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# Reform of China's taxation system: from embedment in the economy to embedment in society

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## Abstract

To match national development goals and increase in the tax base, the government must embed a taxation system in economic and social contexts. Since the founding of the People's Republic of China, the development of taxation can be divided into three stages: one that is embedded in *danwei*, one that is embedded in enterprises, and one that is embedded in society. The corresponding national development goals include stimulating economic growth, promoting coordinated economic and social development, and propelling state governance. As the tax base in China shifts from production to redistribution and wealth accumulation in the circulation of the national income, the taxation system will gradually shift from embedment in the economy to embedment in society, posing new challenges to taxation system reform. Future reform should deepen the extent to which taxation is embedded in society while keeping taxation embedded in a broad economic base. This will help to achieve the goal of building a "consensually strong state."

**Keywords:** Taxation system, National development, Tax base, Embedment

## Introduction: two embedments and two matches of the taxation system

Since the founding of the People's Republic of China (PRC) in 1949, the taxation system has also developed significantly. In the early stages of the new China, the taxation system was not unified, and the distributive relationship between the state and enterprises was not clear. After continuous reform for more than 70 years, China has established a taxation system suitable for the market economic system, reflecting Chinese characteristics. The standardization of fiscal revenue has been significantly improved. Taxation has played a vital role in national governance.

Such remarkable achievements in the taxation system are closely related to the rapid socio-economic development and the continuous reform of the taxation system. Many studies review the history of tax reform in China and divide it into different developmental phases according to the reform objective, specific period, economic background, and other perspectives. Gao (2018) suggested that the marketization of the economy would inevitably bring about the publicization of finance and that the modernization of national governance required the modernization of the fiscal and

taxation system based on distinctive objectives of reform in various phases. Based on the time and content of the reform, Liu (2018) systematically reviewed the reform of the taxation system over more than 40 years since the reform and opening up. Yang (2018) provided three perspectives on the 40-year history of China's taxation system since the reform and opening up: economy, society, and national governance. Li (2018) analyzed China's tax reform since 1978 from the perspective of building a unified market. Chen and Qin (2019) reviewed the evolution of the concept of tax governance since the founding of socialist China. Through the division of specific periods, Yang (2019) reviewed the development process of China's tax reform in the past 70 years.

These studies have enriched our understanding of the taxation system since the founding of new China 70 years ago. However, the analysis of the driving factors of taxation system reform is insufficient, and the key feature of the taxation system, namely, its embedment in the economy and society, has been neglected. In fact, in modern countries, the taxation system has to embed in the fabric of society and economy; that is, it has to make "two embedments."

First, the embedment of the taxation system into society can not only enhance the government's control over society but also stimulate the consciousness of taxpayers regarding their rights, persuade them to be concerned about the fairness and rationality of taxation and the use of taxes, and motivate their advocacy that the government's budget should be open and transparent and that the government's expenditures should "listen to the voice of society." This is a process of in-depth interaction between the state and society and between the government and the people, representing the process of constructing a modern country. There are three forms of this embedment in society. (1) The proportion of the residents' tax can be increased (e.g., the proportion of the individual income tax and the real estate tax can be increased). (2) Taxation can embody the beneficial principle (i.e., the tax revenue can be closely related to the public services provided by the government for the residents). The taxes in line with the beneficial principle are the benefit taxes, typically including the real estate tax, the individual income tax, and the general consumption tax (or retail tax; China's consumption tax is a selective consumption tax, which does not belong to the category of a general consumption tax) (Bird 2000). (3) Through tax deductions, tax reductions, and other preferential policies to taxation can encourage the development of charitable organizations.

Second, there can be an embedment of taxes in the economy. Taxes are generated from the economy; taxes must be embedded in various tax sources to generate financial revenue. There are two forms of tax embedment in the economy. First, taxes can be embedded in the form of a direct tax based on income or wealth and can be further divided into an embedment in enterprise income and an embedment in resident income and wealth. The former corresponds to corporate income tax, while the latter corresponds to individual income and real estate taxes embedded in society. Second, taxes can be embedded in the form of an indirect tax, which is based on price. Gao (2015) called it vividly a "price 'channel' tax." The indirect tax embedment can be further divided into two types: embedment in the form of a weak salience tax and a strong salience tax, which both have distinct influences on tax transfer and tax benefits (see the analysis in the 4th section of this article).

In the 70-year history of China's tax development, the taxation system has always been embedded in society and the economy. With the continuous reform of the taxation system, the magnitude and main targets of the embedment of the taxation system are also constantly changing. Therefore, what was the driving force of the reform of the taxation system? Specifically, what were the "two matchings" requirements inherited by the taxation system?

First, the taxation system should match the national development goals. The national development goals determine the taxation system. In the ancient feudal society, the government emphasized the principle of "encouraging agriculture and restraining commerce." Therefore, the state suppressed commerce by imposing a heavy commercial tax, while the agricultural tax was relatively light. Since the founding of the PRC and the national industrialization and modernization, tax reform has been carried out around the national goal of economic growth. With the establishment, improvement, and development of the socialist market economy, China began to pay attention to coordinated development and national governance. Accordingly, the goal of the taxation system has been to suppress negative externalities and promote national governance.

Second, the taxation system should match the tax base. As the most important and primary policy lever for collecting fiscal revenue, the taxation system has to be rooted in the national economic and social development environment and practically matches the tax base if the goal of "plucking the most goose feathers with the least crowing" is achieved. In ancient feudal society, agriculture was the most important economic form and could be described as "the foundation of building a country." Therefore, agricultural taxes were given priority at that time. Since the founding of the PRC and the development of industry and commerce, the proportion of agriculture in the national economy has decreased, while the proportion of industry and commerce has increased. Therefore, industrial and commercial taxes have gradually replaced agricultural taxes and become the main body of taxation. Later, with the increase in people's income and wealth accumulation, the proportion of direct taxes, such as individual income taxes and property taxes, gradually increased.

Generally, the 70 years of taxation system reform can be summarized and refined as a process of developing crucial insight and laws. To absorb tax sources most effectively, the Chinese government transformed the taxation system from an embedment in *danwei*—the economic and social complex in the planning economy—to an embedment in enterprises, and then to deepening the magnitude of its embedment in society to meet national development goals. Currently, China should promote a modern taxation system and continue to deepen the magnitude of the tax embedment in society.

### **Characteristics of the taxation system from 1949 to 1980: embedment in danwei**

#### **National development goal and tax base**

##### *National development goal*

At the beginning of the founding of the PRC, the country carried out socialist economic construction, aiming to change the poverty situation and realize economic growth. Thus, for a long time, the national development goal was to restore and develop the economy and promote industrial modernization. At that time, economic development and poverty

elimination were almost synonymous with national industrialization. Therefore, China's development strategy started with socialist industrialization, prioritizing heavy industry (Lin et al. 2013) and promoting the nationalization of industry and commerce and the collectivization of agriculture. As a result, the proportion of state-owned enterprises (SOEs) rapidly increased, and SOEs soon became the pillar of the national economy.

### **Tax base**

At the beginning of the PRC, the local tax policies were extremely inconsistent. The agricultural sector was the largest contributor to fiscal revenue, while the tax proportions of industrial and commercial sectors were rather small. With the progression of national industrialization, the proportion of industry in the national economy increased. Under the influence of the planned economic system and nationalization reform, SOEs became the most important economic players. Hence, SOEs naturally became the main contributors to fiscal revenue and industrial and commercial taxes. For instance, in 1960, SOEs provided 92.0% of the national revenue and 89.7% industrial and commercial tax revenue.

