

Административно управленческие проблемы налоговых реформ

Administrative and managerial issues of tax reforms

УДК 336.2(510)

DOI [10.15826/jtr.2015.1.2.009](https://doi.org/10.15826/jtr.2015.1.2.009)

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CHINA: TOWARD THE NEW STAGE OF IMPROVING ITS TAX SYSTEM*

ABSTRACT. China's existing tax system was established via the famous comprehensive fiscal reform conducted in 1994. In the next 20 years a series of incremental measures have been taken to improve this tax system framework. However, along with the increasingly deepened economic reform process, both outside and inside environments and the constrain condition facing the tax system have changed greatly. People have new adequate expectations for the tax policy. Responding to this changing circumstance, the direction of the tax system reform has undergone a fundamental change with its goal switching from «establishing the basic framework of the tax system suitable to the socialist market economy» to «establishing the modern tax regime in line with the modernization of the national administration system and administration capability» since the Third Plenary Session of the 18th Central Committee of the Communist Party of China (CCCPC) on November 12, 2013. Against this background, we comprehensively analyze the causes, main contents, focuses, supporting measures and enforcement roadmaps of this fundamental tax reform.

KEYWORDS. China; tax reform; national administration; modern tax system.

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КИТАЙ: НА ПУТИ К НОВОЙ НАЛОГОВОЙ РЕФОРМЕ

АННОТАЦИЯ. В результате налоговой реформы 1994 г. в Китае была создана современная налоговая система, обеспечившая плавный переход от старой налоговой системы к рыночной. В настоящее время значительные изменения внутренней и внешней среды ставят перед налоговой системой новые, серьезные задачи. Если прежде основной целью было «создание базовой структуры налоговой системы, соответствующей социалистической рыночной экономике», то спустя 20 лет это «движение к современной налоговой системе в рамках модернизации национальной административной системы». В статье подробно описываются причины и направления современных преобразований в налоговой системе. Анализ сложившейся структуры доходов бюджета позволил сделать выводы о сохранившемся влиянии принципов плановой экономики,

* This draft is prepared for the 7th International Symposium focused on Theory and Practice of Tax Reform which will be held on June 29 – July 5, in Irkutsk (Russia) on the basis of Baikal State University of Economics and Law.

так как значительную часть составляют неналоговые доходы и отчисления от прибыли государственных предприятий, а в налоговых доходах преобладают налоги на потребление. Кроме того, до настоящего времени налоговое бремя зависит не от налогового законодательства, а от ежегодно формируемых планов по сбору налогов. Таким образом, выявлены основные предпосылки современной налоговой реформы: обеспечение социальной справедливости становится приоритетной целью государственной политики; меняется структура экономики и тип экономического развития; продолжается рост налогового бремени; уровень налогового администрирования отстает от современных требований к управлению. Основными целями проводимых реформ являются: поддержание стабильности налогового бремени на макроуровне; снижение доли косвенных налогов путем расширения круга плательщиков НДС, упрощение ставок и изменение порядка распределения налога между бюджетами различных уровней; значительное увеличение доли прямых налогов за счет личного подоходного налога и налога на квартиры. Однако все эти изменения требуют адекватного совершенствования налогового администрирования, так как переход к налогообложению индивидуальных налогоплательщиков не возможен без изменения строения и функций налоговых органов.

КЛЮЧЕВЫЕ СЛОВА. Китай; налоговая реформа; национальная администрация; современная налоговая система.

1. Introduction

China's existing tax system was established via the 1994 Tax Reform. Prior to that, the former Soviet Union style tax regime was practiced in China. The year of 1992 represented a landmark in the history of China's tax system transition. Since that year an overall economic reform strategy toward the socialist market economy was initiated from top to bottom. As an indispensable part of this strategy a new round of tax system reform was carried out since 1993 which was entitled as The 1994 Tax Reform for most relating reform measures went in effect at the beginning of 1994.

The history of China's tax reform since 1994 can be divided into three phases. Actually, only a very basic framework of the market-oriented tax system was set up in 1994, being comparative to the old tax system under the traditional planned economy. Series of incremental reform were taken to improve this preliminary framework in the ensuing years especially from the late 2000s, aiming at adapting it more closely to market economy. Since 2013, the course of the tax reform stepped into its third phase with the aim of building a modern tax system in line with the modernization of China's national administration system and administration capability. As seen from the subsequent analysis, the new phase of the tax reform is significantly different from the prior two ones in terms

of its direction, the focal point and the coming major reform measures. Against such a background, this paper is devoted to discussion of the driving forces, main contents, focuses, supporting measures and the enforcement roadmaps for China's tax system reform at the new stage.

In order to set the context, the paper begins with a brief review of the 1994 tax reform and sequent incremental reform measures during the ensuing 20 years in section 2. Section 3 explores why a fundamental tax reform is needed by analyzing pros and cons of the existing tax system based on identification of its key features. In section 4 we explain the constraint conditions the future tax reform faces, its specific reform strategies and accompanying reform measures beyond the tax system reform.

In regard to the linkage of taxation and public administration in our mind. The paper ends with some concluding comments in section 5.

2. A Brief Review of China's Tax Reform during the Past Two Decades

2.1. 1994 Tax Reform: Establishing the Basic Frameworks of the Existing Tax System. Although China's economy has been growing rapidly since 1978 when China began opening itself to the outside world, China's central government continuously suffered fiscal revenue pressure

as the result of its irrational fiscal revenue system with state-owned enterprises that used a profit remittance system as the core and unreasonable central-provincial revenue sharing mechanism which favored sub-national governments at the expense of central government fiscal interests. The extreme revenue shortage facing the central government led to serious regionalism which not only damaged the central macro-control ability but also threatened healthy inter-governmental fiscal relationship and the country's political stability. To solve this predicament, a comprehensive fiscal system reform was initiated by the central government in 1994. There were three main aspects of the reform involving the tax system, the tax sharing system and the tax administration, respectively. The goal of these reforms was to establish a market-related tax system, a standard inter-governmental revenue-sharing mechanism and to set up an independent tax administration agency for the central government, i.e. the State Administration of Taxation, to collect centrally owned and shared revenues. For the purpose of this paper, we only consider the tax reform as a part of this fiscal reform package, among which the major reform measures are concentrated on goods and services tax, income tax and tax administration.

