

Greater emphasis on fair taxation as China deepens tax reform^{*}

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The Third Plenary Session of the 18th Communist Party of China (CPC) Central Committee sets forth the direction and roadmap for a new round of tax reforms in China that promises to tackle deeper problems. Based on the spirit of the Session, this paper examines the new tax reform initiatives from the perspective of fair taxation. This paper points out that fair taxation will be the focus of many aspects of the new round of reform, such as stabilizing tax burden, accelerating VAT reform, enhancing the proportion of direct taxes, promoting real estate tax legislation, and managing tax incentives.

Keywords: deepening tax reform, fair taxation

The 18th CPC National Congress Report points out: “A proper balance should be struck between efficiency and fairness in both initial distribution and redistribution of income, with particular emphasis on redistributive fairness.” According to the decision passed at the Third Plenary Session of 18th CPC Central Committee, “Finance is the foundation and an important pillar of state governance. Good fiscal and taxation systems are the institutional guarantee for optimizing resource allocation, maintaining market unity, promoting social equity, and realizing enduring peace and stability.” The socialist market economy places greater emphasis on fairness in income distribution than other economic systems, insofar as fairness in initial distribution gives workers the incentive to work hard, and fairness in redistribution helps to promote harmony and social stability. Another foundation for the socialist market economy is fair competition. Only when enterprises compete equally in the market can their incentive, proactivity and creativity be fully mobilized; only with a higher level of fair competition can the socialist market economy develop in a more dynamic and vibrant manner; and only with fair competition can productive forces be fully liberated, allowing the market to fulfill its decisive role in resource allocation. As the main source of government income, taxation is also the key economic lever for macroeconomic regulation. Therefore, deepening tax reform must focus on fairness.

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1. Modern theories on fair taxation

The principle of fair taxation was first proposed by the founder of classical political science and a pioneer in the field of fiscal science, the English scholar William Petty, who referred to it as “tax standards.” Petty’s thoughts on fair taxation can be found in two of his books—*A Treatise of Taxes and Contributions* and *Political Arithmetick* (Petty, 1981). Inheriting the ideas of equal taxation from his forefathers, another scholar, Adam Smith, systematically and explicitly put forward his famous theory of the four principles of sound taxation in his book *The Wealth of Nations*. This work, in which tax equality is the first of the four tax principles, raised the issue of taxation to a theoretical level for the first time (Smith, 1981). Adolf Wagner is a master of Western theory on taxation. His ideas on equal taxation not only emphasize the need for fair distribution of the tax burden, but also examine tax policies from the perspective of social equality, highlighting the important role of taxation in the implementation of social policies (Wang & Gao, 1998).

Since the 1930s, various schools of economic and tax theories have been established. Studies on fair taxation have achieved significant development. Two studies, one by Arthur Pigou and one by R. A. Musgrave, provide outstanding contributions on this topic. Pigou, the founder of welfare economics, and his followers propose that when a government enacts levies, both efficiency and fairness should be taken as criteria for judging value. The Pigovian fairness criteria can be understood from two dimensions: horizontal and vertical. Horizontal fairness means that people with equal economic conditions should be treated equally. In other words taxpayers with comparable ability to pay should pay comparable taxes. On the other hand, vertical fairness means that people in different economic conditions should be treated differently, taxing the rich more and the poor less. The other major study on the topic is by two contemporary American scholars, Richard A. Musgrave and Peggy B. Musgrave, for whom the first of the six requirements for a sound taxation system as presented in their book *Public Finance in Theory and Practice* should be fairness in tax burden. They believe that the tax burden should be borne equitably and every individual should pay his “fair share.” In addition to analyzing and summarizing previous research on fair taxation, their research also investigates the application of the benefits principle and the principle of ability-to-pay as the chief criteria for building an equitable taxation structure. This second aspect of their research pushed studies on fair taxation to new heights.

