

A study on budget transparency: an analytical framework for tax-sharing system transparency

Wu Junpei, Gong Min **

Improving budget transparency is imperative in establishing a modern government framework in China. Current research into budget transparency normally focuses on revealing budget information but overlooks the principle of neutrality in budgeting, thus being of little use in promoting a democratic budgeting system. We believe that the issue of budget transparency goes beyond the boundaries of the budget but is also about a tax-sharing mechanism based on budget neutrality¹. The core of transparent budgeting is an orderly, moderate, fair and just budgeting decision-making. In the public's eye, a transparent budget must display fairness and justice. A fiscal mechanism with transparent budgeting should adhere to the rule of neutrality and display fairness and justice in its implementation. Neutral taxation and neutral budgeting systems are indispensable in a transparent budget: general expenditures are to be covered by general fiscal revenue and specific expenditures by specifically selected tax revenue. In this way, it will be easier to achieve orderly, moderate, transparent, fair and just government budget decisions.

Keywords: budget transparency, tax neutrality, general tax, purpose tax, general budget, specific budget

In the context of a global public administration campaign and the transformation of the economic mechanism in China, it is imperative for the Chinese government to be more transparent in budgeting for successful fiscal reform. One point of agreement in Chinese academia is that the State Council kicked off such a move when it authorized the National Audit Office to provide an audit report covering central government budget implementation and other fiscal revenues and expenditures to the National People's Congress each year. Reform of government budgeting began officially in 1999. Since then, a series of concrete reform actions have been taken to make the budgeting process more democratic. As components of budget reform, the organization of departmental budgeting, the implementation of a centralized treasury payment system, the establishment of a government procurement system, the reform of government revenue and

* This research is a major project from Ministry of Education, "China's Public Fiscal Risk Evaluation and Counter Measures" (No.10JZD0023).

** Wu Junpei (email: jpwu@whu.edu.cn), Professor and Doctoral Supervisor, Fiscal and Finance Research Center, Wuhan University; School of Economics and Management, Wuhan University; Gong Min, Ph. D. Candidate, School of Economics and Management, Wuhan University.

¹ To be short, "tax-sharing fiscal system" is abbreviated as "fiscal system."

expenditure categories, the deepening of “separate lines for revenue and expenditure,” and the implementation of the Government Finance Management Information System (GFMIS) have played positive roles to varying degrees in improving the budget transparency of the Chinese government. Nevertheless, it has come to our attention that reforms aimed at improving budget transparency are falling short. With a transparency, the government budget will be a symbol of public justice and fairness and will guide the market economy. Whether a budget is transparent or not has to do with the budget allocation mechanism under the tax-sharing system. For now, China’s tax-sharing system focuses on macro-control and adjustment of the economy but fails to recognize the importance of keeping a neutral fiscal budget. In this case, the core principle, i.e. neutrality, will not be reached even if all information in public accounts is disclosed. Therefore, to find a way towards budget transparency that brings about an orderly, modest, fair, and just fiscal mechanism under the tax-sharing system is pivotal, both theoretically and practically.

1. Literature review

What is the definition of budget transparency? A look into relevant studies in China reveals two situations. In the first situation, the research had no clear definition of transparency, but readers could figure out from the contents that the budget transparency refers to the release of budget information, especially the information about current budgeting. In the second situation, the definition from IMF (2007) was adopted, i.e. the definition by Kopit and Craig (1998). This covers government structure and functions, the intentions of fiscal policy as well as public sector accounts and fiscal planning, suggesting that budget transparency and fiscal transparency overlap. Some researchers have come to realize that the IMF’s definition of fiscal transparency covers a wider area than budget transparency alone. This is because fiscal transparency consists of more than narrowly defined fiscal activities (Liu & Li, 2008). Most researchers, however, still focus on the government’s release of its financial information.

Modern national budgeting is highly complex. This complexity is, on one hand, unavoidable as the economy grows, and on the other hand, man-made (Alesina and Perotti, 1996). The “principal-agent” relationship depicts the complexity and transparency in budget-making (Chari, Jones & Marimon, 1997). As for today’s situation, China’s complicated budgeting process includes at least five “principal-agent” structures: (1) the electorate gives power to delegates to form authorities which practice constitution, fiscal law, budget law, and the right to pass a budget; (2) authorities grant the budgeting right to government for budget-making, budget enforcement, adjustment and final accounts, i.e. the administrative side of budgeting process; (3) the central government authorizes local governments to provide local public goods, deal with public affairs and public expenditure, and share fiscal revenue. The convergence of fiscal incomes and economy within different regions and the equalization of all kinds of basic public services between different regions, urban and rural areas and different groups of people are generally achieved by a horizontal channel of fiscal payment transfers; (4) governments at all levels authorize government departments for specific budget-making and enforcement, providing public services according to

required quality, quantity, and structure, etc; (5) government departments ask suppliers of public goods to accomplish budget-making and enforcement, and endow them with the right to use public resources in providing public services (Lu & Shan, 2012).