Goods and services tax reform. Firstly, to unify taxes on goods and services for both domestic and foreign taxpayers by substituting a new indirect tax mix with value-added tax (VAT) as its core for its pre-1994's equivalent which, to a great extent, can be categorized into turnover taxes although it includes VAT as well. Secondly, excises are imposed on selective goods such as tobacco, alcohol and alcohol drinks, refined oiled products, cars and motor-cycles, cosmetics, jewelry, golf instruments, yacht and other luxuries, etc. And thirdly, the service industries to which VAT was not operated upon were subject to the business tax (BT) which in essence is also a turnover tax. Compared with the standard tax rate of VAT at 17 % and reduced rate at 13%, BT is taxed at variable rates ranging from 3% on average services to 20 % on upscale entertainment services. By introducing VAT,

the long-existing problem of cascading tax under the old tax regime was greatly eliminated because VAT is basically levied on the value added to each economic phase of the commerce chain. The tax credit chain built in VAT discouraged industrial vertical integration which had prevailed before. On the contrary, it encouraged division of labor and specification in society. It is helpful in formation of a unified market and expansion of market breadth. Despite the progress that has been made, the fact that the tax base of VAT is far from final consumption and its tax scope has a limited implied room for further reform.

Income tax reform. Enterprises with different ownership were treated differently under the pre-1994 Tax Code. This discriminatory tax system put public enterprises into a relative preferential tax status and caused unfair competition. By merging the national income tax system, the level of a playing field for all domestic enterprises' business activities was created. The discriminatory income tax existed not only among domestic enterprises but also between foreign and national corporations. Tax preferences were given to foreign enterprises in order to attract FDI, and it resulted in a dual-track enterprise tax system ranging from income tax to others related taxes. By 1994 Tax Reform, the personal income tax with respect to foreigners and Chinese taxpayers were unified preliminarily; meanwhile the internal corporation income taxes are unified, too. But differential treatments on other taxes remained till 2010.

Optimization and simplification of the tax mix. To establish a fairer and more efficient tax regime the original tax mix was greatly simplified. By the eve of 1994 Tax Reform there were 37 kinds of taxes in China. The number of taxes reduced to 25 after 1994. By doing so, the structure of the old tax system was greatly optimized. The basic framework of the current tax system which centered on circulation taxes and income taxes was established later. Up to now, China's fiscal revenue came mostly from modern indirect and direct taxes rather than profit delivery and turnover levied on state-owned enterprises as it did before 1994.

Tax administration reform. Compared with other aspects within 1994 Tax Reform package, less success has been made in modernization of tax administration. A separate central tax agency (The State Tax Administration) was founded to collect tax revenues assigned to the central government and those revenues shared between central and sub-national governments. Except for that, no substantial changes took place in the organization structure of both state and local tax agencies. They are still organized with a focus on the type of tax rather than based on their function as the practice developed countries around the world is.

China's 1994 Tax Reform is part of the world's tax system transition from the former Soviet socialist style tax system to the market-oriented style. It is generally admitted that much compromise have been made due to the presence of variety of constraints in various countries [1], so China did the same thing. Apparently, the political authority of the then China was more concerned about enhancing economic efficiency by economic and taxation reforms than about other considerations such as income redistribution, environmental protection and social justice. Also, Chinese government put more emphasis on realistic consideration other than on an ideal pattern of the tax regime at that time. These all implied the nature of transition of China's existing tax system. Series of incremental reform continued in order to improve the original tax regime framework created in 1994. Here we will provide a synoptic description of this process till the end of 2013.

2.2. Incremental Improvements since 1994. Generally speaking, no significant reform measures were taken during 1995–2005 except for the termination of some ill-timed taxes and some pilot reforms such as «tax-for-fee» in rural areas (beginning from 2000) and the pilot VAT type-conversion reform beginning from 2004. The key reason is that further tax reform was not urgent as compared with other reform tasks within the reform package of establishing and improving socialist market economy. At that time fiscal policy priorities were focused on macro-economic con-

trol and strengthening budgetary and expenditure management. Most subsequent incremental tax reform measures were undertaken since late 2000s. Among them the main improvements are as follows:

VAT: type-conversion and base-broadening reform. The VAT was initially introduced as an origin-based production-type with no credit being allowed on purchases of capital goods to avoid sharp revenue decreasing. It was applied mainly to the manufacturing sector, i.e., purchasing of goods, with exception of providing services with processing facilities, repairs and replacements. Most service sectors and supplies of intangible assets and immovable property are subject to a separate business tax. Although this production-type, narrow-based VAT is disadvantageous for new investments, causes a cascading effect especially in the service sector and results in local protectionism, it was adopted for matching the need to keep tax revenue stable and was in line with the economic situation and tax administration capacity at that time. To eliminate the above-mentioned distortions, the original VAT design was facing three self-renewal tasks accompanied by changed conditions over the time. The first one was to convert the original production-type VAT into the consumption-type one. The second one was to broaden its tax base in order to cover services in addition to taxable goods. And the third one was to switch from the origin-based VAT to a destination-based one (this will be discussed in section 4).

