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The New Round of Deepening Tax Reform in China

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Abstract

In July 2024, the Third Plenary Session of the 20th Central Committee of the Communist Party of China charted a new course for China's tax reform. The reform of China's tax system has progressed through three key phases: the initial phase following the commencement of the reform and opening-up, the phase of establishing a socialist market economy, and the phase of comprehensive deepening of reforms. After a series of reforms, the current tax structure exhibits a high proportion of indirect taxes and a relatively low proportion of direct taxes, which undermines the tax system's capacity to adjust income distribution and promote macroeconomic growth. Therefore, the future trajectory of China's tax reform should prioritize increasing the share of direct taxes, with a particular focus on reforming the corporate income tax, personal income tax, and property tax systems.

Keywords

Tax Reform; Direct Taxes; Indirect Taxes; Deepening Reform; Modernization.

1. Introduction

In July 2024, the Third Plenary Session of the 20th Central Committee of the Communist Party of China adopted the "Decision of the Central Committee of the Communist Party of China on Further Deepening Reform and Advancing Chinese-Style Modernization." This document outlines a grand blueprint for comprehensively deepening reforms and promoting Chinese-style modernization, emphasizing the need to focus on building a high-level socialist market economy. Taxation, as a crucial link between the government and the market, as well as between public finance and the economy, is not only a significant source of national fiscal revenue but also plays a fundamental and supporting role in facilitating macroeconomic growth and optimizing income distribution.

As the international economic environment evolves, the challenges facing the taxation sector are increasingly prominent. China urgently needs to advance tax system reforms, accelerate the modernization of its taxation framework, and enhance the tax system to fully realize its functions in revenue generation and macroeconomic regulation. By constructing a systematic and holistic tax system, China aims to meet the requirements of a high-level socialist market economy in this new era and new journey, thereby providing robust support for the sustained and stable development of the Chinese economy.

2. A Historical Review of Tax Reform in China

Over the past four decades since the initiation of the reform and opening-up policy, China has undertaken a series of explorations and practices in tax reform. This process has been arduous and lengthy, marked by numerous challenges and setbacks. However, it has ultimately yielded significant results that have met public expectations. China's tax system has become increasingly mature, and the legal framework governing taxation has gradually improved. As a

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crucial policy instrument for macroeconomic regulation, taxation has provided a solid foundation for the sustained and healthy development of China's economy.

2.1. The Initial Stage of Reform and Opening-up: 1978-1993

In 1978, the Third Plenary Session of the 11th Central Committee of the Communist Party of China decided to shift the focus of national work towards economic development, optimize the economic structure, and promote rapid economic growth, thereby facilitating a transformation in China's market environment. Internationally, an increasing number of foreign enterprises and individuals began to invest in China; however, the domestic foreign-related tax system was still underdeveloped. Domestically, the ongoing reform and opening-up policy led to a diversification of market entities, a wide variety of goods, and a more complex distribution process, making it difficult for the traditional single tax system to address such complexities.

In response to the policy of reform and opening-up, the government prioritized the resolution of issues related to the foreign-related tax system. During this period, the state improved the income tax system and established a basic foreign-related tax framework in conjunction with the tax laws formulated in the 1950s, which met the needs of attracting foreign investment and promoting economic cooperation.

To regulate the distribution relationship between the state and enterprises, China implemented two rounds of "profit-to-tax" reforms, converting the profits submitted by enterprises into corporate income tax or other tax types. This measure clarified the relationship between the state and enterprises through taxation, making taxes a primary source of national fiscal revenue and ushering in a new phase of comprehensive development in China's tax reform.

Not only did China establish a foreign-related tax system and improve the income tax framework, but it also laid the groundwork for a tax system adapted to the socialist commodity economy through the restoration and enhancement of the tariff system, adjustments to the industrial and commercial tax system, and improvements in agricultural taxes. The establishment of this composite tax system broke through the limitations of the long-standing closed tax system, enriched the collection processes and levels of taxation, and provided a solid foundation for the deepening of subsequent tax reforms.

2.2. Stage of Economic System Transformation: 1993-2012

In 1993, the Chinese government further advanced fiscal and tax reforms by issuing relevant decisions that established the fundamental principles and main content of tax reform.

In 1994, based on the principles of "unified tax laws and reasonable decentralization," China developed a new value-added tax (VAT) system centered on VAT, supplemented by business tax and consumption tax. The scope of resource tax collection was expanded, land value tax was introduced, the individual income tax system was unified, and certain local taxes were abolished or imposed, resulting in the establishment of a novel tax system.

To balance the fiscal powers and responsibilities between the central and local governments, China categorized taxes into central taxes, local taxes, and taxes shared between the central and local governments, thereby forming two distinct tax systems. Corresponding tax authorities were established at both the central and local levels, laying the foundational framework for a tax-sharing fiscal management system.