Facing such a complicated budget structure, efforts aimed at a more transparent budget have not brought about satisfactory results in the past. According to a report from Shanghai University of Finance and Economics, from 2009 to 2012, budget transparency at the provincial level did not improve significantly, with the average score rising to 25.00 in 2012 from 21.71 in 2009, an improvement of merely 3.29 points. In 2012, not a province reached 50.00, with the highest score of 45.20 coming from Hubei Province. For central government departments, none scored over 50.00, and the Ministry of Environment Protection received the highest score, 43.80. A report released by Tsinghua University suggested that among 81 prefecture-level cities sampled, only 8.64% passed, scoring 60 or above (Sun, 2013).

Soft budgetary constraints have garnered attention in the study of budget transparency. With weak constraints and resources at their disposal, local governments have entered into destructive competition, resulting in separated markets, repetitive construction, and vicious competition to attract investment (Qian, 2009). In addition to the above, soft budgetary constraints also impose non-neutral effects on the supply of public goods. Empirical research shows that while soft budgetary constraints work for the supply of economic public goods, they weaken the supply efficiency of sustainable and social public goods (Li & Ren, 2013). With expanded freedom at the local government level, coupled with an unscientific official promotion mechanism, most of the local functional departments do not fulfil their duty of supplying public goods efficiently. Productive fiscal expenditure is at the lower end of the teeter-board, while expenditures on culture, education and health care and public insurance are on the other, unable to meet demand (Fu, 2012).

Analysis of the government accounting environmental assessment model indicates that budget transparency in China is affected by various powers: positive influence from economic development and improved management, negative influence from political systems, digital and technological push, as well as political, social and economic pressure (Xiao & Li, 2011). Starting from a narrow definition of budget transparency, most researchers' focus their suggestion on how a more detailed public financial information could be released (Wang, 2003; Liu & Li, 2008). Of course, the degree to which the information should be released is determined not by government power, but by people—the rights granted to people by the constitution (Zhao, 2009). The “transparency fantasy,” as coined by Ling and Zhang (2011), depicts fiscal transparency as a useful tool in public governance, for which a solid foundation of system framework, organisation, capability, human resources, and many other aspects is needed. When building the system in the first place, government should focus on establishing public governance mechanism, instead of getting trapped in mistakes.

Given this, it is safe to say that most research on budget transparency has long been focused on the release of information in public accounts, with the suggestion being a more transparent public account. We believe, however, that this narrows the scope of budget transparency and is

not complete. Current studies also ignore the dual nature of government, claiming that as long as the public account is open to the public, government behaviours will be constrained. We hold that the essence of fiscal transparency is a transparent budget-making process that is open, fair and just. This paper will provide a few thoughts on how this can be achieved.

2. A benchmark for budget transparency

The government budget mirrors not only the ambitions and goals of a government, but also the relationship between the government and the market. In such a relationship, the market is the determining factor for resource allocation. Thus, the influence of government budgeting on the market economy is neutral. In other words, neutrality is a basic principle of government budgeting. The government budget is mainly embodied in the institutional arrangement of the fiscal system, which secures the transparency of the budget. This demonstrates that orderliness, balance, openness, fairness and justice of government budgeting decisions are the essence of budgeting transparency, and neutrality is the basic principle by which to realize this essence.

In the market economy, fair and just government budgeting is realized by assigning a determinant role to the market in the process of resource allocation. Therefore, neutrality also represents the justice and fairness of a fiscal system, including neutrality in systems, such as tax, tax-sharing, budgeting, and transfer payments, which means that the neutrality of tax-sharing fiscal system is a systematic project, requiring top-level design and comprehensive arrangement.

There are misunderstandings among theorists over the fairness and justice of the fiscal system. That is, they interpret it by the fairness of value distribution rather than by the neutrality of the system. In terms of resource allocation, the public goods provided by the rule of the market economy, by their own forms, represent the equalization of public services. This is because the forms of efficiency of resource allocation in public services and in the market economy are different. For personal goods, the internalization of costs and benefits leads to fairness and justice, seen by the same price available to every customer. In contrast, due to the externalization of costs and benefits, fairness and justice are translated into different prices available to every customer. In the public economy, taxes are the price paid for consuming public goods. A neutral impact of taxes on the market economy means fairness and justice. According to the benefit principle, it should be the case that the rich contribute more taxes, while the poor pays less or even none. Such fairness and justice is not equivalent to the equal value distribution between the rich and the poor.

Some might think the equality of basic public services in the public economy should not take the neutrality principle into account. This is another misunderstanding. Indeed, the public economy has the function of income redistribution, but it does not mean the equalization of materiality between rich and poor. Income redistribution in the public economy also requires a neutral impact on resource allocation. Income redistribution, in its form, is implemented by the ability-to-pay principle, namely, people who receive more income pay more taxes, and people who make less money contribute fewer or no taxes. Income distribution and resource allocation are the two sides of one question. Marx regarded the former as the back of the latter. Certainly,

the change of income distribution would have an effect on resource allocation. For example, the choices between employment and leisure, investment and consumption are influenced by tax. However, income redistribution of tax is limited by neutrality. That is, the process does not affect resource allocation. This is only a theoretic hypothesis, and the actual system arrangement is very difficult, because the “limits” vary and there is no standard. It is a puzzle in mainstream public economic theory.

