China's fiscal and taxation system has been reformed many times in recent years and has conformed to the operation of the market economic mechanism. However, there are still many aspects requiring further reform.

I. The Situation of China's Fiscal System

1. The evolution of China's fiscal system

Before 1978 China had adopted the fiscal system of highly centralized management in accordance with the centralized and planned economic system at that time. Unified control over revenue and expenditure was exercised in public finance. Under such a system, the local governments were required to turn over all their revenues to higher governments, which would then allocate the expenditure of the local governments; the state-owned enterprises were to turn all their profits to the fiscal administrative divisions, the expenditure of the enterprises would then be set the unified standards and subsidies for the losses of the enterprises would be provided by fiscal departments. The Ministry of Finance examined and allocated all the spending of the administrative divisions and public institutions.

Such a fiscal system was not able to meet the needs of the economic development and the increased economic efficiency. In 1978 China started to carry out reform to change her planned economy into market economy. To conform to the overall situation of the reform, a series of transformation reforms were carried out in fiscal system during this period and the former highly centralized fiscal system was gradually broken.

In 1994 China launched a large-scale campaign to reform her fiscal and taxation system. Focusing on establishing a new taxation system and adopting a tax-sharing system whereby the tax revenue is divided by both the central and the local governments, the campaign is aimed at making the fiscal system suitable to the operation of the market economy and will gradually conform to international conventions. Drawing extensively on the experience of the countries with market economy, the campaign initially embodied fair competition, the common principle of the market economy. In short words, a big leap forward was made in the reform of taxation system in 1994, but there were still many problems in carrying out the
tax-sharing system. A perfect tax-sharing system is beneficial to defining the fiscal relations between the central and local governments, stabilizing the regular income of the local authorities, and arousing the enthusiasm of the local governments for collecting taxes. However, the tax-sharing system this time showed too much concern for the vested interest of the former system and lacked the standard system of transfer payment, thus needing further improvement.

2. Achievements in reform of the fiscal system in recent years

At present China has initially established a frame of the tax-sharing system and has basically standardized the relations between the government and taxpayers from the angle of the taxation system. Compared with the situation before the reform, great changes had taken place either in the system or in the volume and the structure of the government funds.

In view of government expenditures, the division of expenditure responsibilities of the governments at various levels is basically conformed to the international conventions and is featured by quite big management power for the governments at all levels. After the reform, the expenses of the scientific research, education, culture, public health and administration rose quickly and the debt service payments in the total expenditure also went up. Thus, the emphasis of the expenditure is more approaching the governmental public economic management functions of the international conventions. Meanwhile, the burden of governmental expenditure in China has gradually been transferred to the lower authorities following reform. The local governments have heavier and heavier burden of expenditure. On the one hand, this is because the projects administrated by the local governments including those of scientific research, education, culture and public health have been developing rapidly. On the other hand, it is because the quick increase of the salaries of administrative expenses has produced more impact on the local governments than the central government as the local governments pay for quite a large amount for the personnel of administrative and public institutions.

In view of the government revenue, taxes have gradually become the major source of the government revenue after the reform. In particular, the reform of the taxation system carried out in 1994 was aimed at unifying tax laws, realizing fair taxation, simplifying the taxation system and paving the way for a thorough exercising of the tax-sharing system. The reform covered a wide scope, had a strong impact and made the taxation system more reasonable and simpler. Meanwhile, the reform of the taxation system is also aimed at realizing the principle of fair taxation, partly solving the problem of tax laws with diversified, dual or even multiple standards, and creating conditions for fair competition among all the major economic bodies.

In view of the division of income, the total revenue is to be divided into the regular fiscal revenue of the central government, the regular fiscal revenue of the local governments and the fiscal revenue is to be shared by both the central and local governments under the 1994 tax-sharing system. The central government is required
to return some of the tax revenue and give some special allocations to the local
governments. But the amount is to be decided in the light of the amount of subsidies
the central governments gave to the local governments and the amount of the tax
revenue the local governments turned over to the central government under the former
system. The special allocations refer to the conditional allocations given on a selective
basis by the central government for the local social and economic projects.