In the planned economy system, enterprises were not like the economic subjects they are in the modern economy, although they were called enterprises. In SOEs, the state implemented direct planned management, which replaced the business autonomy of enterprises. SOEs thus became the extension of state administrative organizations and part of the field subject to the direct state administration over society (Lu 1993). According to the traditional interpretation of socialist principles, people working in the SOEs were the direct owners of social wealth rather than employees. As soon as they entered SOEs for employment, they enjoyed a set of comprehensive welfare benefits, including wages, insurance, and the provision of all their necessities and welfare needs across a life span. The rights of the employees could be recognized in the enterprises, while the enterprises, representing the state, were in charge of the whole life of every worker (Lu 1989). As special cells in the system of a planned economy, state-owned and collective enterprises were special organizations with various economic and social functions, such as production, distribution, and consumption. They were called "units" (*danwei*) in domestic academia (Lu 1989, 1993; Li et al. 1996). The *danwei* had to provide taxes and profits to the state and pay with enterprise revenue the expenses of education, medical care, housing, and social security of the workers and staff in their lifetime.

Therefore, the *danwei* represented the primary tax source of China in the period of the planned economy. Under the unique historical background, *danwei* was characterized by its embedment in the economy and its embedment in society.

### **Taxation system reform: unification of tax administration and simplification of taxation**

In summary, the reform of the taxation system in this period matched the requirements of two historical conditions: first, the national development goal of promoting economic growth; second, the emergence of the *danwei* as the primary tax source. Therefore, the goal of the taxation system was to unify the tax administration, establish a new taxation system, and simplify industrial and commercial taxes.

### ***Unify the tax administration, establish a new taxation system***

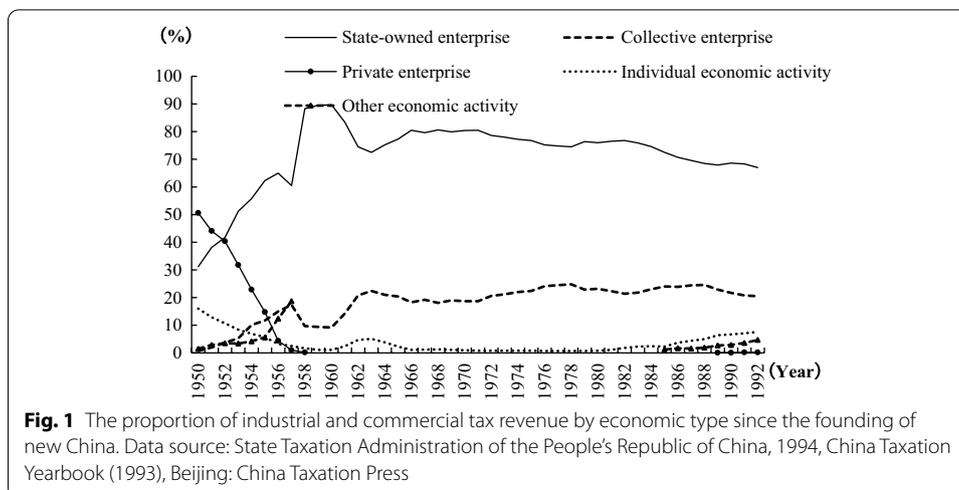
In 1949, the first national taxation conference adopted a proposal to increase tax revenue, unify tax administration, simplify taxation, and make the tax burden reasonable. Afterward, in 1950, the Government Administration Council stipulated that 14 types of taxes should be collected in a unified way throughout the country, including goods taxes and industrial and commercial taxes. A brand new, unified national taxation system was thus established.

### ***Modify and simplify industrial and commercial taxation***

To meet the economic and political needs in different periods, the PRC at the beginning revised the taxation system once and simplified it twice. Specifically, in 1953, the taxation system was revised to introduce the commodity circulation tax, to abolish the special consumption tax, and according to the tax items, to incorporate them into the business tax and the newly established culture and entertainment tax. In addition, the business tax and goods tax were adjusted accordingly. In 1958, the industrial and commercial taxation was simplified, while the original tax bearing was maintained. The four taxes, including the goods tax, the commodity circulation tax, the business tax, and the stamp tax, were merged into an industrial and commercial consolidated tax. The income portion of the original industrial and commercial tax was formed into a separate industrial and commercial income tax. In 1973, industrial and commercial taxation was simplified again. The industrial and commercial consolidated tax was combined with an additional salt tax, the urban real estate tax, the vehicle and vessel license tax, and the slaughtering tax to form the industrial and commercial tax (as a tax item in the industrial and commercial tax, the salt tax was still implemented according to the original system). Thus, SOEs were only levied an industrial and commercial tax, and collective enterprises were only levied an industrial and commercial tax and an industrial and commercial income tax. An industrial and commercial consolidated tax was levied on foreign-invested enterprises, and an urban real estate tax, a vehicle and vessel license tax, and a slaughtering tax were only levied on individuals, foreigners, and a few units.

### **The characteristics of the taxation system and the effect of the reform**

With the simplification of taxation, the role of taxes began to weaken since the proportion of profit delivery from the fiscal revenue gradually increased and finally exceeded the proportion of that from tax revenue. In 1950, the proportion of profit from various taxes was 75.1%, and enterprise profit delivery was 13.3%. By 1978, the profit delivery from various taxes and enterprises were 46.3% and 51.0%, respectively. Among all kinds of taxes, the proportion of industrial and commercial taxes increased from 48.2% in 1950 to 87% in 1978. In industrial and commercial taxes, the proportion of taxes from the SOEs and the collective enterprises increased from 31.2% and 0.7%, respectively, in 1950 to 74.5% and 24.8%, respectively, in 1978 (Fig. 1). Therefore, the profits and the taxes of *danwei* were the primary sources of national fiscal revenue and tax revenue in this period. The taxation system at this stage was thus characterized by an embedment in *danwei*.



Under this unique historical background, the *danwei* was characterized as a “self-production and self-support” work unit, since it had to pay taxes, hand over profits as the main source of financial revenue, and support all the expenses of education, medical treatment, housing, and social security of its workers and staff with the enterprise income. The state in this period can be characterized as an “owner-state” (Campbell 1996), which denotes a framework opposite to that of a modern “tax state” in which tax revenue is the main source of public revenue. Therefore, it can be concluded that in this period, taxation was mainly embedded in the economy and society through the form of the embedment in *danwei*, which, in building a modern country, is an embedment rather different from an embedment in society. When China changed its development goals to market-oriented reform and national governance, the *danwei* system gradually disintegrated, and the establishment of new forms of embedment in the economy and society by reforming the taxation system was an inevitable choice.

### Characteristics of the taxation system from 1980 to 2013: embedment in enterprise

#### National development goal and tax base

##### *National development goal*

In 1978, the Third Plenary Session of the 11th Central Committee of the Communist Party of China (CPC) decided to shift the work focus from class struggle to socialist modernization. However, the most significant problem in the planned economy was the rigidity of the economic management system and the lack of motivation in enterprises. Therefore, the reform started with changing the economic management system and management methods. For instance, in 1984, the Third Plenary Session of the 12th CPC Central Committee put forward the policy of invigorating the domestic economy and opening up to the outside world to speed up the reform of the entire economic system, with cities as the focus. The central link of the reform was enhancing the vitality of enterprises, especially large and medium-sized state-owned enterprises. Later, the 14th National Congress of the Communist Party of China put forward that the general goal of reform was to establish a socialist market economic system. However, the market

economy was not a free economy but an economic system embedded in society. Polanyi (2007: 65) pointed out that "generally speaking, economic progress is always at the cost of social chaos." New problems emerged in China's market economy, including uneven regional development, the persistent urban–rural divide, the widening income gap, the deteriorating environment, and the waste of natural resources. Therefore, the national development goal shifted to emphasize coordinated economic and social development, which was reflected in the "scientific outlook on development" put forward in the report of the 17th National Congress of the CPC in 2007. The development goal emphasized a people-oriented, comprehensive, coordinated, and sustainable outlook on the development of the economy and society.