The neutrality of the fiscal system is also affected by economic stability. Stiglitz (1993) holds that neoclassical synthesis divides economics into macroeconomics and microeconomics. The theory suggests that the micro economy, instead of macro economy, plays its role in a stable economy, and vice versa in an unstable economy. Stiglitz believes that economics is one set of theories, rather than two, but two theories are still in use. This means that macroeconomic policy undermines the efficiency of resource allocation and the fairness of income distribution on the micro level. Therefore, over-dependence on macro-control surely leads to non-neutrality of the fiscal system. The internal integration issue of macroeconomics and microeconomics is still unsettled.

Despite the aforementioned difficulties in fiscal system neutrality, the principle of neutrality is unquestionable.

Fairness and justice are concepts, which are spiritual. The concepts need to be expressed by institutional arrangements. The fiscal system handles the public economy under such concepts. In this sense, the fiscal system is the representation of fairness and justice (Wu, 2009). Neutrality is the rational principle of this institutional arrangement. However, once the system is formed, it will become the policy instrument by which to change economic relationships. The idea of using instruments to change social relationships is the instrument principle. It demonstrates the duality of fiscal system: on one hand, it represents social justice and fairness; on the other hand, it is an important force in changing social relationships. In two of them, the rational principle comes first while the instrument principle is secondary. Therefore, one-sided emphasis on the regulative role of public finances will compromise fairness and justice, affecting the decisive role of market in resource allocation.

The objectives of an economic society are threefold: resource allocation, income distribution, and economic stability, which are jointly accomplished by the market economy and the governmental economy. The fiscal system is the most fundamental system in the market economy. The system not only determines the scope and approaches of governmental activities, but also serves as a benchmark for market economic activities. A transparent government budget is a basic requirement of such a system. The meaning of “transparency” is twofold: first, the whole process of decision-making, implementation, and final accounting of government budgeting is open; second, the system itself is transparent. That is, the public is able to predict the scope and approaches of government activities according to the system. Academia pays greater attention on the publication of information, but less or even no attention to the transparency of the system.

What is transparency of the fiscal system? The transparency of the fiscal system is not subject to any written rules, but subject to the system itself, being the basis of rational judgment. The so-called rational judgment is the judgment made according to the values of the market

economy, so the fiscal system is neutral to the market economy. This means that even though a strong governmental economy exists within the market economy, the market economy is still predictable.

The fiscal system is composed of taxation, tax-sharing, transfer payment, and budgeting systems. Thus, correspondingly, taxation and budgeting should be neutral. A neutral tax system is an important safeguard of budgeting transparency. The tax system is a key component of the fiscal system. A functioning neutral tax system requires the coordination of the tax-sharing, transfer-payment, and budgeting systems. The neutrality of the whole fiscal system is thus realized.

Quantitative restrictions in the budget are an important condition in securing transparency. Quantitative restrictions of governmental budgets in a market economy are different than in a traditional planned economy. In the traditional planned economy, government expenditure is determined by revenue, which means that the ability to receive revenue decides the expenditure capability. Revenue capability is the fiscal distribution of all remaining capital in the value created that year, deducting the portion distributed to personal consumption by residents. The boundary of government budgeting is unclear. It involves both public economic affairs and market economic affairs. Under market economy, government revenue is determined by the expenditures, which means that the government collects tax in accordance to the demands for budget outlays. For that the limit of government budgeting is clear under the market economy and the government only conducts public economic activities.

The income source of the public economy is taxation¹. For a neutral tax system, institutional arrangements should specify what kind of income is allocated to general budgeting, special budgeting, or transfer payments. These institutional rules are highly necessary for ensuring the transparency of budgeting.

Budget decisions are made through a series of political procedures. Politicians make decisions based on the actual political and economic situations. But decisions should follow an institutional framework, which is the basic guarantee of budget transparency.

Rigid constraints over budgeting are an indispensable element in budgeting transparency. This requires, firstly, that budgeting should fully reflect governmental public economic activities; secondly, the rigid constraint over revenue; and thirdly, classified management in accordance with the nature of the revenues and expenditures of the budget.

From the above requirements on budgeting transparency, it is clear that the fiscal system in China is not institutionally transparent. First of all, the current fiscal system in China is not neutral, which is demonstrated by the excessive emphasis on the adjustment role of public finance. In the tax system, the adjustment role of taxes is also overrated, resulting in a set of tax categories that is contrary to the neutrality principle. The overemphasis on the adjustment role of budgeting can also be seen, namely in that social fairness issues are mainly resolved by special budgets and special budget allowances instead of through the general system. This means

¹ To assume taxation is the only way to provide a revenue source for governmental budgeting expenditure is to simplify the analysis, but it does not affect the accuracy of the conclusions.

budgeting is not neutral. Secondly, budgeting restraints in China are soft. For example, the risks of state owned enterprises are not internalized, but are still borne by the government. City investment companies conduct large number of public economic activities, making the relationship between government and the market unclear again. Thirdly, budgeting in China does not fully reflect public economic activities. A vast amount of revenues and expenditures outside the budget and the system are not reflected in the governmental budget. Therefore, to increase the level of budgeting transparency in China, we have to transform the tax-sharing fiscal system in China.