A key to guaranteeing both horizontal and vertical equity is defining the criteria for equity in taxation. There are two positions on this issue in Western economic studies. The first position follows the idea of the benefits principle, and it advocates that anyone who benefits from taxes should pay them. According to this principle, people who enjoy more benefits should pay higher taxes, people who enjoy fewer benefits should pay fewer taxes, and those who receive no benefits should not pay any taxes. However, this principle only solves part of the problem (Huang, 2007). The other position supports the idea that taxation should be based on the principle of ability-to-pay, i.e., paying taxes according to one’s ability. The principle of ability-to-pay states that how

much a taxpayer should pay or how much tax burden he should bear should be determined by the capacity of the taxpayer to pay taxes. People with greater capacity should pay more, those with lower capacity should pay less, and those with no capacity to pay taxes should not pay any. This principle has been recognized as both reasonable and practically feasible. However, how to measure a taxpayer's ability to pay has plagued scholars. Income, property, and consumption are all indicators for the ability-to-pay principle, but each of them is by itself biased. As a matter of fact, it is very difficult to identify one absolutely accurate and fair yardstick by which to measure a taxpayer's capacity to pay taxes.

In China, not only is the principle of fair taxation an important topic of theoretical research but it has also played a significant role in guiding previous tax reforms. As stated in the Constitution of the People's Republic of China, Article 33, Item 2, "All citizens of the People's Republic of China are equal before the law." Tax equity is the legal reflection of fair distribution of the tax burden. It reflects both the spirit of social justice in the field of taxation and the spirit of equality and the rule of law such as reflected in the Chinese Constitution, and is crucial for mitigating social conflicts, stabilizing social and economic order, and building a harmonious society. In addition, implementation of the principle of fair taxation may help taxation authorities to realize a tax system that features ability-to-pay, fair and equitable tax distribution, and equal vertical taxation. Taking the principle of fair taxation as a starting point, the adjustment functions of taxation on income distribution will narrow the wealth gap, promote distributive fairness, and achieve equal treatment for all taxpayers (Chen, 2009). Although economists in different times may have had varied interpretations of the concept of fair taxation, one thing has remained unchanged, namely, most countries recognize the principle of fairness as a basic criterion tax system design and an important goal in tax reform.

2. Analysis of the current taxation system in China from the equity point of view

China has integrated the concept of fair taxation in its previous rounds of tax reforms. For instance, the large-scale tax reform in 1994 was conducted under the guidelines of "unified tax law, fair tax burden, simplified tax system, and reasonable decentralization." The 1994 tax reforms also proposed that "the relation of distribution should be straightened out and fiscal revenue should be guaranteed in order to establish a taxation system that complies with the requirements of the socialist market economy." After the 1994 tax reform and years of progress, China has constructed a tax system that is adequate for meeting the basic needs of its socialist market economic system. The new tax system has played a positive role in ensuring tax revenue, strengthening state macro-control, deepening reform and opening up, and promoting the sustained, rapid and healthy development of the national economy.

Moreover, since 1994, China has progressively realized equity in taxation on various types of enterprises. In addition to ensuring fair treatment of state-owned enterprises and private enterprises pay equal taxes, foreign investment-funded enterprises are also treated equally with domestic companies in terms of taxation. Through non-discriminatory tax treatment, taxation can

greatly stimulate the economic vitality of enterprises by offering a level playing field.

The goods and services tax is a pivotal category in China's current tax system. In 2013, revenue from the tax on goods and services reached 4.54 trillion RMB, accounting for 35.25% of total tax revenue.¹ As many know, the goods and services tax is an indirect tax. Corporations can transfer the burden of this tax to consumers who buy the goods and services. Since the tax burden, either from production or consumption, is eventually transferred to consumers via pricing mechanisms, comparatively speaking, low-income consumers pay more on necessities as a percentage of their total income. This has a regressive effect. The higher the proportion of taxes on goods and services among all tax categories, the greater the regression effect will be. That is to say, China's current high proportion of taxes on goods and services is not advantageous to realizing tax fairness.

In China's current tax system, income tax includes corporate income tax and personal income tax. The revenue of corporate income tax in 2013 was 1.44 trillion RMB, accounting for 11.18% of total revenues.² Corporate income tax is one of the world's most popular tax categories, and most countries collect corporate income tax. Since it is calculated based on the net income of enterprises, the corporate income tax is the most fair as a tax category. However, as a commonly used tool for macroeconomic control, corporate income tax is inevitably applied differently to various types of enterprises, sectors and income levels, resulting in policy-induced tax inequity. Although China's current taxation laws and regulations are highly standardized and in favor of tax equity, excessive and redundant preferential tax policies are not conducive to the realization of fairness in taxation.

