

Chapter 9

Mid-to-Long-Term Fiscal and Tax Reform and Financial Sustainability



Zhiyong Yang and Bin Zhang

The next 15 years will be a crucial period for China to move from building a moderately prosperous society in all respects to basically realizing socialist modernization. It is also a historical intersection period of the “Two Centenary Goals”, and an important opportunity period for China to comprehensively embark on a new journey to build a great modern socialist country.

From China’s external environment, the world is undergoing profound changes unseen in a century, and the political and economic structure and international order are also undergoing great changes. China should play a greater role in global governance. From China’s internal environment, the socialism with Chinese characteristics has entered a new era in which main social contradictions have changed. In the new era, the process of comprehensively deepening reform and promoting modernization of national governance system and governance capacity is progressing in a critical period of “laying foundation for a bright future”. Finance, as the foundation and an important pillar of national governance, should promote modernization of national governance and global economic governance, make fast response to major risks and challenges, address development problems through reform and innovation, and promote reforms in various fields so as to accelerate the establishment of a modern financial system.

Z. Yang (✉)

National Academy of Economic Strategy, Chinese Academy of Social Sciences, Beijing, China
e-mail: 13693186775@163.com

B. Zhang

Institute of World Economics and Politics, Chinese Academy of Social Sciences, Beijing, China

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9.1 Basic Background for Mid-to-Long-Term Operations of Finance and Taxation

9.1.1 *Financial Positioning: The Foundation and Important Pillar of National Governance*

- (1) After building a moderately prosperous society in all respects: China's finance will support new development of Chinese economic society; socialism with Chinese characteristics will enter a new era; and the main social contradiction has been changed into "the contradiction between the people's growing needs for a better life and the unbalanced development".¹ The economy has shifted from a high-speed growth stage to a high-quality development stage, and the development kinetic energy needs to be changed urgently. The people's growing needs for a better life have not only raised higher requirements for material and cultural life, but also increased requirements for democracy, rule of law, fairness, justice, security and environment. After building a moderately prosperous society in all respects, China remains in the primary stage of socialism, which focuses on economic development.

Under this background, the medium and long-term fiscal and taxation reform should not merely be oriented to the high-quality economic development stage, but also to the transformation of the development stage of various undertakings in the social field. The financial function should be comprehensively and profoundly adjusted to provide sufficient financial guarantee for the new development of economic society.

- (2) Goal of state governance: to promote great social revolution

President Xi Jinping pointed out that upholding and developing socialism with Chinese characteristics in the new era is a great social revolution. According to the 4th Plenary Session of the 19th CPC Central Committee, "by the centenary of the founding of the People's Republic of China, the modernization of the national governance system and governance capacity will be fully realized, so that the socialist system with Chinese characteristics will be more consolidated and its superiority will be fully demonstrated".² As the foundation and important pillar of national governance, finance should step out of the limitation of fiscal and taxation reform as a part of economic system reform in the new era. The fiscal and taxation system not only provides financial support for the government to perform its functions, but also the fiscal revenue system, budget system and intergovernmental fiscal relations are the basic institutional arrangements involving the relations between government and market, government and society, government departments and governments at all levels. In the mid-to-long-term fiscal and taxation reform, we should develop

¹ Xi (2017a, b).

² People's Daily (2019).

socialist democracy, display superiority of the socialist system with Chinese characteristics, promote planning of the great social revolution, and advance institutional improvement in the fiscal and taxation sectors in accordance with the requirements of “guaranteeing the unity of Party leadership, the running of the country by the people, and law-based governance”.

Since the outbreak of the international financial crisis in 2008, the process of economic globalization has entered a new stage, characterized by rising protectionism, bitter backlash against globalization and the weakening of the driving force of globalization. In the meantime, the world economy has been in a long-term downturn; the income distribution gap remains high; populism gains strength; and the geopolitical pattern continues to be turbulent. The accelerated development of the new round of industrial revolution has led to the increasing competition among nation-states in the fields of science and technology and innovation, and we are witnessing major changes unfolding in our world. The global governance pattern has put forward new requirements for concrete realization of national governance and financial positioning.

9.1.2 Fiscal and Tax Operation Environment

(1) Impact of urbanization and regional balanced development

In the medium and long term, urbanization will continue developing rapidly to narrow the gap between the east and the west. It will also face the new problem of economic growth differentiation between the north and the south, which will put forward higher requirements for continuing to promote the equalization of basic public services and giving full play to the enthusiasm of the central and local governments. The report of the 19th National Congress of the Communist Party of China clearly put forward the requirement of establishing a central and local financial relationship with clear rights and liabilities, coordinated financial resources and balanced region.³ The Fourth Plenary Session of the 19th CPC Central Committee further required perfecting and giving full play to the enthusiasm of the central and local governments, including giving local governments more autonomy, supporting local governments to work creatively, and stabilizing the rights of governments at all levels, and form a system in which expenditure and financial resources are compatible.⁴ Therefore, from the overall situation of the medium and long-term fiscal and taxation system reform, China’s forms will focus on optimizing the financial relationship between the central and local governments, on building of local tax system and on promoting the equalization of basic public services.

³ Xi (2017a, b).

⁴ People’s Daily (2019).

(2) Changes in the fiscal and taxation operating environment in the stage of high-quality economic development

The transition of economy from high-speed growth stage to high-quality development stage means that the external environment of fiscal and taxation operation has undergone a fundamental change. For a long time, China's fiscal and taxation reform has been promoted under the environment of rapid economic and tax growth. During the 13th Five-Year Plan period, with the downward trend of economic growth and the implementation of large-scale tax reduction and fee reduction policies, the basic situation that the proportion of fiscal revenue to GDP is constantly increasing no longer exists.