3. System framework for budget transparency

3.1. Neutral taxation

3.1.1. Tax categorisation under neutral taxation

American economist Musgrave (1973) has linked tax category with reproduction, which sheds light on the design of a neutral taxation framework. For the relationship between taxation and reproduction, see Figure 1.

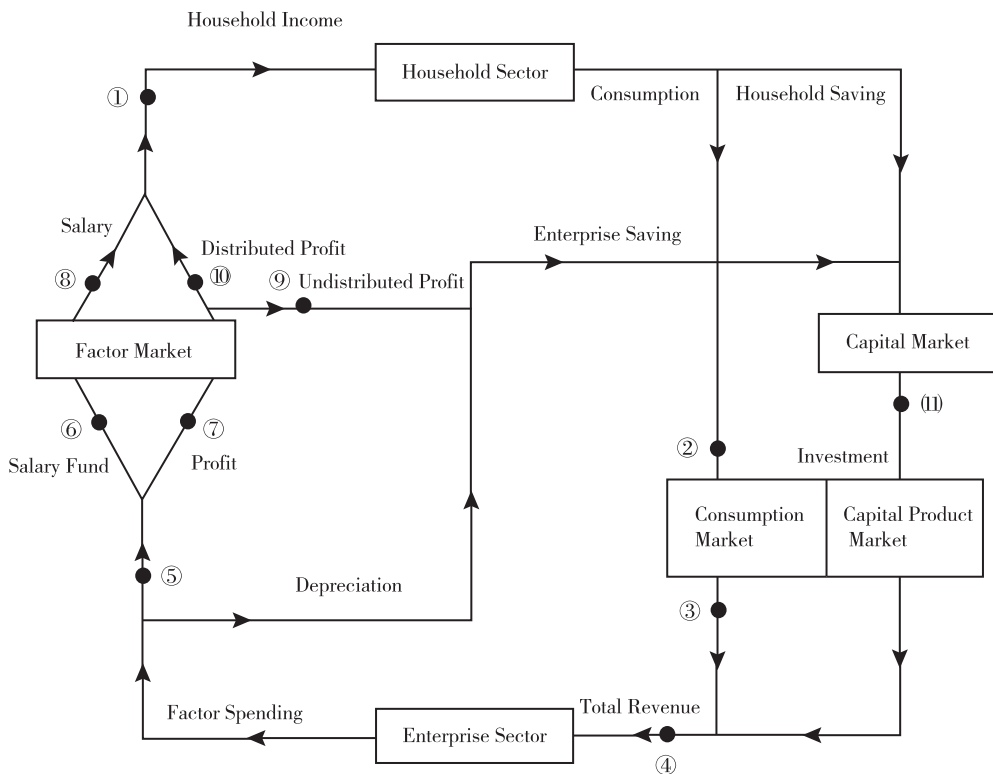


Figure 1. Relationship between taxation and reproduction

The following is a circulation of revenue flows and expenditure flows in the private sector. Tax can possibly be levied on numbered processes. The clockwise flow reflects revenues and expenditures in cash. Keep in mind that the flow of real product for production goes counter clockwise and is not indicated. The household unit is at the top of the graph below, the enterprise unit is at the bottom, the factor market on the left, and the capital/product market is on the right.

Household income translates into household expenditure and household saving. Expenditure flows to the consumption market and becomes the income of suppliers. Household savings ends up as investment, converted into expenditure in the capital market, the income of capital enterprises.

Part of enterprise income, including depreciation and profits, is used to purchase labour, capital and other inputs, representing various factors in national income. The payment then becomes salaries, bonuses (stock dividends), interest, which finally turn into household income. The remainder of enterprise income, including retained earnings¹ and usable depreciation, is enterprise savings, and acts along with household savings as investment capital or is used to purchase capital products.

The graph above depicts a complete circle of revenue and expenditure. Black dots are put at the stages where government can levy tax on, and tax types are indicated by numbers². Dot 1 means tax on household income; dot 2 consumption tax; dot 3 tax on retail income for enterprises; dot 4 tax on enterprise net income; dot 5 tax on enterprise net depreciation income; dot 6 tax on salary funds; dot 7 profit tax; dot 8 salary income tax; dot 9 tax on retained earnings; dot 10 tax on profits from shares³.

In this reproduction circle, all proposed tax types are for value flows; no tax on existing value is mentioned. In other words, from the perspective of reproduction, taxation can be put into two types: flow tax and stock tax.

For turnover tax, two subcategories can be made on the tax basis: (1) tax on commodity and labor; (2) tax on production factors⁴.

3.1.2. General tax and selective tax of flow tax

Following the neutrality principle, taxes can be general or selective. General taxes refer to collecting tax on every tax base that shares the same properties, often called a general tax on product and labor, and general tax on production factor. General tax is an indispensable part of a neutral tax system. Different treatments in levying tax on the same tax base, inevitably lead to

¹ Retained earnings are the portion of revenue that is not paid to the providers of factors.

² “Point(process)” that affects reproduction, or points that affect income and expenditure. With tax levied, that point is a taxation point.