### ***Tax base***

In the early stage of the reform and opening-up process, industrial departments and SOEs were the primary contributors to fiscal revenue and industrial and commercial taxes. Furthermore, a considerable part of fiscal revenue came from the profits handed in by SOEs since the distribution relationship between the state and enterprises had not been fully straightened out. On the one hand, with the advancement of the reforms, China encouraged foreign trade and improved the utilization of foreign capital, which led to the emergence of typical modern economic enterprises, such as foreign-invested enterprises. On the other hand, the function and operating mechanism of state-owned enterprises had also begun to change. They started to retreat from various social functions (social security, medical care, education, and housing) and moved deep into enterprise organization and economic organization. The SOEs were gradually transformed from "*danwei*" organizations with various economic and social functions to modern "enterprise" organizations. Since 1993, China has been in the stage of establishing and improving the socialist market economic system. The SOE restructuring has achieved some of its goals. The economic attributes of the SOEs have been strengthened, and the social function has been stripped off. SOEs are no longer the *danwei* organizations. At the same time, the Chinese economy has eliminated the dependence on SOEs and formed a new economic pattern in which public ownership remains as the main body while multiple forms of economic ownership have simultaneously emerged and developed. The position of enterprises as the real main body of economic activities in the market economy has been established. In addition, economic development has significantly elevated the income level of residents, generating conditions for the taxation of residents.

### **Taxation system reform: mobilize enterprises and promote the socialist market economic system**

In a nutshell, the taxation system reform in this period corresponded two historical conditions: first, the national development goal gradually shifted from promoting economic growth to implementing the scientific outlook of development and promoting the coordinated development of the economy and society; second, the various economic forms replaced SOEs as the primary tax sources. With the establishment and improvement of the socialist market economic system, enterprises acted in the market economy as the real subjects of economic activities. Therefore, in addition to ensuring national financial

revenue, the goal of the taxation system was the adaptation to the requirements of the socialist market economic system, including promoting economic growth by mobilizing enterprises, encouraging the flow of capital and commodities and adequate competition, and restraining the negative externalities of the market economy. To achieve the goals, the embedment of the taxation system changed from an embedment in *danwei* to an embedment in enterprises.

Given that the tax distribution system in 1994 was an important reform in taxation, we further divide this period into two stages: 1980–1994 and 1994–2013.

#### ***Taxation system reform from 1980 to 1994: mobilization of enterprises***

In this stage, the taxation system reform focused on two aspects. One was the establishment of a foreign-related taxation system; the other was the mobilization of enterprises, especially SOEs, and the stimulation of the vitality of enterprises.

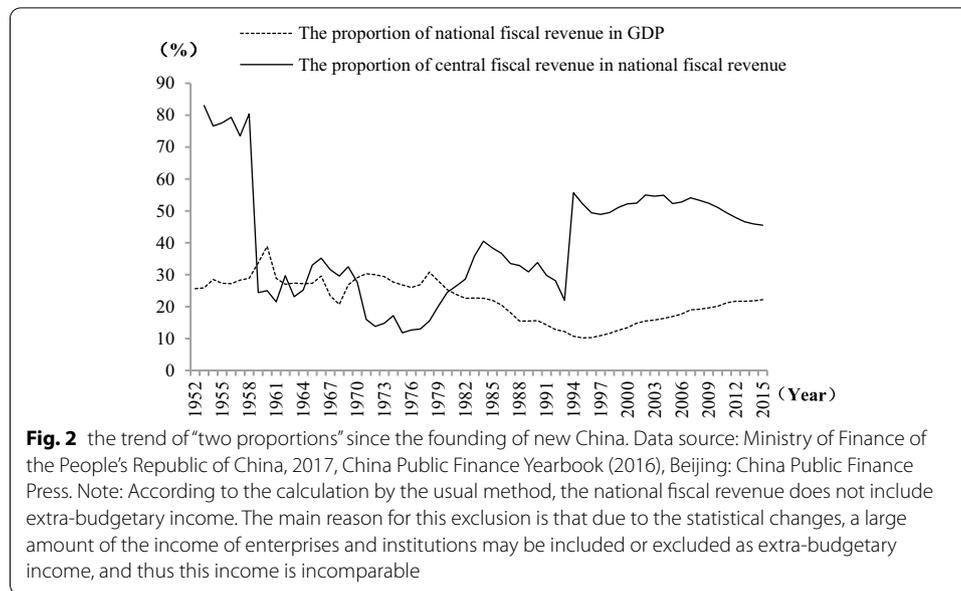
First, in 1980, China established a foreign-related taxation system to facilitate the policy of opening up and economic development and to attract and improve the environment for foreign investment. In terms of the income tax of Sino-foreign joint ventures, foreign enterprises and foreign personnel was clarified in legal form. Regarding turnover taxes, Sino-foreign joint ventures and foreign enterprises were continually levied by consolidated industrial and commercial taxes. In terms of property taxes, the levying of the urban real estate tax and the vehicle and vessel license tax was resumed on foreign-invested enterprises, foreign enterprises, and foreign personnel.

Second, a two-step reform of “profit into tax” was implemented. To mobilize enterprises and stimulate their vitality, in 1983 and 1985, the reform of “profit into tax” was carried out in SOEs; that is, the delivery profits were replaced by taxes, and the after-tax profits were controlled by the enterprises themselves. Through the reform, the distribution relationship between the state and enterprises was fixed in the form of taxes. The total amount and growth rate of the tax revenue from enterprises and its proportion in fiscal revenue increased significantly.

The reforms in this stage stimulated the vitality of enterprises, mobilized SOE production, and continuously boosted the increase in GDP. However, the over-simplification of the taxation system, the “decentralization of power and profits,” and “preservation of wealth in enterprises” led to a significant reduction in the “two proportions” (Fig. 2). Due to the serious shortage of fiscal revenue, the central government had to “borrow money” from local governments and sometimes could not pay the money back. The central finance was on the edge of a cliff. Therefore, the next stage of tax reform was to protect the national fiscal revenue, absorb the tax source effectively, and increase the “two proportions.”

#### ***Taxation system reform from 1994 to 2013: the establishment and improvement of the socialist market economy***

The taxation system reform in this stage was aimed at adapting to the socialist market economic system, encouraging the adequate flow of capital and commodities and competition. Therefore, it was necessary to balance tax bearing among economic subjects so that market subjects could compete fairly and play their roles in market efficiency and resource allocation. However, at that time, the unfair tax bearing among



enterprises seriously hindered the adequate flow of capital and commodities and fair competition. To guarantee national fiscal revenue, encourage the economic flow and full competition, and restrain the negative externality of the market economy, China carried out a two-step tax reform in two aspects: unifying the commodity market and unifying the factor market.

In step 1, to meet the needs of establishing a socialist market economic system, China’s taxation system carried out the largest and most far-reaching reform since the founding of new China in 1994. To unify the commodity market, the government took the following actions: the turnover tax was comprehensively reformed; the product tax and the industrial and commercial consolidated tax levied on foreign-funded enterprises was abolished; the value-added tax was standardized (it was implemented on the production, wholesale, retail and import of goods); the consumption tax was put forward; and the business tax was adjusted (after the reform, the business tax was levied on the provision of services, the transfer of intangible assets and the sale of real estate). With a value-added tax as the main part and a consumption tax and a business tax as the supplement, a circulating taxation system was formed, denoting an internal and external unification. The unification of the industrial market and the domestic and international commodity markets was achieved.

