

# Financial Relationship between Chinese Central and Local Governments after Reform and Open-door Policy

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**Abstract:** The economic achievements that China has made in recent years recognise the contributions of its financial reform. The adjustments of the financial relationship between the central and local governments at the provincial level were appropriate with the economic development's new requirements, ensuring the nature of political centralisation, and partly showing the mind-set of country management throughout the Chinese history. Recent reforms in financial relationship between central and local government of China see the political centralisation maintenance and promoting pilot empowerment in local financial sectors, building theoretical system of central-local financial relationship with Chinese characteristics that lead to the reform of financial transfer regime, tax expropriation regime. This article aims to identify the division of responsibilities and interests between the central and local governments in China and its implications, as well as several Chinese policies to reform and develop the financial relationship between central and local governments at the provincial level.

**Keywords:** Finance, relationship, central government, local government, China.

**Subject classification:** Economics

## 1. Introduction

The financial relationship between the central and local governments can be considered part of the intergovernmental relations, implying the multi-dimensional and complex relationship between governments. In China, such relationship is acknowledged between administrative agencies at all levels, i.e., between central and local governments. "The relationship includes relations in terms of power, function, policy, supervision, tax, budget, law, and justice, among others." (Lin Shang Li, 1998, pp.70-71). According to Article 3 of the 2014 Budget Law of the People's Republic of China, the country has five levels of

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budgets corresponding to the central level and four levels of local governments, that is i) the central government; ii) provinces (including autonomous regions and affiliated cities); iii) cities directly under provinces and autonomous regions; iv) districts, autonomous districts, cities under districts, and cities under counties; and v) townships, ethnic townships, and towns (Budget Law amended in 2014).

As the exceedingly complex and multi-layered system of financial relationship between the central and local governments has been shown, the author only analyses some aspects within the scope of this article regarding the right to make budget estimates, financial expenditure tasks, tax collection, and benefit distribution; as well as some reforms in financial relations between the central and local governments at provincial levels in China after the 19<sup>th</sup> National Congress of the Chinese Communist Party.

## **2. Current financial relationship between central and local governments**

### *2.1. Right to make budget estimates*

China's legal documents from the 1982 Constitution, such as the State Budget Management Charter in the financial contract period to the Budget Law promulgated in 2014 provide that local governments shall be entitled to the right to make budget estimates, arrange collection and expenditure activities in accordance with the yearly financial plan. Further, the local legislatures shall have the power to appraise an approve or veto, amend budget estimates, and approve monitoring mechanism to ensure financial security, as well as to improve the budget efficiency. Nevertheless, all legal procedures, standards, and policy guidelines must be issued by the central government. The Budget Law and regulations, and notices which are prepared by the central government, require the compliance of local governments for the purpose of budget estimates. The central government shall adopt coercive regulations and standards, socio-economic development plans, and working schemes to direct and guide the local budgeting activities. For example, according to Article 31, Paragraph 1 of the 2014 Budget Law (Budget Law amended in 2014), "Concrete matters relating to the compilation of draft budgets shall be arranged by the financial departments under the State Council". It is also stated in Article 32 that, "Agencies and units should base themselves on the regulations on budget estimation such as for revenue and expenditure classification of governments at all levels, budget expenditures standards, and performance objective management which are regulated by the State Council's financial agency, and based on the needs for performance and existing conditions of assets to draft a budget estimate for the agency or unit". This reaffirms China's political unity and economic decentralisation, in which autonomy is given to local budgeting, while on the other hand, emphasising the central governments' leadership, which is considered the inevitable requirement of financial decentralisation in

a country under a unitary institution, as well as the manifestation of the principle of democratic centralism.

Overall, the local governments retain relative independence in making budget estimates, but their autonomy in terms of budget revenues and expenditures is subject to constraints and supervision by the central financial authorities.

## *2.2. Responsibility of financial expenditures*

Since the founding of the People's Republic of China until 1994, the reform of financial decentralisation in the country was implemented only based on documents issued by the Central and State Council. Thus, the financial relationship between the central and the local governments has been only determined in conformity with such non-binding legal documents. These policies have often lacked adjustable sequences and standards and were too subjective, thus repeatedly appearing inadequate when applied in practice. In some cases, the results of bargaining or negotiations on interests happened only between the central and local governments or between localities themselves. According to statistics, before the reform, China made five adjustments to financial institutions in the 1950s, two in the 1960s, and five during 1970-1976, totalling twelve such adjustments within these merely three decades.

