

The Centenary of the CPC: Exploration and Improvement of Central-Local Economic Relationship

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Abstract: Decentralization is a global phenomenon, but growth is not. The economic relationship between central and local governments is an important yet unresolved question in China's economic development. As a large country with unbalanced political and economic development, China is faced with unbalanced and inadequate development as the primary constraint to meeting people's ever-growing needs for a better life. The Communist Party of China (CPC) has been exploring to mobilize the initiatives of both central and local governments. During the planned economy era, China experienced a few rounds of centralization of economic powers but failed to strike a balance in maximizing the initiatives of both central and local governments. After the reform and opening up policy enacted in 1978, China's central and local governments have succeeded in combining economic decentralization with administrative decentralization. China's central government, local governments and enterprises have become resource allocation entities. China's economic growth miracle has been driven by promoting the initiatives of central and local governments. Entering the new era, the central-local economic relationship represents an institutional strength of concentrating resources to accomplish great undertakings and leveraging the initiatives of both central and local governments. With the principal contradiction facing China's development shifted into one between people's growing needs for a better life and unbalanced and inadequate development, the management of central and local government relationship has taken on greater theoretical significance and salient implications in the new era.

Keywords: economic relationship, coordinated regional development, fiscal and taxation system, national governance system

JEL Classification Code: H1

DOI: 10.19602/j.chinaeconomist.2021.11.04

1. Introduction

The relationship between central and local governments is a historical concept, the heart of which is economic relationship. As a large country, China's economic development is highly uneven. The management of central and local economic relationship is a key issue to be addressed by the Communist Party of China (CPC). Upon the founding of the People's Republic of China, Mao Zedong analyzed the relationship between central and local governments in *On the 10 Major Relationships*, putting forth the important thought of giving play to the initiatives of both central and local governments. Since

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Acknowledgement: This paper is supported by the major project of the National Social Science Fund of China (NSSFC) (Grant No.2019MZ019) and the major project of philosophical and social science research of the Ministry of Education (Grant No.17DZJ011).

the reform and opening up policy was enacted in 1978, the Party has relentlessly explored central-local economic relationship and come up with a wealth of creative ideas, policies and strategies that served as scientific guidance for the CPC to properly handle the central-local relationship. Since the 18th CPC National Congress, the CPC Central Committee with General Secretary Xi Jinping as the core has made great efforts to address the contradiction of unbalanced and inadequate development surrounding the modernization of the national governance system and capabilities in light of China's national conditions. By deepening fiscal reforms and modernizing the fiscal system, China has reshaped the central-local economic relationship with explicit rights and responsibilities and balanced fiscal powers and regional development. Instead of either centralizing or decentralizing administrative powers or doing both alternatively, the keynote for adjusting central-local economic relationship in the new era is to give full play to the "two initiatives" on the basis of maintaining the central government's authority and leadership. For this reason, General Secretary Xi Jinping has repeatedly highlighted the importance to fully leverage the initiatives of central and local governments, especially the initiative of people, underscore the authority of the central government, and maximize the institutional strength of concentrating resources to accomplish great undertakings.

The CPC has always attached great importance to the central-local relationship. Upon its founding, the CPC regarded the structure and form of the government as an important question in the development of revolutionary theories and adopted an initial vision to create a "liberal federal system." Around the May Fourth Movement in 1919, the CPC's early leaders including Li Dazhao and Mao Zedong made meaningful explorations of the federal system. Li Dazhao recognized the federal system as a "shortcut to national unification" (Li, 1984), and "federalism is the only path to transforming a new China" (the United Front Work Department of the CPC Central Committee, 1991). During his leadership of communist movement in Hunan Province, Mao Zedong advocated Hunan's autonomy, calling for establishing a "Republic of Hunan". Due to the limitation of historic conditions at the time, such ideal was only an expediency for achieving national unification and unrealistic due to its natural flaw. In 1922, the *Declaration of the Second CPC National Congress* put forth a vision to "establish the Federal Republic of China" (Party Literature Research Office of the CPC Central Committee, 1989). Under the CPC-Kuomintang cooperation, the CPC had been in favor of managing central-local relationship on the basis of local autonomy until 1927, putting forth various local autonomy proposals such as "autonomy of cities and countryside", "rural autonomous agencies", "provincial people's autonomous governments" and "complete autonomy of counties, cities and townships" (Li, 2004). In 1931 and 1934, the *Outline of the Constitution of the Chinese Soviet Republic* drafted under the CPC's leadership called for establishing the "Soviet Federation of China."

In May 1935, the Fourth Front Army established the Northwest Federal Government, along with a republic under its control, reflecting the characteristics of the federal system. In this period, the central government authorities were the National Soviet Congress and the Central Executive Committee. Local Soviet authorities at provincial, county, district and township levels were in absolute obedience to the central authorities. In economic affairs, in particular, local fiscal revenues were submitted to the central authorities. During the War of Resistance against Japanese Aggression, the CPC experimented with local government autonomy in the border region under the National United Front against Japanese Aggression. As special administrative regions under the national government, border region authorities accepted "guidance" from the national central government under the theoretical basis of "local autonomy" followed by the Party (Yang, 2011). After the victory of the War of Resistance against Japanese Aggression, China needed a powerful central government to break through "mountain-strongholds" and unify government orders. In this context, centralized authorities were established in the liberated areas. In October 1949, the CPC Central Committee made a decision to "unify all powers across the nation that can and must be unified to the Central Committee", emphasizing that "all policies of the Central Committee must be implemented without reservation, and without the consent of the central government,

cannot be modified by any low-level authority at its discretion” (Mao, 1996). Meanwhile, the system of work report to the Central Committee was put into place. “For each bureau or sub-bureau of the Central Committee, the secretary is responsible for submitting to the Central Committee and its chairman a comprehensive bi-monthly report (written by himself, not by his assistants)” (Mao, 1991). With changing revolutionary situation and deepening understanding of China’s national conditions during the new democratic revolution, the CPC readjusted the structure and form of state governance and the positions of central and local authorities. Those efforts laid the groundwork for establishing a new central-local relationship and unveiled the CPC’s great historic journey of exploring the central-local relationship.

2. CPC’s Exploration of Central-Local Economic Relationship in the Planned Economy Era

After the founding of the People’s Republic of China in 1949, the CPC’s first-generation leadership made initial explorations of the central-local economic relationship, and formed a highly centralized planned governance system with unified and hierarchical fiscal management. Around the Eighth CPC National Congress, Mao Zedong attempted to decentralize power. Due to the excessive and hasty decentralization during the Great Leap Forward, however, the CPC Central Committee had to take back powers devolved to local authorities. Since then, the central-local economic relationship had been lingering between centralization and decentralization and stuck in the old pattern of administrative affiliation. Attempts to mobilize local initiative often fell in a vicious cycle where centralization stifled local initiative and decentralization led to chaos.

2.1 CPC’s Exploration of Central-Local Economic Relationship in the 1950s

On the eve of the founding of People’s Republic of China in 1949, the war-ravaged national economy was on the brink of collapse. The CPC Central Committee set out to adjust the central-local fiscal economic relationship to secure the victory of the Liberation War, hold down inflation, and stabilize finance and price. In July 1949, the Central Financial Affairs Committee was organized to straighten out the central-local fiscal relationship. On November 15 of the same year, Chen Yun noted at the fourth session of the Central Finance Affairs Committee that “Price problems are fundamentally driven by an imbalance between fiscal income and spending. Our policy should aim to reduce deficit. Specific methods should include: (i) Spend less. Except for essential military and government costs, all other expenditures should be reduced as much as possible; (ii) increase revenues. We should firstly beef up tax revenue and secondly raise public debt; (iii) tighten control. The masses should be mobilized to regulate and supervise private businesses” (Party Literature Research Office of the CPC Central Committee, 2000a). In December of the same year, Chen Yun further suggested that “Fiscal and economic affairs should be brought under unified management” (Chen, 1995).