In the unification of the factor market, there were two main reforms: first, to achieve the unification of the capital factor market of domestic enterprises, the income tax of domestic enterprises was unified, the income tax and regulation tax of state-owned enterprises were canceled, and the income tax of collective enterprises and that of private enterprises were canceled; second, to achieve the unification of the labor factor market, the individual income tax was unified, the individual income adjustment tax and the income tax of urban and rural individual industrial and commercial households were canceled, and taxable items and the tax rates were adjusted.

This tax reform preliminarily established a taxation system that was adapted to the socialist market economic system. The taxation system structure had been simplified and standardized. The leverage role of taxes in regulating the economy had been strengthened, and their function of raising fiscal revenue had been achieved. The trend of the decline of "two proportions" was reversed (Fig. 2). However, the unification of the market was still hindered by some factors, such as different corporate income taxation systems for domestic and international enterprises, different taxation systems for industrial and service enterprises (industrial enterprises were levied by a value-added tax while service enterprises were levied by business tax), and the input tax deduction for fixed assets, such as equipment purchased by enterprises, was not allowed. The next step of taxation system reform was the improvement of the unified market.

In step 2, to meet the needs of improving the socialist market economic system and unifying the market, the Chinese government began working on the perfection of the taxation system.

In terms of the unified commodity market, the following reforms were conducted.

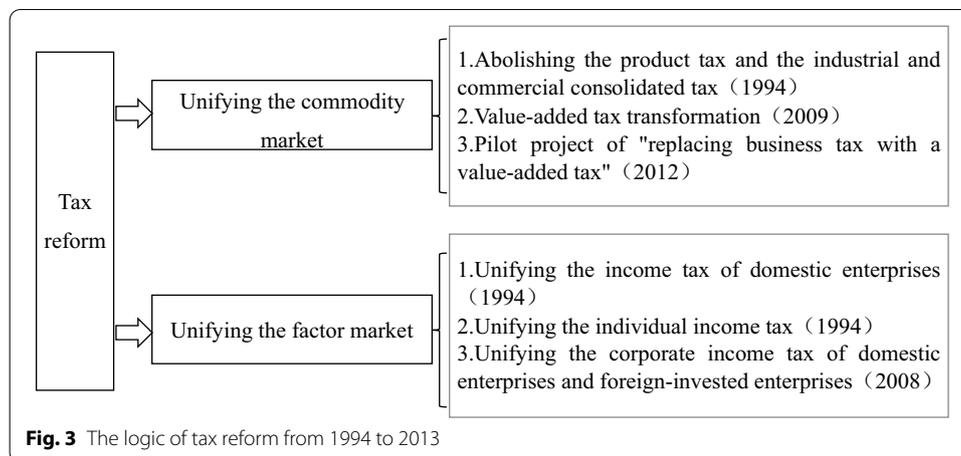
The first was the reform of the "value-added tax (VAT) transformation." In 1994, China implemented a production-oriented VAT; that is, the enterprises' equipment and other fixed assets could not be used for an input tax deduction; this tax implementation was closely related to the economic condition at that time.<sup>1</sup> However, with the development of the market economy, the disadvantages of a production-oriented value-added tax became apparent, hindering the unification of the production input market and resulting in repeated taxation and inhibition of investment. Therefore, China started the pilot project of a "value-added tax transformation" in 2004, and machinery and equipment were officially included in the scope of the value-added tax deduction in 2009, which indicated that the value-added tax has significantly been transferred from a production-oriented value-added tax to a consumption-oriented value-added tax. The reform unified the tax bearing of equipment investment and the raw material market and promoted the unification of the production input goods market (construction products were not included).

The second reform was the reform "replacing the business tax with a value-added tax." Before the reform, industrial enterprises needed to pay value-added taxes, while service enterprises paid business taxes, which hindered the unification of the service industry and industrial market. Hence, China started the pilot project of "replacing the business tax with a value-added tax" in 2012, implemented the reform nationwide on May 1, 2016, and finally realized the unification of tax bearings of the service industry and industrial market.

In terms of unifying the factor market, the "combination of the two laws" of corporate income tax was conducted. Since the reform and opening up, China has been implementing different corporate income taxation systems for domestic and foreign-invested enterprises. The government provided foreign-invested enterprises with preferential tax treatment to attract foreign investment and expand the scale of opening-up. However, with China's accession to the World Trade Organization, the different corporate income

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<sup>1</sup> The economic inflation was very serious at that time, and the "two proportions" declined significantly. To curb fixed asset investment and inflation and to raise more fiscal revenue, China implemented a production-oriented VAT.



taxation for domestic and foreign enterprises have seriously hindered the fair competition of enterprises, which has not been conducive to adjusting and optimizing the industrial structure. Therefore, in 2008, China implemented a law combining the corporate income taxes of domestic enterprises and foreign-funded enterprises, called "the merger of two laws." The reform eliminated the taxation difference between domestic and foreign-invested enterprises, aiming to achieve fair competition among enterprises and unify the capital factor market of domestic and foreign-invested enterprises.

### The characteristics of the taxation system and the effect of the reform

The taxation system reform from 1980 to 1994 was mainly implemented to establish a foreign-related taxation system and a two-step process of "profit to tax." The foreign-related taxation system realized a tax embedment in foreign-funded enterprises, and the two-step "profit to tax" process changed the profits delivered by state-owned enterprises to tax revenue. The state-owned enterprises remained the primary contributor to fiscal revenue and tax revenue. With the advancement of the reform of state-owned enterprises, they gradually changed from "*danwei*" with various responsibilities of economic and social functions to real modern "enterprise" organizations. Accordingly, taxation has been gradually transformed from the embedment in *danwei* to the embedment in the enterprise—an important economic subject. Before 1994, enterprises mainly delivered profits and paid income taxes, and taxes were embedded in the economy in the form of profits and direct taxes. After 1994, enterprises mainly paid value-added taxes, business taxes, and consumption taxes. Taxes were mainly embedded in the economy in the form of an indirect tax on the price channel.

Furthermore, the introduction of an individual income tax enabled a new embedment in society and is also the main form in which modern countries embed taxation in society. However, the degree of embedment in society was still very low. Meanwhile, as mentioned above, the tax reform after 1994 effectively promoted the unification of the commodity market and factor market, as shown in Fig. 3.

However, the fiscal management system of the tax sharing system implemented in 1994 stimulated enthusiasm for economic development among local governments and caused fierce local competition. To gain a competitive advantage, the local government carried

out tax preference practices in disguised form, intervened in tax collection and management, and created tax depressions. Consequently, the market order was disturbed, and the local market was divided. The formation of a unified market was hindered, which weakened the effect of tax embedment in the economy, and the regulation of the economy was not conducive to the optimization of economic structure and scientific development. These problems needed to be solved in the tax reform of the next stage.

### **Characteristics of the taxation system after 2013: stepping into the embedment in society**

#### **National development goal and the tax base**

##### *National development goal*

In 2013, the Third Plenary Session of the 18th CPC Central Committee decided to pursue the overall goal of comprehensively deepening the reform. The overall goal of the reform shifted from establishing and improving the socialist market economic system to promoting the modernization of the national governance system and governance capacity.