In 1994, China unified the tax-sharing financial system, of which the basic principles and contents are "Based on the division of responsibility for public affairs between central and local governments, whereby the scope of financial expenditure at all levels was determined in a reasonable manner; Based on the principle of combining responsibility for public affairs and financial rights, taxes shall be divided into central taxes, local taxes, and general taxes; a central and local tax collection institution shall be built; two systems of taxation and expropriation shall be established; with separate management of central and local governments" (State Council of China, 1993). Under the conditions of a market economy, three major functions shall be implemented by the government, that is resource allocation, income distribution, and economic stability. The resource allocation function is reflected in the ability to provide public goods and services, while public goods and services are characterised by the local or national scope of benefits, thereby determining whether the supplier is central or local. For example, according to the nature of public goods, any goods and services at the national level shall be settled by the central government. In case such good or service contains both national and local characteristics, a joint responsibility shall be applied. Regarding the contribution rate of each specific item, the central government was responsible for spending indirectly or directly. However, if public goods and services are managed by the locality, which could bring greater efficiency due to the advantage of regional information, the local government shall be assigned. The central government then transfers funds for the implementation. The tax reform in 1994 mainly focused on tax division between the central and local governments, thereby improving the income and control capability of the central financial system but this reform did *not seem to pay attention*

*to the division of responsibilities for public issues*, leading to a situation where the central government held too much power regarding financial revenues, despite most of the solving responsibility being transferred to the local governments. In addition to fields like of defence, security, and diplomacy, which are under the central government's responsibility, education, minerals, and non-ferrous metals were transferred to the local governments. Only for some newly arising economic areas, both the central and local governments were jointly responsible. In case the locality lacked funds, these would be allocated by the central government for implementation. According to consolidated data from the statistical yearbook of the National Bureau of Statistics of China, in recent years (China Statistical Yearbook, 2019), the budget revenues at central levels was maintained at a high level with low expenditures. Reversely, the local budget revenues were low but with very high expenditures. If the responsibility for the provision of public products and services by the local governments is imagined as a pyramid, then the financial or budgetary rights are an inverted triangle. Such a situation goes against the original principle of "unified financial rights and responsibilities" of the tax division reform. If the central governments do not have sufficient financial capacities, while their expenditures remain numerous, the macro-regulatory capacity will be reduced, which renders the locality then unable to shoulder important aspects such as national security and diplomacy, also narrowing the regional gap. On the contrary, if there is enough financial potential but a lack of expenditures, the local governments would also suffer under a burden, which could hinder and discourage the economic development. For example, after five years of implementing the tax division regime, the budget revenue in 2000 increased by 17%, and the budget expenditure increased by 20.5%, of which the central governments accounted for 52.2% of the total national budget revenue, and 34.7% of the total national budget expenditure. In 2005, the central revenue and expenditure ratio was 52.3% and 25.9%, respectively, and 51.1% and 17.8% in 2010. By 2010, the central government's budget revenue remained around 50%, while expenditures tended to decrease gradually, since this responsibility was transferred to the local governments. The local budget revenue since 2011 has kept pace with and surpassed that of the central one. However, the expenditure ratio has remained unchanged, as the central revenue and expenditure in 2015 were 45.4% and 14.5%, respectively, and 46.6% and 14.8% in 2018 (China Statistical Yearbook, 2019).

The Chinese Communist Party is also aware of this inadequacy, thus policies to reform the system of separation of powers and responsibilities between the central and local governments have been launched since 2006. On 11 October 2006, the sixth Plenum of the 16<sup>th</sup> Central Committee Congress of the Communist Party of China approved the Decision of the Central Committee of the Communist Party of China on a number of important issues of building a socialist harmonious society; asserting that, for the goal of perfecting the public financial regime and gradually implementing basic and equal public services, it is necessary to "define the responsibility (in the provision of public goods and services) of the central government and local authorities, perfecting a unified financial tax system in harmony with the responsibility for public affairs" (Communist Party of China, 2006). In

2007, the report of the 17<sup>th</sup> National Congress of the Chinese Communist Party emphasised that the goal, “To perfect the institution of harmonisation of responsibilities and financial resources of the central and local levels, and to accelerate the formation of a financial transfer regime in a standardised and transparent manner, improve the proportion and size of financial transfer on a regular basis, and expand investment into public sectors” (Report of the 18<sup>th</sup> National Congress of the Communist Party of China, 2020).