In view of the total amount of the governmental fund, the budgetary fund accounts for
merely 12 percent of the gross domestic product (GDP) at present. The proportion is
not only much lower than that of the developed countries, but also lower than that of
some developing countries.* Such a situation does not reflect the actual achievements
China made in the economic development in recent years. As known to all, the
government service and supply of the pure public goods such as the national defense,
judicature and economic management is the essential condition for the economic and
social development. The social public facilities and the economic infrastructure built
with government investment are also an important factor for promoting the economic
development.

How to appraise the scale and distribution of China's governmental funds? An
analysis shows that the usable funds of the Chinese government includes not only the
budgetary fund,* but also the non-budgetary fund, which mainly consists of the
off-budget fund and the governmental non-tax revenue including various kinds of
charges and funds. While the proportion of budgetary funds to GDP went down year
by year, the non-budgetary fund has grown rapidly. Taking into account all these
governmental funds, the proportion of the government revenue to GDP will surpass
25 percent.* This proportion is equal to or a little higher than that of most developing
countries. This is one of the important factors for the quick development of China's
economy in recent years.

In view of the distribution of the governmental fund between the central and local
governments, the central government makes up 24 percent. After deducting the
transfer payment from the central government to the local governments, the central
government accounts for about 15 percent.* This shows the diversification of the
governmental finance in China.

II. The Problems in China's Fiscal System

Generally speaking, the reform of the fiscal system in China in the past years has
made achievements mainly in the area of government revenue, though further reform
needs to be carried out in this aspect. In expenditure, especially in budgetary
expenditure drafting, however, the reform has remained weak.

1. The taxation system needs further improvement
It is now the seventh year since 1994 when the current tax system went into effect.
The background for designing this system at the time has changed significantly. So,
there is an obvious lack of conformity between the system structure and the current situation. The problems include the heavy taxes imposed on investors and the big difference between the taxation policies towards the domestic-funded and foreign-funded enterprises and towards various regions, all of which violate the principle of fair taxation. Such a system structure is harmful not only to bringing into full play the effect of the macro economic policies for promoting the aggregate demand, but also to the deepening the reform of the state-owned enterprises. Therefore, readjustment of the taxation system structure must be enforced.

In addition, the division of the central and local governments power on taxation is not clear at present. Meanwhile, the local taxation system is too imperfect to secure a stable income source for the local governments. The management of taxation will also be further improved.

2. The scope of the fiscal expenditure need to be further standardized
At present, there are both “power-overstepping” and “duty-neglecting” in the basic government expenditure structure. On the one hand, the government undertakes too many things and is still interfering in some activities that should be dealt with by the market. For example, the governments at various levels are still responsible for the circulating funds needed by the enterprises for their production and business. These however belong to the field of competition. To some extent, different governments are still responsible for different kinds of the funds needed by the public institutions that engage in operating business.

On the other hand, the compulsory education, basic scientific research, public health care and public facilities, which should be funded by the governments, do not have enough funds for development. There is a big gap between the real demand and the funds the governments give. Meanwhile, the number of institutions and personnel supported by the fiscal revenue continues to grow quickly. A significant part (more than two thirds for those poor counties) of the yearly-added fiscal revenue has to be set aside for the payment of personnel fees. Many counties cannot even pay whole salaries on time.

3. The shortcomings of the tax-sharing system
The tax-sharing system is aimed at standardizing the fiscal relations between the central and local governments, yet reform is very difficult. A fiscal system should reasonably divide the revenue of the governments at all levels and enable various governments to have their own stable income sources. The tax-sharing system established in the reform in 1994 still has many problems. Particularly, the reform was carried out on the basis that both the amount of the revenue that the local governments should turn over and the amount of subsidies that the central government should distribute under the former contract system should basically remain unchanged. This gave to a large extent preferential treatment to the vested interests of the former system in various regions and was not able to break through the former distribution structure formed on the basis of one-to-one bargaining.
In addition, no standardized system of transfer payment from the central government to the local governments has been established and too large a part of tax revenues turned over is returned. As a result, the gap of income among the regions after adopting the tax-sharing system becomes bigger and bigger and the income of the local governments does not often conform to their functions. In designing the tax-sharing system, a large part of the tax revenue turned over is to be returned so as to arouse the enthusiasm of the local governments for collecting taxes. Since the rich regions have more tax revenue, they have a relatively larger amount of returned sums and thus become even richer in local governmental funds. In contrast, the governments of the poor regions are relatively short of funds. Moreover, the fund for transfer payment used to maintain the inter-regional balance is less than one tenth of the returned tax revenue.

