Chapter 1
Introduction

The real growth rate of China's gross domestic product (GDP) was 7.4 % in 2014, 0.3 percentage points lower than that of the previous year, the lowest growth rate since 2000. The corresponding consumer price index (CPI) rose by 2 %, but the producer price index (PPI) fell by 1.9 %. Moreover, the investment growth rate fell sharply, leading to the decline in GDP growth.

Although the investment growth rate fell sharply, the growth rate of the private fixed investment was higher than that of the total social fixed asset investment, and investment in the tertiary industry has been gradually expanding. The growth rate of the annual profit of the equipment and high-tech manufacturing industry was strong, and the pace of industrial transformation and upgrading improved. The economy gestates new development space in difficult times. In 2015, we expect investment demand in the modern manufacturing and tertiary industry, except for real estate, to expand further. Therefore, the monetary policy for 2015 should guarantee new credit resources to further meet the needs of emerging industrial expansion and private investment. The government should reform the financial sector and solve the long-standing problem of financing the private investment, which is difficult and expensive. At the same time, fiscal policy should focus on reducing the tax burden on enterprises and ensure the steady growth of private investment. Crucially, government management should reduce administration and decentralize further; carry out negative list management, reducing the burden on enterprises and entrepreneurs; and reduce all kinds of investment and business costs. By comprehensively deepening reforms, adjusting policies, and improving government management, China's economic growth potential could be motivated.

Looking forward to 2015, the US economy will maintain steady recovery, and its growth rate will reach 3.6 %. Following the political upheaval in Greece, the political uncertainty in the eurozone could expand further. Although it has launched a new round of quantitative easing, its economic recovery would be "fragile and unbalanced," with the growth rate likely to be as low as 1.0 %. The euro is expected to maintain its weakening trend in 2015; China's RMB is also expected to face

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modest weakening. Considering the downward pressure faced by the Chinese economy as well as the continuing decline in prices in 2015, the Central Bank of China is expected to cut its interest rate by 25 basis points in the first quarter of 2015 and the annual M2 growth rate is expected to rebound to 12.5 %.

The China Quarterly Macroeconomic Model (CQMM) uses the aforementioned assumptions on exogenous variables and predicts that in 2015, the economy would continue to face downward pressure, although its growth rate would exceed 7.0 % and annual GDP would grow to 7.14 %. China's inflation rate continues to fall, and its CPI will rise by 1.74 %, 0.26 percentage points lower than that in 2014; its PPI is expected to be −2.15 %. As regards imports and exports, China's total exports in USD at current prices will grow by 8.02 %, 1.94 percentage points higher than that of 2014. The growth rate of total imports will rise to 7.57 %, a significant increase by 7 % over total imports of 2014. Influenced by a weaker real estate market and undigested excess production capacity in the manufacturing sector, the growth rate of urban fixed asset investment in 2015 is expected to fall to 10.65 %, 4.57 percentage points lower than that in 2014. The total retail sales of social consumer goods will grow by 11.80 %, 0.32 percentage points lower compared with the previous year.

In 2015, China will complete its 12th five-year plan, and so it is the key year to comprehensively deepen reforms and promote the rule of law and the year in which China's economy will enter a new stage of development under the new normal. Maintaining the economic growth rate at over 7 % and a stable employment situation would help the Chinese government achieve the plan's targets and create favorable conditions to speed up the implementation of its comprehensively deepening reforms.

China's fiscal revenue increased by only 8.6 % in 2014; this was the lowest growth in 23 years. However, from the point of tax revenue structure, the growth rate of indirect taxes, mainly comprising turnover taxes such as value-added tax, business tax, consumption tax, and tariff, showed a reducing trend, whereas, thanks to the people's increasing income, increasing automobile sales, and the expansion and high growth of the state-controlled land transfer tax and property tax base, the growth rate of direct taxes maintained a rapid growth. Furthermore, the ratio of direct taxes to indirect taxes in the tax revenue increased considerably, rising from 0.48 in 2010 to 0.59 in 2014.

"The Decision on Major Issues Concerning Comprehensively Deepening Reforms" (henceforth, the "Decision") points out that gradually raising the proportion of direct taxes is an important part of deepening the tax system reforms and improving the tax institution. The current fall in indirect taxes is mainly due to the decline in economic growth, fall in investment, and reduction in production capacity. Meanwhile, the marginal tax effect of individual production or consumption activities does not change. In other words, the fall in indirect taxes is due to the narrowing tax base and not the declining marginal tax rate, and it is transient, a temporary adjustment that would change along with the growth rate of the economy. The increasing weight of direct taxes due to the difference between the growth rates of direct and indirect taxes is not the same as that caused by institutional tax adjustments.

For a long time, China's tax structure has been based more on indirect taxes because it enables the tax burden to be easily transferred from producers to consumers. Actually, this causes consumers to bear most of the tax burden, reducing their disposable income and thereby inhibiting the growth of consumption. In addition, indirect taxes are unfair over extended time periods. Levying more categories of taxes, which is directly related to personal income level, benefits the income distribution adjustment between enterprises and residents, narrows down the income gap, and promotes residents' consumption.