The conversion type reform was piloted since 2004 in selected industry in three Northeast provinces of China. Then it was extended nation-wide on January 1, 2009. Since then, all VAT business-related assets as inputs other than immovable property are entitled to be deducted. Up to date, the process of turning the a production-type VAT into consumption one has not been finished yet, and this immovable property purchase is still out of the taxable scope of VAT.

The VAT base-broadening pilot began in Shanghai on January 1st, 2012. VAT was extended to six modern service industries (R&D, IT, logistics, leasing, ad-

vertisement, consultation) and transportation (except for the railway transport) which were subject to BT previously. Subsequently, the pilot program spread to 8 provinces and municipalities with broadcasting and film industry included beginning from August 1st, 2013. Along with provision of other services including railway, postal and telecommunication services, etc. they were continually included into the VAT base across the country, so the task of «integrating BT into VAT» (YING GAI ZENG in Chinese Pinyin) is underway, which is planned to be accomplished by the end of 2015.

Corporation Tax: to unify tax codes for domestic and foreign enterprises. At the early stage of China's opening to the outside world and its transition to market economy, a dual-track corporation tax mix was employed to attract foreign direct investments. Foreign-funded businesses were preferentially treated under such a tax mix. For example, two different corporation income taxes and property taxes were respectively imposed on national and foreign enterprises. In addition, some taxes were only applied to domestic enterprises while the foreign ones were exempted from such ones as urban and township land use tax, farming land occupation tax, city maintenance and construction tax and sur-charge levied along with VAT, BT and excises for educational use. In January, 2008, domestic and foreign income tax first merged. Then those taxes were applied only to domestic enterprises extended to foreign ones. By the end of 2010, the unification of domestic and foreign house property tax marked the achievement of the goal proposed in the 1994 tax reform project, i.e., to unify all of the taxes that treated domestic and foreign enterprises differently.

Environment-related Tax Reform: toward a resource-economized and environment-friendly tax regime. Responding to challenges of the world-wide climate change and national environment deterioration, China reformed its environment-related taxes to get a more resource-economized and environment-friendly tax regime. Specific measures involved the

resource tax, the excise tax, the pollutants discharge fee, and others.

In China natural resources had been taxed on the volume basis for long. So the resource tax revenues could not grow up along with run-up of world resource commodities prices. This led to resource waste and loss of the tax revenue. A pilot oil and gas resource tax reform was launched in Xinjiang Autonomous Region starting from June 1, 2010 and then it was extended to 12 western provinces. On November 1, 2011 it was rolled out nationwide. The most remarkable changes in this reform were that crude oil and natural gas were levied on the ad valorem basis rather than on the volume basis like before. Beginning from December 2014, coal as a taxable item was covered by the resource tax on the volume basis, too. Other taxable items such as coking coal, rare earths, and other valuable non-metal ores were subject to a higher tax amount although they are still levied on the volume basis.

Meanwhile, Chinese government broadened the tax base of excises, adapted its rate schedule and improved the related administration. China has been considering introduction of a new environment protection tax by replacing the existing pollutants discharge fees to standardize its environmental tax regime.

Direct Tax on individuals: to improve direct tax system. In comparison with developed countries, China's tax system structure is marked by extremely small ratio of direct tax on individuals to total revenue. To cope with the possible crises caused by continuously enlarged income disparity among individuals, the amount of exemption to wage and salary income was increased from initial 800 yuan to 1,600 (in 2006) and 2,000 yuan (in 2008) per month by two steps. In September, 2011, personal income tax code was amended to increase the employment income allowance up to 3,500 yuan per month, to decrease the number of tax brackets from 9 to 7 and to lower the tax burden of relatively low income groups. High-income taxpayers whose annual income exceeds 120,000 yuan were required to file returns annually. Also, the pilot projects of the property

tax on individuals were launched in two municipalities of Shanghai and Chongqing from January 1st 2011.

2.3. A Glimpse of China's Current Tax System. The past 20 years have witnessed continuous improvements taking place in China's tax system. Just like other transitional countries the evolving of China's tax system reflects the impacts of developed market economies in the western world. Nonetheless, it still holds the imprints of the planned economy regime where it rooted from and identifies China's contemporary economic and social situations. An anatomy of the existing tax system will be discussed below.

China's current tax system consists of 18 taxes. Its revenue structure with data available for Year of 2013 is illustrated in Table 1. Looking at this tax mix in regard to the by source, three key features of the current tax system can be concluded.

Firstly, China taxes goods and services (hereafter, the indirect tax) more heavily than income and property. Indirect taxes as a share of total revenue amounted to more than 67,04 % in which VAT and business tax jointly account for 41,66 % in 2013. While the income and property taxes respectively contribute 29,18 and 3,78 % to the total tax revenue (see Figure 1).

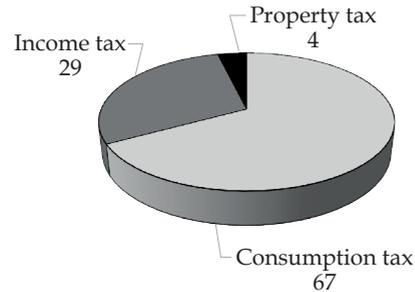


Figure 1. Structure of tax revenue in China, %

Table 1

Tax Mix by Sources (per cent share of total tax revenue, 2013)