For a considerable period of time, fiscal policy has continued its counter-cyclical adjustment role in "stabilizing growth", promote supply-side structural reform, stimulate market vitality and promote economic structure optimization. How to promote fiscal and tax reform under the background of economic growth and economic restructuring is a basic issue that needs to be studied in the medium and long term.

(3) Impact of population aging

In the medium and long term, China's population aging process will further accelerate, which will not only have a significant impact on China's factor endowment, resulting in profound changes in the structure of savings, investment and consumption, but also have a significant impact on the total amount and structure of fiscal expenditure. The gap between fiscal revenue and expenditure caused by the increase of aging social welfare expenditure will bring great challenges to fiscal sustainability. In order to change from "demographic dividend" to "talent dividend" as soon as possible, it is extremely urgent for China to optimize the structure of education expenditure.

As far as tax system reform is concerned, the accelerated development of population aging first requires accelerating the reform of social insurance payment system. While promoting the overall planning of the whole country and the unified tax collection by tax authorities, we should handle the relationship between moderately reducing the nominal rate of social security contributions and increasing the charge rate, and study and promote the transformation of social insurance fees into taxes. In addition, the dynamic changes brought about by population aging, such as the decrease of labor participation rate and the increase of the organic composition of enterprise capital, will profoundly affect the structure of labor returns and capital remuneration, savings and consumption, and tangible goods and services within consumption. This will have an important impact on the tax base of value-added tax and personal income tax. The tax system should be adjusted accordingly to adapt to this change.

(4) Impact of the digital economy and the new round of industrial revolution

In the future, a new round of industrial revolution represented by digital economy, new energy, new materials, quantum technology and bioengineering will develop rapidly, and the competition among major countries in the world for new technologies will become increasingly fierce, which is both an opportunity and a challenge for China. Therefore, promoting the innovation-driven development strategy and realizing the transformation of old and new kinetic energy will remain a key and important strategic task, in which fiscal and taxation policies have to play an important role. The creative destruction, the total employment and structural changes, and the expansion of income distribution gap caused by new technological revolution have also raised new requirements for the adjustment and optimization of the structure of fiscal expenditure.

In the future, we will pay special attention to the impact of the development of digital economy on the tax system. Digital technology has changed the production organization mode, the spatial structure of production factors and the connection mode between production and consumption in the era of industrial economy, and is reshaping the internal and international benefit distribution pattern of various countries, thus bringing revolutionary challenges to the current tax system and international tax rules based on industrial economy. At present, countries all over the world are generally faced with important tasks such as the transformation of tax system towards the digital economy era, deepening the coordination of global tax system and collection and management, etc. Meanwhile, digital technology has also provided tax authorities with brand-new tax-related information collection and processing technology, and brought about digital changes in tax collection and management.

(5) Impact of economic globalization and opening up in a new stage

In the future, the external environment facing China's economic and social development may be more complex due to more uncertainties and challenges. Under the background of economic globalization entering a new stage, China will promote a new round of high-level opening up and form a new structure of all-round opening. How to introduce an internationally competitive tax system and policy in the construction of Hainan Free Trade Port is an important task to meet the needs of the establishment of an open economic system.

To adapt to new changes in global economic governance, while participating in the global supply of public goods and promoting the reform of supply mechanism, we should carefully evaluate and judge the development trend of international tax system and enhance the international competitiveness of China's overall tax system. In order to meet the needs of the development of digital economy and the building of the Belt and Road, while enhancing the international competitiveness of China's tax system, we should strengthen the coordination of international tax system from a global perspective, and lay a tax system foundation for promoting connectivity, openness and inclusive development of the global economy.

9.1.3 Medium and Long-Term Fiscal Policy Control System

Fiscal policy and the reform of fiscal and taxation system are two relatively independent and closely related aspects. Fiscal policy in a narrow sense aims at coping with short-term macroeconomic fluctuations and focuses on demand management, while the fiscal and taxation reform is a change of system and mechanism and a long-term institutional change. In the medium and long term, China's external environment may be more complex. Under the circumstances of more uncertainties and challenges, it is necessary for China to optimize its fiscal policy regulation system, strengthen the overall coordination between fiscal and taxation system reform and fiscal policy, and handle the relationship between short-term impact and long-term system optimization in response to economic and social risks.

China's fiscal policy will be more flexible so as to meet the changes of domestic and international economic situation. We will deepen our understanding of different types of fiscal policy tools, optimize the policy combination, and consolidate and expand the policy effect in terms of "improving quality and increasing efficiency". We will improve the scientific nature of the formulation and implementation of fiscal policies, delimit the functional boundaries of policies, and clarify what fiscal policies can do, what they are not good at, what they are efficient in and what they are ineffective in. In addition, by deepening reform of the fiscal and taxation system, especially reforms of the tax system reform, the reform of financial relationship between the central and local governments, and the supporting reforms of state-owned enterprises, financial system, market quasi-personnel, etc., we will smooth the transmission mechanism of fiscal policy in the middle and micro fields, strengthen the quantitative evaluation of policy effects, and lay an institutional and technical foundation for "improving quality and increasing efficiency" of fiscal policy. More attention will be given to the role of fiscal policy as macroeconomic policy so as to further strengthen the coordination between fiscal policy and monetary policy.

