

A review of tax-sharing reform and related thoughts

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Begun in 1994, tax-sharing reform in China has been a major adjustment to and innovation within the taxation and fiscal system. Yet, despite its sound policy effects on the economy, there is still room for improvement. This essay starts with a review of its implementation and problems over the past 20 years, and based on that, seeks to discuss some enablers of deeper fiscal reform. The essay also goes into details in the analysis of measures for completing a hierarchical fiscal system, making the division of administrative power more rational, having a clearer definition of centrally and locally owned revenues, optimizing the transfer payment system, and improving the fiscal system below the provincial level.

Keywords: tax-sharing system, fiscal system, transfer payment

1. Review and analysis of tax-sharing reform over the past 20 years

Since its founding, to cope with variations to economic and social needs at various stages of development, China has practiced a number of reforms and fiscal management measures. From centralized to decentralized ownership of fiscal revenue and administrative authority of public finance, the power of both collecting and spending tax revenues used to be in the hands of the central government in the early years when the war-torn economy was recovering. Beginning with the inception of the first five-year plan, the fiscal system developed, to different degrees at different times, into a state-led, hierarchically managed system. Then, various forms of fiscal responsibility were introduced to ensure that local governments were engaged in the then-freshly minted policy of reform and opening. Since 1992, when the Fourteenth CPC National Congress set the vision of a socialist market economy, China has incorporated experiences from mature market economies into its reality and launched tax-sharing reform, income tax-sharing reform, and reform of the export rebate mechanism, among others.

Tax-sharing reform is the most powerful, extensive, and influential of all the innovations to the fiscal system. It is a major adjustment of great significance. In 20 years of practice, the general direction of reform has been in line with the internal requirements of the socialist market economy, and positive effects on the economy have occurred in the process. To be specific, reform has had the following outcomes.

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1.1. The first outcome is a hierarchical fiscal framework compatible with the development of the socialist market economy

Designed on general principles—maintaining the base amount of fiscal revenues and reallocating increments, ramping up state-level macro-control, and building an appropriate mechanism of public finance distribution—and executed on the basis of “three divisions, one refund, and one transfer” (that is, division of revenues, expenditures and tax authorities, tax refunds, and transfer payments), the reform and ensuing regulations frame the fiscal relationship between the central and local governments.

1.2. Reform has led to stronger motivation of all stakeholders and more robust public finances

The 1994 reform laid out clearer, more reasonable rules of taxation on businesses and individuals and revenue distribution between the central and local governments. The consequent boost to the willingness of governments at all levels to stimulate economic growth, strengthen taxation oversight, and collect tax payments has ensured steady, growing streams of fiscal income. From 1993 to 2012, national fiscal income rose 26.96 times from 434.9 billion to 5.62 trillion yuan, an annual increase of 19.02%. The proportion of fiscal income to GDP grew from 12.30% to 22.58% (See Table 1).

1.3. Reform has consolidated control and coordination of regional development at the state level

Tax-sharing reform has gradually resulted in a mechanism for the steady growth of revenue going into central government coffers. This is key to the subsequent ascent of its proportion of total national fiscal revenue. By implementing tax-sharing reform in 1994 and income tax-sharing reform in 2002, the central government has gained a large majority of income collected from main taxes, and the share that the centrally collected revenues account for among all levels of governments shot up from 22.00% in 1993 to 47.91% in 2012 (see Table 1). This gives the central government stronger leverage by which to achieve steadily rapid economic growth and long-lasting peace and stability. That partly explains why China in recent years has managed much of what was previously unattainable. For example, it knitted together a stronger social safety net for the poor, granted more funds for scientific research and education, and spent more on building infrastructure. In face of the financial crisis that erupted in 2008, China was able to adopt proactive fiscal policies, came up with initiatives aimed at boosting consumption of home appliances and vehicles in the countryside, and introduced a home appliance trade-in scheme. Another benefit of the beefed-up fiscal capacity is that transfer payments have gathered pace (see Table 2), which helps to narrow the gap in public finances among regions.