China's personal income tax receipt reached 391.88 billion RMB in 2013, accounting for 3% of total revenue.³ Taken from the net income of a natural person, personal income tax is common tax category that applies in most countries. With the breadth of its scope, personal income tax plays a crucial role in the regulation of personal income distribution and mitigating a country's income inequality. Under China's current tax system, personal income tax is withheld at the source at different fixed rates depending on one's income level. From a taxation system perspective, having different tax rates for different sources of personal income is disadvantageous to achieving tax equity. The low proportion of personal income tax revenues in the country's total tax revenue has also undermined its role in mitigating income inequality.

In many countries, property tax is imposed on existing assets and plays a similar function in regulating the wealth gap. China only imposes property tax on enterprises and real estate used for business activities. In 2012, property tax revenues were 137.24 billion RMB, accounting for 1.36% of total tax revenue.⁴ The provisional regulation on property tax introduced by the State Council in 1986 is still in effect today. Outdated in terms of its scope, why must pay it, at what rates and its total burden, these regulations can no longer satisfy the demands of the socialist market

¹ Source: Ministry of Finance, China.

² Source: Ministry of Finance, China.

³ Source: Ministry of Finance, China.

⁴ Source: Ministry of Finance, China.

economy. They have failed to meet the needs of development or to adjust property ownership, and do not help to achieve equity in taxation.

3. Building a modern and more equitable taxation system through comprehensive deepening of reform

Decisions of the Third Plenary Session of 18th CPC Central Committee repeatedly stressed the importance of equity in the economy, market, distribution, and social development. The document states, “We will uphold the direction of reform towards the socialist market economy, and hold the promotion of social fairness, justice, and improvement of people’s lives as the starting point and ultimate goal.” *Decisions* suggest that to deepen reform in a comprehensive manner, China must consider both equity and efficiency, with a greater emphasis on the former in future reforms.

3.1. The fundamental transformation

Decisions pointed out that, with respect to economic activities, “We must accelerate the transformation of our growth model, and make China an innovative country. We must promote more efficient, equitable, and sustainable economic development,” and “improve the efficiency and fairness of resource allocation.” This is to make sure that “all the wealth-creating sources completely flow, and that the fruits of development benefit all people still more and equally.” The *Decisions* marks the fundamental change in China’s economic development from “prioritizing efficiency over fairness” to firmly keeping “a proper balance” between the two. Fair treatment in economic activity can be achieved in three stages: fairness in starting point, fairness in procedure and fairness in outcome. China’s future economic plans must aim to achieve all three forms of fairness.

3.2. Stabilizing the tax burden

As was pointed out in *Decisions*, “We must improve legislation, clarify the assignment of powers and responsibilities, reform the tax system, and stabilize tax burdens.” China has successfully achieved the goal of increasing the “Two Ratios”¹ proposed in the 1994 tax reforms. The next step for deepening tax reform is to stabilize the tax burden. A high aggregate tax burden hurts economic development and undermines efforts to mitigate regional and urban-rural development gaps. It neither increases supply nor expands domestic demand. Therefore, stabilizing the tax burden is an appropriate strategy for sustaining China’s future development. According to the data in the OECD’s *Income Statistics 1965-2012* that was published at the end of 2013, the aggregate tax burden in OECD countries has continued to rise in the past few years, which were 33.6% in 2009, 33.8% in 2010, and 34.1% in 2011 and 2012.² Although the number

¹ These refer to: (1) the value of fiscal revenue as a share of GDP, and (2) central government revenue as a share of total government revenue.

² OECD, Revenue Statistics 1965—2012.

for China, 19.4% in 2009 (Zhang, 2013), is still relatively low, the country faces a similar upward trend as do OECD countries. In order to realize equitable social distribution, under the premise of structural tax reduction, it is necessary to stabilize the tax burden and to adjust the tax burden distribution among residents with varied incomes and of different sectors via tax reform.

3.3. Turning business tax into value-added tax (VAT)

According to *Decisions*, “We will promote VAT reform and simplify the tax rate appropriately. We will adjust the scope of collection, procedures and rates of consumption tax, and impose this tax on products that consume too much energy and cause serious pollution, as well as on some high-end consumer goods.” One challenging task that China faces in reforming the tax system is to turn business tax into VAT as soon as possible.