There are two main principles for the establishment of the division of labor and cooperation mechanism between fiscal policy and monetary policy. First, we should establish the division of labor between "big finance" and "big monetary".⁵ The fiscal departments and the monetary and financial departments will be well coordinated. Cost sharing and risk control of counter-cyclical adjustment are particularly important issues in the process of division of labor. Second, we will set out to establish the division of labor framework and working procedures to deal with the crisis. China's fiscal policy will continue to guarantee economy and society, and make good use of the advantages of the administrative system. The monetary policy will focus on stabilizing market confidence and supplementing liquidity, and make good use of the advantages of financial markets.

⁵ Yang (2018a, b).

We will strengthen the construction of a reciprocal coordination mechanism. We will begin with resolving specific problems such as local government debts and improving cooperation between financial departments and financial institutions, e.g. setting up working relations and cooperation mechanisms, and when conditions permit, establishing a “fiscal policy committee” with the participation of relevant departments.

9.1.4 Challenges Facing Public Finance

In the medium and long term, public finance faces four challenges when profound changes have taken place in internal and external environments.

First, there exists the financial sustainability problems brought about by the declining economic growth rate and the “steady growth” fiscal policy, such as the expansion of the pressure of fiscal deficit, the aging of the population, the sustained growth of the rigid expenditure for people’s livelihood in education, medical care and other aspects, and other problems caused by the interweaving of short-term, medium- and long-term factors, especially the local financial risks caused by the accumulation of local debts.

Second, it is getting more difficult for the reform of local fiscal and taxation system to seek balance among more complex and interactive contradictions, such as the relationship between large-scale tax reductions and fee reductions and fiscal sustainability, the relationship between tax reductions and fee reductions policy and medium- and long-term tax system optimization, the relationship between fiscal and taxation policies that encourage innovation and investment, especially the investment promotion policies of local governments and the decisive role of market in resource allocation, and the relationship between building an internationally competitive tax system and increasing the tax burden of capital and high-income groups to adjust income distribution.

Third, the reform of fiscal and taxation system has entered the deep water area. While playing the role of fiscal and taxation reform as the “breakthrough point” and “trailblazer” of comprehensive reform, the deepening of fiscal and taxation system reform urgently needs to strengthen overall coordination with reforms in various fields of state governance. For example, the division of authority of office and responsibility of expenditure between the central and local governments and the reform of local debt system need to be based on the reform of the relationship between the central and local governments at the constitutional level. If we can’t solve the problem that the higher-level government arbitrarily hands over its own fiscal powers and expenditure responsibilities to the lower-level government, the reform of the division of fiscal powers and expenditure responsibilities will be unenforceable. The reform of budget system, the establishment of local income system and the local debt management system of governments at all levels should be based on the improvement of relevant systems of the people’s congress system, and should be connected with the management system of state-owned assets enterprises.

Fourth, facing challenges brought about by economic globalization and opening to the outside world, fiscal and tax reform needs to broaden its “international” vision, so as not only to strengthen research on the influence of external environment on fiscal policy and the spillover of fiscal policy under the new pattern of opening to the outside world, but also to meet the needs of optimizing global economic governance rules and promoting the construction of a community with shared future for mankind.

9.2 Mid-to-Long-Term Reform of Fiscal and Taxation System

9.2.1 *Progress and Existing Problems of the Reform of Fiscal and Taxation System in the 13th Five-Year Plan Period*

- (1) Goals and tasks of the reform of fiscal and taxation system during the 13th Five-Year Plan period

The *13th Five-Year Plan for National Economic and Social Development* (hereinafter referred to as the “13th Five-Year Plan”) reviewed and approved at the National People’s Congress raised specific requirements for “accelerating reform of the fiscal and tax systems”, such as establishing “reasonable and orderly division of financial resources”, “a comprehensive, well-regulated and transparent budget system”, “tax and fee systems” and “mechanisms for financial sustainable development”.

The Report of the 19th National Congress of the Communist Party of China states that “we will expedite the creation of a modern public finance system, and establish a central and local financial relationship with clear powers and responsibilities, coordinated financial resources and regional balance. We will put in place a comprehensive, procedure-based, transparent budget system that uses well-conceived standards and imposes effective constraints; and we will implement performance-based management nationwide. We will deepen reform of the taxation system, and improve the local tax system.”⁶

The Fourth Plenary Session of the 19th CPC Central Committee states that “we will put in place a comprehensive, procedure-based, transparent budget system that uses well-conceived standards and imposes effective constraints. We will optimize the division of the authority of office and fiscal powers between governments at different levels, establish a central and local financial relationship with clear powers and responsibilities, coordinated financial resources and regional balance, and form a stable system in which the powers, expenditure responsibilities and financial resources of governments at all levels are compatible. We will improve the regulatory mechanism of income redistribution mainly by the means of taxation, social

⁶ Xi (2017a, b).

security and transfer payment, enhance the regulatory role of taxation, and perfect the direct tax system.”⁷

(2) Progress of the reform of fiscal and taxation system during the 13th Five-Year Plan period

In the reform of the financial relationship between the central and local governments, the reform on the division of fiscal authority and expenditure responsibilities between the central and local governments has been steadily advanced. The State Council’s *Guidelines on Advancing Reform for the Sharing of Fiscal Authority and Expenditure Responsibilities between the Central and Local Governments* were issued in August 2016, and then the General Office of the State Council has successively published specific reform plans in the fields of basic public services (January 2018), medical and health care (July 2018), science and technology (May 2019), education (May 2019) and transportation (June 2019). In 2020, the sharing of the central and local fiscal powers and expenditure responsibilities in major areas will be basically completed. We will rationalize the sharing ratio of value-added tax revenue between the central and local governments after comprehensively replacing the business tax with a value-added tax, adjust the method of returning value-added tax from the central government to the local original system, implement return of fixed amount of tax, and issue the *Reform Promotion Plan for Adjusting the Income Division between the Central and Local Governments after Implementing Large-scale Tax Reductions and Fee Reductions*. It will be decreased below 0.4 by 2035 and to a relatively reasonable level of about 0.35 by 2050. We will reform and improve the transfer payment system, clean up and integrate special transfer payments, and increase the proportion of general transfer payments.