Table 1
The proportions of national revenue to GDP and central government revenue to national revenue (1993-2012)

Year	National Fiscal Revenue (billion yuan)	GDP (billion yuan)	Proportion of National Fiscal Revenue to GDP (%)	Central Government Revenue (billion yuan)	Percentage of Central Government Revenue to National Revenue (%)
1993	434.895	3533.39	12.30	95.751	22.00
1994	521.81	4819.786	10.80	290.65	55.70
1995	624.22	6079.373	10.30	325.662	52.20
1996	740.799	7117.659	10.40	366.107	49.40
1997	865.114	7897.303	11.00	422.692	48.90
1998	987.595	8440.228	11.70	489.2	49.50
1999	1144.408	8967.705	12.80	584.921	51.10
2000	1339.523	9921.455	13.50	698.917	52.20
2001	1638.604	10965.52	14.90	858.274	52.40
2002	1890.364	12033.27	15.70	1038.864	55.00
2003	2171.525	13582.28	16.00	1186.527	54.60
2004	2639.647	15987.83	16.50	1450.31	54.90
2005	3164.929	18308.48	17.30	1654.853	52.30
2006	3876.02	20940.7	18.50	2045.662	52.80
2007	5132.178	24661.9	20.80	2774.916	54.10
2008	6133.035	30067	20.40	3268.056	53.30
2009	6851.83	34090.3	20.10	3591.571	52.40
2010	8310.151	40120.2	20.71	4248.847	52.40
2011	10387.44	47156.4	22.03	5132.732	49.41
2012	11725.35	51932.2	22.58	5617.523	47.91

Source: Statistics for 1993-2011 are from *China Statistical Yearbook (2012)*, China Statistics Press, 2012. Statistics for 2012 are from National Fiscal Accounting 2012, Ministry of Finance, <http://yss.mof.gov.cn/2012qhcjzs/index.html>.

1.4. Reform has also contributed to a certain extent to restraining blind investment

Tax-sharing reform makes the number of tax sources and the amount of revenue available for local development less relevant. By consigning all consumption tax revenues of merchandises like cigarettes and wine and a big part of VAT to the central government, and by the introduction of income tax-sharing rules that follow the same logic, the reform waters down the drive at the local level for extensive development of industry and blind investment. In turn, local governments are encouraged to develop their tertiary industry because they are permitted to retain business tax revenues generated from it. In this way, a positive change has occurred in local economic behavior and investment decisions, and hence, a better industrial structure and development model.

Table 2

Tax returns and transfer payments from central to local governments since 1994

Year	Transfer Payments from Central to Local Governments (billion yuan)	Local Fiscal Expenditures (billion yuan)	Proportion of Transfer Payments to Local Expenditure (%)
1994	59	403.819	14.61
1995	66.6	482.833	13.79
1996	72.4	578.628	12.51
1997	78.9	670.106	11.77
1998	120.2	767.258	15.67
1999	187.1	903.534	20.71
2000	254.1	1036.665	24.51
2001	380.9	1313.456	29.00
2002	434.6	1528.145	28.44
2003	463.3	1722.985	26.89
2004	617.2	2059.281	29.97
2005	732.997	2515.431	29.14
2006	914.355	3043.133	30.05
2007	1399.09	3897.086	35.90
2008	1870.86	4924.849	37.99
2009	2367.709	6104.414	38.79
2010	2734.776	7388.443	37.01
2011	3488.133	9241.548	37.74
2012	4023.364	10718.83	37.54

Source: *National Fiscal Accounting*, Ministry of Finance, <http://yss.mof.gov.cn/zhengwuxinxi/caizhengshuju/>.

1.5. Reform has imposed tighter discipline on local financial administrations

The current fiscal system puts the central government and each level of local governments within clear boundaries of power, duties, and interests, under a primary mechanism that stipulates sharing of expenses and benefits. It carves up categories and sources of taxes for central and local governments, restraining how much income they can obtain and where they can obtain it. Localities, therefore, have more responsibilities to practice revenue-based budgeting and spend within their means. The fiscal system creates in them a sense of necessity and drive to balance their own books.

