

# Interpretation of fiscal policies from the Third Plenary Session - the direction of the reform of the fiscal and tax systems indicated

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## In brief

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The recent 3rd Plenary Session of the 20th Central Committee of the Communist Party of China has adopted the *Resolution of the Central Committee of the Communist Party of China on Further Deepening Reform Comprehensively to Advance Chinese Modernization*<sup>1</sup> (“the Resolution”). The Resolution points out, as part of the section of Improving Macroeconomic Governance, to deepen the reform of the fiscal and tax systems. It details the key tasks and directions of the reform for the next five years, from three major aspects of further improving the budget system, the tax structure, and the fiscal relationship between the central and local governments.

To improve the budget system, the Resolution specifies that all revenues generated on the basis of the exercise of administrative power, government credit, state-owned resources and assets will be placed under government budget management, the budgeting and performance assessment systems for state capital operations will be improved, and reforms for zero-based budgeting will be advanced.

To improve the tax system and optimize the tax structure, the Resolution puts forward to look into approaches for better adapting the systems to new forms of business; to fully implement the principle of legality of taxation, regulate policies on tax breaks and improve the support mechanisms for key sectors and links; to refine the system of direct taxes, improve the individual income tax system, regulate taxation on income generated from business operations, capital, and property, and unify taxation for earned income; to deepen the reform of the tax collection and administration system, and strive to make taxation systems more conducive to high-quality development, social fairness, and the building of a unified market.

To improve fiscal relationship between the central and local governments, the Resolution includes a series of reform arrangements such as establishing a fiscal relationship that features well-defined powers and responsibilities and the appropriate allocation of resources, with an optimum balance between regions; expanding the sources of tax revenue at the local level to place more fiscal resources at the disposal of local governments; moving consumption tax collection further down the production-to-consumption chain, with the power of collection steadily being passed to local governments, improving the value-added tax (VAT) credit refund policy and the channels for making tax deductions, and optimizing the ratio for taxes shared between the central and local governments; looking into rolling the urban maintenance and construction tax, education surcharges, and local education surcharges into one single local surtax; giving local governments the authority

to set the rate for this surtax within a predetermined range; appropriately expanding the scope of use for funds raised from local government special-purpose bonds; and appropriately strengthening the central government's fiscal powers and raising the proportion of central government expenditure accordingly.

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## In detail

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**All types of government-related revenues will be placed under government budget management and reforms for zero-based budgeting will be advanced.** The Resolution calls for improving the budget system and sets out plans for strengthening unified management of all fiscal resources and budgets, enhancing macro guidance on budgeting and fiscal policies, further improving the zero-based budgeting, unifying budget allocation powers, and improving the system for comprehensive government financial reporting based on accrual accounting. These strategies are designed to chart the cause ahead for deepening the reform of the budget system.

As of now, the Ministry of Finance has issued several rules and regulations including *Government Financial Reporting Preparation Methods*, *Government Department Financial Reporting Preparation Operation Guide*, and *Government Comprehensive Financial Reporting Preparation Operation Guide*.

**VAT reform aligns with market expectations.** The Resolution puts forward to improve the VAT credit refund policy and free up the channels for making tax deductions, and to optimize the ratio for taxes shared between the central and local governments. Placing such improvement in the context of central-local relations will help guarantee the main sources of tax revenue at the local level.

The reform will also help reduce the share of indirect taxes, better regulate corporate tax behaviour and enhance the fairness and neutrality of the tax system. The VAT reform mentioned in the Resolution is in line with market expectations. According to the *2024 Legislative Work Plan* issued by the Standing Committee of the National People's Congress, the third review of the "VAT Law" has been scheduled for December this year.

**Consumption tax reform is a key measure in adjusting the fiscal relationship between the central and local governments.** The Resolution calls for efforts to move consumption tax collection further down the production-to-consumption chain, with the power of collection steadily being passed to local governments, aiming to allocate consumption tax revenue to local governments to supplement their main tax sources.

Among the 18 major taxes in China, the consumption tax is the third largest tax after VAT and corporate income tax, and is the largest tax fully allocated to the central government. According to information released by the Ministry of Finance (please refer to the Appendix), in 2023, the consumption tax accounted for 8.9% of China's tax revenue, amounting to about RMB 1.6 trillion. Similar proposal was made in 2019 in the *Plan for Adjusting the Division of Central and Local Revenues after Implementing Larger-Scale Tax and Fee Cuts* issued by the State Council, and there has been a long-standing market call for consumption tax reform. Moving consumption tax collection further down the production-to-consumption chain means that economically powerful provinces with a huge market, large population and strong consumption power will benefit more.