Reducing the proportion of indirect taxes while raising that of direct taxes could bring down indirect taxes in the short run. However, in the long run, it can help achieve economic transformation and upgrading, promote enterprise investment, boost economic growth, drive the sustainable growth of tax revenue, and avoid the risk that the growth rate of tax maintains a decrease caused by passive adjustments. At the same time, under the current price system based on taxes, as designed in China, reducing the marginal rate of indirect taxes will drive prices down, raise the residents' real purchasing power, promote consumption, fuel economic growth, and improve the demand structure.

Finally, a comparison with other countries or regions in the world shows that the proportion of direct taxes in China is now low—it is lower than that of not only the developed and high-income countries but also the same-income (above-average countries), middle-income, and low-income countries. Thus, there is more room for increasing direct taxes in China.

From the above analysis and using the CQMM, our research group simulates the macroeconomic effect of improving the proportion of direct and indirect taxation to the world's average level (0.63:1) for the period 2012–2014. The policy simulation is designed as follows: The first scenario requires the government to maintain the tax amount, reduce indirect taxes, and increase direct taxes simultaneously and finally to adjust the proportion of direct and indirect taxes to a new scale. Under the second scenario, the government should reduce the indirect taxes, keeping the direct taxes unchanged, and adjust the direct and indirect taxes to a new scale under the falling total tax situation. In this scenario, the simulation includes both the tax structure adjustment and macroeconomic effect of cutting the total tax. Simulation results show that the tax structure adjustment, especially that of reducing the proportion of indirect taxes while reducing the total tax burden on the national economy, strongly promotes investment, expands consumption, and improves the economy's growth rate.

We believe that at this stage, moderately reducing indirect tax and then the total tax burden on the national economy is not only feasible but also necessary. This can even be considered one of the important ideas to motivate China's economic growth potential in the next stage.

From the above analysis, the research team makes the following policy suggestions:

1. In 2015, an important option in financial system reform is to cut the total tax burden. The government should actively reduce the total tax burden on the national economy by adjusting the marginal tax rates and cutting indirect taxes. Although progress in this direction is visible in fiscal and taxation reforms over the past few years, the ratio of fiscal revenue or that of the general government revenue to GDP remains at a high level, and the ratio of nontax revenue even reveals a contrarian rise. During the transformation of this development stage, macroeconomic decision-making authorities should consider the overall situation in which the market plays a decisive role in the allocation of resources, fully consider the reasonable proportion of fiscal revenue and the general government revenue in GDP, and make a determined effort and smooth away any obstacle. Institutional across-the-board tax cuts can be expected to benefit people, reduce the burden on enterprises, motivate social economic activity, and promote market entities to innovate independently and thereby improve the efficiency of resource utilization, reengineer economic growth potential, stabilize investment, and boost consumption.
2. The government should speed up the policy of replacing business tax with value-added tax (VAT). It should extend VAT to construction, real estate, finance and insurance, living service industries, and other fields. The tax rate should be simplified, providing reasonable standards to the average taxpayer and a suitable tax environment for the development of the service economy. The government should sharply reduce the VAT rates in line with the above analysis, perfect the consumption tax system, and adjust the scope of consumption tax, thereby transferring the consumption tax from production or the import link to retail or the wholesale link and from the taxes included in the calculated prices to taxes not included in the calculated prices. The authorities should break up the original distribution pattern by which consumption tax is fully owned by the central government and reserve a part of consumption tax to supply the local financial resources. At the same time, they should reform the existing real estate tax, build a real estate tax system with link tax, promote the reform of personal income tax, pay close attention to construct a personal income tax system combining comprehensiveness and classification, and enable the timely levy of inheritance tax. The government should promote the reform of resource taxes and add water and other natural resources to the scope of resource tax step by step, combining characteristics of the related resources and the nature of resource tax.
3. The government should improve the structure of fiscal expenditure, compress all administrative expenses, and increase the service efficiency of government funds. It should further cut competitive industrial spending and strengthen its support in the field of basic public services that simultaneously has a strong demand for but seriously lacks investment. At the same time, the authorities should strive to maintain an open, just, and fair market order and release entrepreneurship, innovation potential, and vitality of the market entity.
4. The government should promote the administrative power and responsibility list system and strengthen power supervision. Setting up a power list system is not simply combining administrative power but accurately defining the boundary

of power and then solving the decentralization problem between the government, market, society, and the government hierarchy or departments. According to this, the government should reengineer the organization system and business process and enhance the level of governance. Thus, it should also develop the responsibility list and perfect investigation of the responsibility of illegal administration. Specific to offside, absence, and dislocation behaviors during the execution of power, the executants of power should finally be held accountable for their actions. At the same time, the government should continue to improve and revise the market access negative list, carry out enterprise-independent investment decision making, reduce the examination and approval in advance, strengthen supervision during and after processes, and perfect the market regulation system.

Promoting the reform of fiscal and taxation systems and optimizing the tax structure are not meant to cut tax for the sake of tax cuts but to encourage production and consumption and meanwhile go Dutch and avoid crossing subsidies on resource usage and consumption. At the same time, the government should improve the local tax system and make property behavior items such as the real estate tax, consumption tax, resource tax, and deed tax important local tax sources. It should motivate financial power and the responsibilities to match each other and achieve the organic unification of market effects and government in the allocation of resources and thereby strengthen the growth potential. From international experience, for a better and more efficient allocation of resources and a more conducive way to improve the quality of life, common people should participate in public management and supervise government behaviors; this is a more conducive way to cultivate local autonomy, autonomous management, and civil consciousness.