While we fully recognize the benefits that the tax-sharing reform has brought about, we cannot lose sight of the fact that reform has been based on the situation in 1994. It was at the time subject to many constraining factors such as a fledgling socialist market economy and local vested interests. The fiscal system born out of the 1994 reform, imprinted with traces of the old century,

still falls short of a standard hierarchy. The well-off society China wants to build covers a range of aspects—accelerating changes to the model of growth, restructuring the economy, making headway in social programs, protecting and improving people's lives, narrowing the income gap, promoting social harmony, etc.—that requires stronger fiscal capacity. In order to close the gap and live up to the new dynamics of Chinese economic and social development, especially to keep pace with the changes taking place across the globe, there remain some eminent issues to be solved, as listed below.

First, the inter-governmental division of administrative power and expenditure responsibility is not sufficiently clear, rational, or standardized. It was not part of the reform package in 1994, but only an idea that was promised to materialize after the reform. Today, little progress has been made on this front, and the division is basically a legacy of the past. This, to some degree, has limited the role that local governments are able to play local matters(Lou, 2013).

Second, the inter-governmental division of tax revenues is not entirely rational. Instead of allocating revenues based on the attributes of tax categories, which is internationally accepted, China uses methods that cause misalignment. This is a recipe for reckless local government interference in business and a barrier to complete local taxation systems. At the same time, non-tax revenues such as government-controlled funds were kept out of the scope of inter-governmental fiscal reallocation. In a two-tiered taxation system made up of tax collectors both on the central and local level, authorities of tax collection overlap, duties on shared taxes contradict, and the power of taxation and other powers necessary for a seamless tax law enforcement process do not share the same ownership. Legislative powers to tax are so centralized that local governments have no right to tax new items or to adjust tax rates or the tax base, etc.

Third, the transfer payment system needs to be improved. Over-complication is one of the issues. Moreover, it turns out to be developed regions, not developing ones, that benefit the most from the fiscal transfer structure that awards higher tax returns to areas where more revenues are collected. The effect runs contrary to the ultimate purpose of transfer payments: general equalization through revenue reallocation. While the allocation of transfer payments is problematic, the total scale of special transfer payments has also overshot the target.

Fourth, the fiscal system below the provincial level needs to be standardized. Its major dilemma is that many local governments have such a dearth of tax income that they have to keep their belts tight or even live outside of their means. Given the current administrative and fiscal architecture, numerous low-level governments find it hard to maintain the necessary level of spending that pays workers, keeps institutions running, and protects the public wellbeing. Some explore expediciencies, such as land finance and debt financing, for more discretionary income, but this to certain extent poses a hidden danger to local economic development and social stability.

2. Focal points for deepening fiscal system reform

The fiscal system is a crucial set of institutional rules that demarcate the boundaries of fiscal

authority for all levels of government, strengthen macro-control at the center, and coordinate regional development. Deeper fiscal reform, and a direction of benefits that keeps governments on the right track, help drive scientific development and promote social harmony. It was explicitly put forward in the communiqué from the Third Plenary Session of the Eighteenth National Congress of CPC that ‘China must improve relevant legislation, ascertain government bodies’ responsibilities, reform the taxation system, stabilize the tax burden, and ensure budgeting is transparent and efficiency improved. China must build a modern fiscal system, in which both local and central initiative should be brought into play.’ According to this spirit of the Congress, we must comply with the following points when deepening fiscal reform.