*Financial relations between the central and local governments in China are now adjusted in the direction of clearly demarcating budget expenditure responsibilities.* The financial reform plan raised by the 18<sup>th</sup> National Congress of the Communist Party of China and the third Plenum of the 18<sup>th</sup> Central Committee considered this as one of the three important tasks of financial reform. In August 2016, the State Council officially kicked off the reform by promulgating the “Directive Opinion of the State Council on promoting reform, clearly defining tasks and responsibilities for using the financial budget to provide basic public goods and services and expenditure responsibilities of central and local governments” (Government of the People’s Republic of China, 2016). The directive stated three key requirements of reform, that is: i) Promote the decentralisation of financial rights between the central and local governments in the direction of rationally strengthening the duties and responsibilities of the central government in using the financial budget to provide basic public services and goods and, at the same time, ensuring the tasks belonging to the local governments and gradually reducing as well as defining the common tasks of the central and local governments; ii) Completing the sharing of expenditure responsibilities between the central and local governments in the direction that the central governments shall expend for what they are responsible for, and the local ones shall expend for what they are responsible for; in cases of the common responsibilities shall be jointly expended by both two sides according to the contribution ratio as prescribed; and iii) Strengthening the clear demarcating of tasks and responsibilities in using the financial budget to provide basic public goods and services and expenditure responsibilities of localities at the provincial level.

In January 2018, the Office of the State Council of China issued a notice on reforming the sharing of expenditure responsibilities, the tasks and functions of providing basic public goods and services in the use of state budget, in which three issues were strongly emphasised as follows: Using budget money must correspond to job tasks; the basis for the division of responsibilities must be public issues (including public goods and services); and finally the budgetary responsibility for common tasks lies with the central and local governments. On the surface, this adjustment is aimed at redistributing financial resources, but, it is rearranging work items, clearly defining what shall be done by the central and local governments. Taking the task of providing public goods and services as the basis for determining China’s expenditure responsibility is also in line with the trend in the world and the superiority of the socialist state since the tax revenue is also used to serve the people. China’s 2018 plan pays special attention to fields such as vocational education,

compulsory education, and social security assurance, which are all important issues of the society, specifically:

*Central expenditures:* National defence, armed forces, diplomacy and international aid, central administrative management, infrastructure investment under the unified central management, technical renovation and piloting of new products of central enterprises for management, geological exploration, agricultural support, principal and interest payments for central loans, expenditures by police agencies, and courts and procuratorates at central level, as well as expenditures on culture, education, health, science and technology.

*Local expenditures:* Local administrative management, operational funding of the armed forces, expenditures by local police agencies, courts and procuracies, technical improvement and piloting of new products of local enterprises, agriculture support, and urban construction and maintenance, as well as expenditures on local culture, education and health, price subsidisation, and some other expenditures (Government of the People's Republic of China, 2016).

Although the reform measures are based on “clearly demarcating the budget sources according to separate expenditure tasks between the central and local governments”, the central government still adopts several legal-binding measures to put the local government under control, such as determining expenditure bases, expenditure standards or even coercive items (Budget Law amended in 2014; Law on Agriculture 2003; Law on Progress of Science and Technology amended 2007). Those measures can be mentioned as using the supreme legislative power of the National People's Congress and its Standing Committee, the executive power of the State Council, with the most powerful tool being the right of the absolute leadership of the Central Committee of the Chinese Communist Party. All these measures are legal and comply with the political system, as well as the Chinese constitution, demonstrating the central political power of the central government over the localities.