**Rolling related taxes and fees into one single local surtax is newly introduced by the Resolution.** The Resolution puts forward to roll the urban maintenance and construction tax, education surcharges, and local education surcharges into one single local surtax and local governments will have the authority to set the rate within a predetermined range. These taxes and fees are all based on consumption tax and VAT. Merging these taxes and fees and granting local governments a certain degree of autonomy will simplify the tax system, facilitate tax collection and administration, improve tax compliance, stabilize local income, and enhance the enthusiasm for local tax administration.

**Individual income tax is an important component of the direct tax system, and its reform will go further towards the simplification of the tax system and the fairness of the tax burden.** Currently, wages and salaries, remuneration for personal services, author's remuneration and royalties are taxed comprehensively at unified rates, however, different rates still apply for provisional withholding purpose, with the possibility of further unification in the future. Income derived from business operations by individual households, sole proprietors and partners of partnerships, which also has the nature of earned income, is not included in the comprehensive income and subject to separate tax rates and calculation methods. The tax rate difference between the income categories and the difficulty in differentiating the income nature in certain situations bring complexity, and has made it a hot issue in practice in recent years. Whether income from business operations will be consolidated into comprehensive income for unified taxation in the future is worth attention. The requirement for regulating the taxation on capital and property income mentioned in the Resolution may imply both the improvement of related tax policies and the enhancement of regulatory compliance.

**Deepening tax collection and administration reform.** The Legislative Affairs Office of the State Council released *the Draft of Tax Collection and Administration Law (Draft for Comments)* in 2015, but the legislative process has lagged behind the revisions of several tax substantial laws in recent years. Since the issuance of *The Opinions on Further Deepening the Reform of Tax Collection and Administration* by the General Office of the CPC Central Committee and the General Office of the State Council in March 2021, China's reform of the tax collection and administration system has steadily progressed (for example, several provinces and cities have piloted advance tax rulings in recent years, laying the foundation for the next revision of the Tax Collection and Administration Law). It is expected to be one of the focuses of the next stage reform, and taxpayers and the industry also look forward to opportunities to make input and suggestions on the new draft.

**Improving the green tax system.** The Resolution calls for efforts to improve the mechanisms for green and low-carbon development; implement fiscal, tax, financial, investment, and pricing policies as well as standards to support green and low-carbon development, develop green and low-carbon industries, improve incentive mechanisms for eco-friendly consumer spending, and work toward an economy that facilitates green, low-carbon, and circular development; optimize policies on green government procurement and refine the green taxation system; and enforce the system of mandatory limits on the use of water resources and replace the water resource fee with a tax nationwide. Although China's green tax system has been established, there is still significant room for improvement to achieve the goals of dual carbon. The importance of the green tax system is highlighted in deepening the reform of the ecological civilization system.

Regarding the replacement of water resource fees with taxes, China started the pilot reform of the water resource tax in Hebei Province on July 1, 2016, and expanded it to nine provinces and municipalities including Beijing, Tianjin, Shanxi, Inner Mongolia, Shandong, Henan, Sichuan, Shaanxi, and Ningxia since December 1, 2017. The taxpayers of the water resource tax are the entities and individuals that withdraw and consume surface water or groundwater and the tax shall be calculated and collected on a volume basis. The pilot reform has gone smoothly and orderly, effectively curbing unreasonable water use, and accumulating experience for the comprehensive promotion of the water resource tax system.

**Tax system for new business forms receives attention.** The Resolution proposes to look into approaches for better adapting the tax system to new forms of business. Emerging business forms represented by artificial intelligence, big data, and the internet are at the forefront of technological innovation and business forms innovation, representing national competitiveness in technology, economy, and international trade. The development of new business forms brings new opportunities and challenges to the traditional tax system and administration. Tailoring a tax system that fits the development of new business forms, reduces institutional costs, and improves international competitiveness poses a new proposition for China's tax reform. Therefore, it is necessary to conduct in-depth research to improve the adaptability of the tax system to the emerging economy and promote the sustainable and healthy development of the emerging economy.

**Improving the high-level open economic system and mechanisms and strengthening the construction of multilateral cooperation platforms in areas such as taxation.** The Resolution puts forward plans for improving the mechanisms for high-quality cooperation under the Belt and Road Initiative; implementing the Belt and Road science, technology, and innovation cooperation action plan and redoubling efforts to develop multilateral platforms for cooperation in green development, digital economy, artificial intelligence, energy, taxation, finance, disaster mitigation, and other areas. The Resolution emphasizes that opening up is a defining feature of Chinese modernization, and particularly stresses the improvement of the mechanisms for promoting high-quality cooperation of the Belt and Road, which is not only beneficial to China's development but also to the construction of multilateral cooperation frameworks, including the Belt and Road Initiative.

**Placing more fiscal resources at the disposal of local governments, raising the proportion of central government expenditure, and perfecting the transfer payment system.** The policy direction in this regard is to increase the proportion of central government expenditures and reduce the fiscal burden on local governments. The Resolution puts forward specific measures to optimize the fiscal relationship, including increasing local fiscal autonomy, perfecting the transfer payment system, optimizing the management of local government special-purpose bonds and local government debt, and reducing local expenditure responsibilities.