In March 1950, the Government Administration Council issued *Decisions on Unifying National Fiscal and Economic Work* and *Decision on the Unified Management of Fiscal Income and Spending in 1950* to implement a highly centralized fiscal system with “unified income and spending.” Subsequently, central and local economic authorities also started to make adjustments. In March 1951, the Government Administration Council divided fiscal responsibilities into three levels of central, greater regional and provincial authorities. In November 1952, China established the State Planning Commission parallel to the Government Administration Council.

On November 15, the People’s Governments of Grand Administrative Regions (the Military and Political Affairs Committee) were reformed into the Administrative Commissions of Grand Administrative Regions and downgraded from tier-one authorities to local offices of the central government. Meanwhile, the central government canceled and merged administrative offices and provinces and downgraded municipalities into cities. Accordingly, the central government created

an authority in charge of economic affairs, thus forming a centralized and unified management pattern. In the First Five-Year Plan period since 1953, the central government withdrew the economic administration function of the Grand Administrative Regions, and additionally created county-level public finance. The State Public Finance implemented an administrative system at the central, provincial and municipal levels. In 1954, the Central Committee abolished the Administrative Commissions of Grand Administrative Regions, and replaced them with provincial governments. This reform enhanced the central government's control and authority over provincial authorities.

2.1.1 Formation of a highly centralized fiscal management system

Based on the public ownership of the means of production, China's fiscal management system was highly centralized with "two lines of revenue and expenditure." With the rearrangement and adjustment of central and local economic authorities, the central-local economic relationship also underwent adjustment accordingly.

First, the fiscal management system. In August 1953, Zhou Enlai identified the principles and tasks for improving the budgetary management system at the National Fiscal and Economic Work Conference: The scope and share of central and local revenues and spending should be divided reasonably, and a three-tier budgetary system should be implemented within the unified state budget. In 1954, Deng Xiaoping put forth the "six principles" as a further instruction on the division of central and local fiscal public finance, and China started to implement a fiscal management system of "unified leadership, division of income and spending responsibilities, and determination of central-local distribution ratio for different types of fiscal revenues under classified management." By dividing the scope of central-local fiscal spending, state budget was divided into fixed revenue, revenue subject to fixed distribution ratio, and cross-regionally allocated revenue, which ensured fixed revenue sources for local governments, expanded local economic administrative powers, and mobilized the limited initiative of local governments.

Second, economic administration. Under the planned economic system, the whole country was a large socialized factory, in which the government was the headquarters, "enterprises" were just workshops or workgroups of the large state factory, and the state was in charge of anything from human resources to finance, materials, production, supply and distribution of state-owned enterprises (Wu, 2010). Financial reforms centralized financial administration powers by putting the People's Bank of China (PBoC) - China's central bank - in charge of capital allocation, supervision, administration, and especially over capital construction investments. After the socialist transformation of the private ownership of the means of production, China's socialist development required more financial and material resources already in shortage. In this context, the central government took over economic powers from local governments in the late stage of the First Five-Year Plan period. For instance, there were 227 types of materials subject to allocation planning in 1953, which increased to 532 types by 1957 (Bo, 1991).

Lastly, government functions. Among the 17 departments newly established by the State Council at the end of 1956, most were economic administration institutions (Wu, 2006). Hence, the central-local economic relationship morphed into a highly centralized economic system dominated by departmental administration.

2.1.2 Mao Zedong's thought of giving play to "two initiatives"

The period from the founding of the People's Republic of China in 1949 to the First Five-Year Plan marked the formation of China's highly centralized economic system. With most economic powers at the central level, the state allocated resources to individual workshops, similar to the headquarters of a large corporation. The central government mobilized limited resources to accomplish key projects, including the 156 construction projects aided by the Soviet Union in the First Five-Year Plan period. Yet the

concentration of administrative affairs presented high costs of information and supervision, resulting in a supply-demand mismatch and economic inefficiencies. With longer administrative chains came greater administrative challenges. Detailed and complex regulatory work diverted the central government's attention from macroeconomic regulation. Horizontal segmentation led to a mismatch between regional economic and departmental targets, resulting in an expansion of capital construction investment and an imbalanced industrial structure. In the First Five-Year Plan period, China's capital investment surged and exceeded 25% of national income, resulting in a serious waste of resources and inefficient growth.

Aware of the defects of centralization, Mao Zedong decided to blaze a trail of economic development in light of China's actual conditions. In April 1956, Mao put forth the importance thought of "two initiatives" in his speech entitled *On the 10 Major Relationships*. Proceeding from China's national conditions, Mao Zedong regarded the central-local relationship as a contradiction. "Our territory is so vast, our population is so large and the conditions are so complex that it is far better to have the initiative coming from both the central and the local authorities than from one source alone" (Mao, 1999a). Yet Mao did not negate the unified leadership of the central government. "To build a powerful socialist country", he said, "we must have a strong and unified central leadership and must have unified national planning and discipline; disruption of this indispensable unity is impermissible" (Mao, 1999b). As a result of the leftist "Great Leap Forward" movement in economic life, however, this important thought of Mao Zedong was not put into practice. Instead, a large-scale movement to decentralize power swept across the nation.

2.1.3 Attempts to decentralize power during the Great Leap Forward

After a thrilling success of the First Five-Year Plan, China launched the Second Five-Year Plan in 1958. To overcome the rightist conservative ideas within the Party, Mao Zedong convened a series of meetings to criticize voices against "adventurous advance." At a meeting in Hangzhou on January 3 and another in Nanjing on January 11, Mao Zedong sharply criticized those voices. He attempted to accelerate economic development by decentralizing power. In February, he remarked at a Spring Festival party held with the CPC Central Committee that "Too much centralization of power will restrain productivity. This question concerns the relationship between the superstructure and the economic base. I have been always in favor of a 'republic with powerless monarch.' While the central government needs to take care of some affairs, it cannot go too far. Large chunks of work should be left to provincial and municipal authorities, which will do a better job compared with ours. We should trust them." "Industry, agriculture (which used to be a local affair), finance, commerce and culture and education were all devolved" (Bo, 1997).

In the whole year of 1958, the CPC Central Committee and the State Council held many rounds of meetings to expand the scope of local economic management and accelerate the Great Leap Forward of the economy. While the central government was responsible to review and approve ultra-large construction projects, local large projects were subject to record filing at the State Planning Commission, and the projects of small and medium-sized enterprises were not required to be reported. In just over ten days, the number of enterprises and public institutions affiliated to the central government - including key enterprises concerning national economic lifeline in such sectors as railway, transportation, post and telecom, aviation and sea ports, reduced from over 9,300 to 1,200, down 88%. By the end of 1958, fiscal resources at the disposal of the central government accounted for only 20% of the total budget (Liu, 1984). In tandem with decentralization, the number of State Council departments also reduced from 81 to 60 by the end of 1959, including the reduction of departments in charge of economic administration from 50 to 36 (Liu, 2003). The central government divided the whole country into seven collaborative regions, including North China, South China, Central China, East China, Northeast, Northwest and Southwest. The powers of planning and decision-making, fiscal management and capital construction investment were devolved on a massive scale to establish an economic system of independent and self-

balanced regions. Decentralization of power to local authorities peaked. According to statistics, 88% of enterprises under central ministries were devolved to local governments. Massive devolution of state-owned enterprise led to chaotic segmentation between regions, posing great challenges to the central authority.

2.2 Adjustment of Central-Local Economic Relationship in the 1960s-1970s

During the Great Leap Forward, leftist ideology held sway in the economic sphere. Drastic decentralization and change in the political superstructure were disproportionate to productivity development. As a result, serious imbalance occurred in the proportion of economic sectors, and the economy underwent turmoil. In 1959, the central authorities took back various fiscal and economic planning powers devolved to the local level during the Great Leap Forward. In January 1961, the central authorities launched a campaign to “adjust, consolidate, enrich and improve” the economy. After re-centralizing economic, fiscal and administrative powers by 1965, China’s aggregate industrial and agricultural output increased sharply, fiscal income and spending became rebalanced, and the economy recovered across the board.