The 1994 tax reform was the largest, broadest, and most profound reform in China's history. Its core objective was to implement a tax-sharing system throughout the entire tax reform process, aiming to construct a tax structure that aligns with the socialist market economy and the industrial modernization. With the advancement of a series of reform measures, the tax system gradually improved, leading to a fairer tax burden and a more balanced distribution of fiscal powers and responsibilities between the central and local governments. This not only

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enhanced central fiscal revenue but also ensured local fiscal stability, thereby strengthening the leverage of taxation in the economy.

Following 1994, China successively implemented a series of measures, including the abolition of agricultural tax, the unification of income tax for domestic and foreign enterprises, the improvement of personal income tax, and the advancement of VAT reform, further consolidating and deepening the achievements of the tax-sharing reform.

2.3. Phase of Comprehensive Deepening of Tax System Reform: 2012 to Present

In 2012, the convening of the 18th National Congress of the Communist Party of China provided a strategic guideline for the development of fiscal reform and marked the beginning of the phase of comprehensive deepening of tax system reform. Since then, tax reforms have been continuously advanced, leading to a more scientifically established tax structure, optimized tax system, improved legal framework, and increasingly efficient tax administration, resulting in profound transformations in the national governance system and governance capacity.

In response to the directive of the "Decision of the Central Committee of the Communist Party of China on Several Major Issues Concerning Comprehensive Deepening Reform," which emphasized "reforming the tax system and stabilizing the tax burden," China has implemented a series of tax reform measures. In terms of value-added tax (VAT), China initiated the "replacement of business tax with VAT" reform, streamlined tax rates, and established a standardized consumption-oriented VAT system. Regarding consumption tax, adjustments were made to the scope of collection, tax rates, and collection procedures. For personal income tax, a system combining comprehensive and classified taxation was implemented. In the area of resource tax, a value-based assessment approach was adopted, and the scope of taxation was gradually expanded.

Following these deep reforms, China's tax system has become more standardized, tax burdens have been alleviated, the proportion of direct taxes has increased, and taxation has played a pivotal role in enhancing national governance capacity, allowing the process of deepening reform to advance steadily.

3. The Current Status of the Development of China's Tax System

Through multiple reforms, China's tax structure has gradually simplified and become more rational, adapting to an economic landscape characterized by diverse levels of productivity and various modes of operation. This has resulted in a tax system primarily based on turnover taxes, supplemented by income taxes and property taxes. In the course of these reform explorations, the government has progressively constructed a tax structure that aligns with the socialist market economy; however, this has also given rise to several new challenges.

3.1. Imbalance in the Tax Structure

High Proportion of Turnover Taxes. In China's turnover tax system, the proportion of turnover taxes has long been relatively high, particularly in the case of value-added tax (VAT). Since the implementation of the "tax-sharing system" reform in 1994, VAT has consistently served as a major pillar of tax revenue. In 2016, with the comprehensive rollout of the "transition from business tax to value-added tax" reform, VAT and business tax were merged, further solidifying VAT's status as the most significant turnover tax in China.

Low Proportion of Income and Property Taxes. Following multiple rounds of tax reform, especially the corporate income tax reform in 2008 and the individual income tax reform in 2018, the proportion of income taxes has shown an upward trend. Income taxes encompass a wide range of sources and have a solid tax base, with their growth rate and share significantly outpacing those of property taxes. However, both income and property taxes still represent a

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smaller proportion compared to turnover taxes. Moreover, the existing property tax system faces challenges such as double taxation, unclear definitions, and a narrow tax base, indicating that the property tax framework remains incomplete.

3.2. Insufficient Regulatory Capacity

The imposition of indirect taxes by the state is aimed at fulfilling the revenue requirements, while direct taxes are designed to adjust income distribution. However, China's tax system, primarily based on turnover taxes, has resulted in an excessively high proportion of indirect taxes and a relatively low proportion of direct taxes. This leads to a regressive tax burden that fails to effectively play its role in income redistribution, further exacerbating wealth inequality among different groups.