In the past few years, China has also detailed a series of documents that define the rights, responsibilities, and financial expenditures between the central and local governments in different sectors, such as transportation in 2019<sup>2</sup>, and natural resources, ecological environment, relief and emergency handling, and public culture in 2020. China is promoting the reform of sharing the expenditure responsibilities and financial administration power between the central and local governments. However, there are some shortcomings that need to be further adjusted in the coming time. *First*, China's transition expenditures have not been normative. The transition expenditure regime including tax

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<sup>2</sup> In the transportation sector, China has delineated financial rights and expenditure responsibilities in six major categories: road, waterway, railway, aviation, post, and mixed traffic, strengthening the central management and expenditure responsibility on national highways, roads at national border gates, transportation airports, waterways at border gates, interconnected bridges, and roads between two countries. Besides this, some items such as civil airports, which were jointly managed by both central and local governments, have now been transferred to localities.

refund, special, and regular transition expenditure is mainly to solve the financial imbalance between the central and local governments caused by the disparity of economic development across regions. Nevertheless, the transition expenditure regime currently no longer meets the needs of socio-economic development, while not being properly distributed among regions, and maintaining a too large proportion for special transition expenditure. In addition, the inadequate management and supervision of transition expenditures could cause appropriation of funds. *Second*, the lack of professional regulations for the division of administrative powers among the local governments could create an unstable situation. *Third*, the financial conflict between the central and local governments is more and more deepening since the proportion of the central budget revenue in total budget revenue continues to decrease, with the core of which being the rapid growth of the local economy. Local governments do not make every effort in the tax collection process to keep their piece of the cake from being taken away by central governments due to the fear that, if they pay more than the quota assigned in this year, they would be requested to pay even higher rates for the next year.

### *2.3. Right of financial collection*

#### *- Legislative power over taxes (tax making power)*

In China, the body with legislative power over tax collection is currently the National People's Congress and its Standing Committees, but they practically empower executive bodies such as the State Council, the Ministry of Finance, and the State Taxation Administration to develop and promulgate most of the legal documents on tax. Considering the relationship between the central and local governments, the decision-making power rests with the central government.

It was asserted at the very first legal documents promulgated in 1993 as: "The legislative power over taxes belongs to the central government, local taxes, and general taxes (central and local) are concentrated in the central government"; "The legislative power for central taxes and local taxes being implemented across the country is concentrated at the central government." Thus, all tax laws, regulations, charters, and implementation guidelines at local levels are uniformly formulated and promulgated by the central government.

Preferential policies on tax collection, tax exemption, and reduction are decided by the central government. Although the Chinese constitution contains provisions for the National People's Congress and Standing Committees of provinces, autonomous regions, and municipalities directly under the jurisdiction of the People's Republic of China, in case the constitution, laws and administrative regulations are not appropriate with the actual local situation, possibly developing local legal-binding regulations, but this provision is basically impossible to be implemented. At present, the National People's Congress only

empowers Hainan province, ethnic autonomous regions of provinces, and Shenzhen special economic zone to develop local tax legislation. The Legislative Law clearly states that: “The tax legislation is the power that only belongs to the National People’s Congress and the Standing Committee of the National People’s Congress. The local governments are not entitled to the right to collect taxes separately” (Qian, Y. & Roland, G., 1998, Vol. 88, No. 12, pp.782-799). For a country as large and powerful as China, this can be considered a pity, because localities are unable to promote the advantage of possessing their abundant income sources. Each locality has its own socio-economic characteristics, and tax revenue sources also have its own characteristics accordingly. The disapproval of the tax making power could be considered a waste of this potential source of revenue. On the other hand, the central government has agreed on the types of taxes to be collected throughout the country, but in some localities, this source of revenue may not exist, or is inadequately collected. Consequently, what should be collected is not collected, whereas unnecessary or unworthy taxes being collected is uncondusive to promoting the activeness and initiative in ensuring the local budget.

Since the local tax revenues in China are abundant, to partially overcome the inefficiencies of tax making across the country, the central government has to reserve a certain amount of space for localities in its legislation. The 2016 Law on Environmental Protection, which was revised in 2018, has allowed localities to participate in the regulation of payable tax rates in Article 6, and in determining the objective basis of the tax collection in Article 9 (Environmental Protection Law 2016, revised in 2018).

With the new tax division regime, since 1994, China has accelerated the implementation of the open reform, moving steadily towards a market economy.

*- Right to tax collection and benefit distribution*

According to the Chinese legal provisions, the power of tax authorities in tax collection and management and supervision of tax collection activities is very specific (Gao Ya Jun, 2012, p.24), of which the core is the right to tax collection. One of the contents prescribed when implementing tax sharing in 1994 was to establish a system of organisations and units according to a decentralised model, with the tax authority playing the leading role, in coordination with administrative and custom agencies, in charge of tax collection and management. This approach aims to reduce the burden of management and supervision of the central government, promote the advantage of being close to the locals, and grasp the local situations under the management of the local government while ensuring the right to enjoy the benefits from collected taxes. This is because in terms of the distribution of benefits from the tax collection, it is reflected in the classification of the collected tax as belonging to the central or local governments or both according to the prescribed distribution ratio (see Table 1) (Budget Law amended in 2014). Tax demarcating now becomes “sharing”, in which the decision-making power is completely concentrated in the hand of the central government.