Mao Zedong became dissatisfied with the re-centralization of power. On March 12, 1966, he said in a letter to Liu Shaoqi that “We should fight for some machinery manufacturing rights for localities and approve local retention.” “We must not concentrate everything in the hands of the central authorities, shackling the local authorities and denying them the right to independent action” (Mao, 1999b). On March 20, he said at the Hangzhou meeting that “The central government should be a republic with powerless monarch and only take care of general guidelines, policies and plans. The central government should be called the factory of plans because it deals with guidelines and principles rather than substantive matters. Even if it takes charge of substantive matters, those matters should be as few as possible. The Central Bureau and provincial, prefectural and county-level authorities should seek opinions from lower-level subordinates and when everyone agrees, make those plans. That is a relatively reliable way. We must make plans relying on typical facts and our mind and make good materials based on practice. In this manner, local authorities should work with the central government to set principles, policies and plans. The central government only produces the spirit. Central planning should be combined with local planning. No control should be stifling, whether it is from central or local authorities or government planning. In a word, we should not leave no room for flexibility” (Party Literature Research Office of the CPC Central Committee, 2013).

Under the interference of ultra-leftist fervor, however, the 11th Plenum of the Eighth CPC Central Committee adopted the *Decisions on the Proletarian Cultural Revolution*, calling upon the Party’s organizations at all levels to “put daring above all else and mobilize the masses”, demanding them to practice the policy of “grasping revolution and promoting production” (Party Literature Research Office of the CPC Central Committee, 2011). In this period, Revolutionary Committees in charge of rebellion and seizing power were regarded as “newborn things”; central leadership exercised by the central authorities and various departments over the economy was criticized as “vertical dictatorship” to be overthrown; the central-local relationship was distorted as localities overrode central authorities. With the ill-intentioned misinformation by the Gang of the Four, the central-local economic relationship became distorted with administrative powers taken over by localities.

2.2.1 Adjustment of central and local economic powers

During the Cultural Revolution of 1966-1976, the tumultuous situations of sidelining numerous cadres, waging an “all-out civil war” and “rebellious against everything” occurred. In 1967 and 1968, the economic sphere was in a mass turmoil, and the planned system failed to function. Because no economic plan could be drafted, the year 1968 became the only year without planning in the history of China’s planned economic system. Any coordination between central and local authorities for economic

development was out of the question. China's economy plunged into deep chaos.

First, the powers of enterprise management were blindly devolved to the local level. In 1968, the First Ministry of Light Industry devolved a group of tobacco enterprises to local authorities, and 92 enterprises directly affiliated to the Ministry of Chemical Industry were also devolved. On February 27, 1969, a national planning conference released the *Preliminary Opinion on Reforming the Fiscal Management System (Draft)*, *Preliminary Opinion on the Devolution of Enterprise Management System*, and *Preliminary Opinion on Reforming Material Management System*, which decided to devolve economic powers in three aspects, including fiscal, enterprise and material management. By the second half of 1969, 294 out of 489 enterprises affiliated to the Ministry of Chemical Industry were devolved, and only over 20 enterprises affiliated to the Ministry of Light Industry were not devolved. The Ministry of Coal Industry, the Ministry of Metallurgy Industry, the Ministry of Hydropower Industry and the Ministry of Building Materials Industry devolved enterprises and public institutions in stages. In 1976, the number of industrial enterprises affiliated to central government ministries decreased from 10,533 to 1,600, down 85%, and their share in gross industrial output value decreased from 42.2% to 6%, with 85% of industrial enterprises "banished" to localities (Zhao, 1989). As described by Xin Xiangyang, "Central government economic powers streamed to localities like waterfalls" (Xin, 2000).

Second, the concept of industrial provinces was established. In February 1970, the *Outline of the Fourth Five-year Plan on National Economic Development (Draft)* called upon various provinces, municipalities and autonomous regions to vigorously develop the "five small" industries such as small steel mills and coal mines, and put forth a vision to establish "industrial provinces." Various provinces, municipalities and counties established functional agencies to take over the economic, planning and fiscal powers devolved from central authorities. The whole country was divided into ten economic collaboration zones with independent economic systems. Around 1970, over 2,600 large enterprises and public institutions affiliated to the central government were devolved, and some were even devolved to prefectures, cities and counties. Along with the devolution of enterprise affiliations, powers were also devolved for planning and administration, public finance and taxation, investment and construction, and materials management, giving rise to a "cellular" economic structure.

Third, the powers of material supply and infrastructure administration were devolved. In May 1972, the *Opinions on Enhancing Capital Construction Management* decided to experiment "all-round contract" of capital construction investments and material allocation. In 1974, central authorities made up 40% of total national investment, local authorities made up 30%, and the rest 30% was jointly controlled by central and local authorities. Local authorities increasingly controlled material allocation. In 1972, the types of materials subject to central allocation and ministerial management decreased from 579 in 1966 to 217, and the types of materials subject to unified distribution dropped from 326 to 49, and the types of materials subject to ministerial management decreased from 253 to 168 (NBS, 1983).

Fourth, the economy across the board was straightened out. Since 1975, Deng Xiaoping started to preside over the work of the central government and bring government affairs back to order. The powers of public finance, taxation, material management and enterprise management became concentrated at the central authorities under the banner of the new eight-word principle of "adjustment, reform, straightening out and improvement." As a result, the national economy started to recover. With the bust of the Gang of Four, China's economy returned to normality.

2.2.2 Adjustment of central-local fiscal and administrative powers

In 1966 and 1967, the fiscal system of "revenue linked with spending and total fiscal revenue distribution" became implemented. In 1968, the Cultural Revolution brought havoc to industrial and agricultural production and paralyzed government work. During this trying period, the all-in-one fiscal management system featuring two separate lines of revenue and spending became reinstated. In 1969, the situation of economic development experienced an upturn, and the practice of "linking revenue with

spending, sharing total tax revenue, and annual reassessment of the distribution ratio” became restored. In 1970, the practice of “fixed revenue and spending”, i.e. local authorities were required to hand over a fixed amount of revenue and paid for a fixed amount of expenditure, was introduced in light of increasing budgetary spending due to the decentralization of enterprises and growing local fiscal powers.

From 1971 to 1973, China practiced the revenue and spending contract system of “fixed revenue and spending, guaranteed submission (subsidized difference), retention of surplus, and annual reassessment of the distribution ratio.” Except for the corporate revenue, tariff income and expenditures subject to management by the central authorities, all the rest revenue and spending powers were devolved to localities. This round of power decentralization is referred to as the second large-scale fiscal decentralization experiment under the planned economic system (Hu, 2001). Under this system, the surplus was all left to local authorities, encouraging them to raise revenue and cut spending. Yet uneven economic development across regions meant that some localities had more while others had fewer surplus revenues, and still others were running deficits. In the end, the shortfalls were all covered by the central government, adding to the pressures of central fiscal spending.

From 1974 to 1975, China implemented a revenue sharing and spending quota system with “revenue retention at a fixed ratio, surplus revenue distribution at a floating ratio, and spending quota contract.” Fixed revenue retention ratios averaged 2.3% for various provinces, and surplus revenue distribution ratio was generally less than 30% for local authorities, which committed to locally designated spending quota and exercised control over the year-end balance. While increasing local fiscal resources, the system also enhanced the central government’s budgetary equilibrium. Due to the mismatch between revenue and spending and vague local rights and responsibilities, local authorities lacked motivations to increase revenue, cut spending and maintain budgetary equilibrium.

Fourth, from 1976 to 1979, China implemented a fiscal management system characterized by “revenue linked with spending and total revenue distribution.” This system marks a return to the “distribution of total revenue and annual reassessment of the distribution ratio” before dividing revenue and expenditure between the central and local governments. As a slight difference from the previous system, the new system expanded the scope of local fiscal revenues and spending and administrative powers. Local authorities were given fixed fiscal powers and entitled to retain 30% or 70% of surplus revenue as local discretionary revenue. In 1978, China piloted the fiscal system of “revenue linked with spending and surplus revenue distribution” in some provinces and cities, which determined local discretionary fiscal resources according to the year-on-year revenue growth and the surplus revenue distribution ratio.