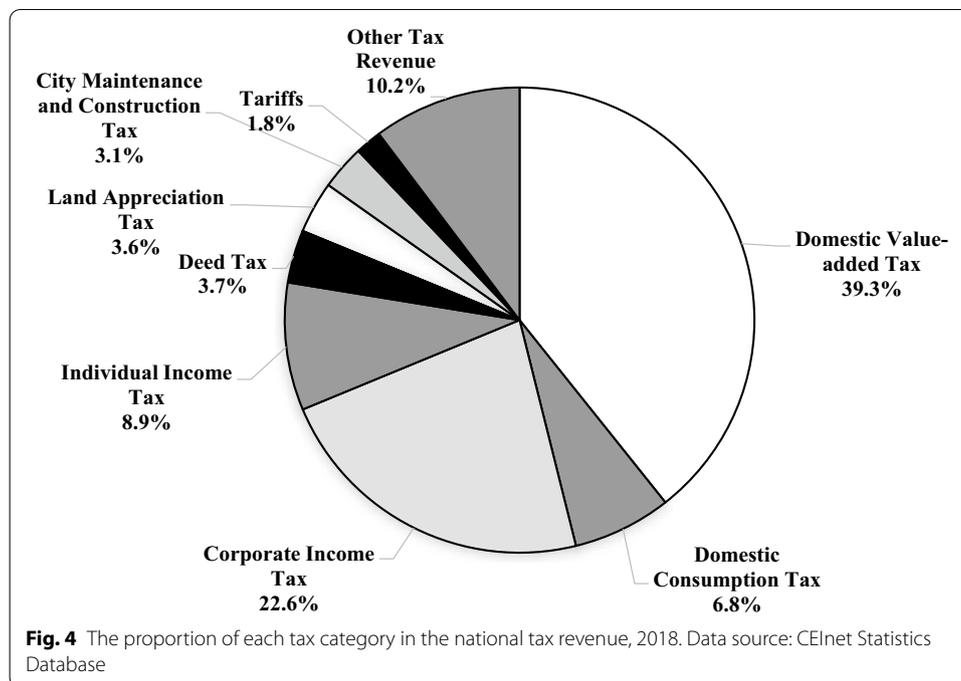
##### *Tax base*

After 20 years of developing and improving the socialist market economy, the tertiary industry in China has developed rapidly, basically reaching the proportion of the secondary industry and contributing more than 50% to tax revenue. The secondary and tertiary industries accounted for 90% of the tax increase and almost all of the total tax revenue. Even more importantly, the income of Chinese people has increased greatly, and the people's wealth, represented by real estate, had increased significantly. The national income gradually transitioned to the stage of redistribution and wealth accumulation. The generation of income and wealth transitioned from enterprise production to households, laying a reliable foundation for tax reform embedment in society.

#### **Taxation system reform: promote the modernization of the national governance system and governance capacity**

The national goal of this stage was national governance, and the kernel of national governance was economic governance, social governance, and political governance. Before 2013, the focus of the development of taxation was mainly economic governance, which led to a high degree of embedment in the economy. After 2013, the focus of taxation development was more on social governance, and the degree of its embedment in society was elevated.

The first focus was stimulating economic vitality. The main reforms included the following: the continuous promotion of the reform of "replacing the business tax with a value-added tax" and its implementation nationwide after May 1s, 2016; the partial promotion of the unification of the tax bearing of the service industry and that of the industrial market; the fueling of the specialization of labor division; the adjustment of the industrial structure and the development of modern service industry; and the implementation of tax reduction and fee reduction policies, such as the simplification of the value-added tax and the reduction of the tax rate, to cope with the downward pressure of economy.

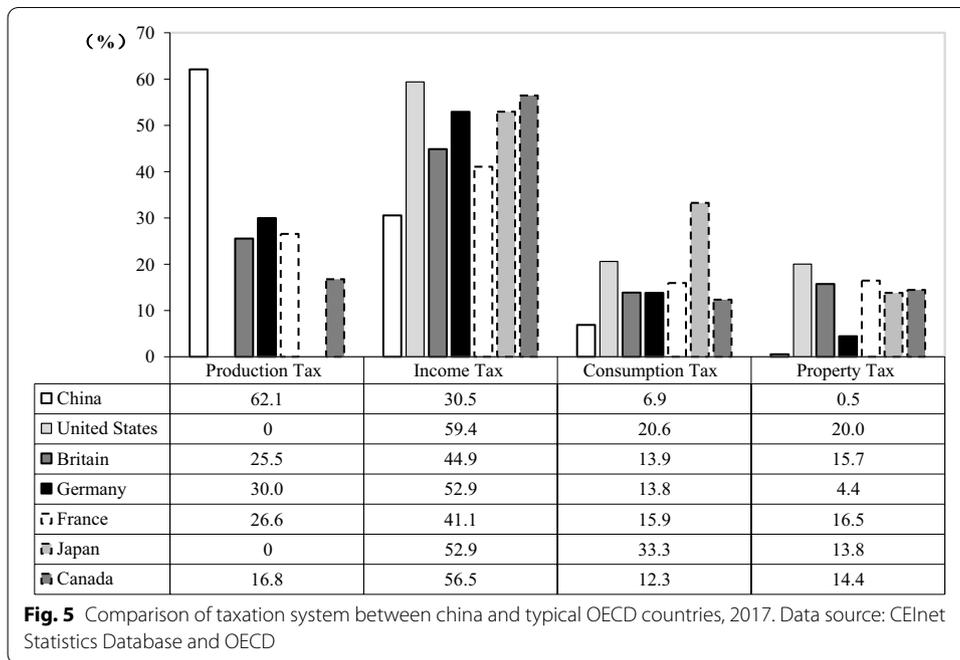


The second focus was social governance. The main reforms included the following: the implementation of the principle of statutory taxation; the acceleration of the pace of tax legislation; the passing of the environmental protection tax law, the tobacco tax law, and the ship tonnage tax law; the revision of the corporate income tax law and individual income tax law; and the acceleration of the legislation of other taxes. The individual income tax reform in 2018 established a taxation model, which was both comprehensive and classified. This was the first time the comprehensive collection had been implemented since the introduction of individual income taxes. It was also the first time since the ninth five-year plan that taxpayers were transformed from passive individuals who accepted the management of withholding and remitting taxes into active actors who paid taxes by themselves, which was conducive to stimulating the taxpayers' awareness and making a significant step toward embedment in a type of social cell—the family.

It would be reasonable to conclude that the taxation system was continuously improved in the five years in which national governance was promoted and that more attention was especially paid to participating in social governance. Although taxes took a significant step toward embedment in families, the degree of embedment in society remained low. The next step of reform needed to establish a modern taxation system and deepen the degree of tax embedment in society. For the reform direction and specific measures taken, we should start with the problems in the current taxation system.

#### Problems in the current taxation system

There are 18 tax categories in China's current taxation system. Figure 4 shows the proportions of each tax category in the national tax revenue in 2018. The value added tax is the largest tax in China, accounting for a much higher proportion of tax revenue than other taxes. Corporate income tax is the second largest tax in



China, followed by the individual income tax and the consumption tax. These four taxes account for 77.6% of the tax revenue in China. What is the problem with this tax structure? We believe that the tax structure of China is not embedded enough in society to adapt to the requirements of a national governance capacity and the changes in tax sources. In the following section, this paper analyzes the problems of China’s taxation system from the perspective of the national income cycle and makes international comparisons.