Table 1: Statistics of Some Main Sources of Financial Revenues

CLASSIFICATION		
Fixed revenues of central governments	Common revenues*	Fixed revenues of local governments
Tariffs (import and export duties);	Value added tax, corporate tax	Corporate tax (excluding corporate tax belonging to the central government);
VAT collected by customs;		Personal income tax;
Consumption tax;		Property tax;
Registration fee of securities transactions;		Business profits of local companies;
State enterprise income tax;		City land use tax;
Railway tax;		Tax on use of vehicles and boats;
Registration fee of securities transactions;		Tax on adjustment of investment direction of fixed assets;
Corporate income tax of local banks and foreign-invested banks, non-banking financial institutions;		Local corporate income tax (excluding the central tax collection mentioned above);
Corporate tax, income tax, profits, and urban construction protection tax of the headquarters of banks, insurance corporations.		Urban construction protection tax (excluding the central taxes);
		Land value-added tax;
		Tax on appropriation of arable land;
		Contract tax;
		Environmental protection law;
		Tobacco tax.

*Source:* Budget Law of the People’s Republic of China, amended in 2014.

\* For some tax revenues from special subjects, which are not considered official common tax revenue sources, such as local corporate income tax, the central government shall collect taxes from banks, as shown in Table 2.

Financial revenues belonging to the local governments will normally be collected by them, in addition to common parts collected directly by the central ones. However, after the China’s merging of central and local tax authorities in 2018, which ended the separate operation of the two systems since 1994, the tax system is governed by the central level. Some fees and non-tax incomes are to be collected by the central government, which means that the financial autonomy of the central government is narrowed. Furthermore, for

tax revenue sources that are autonomously proposed by the local governments - including non-tax revenues - although not directly abolished, the central government may, under the unified management right of the State Council, request the local to settle in the form of “a decision made by the upper level must be complied by the lower level”. This additionally shows the limitation of the local financial autonomy, reflected in the right to expropriate taxes and profit from taxes and fees. For example, the Ministry of Finance and the National Reform Commission issued the “Notice on normative shakedown in a number of policies related to administrative fee collection” in 2017, which requested financial departments of provinces, autonomous regions, affiliated cities, and related agencies to carry out a streamlined review of administrative fee collection policies in their localities.

Table 2: Tax Sharing Rates between Central and Local Governments Applied for Some Common Taxes

*Unit: %*

Tax types	VAT <sup>3</sup>	Corporate income tax	Personal income tax	Resource tax <sup>4</sup>	Business tax
Central	50	60	60	2.7	50
Local	50	40	40	97.3	50

*Source:* Budget Law of the People’s Republic of China, amended in 2014.

In conclusion, the current tax division regime has shaped the financial relationship between the central and local governments in a way that is consistent with the changes from the planned economic institution to the market economy and, at the same time, ensures the unified and centralised management of the central government and the centralisation of political power in parallel with the decentralisation of the economy. The central government’s budget deficit caused by the financial contract policy in the early years of reform and opening-up has been resolved.

Despite that, the tax sharing system also brings many problems affecting the financial relationship between the central and local governments. These are, the decrease of financial revenue of the local government, and the disproportionate financial capacity to public issues under responsibilities. Such problems are more and more serious at the local governments, where the burden of providing public goods and services confronts some

<sup>3</sup> All VAT collected by customs belongs to the central tax agency.

<sup>4</sup> The rest of resource tax collected by the central governments from offshore oil companies belongs to the local government. The sharing ratio shall be calculated according to the specific data in 2018.

localities with financial shortages. The budget source transferred from higher levels is used to develop infrastructure to create competitive advantages in attracting investment and providing many preferential policies and tax exemptions for manufacturing enterprises. The goal is always towards GDP growth. Even when the central budget becomes more abundant, the central government cannot fully assume the responsibility of providing public goods and services on behalf of the local government, because the fact that China is the largest country by population with 4.4 billion people, makes it difficult for the central government to grasp all issues in different regions thoroughly, without having an advantage in information about people's preferences and needs compared to local authorities. Thereby, there is a requirement to adjust the financial relationship between the central and local governments to harmonise the responsibilities and interests among them, which comes in addition to improving the welfare of the people and facilitating the sustainable development of the region.