Under the planned economic system, the devolution of economic powers from central authorities only marked a simple decentralization of a highly centralized fiscal system. Adjustment to the central-local economic relationship was confined to administrative decentralization, i.e. the central government decided whether or not to decentralize and to what extent. The central-local economic relationship lingered between centralization and decentralization of power. On one hand, local governments were eager to invest and hasten project implementation before their powers could be taken back at any time. That is why China’s economy overheated as soon as administrative decentralization occurred, i.e. the vicious cycle where decentralization led to chaos. On the other hand, the re-centralization of economic powers led to information and supervision problems under resource allocation by administrative diktats.

3. CPC’s Reform and Improvement of Central-Local Economic Relationship since 1978

In 1978, the Third Plenum of the 11th CPC Central Committee unveiled a new historic stage of China’s opening up. Led by Deng Xiaoping, Jiang Zemin and Hu Jintao, Chinese communists relentlessly explored the central-local economic relationship and came up with a succession of creative

ideas, policies and strategies that served as scientific guidance for the CPC's management of central-local relationship.

3.1 Deng Xiaoping's Understanding and Practice of Central-Local Economic Relationship

Decentralization held the key in Deng Xiaoping's policy to mobilize local initiative. Under the Party's unified leadership, China had long practiced a highly centralized governance system. "First secretaries were in charge of and decided everything" (Deng, 1994). Believing that the central government's powers were too concentrated, Deng Xiaoping took proactive steps to decentralize power.

First, the focus of decentralization was economic powers. On the eve of the Third Plenum of the 11th CPC Central Committee, Deng (1994) noted that "There is too much concentration in the powers of China's economic administration system. We should take bold steps to devolve those powers in a planned manner. Without devolution of power, it is unfavorable to leverage the initiative of the national government, localities, enterprises and workers, not to mention modernize economic administration and raise labor productivity. We should give more autonomy to localities, enterprises and production brigades over their operation and management affairs." Emphasis was also laid on administrative decentralization in the process of political reforms. "Power should be devolved to address the relationship between central and local authorities. Meanwhile, local authorities should also devolve power further down the line" (Deng, 1994). Regarding the excessive and stifling control of the economic system, economic development should be accelerated by "decentralizing power and invigorating the economy."

Second, the decentralization of power should be combined with the transformation of government functions. "Our leading organs at various levels have taken charge of many matters which they should not and cannot handle, or cannot handle efficiently" (Deng, 1994). The Party should be separated from the government, the government separated from enterprises, and the government separated from social organizations in order for the adjustment and reform of central-local relationship to be carried out properly.

Third, decentralization should be carried out according to local conditions with differentiated treatment. Based on the actual conditions of reform and opening up, Deng Xiaoping put forth the creative vision of allowing some regions to become rich first and assist others in getting rich. "We shall allow some areas to become rich first; egalitarianism will not work. This is a cardinal policy, and I hope all of you will give it some thought" (Deng, 1994).

Fourth, another aspect of Deng Xiaoping's practice of promoting the initiative of local authorities was to enhance the CPC Central Committee's authority while preventing misguided decentralism. Deng always stressed that decentralization should be moderate and cannot undermine the central authority. Under the guidance of Deng Xiaoping's thought on the central-local economic relationship, China's reform approach focused on "streamlining government and devolving powers" or "decentralizing powers and retaining revenues."

3.1.1 "Eating from separate stoves": Adjustment to central-local fiscal powers

In this stage, China's economic restructuring featuring "decentralization of power and retention of revenues" focused on fiscal reforms as the theme. Unlike the previously highly centralized planned system, more economic powers were devolved to local governments and production entities. In February 1980, China started to reform its fiscal system by "dividing revenues and expenditure and implementing multilevel contracting." Prior to this reform, China's fiscal system featured state control over revenues and expenditures, a mismatch between revenues and expenditures, and the whole country "eating from the same pot." The reform matched rights with responsibilities, formed independent interests for local authorities, and motivated local authorities to increase revenue, reduce spending and develop the economy. In 1983 and 1984, the central government implemented a two-step "profit for tax" reform, and taxation became a major source of national fiscal revenue. In 1985, China implemented a budgetary

management system of “division of tax types, assessment of revenue and spending responsibilities, and hierarchical contracting” for all provinces and municipalities except for Guangdong and Fujian provinces. Since conditions for “dividing tax types” were not ready due to incomplete tax reform and price system, the central government had to adopt the “apportionment of total revenue” transitional scheme. After 1988, “various forms of fiscal contracting” were practiced.

The fiscal contract system mobilized the initiative of local authorities, putting an end to the highly centralized state control over revenues and expenditures. Instead of “eating from the same pot”, local and central authorities had to “eat from separate stoves.” The fiscal contract system clarified the division of central-local revenue and spending and fiscal powers. For a certain period of time, central and local authorities shared in total revenues by a certain ratio or quota, and local authorities were entitled to the bulk of additional revenues. Devolution of fiscal powers or resource allocation powers encouraged local authorities to seek fiscal revenues within the relationships of affiliation and beyond institutional boundaries. Under the fiscal contract system, the central government accounted for a smaller share of fiscal revenue and expenditure and local authorities and enterprises had greater autonomy. While the central government relied on revenues submitted from local authorities, the amount of which was unstable, local authorities offered tax rebates in various disguised forms to avoid submitting revenues. Moreover, there was an absence of institutional mechanisms and legal assurance for regulating central-local economic relationship. In this sense, the fiscal contract system contributed to institutional development only in the immaterial political sense and not in the substantive institutional sense. The reform of “devolving power and retaining revenue” went too far in reducing the central government’s macro-regulatory ammunitions, severely undercutting national capabilities (Wang, 1997).

3.1.2 Putting cities in charge of counties: Expanding the jurisdictions of cities

China attempted to put cities in charge of counties before reform and opening up in 1978. At the end of 1949, Wuxi, Xuzhou and Lanzhou cities expanded their jurisdictions over counties. After reform and opening up, the central government enacted the *Circular on Reforming the Regional System and Implementing Cities Administering Counties*, *Circular on Matters Concerning the Reform of Party and Government Agencies*, among other documents. It was decided to experiment the merger of prefectures and cities in Jiangsu Province as a pilot program. Since then, more cities started to exercise administration over counties. In addition, China established a group of cities under separate planning with provincial-level economic powers to increase the authority of city management, highlight the status of specially-designated cities, and enhance the economic functions of cities.

3.1.3 Special economic zones: Conferring greater economic powers to the local level

Special economic zones are the experiment fields of China’s economic restructuring and the window of opening up. In the 1980s, China started to create opening up zones. In April 1979, Deng Xiaoping approved the vision of Guangdong and Fujian provinces to establish “export processing zones” and made the following important instruction: “It’s better to call it a special zone. Shaan-Gan-Ning base was called a special zone at the beginning! Though the central government has no money, it may give you some policies for you to make your own way” (Party Literature Research Office of the CPC Central Committee, 1998). In May 1980, the CPC Central Committee and the State Council made an instruction entitled *Regarding the “Minutes of Meetings in Guangdong and Fujian Provinces”*, designating special export zones as “special economic zones (SEZs) entitled to more policy preferences. Such policy preferences as the devolution of administrative review and approval and the increase of fiscal autonomy motivated SEZs to develop the economy. In 1992, Deng Xiaoping’s talks during his tour to southern China stirred a new wave of development and opening up across the nation. The CPC Central Committee and the State Council decided to open another group of provincial capital cities in interior regions, border towns with appropriate conditions, and capitals of autonomous regions, granting them

the same policy preferences as for coastal open cities. By then, China's all-round opening up took shape. Deng Xiaoping's thought on SEZs made a breakthrough to the highly centralized economic system. Special policy preferences to SEZs mobilized local initiative. Over the past 38 years since its founding, Shenzhen as the forerunner of China's reform and opening up program developed from a small fishing village with only 300,000 inhabitants to a modern metropolis with a population of 20 million; the city's urban area expanded from 3 km² to 1,996.85 km² and GDP rose from 179 million yuan in 1979 to 1,949.26 billion yuan by 2016, making the world marvel at "Shenzhen speed" (Guo, 2017).