2.1. To complete a hierarchical, tax-sharing-based fiscal system

The introduction of tax-sharing rules to the fiscal system in 1994 is in general aligned to what the reform and opening process requires. It plays an important role in normalizing inter-governmental fiscal relationships, creating a level playing field for businesses, enhancing central government’s capabilities of control and oversight, improving the behavioral pattern of local governments, and more. These rules come together as a basic framework that sits the central government in the driver’s seat of adjusting the behavior of local government, which is systematically and institutionally favorable to the consistency of government decrees and the stability and security of the country. For this reason, a stable, tax-sharing-based fiscal system should be the overarching premise for future work. We must continue to match the fiscal and administrative power of central and local governments, make sure the fiscal system does not deviate from the purpose of public service equalization and supports the development of main functional areas, coordinate development among regions and between cities and countryside, and strive for a better fiscal hierarchy.

2.2. To flatten the fiscal management hierarchy in an appropriate way

Overdone in China, administrative stratification is a major constraining factor to a better fiscal system. To begin with, China can reduce the number of fiscal management layers. Connection to the administrative system being seamless, it takes reforms — direct management of counties by provinces and managing villages’ finances their counties, to name a few — to increase efficiency. The ultimate objective is to form a flattened, three-tiered fiscal architecture consisting of central, provincial, and municipal (county) entities only and, by relating fiscal authority and tax bases to their administrative power in an appropriate, explicit way, to build a full-fledged, top-down mechanism that can adjust discrepancies in fiscal capacity among the three layers (Jia, 2012). At the end of the day, the “flattening” of the fiscal strata is also expected to “ease administrative stratification”. Administrative cost can be cut. Substantial progress can be made in smoothing out obscurities in the administrative power structure. The whole administrative system, geared to a hierarchical fiscal system, will be able to run at a higher standard.

2.3. To establish a clear and rational division of administrative power

A clear division of administrative power and expenditure responsibilities among all levels of government is the basis for building a fiscal system where fiscal and administrative powers are aligned. It should be the starting point for all-out fiscal reform. Furthermore, the portion of administrative power and expenditure responsibilities currently belonging to counties or villages should be taken out and given to governments of higher levels. Provincial governments should be granted a greater share of public service expenditure responsibilities for them to play a bigger role in the provision of public services.

2.4. To move fiscal authority upward and revenue resources to fiscally weaker regions

China is a huge developing country where the economic and social gap among regions is huge. Development is imbalanced, horizontally when comparing the east with the west, vertically at different levels, and between rural and urban areas. Therefore, it is necessary to increase the share of revenue that the central government enjoys through a scientific fiscal system and by appropriate means and to enlarge major, sustainable sources of income for local governments, such as a real estate tax, to the point that transforms their roles.

Different from the allocation of fiscal power, the allocation of fiscal revenues is aimed at making a basic match of local fiscal capacity and administrative power. Shifting the focus of fiscal support to middle and western China not only guarantees regional balance, but also is conducive to public service equalization and central government control.

3. Specific measures for deepening fiscal system reform

With clear guidelines and policy focus for deepening fiscal system reform, efforts are required to advance the fiscal system reform in a proactive and steady way, and to establish and improve a fiscal system commensurate with administrative authority and expenditure liability. This provides an institutional guarantee for the equalization of basic public services, and is also a prerequisite for bringing fiscal functions into full play.

3.1. Rational division of administrative authority between the central and local governments

After the three-level (central, provincial and municipal/county levels) fiscal framework has gradually taken shape, the administrative authority and responsibilities of governments should be specified based on principles such as laws, scope of benefits, and cost effectiveness.

Specifically, central and local governments ought to be assigned with administrative authority and expenditure responsibilities rationally. Central government spending should focus on the following aspects: national security, national defense, internal affairs, foreign affairs, macro-

control, regional fiscal balance, nationwide and trans-regional major projects for infrastructure construction and environmental protection, and undertakings regarding coordinating the development of the economy and social programs among regions, implementing functions of central government agencies, and business development under direct management of the central government. The purpose of spending is to ensure unification of markets, laws and government decrees. Provincial-level financial administrations, however, are aimed at improving intermediate control and regulation and boosting administrative vitality, and therefore should be put into the following use: functional operation of administrative bodies within their jurisdictions, public security, regional economic restructuring, regional road planning, river improvement and environmental protection, control of intermediate objectives, and local projects such as those for development of the undertakings directly under the supervision of provincial governments. Municipalities and counties should utilize their fiscal revenues in economic development, administrative management, public utilities and other causes within their jurisdictions. Specific areas covered by municipal and county-level government spending should include government administration, operation of public security organs, capital outlays in overall local arrangements, technological innovation and R&D, urban construction and maintenance projects, agriculture support, and social insurance.