4. The budget management still adopts the method of the old system
There are many problems in budget management in China. First, the scope of the budget is incomplete, thus unable to reflect the overall situation of the use of governmental funds and consequently unable to reflect the situation of the implementation of the governmental functions. Second, the budget drafting method is unscientific and there are not enough details available. As a result, the distribution and application of the budgetary fund is not transparent enough and the legal restricting force on the budget is lowered. Third, the design of the budget items and categories does not conform to international conventions. Thus, it is impossible to make comparative studies. In addition, there is no required system of essential standards for quotas and no unified standards for various concrete items of expenditure.

Such a budget is not only difficult for the legislative institutions to carry out any budget examination, but it is also harmful to the standardized implementation and legal supervision of the budget. Besides, the diversified channels of the fund distribution result in a diversified management of the governmental fund. Large amounts of charges and funds remain idle and not included in the budget. Thus, the budget is not able to accurately reflect the overall picture of the governmental revenue and expenditure. Moreover, it is difficult to make a unified arrangement and any standardized management of the budget. It will result in a low efficiency of expenditure.

5. Problems in treasury payment system
At present, China employs the decentralized treasury payment system, under which the annual total budget quota distributed to various departments is allocated on schedule to the respective departments and is used independently by the departments. The major problems of such a practice include that the expenditure process of the governmental fund is removed from fiscal supervision and that causes information feedback delays. The fiscal departments can only rely on the financial reports of the departments making the expenditure to carry out supervision afterwards and cannot quickly discover and curb any actions violating the disciplines and laws in the expenditure process. It is also difficult for them to make timely and accurate
judgements on the economic situation. The decentralized payment and deposit system will surely result in a low efficiency of fund use. In addition, on the one hand, the budgetary fund is scattered and deposited in various units. On the other hand, the fiscal departments have to borrow loans from the bank to deal with the needs for short-term funding, thus increasing the interest burdens of the government.

III. Further Reform of China's Fiscal System

The further reform of China's fiscal and taxation system will put the emphasis on establishing a framework of public finance suitable to the market economy. In the mixed economic system,* the existence of the government is essential and the governmental functions are constantly expanding. Implementation of the governmental functions needs to be on the basis of a secured income. Therefore, a well-functioned fiscal and taxation system is an important condition for smoothly implementing the governmental functions. At first, it is necessary to define what are the government functions in the market economy, in what fields and how the government functions will be implemented. Second, it is imperative to define the scope and emphasis of the revenue and expenditure of the governments at various levels on the basis of defining the functions of these governments.

1. Further improvement of the taxation policies and system

It is necessary to readjust the policies towards taxation and the system of taxation in order to make the implementation of policies more effective, make them comply with the new macro economic policies, and support the reform of the state-owned enterprises. At present, the emphasis should be put on the reform of the value-added tax bases, the expansion of the value-added tax scope, and the unification of the income tax standards for domestic-funded and foreign-funded enterprises. It is also necessary to improve or add some other kinds of taxes including an individual income tax and a social insurance tax and to improve the local taxation system. Local authorities will be given a certain right to tax legislation. Meanwhile, administration of tax collection needs to be further strengthened.

First, it is necessary to change as soon as possible the value-added tax, which impedes investment. The value-added tax designed in 1994 is harmful to investment at both the aspect of tax bases and the aspect of tax scopes. The provision that the production-based value-added tax is not allowed to offset the taxes on purchased capital goods has played an obvious role of impeding investment, particularly in those capital-intensive enterprises. To make a practice impeding the investment for a long period will affect the continuous economic growth. It is urgent to change this into a consumption-oriented tax base.

The current value-added tax does not include all kinds of commodities and labor service. Excise tax, which cannot be deducted, is imposed on most kinds of labor service and the sales of intangible assets and real estate further impeding investment.
Only by having the characteristics of both a wide tax scope and a unified tax ratio can the value-added tax achieve the advantages of fair taxation.

