods of extremely high growth when debt could be serviced by rapidly increasing land sale revenues. The subsequent crisis was fundamentally triggered by the confluence of three factors: the economic slowdown, the collapse of land finance (the LGFVs' collateral), and the substantial increase in mandatory, non-discretionary expenditures (like COVID-related spending). The debt crisis is exactly why the aggressive "city war" in the Caixin article is necessary; the collapse of traditional revenue streams forces local governments into desperate competition for mobile capital.

Furthermore, the behavior of private businesses is also shaped by the institutional environment. As Oppen and Nee (2015) ^[6]point out, weak formal legal protections mean private businesses must rely on informal networks (guanxi) and good relations with local officials for success. That's why firms quickly accept informal offers like rent-free spaces. These deals, while potentially inefficient, act as political insurance, effectively substituting for formal legal safeguards. This mutual adaptation creates a unique localized system^[5], demonstrating how economic life can proceed by creating new, localized rules where national rules are contradictory. The current institutional equilibrium is defined by high growth pressure, high debt, and continuous local improvisation.

4. My critical evaluation of the underlying issue

The core issue is that China's development model, built on confusing signals and informal workarounds, is fundamentally unsustainable. Regional competition, which was crucial for growth, quickly turns into a damaging "race to the bottom" when local governments are fiscally distressed and constrained by central discipline. Officials are wasting scarce public resources on non-budgeted subsidies, distorting markets, and

creating a moral hazard.

The central government is effectively trapped by its own institutional design. Trying to fix the debt problem by banning old tricks like LGFVs only addresses the symptoms. Because the main informal rule—the promotion system that prioritizes GDP growth—is still overwhelmingly in place, officials will simply innovate new, riskier, and less transparent informal mechanisms to meet the career mandate. This clash between the formal goal of fiscal stability (top-down) and the informal goal of growth performance (bottom-up) is the institutional fault line.

The most immediate threat posed by this institutional dissonance is the potential for a localized debt crisis to metastasize into a national financial crisis^[7]. LGFVs are heavily financed by state-owned banks, meaning local defaults translate directly into non-performing loans, threatening the stability of the entire banking system, which is already stressed by the property sector slowdown. This interdependence transforms the local fiscal black hole into a profound political stability challenge, forcing Beijing into bail-out decisions that contradict its disciplinary goals. Each central government intervention or veiled bailout, while necessary to prevent systemic collapse, further reinforces the moral hazard—the expectation that local officials will not face the full consequences of their reckless borrowing. This cycle of rescue undermines Beijing's political credibility regarding its fiscal discipline mandates, sending mixed signals to the bureaucracy and the market alike. The central authority faces a fundamental institutional dilemma: saving the system today by forgiving past debts guarantees future misconduct. Furthermore, the opaqueness of LGFV liabilities creates massive systemic information asymmetry, making effective top-down risk management nearly impossible. The uncertainty over debt ownership and loss bearing significantly raises transaction costs for all market participants, slowing private investment and undermining confidence.

If there is no real plan to make local government income structurally match their spending duties, and to fundamentally change how officials get promoted^[1], they will be stuck in this bad pattern. The necessary structural reforms, from an NIE perspective, must focus on aligning the formal and informal rules. Specifically, this requires two key, mutually reinforcing changes:

Rebalancing the Vertical Fiscal Structure: The central government needs to close the structural fiscal gap by either taking over more massive local expenditure responsibilities or by giving local governments a stable, long-term revenue source commensurate with their duties, such as a property tax system. Introducing a broad-based property tax, while politically challenging, is the most crucial institutional step, as it would create an independent, recurring, and locally accountable revenue stream, finally offering a sustainable substitute for volatile land sales. Without this structural fix, the debt-for-growth imperative will persist, incentivizing short-term land-based revenue extraction over long-term, sustainable tax-based income generation.

Reforming the Official Promotion System: The informal institution driving the behavior—the promotion tournament—must be reformed to prioritize metrics beyond simple GDP growth. Incorporating comprehensive metrics like debt sustainability, environmental quality, social equity, and public service provision would reduce the intense pressure to chase growth at any cost. This shift would fundamentally alter the rational calculus of local officials, incentivizing them to manage resources responsibly.

The current situation represents a profound political risk. This constant loop of making risky investments and dealing with one financial scare after another is a huge threat to the country's economic stability and the credibility of its institutional governance for the future. The debt crisis is not just a balance sheet problem; it is a crisis of incentives and institutional design.

5. Conclusion

To summarize, the cash shortages and cutthroat competition among local authorities are outward signs of a dysfunctional system running on informal bargains and regional turf wars. The structural fiscal gap created by the 1994 reforms, combined with the powerful, growth-obsessed official promotion system, has created an institutional environment where local officials rationally choose informal debt creation over formal budgetary prudence. This model has reached its limit. Until the basic clash between formal fiscal rules and the informal pressure for growth is fixed through structural reform of the tax-sharing system and the promotion criteria, these issues of debt, moral hazard, and unsustainable competition will continue. Only an institutional realignment that harmonizes fiscal responsibilities with performance incentives can achieve stable, high-quality growth.

Disclosure statement

The author declares no conflict of interest.

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