In terms of finance, the central, provincial and municipal/county governments share responsibilities in compulsory education, public health, environmental protection and other areas that concern the populace's cultivation, national economy, people's livelihood, and environmental management. The central government makes overall arrangements, regulates and controls, and coordinates development on a nationwide scale.

The key to further clarifying the administrative authority and expenditure responsibilities of governments at all levels as efforts are made to deepen fiscal restructuring lies in the following aspects. First, to strengthen administrative authority of the central government to an appropriate level. Power should be centralized to the central government when it comes to important issues, such as maintaining a unified market, promoting regional coordination, ensuring national security in all sectors, and affairs that involve government decree unification nationwide, such as national defense, diplomacy, and national security. As a result, entrusted affairs should be decreased, enhancing national central management and improving national public service capacities and qualities. Second, to specify the common administrative authority shared by central and local governments. The central government and local governments should be given joint authority over public products and services that boast regional management information advantages yet exert great influence on other regions, for example, social security and major trans-regional construction and maintenance projects. Third, to manage regional public services locally. Local governments should be left with authority over issues that are strongly related to regional information yet have poor externality and are mainly related to the life of local residents. This will arouse and give play to the enthusiasm of local governments at all levels and better satisfy the regional demand for public services. Last, to adjust the expenditure responsibilities of central and local governments. On the basis of clear administrative authority,

expenditure responsibilities for the central government and local governments should be further clarified, and both parties should shoulder expenditure responsibilities for issues over which they share common authority based on the rules. The central government can entrust the expenditure responsibilities of certain administrative authority to local governments by means of transfer payments. According to administrative authority and expenditure responsibilities and under clear laws and regulations, the central government can conduct general transfer payments to regions with fiscal difficulties. Provincial governments should also take up the responsibility of balancing intra-regional fiscal capacities and establishing transfer payment systems below the provincial level.

3.2. Clear revenue distribution between the central government and local governments

In the course of deepening fiscal system reform, it is important to build harmonious fiscal relations by proactively exploring the balance points between centralization and decentralization in the fiscal resources pattern, and by improving the efficiency of government in allocating fiscal resources. As a single country with a vast territory and enormous differences, China varies tremendously in terms of regional economic and social development. The differences include development imbalance among eastern, central and western regions and that between urban and rural areas. To ensure equalization of basic public services between regions, and urban and rural areas, it is necessary for local governments to enhance fiscal capacities within a reasonable range and for the central government to properly centralize a portion of fiscal resources. This intensifies transfer payments and balances fiscal capacity differences among regions.

During fiscal system reform in the next phase, overall stability of the fiscal capacity pattern of central and local governments should be maintained, with the purpose of ensuring steady and smooth operation of the current fiscal system. With regard to the revenue structure, it is reasonable that fiscal revenues of the central government, provincial governments, and municipal/county-level governments should account for 50%, 20% and 30%, respectively, of the national total. Such a practice ensures not only stable fiscal income for governments at all levels but also the control and transfer payment capacities of central and provincial governments. Allocating fiscal resources based on clear fiscal and administrative authority according to the former proportions and structure will facilitate stabilizing relations between governments at different levels as well as consolidating and balancing national finances.