In the reform of budget management system, we will further promote the openness of budget and standardize the operating procedures for the openness of local budgets and final accounts. We will fully implement budget performance management, speed up the establishment of an all-round, whole-process and full-coverage budget performance management system, and achieve full coverage of project expenditure performance target management of central departments. We will strengthen the establishment of local government debt management system, introduce emergency response plans for local government debt risks, carry out risk assessment and early warning, and actively prevent and resolve local government debt risks. Specific standards and application guidelines related to government accounting will be issued and implemented so as to carry out pilot projects for the preparation of government financial reports. The reform of full-scale budget management has been further deepened, and the overall coordination among budgets has been continuously strengthened.

In terms of the tax and fee system reform, we have carried out pilot reform of replacing business tax with value-added tax (VAT), and deepened adjustment of the VAT rate and reform of refunding tax credit to enterprises. We have made historic

⁷ People’s Daily (2019).

progress in the reform of personal income tax system, and established a special additional deduction system and a tax system combining synthesis and classification. We have completed the reform of ad valorem taxation of resource tax and the reform of replacing environmental protection fee with tax, and improved the preferential tax policy system focusing on promoting innovation and safeguarding people's livelihood. We have made great progress in implementing the principle of taxation legitimacy. By the end of 2019, many tax laws have been upgraded from regulations to laws, and it is expected that the taxation legitimacy work will be basically completed around 2020. The reform of state and local tax collection and management system has progressed smoothly. The level of informatization and digitization of tax collection and management has been significantly improved, and the tax business environment has been continuously optimized.

(3) Major problems in the reform of the fiscal and taxation system during the 13th Five-Year Plan period

First, in terms of financial relations between the central and local governments, the reform of dividing fiscal powers and expenditure responsibilities lacks support from deep-seated reforms related to the transformation of local government functions, and its coordination with the construction of budget expenditure standard system, with the division of central and local income, local tax system, local debt management system and with the reform of financial system below the provincial level needs to be further improved.

Second, in terms of budget management, we will promote budget openness. The construction of the system and mechanism for full implementation of budget performance management has lagged behind, and the role of people's congresses at all levels in budget review and supervision needs to be further strengthened. Basic work such as the construction of budget expenditure standard system, the government's comprehensive financial report and public sector financial management system, the implementation of inter-annual budget balance mechanism and medium-term financial planning management are progressing slowly. The positioning adjustment and overall coordination among budgets in the full-scale budget system need to be further optimized.

Third, in terms of government revenue system reform, VAT simplification and consolidated tax rate reform need to be accelerated, and the reform of real estate tax and social insurance collection system is relatively slow due to internal and external conditions. Improvements will be made in the coordination between large-scale tax cuts and fee reductions reform and medium-and long-term tax reform to increase the proportion of direct tax and optimize the tax system structure. The coordination between large-scale tax reduction and fee reduction reform and medium-and long-term tax reform to improve the proportion of direct tax and optimize the tax structure, the coordination between local tax system construction and tax reform (for example, the contradiction between moving backward the consumption tax collection link and steadily allocating it to the local government and the functional orientation of consumption tax), and the quality of tax legislation need to be improved.

9.2.2 *Medium and Long-Term Reform of the Central-Local Financial Relations*

(1) Reform on dividing fiscal powers and expenditure responsibilities

In the medium and long term, the division of fiscal powers and expenditure responsibilities between the central and local governments will be put under the overall framework of “perfecting and giving full play to the enthusiasm of the central and local governments”, We will make overall progress based on deep-level reforms, such as improving the national administrative system, optimizing the government responsibility system and government organizational structure, giving local governments more autonomy, supporting local creative work, and standardizing the vertical management system and local hierarchical management system.

According to the deployment of the Fourth Plenary Session of the 19th CPC Central Committee, the central government’s authority and powers in intellectual property protection, endowment insurance, cross-regional ecological environment protection, etc. should be appropriately strengthened, and the sharing powers of the central and local governments should be reduced and standardized. Optimization of the division of inter-government authorities and fiscal powers will aim to establish a fiscal relationship between the central and local governments, with clearly defined powers and responsibilities, appropriate financial resource allocation, and greater balance between regions as goal. Emphasis will be placed on optimizing the financial system below the provincial level, promoting the legalization of intergovernmental financial relations, strive to form a stable government power at all levels in the medium and long term, and establish a system in which expenditure responsibility and financial resources are compatible, and study and formulate the *Law on Intergovernmental Fiscal Relations* at an appropriate time.

The division of intergovernmental powers and expenditure responsibilities should comply with the requirements of building a standard system of budget expenditure and promoting the equalization of basic public services. The implementation plan will be refined according to the characteristics of different government powers. Such division should not be limited to the division of financial resources, but also make provisions on standard formulation, organization and staffing, funding guarantee, performance evaluation and supervision and accountability, covering the whole process in which a government performs its functions.