From the perspective of indirect taxes, mechanisms for tax burden transfer, such as those associated with value-added tax (VAT) and consumption tax, enable enterprises to shift tax liabilities onto consumers by raising the prices of goods and services. This transfer of tax burden results in the distribution of tax liabilities across various economic agents, diminishing the directness and precision of tax regulation. Regardless of income levels, both high- and low-income individuals are subject to the same tax rate when purchasing goods, thereby causing indirect taxes to exhibit a "regressive adjustment" effect. For low-income groups, the proportion of consumption expenditures relative to income is significantly higher, rendering their tax burden comparatively heavier and further intensifying social inequality. Consequently, the objective of redistributing wealth through taxation becomes challenging to achieve effectively. The inherent nature of indirect taxes distorts market prices due to tax factors, leading to distorted price signals and ultimately causing consumer behavior and business decisions to deviate from optimal pathways. Consumers may lose their desire to spend, resulting in a decline in consumption demand; similarly, businesses may reduce their investments in technological innovation and product development due to rising costs, redirecting their resources toward cost reduction or tax avoidance strategies. This behavior not only affects long-term competitiveness but may also hinder technological advancement and product upgrades across entire industries, dampening firms' investment enthusiasm and willingness to expand.

From the perspective of direct taxes, the relatively low share of direct taxation indicates a lack of effective means to adjust income distribution. The primary tool for addressing income disparity in China is the individual income tax (IIT). However, due to a narrow tax base and limited overall tax revenue, the IIT struggles to exert significant regulatory influence, failing to effectively narrow the wealth gap. Specifically, the current personal income tax system imposes a relatively light tax burden on high-net-worth individuals, particularly concerning the taxation of capital income. Although recent years have seen the introduction of policies aimed at stricter tax administration for high-net-worth populations, the overall tax enforcement on capital income remains insufficient. This results in high-income individuals bearing a relatively low tax burden while accumulating capital income, further widening income disparities. Additionally, the absence of property taxes diminishes the effectiveness of taxation in adjusting wealth distribution. The property tax system is still underdeveloped, with a narrow coverage and limited types of taxes, leading to high-value assets such as real estate and land being inadequately taxed. The lack of effective property or inheritance tax systems allows high-net-worth individuals to maintain their wealth through the ownership and inheritance of real estate, depriving other social strata of the benefits of effective tax redistribution. This encourages substantial real estate investment and speculation, disrupting the property market.

3.3. The Boundaries between Different Tax Categories are Unclear

In tax theory, the classification between direct and indirect taxes is typically based on whether the tax burden can be shifted. However, there remains a degree of conceptual confusion

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regarding this classification standard in the study of existing structural issues within the tax system.

Corporate income tax is often categorized as a direct tax due to its alignment between the statutory tax burden and the actual taxpayer. Nevertheless, in practice, the burden of corporate income tax can be partially transferred to consumers, employees, or other stakeholders through mechanisms such as price adjustments and reductions in employee compensation.

Similarly, the payments related to land transfer fees and land value increment tax within property tax frameworks also exhibit characteristics of indirect taxes. The collection of these fees does not directly target the property held by landowners; rather, it is levied on the act of land transfer. Consequently, the costs associated with land transfer fees and land value increment tax are frequently passed on to the buyers of land use rights or developers, ultimately being transmitted to the end consumers through subsequent pricing adjustments.

Moreover, while classified as indirect taxes, consumption taxes also embody direct tax characteristics. Although businesses can pass on the consumption tax to end consumers, households are unable to transfer this tax burden, thereby rendering it akin to a direct tax.

Therefore, categorizing taxes solely based on whether the tax burden can be shifted is not entirely accurate. As the country undertakes tax reform, it is essential to solidify the theoretical foundations of taxation and clarify important fundamental concepts.

4. Main Pathways for Deepening Tax System Reform

4.1. Adhere to the Principles of Equity and Efficiency

The coordination and unification of equity and efficiency is an essential principle that must be adhered to in tax reform. An effective tax system should balance both equity and efficiency, which is an intrinsic requirement of deepening reforms in the new era. An equitable tax system contributes to narrowing the wealth gap in society, thereby promoting social harmony and stability. The principle of tax efficiency serves to constrain and regulate government taxation behavior, while enhancing tax efficiency is a key pathway to achieving a Chinese-style modernization. Through tax reform, China aims to further balance the tax burdens among different groups, enhancing the tax adjustment function without compromising economic efficiency.

4.2. Consolidating the Theoretical Foundation of Taxation

There exists a degree of confusion in China regarding the definitions of direct and indirect taxes, highlighting the necessity of solidifying the theoretical foundation of taxation. This is particularly crucial for ensuring the scientific and effective nature of tax reform. In the process of clarifying tax theory, the government should enhance its research on the concepts of direct and indirect taxes, establish clear classification standards for tax types, and ensure the application of sound tax theory in the design and reform of the tax system.

To maintain the unity and stability of the tax system, the government should adhere to the principle of tax legality, ensuring that all tax types, rates, elements, and procedures are clearly defined through legislation. In addition to reinforcing the theoretical foundation, it is essential to enhance the practical effectiveness of tax reform. The government should establish a feedback mechanism between tax theory and practice, validating theories through practical application and promptly adjusting and refining tax policies as necessary.

