Research on the Transmission Mechanism of Financial Risks under the New Changes in the PPP Mechanism

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Abstract: This study examines financial risk transmission under China's new PPP mechanism (Document No. 115, 2023). Pre-reform, risks spread directly/indirectly to the financial system via government payment defaults, local debt accumulation, and credit contagion. The 2023 reforms centralize oversight, prioritize user-pay models, and narrow project scope to sever government-debt links, shifting risks to market entities. However, structural flaws like fiscal imbalances and regulatory fragmentation persist. Post-reform risks now manifest through market demand volatility, operational efficiency, and pre-implementation feasibility flaws, increasing market sensitivity and operational exposures. While reducing direct fiscal risks, financial vulnerabilities endure via altered channels, necessitating enhanced regulatory capacity and market discipline.

***Keywords*:** New PPP Mechanism, Financial Risk Transmission

1. Introduction

In modern economic systems and public service sectors, the Public-Private Partnership (PPP) model has emerged as a critical mechanism for advancing infrastructure development and enhancing public service delivery. Leveraging its innovative design and collaborative framework, PPP integrates governmental oversight with private sector efficiency, aiming to address fiscal constraints, improve service quality, and foster sustainable governance. Since 2014, China's Ministry of Finance and other regulatory bodies have actively promoted PPP adoption, envisioning it as a transformative tool to mobilize private capital, alleviate fiscal burdens, and modernize public service provision. Consequently, PPP projects have proliferated across diverse sectors, including energy, transportation, environmental conservation, and municipal engineering, contributing significantly to national development.

However, empirical data reveals a paradoxical trend: PPP adoption rates in China's less-developed central and western regions surpass those in economically robust eastern provinces. This disparity stems not from superior institutional understanding but from the heightened fiscal pressures faced by under-resourced local governments. In pursuit of rapid infrastructure expansion, many local authorities have exploited PPP's financing capabilities while neglecting its core principles of risk-sharing, efficiency optimization, and equitable benefit distribution. Such deviations have led to widespread misuse, including overleveraging, rigid fiscal commitments, and the accumulation of implicit local government debt. These practices amplify financial risks, transmitting vulnerabilities from public budgets to the broader financial system.

To realign PPP with its foundational objectives, the National Development and Reform Commission (NDRC) and the Ministry of Finance (MOF) introduced the Guidelines on Standardizing the Implementation of the New Government and Social Capital Cooperation Mechanism (Document No. 115) on November 8, 2023. This reform centralizes regulatory authority under the NDRC, prioritizes user-pay revenue models, and mandates private sector participation to mitigate state-owned enterprise dominance. [1]

Despite these measures, subsequent policy directives — such as the NDRC's Notice on Further Regulating the Implementation of New Mechanism PPP Projects (Document No. 1013, December 2024) — highlight persistent challenges. Moreover, economic principles dictate that risks inherently propagate through resource allocation channels, necessitating a thorough examination of how PPP's financial risk transmission mechanisms evolve under the new framework.

This study explores the continuity and transformation of PPP-related financial risks, offering insights critical to safeguarding public interests, ensuring fiscal sustainability, and maintaining financial stability.

2. Pre-Reform PPP Risk Transmission Pathways

2.1 Direct Risk Transmission Mechanisms

PPP projects transmit risks to the financial sector through interconnected stages: investment, financing, construction and operation.

2.1.1 Transmission of Investment and Financing Risks

Financing Gaps and Credit Risk: PPP projects often require substantial upfront investments, with complex financing structures involving equity, loans, and bonds. Weak project planning, flawed feasibility assessments, or adverse macroeconomic conditions may deter investors, leading to financing shortfalls. Financial institutions face heightened credit risks due to delayed loan disbursements, idle capital, or project suspensions.

Cost Escalation and Interest Rate Volatility: Elevated project risks — such as policy ambiguity, legal disputes, or market uncertainties — compel lenders to demand higher risk premiums. This increases financing costs, potentially destabilizing financial markets if multiple projects experience parallel cost surges.[2]

2.1.2 Transmission of Construction and Operational Risks

Asset Quality Deterioration: Construction delays, budget overruns, or substandard deliverables undermine project viability, rendering loans non-performing and impairing financial institutions' balance sheets. For instance, large-scale infrastructure projects grappling with technical complexities or force majeure events often face prolonged timelines, exacerbating default risks.

Revenue Shortfalls and Profit Erosion: Post-construction operational risks—such as insufficient demand, cost inefficiencies, or mismanagement—reduce cash flows below projections. Financial institutions, as primary funders, bear the brunt of diminished returns. A case in point: declining industrial activity in a region may reduce wastewater volumes, crippling the revenue model of a PPP sewage treatment plant and jeopardizing debt repayments.

2.1.3 Transmission of Capital Reflux Risks

Government Payment Defaults: Many PPP projects rely on government subsidies or contractual payments. Fiscal stress, policy reversals, or administrative turnover may disrupt these obligations, destabilizing project cash flows and triggering loan defaults.

User-Pay Instability: Revenue-dependent projects (e.g., toll roads, utilities) face volatility from fluctuating user numbers, payment capacities, or regulatory price caps. Systemic failures in such projects can escalate financial institutions' non-performing loan (NPL) ratios, threatening sector-wide stability.