(2) Division of central and local revenues

We will further rationalize the division of revenues between the central and local governments through reform on dividing their authority of office and expenditure responsibility and the reform of tax system and taking into consideration the tax categories. By maintaining the overall stability of the current financial pattern of the central and local governments, we will properly handle the relationship between the enthusiasm of local governments to develop economy according to local conditions

and maintaining market unity, reduce government intervention and let the market play a decisive role in resource allocation. Based on impact of the development of digital economy on the distribution of inter-regional tax sources, we will determine the rules of local tax source contribution ratio, seek for a more reasonable VAT income sharing model, improve the inter-regional income division model of enterprise income tax (headquarters economy), and innovate the income division model between central and local governments.

(3) Improvement of the local government debt management system

From the perspective of debt risk indicators, the current local debt risk is generally controllable. Due to low asset-liability ratio of local governments, there is still room for local debt issuance. Local debt risk can be gradually resolved with the rapid economic growth. In the future, while moderately expanding the local debt limit on the basis of evaluating the solvency of different places, we will focus on establishing the local debt management system and giving full play to the role of local people's congresses in debt management, strengthen the feasibility assessment of special debt projects, give full play to the market's role in identifying debt risks, and do a good job in risk control of specific projects. We will further improve the local government debt risk emergency response system and establish a mechanism to effectively constrain the internal expansion of local debt demand. In addition, we will establish a correlation mechanism between local debt risk and fiscal expenditure control to strengthen restraint of local fiscal expenditure with high debt risk.

(4) Equalization of public services and reform of transfer payment system

In the medium and long term, we will combine the requirements of urbanization and balanced regional development, and align with the reform of the division of government authority of office and responsibility of expenditure. Continuous efforts will be made to promote the construction of a national basic public service system with the list of basic public services as the core, and equalize basic public services in urban and rural areas. Based on key tasks and safeguard measures, we will build the national basic public service system supported by five implementation mechanisms, such as overall coordination, financial security, personnel development, diversified supply channels, as well as supervision and evaluation. The transfer payment system should focus on handling the relationship between region-based equalization and people-based equalization (supporting the citizenization of agricultural transfer population and eliminating differences in household registration system), realizing rational allocation of general transfer payment and special transfer payment, and improve the transparent, well-regulated and law-based transfer payment.

In the medium and long term, we will build and improve the mechanism for the central government to provide financial assistance for local governments.

9.2.3 Reform of the Budget System

(1) Improving the budgetary system of all revenue and expenditures

In the medium and long term, we will put in place a comprehensive, procedure-based, transparent budget system that uses well-conceived standards and imposes effective constraints in accordance with the Fourth Plenary Session of the 19th CPC Central Committee. While further strengthening the overall coordination between budget revenues and expenditures and the budget examination and supervision of people's congresses at all levels, and improving the budget openness, we will adjust and optimize the budget management system for all revenues and expenditures in light of the progress of comprehensive tax and fee reform. In general public budget, we will try to compile a tax expenditure budget that can reflect the items and quantities of tax reduction and exemption, and strengthen budget management of preferential tax policies.

In the financial field, the socialist public ownership means that China has a large number of state-owned assets and resource income. We will distinguish the revenues obtained by political power from the revenues of assets, and establish a complete and unified budget of state-owned assets (resources). Along with the mixed system reform of state-owned enterprises and the compilation of government balance sheet and natural resources balance sheet, we will include related revenues and expenditures of state-owned capital, assets, land and natural resources scattered in general public budget and government fund budget into a unified state-owned assets (resources) budget. We will establish an institutionalized linkage mechanism between state-owned assets (resources) budget and other budgets, especially social insurance budget.

On the basis of cleaning up and integrating various special funds and government fund projects and in order to meet legislative review and supervision of medium and long-term major projects, the government fund budget will be transformed to the budget of major projects so as to build a budget review and supervision mechanism that covers the whole process of feasibility demonstration, investment scale, time limit, fund raising and debt repayment, and project construction progress, project final accounts and performance evaluation of major projects. From the perspective of fund raising, the budget of major projects should include funds invested by public finance budget, government funds collected from the society, special transfer payments from higher-level governments, various government debts directly related to the project and the investment of social capital. For the use of the fund, the budget of major projects should not only include expenditure progress of project construction funds, but also include financial arrangements for repaying principal and interest.

(2) Standardization of budget expenditure and comprehensive performance evaluation

We will distinguish between recurrent expenditure and different types of project expenditure, and prepare budget expenditure standards covering various fixed costs and variable costs. In addition, governments at all levels should rationally allocate

the right to formulate and revise budget expenditure standards on different expenditure items based on the reform of dividing authority of office and expenditure responsibilities and the requirements of equalization of basic public services. The central government should select places with advanced experience in different fields to work out budget expenditure standard models for each specific project, which will be popularized and used nationwide after being revised and improved.

Efforts will be increased to implement comprehensive performance management, establish and improve the system and mechanism whereby the National People's Congress, finance, auditing, government functional departments and social forces play a role in comprehensive performance management. We will focus on application of performance evaluation results, promote optimization of fiscal expenditure structure, and improve the efficiency of capital use.

(3) Cross-year budget balance mechanism and medium-term financial planning

It is clearly required in the 13th Five-Year Plan that "we will implement a mechanism for balancing budgets across fiscal years and put in place medium-term fiscal planning to achieve greater coordination between budgets and plans for economic and social development". But in the process of implementation, this reform involves many environmental, technical and institutional factors, such as the stability of internal and external environment, the formulation of budget expenditure standards, the accuracy of revenue and expenditure assessment and forecast, and the connection between career development planning and financial planning of various departments. On the basis of establishing the budget expenditure standard system and improving the ability of budget revenue and expenditure evaluation, we will make efforts to solve the institutional and institutional obstacles between the inter-annual budget balance mechanism and the medium-term financial planning, and to make overall plans and coordination between the career development planning and the financial planning of various departments by highlighting the role of the National People's Congress in budget preparation.