3.2 CPC's Adjustment to Central-Local Economic Relationship in the New Era

At the Fifth Plenum of the 14th CPC Central Committee, Jiang Zemin stressed in his speech on *Properly Balancing Some Major Relationships in the Socialist Modernization Drive* that we should properly balance 12 major relationships of overall importance. In his speech, Jiang Zemin elaborated the relationship between central and local authorities. On one hand, we should follow the principle of adhering to the "two initiatives" under the central leadership while seeking a dynamic equilibrium between the central authority and local autonomy. On the other hand, importance should be given to balancing local economic development and promoting the institutional and law-based relationship between central and local authorities. This is of great significance for the Party to manage the central-local relationship under the new situation. Guided by this important thought of Jiang Zemin, the third-generation leadership collective of the CPC Central Committee further advanced the regulated and law-based economic relationship between central and local authorities (Guan, 2010).

3.2.1 Attempts to implement the "tax-sharing system" reform

The Party took gradual steps of the tax sharing reform to address various problems emerging from the fiscal contract system. It took eight years for the tax sharing system to be deliberated and piloted before officially rolled out. On December 15, 1993, the State Council made the *Decision on Implementing the Tax-Sharing Fiscal Management System*, which prescribed the official nationwide implementation of the tax sharing system as of January 1, 1994. Under the tax sharing system, China's tax types include central government tax, local tax, and shared tax between central and local governments. The classified budget system was established and improved to tighten budgetary constraints at all levels. The tax sharing system broke through fiscal revenue allocation according to administrative affiliation, overcoming the vicious cycle of administrative centralization and decentralization. It divided central and local fiscal revenues according to tax types for central and local governments to maintain their respective fiscal equilibrium. A benign mechanism was put into place to steadily increase central and local fiscal revenues. As a result, the central government made up a growing share of fiscal revenue and spending with improving macro-regulatory capabilities.

3.2.2 Reforming the central vertical administration system to underscore the economic authority of the central government

First, reform of the People's Bank of China (PBC), China's central bank: In 1998, the State Council abolished the PBC's provincial branches and instead opened nine cross-provincial branches, together with the Business Management Divisions in Beijing and Chongqing, 20 Financial Regulation Offices, and 20 central branches. The PBC's institutional reform enhanced the central government's macro-regulatory capabilities in the financial sphere and avoided administrative intervention from local authorities in the financial sector.

Second, reform of grain production and distribution system in 1998: The separation of the rights and responsibilities in grain production and distribution led to the creation of a brand-new system in which the central government was responsible for macro-regulation and special grain reserve management and local authorities were in charge of local grain production and distribution. The central government was

primarily responsible for overall policies and principles and infrastructure construction such as farmland water conservancy. Greater autonomy at the local level increased the balance and stability of grain supply and demand.

Third, reform of industrial and commercial administration in 1998: Vertical management of organizational structure, personnel and budget for industrial and commercial administrative agencies below provincial level helped avoid administrative intervention from local authorities and ensure smooth implementation of central government policies.

Fourth, reform of quality and technical supervision system in 1999: Vertical administration was implemented for the nationwide quality and technical supervision system below provincial level to avoid interference of local protectionism, enhance regulatory functions and law enforcement, and contribute to the central government's macro-regulatory capabilities.

Fifth, reform of state assets administration system: On March 24, 2003, the State Council established the State Assets Supervision and Administration Commission (SASAC). On May 27 of the same year, the State Council enacted *Interim Regulations on the Supervision and Administration of Enterprise State-owned Assets*. By the end of 2006, the total assets of China's state-owned enterprises (SOEs) reached 29 trillion yuan, up 4,517% over the end of 2003 or 1,314% on an annual average basis. Profits and tax payments by central SOEs increased by over 100 billion yuan at an annual growth rate over 20% (Wang and Wang, 2008).

3.2.3 Implementing the vision of "two overall situations" to balance regional development

As early as in 1988, Deng Xiaoping put forth the vision of "two overall situations" to allow some people and some regions to become rich first before assisting others in getting rich. Prosperity in the eastern region and national fiscal strength created conditions for balanced development between central, eastern and western regions. In 1997, Jiang Zemin said in his Report to the 15th CPC National Congress that "The State should step up support to central and western regions and give priority to infrastructure and resource development in those regions" (Party Literature Research Office of the CPC Central Committee, 2000b).

In 1999, the Fourth Plenum of the 15th CPC Central Committee deliberated and approved the *Decision of the CPC Central Committee on Major Issues Concerning the Reform and Development of SOEs*, sounding the clarion to develop the western region. Policy preferences such as industry access threshold and tax incentives were offered to attract foreign capital and raise productivity. In 2003, then Premier Wen Jiabao said at a meeting that restructuring the old industrial base in the northeast was a strategic decision, and that the CPC Central Committee made a strategic arrangement to support the restructuring and renovation of old industrial bases to promote the interplay between China's eastern and western regions and drive development in the central region for balanced regional economic development (Party Literature Research Office of the CPC Central Committee, 2005).

In October 2003, the State Council issued *Opinions on Implementing the Strategy to Revitalize the Northeast and Other Old Industrial Bases*, which put forth the strategy of revitalizing the northeast old industrial base. In March 2004, then Premier Wen Jiabao for the first time vowed to revitalize the central region in his Government Work Report (Party Literature Research Office of the CPC Central Committee, 2005b). In April 2006, the *Opinions of the CPC Central Committee and the State Council of Revitalizing the Central Region* was promulgated. Revitalization of the central region marks another major regional development strategy enacted by the central government following the strategies to develop the western region and revitalize old industrial bases such as the northeast, forming a new pattern of China's balanced regional development.

3.3 Theory and Practice of Central-Local Economic Relationship Guided by the Scientific Outlook on Development

After the 16th CPC National Congress, the CPC Central Committee with Hu Jintao as General

Secretary creatively put forth the scientific outlook on development and the strategic vision of building a harmonious society, which marks a major theoretical innovation and exploration.

The scientific outlook on development calls for establishing a science-based concept of reforming central-local economic relationship and dividing central and local fiscal and economic powers. On one hand, efforts must be made to accelerate the transformation of government functions and reasonably divide the functions and powers of central and local authorities. According to the intrinsic requirements of the market-based economy, the government should shift from microscopic management with excessive responsibilities to the macroscopic adjustment of regulatory functions, focusing on matters that the market cannot address or address well. The boundary between government and market responsibilities should be regulated. In a market-based economy that pursues efficiency, local governments are more informed about local conditions and thus better-positioned to make decisions to meet local preferences. In this sense, the devolution of fiscal and economic powers would raise efficiency and accelerate growth. Hence, local authorities should be given more economic powers to keep pace with the development of socialist market economic system.

On the other hand, the public finance system should be further improved to equalize access to basic public services. Reform of the tax-sharing fiscal system sharply increased the central government's share in fiscal revenue and spending and boosted its macro-regulatory capabilities. However, demarcation between central and local administrative powers and inadequate fiscal transfer system led to centralized fiscal powers and decentralized administrative powers. As a result, local governments experienced fiscal difficulties due to uneven regional distribution. Under the scientific outlook on development, efforts must be made to reform the fiscal system, further improve public finance, and continuously unify fiscal powers, financial strengths and administrative powers between central and local authorities. In addition, the GDP-dominated growth pattern prompted local governments to pursue growth rate at the expense of quality and efficiency. Resource inefficiency, environmental pollution and environmental degradation go against the principle of sound, rapid and sustainable development. In achieving the goal towards "more complete basic public services and significant improvement in the level of government administration and service" (Party Literature Research Office of the CPC Central Committee, 2008), the central-local economic relationship under the guidance of the scientific outlook on development should shift from "GDP-oriented growth" to "equal access to basic public services."