Taxes	Amount (ten 100 million yuan)	As % revenue	
Total Taxes	110 530,7	100,00	
VAT on domestic	28 810,13	26,07	
Business Tax	17 233,02	15,59	
Domestic Excises	8 231,32	7,45	
Excises and VAT on Imports	14 004,56	12,67	
Excises and VAT Refund for Exports	-10 518,85	-9,52	
Tariffs	2 630,61	2,38	
Resource Tax	1 005,65	0,91	
City Maintenance and Construction Tax	3 419,9	3,09	Tax on Flow of GDP 96,22 %
Stamp Tax	1 244,36	1,13	
Vehicle and Vessel Tax	473,96	0,43	
Cargo Tax	43,55	0,04	
Urban and Township Land Use Tax	1 718,77	1,56	
Farming Land Occupancy Tax	1 808,23	1,64	
Deed Tax	3 844,02	3,48	
Tobacco Leaf Tax	150,26	0,14	
Total Goods and Services Taxes	-	67,04	
Individual Income Tax	6 531,53	5,91	
Corporation Income Tax	2 2427,2	20,29	
Land Appreciation Tax	3 293,91	2,98	
Total Income Taxes	-	29,18	
House Property Tax	1 581,5	1,43	Tax on Stock Wealth 3,78 %
Vehicle Purchase Tax	2 596,34	2,35	
Total Property Taxes	-	3,78	
Others	0,73	0,00	-

Source: National Bureau of Statistics of China. Available at: <http://data.stats.gov.cn/workspace/index?sessionid=9059BD4E1C72455DD389DEB35C3829C4?m=hgnd>.

Secondly, tax is imposed mainly on the flow of GDP (circulation of wealth/GDP,) i.e., on consumption and income rather than on stocked wealth. As column 5 in Table 1 illustrates, 96,22 % of the tax revenue are collected when it is generated in production process and when it accrues to production factors in China. Only 3,78 % of the revenue comes from stocked wealth. This explains the extremely low share of taxation on property.

Thirdly, most current taxes in China are collected at manufacturing or wholesale stage instead of retail stage. This means that tax revenues are collected from providers to a much greater extent rather than from individual taxpayers. As Figure 2 and Table 1 jointly indicate only less than 10 % are collected directly from individual taxpayers. Among them, the personal income tax revenue amounted only about 5,91 % in 2013 (1,1 % of GDP). With regard to the property tax, it hasn't been applied to individual taxpayers yet in contemporary China. Such situations imply inability of tax administration in China just as in many developing countries. Traditional tax administration system remained untouched in the 1994 Tax Reform package except to separate tax administration agencies at central and provincial lev-

els of governments. China has been trying to modernize its tax administration mechanism since then.

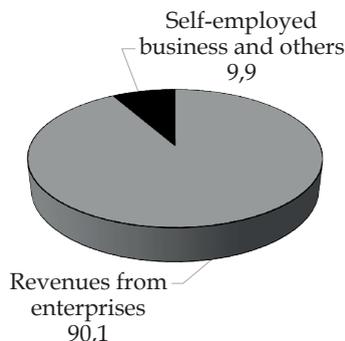


Figure 2. Division of tax revenues collected from enterprises and self-employed business, %

Finally, let's have a look at the structure of the total government revenue in China (see Column 3, Table 2). Up to 25 % plus the government revenue comes from non-tax sources. If we add the non-tax compulsory revenue, the number goes up to 34,28%. Among them the land transfer fees and state-owned enterprise profits hold a leading position. Besides, social security contribution is not classified as tax in Chinese fiscal statistics. Thus, the ratio of the non-tax revenue to the total one rises to 47,85 %.

Table 2

Macro Tax Burden of China in Various Measurements (2013)

Items	Amount (100 million yuan)	% as total government revenue	% as GDP
General public revenues	129 209,64	60,96	21,97
Among them: taxation	110 530,7	52,15	18,80
Non-tax compulsory revenue	18 678,94	8,81	3,18
Government fund revenues	52 268,75	24,66	8,89
Among them: government fund revenue(except for land transfer fee)	10 630,39	5,02	1,81
Land transfer fee	41 638,36	19,65	7,08
Social security contributions	35 993,58	16,98	6,12
Among them: subsidy for general public revenue	7 234,19	3,41	1,23
Net income of social security	28 759,39	13,57	4,89
State-owned enterprises profits	1 713,36	0,81	0,29
Among them: central level	1 058,43	0,50	0,18
Sub-central level	654,93	0,31	0,11
Total	211 951,14	100,00	36,04

Source: National Bureau of Statistics of China, Dr. Zhang Bin sorted out data appeared in this table.

China's government revenue mix in the broad sense reflects the remaining impacts of planned economy so that a large amount of revenue is derived from non-tax sources such as state-owned enterprise profits, land transfer fees and governmental fund revenues. Usually, these revenues are not administered as strictly, transparently and lawfully as the tax revenue not only because of their imposition but also because of their later use.

To conclude, China's goal since launching the 1994 Tax Reform was to build a pro-efficiency and market-friendly tax regime. Comparative to the multiple-stage cascading tax system implemented before 1994, the current tax system is credited with achievements in improving economic efficiency by eliminating the cascading effect and functioning as a level of a playing field of taxation for various economic agents. In this sense, the 1994 tax reform and subsequent incremental measures successfully established a pro-efficiency tax regime which is geared to market economy. Yet it still has room to improvements especially in confronting the new backgrounds of the oncoming time.

3. The Reasons for Launching Fundamental Tax Reform

3.1. Changes in Economic and Social Situations. No tax system is independent from the economic and social environment it roots. China's tax system is no exception. It must respond to the demands of its time in economy, politics and society. We note that the national and international environments in the field of tax system function has changed. China's ongoing tax system is facing new challenges.

Social justice as an objective of public policy is getting more substantial. The 1994 Tax Reform is actually efficiency-oriented with the principle of public policy described as «giving efficiency priority with due consideration to fairness». Since early 2000s, the Chinese government began to put more weight on social justice than on economic efficiency than before.