Second, it is imperative to unify as soon as possible the income tax on domestic-funded and foreign-funded enterprises, so as to realize a fair competition on the fair taxation among all the enterprises. At present, the tax rates are not unified. Additionally, there are many preferential policies towards foreign-funded enterprises. These lead to a big gap in the tax burdens among enterprises. It is estimated that the tax burden of a domestic-funded enterprise is more than double that of a similar foreign-funded enterprise. One of the negative impacts of such a taxation system is that some domestic-funded enterprises are stimulated to falsely report as foreign investment. This is a distorted action stemming from the wrong policies.

Meanwhile, it is necessary to reform the deduction system of the enterprise income taxes and to strive to realize compensation of full costs. The insufficiency of the cost compensation of domestic-funded enterprises is shown as follows: The set depreciation ratio at present is obviously too low. The compensation of the labor cost is insufficient. The wages of the domestic-funded enterprises are not allowed to be completely deducted. For example, the expenditure on pensions should make after paying income tax. R&D expenditure accounts for a very low proportion in the total expenditure of the enterprises.

2. Acceleration of the budgetary system reform
The current budget system is far from the demand of the market economy and needs to be reformed as soon as possible. Besides the reform of the aspects such as the budget drafting procedure, the scientific classification system and the system of formulating standards for fees and funds, it is even more important to carry out reform aiming at establishing a complete budgetary system consisting of the governmental public budgets, state-owned capital budgets and the social security budget. Such a system should be unified, standardized, clear and easy for legislative institutions to check and supervise and needs to be in conformity with international conventions.

The current reform of the departmental budget is an important step towards unified budget management. It operates in the following way: the grassroots units of all the ministerial departments make their own general budget are budgeted according to their functions and the needs of their social development and submit the budget to their ministerial departments. Then, the ministerial departments summarize and examine the budget together with the Ministry of Finance before submitting the budget to the legislative institutions for approval. However, since a large part of non-budgetary funds is not included in the budget management at present, the data about China's total governmental funds are inaccurate. Apart from this, the sources of such fund are unfairly used and are not economical. Thus, it is absolutely necessary to make unified budget management of the Chinese government's funds.
While reforming the tax and charges, non-budgetary funds must be checked. The charges on some public goods and services with a spillover effect will be changed into taxes. The management of the charges on some items in which the beneficiaries and payers are directly related to each other will be standardized. At the same time, illegal charges are to be completely abolished. By then, a perfect, unified and open budget management system will be established.

In coordination with the reform for the departmental budget is the reform aimed at establishing a government procurement system. Under the system, the direct budgetary expenditure such as the expenses on strengthening of the political power, public facilities, scientific research, education and wages should adopt the competitive method of inviting bids so as to raise the efficiency of the use of government funds and reduce the rent-seeking chances.

To establish a centralized treasury payment system is another important aspect of the current reform of the budget management system. All governmental funds will be paid through a single account of the treasury, thus being able to avoid the problems existing in the above-mentioned former treasury payment system.

3. The reform of other aspects
First, it is necessary to further readjust the scope of the government expenditure according to the theory of public finance to optimize the expenditure structure and raise the efficiency of resources allocation. The governmental allocation of resources will withdraw from the field of competition. The expenditure on public projects including public facilities, social insurance, science and education, environment protection and national defense will be raised so as to create a good environment for economic growth.

Second, in coordination with further reform of the tax-sharing system, a standardized system of transfer payment is to be established thereby creating the equalization of the public service in various regions. It is the duty of the central government to narrow the excessively large gap between the poor and the rich regions. Therefore, it is one of the important aspects of the reform of the fiscal system to establish as soon as possible a reasonable and effective system of transfer payment in order to form a fair means for inter-regional readjustment.

Third, it is necessary to rationally apply the policy of treasury bonds and strengthen administration of treasury bonds. Meanwhile, it is imperative to make plans about formulating sets of rules on issuing and administration of local bonds. Although the local governments have now been forbidden to issue local bonds so far, they have been actually issuing disguised local bonds in their many practices. It is now necessary to include such practices in more standardized fiscal management.
Finally, it is necessary to establish a complete system of fiscal laws and regulations and a complete system of supervising institutions both within and beyond the fiscal departments.

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