3.3.1 Further improvement in the tax-sharing fiscal system

Public finance needs to be compatible with national development strategies and social development goals. Public finance should contribute to a harmonious society of fairness and justice and the scientific outlook on development that puts people first. Under the scientific outlook on development and the requirements of building a harmonious society, it became necessary to expedite fiscal reforms, further improve the public finance system, adjust fiscal spending structure, and equalize access to basic public services.

First, reform of income tax revenue. After the tax sharing reform in 1994, corporate income tax in China was still divided by enterprise affiliation and tax types since government functions and government-enterprise relationship had yet to be transformed. With the establishment of the socialist market economic system, such methods of division became unfavorable to enterprise reform and tax collection and management and gave rise to local protectionism and repetitive construction. In 2001, the State Council issued *Circular on Reforming the Sharing of Income Tax Revenues*. With the implementation of the reform by the central government in the following year, corporate income tax and individual income tax revenues had to be shared between central and local governments with the exception of special sectors and enterprises. In 2002, the central-local sharing ratio was 5:5, and since 2003, the central government has been entitled to 60% of those revenues. Furthermore, the central

government increased general transfer payments to poor areas in central and western regions to reduce interregional fiscal gaps and balance regional development.

Second, reform of the tax rebate burden. In coping with the Asian Financial Crisis of 1997, the central government adopted a proactive fiscal policy and raised export tax rebate to stabilize export and increase domestic demand. From 1998 to 2003, China's composite tax rebate ratio was raised from 8.29% to 11.8% (Lou, 2013). Export tax rebate as a complete responsibility of the central government led to growing central fiscal burden, causing central government tax rebates to exceed revenue and making the export tax rebate policy unsustainable. In 2004, China reformed the export tax rebate burden. Based on the actual tax rebate index of 2003, the tax rebate burden was shared between central and local governments at the ratio of 75:25. Due to such problems as local government intervention in trade affairs, this ratio was adjusted to 92.5:7.5 in 2005. Meanwhile, it was stipulated that no export tax rebate should be decomposed into townships and enterprises. The reform of the tax rebate burden further straightened out central-local fiscal revenue relationship.

Third, increasing the central government's share of revenues from stamp duty on securities transactions. The *State Council Decision on Implementing the Tax Sharing Fiscal Management System* enacted in 1994 prescribed that "The central stamp duty on securities transactions is a shared tax subject to a sharing ratio of 5:5 between central and local governments." With the rapid development of China's securities exchange market, hefty revenues from stamp duty and securities transactions collected and the shared by Shanghai and Shenzhen caused discontent from many other localities. In 1997, the ratio of sharing to the central government was raised to 88% for a reasonable allocation of intergovernmental fiscal resources. In 2000, the *Circular of the State Council on Adjusting the Ratio of Sharing of Revenues from Stamp Duty on Securities Transactions between Central and Local Governments* prescribed that as of 2000, the ratio of sharing to the central government shall be raised annually step-by-step to 91%, 94% and 97% of revenues from stamp duty on securities transactions in three years. This has raised the central government fiscal revenues to support the development in poor areas of China's western region to narrow original gaps.

3.3.2 Improving fiscal management system below provincial level

The tax sharing reform of 1994 enhanced the central government's fiscal powers and resources, initially standardized central-local fiscal distribution, and motivated various levels of government to raise fiscal revenues. Yet differences existed in the levels of economic development across regions and the spending responsibilities of government at various levels. Below provincial level, there were significant fiscal gaps and imbalances. Counties and townships, in particular, faced great challenges to fiscal revenue growth. Some county and township governments struggled to go about their work and, in some cases, were unable to pay the full salaries of grassroots cadres. To improve the severe shortfall of local fiscal revenues, the Ministry of Finance issued the *Measures for the Central Finance to Reward and Subsidize Localities for Easing County and Township Fiscal Difficulties* to implement the "three rewards, one allowance" policy.¹ From 2005 to 2007, the central government allotted a total of 72.5 billion yuan under this policy, which bolstered county and township fiscal strengths. Rewards and incentives motivated county and township governments to raise revenue, cut spending, streamline institutions, and develop the economy. On the basis of existing transfer payments and the "three rewards, one allowance" policy, the CPC Central Committee and the State Council assured the minimum fiscal resources of counties and townships to stay fiscally viable.

¹ The "three rewards, one allowance" policy means that the central government would increase the tax revenues of county and township governments in fiscal difficulties, and reward provincial and municipal governments for increasing fiscal transfer payments to counties in fiscal difficulties; reward county and township governments for streamlining institutions and personnel to raise efficiency and reduce cost; reward major grain-producing counties to ensure grain security; and offer allowances to regions that did well in reducing county and township fiscal difficulties.

Another initiative was the “Province Administering Counties and County Administering Township Finance” reform. This reform removed prefectural government as the intermediate layer between provincial and county governments to improve efficiency and reduce county-level fiscal stress. Under China’s government framework, there are five hierarchies from central to provincial, city, county and township levels. Due to political centralization and economic decentralization, county and township authorities at the lowest level often faced a fiscal squeeze. The Fifth Plenum of the 16th CPC Central Committee called for straightening out the fiscal management system below the provincial level and implementing direct administration over counties by provincial governments (Party Literature Research Office of the CPC Central Committee, 2006). The policy goal was to expand county-level administrative authority, enhance balanced socio-economic development and fiscal autonomy of counties and partnerships, and address fiscal challenges facing counties and townships.

At the National Work Conference on Rural Tax-for-Fee Reform in 2005 and the National Work Conference on Comprehensive Rural Reforms in 2006, then Premier Wen Jiabao twice mentioned this fiscal management system. The *Opinions on Implementing the Reform of Direct Administration of County Finance by Provincial Governments* released by the Ministry of Finance in 2009 stipulated that the “Province Administering Counties” reform should be implemented across the board with the exception of ethnic minority autonomous regions. Similar to the “Province Administering Counties” reform, the “County Managing Township Finance for Township Use” mode features townships as independent accounting entities and “joint budgeting, unified accounts, centralized income and spending, and unified procurement and invoice management.” After many years of exploration, China has made initial progress in the “Province Administering Counties”, as evidenced in sharp increases in local tax autonomy and government efficiency, the demonstrative effect of direct administration over counties, and rapid county-wide economic development. However, there have been controversies regarding the reform’s effects on the fiscal strengths of counties. Further steps should be taken to reform the “Province Administering Counties” system and develop the county economy.

After reform and opening up in 1978, national fiscal pressures forced China to devolve fiscal powers and give up revenue to local authorities. Indeed, there have been inadequacies in the institutional design of the “fiscal contracting” system, and the “tax sharing” system obviously went too far. Yet practice has shown that improvements to the central-local economic relationship have fully motivated central and local authorities. The combination between economic and administrative decentralization is regarded as a key driver behind China’s economic miracle. However, China’s intergovernmental fiscal system remains an administrative institutional arrangement, i.e. the division between administrative powers and spending responsibilities between central and local authorities, revenue distribution and transfer payment systems are all completed with administrative means without necessary institutional basis and legal assurance. As a result of local governments assuming the bulk of public spending responsibilities, their fiscal powers are not matched with fiscal strengths. Grassroots governments, in particular, are heavily dependent on transfer payments and became trapped in “payroll finance.” With an inadequate supply of public goods, localities suffered from a poor level of public services. The structure of transfer payments was unreasonable and lacked standardization. Further improvement had yet to be made to the central-local economic relationship.

4. CPC’s Further Improvement to the Central-Local Economic Relationship in the New Era

In improving the socialist market economic system since the 18th CPC National Congress, China has maintained the authority and centralized leadership of the CPC Central Committee while mobilizing the initiative of local authorities to develop the economy. In the new era, continuous improvements have been made to the central-local relationship, contributing to China’s economic miracle and social stability.