As we claimed in the preceding part, China has a consumption-oriented tax

system¹. In the light of traditional wisdom the consumption-oriented tax system has an advantage in raising revenues but its inferiority in income distribution and macro-economic control is remarkable, too. With the shift of public policy priorities, the tax system as a policy tool needs corresponding adjustment.

Transition of economic development mode and economic structure. China has been struggling for a new development track by avoiding the old one that depends on capital investment, natural and labor resources inputs and exports. The change of the economic development mode and the adjustment of the economic structure can promote major tax bases to alter, which set the foundation for rebuilding the future taxation structure.

Continuously increasing fiscal pressure. China is experiencing rapid increasing fiscal pressure due to aging and urbanization. A stable tax system is required to deal with such a fiscal pressure that may occur. China's current revenue system relies heavily on non-taxation sources such as state-owned resources, assets and lands. With the land fiscal pattern being under crisis, the Chinese government, especially at the sub-central level, needs a standard and stable revenue system to finance its expenditures.

The awakening of the awareness of the rights of taxpayers promotes the rule of law in tax administration. Under the planned economy the relationship between the state and taxpayers are not closely related because tax had never served as the primary source of state revenue. Moreover, all these taxes are largely collected from or withheld by enterprises and other organizations. So in China as

¹ On the one hand, China's goods and services tax can be regarded as consumption-oriented to a great extent with a consumption type of VAT as its major revenue source. Accompanied by the ongoing process reform proposal of «integrating BT into VAT», the share of VAT-to-total revenue is expected to go higher. So the consumption-oriented characteristics of China's indirect tax would be more remarkable in the future. On the other hand, China's income tax also featured the consumption-oriented characteristics taking form of treating capitals, savings and investments more favorably than doing to consumption.

in other transitional economies the tradition or culture for both administration by law and compliance and voluntary compliance are both inadequate. Up to today, government revenues are collected not according to tax codes but according to revenue plans which are formulated annually. The tax administration reform lagged far behind reforms in the field of tax policy and tax regime.

In the medium and long terms, China will face the economic development of transformation mode, the adjustment of economic structure, the task of accelerating the process of urbanization. While achieving these tasks, the pressure derived from population ageing and resource-environmental constraints will be ubiquitous; also, China will continuously participate in the process of economic globalization in the future. The boundary of its tax sovereign will definitely be affected, which will have a comprehensive impact on the elements of future tax system. The tax system reform should be saved against a rainy day and remain highly sensitive to changes in the tax structure and other elements of the tax system.

3.2. Only Incremental Reform Can't Satisfy Policy Needs. Although the previous reform of 1994 and the sequent years have succeeded in many aspects, it is not perfect yet. Those defects of China's current tax system outcrop against a new context. Plenty of critical comments have been made by people from both academic and political circles which are outlined below.

Biased tax bases. Most of disadvantages of the current tax system are related with its biased bases. China's current tax system imposes more heavily on flow of GDP rather than on stock wealth, more heavily on consumption rather than on income, and more heavily on goods and services rather than on income and property. A simplified tax base not only distorts economic agents' behavior but also limit the state's ability to realize its societal goals such as more equitable income and wealth distribution.

Higher tax rates and consumption outflow. Tax system with a comparatively single base must lead to a higher tax rate

on this specific base. That's why, goods and services in China are taxed more heavily than in its OECD counterparts where a more balanced tax base is available. Relying heavily on the consumption tax base in China has resulted in higher tax rates on domestic goods and services relative to the oversea markets. This results in weak domestic consumption and purchasing power outflow. It is reported that China has remained the top buyer of luxury goods for 3 years (since 2012, while in 2014 China's luxury consumption made up 76 % of global luxury sales with 76 % occurred overseas).

Malfunctioning of tax system. In comparison to an income-oriented and base-balanced (among consumption, income and property) tax system, which is more common in developed countries, the consumption-oriented tax system makes much more allowance for capital purchases or depreciation. From the standard point, a consumption-oriented tax is conducive for encouraging savings, investments and eventually economic growth but goes against income distribution improvement and macroeconomic stabilization. With some important tax bases such as various properties being excluded, the function of tax system will be greatly limited.

Recent researches have revealed that the tax and benefit system hardly impact on the income distribution in China. Only a tiny decrease occurs (after personal income) the tax Gini-coefficient although the situation of before-tax inequality is already very serious. The reason that China's current tax system has failed to mitigate the income disparities among individuals lies in its structural flaws. Income inequality in China results mostly from unbalanced distribution of the non-labor income and assets among people, while an extremely low tax is imposed on non-labor income and assets. Some taxable items are even out of the scope of tax under the existing tax regime.

Inconducive to the shaping of local tax system. According to traditional wisdom of fiscal theory, taxes with poor mobility are appropriate as revenue sources assigned to local governments. With the

pace of integrating BT into VAT, sub-national governments must face great losses of revenue derived from the previous business tax. While under a tax system with mobile tax bases as its major base, reasonable local tax system is hard to reconstruct.

To sum up, although the significance of the current tax system for improving socialist market economy is self-evident, it still needs to be adjusted responding to inner and external environment changes. So far, the existing tax reform measures were taken piecemeal within the primary framework of the 1994 tax regime. Despite this biased-based consumption-oriented tax system is used in the period when economic efficiency acts as public policy priority, it now needs to be reshaping and restructuring in order to meet new challenges and to satisfy new policy objectives. That means that only incremental reforms are not enough, a fundamental overall tax reform is a must.