China started its VAT pilot project in the second half of 1979. The initial stage of the project included cities such as Xiangfan, Shanghai, and Liuzhou and focused on five categories of goods, including machinery. In 1982, the Ministry of Finance issued *Provisional Regulations of the People's Republic of China on Value-added Tax*, which required certain industries to put the VAT into trial use by 1983. By 1984, the State Council passed *Regulations of the People's Republic of China on Value Added Tax (Draft)*, which required levying value added tax on 12 categories of goods, including machinery, automobiles, and steel. The *Draft Regulations* can be seen as a landmark for China in its efforts to adopt and implement a value-added tax.

In 1993, during China's comprehensive industrial and commerce tax reform, the State Council passed and introduced *Interim Regulations of the People's Republic of China on Value-added Tax* which required VAT nationwide on sale services, goods imports, processing, repairs, and replacement services. Since the 1994 industry and commerce tax reform, VAT taxes have become China's largest source of tax revenues, reaching 221.26 billion RMB in 1994, and accounting for 43.3% of total revenue. VAT taxes in China were a solid second step in tax reform, and VAT has since achieved tremendous progress. The new version of VAT regulations unified standard tax rates, extended the scope of application, and increased tax revenue; however, China's VAT taxes are a production-type VAT that do not deduct corporate capital goods. Moreover, most corporations in the service sector are still paying the business tax, which results in double taxation. “Restrained by certain conditions of the time, the VAT system that was established in the period of economic transformation has not been fully developed in depth and breadth compared with those of other countries” (Xiao, 2012). The task of deepening China's VAT reform remains challenging.

Beginning in July 2004, China set up several VAT pilot programs for eight industries in the northeast region. Later, In July 2007, 26 cities of the central region joined the project. From July 2008, five cities in the eastern Inner Mongolia autonomous region and the earthquake-hit areas in Sichuan also became pilot cities. To encourage investment and promote the advance of technology, in November 2008, the State Council adopted the amended *Interim Regulation of the People's Republic of China on Value-added Tax*, which called for nationwide shift toward VAT

to begin in January 2009. Full implementation of the VAT reform would include machines and equipment in the scope of VAT deduction, allowing companies to deduct VAT when purchasing new machinery. The nationwide implementation of VAT reform beginning in 2009 took a different approach than the pilot projects. First, as mentioned, newly purchased equipment would be deductible whether the company made newly-added VAT in the current tax year, or had existing VAT. Second, a unified VAT tax policy for all industries applies across the country. Third, purchased fixed assets could be deducted without the need for tax reimbursement via special VAT invoices and customs tax payment receipts, or other legitimate deduction vouchers. These measures help to transform production-type VAT to consumption-type VAT. Serving great strategic significance, this transformation can be seen as the third step of China's VAT reform.

To further address the problem of double taxation in goods and services tax, to improve the tax system, and to facilitate the development of a modern service industry, the Twelfth Five-Year Plan for National Economic and Social Development of the People's Republic of China, which was passed during the Fourth Plenary Session of the 11th National People's Congress, proposed to "expand the scope of VAT and reduce the business tax accordingly," marking the beginning of a new round of tax reform. This pronouncement showed that China was ready to conduct another round of VAT reform and to set up a modern VAT system with wide scope, low tax burden, simple mechanisms, and a strict enforcement. At its executive meeting on October 26, 2011, the State Council decided to start the effort to deepen VAT reform and gradually replace the business tax with VAT through pilot projects in some regions and industries after January 1, 2012. As decided by the State Council, the first step was to carry out a pilot program in Shanghai to serve as an exemplary model. The second step was to enlarge the scope of the pilot program, replacing the business tax with VAT in the transportation industry and modern service sector in Shanghai and 8 other cities and provinces, including Beijing, Tianjin, Jiangsu, Anhui, Zhejiang (including Ningbo), Fujian (including Xiamen), Hubei, and Guangdong (including Shenzhen). The organizers of these pilot regions started preparatory work on August 1, 2012. To ensure the smooth progress of the pilots and keep the conversion of the old tax system to the new system on schedule, pilot regions provided training and certification for taxpayers, helped taxpayers install collection equipment and systems, issued invoices, among other preparatory measures. Beijing completed the conversion on September 1, 2012; Jiangsu and Anhui on October 1, 2012. Fujian and Guangdong provinces were scheduled to finish theirs on November 1, 2012, and Tianjin, Zhejiang, Hubei by December 1, 2012. Throughout the whole process, authorities closely tracked the operation and recorded what lessons that could be learned. China aimed to gradually expand the scope of the pilot over the "Twelfth Five-Year Plan" period from individual regions to the whole country. The expansion of the scope of the VAT reform is the significant fourth step in China's VAT reforms. Upon completion, China's VAT system will only be one step of becoming a fully modern one.