³ The U.S. government imposes tax on these points, but there is no VAT.

⁴ In China, we usually call the former mobile tax and the later income tax. In reality, both are “turnover” from the perspective of reproduction.

non-neutrality. Selective tax is further imposed on a selected tax base on the basis of general tax, and is also categorized as selective tax on commodities and labor, and selective tax on production factors.

Selective taxation, compared to general taxation, is repetitive and non-neutral at first glance. However, given that economic activities are complicated, general taxation alone cannot guarantee the neutrality of taxation. Selective taxation is a necessary supplement to general taxation. Yet, selective tax cannot be too heavy and the scopes cannot be too wide, in fulfilling its supplementary function.

It should also be noted that there is no general tax on existing stocks. That is, it is impossible to generally levy tax on capital and consumption stocks. Internationally, real estate tax is more common.

3.1.3. Neutrality design for general taxes and selective taxes

In the commodity and labour sector, a single fair general tax builds up neutrality. Developed countries normally levy one tax only, for instance value-added tax in OECD countries, and sales tax in the U.S. In tax reform in 1994, China began levying value-added tax. The general tax for commodity and labour consists of value-added tax and business tax, making it unfair, or non-neutral, to the economy. Value-added tax is further divided by taxpayer types—small-taxpayers and value-added taxpayers. Fairness is beyond reach.

The on-going pilot programme that aims to replace business tax with value-added tax intends to reduce the tax burden and to promote the service industry. We believe, however, that tax reform that promotes one particular industry does not keep the taxation system neutral. The ultimate purpose of “business-to-value-added tax” reform should be to combine two general taxes into one for commodity and labour in a neutral way. Theoretically, a general tax is practiced across the whole country. Pilot programmes in some certain areas mean there would be a relatively heavier burden on the rest of the country, which obviously undermines tax neutrality.

Similarly, for the general tax on production factors, one single tax gives more neutrality. These taxes in developed countries are usually personal income tax. The foundation of developed economies is private ownership; therefore, revenues for the various factors of production can be assigned to every individual. There is no distinguishing between incomes from different production factors. All income is categorized as “individual” annual incomes. In China, however, the general tax on production factors includes corporate income tax and personal income tax. Among these two, the corporate income tax accounts for the vast majority. In foreign countries, corporate income tax is not a general tax and is collected in a way that is different from China. Corporate income tax does not involve organizations that are not corporates. In other words, corporate income tax is a selective production factor tax. Personal income tax occupies only a small proportion of fiscal revenue in China. Compared with international practice, China’s personal income tax has three features. First is the distinction by the nature of income, such as labour income, capital income, interest income etc. The tax threshold for different types of

income differs in China, whereas foreign countries treat all sorts of income the same. Second, China's income tax is levied at every occurrence of income, while developed countries collect income tax annually. Third is tax exemption. In China, there is an exemption threshold on every type of personal income. In other countries, exemption criteria (referred to as the household deduction) is based on household, related with the numbers of dependants. From the above analysis, one can conclude that China's general tax on production factors is seemingly composed of two, but actually a number of taxes, apparently lacking neutrality.

A general tax is the foundation of a neutral tax system and is also the major contributor to fiscal expenditure.

A selective tax is a supplement to general tax and helps to make the tax system more neutral. But our selective taxes are set not to build neutrality, but for "adjustment." "Behavioral taxes" and "purpose taxes" in China are two examples of adjustments rather than neutrality. China's urban maintenance and construction tax, education surcharge, and other taxes are not consistent with the principle of neutrality.

For selective tax to achieve neutrality, there should be clear boundaries for a tax's role. Selective taxes under the commodity and service category are usually tariffs and consumption taxes. For tariffs on the import and export of goods and services, the role is very clear. When it comes to opening up the economy, international competition and collaboration, tariffs are conducive to the development of the domestic economy as well as to maintaining the principle of neutrality. Consumption taxes are divided into tax on basic consumption and luxury consumption, the latter is listed as the consumption tax base in China.

Another form of selective tax are called "fees," but collected in the form of taxes. User fees are the price to be paid by the consumer for a public commodity, and that price is determined by the benefit principle. Therefore, user fee is neutral. To change a user fee to a tax, for example, to replace road usage fees with oil tax and tire tax, helps to reduce administrative costs, as the more oil and tires one consumes, the more he uses the road.

The above explanation is an attempt to prove that selective taxes are the main source of specific public expenditure, and pre-determine how this tax revenue is to be spent.

3.1.4. Tax design under a neutral taxation system

The tax burden of neutral tax system should be designed according to the needs of budget expenditure. With the total tax burden set, we allocate that burden to each tax by proportion. Social development is a continuous process; thus, creating a tax structure is a historical process. Our transition to a market economy from a traditional planned economy system has necessarily been a process of decreasing the tax burden.

Government budget is made up of two parts: general expenditure with general budgets and special expenditure with special budgets. General expenditures are recurrent public expenses in meeting the demands of the public everywhere, including education, culture, healthcare, agriculture, forestry, water, gas, road transport, security, and administrative expenses. Special

expenditures are used to meet special needs in certain areas, such as river management, forest protection, environmental protection, and poverty relief.