The national income cycle can be divided into production, redistribution, expenditure, and accumulation, and the taxation system corresponds with production taxes, income taxes, consumption taxes, and property taxes (Lv 2017). According to this classification of taxes, we compare all kinds of taxes collected in China with those in several OECD countries.<sup>2</sup>

The results of the comparison are shown in Fig. 5. In China’s taxation system, the proportion of the production tax is 62.1%, the income tax 30.5%, the consumption tax 6.9%, and the proportion of the property tax is 0.5%; however, in the USA, the proportion of production tax is 0%, the income tax 59.4%, the consumption tax 20.6%, and property tax 20.0%. In Britain, Germany, France, Japan, and Canada, the states levy less in production and more in redistribution. The taxes levied on consumption and property accumulation are also much higher than those in China.

The comparison reflects that the problems of the Chinese taxation system include the concentration of tax collection in the production link, too little taxation in the redistribution link and accumulation link, a tax base in which enterprises are the

<sup>2</sup> Given the return from social security taxes and the fact that China’s tax revenue does not include social security income, this study excludes social security tax of OECD countries in comparison. The specific calculation method is demonstrated in Lv et al. (2020).

main taxpayers, and too little taxation on residents. However, different countries have distinct historical processes<sup>3</sup> that prevent them from choosing at will a taxation system. The problems in China's taxation system cannot be identified and mechanically through the cross-nation comparison of taxation systems. A theoretical analysis is required.

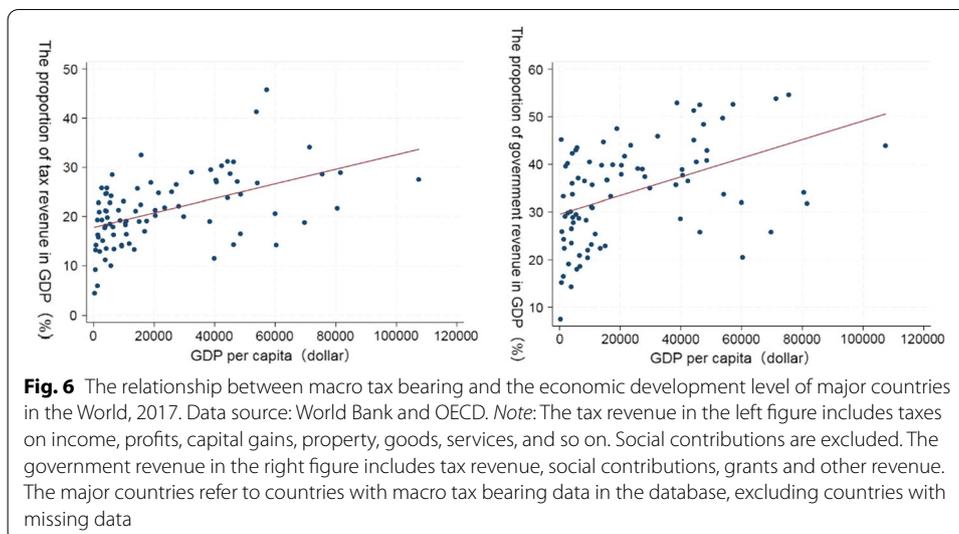
Theoretically speaking, the taxpayers in the production link are enterprises; the primary tax levied in the redistribution link is the corporate income tax; therefore, the taxpayers are still enterprises, while the taxpayers in the accumulation link are residents. In the process of production, taxpayers are enterprises, and taxation mainly affects the prices of goods and services, which makes residents difficult to perceive the existence of taxes and causes the tax salience weak.<sup>4</sup> However, enterprises can transfer their taxes by raising the prices of goods and services or lowering the workers' wages. The regulating role of taxes in income distribution is thus weakened, and their beneficial characteristics are not significant. In the redistribution link, the corporate income and individual income are the primary tax items. The individual income tax is closely related to public service, exhibits obvious beneficial characteristics, and plays a strong role in regulating income distribution. In the accumulation link, residents as main taxpayers are more likely to perceive the existence of taxes, and so the tax salience is strong. As it is difficult to transfer this tax, it could play a stronger role in regulating income distribution. Since the public services enjoyed by taxpayers are closely related to the taxes they pay, the beneficial character of tax revenue is also more significant.

Therefore, from the perspective of regulating income distribution and the beneficial characteristics of taxes, the problems in China's taxation system structure include the following: the taxation is concentrated in the production link, and there is too little taxation in the redistribution link and accumulation link; the main taxpayers are enterprises, and too little taxation is levied on residents. The problems lead to the low extent of tax embedment in society, which results in the government having limited information about natural persons. This situation is not conducive to the government's social governance, social protection, or social control. In 2018, of China's national tax revenue, the individual income tax only accounted for 8.9%, which is the highest proportion of it in the national tax revenue since the introduction of individual income tax in 1999, while the proportion of property tax is almost zero. In other words, the current structure of the Chinese taxation system has to be changed.

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<sup>3</sup> There are historical causes for the formation of the taxation system in China. Since the founding of the PRC, the fiscal revenue has mainly come from enterprises. Enterprises have to pay taxes as well as hand in profits. There was almost no tax levied on natural persons. After the reform and opening up, a personal income adjustment tax, an individual income tax, and other taxes have gradually been levied on natural persons. However, due to the weak tax awareness of taxpayers, the lack of the information processing ability of tax departments, and the high cost of tax collection and management, the proportion of the natural persons' tax payment in China has always been low. In the process of taxation in production, the tax accounting method is simple, and the efficiency of tax collection and management is high, enabling this type of taxation to largely meet the fiscal revenue needs of the government and further leading to the path dependence in the issue of taxation by the government (Lv 2017).

<sup>4</sup> Tax salience refers to the visibility of tax to taxpayers (Chetty et al. 2009). In the theory of tax salience, the stronger the tax salience is, the more difficult it is to transfer it (Goldin and Homonoff 2013).



### The reform direction and concrete measures of establishing modern taxation system in the future

#### *The reform direction*

Future taxation system reform needs to maintain the deep embedment of the taxation system in the wide-ranging economy while deepening the degree of tax embedment in society to achieve the national governance goal of building a "consensually strong state."

In *The Crisis of the Tax State*, Schumpeter (1918: 122–123) pointed out that "only a strong government on the broadest political base, impressing the public with real power and leadership, could dare to attempt the task of overcoming all resistance." Acemoglu (2005) proved the "consensually strong state equilibrium" in the economy through a theoretical model. He believed that OECD countries are in this equilibrium state.

From the relationship between per capita GDP and macro-level tax bearing in the world, the macro-level tax bearing of strong countries is generally high, while the taxation capacity of weak countries is often limited (Fig. 6).

How can tax reform achieve the goal of building a "consensually strong state"? The deep embedment of taxes in the wide-ranging economy should be maintained, and at the same time, the degree of tax embedment in society should be deepened. Tax embedment in society has the following four benefits.

First, tax embedment can stabilize social order. With the development of the Internet, the level of modernization, informatization, and intellectualization is constantly elevating, while the factors destroying social order and stability are increasing and the destabilizing means are being constantly upgraded. Network fraud, high-tech theft, financial crime, power rent-seeking, and corruption cases occur from time to time, increasing the difficulty of social governance. At the same time, the digital economy provides strong support for the modernization of tax collection and management and offers important opportunities for making natural persons the main body of taxation (Zhang 2016). If the government had information on residents and families, the difficulty of social governance would be reduced. Schumpeter (1918:108) pointed out in *The Crisis of the Tax State* that "the kind and level of taxes are determined by the social structure, but once taxes

exist they become a handle, as it were, which social powers can grip in order to change this structure.” Therefore, taxes are an important means for the government to grasp the information of residents and families. However, at present, 90% of the tax revenue in China comes from enterprises, while less than 10% comes from individuals. Therefore, in the future, the social order can be stabilized through tax embedment in the family.