(4) Government financial reporting system and public sector financial management system

The comprehensiveness and accuracy of government financial revenue and expenditure information and sound financial management system of public departments are important foundations for modern financial system. In the medium and long term, we will further speed up the construction of accrual-based government comprehensive financial reporting system, draft government financial reports, establish and improve the analysis and application system of government financial reports, and formulate the audit system and disclosure system for issuing government financial reports. As the *Government Accounting Standards* was in place, we will promote reform of the financial management system of the public sector through further strengthening the accounting, internal control and fund management of the public sector, especially the accounting and management of assets and liabilities.

9.2.4 Reform of the Tax System

(1) Medium and long-term macro tax burden and comprehensive reform of taxes and fees

Since 2013, the growth rate of China's tax revenue has been lower than the nominal GDP growth rate, and the proportion of tax revenue in GDP has decreased from 18.7% in 2012 to 15.9% in 2018. The proportion of general public budget revenue to GDP has also decreased year by year since 2016, from 22.2% in 2015 to 19.2% in 2019.⁸ The proportion of government revenue to GDP in a broad sense (excluding land transfer income) decreased from 29.1% in 2015 to 28.0% in 2018.⁹ Due to continuous large-scale tax reductions and fee reductions, the macro tax burden level will further decline in 2020.

The medium and long-term macro tax burden is influenced by many factors, such as the scale of fiscal expenditure, the strength of proactive fiscal policy, and the progress of tax and fee system reform. From the evolution of the world political and economic pattern, there are great differences in development stages and government functions; however, as two largest economies, China and the United States are more comparable in promoting economic growth and scientific and technological innovation. At present, China's overall macro tax burden is close to that of the United States. Considering the increasingly fierce economic and technological competition between China and the United States and the fiscal expenditure pressure brought by the aging population, it is necessary for China to maintain the current macro tax burden level in the medium and long term.

The revenue structure of Chinese government is characterized by complexity and diversity. Under the constraint of fiscal sustainability, we will control the scale of fiscal deficit and debt. Therefore, the reform of government revenue system related to medium and long-term state-owned enterprises (including state-owned financial enterprises), state-owned resources and state-owned land is an important factor affecting the space of tax reductions and fee reductions and the mid-to-long-term tax and fee system reform.

After large-scale tax reductions and fee reductions, the institutional arrangement for improving the profit payment of state-owned enterprises should be based on the premise that all kinds of ownership enterprises carry out competition based on fair, open and transparent market rules and business environment ruled by law, and avoid obtaining greater excess profits by strengthening administrative monopoly position as a compensation channel for government revenue after tax reductions and fee

⁸ Data in 2019, calculated according to the number of budget reports in 2020. Ministry of Finance: Report on the Execution of the Central and Local Budgets for 2020 and on the Draft Central and Local Budgets for 2021, At the Third Session of the 13th National People's Congress on May 22, 2020, May 30, 2020, official website of the Ministry of Finance of the People's Republic of China, http://www.mof.gov.cn/gkml/caizhengshuju/202005/120200530_3523307.

⁹ Financial data sourced from official website of the Ministry of Finance of the People's Republic of China, www.mof.gov.cn; GDP figures are from the National Bureau of Statistics, www.stats.gov.cn.

reductions. We will continue to observe the guiding idea of “abolishing fees and replace them with taxes”, extend the principle of taxation legitimacy to all kinds of special income collected free of charge and government fund projects, and give local people’s congresses the legislative power over all kinds of non-tax income set up by local governments.

(2) Reform of the tax system and improvement of the local tax system

In 2019, after the VAT rate was lowered to 13, 9 and 6%, China’s VAT rate was close to the level of Goods and Services Tax (GST) in non-EU countries. Under the condition that the tax base is converging and the tax rate was significantly lower than the VAT in EU countries, it is expected that relative revenue scale of VAT will drop significantly in the future, thus leading to a major adjustment of the tax system structure. In the medium and long term, the focus of VAT reform is to simplify tax rates; however, if the reform cannot be implemented by raising tax rates, it will lead to further reduction of tax rates.

While the proportion of value-added tax in tax revenue is declining, the medium and long-term tax system reform should move along the direction of “gradually increasing the proportion of direct tax” and continue to promote the reform of personal income tax. Under the existing comprehensive and classified tax system framework, we will strengthen tax adjustments for high-income earners and gradually increase the income scale of personal income tax and its proportion in tax revenue. The reform of real estate tax will also be carried out when most of conditions are met. On the basis of improving the preferential income tax policy system for SMEs and encouraging innovation, the enterprise income tax rate will be moderately lowered. After perfecting the social security system, improving the overall planning level and promoting the reform of the social security collection and management system, we will further optimize the social insurance payment system, when conditions are ripe, the social insurance fee will be changed to tax.

After giving full play to the role of taxation in raising fiscal revenue, we will build and improve a compound tax system with different duties, coordination and complete functions in line with attributes of taxes, and continue to promote the reform of consumption tax, resource tax and environmental protection tax, improve the indirect tax system, and let taxation play a role in promoting resource conservation, environmental protection and guiding production and consumption in accordance with the requirements of “moderate adjustment”.