In setting taxes, general tax revenue should cover general budget expenditures. Turnover taxes and special tax revenues, user fees, and “fees-to-taxes” should cover special budget expenditures.

This arrangement allows revenue and expenditure of general budget and special budget to work within a certain boundary, which is intrinsic to a transparent tax system.

Looking at China’s situation, these assumptions can be achieved. According to the *China Statistical Yearbook (2012)*, the ratio of general commodity and service tax (value-added tax and business tax) to GDP was 8.12%, 5.09% from VAT and 3.03% from business tax; general tax on production factors (corporate income tax and personal income tax) contributes 4.90% of GDP, with 3.78% coming from corporate income tax, and personal income tax accounting for 1.12%; a total ratio of about 13%. General budget expenditures can be covered. Selective taxes are enough for specific expenditure needs too.

3.2. Neutral tax-sharing

3.2.1. Tax system and tax-sharing system

Tax sharing is a redistribution of tax revenue among all levels of governments. A neutral tax sharing helps to guarantee neutrality in taxation.

The tax system needs to be fair, honest, simple and economic, as Adam Smith suggested in 1776. This requires a neutral tax system, especially remaining neutral to market economic activities. In this context, the system-maker focuses on reducing the cost of tax collection. For commodity and service tax, tax is usually levied on the seller for better convenience, such as VAT. Exceptions can be found in the purchase of agricultural products where the buyer bears the VAT. Taxes on production factors are usually levied on the buyer for easier administration. This suggests that when selecting the taxpayer, the major consideration is simplicity and convenience. Thus, there is no fixed relationship between the location of the taxpayer and the tax revenue to be shared by that area. In other words, tax sharing is not about where the taxpayers are located.

The tax-sharing system is based on the principle of the equalization of public services. Of course, this public service equalization abides by the principle of neutrality in the budget. Tax revenue needs to be redistributed across the country, as all people should share fiscal income, by being collected as central government taxes institutionally. This is due to the fact that only the central government has the right to reallocate revenues equally on behalf of the people. In this sense, the central government tax is a “shared tax,” reallocated to local budgets across the country. Thus, the essence of tax sharing is a clear distinction between central and local taxes, explaining, in theory, why some taxes are central taxes and others are local taxes.

The tax-sharing system should also address distribution principle and enforcement regulations for distributing central taxes among governments of different levels and the distribution relationship between central and local taxes. This is of vital importance for a

transparent tax system.

3.2.2. Central tax principles

Given the function of taxes in reproduction, turnover tax should be regarded as a central tax in principle and local tax is a tax for local public commodity revenue.

Why is turnover tax a central tax? First, in a market economy, capital flows across the entire country. The revenue generated from the turnover tax base should be awarded to the entire market economy, and thus all citizens. The taxpayer and the tax bearer are usually not the same entity. Commodity and service taxes, if set neutrally, do not affect market prices. Tax is the deduction from the new value created by commodity and services. The end consumer of a commodity or service ultimately bears such tax. Commodity and services circulate across the country, and the revenues generated should belong to all citizens. For taxes on production factors, capital and labour circulate. Although land does not move as people and capital do, its price also related to the mobility of labour and capital. Therefore, land is circular in terms of value. The taxes on production factors should belong to all people as well. Second, the externality of public economy needs central unified allocation of mobile tax base across the country. For example, the costs of national defence, environmental protection, market credit, security, and other national public goods should be shared by all, and be paid by general tax revenue in accordance with the equalization principle. Then, there are also external local public services. Local security is to a certain extent a local public good. If one area suffers from security problems and high crime rates, it will put pressure on security in other areas. Fourth, for a country, private goods have externalities too, some being positive externalities. For instance, a new technology product could generate considerable benefits by making use of new materials or new energy. Yet its preliminary research costs cannot be covered by the sales of the product. Some bear negative externalities, creating high profits for a particular product or a particular industry, but driving up costs for other industries or other products.

How should central taxes be allocated throughout the country? First, central tax should be used to satisfy demand for national public goods spending. National defence, foreign affairs, environmental protection, science and technology development, and other expenses are beyond doubt national public goods. Second, the central taxes should cover expenditure of general public demands for all levels of government. General public demands are the same in every place, being administration, ESCH, agriculture, forestry, water, gas, etc. For central arrangement of such public goods is more efficient. This means that the funds are provided by the central government. It should be noted that this is not an egalitarian distribution. Because all general public needs are externally-linked, if any one place fails to address these needs well, overall tax revenue will be affected. Third, we need to address the externality problem of the allocation of public goods resources. In general, local public goods provided by local governments always create spillover of benefits, which leads to inefficiency. Due to the limitations of local government jurisdictions, the spillover costs of local public goods provided locally cannot be recovered through a neutral

tax, resulting in great inefficiencies. To recover efficiency, the central government practices nationwide tax redistribution to make up for this spillover.

Taxes with mobile tax base made up of the general tax base and selective tax base¹. General tax is the foundation of tax neutrality, the source for central expenditures under general budget. Central selective tax revenue is used to solve special needs and cater to specific budget expenditures, as selective tax is related to special expenditures from the start.