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## The takeaway

One of the core objectives of the fiscal and tax systems reform set in this Plenary Session is to effectively increase local fiscal capacity. The Resolution points out that to achieve this goal, it is necessary to increase local fiscal autonomy, expand local tax sources, appropriately broaden local tax administration authority, and proposes the following fiscal and tax measures: 1) steadily promoting the power of consumption tax collection to be passed to local governments; 2) improving the VAT credit refund policy and the channels for making tax deductions, and optimizing the ratio for taxes shared between the central and local

governments; 3) giving local governments the authority to set the rate for the new single surtax within a predetermined range; and 4) perfecting the fiscal transfer payment system and increasing general transfer payments.

According to the *Legislative Plan of the Standing Committee of the 14th National People's Congress* announced in 2023, the VAT Law, Consumption Tax Law, Customs Duties Law, and Tax Collection and Administration Law are all listed as first-category items (i.e. conditions are relatively mature, and these draft laws will be given priority for deliberation during the five-year term of the 14th Standing Committee of the National People's Congress). Among them, the Customs Duties Law was passed in April this year and will take effect on December 1, 2024. The third review of the VAT Law (Draft) will take place in the coming December. According to the *2024 Legislative Work Plan for the State Council*, it is planned to submit the draft Consumption Tax Law and the draft Tax Collection and Administration Law for deliberation by the Standing Committee of the National People's Congress. Therefore, we expect that these two laws will be the short term focus of tax legislation. And there will also be steady progress in rolling the urban maintenance and construction tax, education surcharges, and local education surcharges into one single local surtax, as well as improving the individual income tax system.

From the previous versions of VAT Law (Draft), it is expected that the VAT legislation will mainly follow the prevailing policies. The revision of the Tax Collection and Administration Law may cover important items such as late payment surcharge, standards for penalties and fines, statute of limitations, dispute resolution mechanisms, and information disclosure, which will affect all corporate and individual taxpayers. The reform of the consumption tax will have a significant impact on related industries, and the development in terms of applicable industries, adjustment to the scope of taxation and the tax rates, etc. shall be focused.

We will closely monitor the introduction and implementation of the relevant policies and share our observations and insight promptly.

## Endnote

1. *Resolution of the Central Committee of the Communist Party of China on Further Deepening Reform Comprehensively to Advance Chinese Modernization*

[https://www.gov.cn/zhengce/202407/content\\_6963770.htm](https://www.gov.cn/zhengce/202407/content_6963770.htm)

## Appendix: The Proportion and Allocation of Tax Revenue for the Current 18 Types of Taxes

Level of Revenue	Type of Tax	2023 Tax Revenue Proportion	Remarks	Central Proportion	Local Proportion
<b>Central Level Taxes:</b> Central government fiscal revenue, collected by tax bureaus and customs	Consumption Tax	8.9%		100%	
	Customs Duties	1.4%		100%	
	Vehicle Purchase Tax	1.5%		100%	
	Vessel Tonnage Tax	<1%		100%	
<b>Local Level Taxes:</b> Fiscal revenue of all local levels of government, collected by tax bureaus	Land Appreciation Tax	2.9%	special taxes on real estate		100%
	Deed Tax	3.3%			100%
	Real Estate Tax	2.2%			100%
	Urban and Township Land Use Tax	1.2%			100%
	Farmland Occupation Tax	0.6%			100%
	Vehicle and Vessel Tax, Tobacco Tax, Environmental Protection Tax	<1%			100%

Level of Revenue	Type of Tax	2023 Tax Revenue Proportion	Remarks	Central Proportion	Local Proportion
<b>Shared Taxes between Central and Local Governments:</b> Fiscal revenue shared between central and local governments, collected by tax bureaus	Value-Added Tax (VAT)	38.3%	VAT not collected by customs	50%	50%
			VAT collected by customs	100%	
	Corporate Income Tax	22.7%	Paid by central enterprises, local banks and foreign banks, non-bank financial enterprises, head offices of banks, railway departments, parent insurance companies, etc.,	100%	
			Paid by other enterprises	60%	40%
	Individual Income Tax	8.2%		60%	40%
	Urban Maintenance and Construction Tax	2.9%	Paid by China Railway Corporation, head offices of banks, parent insurance companies	100%	
			Remaining		100%
	Stamp Duty	2.1%	Securities transaction stamp duty	100%	
			Non-securities transaction stamp duty		100%
Resource Tax	1.7%	Paid by offshore oil enterprises	100%		
		Paid by non-offshore oil enterprises		100%	

Source of Information: Ministry of Finance, Public Information.

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**Let's talk**

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