In the medium and long term, the establishment of local tax system should combine the progress in the reform of dividing authority of office and responsibility of expenditure with the reform of tax system. We will start with the government’s total financial revenue and expenditure management system and optimizing the local government’s financial structure. Then we will determine the reasonable scale of local tax by combining local government expenditure structure and the corresponding special revenue, asset revenue and debt revenue. According to the requirement of “giving local governments more autonomy to support them in carrying out creative work”

at the Fourth Plenary Session of the 19th CPC Central Committee, we will carry out pilot projects to expand the legislative power of local taxes and fees, give local people's congresses the power to add tax items, determine tax rates, levy or attach local taxes under certain conditions, establish a local income system that matches the national governance system and governance modernization, and better mobilize local enthusiasm.

(3) Preferential tax policies

As an important policy tool, taxation should be guided by “implementing the new development concept” and play its due role in “building a modern economic system” by establishing and perfecting a preferential tax policy system that encourages R&D and promotes innovation and entrepreneurship. In the medium and long term, under the principle of competition neutrality, we will comprehensively evaluate the effects of current preferential tax policies according to the functional industry policies, so as to narrow the scope of selective policies, improve the inclusiveness of preferential tax policies, and reduce unnecessary intervention in market players.

In order to promote the formation of a new pattern of all-round opening up, an internationally competitive tax system will be introduced in the construction of the pilot free trade zone and Hainan free trade port in the medium and long term. The management of local government's preferential fiscal and tax policies for attracting investment will be strengthened to make these policies more transparent, regulated and rules-based.

(4) Promoting the modernization of tax administration

Based on the merger of state tax and local tax offices, we will make full use of modern technologies such as the Internet, big data, blockchain and artificial intelligence to accelerate the modernization of tax administration by optimizing the tax management process and improving the tax service level and tax business environment, with the aim to improve taxpayers' tax compliance, reduce the cost of tax collection and management, and improve the efficiency of tax collection and management.

Tax collection and management offices should deeply participate in international cooperation and actively serve the opening-up strategy. In order to adapt to the development trend of economic globalization and digitalization and the requirements of China's opening to the outside world, taxation departments should actively participate in the formulation of international tax rules., strengthen international tax cooperation, and serve the opening-up strategy while severely cracking down on international tax evasion, so as to provide high-quality foreign-related services for Chinese enterprises to “go global”.

In the medium and long term, China will establish a tax system with strong international competitiveness.

9.3 Financial Sustainability

9.3.1 *Research on Government Balance Sheets*¹⁰

The compilation of government balance sheets is the basis of accurate judgment of the financial sustainability. According to economic strategy's research on China's balance sheet by Chinese Academy of Social Sciences, on the asset side, Chinese government has a huge amount of assets with reasonable structure, which is strong enough to resist debt risks. On the debtor side, Chinese government also has a huge scale of debts and its ratio to GDP has exceeded the warning line of 60%, which contains great risks. On the whole, the structure of Chinese government debt is mainly contingent and implicit debt, which reduces the size of debt risk on the one hand, and increases the uncertainty of debt risk on the other hand.

According to the results of joint analysis of the assets and liabilities of the Chinese government as a whole, in terms of total amount, no matter whether the gap of social security fund is taken into account or not, the total assets of Chinese government can completely cover its total liabilities, and there is still a large balance. Chinese government is strong enough to resist debt risks, and can effectively deal with debt risks.

From the perspective of liquidity, that is, only considering the matching between the most liquid assets of government assets and liabilities, the overall asset-liability ratio of Chinese government has been greatly improved, no matter whether the gap of social security funds is taken into account. However, it is not comprehensive to restrict assets only, which will enlarge the debt risk, because not all liabilities should be matched by liquid assets. From the perspective of liquid assets, when the conversion rate of contingent liabilities is 50% or less, Chinese government will face low debt risk; when the conversion rate of contingent liabilities exceeds 50% but below 75%, the debt risks will fluctuate within a controllable range; when the conversion rate of contingent liabilities reaches up to 75%, the debt risk will begin to break through the critical point and enter the dangerous area, which deserves high attention.

9.3.2 *Prevention Against Major Financial Risks*

In the medium and long term, we will attach great importance to the prevention against major financial risks, including local debt risks, aging and social security risks, and risks brought by major internal and external shocks.

(1) Assessment and prevention of local debt risks

No matter whether the gap of social security fund is taken into account or not, the local government still has many available resources after deducting the need to match

¹⁰ Tang (2019).

the total liabilities, and the debt risk it faces is lower than that of the government as a whole. This is based on the comparison result that all contingent liabilities are regarded as direct liabilities. In reality, however, it is almost impossible for a local government's contingent liabilities to be converted into direct liabilities, and the actual total government liabilities should be much smaller. Therefore, the total assets of local governments in China can completely cover their total liabilities, and there is still a large space, so local governments have strong ability to resist debt risks.

From the structural point of view, because local government only bears local debt payment responsibility, part of local debts with weak financial resources may be under heavier burdens; in particular, the social security expenditure in three northeastern provinces is under great pressure and needs the support of the central government. Therefore, it is necessary to construct corresponding risk prevention and resolution mechanism as soon as possible on the premise of avoiding formation of soft budget constraint mechanism.