On the basis of taxation improvement, tax categories must be properly set in combined consideration of their attributes and factors such as inter-regional differences in fiscal capacity and the division of administrative authority and expenditure responsibilities. Generally speaking, taxes with strong reallocation uses, unbalanced distribution of tax bases, great mobility of tax bases, and those that are easily shifted should be classified as central taxes or occupy a larger proportion of central taxes. Other taxes that are distinctly beneficial and regional and exert no direct or major influence on macroeconomic operation should be categorized as local taxes or account for a bigger portion of local taxes. This will stimulate the initiative of both the central

government and local governments. In adherence with the above principles, taxes can be classified as follows. (1) The central government takes value-added tax revenues instead of taking them jointly with local governments as before. The central government also takes full charge of export rebates. To reduce the impact on local government revenues, the same distribution pattern of value-added tax revenues for central and local governments can be maintained, and the value-added tax revenues shared by local governments can be reallocated among regions based on objective factors such as population. This will change the current situation where value-added tax revenues are shared depending on tax sources. (2) The central government should still levy the consumption tax given its role of facilitating the implementation of industrial policies. (3) Personal income tax is used for income distribution and usually should not be considered as local government revenue. Therefore, it is necessary to change the original percentage-based sharing system of distributing personal income tax between central and local governments. Instead, the local government and central government should share personal income tax by approved tax base, with the former collecting the tax according to a fixed proportion and the latter levying a progressive tax. (4) It is appropriate for local governments to enjoy real estate tax revenues due to the fact that real estate tax has poor fluidity and local governments boast information and tax collection and management advantages. (5) In principle, letting the central government collect resource taxes is more reasonable. However, most resources in China are distributed in the central and western regions, most of which are impoverished areas. To support the development of these regions, resource taxes can be left to the management of local governments, but their eventual ownership should be provincial governments, in case new conflicts are triggered due to unbalanced distribution of resources and fiscal revenues. (6) An environmental tax can be levied as a move to step up environmental protection, and the tax can be shared by central and local governments.

3.3. Improvement of the fiscal transfer payment system

Currently, major transfer payments in China include general transfer payments and special transfer payments. General (unconditional) transfer payments are usually made to offset horizontal fiscal imbalances and provide disposable fiscal resources for local governments. Special transfer payments can directly and effectively reflect the policy intentions of upper-level governments, and they ensure that all spending programs can be implemented in terms of system and expenditure responsibility. Besides, special transfer payments are aimed at satisfying the public service demands of special groups. The key to improving the transfer payment system is the scientific design and appropriate combination of transfer payment methods.

The scale and proportion of general transfer payments ought to be increased. Local governments boast the advantages of being close to the grassroots and able to conduct handy management, and these advantages must be brought into better play. It is imperative to promote fiscal balance between regions, with emphasis given to increasing transfer payments to old

revolutionary base areas, regions inhabited by ethnic groups, border areas, and poverty-stricken areas, thereby maintaining social stability and national unity, and building up the capacities of these areas to provide basic public services. The local fiscal gaps brought by revenue reduction and expenditure increase policies adopted by the central government are in principle adjusted by general transfer payments. In addition, special transfer payment projects should be sorted, integrated and standardized. It is necessary to cut down transfer payment projects by a large margin, merge repetitive programs, phase out special projects in competitive fields and local supporting funds, and strictly control the special projects of guidance, relief, and emergency handling purposes. Reserved special projects should be examined and distinguished, and the projects concerning local affairs and those with relatively fixed amounts should be categorized as general transfer payment projects.

More should be done to improve the method of transfer payment distribution as well as the transparency and utilization efficiency of transfer payment amounts. Transfer payments can be distributed as follows. First, upper-level governments should calculate the per capita public expenditure standards of each region and guarantee the equalization of per capita fiscal resources when providing transfer payments for basic-level governments whose per capita expenditure standards are lower than the calculated standards. Second, unified payment standards should be set and used as the basis for determining transfer payment amounts for specific public service projects, therefore realizing the standardization of public services. Third, considering the characteristics of different public service programs, material standards, expenditure standards, and service quality standards should be adopted, and guarantee should be provided through transfer payments to achieve fairness of basic public services.