3.2.3. Local tax principles

Local taxes generate tax revenue for local government budgets. In the principle of neutrality, local taxes are benefit taxes. Local residents benefit from local public goods, so they pay local taxes. Therefore, the characteristic of the local tax base is local; and hence, an immobile tax base is suitable for local taxes. In foreign countries, local taxes are usually levied on real estate, as this helps to link taxes to beneficiaries. Local taxes create a revenue pool for local public expenditures. Local tax can also be levied on a mobile base, because people move around. One can live in one location, shop in another, and work in a third. Internationally, general commodity and service taxes are generally collected by the central government and added with local taxes. As for general taxes on production factor (or the personal income tax in some countries), central, state, and local levels all collect a share whereas some share personal income taxes among all levels of government².

Another source of revenue to cover local government expenditure is user fees for local public commodities, or fees in a form of taxes. For this, public commodities have to be absolutely local, otherwise tax neutrality would be damaged by such local taxes or user fees.

A neutral local tax needs to meet the following two requirements: (1) provide exclusive funds for local public goods; (2) benefit the same group of people who pay the local tax, or pay tax for local public goods (as part of the sales prices). Local taxes are meant to fulfil both general and specific public demand in the local area. For the former, this should be considered thoroughly together with the central tax and for the latter, local demand depends on how affordable the local budget is.

After “business-to-VAT” reform, local revenue is reduced. Some argue that consumption tax should go to local governments, which is contradictory to the neutrality principle. The nature of consumption tax makes it central specific income.

3.2.4. Establishing a general transfer payment system

The precondition is that general tax revenue is used to provide funds for general budget

¹ Local tax on a mobile tax base is a special selective tax. This will be further discussed.

² In China, shared tax is a tax that is shared by central and local governments in a certain proportion. In foreign countries, more emphasis is placed on the sharing portion of shared tax. Shared tax will be allocated according to demand and revenue. This will be further discussed.

expenditures. With historical data, it is easy to make an estimation of the scale of general transfer funds. For instance, if the general tax revenue is 15% of GDP, and 40% of the general tax revenue is reserved for general fiscal expenditures, the remaining 60% therefore ends up in the general transfer payment fund. 60% of the commodity and service tax, consisting of VAT and business tax, and 60% of the production factor tax, consisting of corporate income tax and personal income tax, will be in the general transfer payment fund.

A general transfer payment fund system is necessary for placing constraints on the general budget. In good years, the remainder in the transfer payment fund can be carried over to the following year or be used in the same year with a make-up budget administration process. In bad years, when there are not enough funds for transfer payments, a discount is made based on the corresponding proportion. The payment transfer method is pre-decided with little room for choices. Experience in developed countries shows that the amount of payment transferred from the central government to local governments depends on local governments' revenue-making ability and the expenditure demand. The ability of a local government to make revenue means the revenue a government endeavours to make in its budget.

Earning capacity can be assessed by a standard. This ability is not the actual sum of revenue but the amount that could be achieved with effort. The transfer total is the difference between this assessed number and local general budget expenditures. Obviously, this assessed number is different from real local fiscal revenue. This is done to encourage local governments to increase revenue themselves. This transfer payment system helps to create a fair environment for competition between local governments. If a local government increases its local tax revenue by imposing a heavier tax, people would have to endure a greater tax burden. Capital and labor force may leave instead of contributing to local revenue. If local revenue is increased, the central government would give fewer subsidies, and the local governments' budget revenue would thus stay the same. This can help guarantee that local governments can afford general budget expenditures. It also proves that the total subsidies a local government can obtain is unrelated to how much general tax the central government can obtain from that area.

Currently, China's tax-sharing and transfer payment systems are neither neutral nor transparent. First, we have no restrictions on general budget revenue or expenditure. Categories in current budget and construction budget fail to provide a clear boundary between spending and revenue, resulting in weak budget constraints. Second, tax-sharing and transfer payments in China do not consider neutrality. Central and local governments share tax revenue in a set proportion. For example, 75% of VAT goes to the central government, and 25% goes to local governments. General taxes on production factors are taken by a fixed ratio too. Moreover, VAT and business tax together constitute the general commodity and service tax, both of which are the same in nature. However, China treats VAT as a "shared tax," while business tax is a local one. This shows that there is no uniform policy in categorising central and local taxes. We have already pointed out that this method is not neutral. Moreover, judging from the tax structure, general tax revenue is the main source of local budget revenues. The practice of sharing tax by a fixed

ratio will inevitably lead to vicious competition between regions. To increase budget revenues, local governments would have to increase general tax revenues. One effective way to do this is through attracting investment. The so-called “land finance” wave among local governments is in its nature an effort to attract investment by giving out land rights and increasing general revenue. This competition in attracting investment should reduce resource allocation efficiency, thus being regarded as vicious competition.

3.2.5. Setting up a specific transfer payment system

A specific transfer payment system refers to special subsidies to certain areas from the central government. Unlike general subsidies, such subsidies only go to a limited number of areas. The sources of such subsidies come from either selective taxes on the mobile tax base or user fees or tax equivalence of such fees. Selective taxes can be tariffs and consumption tax. Tariffs protect industries at home and introduce advanced technologies. Therefore, revenues from tariffs should be used as a special subsidy fund to provide public services for international trade and investment, as well as for scientific research. Consumption tax, on the other hand, should be used for poverty relief funding. Most of the specific subsidies are fees by nature, with symmetry of benefit obvious.