The conversion from business tax to VAT does not by itself amount to the optimization of the tax structure or simplification of the tax code, which were called for by the Third Plenary Session of the 18th Central Committee of the CPC which required further efforts. In addition to

the conversion, the calculation methods need to be simplified to lower the costs of compliance for both tax collectors and taxpayers. Appropriate simplification of the VAT rate can help to reduce the tax rate and thus optimize the tax structure. Together with consumption tax reforms that may realize structural tax reductions, continued VAT tax reform will ultimately reduce the regressive effects on goods and services tax.

3.4. Adjusting the tax structure and personal income tax

On the topic of deepening taxation system reform, the *Decisions* pointed out the need to “deepen the reform of the taxation system, improve the local tax system, and gradually increase the proportion of direct tax.” The *Decisions* further called for “establishing a personal income tax system that combined different rates for different sources and flat rates across different sources.” Moreover, the *Decisions* stressed the need to “strengthen the income redistribution function of taxation, social security, and transfer payments” and to “protect legitimate earnings and check excessively high earnings.” To optimize the structure of the tax system and increase the proportion of direct tax, many factors need to be considered. Tax reform aims to adjust the tax system from two aspects: increasing the proportion of direct taxes and reducing that of the indirect taxes. On one hand, we can increase the proportion of direct taxes by lowering tax rates and broadening the tax base. So it is imperative to sort out and standardize preferential corporate income tax policies. On the other hand, continuously optimizing the tax structure through a VAT reform is the solution for reducing the proportion of indirect taxes. In addition, we must enhance the income redistribution function of taxation, and combine source-specific and flat rates for personal income tax as soon as possible. There is no doubt that instituting a progressive taxation system is an important part of the current round of reform.

The history of personal income tax in the People’s Republic of China can be traced to 1950’s *Main Points of the Implementation of Nationwide Tax Policy*, which required levying “tax on wage and salary earning” and “tax on interest earning.” But since most working people earned very low wages during that time, the conditions for levying a personal income tax did not exist. After the 1978’s Third Plenary Session of the 11th Central Committee of the CPC, China began reform and opening-up. To adapt to the new trend of development, on September 1980, the Third Session of the 5th National People’s Congress passed the *Personal Income Tax Law of the People’s Republic of China*, which soon took effect. Initially, the law applied to both Chinese citizens and foreign citizens, but applied to the latter only after *Provisional Regulations of the People’s Republic of China Income Tax on Urban and Rural Individual Industrial and Commercial Households* and the *Provisional Regulations on Personal Income* were passed in 1986. Taxation for Chinese citizens were covered by these new regulations. These three regulations on personal income coexisted for quite some time. In 1993, the Fourth Session of the 8th National People’s Congress revised and adopted the new *Personal Income Tax Law of the People’s Republic of China* while abolishing two other regulations in order to have a uniform personal income tax law. Furthermore, the State Council issued *Rules for the Implementation of*

the Individual Income Tax Law of the People's Republic of China and Regulations on Issues of Personal Income Tax Provisions on January 28, 1994 and March 31, 1994, respectively. Since then, the National People's Congress has made minor modifications to the personal income tax law. For instance, the tax authority started to levy personal income tax on residents' interest earnings from their savings deposit from November 1, 1999 but temporarily suspended it after October 9, 2008. From January 1, 2000, sole proprietorships and partnerships were no longer required to pay corporate income taxes. Instead, income of their investors and that of industrial and commercial households had to pay personal income tax. Adjustments were also made to the amount that is tax exempt for wages and salaries. On January 1, 2006, it was increased from 800 yuan to 1,600 yuan, and to 2000 yuan on March 1, 2008, and finally to 3500 yuan on September 1, 2011. Nevertheless, the current personal income tax system is still based on the *Personal Income Tax Law* issued during the 1994 tax reform.