Second, tax embedment can stimulate social vitality. The goal of social governance is to make society both stable and active. Embedding taxes in families can help stabilize social order, and the vitality of social organizations can be stimulated by properly applying tax preferences to social organizations. For example, the implementation of tax incentives, such as deductions and reductions for the donations to social organizations from individuals, can to some certain extent encourage the donations to charity organizations from individuals and the development of charitable institutions, promote the flow of capital and labor, optimize the allocation of resources and stimulate social vitality. However, China’s preferential tax policies are mainly implemented in enterprises for promoting economic growth, and their effect on social organizations is very limited. Therefore, in the future, China can stimulate social vitality by appropriately applying preferential tax policies to charitable and other related social organizations.

Third, social equity can be promoted through tax embedment in society. It is generally believed that taxation can change income distribution to promote social equity. The ways in which taxes can promote social equity are more than that, as social equity can be facilitated by promoting tax equity. At present, the division of the local market has resulted in the unfair tax bearing of taxpayers and affected social fairness. Therefore, in the future, China can promote social equity and create a fair, competitive environment by increasing the proportion of direct taxes and cleaning up and rectifying unreasonable tax preferences.

Fourth, tax embedment in society can stimulate the taxpayers’ sense of rights. Rights and obligations are accordant. Taxpayers should enjoy the corresponding rights when they undertake the duty of paying taxes. They have the right to enjoy the public goods and services provided by the government. When they fulfill their duty of paying taxes in accordance with the law, their rights should also be confirmed, protected, and supported by national law. The rights of taxpayers include the right to supervise the use of taxes and the right to know tax laws (Zhu 2009). Liu and Yu (2006) believe that after the public becomes knowledgeable about aspects of the taxation system, they have the right and motivation to restrict and supervise government behavior and express concern regarding the use of taxes and the provision of public goods. Therefore, tax embedment in society can stimulate the taxpayers’ awareness of their rights, increase their concern about the fairness, rationality, and the use of taxes, cause them to advocate an open and transparent government budget and a government that listens to the voice of society. Therefore, the stimulation of these rights and consciousness is a process of in-depth interaction between the state and society and between the government and the people, which is also a modern state-building process.

#### ***Concrete measures***

Tax structure reform and the construction of the modern taxation system can be carried out in three ways.

One way is to move down taxation, i.e., to transfer tax bearing downstream of the national income cycle, appropriately increase the taxation bearing of residents and families, and increase the proportion of direct taxes. On the one hand, with the continuous increase in the residents' income and wealth accumulation, direct taxes such as individual income taxes will become taxes with great growth potential. Therefore, this income growth and wealth accumulation provide a strong foundation and positive conditions to increase the proportion of direct taxes. On the other hand, to cope with the downward pressure of the economy, the country is implementing a large-scale tax reduction and fee reduction policy. The tax reduction is mainly aimed at enterprises. However, a tax reduction is not conducive to the provision of government functions, and a large part of government expenditures comprises fixed expenditures, which are difficult to reduce or which have to even increase from time to time. This forces the government to increase the proportion of direct taxes to effectively compensate for the government revenue loss due to tax reduction and bearing reduction policies and strengthens the role of taxes in regulating the distribution and promoting social governance. Therefore, in terms of specific taxes, the reform of the value-added tax, the individual income tax, and the real estate tax should be taken into account.

For the value-added tax reform, an appropriate tax reduction should be considered. As the value-added tax is a commodity tax levied in the process of production, full play should be given to its neutral characteristics. The value-added tax reforms should primarily include the following: using two tax rates; reducing the tax rate appropriately; and reducing unreasonable and unnecessary preferential tax policies (because the implementation of preferential tax policies in the production process will interfere with the price mechanism of factors and goods, hinder the free flow of factors and goods, and disrupt the market operation and market order).

For the reform of the individual income tax, the number of taxpayers should be enlarged, and efforts to improve the individual income taxation should continue, combining reforms in classification and synthesis. In 2018, the implementation of comprehensive and classified individual income taxation improved the level of tax collection and management to a certain extent and stimulated the consciousness of taxpayers. However, the increase of the "threshold" and the increase of the scope of expense deduction may reduce the total amount of tax paid by natural persons, which will further reduce the role of the personal tax in raising fiscal revenue and regulating income distribution. The reform of individual income tax should be implemented on the principle of a "wide tax base, simple taxation system, strict collection and management" to adapt to the reality of people's income growth and source diversification.

The real estate tax reform should be carried out steadily, and selective taxation could be implemented first. It is both economically and socially significant to levy real estate taxes on the residents' housing property. Similar to individual income taxes, real estate taxes can be embedded in the family. Therefore, real estate tax law should be steadily promoted. In levying real estate taxes, the principle of statutory taxation should be strictly followed. Before the legislation regarding real estate tax law is implemented, public opinion should be taken into account thoroughly, an in-depth investigation and study should be conducted, the pros and cons should be carefully weighed, and the social consensus should be reached. The first group of taxpayers could be limited to residents with

multiple apartments or houses. Then, the scope of taxpayers could be gradually extended to include all residents with real estate property.

The second way tax reform can be carried out is to cultivate beneficial taxes. Beneficial taxes refer to the taxes that are closely related to the public services provided by the government for residents, including real estate taxes, retail taxes, individual income taxes, and social security taxes. The cultivation of beneficial taxes will help the government provide better public services, promote social equity, stimulate social vitality and stabilize social order. Therefore, in terms of specific taxes, China should consider the reform of real estate taxes, retail taxes, individual income taxes, and social security taxes. The sections above analyze the reform of real estate taxes and individual income taxes, and the following section considers only the reform of retail taxes and social security taxes.

A retail tax should be levied<sup>5</sup> in the process of commodity consumption, replacing the original value-added tax and assigning the full amount of the retail tax as a local tax (Lv 2013). Taxing the residents' consumption could motivate the local government to protect the consumer market, safeguard the residents' interests, and ensure social order. Taking the "Sanlu milk powder incident" as an example, when *Sanlu* infant formula was first exposed to quality problems, the local government did not immediately investigate but protected the problem enterprise because it was a large local taxpayer. If the local government's tax revenue mainly came from the retail tax of commodity consumption rather than the value-added tax and corporate income tax sharing, the local government would have no incentive to protect the enterprise but strengthen supervision and protect consumers; if residents boycott *Sanlu* infant formula, they could also choose other brands, such as *Yili* and *Mengniu*. As long as residents consume products, local governments will obtain tax revenue from their consumption. Therefore, the retail tax should be levied in time.

Social security taxes should be levied at the right time. A social security taxation plan could have a significant effect on adjusting income distribution. As early as 1996, in the *Ninth Five-year Plan of National Economic and Social Development of the People's Republic of China and the Outline of Long-term Goals for 2010*, China put forward the idea of levying a social security tax. However, this plan has been "stagnant," and the tax has not been levied so far. At present, there has been no overall nationwide planning for China's social security system, and most of the planning is conducted at the provincial level. The different provincial standards for social security fund payments and distribution have led to a very strong reordering effect in social security collection and distribution, which has not been conducive to the role of social security in regulating income distribution. To eliminate the adverse effects of this reordering effect, the government should levy a social security tax nationwide when conditions permit.

The third way to carry out tax reform is to reform the preferential taxes. A preferential tax policy is an important taxation lever to regulate the economy, guide resource allocation, and promote structural adjustment. At present, preferential tax policies are mainly imposed on enterprises as an important way of supporting regional tax competition to attract investment and stimulate economic growth. Unreasonable preferential

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<sup>5</sup> Lou (2013) also proposed a similar idea and named it "local sales tax".

tax policies will enlarge the regional tax gap, destroy market unity, hinder the flow of factors, and interfere with the optimal allocation of resources, all of which represent problems that should be resolutely cleaned up and rectified. At present, little attention is still paid to preferential tax policies conducive to stimulating the vitality of charitable institutions and other social organizations. To stimulate social vitality and promote social governance, the government should put forward preferential tax policies for social organizations in the future.