China lacks comprehensive constraints over the specific transfer payment system. There is no control over the total amount, nor is the system handled in accordance with the benefit principle. Decisions seem random and the system is not transparent. For example, natural resource taxes should be used as specific transfer payment funds for environmental protection, but actually end up as local taxes. Most of the specific funds are not recorded in the budget, which makes them become interests specific to certain departments. This hinders the progress of solving externality problems in the public economy. Besides, many items managed outside the budget are national public goods, including forest funds and river management fees. It is imperative to rectify the system of special transfer payments.

4. Conclusions and suggestions

4.1. *Conclusions*

The core issue in a transparent fiscal budget is a transparent system. It is not enough to have fiscal information released. A transparent financial system must abide by the principle of neutrality in order to ensure that the market economy plays a decisive role in resource allocation. This involves tax collection, the sharing of taxes, transfer payments, and the budgeting system. A neutral tax system should be set up in accordance with the characteristics of the reproduction of capital circulation, and distinguish between general taxes and selective taxes, selective central taxes, and selective local taxes. The tax system is not the same issue as tax sharing. The tax system should be decided according to public demand.

Budget transparency requires rigid budget constraints for moderate and clear public revenue and expenditure. General tax revenues should cover general budget expenditures. Revenue from selective taxes and fees should meet specific budget demand. Meanwhile, a general transfer payment system and special transfer payment system should be established.

Budget transparency is a long-term project requiring top-level design, a smart breakthrough, and well-planned reform.

4.2. Policy suggestions

China's current tax-sharing system is neither neutral nor transparent, which needs to be reformed. As China's public fiscal management contains both budgeted and off-budgeted items, coupled with blurred boundaries between state-owned enterprises and public economy, budget transparency reform needs to address the relationship between the fiscal economy and market economy.

First, a boundary has to be drawn between public economy and market economy. The key point is the rigidity of government budgeting. Second, the public budget should reflect public economic activities. In other words, all public economic activities should be included in the budget. Third, top-down reform should destroy vested interests in the current tax-sharing system. A transparent tax-sharing system needs to address issues on tax-setting, tax-sharing, transfer payments, and budgeting, and such reform should be carried out based on adequate augmentation, test and evaluation.

References

- Alesina, A., & Perotti, R. (1996). Income distribution, political instability, and investment. *European Economic Review*, 40 (6), 1203-1228.
- Chari, V., Jones, L. E., & Marimon, R. (1997). The economics of split-ticket voting in representative democracies. *American Economic Review*, 87 (5), 957-976.
- Fu, W. L. (2012). Immigration, incremental budget, and the congestion on local public goods. *Economic Issues in China (Zhongguo Jingji Wenti)*, 1, 41-53.
- International Monetary Fund. (2007). *Manual on Fiscal Transparency*, Washington, D.C.
- Kopits, G., & Craig, J. D. (1998). Transparency in Government Operations, *IMF Occasional Paper*, 158.
- Liu, X. X., & Li, J. F. (2008). A study on fiscal transparency in China. *Journal of Xiamen University (Xiamen Daxue Xuebao)*, 6, 34-41.
- Ling, L., & Zhang, L. (2011). Limits and efficiency of a transparent fiscal system: interpretation of an analytical framework. *Contemporary Finance & Economics (Dangdai Caijing)*, 6, 23-29.

- Li, H., & Ren, L. Y. (2013). Fiscal decentralization, budget constraints, and supply efficiency of local public goods. *Contemporary Finance and Economics (Dangdai Caijing)*, 3, 35-43.
- Lu, H. Y., & Shan, X. P. (2012). Citizens' rights, democratic budgeting, and budget information release, *Public Finance Research (Caizheng Yanjiu)*, 4, 19-21.
- Qian, H. G. (2009). Fiscal decentralization, budget soft constraints, and vicious competition among local governments. *Public Finance Research (Caizheng Yanjiu)*, 3, 17-19.
- Sun, W. J. (2013). Public governance and public democracy: fiscal transparency in China. *Research on Financial and Economic Issues (Caijing Wenti Yanjiu)*, 8, 84-88.
- Wang, Y. J. (2003). Fiscal transparency in globalization: gap and direction for China. *International Economic Review (Guoji Jingji Pinglun)*, 4, 34-39.
- Wu, J. P. (2009). *Public economics*, Wuhan University Press. (in Chinese)
- Wu, J. P. (2012). *Budget reform in Chinese local governments*, China Financial and Economic Publishing House. (in Chinese)
- Xiao, P., & Li, Y. (2011) Fiscal Transparency: Environmental Foundation, Motivation, and Promoting Path. *Finance and Trade Economics (Caimao Jingji)*, 1, 21-25.
- Zhao, Q. (2009). Fiscal Information Release and Fiscal Transparency: Concept, Rules and International Experience. *Finance and Trade Economics (Caimao Jingji)*, 11, 61-65.