The third plenum of the 18<sup>th</sup> Central Committee of the Chinese Communist Party has defined the goal of tax reform, which is “stabilising the tax liability” and “step by step increasing the proportion of direct taxes” (Report of the 18<sup>th</sup> National Congress of the Communist Party of China, 2012). This goal is set by the Chinese government due to the imbalance in the tax regime structure at that time (revenues from indirect tax and business tax accounted for a very high proportion, which distribution of tax burden unfair and hindered the efficient regulation of tax revenue distribution). In addition to the unique application of VAT to all economic sectors (State Council of China, 2016) to avoid double taxation - a move that is expected to reduce tax payments - improving the efficiency of the tax system through adjusting procedures of tax payments and the application of information technology to make the tax payment easier are also aggressively implemented by China.

### **3. Recent reforms in financial relationship between central and local governments**

The report of the 19<sup>th</sup> National Congress of the Chinese Communist Party considers the reforms of the financial relationship of the central and local governments that is the most important task in reforming the financial tax sector, urging to accelerate the development of a modern financial regime and establishing a financial relationship between the central and local governments in which rights and responsibilities are demarcated, financial capacity is harmonised, and localities' development is balanced. As assessed, the current reform implementation has not fulfilled the requirements set forth by the Central Committee of the Chinese Communist Party yet. The very first reasons come from the ambiguous scope of the government's authority and responsibility, and the vagueness within the scope of promoting the role between the State and market, and between the State and society. In addition, the reform progress is considered extremely complicated and arduous, by virtue of its forceful influence on the relationship of interests between the central and local governments, among the government agencies, the market, and the people. The trend of reforming the financial relationship between the central and local

governments in China in the coming time, on the one hand, is to maintain the centralised power of the central government in harmonisation with that of the localities, clearly demarcating the scope of functions and authority of the central and local governments and thereby determining the responsibility of public issue expenditures. On the other hand, it is about financial rights, including the financial transfer support regime and the right to promulgate tax policies and tax expropriation activities.

### *3.1. Maintaining political centralisation and promoting pilot empowerment in local financial sectors*

The supreme and absolute leadership of the Chinese Communist Party is an immutable principle for all major undertakings and policies of China, including the financial sector. Within the utmost power of the central government, no local financial autonomy can exceed the limits set by the central government. Vertical management may not be completely optimal due to inadequacies, but for a large country with a political regime like China, the benefits that it could bring are greater than the inadequacies, while this also helps keeping the unity in activities, ensuring the solidarity and fairness to serve the purpose of national development. Like launching the market economy under the state regulation, the financial empowerment would create chaos if it was uncontrollable. The uneven development between eastern and western provinces, and the differential resources for economic development between coastal provinces and those located in remote areas cannot be solved in a short time. Along with that, if lacking a unified direction and orientation on the guidelines and macro policies, it will inevitably create unfair competition and local phenomena, where the richer provinces will become richer, and the underdeveloped ones rarely have an opportunity to improve their situation.

In addition, the difference in development resources between regions and localities creates favourable conditions for China to pilot the empowerment for several specific regions and localities. In provinces such as Shanghai, Guangdong, and Chongqing, the ethnic autonomous regions, due to their specificities, should be given some special powers, including financial issues, more than other localities. Pilot programmes are generally a common policy implementation method in China, through summarising the experience of piloting in a certain area, it could be replicated to many other areas. The financial reform is a part of the economic reform pilot. Since the 18<sup>th</sup> National Congress of the Chinese Communist Party, the construction of pilot free-trade zones in Shanghai, Guangdong, Tian Tan, and Fujian has been boosted harder than ever. In the 1980s, China did allow pilot special economic zones in Shenzhen, Zhuhai, Shantou in Guangdong Province, and Xiamen in Fujian Province. The central government then gave these cities some special powers in implementing foreign economic activities, with prominent features including the fixed rate regime for finance and foreign exchange earnings; rationally applying the regulation of the market for materials and trade; as well as expanding rights in terms of planning, pricing, and workers' wages. The management of special economic zones was

entitled to apply institutions and policies that dissimilar to those of other localities (Tiebout, M. C., 1956).