4. Stepping into the New Stage of Tax Reform/ Fundamental Tax Reform

4.1. General Goal: To Promote the Modernization of State Governance System and Governance Capability. Actually, this comprehensive reform was under consideration when Xi Jinping and Li Keqiang administration took office in 2012. Its general goal was promulgated at the third plenum of 18th CCCPC, that is, to «promote modernization of the public administration system and administration capability» in order to remain its sovereign peace and stability. Although the definition of modern public administration has not been clarified in details in the official documents, the relationship between fiscal system and modern public administration was pointed out in the plenum which said:

«Public finance is the foundation and an important pillar of public administration. Good fiscal and taxation systems are the institutional guarantees for optimizing resource allocations, maintaining market unity, promoting social equity, and realizing enduring peace and stability».

To accomplish this general goal «we must... establish a modern fiscal system» in view of the close relationship between public administration and fiscal system². As one of the three proposed specific fiscal reform tasks that should be fulfilled in the next few years, improving the taxation system has been highly emphasized³.

It is on the third plenum that the overall target of deepening the reform in a comprehensive way was set, which is «modernization of the public administration system and administration capability». We note that the role of the fiscal system has been defined as «the foundation and an important pillar of public administration» for the first time by the highest authority. Contrasting to its traditional role to be officially recognized as tools for resource allocation, income distribution and macroeconomic regulation, the ruling party's view of the role that the fiscal system can play in the future has changed explicitly. This is the most prominent characteristics of the third phase of the tax reform. But how to accomplish the objective in the process of planning and carrying out the tax reform must be an extremely challenging task for the Chinese government. In the next part, we will focus on the goal, specific measures and supporting measures for the new round of the tax reform.

4.2. Taxation and Modern Public Administration. Since the Third Plenum of the 18th Central Committee of the Communist Party of China (CCCPC) on November 12, 2013, the direction of the tax system reform has undergone a fundamental change with its goal to switch from «establishing the basic framework of the tax system suitable to the socialist market economy» to «establishing the

² The full text is as follows: «We must improve legislation, clarify powers and responsibilities, reform the taxation system, stabilize tax burdens, have transparent budgets, increase efficiency, and establish a modern fiscal system to mobilize the initiative of both the central and local governments».

³ The other two specific tasks are improving the budget management system and establishing a system whereby the authority of office matches the responsibility of expenditure.

modern tax regime in line with the public administration system and administration capability». That mean that the tax system is regarded as not only part of the socialist market economy but also part of public administration system. So any further adjustment or reform of the tax system should take modernization of China's public administration system and administration both as a starting point and an end result as well.

To understand the roadmap of the future tax reform, we'd better clarify the relations between taxation and modern public administration. In our opinion, the essence of administration is a mechanism by which people take actions to satisfy their common needs and share related benefits and costs in a specific way. Taxation, like other tools such as fees, earmarked funds, profit delivery, etc., function as a tool to finance this mechanism. Nonetheless, the linkage between taxation and administration is not limited by financing. The way a country finances its activities and related administration reflects and to some extent determines the structure of administration in this country.

The way any country finances itself is not unimportant from the perspective of public administration. In reality we observe many less developed countries and non-market economies that finance themselves through non-tax sources, for example, state-owned assets revenues, state-owned enterprises profits, natural resources revenue and profits from money printing. For them, to obtain fiscal revenues via y these channels is easier than via taxation. When a country takes taxation as primary revenue, it is economically and politically costly to get enough revenue if the authority cannot stay in good relationship with private economy. By way of comparison, there is no such risk in financing with help of other methods as the state has a greater autonomy and control over the latter. So, with taxation as a primary revenue source, the best strategy for the state is to share revenue from the growth of private economy. Then the state tends to create and maintain an encompassing but not predatory relationship

with private economy in its own interests, which would promote a more transparent, responsive, accountable and effective government to form.

The structure of the tax mix is equally vital for public administration. Under an indirect tax system, especially under the origin-based ones, the government collects taxes at the stage of production. Its ability of revenue mobilization will not be affected even the government overlooks the taxpayers' demands. While under a direct tax system in particular those ones imposed on an individual taxpayer, the government cannot obtain revenues smoothly unless it pays more attention to taxpayers' preferences and treat them nicely.

Similarly, the tax administration plays a significant role in public administration. For instance, the taxes collected directly from individual taxpayers need a more complicated administration mechanism. By establishing effective institutions to fulfill administrative tasks the public management in general can be improved. In today's China, it has been recognized that the defects of general public management hinders tax administration and even the tax system reform. For lack of necessary information the governments of various levels even could not master the amount of taxpayers' comprehensive income, let alone their properties information, so that it is hard to make a fundamental progress to levy on individual taxpayers.

In summary, the extant researches specify the effect of taxation on public administration system as seen from four aspects⁴:

- the tax as a primary source to finance government activities;
 - the tax system functions as a tool for the government to intervene the economy or society;
 - transparent democratic taxation process which is responsive for taxpayers' needs and accountable;
 - voluntary rather than coercive compliance and enforcement according to law [2-4].
- With above understanding of the

⁴ Governance, Taxation and Accountability: Issues and Practices / OECD. Paris, 2008.

relationship between taxation and public administration on our mind, it is useful for us to revisit the extant tax system against new situations and to explore how to promote modernization of the public administration system and administration abilities via the tax reform.

4.3. Important Focus: To Develop Modern Tax System. In a standard public finance textbook the functions of public finance are always characterized as three parts: resource allocation, income redistribution and macro-economic control. But here in the Decision of the 3rd Plenum the functions of the modern public finance are redefined. Besides, the aforesaid three traditional functions are revised to a more precise version, a new function that usually can't be found in the extbook is proposed, that is, to realize enduring peace and stability.

It is the first time that the significance of public finance system (including the tax regime) has been promoted to such a height as tools of public administration in China's official documents. This implies that China's future fiscal reform (including the tax reform) must be undertaken in view of the general goal of deepening the reform in a comprehensive way aiming at promoting modernization of national public administration and administration capacity.