### ***The influence of taxation system reform on financial absorptive capacity and economic efficiency***

The primary function of taxation is to raise fiscal revenue. When raising fiscal revenue, attempts should be made to avoid the loss of economic efficiency. Will the aforementioned direction of tax reform enhance the ability to raise fiscal revenue and reduce the loss of economic efficiency?

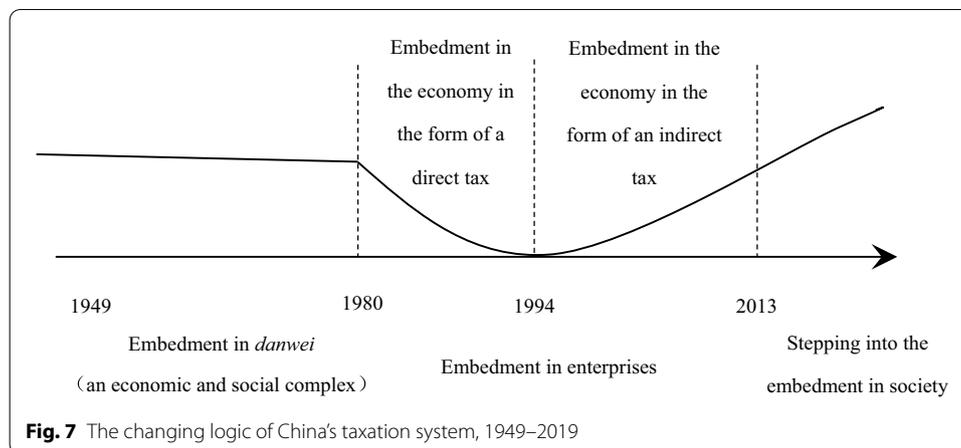
The answers to these questions can be found by comparing the designed plan with the current taxation system. As pointed out above, the key characteristics of the Chinese taxation system are that it mainly levies taxes on enterprises and that the taxes mainly come from the production link. In recent years, an economic downturn has created the fiscal dilemma that although a tax reduction has been conducive to reducing the cost of enterprises, it has caused a decline in fiscal revenue. Moreover, after the tax reduction, governments at all levels have increased their dependence on non-tax revenue. In fact, taxes only account for slightly more than half of the government's revenue (Lv et al. 2020). It is well known that the distortion of tax revenue is less than that of other forms of government revenue (such as fees, rents, and debts), but the latter is more invisible and less noticed.

With economic development, the tax source of Chinese government has gradually shifted from enterprises to families and from production to consumption. Along the direction of deepening the tax embedment in society, tax reform has broadened the tax source, even the taxation system, and improved the financial absorptive capacity. In other words, tax reform has been in line with the two fundamental principles of taxation efficiency and fairness.

### **Conclusion**

Since the founding of the PRC 70 years ago, the development of China's taxation system has made extraordinary achievements. Based on the analysis of national development goals and the tax basis (i.e., "two matchings"), this article portrays the changing logic of Chinese taxation from two dimensions—economy and society (i.e., "two embeddedness"). It divides the tax reform enacted since the founding of China into three stages. The conclusions are as follows.

The first stage lasted from 1949 to 1980, and during this period, taxes were embedded in the *danwei*. The national development goal was to rapidly change the situation of economic poverty and promote economic growth. At that time, regarding tax sources, the situation was characterized by a weak economic foundation, the limited income of residents, and the economic significance of the SOEs. To match up with the national development goals and the increase in the tax base, the tax reform focused on the unification



and simplification of taxation. In this stage, the national financial revenue mainly came from SOEs. Under the planned economic system, the *danwei* organization integrated various economic and social functions, such as production, distribution, and consumption. Therefore, the taxation system can be characterized as an embedment in *danwei*, which reflected an embedment in the economy and an embedment in society under this special historical background (Fig. 7).

The second stage was from 1980 to 2013, and during this period, taxes were embedded in enterprises. The national development goal was to gradually transform from promoting economic growth to adapting to the socialist market economic system and implementing the scientific outlook to achieve coordinated development. The tax source changed with the development of the manufacturing industry. Production rapidly expanded, and various economic components were active. At this stage, tax reform was carried out around establishing foreign-related taxation, the mobilization of enterprises, especially SOEs, the stimulation of enterprise vitality, the establishment of a unified market, and the guarantee of national fiscal revenue from production. In this stage, the *danwei*, as an economic and social complex, gradually stripped off its social functions. The taxation system gradually transformed from an embedment in *danwei* to an embedment in enterprises. Before 1994, taxes were embedded in the economy mainly in the form of direct taxes provided from profits and income, and after 1994, taxes were embedded in the economy mainly in the form of indirect taxes reliant on price channels.

The third stage is the period after 2013. During this period, the general goal of national development changed to the deepening of the tax embedment in society. The national development goal was to promote the modernization of the national governance system and governance capacity. Based on the gradual transfer of national income to redistribution and wealth accumulation, the tax source has been shifted from enterprise production to household income and wealth. Therefore, the tax reform has focused on stimulating economic vitality and promoting social governance. The embedment of taxes has gradually extended from the economy to society. Although the individual income taxation, as a result of comprehensive and classification reforms, made a significant step toward inclusion of the family, the degree of tax embedment in society remains low.

How can the degree of tax embedment in society be evaluated? The degree of tax embedment in society can be divided into three levels: strong embedment, weak embedment, and no embedment. The evaluation criteria are related to the form of tax embedment in society. (1) When the form of tax embedment in society is reflected in the increase in the proportion of the residents' tax payments, the embedment degree of a tax, which is based on a family's income or property, is strong, while the embedment degree of a tax, which is based on personal income or property, is weak; moreover, the embedment degree of a tax, which is based on comprehensive income, is strong, and the embedment degree of a tax, which is based on classified income, is weak; the embedment degree of independent declaration and collection is strong, while the embedment degree of withholding and collection is weak. (2) When the form of tax embedment in society reflects the principle of benefit, the tax with a strong benefit has a strong degree of embedment in society, and the tax with a weak benefit has a weak degree of embedment in society. Regarding beneficial taxes, the benefit of the real estate tax is stronger than that of the general consumption tax and that of an individual income tax; therefore, the real estate tax has the strongest degree of embedment in society, followed by the general consumption tax and the individual income tax. (3) When the form of tax embedment in society encourages the development of charitable social organizations, taxes directly affect the development of social organizations and are a strong embedment in society.

Note that the advantages and disadvantages of the taxation system cannot just be explained by the degree of its embedment in society. The advantages and disadvantages of the taxation system depend on whether it matches the stage of economic and social development. In different stages of development, the degree of tax embedment in society and the taxation system should be different. This article shows that China's taxation system has a relatively weak degree of embedment in society, which has delayed the pace of tax reform. In general, the existing problems of the current taxation system structure include the following: the tax is concentrated in the production link, and too little is concentrated in the redistribution link and accumulation link; the main taxpayers are enterprises, and too little tax is levied on residents. Therefore, the future direction of tax reform should be to keep the tax embedment in the broad economic foundation and to deepen the degree of tax embedment in society, achieving the goal of building a "consensually strong state." The main measures are to move down the tax link, increase the proportion of direct taxes, cultivate beneficial taxes, and reform the tax preference system.

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##### **Competing interests**

The authors declare they have no competing interests.

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