China aims to adopt a flat rate personal income tax system when conditions permit and the time is right. Meantime, however, to improve fairness and operability, China has adopted a gradualist approach to the shift from a source-specific rate system. Currently, a combination of both source-specific and flat rates is being used for calculating personal income tax.

There are several key points that need special attention when designing a mixed rate personal income tax system. On one hand, a flat rate must apply to four common types of labor earnings, including earning from wages and salaries, from self-employment, from partnership ventures, and from wholly owned enterprises. Tax from these types of earnings should be paid in advance and the consolidated taxable income should be calculated based on annual net income in accordance with the progressive tax rate at the end of each year. On the other hand, the collection of personal income tax from remuneration, royalties, dividends, capital gains, income from the transfer of property, and incidental income still follows the current practice of withholding at the source. By doing so, the current personal income tax system achieves both feasibility and equity.

To reduce the burden on individual taxpayers, the deduction system needs to be improved. Under the current personal income tax system, a fixed proportion is deducted according to the requirements of various categories of tax. This simple deduction mechanism cannot objectively reflect the cost to taxpayers of obtaining their income or effectively show one's "ability to pay." It is a common practice in many countries to divide the deduction from taxable personal income into three categories, namely basic deductions, cost-of-living deductions, and special deductions.

Basic deductions are based on the costs obtaining an income, as well as tax-relief items. Tax relief is an income waiver issued by a country based on various strategic considerations such as economic efficiency, social justice, political stability, and the development of key industries. Provided to those who have taxable income but are exempt due to preferential tax policies, tax relief is by nature a tax incentive (Chen, 2009). The aim of cost-of-living deductions is to help make sure taxpayer has enough to money to maintain subsistence. China's personal income tax system is thus progressive insofar as it exempts low-income earners from paying personal income tax and levies higher taxes on high-income groups. But even for taxpayers at the same income level, a uniform personal income tax rate is inapplicable since different families can vary

widely in their actual circumstances. For example, families with dependent spouse, children, and elderly should be treated accordingly. Special deductions mainly aim to reduce other living expenses borne by taxpayers besides the aforementioned. Considering that all taxpayers do not have the same cost of living expenses, honesty is imperative if the system is to work as intended. Special deductions can be divided into three categories: medical expense deductions, educational expenses deductions, and housing mortgage interest or rent deductions.

Filing of personal income tax returns should be encouraged and promoted, as it is an important supporting measure for the implementation of the mixed rates system for personal income tax. Most countries adopt a personal income tax return system. For example, in the U.S. and Germany, couples are allowed to file joint tax returns. France adopts a more complex and unique “head of household” method for filing tax returns. Currently, only taxpayers with over 120,000 RMB in annual income are required to file returns, but we can already draw lessons from these experiences that may be applied to universal filing. To summarize, a mixed rate system can improve China’s personal income tax system with respect to equity.

3.5. Real estate tax reform

Regarding the reform of the tax system, the *Decisions* of the Third Plenary Session of the 18th CPC Central Committee also pointed out that we will “accelerate real estate tax legislation and push the related reform forward in a timely manner.” The real estate tax is a major property tax and also an important category of direct tax. Since it is closely related to the economic interests of thousands of families, real estate tax should be treated with great caution so that it is fair and sensible. It is necessary to balance between using it as a source of local tax revenue and as a tool for regulating existing assets.

After the founding of the People’s Republic of China, the State Council passed the “Main Points for Implementing a Nationwide Tax Policy” in January 1950, which called for a unified national housing property tax. In June of the same year, the tax authority made a minor adjustment that combined the housing property tax and land property tax. In August 1951, the State Council introduced the “Provisional Regulations on Urban Real Estate Tax,” which provides a unified set of codes for real estate tax in the form of a separate law. During 1973’s simplification of the country’s tax codes, two adjustments were made to real estate tax: (1) to make collection simpler, pilot urban housing property taxes that used to be paid by enterprises were merged into the industrial and commercial tax paid by these enterprises; (2) individuals who owned property, including foreign nationals and enterprises in property management sectors would continue to pay urban real estate taxes.