Thus, the role and function of the tax system has been greatly promoted and expanded. When looking at China's current tax system, it is not difficult to find its serious structural weakness. The reason why China's current tax system lacks some important functions lies in the fact that no tax category with corresponding functions exists within it. To make up the deficiency, a more balanced and modern tax system is needed in China. This situation not only causes function insufficiency of the tax system but also leads to other economic and social problems, it even triggers international trade conflicts. In fact, China's current tax system needs restructuring into a fully-functional one in order to be improved and modernized. In our opinion, the first priority task is to impose taxation on a broader economic base.

This means an increase of taxes levied on income and wealth and corresponding reduction of taxes imposed on consumption. By doing so, the percent of the direct tax to the total revenue will rise up conditionally in regard of the general tax burden which is kept constant⁵.

4.4. Reforming Measures

Constraint Condition: Keeping Macro Tax Burden Stable. Revenue-neutral requirements imply that a revenue-raising effect of certain taxes should be compensated for the revenue-cutting effect on others, and vice versa. Against China's particular background adhering to this constraint condition it is of special significance. Over the past several decades all we've heard is how to keep the tax revenue growing at a relatively high rate. This idea still dominated even when the fiscal revenue grew at the rate of more than 10% over the same period in term of GDP. Breaking away from this normal thinking pattern suggests that the Chinese government pays more attention to the quality but not quantity of the revenue generation. It is also a passive acceptance to a revenue decline since 2012 accompanied by China's economic structural transition and a reduced economic growth rate.

Table 2 provides macro tax burden of various measurements in China. It ranges from the lowest one of 21,97 % to the highest one of 36,04 % as a ratio to GDP depending on how we define the tax revenue. According to the definition of Chinese fiscal statistics, only the revenues that are collected in terms of the related tax codes are included (general public revenue in

⁵ As for the tax reform task in the near future, it is planned in the 3rd plenum like this: «We will adopt a completely standardized, open and transparent budget system. The focus of budget review will be extended from fiscal balance and deficit scale to expenditure budget and fiscal policies. We will clear up major expenditures that are linked to increases in financial revenues or GDP, and normally we will not link them up. We will establish a cross-year budget balance mechanism, a comprehensive government financial reporting system on an accrual basis, and a standardized and reasonable debt management and early risk-warning mechanism for both central and local governments».

Table 2). This ratio is similar to that one in South Korea, Japan, Australia and the United States (while in China the social security contributions are not included). By calculating in terms of the OECD's tax classification, the tax receipt (including general public revenue, government fund revenue and social security contributions in Table 2) as percentage to total government revenue goes up to 35,75 %, which is slightly higher than OECD countries' balanced average tax burden (33,8 % in 2010).

Considering that in one respect, China's rigid expenditures will continuously grow alongside with population ageing and urbanization, and on the other hand, the tax system restructuring has a revenue reducing effect at least in the short term, so the room for China to lower its macro tax burden is small. Meanwhile, China doesn't have much room for raising its macro tax burden either not only because the ratio itself is actually not low but also because the benefits that taxpayers receive don't match the costs they bear. The performances of public sectors in China are not as efficient, transparent, responsive and accountable as the taxpayer expects. All these factors make the Chinese government very careful about both the tax increase and the tax cut.

Reducing Proportion of Indirect Taxes Gradually by Replacing Business Tax with VAT. As the first step of the structural adjustment of the tax system, the selection of timing and the foothold of reducing the proportion of indirect taxes are very important. Of course, the focal point should be put on indirect taxes which have a significant impact on the tax structure. Fortunately, the ongoing «integrating BT into VAT» reform can achieve this goal. Being the first and third largest taxes of the current tax system, the revenue of the VAT and business tax is 55 % in the total tax revenue and accounts for 78,6 % of all indirect taxes. Hence, reducing the proportion of indirect taxes gradually via replacing the business tax with VAT can produce multiplying results with less efforts.

So far, the reform process of VAT-for-BT is a structural tax-reducing measure

aiming at reducing the ratio of indirect taxes as percentage to the total tax revenue. It has taken and will take three steps to achieve tax reduction effects.

Step 1: extending the scope of VAT.

By extending the scope of VAT, the cascading effects in the service sector under previous business tax were removed. From 2012 to 2014 the average amount of tax reduction reached up to 200 billion yuan each year. According to the reform agenda, VAT will be extended to all sectors around China by the end of 2015. Thus, the business tax will be repealed. By that time, the tax cut will amount to 500 billion yuan for one year.

Step 2: simplifying tax rates.

After base-extension reform task is implemented finished, VAT rates structure will be simplified in terms of four categories (17 and 11 %, 13 and 6 %) to three or two. The merge of the tax rates will further reduce indirect taxes as percentage of the total tax revenue. According to our tentative calculation based on 2012 statistics, the standard tax rate of VAT goes down by one percentage point, and the corresponding tax revenues decrease by 200 billion. Coupled with such additional taxes as the city maintenance and construction tax, education and local education surcharge attached to VAT, the total tax reduction will reach 220 billion. Assuming that VAT rate goes down by two percentage points, the overall tax reduction will amount to 900 billion yuan [5], which accounts for 8,1 % of the total tax revenue and 11,6 % of the indirect tax revenue.

Step 3: reforming the VAT sharing scheme between central and provincial governments.

Because the VAT was introduced on an original base rather than a destination-based one, goods and services taxes are imposed on manufactures. This means that most consumption taxes flow to the governments where manufacture is located or where enterprises are registered. Meanwhile, the revenues derived from VAT are shared between central and provincial governments on the original base as well, i.e., the VAT revenue goes to the

governments where it was collected according to the established proportion and not to the governments where consumption occurred. Hence, the sub-national governments have a great incentive to compete investments which creates invalid GDP and resources waste. The distorting effects on sub-national governments' behavior not only result in unreasonable expenditure structure which puts more emphasis on economic constructive expenditure than on the public goods provision but also triggers fiscal risks by accumulating massive debts.