2.1.4 Credit Risk Contagion

Participant Defaults: Credit deterioration among key stakeholders — governments, private partners, or subcontractors — can derail projects. For example, abrupt contractual revisions by newly elected local governments inject uncertainty, undermining lender confidence.[3]

Credit Rating Downgrades: A project's credit rating downgrade due to operational failures or governance lapses raises borrowing costs, tightens financing access, and triggers broader market skepticism.

2.2 Indirect Risk Transmission Mechanisms

2.2.1 Local Debt Accumulation due to PPP risks to local debt

Fiscal Overcommitments: Local governments often overestimate project viability to attract private investment, locking themselves into unsustainable payment obligations. For instance, subsidizing loss-making public transit projects strains budgets, necessitating debt issuance to cover gaps.

Viability Gap Funding (VGF) Pressures: Projects with partial user-pay revenues rely on government subsidies to bridge financial shortfalls. Unanticipated revenue declines — due to economic downturns or policy shifts — increase subsidy demands, exacerbating fiscal deficits.

Collateral Fiscal Risks: Land concessions, asset disposals, or direct fiscal injections to salvage struggling projects indirectly inflate local debt.[4]

2.2.2 Financial System Vulnerabilities due to local debt risk to financial risks

Bank Exposure: Commercial banks, as primary holders of local government bonds and lenders to financing platforms, face direct losses from defaults. For example, a province's fiscal crisis could render its bonds worthless, eroding bank capital adequacy.

Liquidity Crunches: Overleveraged local debt markets risk illiquidity, forcing fire sales of assets and credit contraction. Investor panic may trigger bond yield spikes, destabilizing interbank markets.

Systemic Contagion: Rising risk premiums, capital flight, and inter-institutional linkages amplify vulnerabilities, potentially cascading into broader financial crises.[5]

3. Post-Reform PPP Risk Dynamics

3.1 Regulatory Overhaul Under Document No. 115

Unified Oversight: The NDRC assumes centralized regulatory authority, eliminating fragmented multi-agency oversight and enhancing policy coherence.

Concession Model Mandate: All new PPP projects must adopt concession agreements with fixed terms, revenue rights, and private sector participation.

Strict Project Screening: Projects lacking user-pay feasibility or clear revenue streams are excluded, narrowing PPP's scope to commercially viable ventures.

Fiscal Discipline: Government support is restricted to operational subsidies, prohibiting construction cost subsidies or implicit debt guarantees.

3.2 Evolving Risk Transmission Mechanism and Characteristics

Reduced Fiscal Linkages: By curtailing government payment obligations, the reform limits direct fiscal risk transmission.

Market-Driven Risk Exposure: Projects now hinge on user demand and operational efficiency, shifting risks from governments to private entities.

Emerging Risk Catalysts: Inadequate demand forecasting, technological obsolescence, or managerial incompetence replace fiscal guarantees as primary risk drivers.

Accelerated Risk Propagation: Market sensitivity amplifies the speed at which operational failures transmit risks across stakeholders, including lenders, investors, and service providers.

Heightened Market Volatility: Revenue streams tied to user payments expose projects to demand shocks, price fluctuations, and competitive pressures.

Pre-Implementation Vulnerabilities: Rigorous feasibility assessments elevate the stakes of early-stage planning; flawed projections may doom projects before breaking ground.

Increased Operational Risks: Extended concession periods intensify challenges such as maintenance costs, technological upgrades, and regulatory compliance.

4. Persistent Challenges Under the New Mechanism

4.1 Structural Incentives for Risk

Fiscal Imbalances Unaddressed: Local governments' chronic revenue-expenditure mismatches persist, perpetuating reliance on PPP as a financing tool rather than a service delivery mechanism.

Regulatory Fragmentation: Overlapping mandates, inconsistent standards, and inadequate enforcement undermine the NDRC's centralized oversight, allowing loopholes for non-compliant practices.

4.2 Unaltered Economic Realities

Direct Risk Channels: Financial institutions remain exposed to PPP risks through loans, bonds, and equity investments. Policy non-compliance or project failures may trigger abrupt credit withdrawals, destabilizing projects.

Indirect Contagion Pathways: Local debt crises, liquidity crunches, or investor panic retain their capacity to transmit shocks across financial systems, echoing pre-reform dynamics.

5. Conclusion and Policy Implications

The 2023 PPP reforms mark a significant stride toward curbing fiscal profligacy and aligning projects with market principles. By narrowing project scope, emphasizing user-pay models, and centralizing oversight, the new mechanism reduces direct linkages between PPP and public debt. However, structural fiscal imbalances, regulatory gaps, and inherent market uncertainties make that financial risks persist, albeit through altered transmission channels.

Key recommendations include:

Enhancing Regulatory Capacity: Investing in digital monitoring tools, third-party audits, and inter-agency coordination to close oversight gaps.

Promoting Market Discipline: Encouraging private sector innovation, risk-sharing, and transparency to mitigate operational and financial vulnerabilities.

Ultimately, the sustainability of PPPs hinges on balancing public service objectives with market realities. While the new mechanism mitigates certain risks, vigilance remains imperative to prevent systemic financial disruptions and ensure PPPs fulfill their transformative potential.

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