By 1984, the State Council decided to implement the second step in replacing a system of profit-sharing between state-owned enterprises and the government with corporate income tax and to deepen reform of industrial and commercial tax. At the same time, the government reinstated urban real estate taxes for businesses. However, since urban land is owned by the state, and users do not have ownership, urban real estate tax was divided into two categories: housing property

tax with the nature of a property tax, and urban land use tax that can be seen as essentially a type of resource tax. In September 1984, the State Council passed the “Interim Regulations of the People’s Republic of China on Real Estate Tax” (which took effect on October 1, 1984), which retained the previous rules on urban real estate tax for foreign nationals who possessed and used housing property and for foreign-invested enterprises. This created a real estate tax system that treated enterprises with domestic and with foreign investment differently. In September 1988, “Provisional Regulations of the People’s Republic of China on Urban Land Use Tax” was introduced by the State Council, and took effect on November 1, 1988.

With the progression of economic reform and the development of the socialist market economic system, China joined the WTO in 2001, which offered more mature conditions for unifying the tax system for both domestic and foreign-invested businesses. In 2008, the State Council issued Order No. 546 in which it was stated that foreign-funded businesses and foreign individuals would pay housing property tax. The “Interim Regulations of the People’s Republic of China on Real Estate Tax” were abolished at the same time. Only domestic and foreign enterprises, organizations and individuals owning property or gaining rent from the property were required to pay housing property tax and urban land use tax. Housing property owned and used by individuals, government agencies, and non-profit organizations for their own needs was not subject to taxation.

Real estate tax has many functions, such as (1) providing tax revenue for local governments; (2) mitigating the gap between the rich and poor; (3) regulating resource allocation on the real estate market; (4) curbing real estate speculation. But the tax has many problems too. First, the current real estate tax in China is quite narrow in its scope, has a weak tax base, and generates little revenue. It can hardly provide a stable source of income for local governments, who have to rely on the real estate tax revenue collected during the development stage, causing inflated market prices. Therefore, in many regions, maldistribution of taxes provides a breeding ground of corruption for the privileged few. Second, since the current real estate tax is levied on commercial real estate, owners of housing property incur zero tax burden. In other words, the opportunity cost for real estate speculation is very low, encouraging a strong willingness among the rich to own multiple homes. This exacerbates the mismatch between housing demand and supply and causes a false bull market, while seriously wasting resources by creating a huge number of vacant homes. Third, excessive profits from real estate investment have lured both individuals and businesses to rush to the market, upsetting the order of market economy and income distribution while widening the income gap. To cope with these challenges, the regulating function of taxation should be given full play in order to guide the sound and stable development of the real estate market. It is imperative and urgent for China to carry out reform of its real estate tax system. It is also crucial to ensure the reformed taxation is a rule-based system that strictly follows legislation before formal and full implementation.

It is a common practice internationally to levy property tax on real estate appraisal values, and a tax base that references market values better suits the principles of the market economy. China should base its real estate taxation on real estate appraisal values instead of the original value,

closely connecting tax revenue and the market value of real estate. Using the appraisal value as the basis for taxation, the tax system can not only create a rich and wide tax base to provide stable revenue, but also effectively enhance the optimal use of land resources by fully utilizing the regulatory function of taxation. Thus, using real estate appraisal values as the basis for tax rate calculation and setting up a scientific and reasonable evaluation system should be a key objective in China's real estate tax reform.

In summary, China should gradually establish its property tax system by designing taxation for the development, holding, and transaction of real estate to better regulate income distribution and achieve tax equity in the field of property tax.

3.6. Preferential tax policies

To deepen the reform of the tax system, the *Decisions* states that China will be “in line with the principles of unifying taxation and promoting equality in tax burdens and fair competition” and “will strengthen management of preferential tax policies, especially regional preferential tax policies.” Preferential tax policy is a specific measure employed by a nation as a regulatory tool to achieve macro-control. Such tax policies may play significant roles in supporting reform, promoting development, and ensuring fairness. However, excessive and haphazard use of preferential policies may bring unwanted effects such as disrupted order of the market economy or an environment unfavorable to competition. Therefore strengthening management of tax incentives, especially regional tax incentives, is also a major task for tax reform.

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