When liquid assets are taken into consideration, the situation may change greatly as compared with the situation when total assets are considered. From 2010 to 2017, when the social security fund gap is not considered, the current assets/liabilities of local governments reached an average level of about 60%, higher than the average total asset-liability ratio of about 20%. When the social security fund gap is considered, the current assets/liabilities of local governments further increased to an average level of over 100%, with a maximum of nearly 120% and a minimum of about 70%. In this case, it is difficult for local government assets to cover all their government liabilities. This means that the most risk-resistant resources controlled by local governments are not sufficient enough to fully cover all debt risks. When the conversion rate of contingent liabilities is below 50%, the risks faced by local governments will be still within the safe and controllable range. When the conversion rate of contingent liabilities exceeds 50%, local governments need to pay attention to and even guard against debt risks.¹¹

(2) Aging and social security risks

In the medium and long term, with the acceleration of China's aging population, the gap between income and expenditure under the current social security system will continue to expand, and other expenditures on people's livelihood (aging) will also continue to increase. From the perspective of social security financing, social discussions caused by the unified collection of social security premiums by tax authority in 2018 have reflected the huge gap between nominal rates and actual rates in the operation of social security system for a long time. It is the goal of the future reform of social security payment system to greatly reduce the nominal rate and increase the actual collection rate, so as to create a fair competitive market environment for enterprises.

While measures such as reducing the endowment insurance rate paid by enterprises to 16% for urban workers and lowering the social security payment base have been introduced, the nominal rate of social security payment in China remains at a

¹¹ Tang (2019).

high level, and problems in the operation of social security payment system have not been fundamentally solved. In the medium and long term, while promoting the overall planning of social security nationwide, unified collection of tax authorities and reform of social insurance fees into taxes, we will give full consideration to profound changes in the size and structure of jobs brought about by new technological revolution, and seek establishment of a multi-channel social security fund raising model including state-owned assets income and general public budget income on the basis of actuarial balance of social insurance to cope with social security risks brought by aging.

(3) Impacts of internal and external major risk

In the medium and long term, the public finance authority should make sufficient reserves and plans to cope with the impact of major risks from internal and external, local or global sources. These risks include regional financial risk, local or national public health risk, and external risk brought about by drastic changes in international environment.

9.3.3 Tracking Study of the Financial Revenue and Expenditure Situations

Tracking the situation of fiscal revenue and expenditure is the basic work of China's fiscal sustainability research. At present, it is necessary for us to do a good job in analyzing the impact of large-scale tax reductions and fee reductions on fiscal sustainability. Temporary tax reduction policies aimed at coping with economic cyclical problems and stabilizing aggregate demand are often accompanied by the expansion of fiscal expenditure, and the resulting fiscal deficit is usually remedied by issuing additional public debt. Short-term temporary tax reduction policies have little impact on long-term fiscal sustainability in theory. The permanent institutional tax reduction focusing on the supply side has a significant impact on the long-term fiscal sustainability. Theoretically, the tax reduction policy for the supply-side structural reform should accord with the reduction of fiscal expenditure scale, so as to stabilize the deficit and the issuance scale of public debts.

Seeing from the policy practice of western mature market economy countries, we have found great difference between the political pressure of tax reduction and expenditure reduction because the welfare expenditure of residents accounts for a high proportion in the fiscal expenditure. With economic globalization and free flow of capital, the income distribution gap within a country continues to widen. Under the pressure of international tax competition, we find it impossible to adjust by increasing tax burden on capital, so it depends more on welfare expenditure to maintain social stability. As a result, many western countries saw serious "structural deficits", and experienced the fiscal evolution from countries supported by public tax to indebted countries.

With the development of new technologies such as digital economy, automation and artificial intelligence in recent years, the digital transformation of economy and society led by structural changes in job market is about in full swing. This will have a far-reaching impact on the government's tax revenue from labor remuneration and the expenditure on unemployment relief and education and training. In addition, the accelerated development of population aging will have a further impact on the current fiscal revenue and expenditure system, structure and fiscal sustainability.

Therefore, China's tax reductions and fee reductions policy should attach great importance to its impact on fiscal sustainability and its countermeasures, On the basis of fully summarizing the practice of tax reduction policies in western countries, combining the digital transformation of economy and society, the application of new technologies such as artificial intelligence and the specific national conditions of China at present, taking into account both short-term and long-term reasonable arrangements.

9.3.4 Optimization of Fiscal Revenue and Expenditure Structure and Institutional Reform to Promote Fiscal Sustainability

In the medium and long term, we will promote the optimization of fiscal revenue and expenditure structure and related supporting reforms in accordance with the requirement of fiscal sustainability. In terms of fiscal revenue, we will further optimize the policy for tax reductions and fee reductions, and promote the tax system reform with income increase effect to increase revenue. This includes optimizing specific tax systems such as environmental protection tax and consumption tax under the direction of "green tax system" construction, and increasing tax revenue with regulatory effect. We will also carry out reform to levy real estate tax on residential houses on the premise of fully considering the stable and healthy development of the real estate market and social stability, and continue to promote the reform of personal income tax under the framework of comprehensive and classified tax system. While meeting the requirement of competition neutrality, we will sell some state-owned assets, speed up the reform of mixed ownership, obtain some government revenue, and ease financial pressure.

In terms of fiscal expenditure, we will pay attention to reducing non-rigid and non-key expenditures, reasonably determine the boundary between market and government, clarify the list of government powers, responsibilities and negative lists, and reduce government's unnecessary expenditures, so as to focus on key areas and key links such as industrial transformation and upgrading, scientific and technological innovation, major infrastructure construction and people's livelihood. We will strengthen the evaluation of financial affordability of major expenditure projects, and prevent blindly increasing investment in construction projects. In addition, we will lay an institutional foundation for the optimization of fiscal expenditure structure by

perfecting budget management of all revenues and expenditures. We will implement budget performance management, promote the establishment of budget expenditure standard system, implement cross-year budget balance mechanism and medium-term financial planning, and compile tax expenditure budget.

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