4.1 Background of the Party's Exploration of Central-Local Economic Relationship since the 18th CPC National Congress

First, change in the primary social contradiction naturally requires adjustment to the central-local economic relationship. As noted in the *Report to the 19th CPC National Congress*, “As socialism with Chinese characteristics has entered into a new era, the principal contradiction facing the Chinese society has turned into one between people’s ever-growing needs for a better life and unbalanced and inadequate development” (Xi, 2020a). In the face of the changing primary contradiction facing the Chinese society, we must adhere to the Party’s leadership over economic work and constantly adjust the division of fiscal and administrative powers between central and local authorities, motivating both of them to address the problems of uneven and inadequate development. Currently, China’s interregional productivity is uneven, urban-rural development and income gaps remain significant, and vulnerable groups still exist. Those intertwined problems of unbalanced and inadequate development present many social contradictions and problems. Hence, we must follow a people-centered approach and create a sustainable modern fiscal system conducive to efficient economic growth with better quality. Such fiscal system should contribute to improving public services and regulating income distribution for socio-economic progress across the board.

Second, we should meet the requirements of national governance modernization. The Fourth Plenum of the 19th CPC Central Committee identified “improving the institutional mechanisms for giving full play to central and local initiatives” as a key aspect in modernizing the national governance system and capabilities. Based on the concept of “modern national governance”, we should build a modern fiscal system to propel socio-economic transition and reshape the central-local relationship. Through budgetary income and spending arrangements and the division of spending responsibilities, public finance plays an important role in regulating the economy. Being directly at the service of the modern market economic system, public finance may bring into full play the decisive role of market in resource allocation. By controlling budget according to administrative responsibilities and designating administrative responsibilities according to fiscal strengths, we should promote the reasonable allocation of public resources between central and local governments, properly balance government-market and central-local relationships, make up for market failures, and optimize revenue distribution for the government to fulfill its due responsibilities without overstepping its authority and better perform macro-regulatory functions (Pang, 2020). Public finance is an economic behavior of the government and the foundation for national governance. The state is an apparatus for class domination, and public finance as an economic behavior of the state also has salient class attributes and reflects the will of the vast majority of people. Yet public finance is not just an issue of the economic sphere. Government fiscal revenue and spending also have broad implications in political and social domains. In modernizing China’s national governance in the new era, we must create a modern fiscal system that gives full play to all fiscal functions.

Third, the Party’s leadership is of great importance to achieving high-quality development and common prosperity in the new development stage. The shift of China’s economy from rapid growth to high-quality growth and the entry into the new era of socialist economic development call for enhancing the Party’s leadership over the economy and maintaining the authority of the CPC Central Committee, steering economic development towards the right direction, and constantly adjusting the relations of production (Zhou and Li, 2019). In the new era, the Party is committed to leading the people to build a moderately prosperous society in all respects and turn China into a socialist strong country and achieve common prosperity. We should make steady progress in balancing regional development, coordinate all the activities of the nation as in a chess game, and give greater play to the initiatives of central and local governments and various sides. Currently, China has made tremendous progress in economic development, but grave domestic and international challenges remain. While the central government is confronted with greater macro-regulatory challenges, local authorities face a more complex environment

and are often trapped in short-term behaviors. In this context, we must strengthen the Party's leadership in regulating the central-local economic relationship.

4.2 Adjustment of Central-Local Fiscal Powers

Public finance is the foundation and pillar of national governance. We must establish a modern fiscal system compatible with modern national governance. As noted in the Report to the 19th CPC National Congress, "We should accelerate the development of a modern fiscal system and establish a central-local fiscal relationship with clear rights and responsibilities, coordinated fiscal powers, and regional balance" (Xi, 2020b). The Fourth Plenum of the 19th CPC Central Committee further stressed the importance to optimize the division of intergovernmental administrative and fiscal powers to form a stable system with compatible administrative powers, spending responsibilities and fiscal resources between various levels of government, which is the premise and foundation for maintaining the central authority.

In recent years, fiscal powers and resources have been increasingly concentrated at higher levels of government, especially the central government, and tax legislation powers are controlled by the central government. While centralization allowed major undertakings to be carried out under the whole-nation system, it has weakened local governments in revenue distribution. Centralization of fiscal powers led to a severe shortfall of local government fiscal resources. To some extent, this is a legacy problem left over from China's tax-sharing reform of 1994 and highlights the necessity to continue deepening the tax sharing reform (Wang and Cai, 2014). On one hand, there lacks legal assurance for the division of fiscal powers between central and local governments. Over the years, the implementation of China's tax sharing system has been focused on negotiations and pilot programs. While helping to reduce the cost and resistance of reform and to exchange information, negotiations left a big room for bargaining and gave rise to opportunistic risks. Pilot programs represent a process of continuous exploration and "crossing the river by feeling your feet on the stones" and may correct mistakes and minimize the risk of reforms, but are unfavorable to overall institutional development. On the other hand, transfer payments have failed to correct the drawbacks of the tax sharing reform. In contrast to the limited amount of China's general transfer payments, tax return and special transfer payments account for an excessive share, which led to a dispersion of financial resources. Special transfer payments are too hefty and wide-ranging, and the use of special transfer funds is wasteful and inefficient due to a lack of standardization and inadequate management. Hence, a clue to China's fiscal reform is to motivate local governments to develop the economy by adjusting the central-local fiscal system (Lyu, 2020).

The first question is how to stabilize interregional fiscal strengths. As independent entities, central and local authorities seek to maximize their interests and control tax revenues with promising growth potentials. On one hand, such adjustment to the regional distribution structure of transfer payments will change local fiscal revenues, along with the existing revenue distribution system. On the other hand, local governments will rush to support industries that generate the most tax revenues, which may increase the homogeneity industrial structure. For this reason, we should create a modern fiscal system with unified fiscal and administrative powers between central and local authorities and improve the fiscal management that ensures administrative powers be compatible with spending responsibilities. Administrative powers should be divided reasonably to coordinate fiscal and administrative powers with spending responsibilities.

The second question is how to coordinate with the tax reform. A complete tax collection and management system serves as an infrastructure and important assurance for the effective operation of the tax system. With the adjustment to the division between central and local revenues, we should further enhance tax collection and management and integrate state and local tax agencies. Proactive efforts should be made to develop a modern IT-based tax collection and management system with clear rights and obligations between tax collectors and payers under a risk management approach focusing on major tax sources. We should develop a government information system and improve tax information sharing

between government departments. Platforms should be created for public resource transactions, credit information and citizen credit code to support the tax reform, law-based tax management, and modern national governance.

4.3 Straightening out the Division of Central-Local Administrative Powers

The tax sharing fiscal reform of 1994 initially straightened out the fiscal income distribution relationship between central and local authorities, but no substantive progress has been made in the division of administrative powers, which became increasingly incompatible with fiscal powers. Upon the reform of the tax sharing system in 1994, the demarcation of administrative powers was not much more than a description of the status quo. Due to the lack of progress in the reform of administrative powers, fiscal resources increasingly concentrated at the central level while grassroots governments faced increasing fiscal constraints, giving rise to gaps in the vertical distribution of fiscal resources. In dividing administrative powers, therefore, more consideration should be given to spending responsibilities, i.e. administrative powers should be compatible with spending responsibilities.

The reasonable division of fiscal and administrative powers and spending responsibilities between central and local authorities are conducive to creating a reasonable layout of fiscal strengths at central and local levels and equalizing access to basic public services. China has experienced three stages in the division of administrative powers between central and local authorities with evolving priorities from “compatibility between administrative and fiscal powers” to “fiscal strengths matched with administrative powers” and “compatibility between administrative powers and spending responsibilities.” Yet some prominent issues still exist in the demarcation of intergovernmental administrative powers.