Although reforming the VAT sharing scheme is not necessary for the VAT reform per se, it is crucial for the stability of central and local fiscal relationship. Along with the process of the VAT-for-fee reform, the VAT sharing scheme attracts more attention albeit the detailed project has not been introduced.

Raising the Proportion of Direct Taxes Gradually by Rebuilding and Strengthening the Individual Income Tax and the House Property Tax. Such a big scale of indirect tax reduction must make room for increase of direct taxes. This paves the road for increasing the ratio of the direct tax on individuals by levying the house property tax and restructuring the individual income tax. China is also considering levying the inheritance and gifts tax when the time is right.

As is known to all, the U.S. is the forerunner of the modern comprehensive personal income taxation in the world. Five to six decades ago the U.S. government tried to make domestic income distribution more equitable by adopting a more progressive comprehension-based personal income taxation. It also recommended this approach to other countries around the world. It seems that China is facing the similar situation like the U.S. experienced half a century ago.

At the stage of economic globalization, the individual tax still serves as one of the most important policy instruments of income redistribution, but the tax regime has undergone significant changes due to consideration of keeping capital and skilled-labor inboard. The highest

and average marginal rates of the individual tax both have tended downwards in recent 40 years around the world. Although the progressive rate is still dominant, the number of tax brackets has been reduced significantly. The emergence and later the popularity of flat rate is particularly remarkable.

To promote domestic distributional justice by fiscal instruments, the Chinese government has been setting the objective of launching the personal income tax reform from a scheduler style toward a combined one as early as in 1996. Nearly 20 years later, this objective has not been implemented. According to the agenda of the third plenary of 18th CCCPC, this task must be accomplished within 2-3 years (beginning from 2013). Hence, a combined style of the individual income tax reform agenda is supposed to be announced this year. Currently, the corresponding amendments of the individual income tax code are under discussion.

This oncoming reform agenda contains the feature of the dual individual income tax. The labor income and capital income will be separated and treated in a different way. Most of the labor income will be integrated and levied according to progressive tax schedules while the capital income still be staying within the scheduler system taxed at relatively lower rates. The number of tax brackets will be further reduced. Although these consensus have already been reached, certain disagreement still exist in some aspects such as the taxable unit, the exemption item, the highest marginal rate, etc.

Comparative to the individual income tax, the house property tax and inheritance and gifts tax on individuals should be seen as starting from scratch. Currently, the house property tax is in the process of legislation. Some economists warn the government should be cautious about levying this tax in case it might lead to political opposition and threaten its governing legitimacy. Yet the Chinese government has other considerations to insist on introducing the house property tax. Among them, the most important reason is to finance local governments.

Supporting Measures: To Modernize China's Tax Administration Mechanism. No matter how many reasons we have to reform the tax system, but whether or not its goal can be achieved depending on the administration conditions to a large extent. Many researchers have already emphasized an importance of administration for the tax reform success in transitional and developing countries. This judgment can be applied to China as well. For China, the adjustment of its tax mix structure has to face the knotty problem of the tax administration.

The traditional Chinese tax administration exhibits characteristics of «all-in-one collector and tax payer». Collectors not only decide on tax liability, go to taxpayers for collections, audit, but also take responsibility for tax avoidance and tax evasions. Taxpayers only pay the requested tax amount passively without any interest in how their payments are assessed. As for the tax agencies, most of them are organized in terms of the tax type. No specialization and labor division based on administration process exists.

So far, The tax agencies in China lack experiences in collecting taxes directly from the individual taxpayer. One can take the individual income tax as an example, where only incomes of employees in formal sectors can be withheld. The existing mechanism cannot administer persons with various kinds of revenues although the filing return system has already been in effect. The most important thing is that the tax agencies have no idea about the taxpayer's taxable income amount without third information reporting. Additionally, taxation is not regarded as a necessary cost for government services but as a coercive exploitation in the Chinese culture. So, the concept of voluntary compliance by the taxpayer is unpopular. In this sense, China's extant administration is incompatible with the tax system with direct taxes as its main revenues. Hence, the process of improving the tax system cannot be moved forward unless the related administration reform goes hand in hand with it.

After two decades of exploration, China eventually found its way to modernization of the tax administration in 2012. Up to date, a function-based administration process has been employed by most tax agencies especially within the separate sector which is responsible for large scale enterprises. Yet, tax administrations at local level are mostly in traditional style. As the administration tasks involved individual taxpayers, the most urgent task is to establish a service system and the third party information reporting system.

5. Conclusions

China has been at a new starting point in its history after nearly 40 years of development since 1978. Its course of reform has entered into a crucial stage and the deep water area. The further reform does not evince any Pareto improvement characteristics any more but it has to touch vested interest of elites groups. Constituting a system of fair taxation rules is of highest priority in current China where not only an economic but also a comprehensive reform strategy is required.

On the other hand, accompanied by China's economy entering into a new normal high growth, the rate of the tax revenue could not continue. Chinese tax regime is expected to evolve into a new stage with a more advanced shape, more reasonable structure, more complete function and more modernized administration mechanism.

In our opinion, future reform tasks should focus on developing a modern tax system. Yet this is a step-by-step process. We should take targeted and proactive actions to promote the tax reform process based on historical and dialectical understanding of the stage characteristics of the tax system. In this paper we illustrate what features makes the new phase of the tax reform as compared to the prior two ones and analyze what factors motivate this change ranging from changes in national policy priorities to international environments. We also portray how this tax reform strategy will be enforced in the future.

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