4.3. Optimize the Tax System Structure

The balance and coordination between direct and indirect taxes are crucial to China's economic development level, tax efficiency and equity, as well as per capita national income. Despite several rounds of tax reforms leading to a gradual increase in the proportion of direct taxes, it

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remains lower than that of indirect taxes. Given that direct taxes can effectively adjust income distribution, increasing their share continues to be a focal point of the current tax reform.

4.3.1. Corporate Income Tax

China should enhance the preferential policies for corporate income tax to alleviate the burden on enterprises and unleash their potential.

Firstly, the government should increase the ratio of additional deductions to reduce the tax burden, encouraging greater investment in research and development (R&D) while easing the tax liabilities of high-tech and innovative enterprises.

Secondly, industry restrictions within the corporate income tax should be eliminated. The standards for tax incentives should be linked to the actual R&D and innovation activities of enterprises, reducing the reliance on high-tech enterprise recognition as a prerequisite for tax rate benefits. This approach can broaden the scope of tax incentives, encouraging more enterprises to engage in technological innovation and industrial upgrading, thereby avoiding compliance-driven innovation merely to obtain tax benefits.

Thirdly, a modest reduction in the tax rate is warranted. Currently, China's corporate income tax rate is relatively high on a global scale, slightly exceeding that of many developed countries. To enhance the overall competitiveness of domestic enterprises, attract foreign investment, and prevent capital outflow, the government should consider lowering the corporate income tax rate.

4.3.2. Personal Income Tax

The government should enhance tax regulation for high-income groups while providing more tax benefits and exemptions for middle- and low-income earners, based on improving tax system efficiency. However, the current effectiveness of personal income tax in adjusting income distribution in China is not significant and requires urgent adjustments.

With the diversification of income sources, an increasing amount of income is no longer solely derived from labor but also includes property and capital income. To achieve tax fairness, the government should gradually expand the scope of comprehensive taxation in the future, incorporating more categories of income tax into the overall income, thus comprehensively reflecting taxpayers' overall tax-paying capacity.

The intensity of tax benefits should also be adjusted. For middle- and low-income groups, a reasonable exemption threshold should be established to avoid excessive tax burdens due to income increases. Additionally, the scope of medical expense deductions should be expanded to benefit special groups such as the elderly and the disabled. At the same time, tax benefits for research personnel should be increased to support the innovation-driven development strategy and the strategy for building a strong nation in terms of talent.

4.3.3. Property Tax

Optimizing the structure of property taxes is a crucial approach to implementing the principles of tax fairness and efficiency.

China's existing property tax system remains underdeveloped, with taxes like land appreciation tax, deed tax, and urban land use tax mainly focusing on land and real estate transactions. These taxes are not strongly linked to individual wealth and thus have limited effectiveness in redistributing income. Although the vehicle and vessel tax has certain property tax characteristics, its tax base is not value-oriented, so its impact on income distribution is weak.

The scope of real estate tax should be determined by balancing factors such as social equity, economic efficiency, and administrative complexity. During real estate tax reform trials, the government has cautiously set tax rates at modest levels, limiting the tax's effect on adjusting high-income groups' wealth. Therefore, the government should enhance the supporting measures for real estate tax, including the construction of a nationwide personal property

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information platform to track residents' income and wealth. By quantifying the value of property and implementing grid-based management, the government can clearly define the real estate tax base, regulate wealth accumulation, prevent tax evasion and illegal income accumulation, and ensure fair wealth distribution while improving tax efficiency.

5. Conclusion

China's tax reform is an ongoing process of adapting to economic development and progressively deepening adjustments. Since the reform and opening up, China has continuously developed and refined its tax system. It began by establishing a tax structure compatible with a socialist market economy, progressed to the implementation of a tax-sharing system, and has since focused on optimizing tax structure and increasing the share of direct taxes, building an institutional framework aligned with market economy principles.

At present, given the shifts in both domestic and international economic contexts, taxation plays an increasingly crucial role in income redistribution, resource allocation, and the sustainable development of the economy and society. Further deepening of China's tax reform is essential to achieving high-quality growth and promoting common prosperity. Future reforms must persist in strengthening the theoretical foundations of taxation, optimizing the tax structure, and enhancing tax governance capabilities to strike a balance between equity and efficiency.

On this basis, China’s tax reform should emphasize institutional innovation and legal development. This entails gradually establishing a comprehensive property tax system, reasonably adjusting income tax burdens, and further refining local tax systems. Such measures will lay a solid foundation for building a unified, standardized, and efficient modern tax regime, thereby bolstering the government's capacity for macroeconomic management, enhancing national governance, and providing sustained momentum and institutional support for China's high-quality development and the realization of Chinese-style modernization.

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