First, local governments have been given increasing administrative powers. Amid China’s rapid economic development since reform and opening up, local governments have been charged with economic development priorities and administrative powers. Tax sharing reform centralized fiscal powers and resources while decentralizing administrative powers, transferring many administrative powers from the central government to local authorities. Moreover, SOE reform brought additional administrative responsibilities. Hefty government subsidies and investments on SOEs and the subsequent reform to replace government appropriations with commercial loans transferred the cost of reform to state-owned banks and capital markets that provided direct financing and brought massive non-performing assets or implicit debts to the government. Furthermore, responsibilities for providing public goods were divided improperly. While central, provincial and municipal governments are concerned with intermediate functions such as infrastructure construction, the most basic public goods such as elementary education, public health and social security are left to county and township governments, aggravating grassroots fiscal challenges. Lastly, the career prospects of local cadres are linked to local economic performance. As such, local authorities compete for GDP growth through massive infrastructure construction and short-term projects with quick results. Such competition has led to an unchecked expansion of government and administrative powers and spending.

Second, the division of administrative powers between central and local governments is not based on a sound legal system, and detailed rules have yet to be spelt out in relevant laws and regulations. China’s *Constitution* prescribes that the division of duties between central and local governments should give full play to the initiative and enthusiasm at the local level under the unified central leadership. While this provision sets forth the principle of giving full play to the local initiative under the central leadership, it does not specify the approach to unify leadership and promote local initiative. There are inconsistencies in the existing laws and regulations regarding the reform of dividing administrative powers between central and local authorities. More attention, therefore, should be paid to the standardized and law-based division of administrative powers. The *Constitution* should prescribe the administrative powers of central and local governments and relevant principles. Fiscal and administrative powers should be balanced with fiscal strengths and spending responsibilities in accordance with the overall institutional arrangement

of “specifying administrative and fiscal powers, tax base, property ownership, borrowing power and budget corresponding for each level of government, and making transfer payments from central and provincial governments to lower-level authorities.” Moreover, intergovernmental administrative powers and spending responsibilities are too complex between China’s five levels of government and public finance for fiscal powers to be matched with fiscal resources. This intricate hierarchical system cannot meet the needs of modern national governance. As township public finance departments become regional offices of municipal and county governments amid the rural tax-for-fee reform, a check and balance fiscal system should be created between the three levels of central-provincial and municipal/county governments regarding the division of fiscal and administrative powers.

4.4 Reasonable Demarcation of Central and Local Economic powers

Government powers for economic administration refer to powers lawfully entitled to and exercised by the government as an economic administration entity under the economic law. The powers of central and local governments for economic administration are the powers of central and local governments as two economic administration entities for macroeconomic administration and regulation. Those powers will, if exercised properly, safeguard the development of market-based economy and give full play to the initiatives of central and local authorities or, if expanded viciously, impede the performance of local government functions and the realization of private interest. Only by making “law-based exercise of power” and “consequences for overstepping one’s authority” a Sword of Damocles over the exercise of government powers for economic administration can we ensure the proper performance of those powers and give better play to the initiatives of central and local authorities (Zhang, 2015).

First, streamlining matters subject to administrative review and approval. As a key aspect of government regulation, administrative review and approval represent an important way to regulate resource allocation. Administrative review and approval powers are essentially monopolistic powers that may generate lucrative profits and can be seen as rare and exclusive assets, the reasonable allocation and use of which are an important question with broader socio-economic implications (Fan, 1995). China’s reform of administrative review and approval powers also went through a cycle of centralization and decentralization in the planned economy era, decentralization at the inception of reform and during the market-oriented transition, and all-round reforms under the market economic system.

China’s current configuration of administrative review and approval powers has the following problems: First, the boundary between government and market is blurred. Various levels of government control most administrative powers and take charge of many matters that it shouldn’t manage and cannot manage efficiently. Over-regulation has deeply stifled corporate dynamism and hurts the initiative of the market-based economy. Second, the configuration of powers between central and local governments is uneven. The administrative review and approval powers of central and local governments are in an inverted pyramid structure. While most review and approval powers are concentrated at the central government at the top, local authorities have relatively few administrative review and approval powers. Unequal responsibilities and powers have led to an inefficient configuration of administrative review and approval powers, which hurts the initiative of local authorities. Since the 18th CPC National Congress, the Party has optimized the configuration of administrative hierarchies and jurisdictions, re-organized public institutions, and revamped township administrative system as part of the reforms to establish super-ministries and delegate power, streamline administration and improve government services. Positive attempts of “Province Administering Counties” reform were made to invigorate local administration and increase government efficiency.

Second, local governments should be given greater fiscal powers and resources to provide public services. Since reform and opening up in 1978, China’s fiscal reform has been characterized by decentralization in the two stages of administrative decentralization and economic decentralization (Jia, 2015). The former refers to the “eating from separate stoves” fiscal reform of dividing government

revenues and spending and multi-tiered fiscal contracting, in which central and local governments at various levels organize revenues based on administrative affiliations. The latter refers to a new multitiered fiscal system based on tax sharing under the perspective of separating government from enterprise operations. After the tax sharing reform to enhance the central government's macro-regulatory capabilities, China initially established a basic structure of powers and responsibilities at central and provincial levels without prescribing reform initiatives for the sub-provincial fiscal system. As a result, fiscal powers have been moved upwards to central and provincial governments. Without explicit criteria for the demarcation of administrative powers, the basic administrative powers of government have been continuously devolved under the hierarchical bureaucratic system. Due to fiscal hardships at the grassroots level, county and township governments are severely underfunded and struggle to pay public servants' wages in time, not to mention paying for basic public services and social protection. To make up for local fiscal shortfalls, we should establish a sound mechanism for ensuring basic fiscal resources at the county level, determine a more reasonable scope of county government spending responsibilities, increase the share of general transfer payments, and vigorously develop county economy.

Third, local governments should be granted greater powers for economic administration through the establishment of free trade areas. Amid deepening economic globalization, a new wave of anti-globalization sentiments has emerged in recent years in the developed world led by the US and the UK. Meanwhile, China is experiencing a critical stage of comprehensively deepening reforms. At this juncture, it is of great importance to transform economic growth pattern, upgrade industrial structure, and seek new drivers of regional economic growth. As such, China should strive to shape a new pattern of inclusive globalization characterized by a development orientation (Sheng and Li, 2020). Among various initiatives, the establishment of free trade experiment areas represents a new round of China's opening up and institutional innovation. The Report to the 18th CPC National Congress called for accelerating the implementation of the free trade area strategy. The Third Plenum of the 18th CPC Central Committee enacted *Opinions on Accelerating the Implementation of Free Trade Zone Strategy*. The 19th CPC National Congress vowed to develop free trade areas and an open world economy, and clarified the pathway and direction for developing free trade areas in China. China's development of free trade areas turned from a strategic vision to a blueprint with more clarity. In April 2018, the State Council released the *Guiding Opinions on Supporting Hainan in Comprehensively Deepening Reform and Opening-up*. In June 2020, the CPC Central Committee and the State Council decided to establish Hainan as a free trade port and released a reform plan. In supporting Hainan to develop an island-wide free trade area, the CPC Central Committee is determined to grant local governments greater powers for economic administration for broader openness and institutional innovation.

Since the 18th CPC National Congress, the CPC Central Committee with General Secretary Xi Jinping as the core has further reformed the central-local economic relationship with a problem-oriented approach to address prominent issues and modernize national governance. The central-local economic relationship should mobilize resources for major undertakings and incentivize both central and local authorities. Such relationship is of great significance to improving economic growth quality, government functions, and national governance. It also helps resolve various socio-economic contradictions. Over the past 100 years since the founding of the Communist Party of China (CPC) in 1921 and especially the past seven decades since the founding of the People's Republic of China in 1949, China has been exploring a central-local economic relationship with great achievements under the CPC's leadership. Foreseeably, the economic relationship between China's central and local authorities will continue to evolve to keep pace with productivity development and contribute to socio-economic development with higher quality. ■

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