### *3.2. Building theoretical system of central-local financial relationship with Chinese characteristics*

The financial relationship between the central and local governments in China has constantly been adjusted to suit the country's economic institutional reforms. From the perspective of power, the financial relations between the Chinese central and local governments avail two states of agreement and intervention. Any adjustment to the extent of the agreement or intervention directly affects the substance of such financial relationship. "Agreement", means that the central government accepts the decentralisation of powers to the locality and decides the scope and extent of its remaining power. As for the second state, "intervention" refers to the ability to interfere in the local government's regulations and regimes, in which maintaining this ability, in other words, is the absolute authority of the central government and the characteristic requirement of socialism with Chinese characteristics. This is also an advantage of the regime, which helps China to concentrate resources adequately to solve significant national issues and is an important basis for China to let some of the people get rich first, before all people become rich with their help. At the same time, the nature of the financial relationship between the central and local governments is also reflected here, which means, on the one hand, promoting the activeness of the local government in the financial sector, while still ensuring the absolute authority of the central government, on the other hand. In 2019, the State Council of China promulgated a series of sharing plans in the fields of education, health, and transportation, among others.

### *3.3. Reform of financial transfer regime*

Financial transfers include the transfer of corporate and government expenditures, but in China it mainly refers to the transfer of financial capital between governments, which is a part of the financial expenditure of the Chinese government. Funds that are supported by the governments at higher level allocated to the lower governments are considered a crucial source of local budgets. It is in essence a redistributive policy of public financial resources in line with the financial regime with Chinese characteristics, which plays a substantial role in regulating the financial relationship between the central and local governments (Ye Shan, 2012, No. 4, pp.782-799). On 3 August 2020, the State Council of China announced the revised Statutes on the Implementation of the Budget Law of the People's Republic of China, effective from 1 October 2020, setting out several regulations over the financial transfer regime. These comprise: *first*, clearly defining the scope of normal financial transfers, regulating normal financial transfers including peer-to-peer financial transfers, and providing additional financial support for the former revolutionary

areas, ethnic areas, border areas, and disadvantaged areas. Other financial transfers are considered normal; *second*, establishing and strengthening a mechanism for the assessment and recovery of special financial transfer payments; *third*, normatively regulating the transfer of financial estimates to lower levels, clearly defining that both the transfer of estimates and financial expenditures should be handled by Ministry of Finance's departments (Yunnan Provincial People's Air Defense Office, 2021).

### *3.4. Reform of tax expropriation regime*

The reform in tax expropriation activities was mentioned in the "Plan to deepen the organisational reform of the Party and State" launched by the Central Committee of the Party in 2018, to solve the shortcomings arising in the separated systems of central and local tax expropriation that are formed together with the tax sharing system after nearly 24 years, which is in line with the current economic development situation in China. Its specific content is to merge the central tax authorities at the provincial and sub-provincial levels with the local tax authorities, implementing a parallel management mechanism between the State Taxation Administration and the provincial governments. This merging would bring many advantages to taxpayers, as well as tax collection agencies, and helps to reduce the operating costs of tax collection agencies. The organisational structure of the tax system is streamlined in the direction of increasing efficiency and effectiveness, and taxpayers do not have to submit documents to many places. Besides this, standards of tax expropriation and administration activities are subject to unification, which improves the management efficiency. In addition, the merging will also help optimise and mobilise resources, human resources, financial resources, and techniques to improve the service quality, thereby reducing the inconvenience or anxiety for taxpayers when paying taxes.

## **4. Conclusion**

Researching the financial relationship between the central and local governments is crucial in promoting and motivating localities for socio-economic development and, at the same time, creating a harmonious development between the central and local governments. In order to promote effective financial reform, it is necessary to not only reform the tax regime or tax estimates, but to also reform overall issues including tax regime and tax estimates reform, adjusting the relationship between the central and local governments, especially to solve the distribution relationship between the central and local governments. In the coming time, the Chinese government must continue to reform the financial relationship between the central and local governments in a more deeply and substantively manner to keep up with the national economic development in the context that many potential risks still emerge in the economy.

**Note:** Translator: Do Quynh Nga. Language editor: Etienne Mahler.

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