3.4. Improvement of fiscal systems below the provincial level

Beginning in 1994, reform of the tax-sharing fiscal system aimed to improve fiscal relations between the central and provincial governments. However, the reform of fiscal systems of governments below the provincial level has lagged far behind. Since the administrative authority and expenditure responsibilities of local governments at all levels remain insufficiently clear and standardized, basic-level governments shoulder excessive spending burdens, and local fiscal resources are inadequate, special efforts should be made to improve and regulate fiscal systems below the provincial level.

Reform measures were taken to put county-level government finances under direct management of provincial governments and place the finances of villages and towns under the management of county-level governments. These measures have helped to level the fiscal management hierarchy, enable provincial fiscal authorities to better control and regulate fiscal differences within jurisdictions of the provinces, ease fiscal difficulties facing counties and townships, and improve their fiscal management. However, due to restrictions from existing systems, a series of problems that require urgent solutions has appeared during the course of reforming fiscal systems below the provincial level. Such problems include mounting fiscal

pressure of provincial governments, the need to reposition fiscal functions at the municipal level, the yet-to-be strengthened supervision of county and township-level government finances, and the failure to put in place administrative control systems commensurate with local fiscal systems. To achieve higher operational efficiency of fiscal systems, reforms should be further carried out for provincial governments to directly manage county-level government finances and for county-level governments to manage the finances of villages and towns, combining and simplifying the hierarchy of the current fiscal system step by step with county-level finance as the core. In practice, fiscal management patterns should be subject to constant summarization, improvement, and promotion to make sure that the reform of placing the finances of villages and towns under the management of county-level governments can be undertaken smoothly. In the meantime, support policies and relevant management systems for the reform need to be improved, thereby enabling the village-finance-supervised-by-county system to play a bigger role in tightening the expenditure and revenue control of villages and towns, and resolving deficit and debt issues.

In an effort to enhance the capacities of county-level governments to guarantee basic services and put county-level financial administrations on a sound operating track, the basic mechanism for ensuring county-level finances should be further improved, and a long-term mechanism that features hierarchical responsibility, dynamic guarantee, performance orientation, openness, and transparency is required. This will lead to strengthened fiscal guarantees for county-level governments and enable county-level government financial administrations to be dynamically commensurate with their basic expenditure responsibilities.

As tax system is gradually improved, it will be necessary to enrich the local tax system, to increase local tax revenues to an appropriate level, and to improve the capacities of local governments to provide public services. With the deepening of the “business-tax-to-value-added-tax” reform, business tax, which is currently the main local tax, will gradually be replaced by value-added tax. It will become a top priority for local tax systems to nurture main local taxes. The main body of local taxation bears features including a broad tax base, stable revenue, large scale, illiquidity, and non-transferable tax burden. Local tax burdens should be shouldered by local residents. The cost and effect of local public products should be better linked. Real estate taxes, resource taxes, as well as city maintenance and construction taxes should be fostered as the principle taxes in local taxation systems.

A reasonable and standard transfer payment system for governments below the provincial level provides basic institutional assurance for local balance of revenues and expenditures, as well as fiscal capacity equalization within provincial jurisdictions. The transfer payment system design made by the central government for provincial governments can be used as reference point by which to analyze the current complicated forms of transfer payment below the provincial level in all regions, and to set up a sub-provincial transfer payment system with a basic framework accommodating general transfer payments, special transfer payments, and horizontal transfer payments. In the framework, general transfer payments are oriented toward fiscal resource equalization, and aimed at bridging fiscal gaps among areas in provinces, filling fiscal gaps

in areas with weak fiscal capacities, and achieving equal capabilities to provide basic public services within jurisdictions. Special transfer payments, however, are oriented toward reflecting the special policy objectives of upper-level governments. They refer to the subsidies provided by provincial fiscal bodies to attain specified policy goals, strategic targets of business development, and compensate basic-level governments that are entrusted with certain affairs or for the affairs on which provincial and county-level governments share common responsibility. As a necessary supplement to vertical transfer payments, horizontal transfer payments are oriented toward ecological protection and pollution regulation, and mainly apply to coordinating and resolving problems concerning cross-jurisdiction and cross-basin environmental pollution and ecological protection.

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