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The Relationship Between China's Tax System and Economic Inequality

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Abstract: Along with China's sustained rapid economic growth, the nation confronts persistent structural challenges manifested in widening income inequality and deepening regional developmental imbalances. This study conducts an examination of how China's fiscal architecture contributes to these economic disparities by analyzing the current tax structure and the tax-sharing system. The analysis first argues that the regressive nature of China's tax system perpetuates wealth concentration. Systemic deficiencies in direct taxation, particularly the delayed implementation of property tax reforms, significantly undermine fiscal redistribution effectiveness. This article then investigates that, after the reform of the tax-sharing system, local governments are facing serious mismatch between the administrative responsibility and fiscal capacity. The imbalance has further compelled local governments to increasingly rely on land finance and debt instruments, which exacerbated regional disparities in financial capacity. The article highlights three policy responses. It further evaluates the realization path and fundamental requirements of the rural revitalization strategy, the resistance faced by the property tax reform, and the deficiency of endogenous incentives and debt inflation that fiscal transfer payments bring.

Keywords: tax structure, tax-sharing system, economic inequality, urban-rural dualism

1. Introduction

China has sustained a high growth rate over the past decades. Nevertheless, the Chinese economy still confronts numerous problems, particularly the gradually expanding economic inequality. This is mainly manifested in two aspects: income inequality and regional inequality.

The Gini coefficient serves as a crucial indicator for inequality in income distribution. According to the National Bureau of Statistics (NBS), exceeding the internationally recognized warning line, China's Gini coefficient has long been above 0.4. However, the issue of underestimation of income disparity still persists. This can be attributed to the low-level cooperation of high-income groups in surveys and the concealed nature of income [1].

Regional inequality constitutes another crucial manifestation of economic inequality within China. The per capita Gross Domestic Product (GDP) indicates a substantial disparity in economic development between the eastern coastal areas and the central and western regions. According to the NBS, the per capita GDP in the eastern region far surpasses that of the central and western regions. For instance, in 2023, the per capita GDP of Jiangsu and Zhejiang respectively exceeded 150,000 yuan and 120,000 yuan, whereas the per capita GDP of western provinces like Gansu and Guizhou still lingered around 50,000 yuan. Moreover, in China's first-tier cities, wealth is highly concentrated.

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For example, per capita GDP in Beijing and Shanghai, respectively, exceeded 200,000 yuan and 190,000 yuan.

The economic strength and public service capacity of regional governments further intensify this disparity. In 2023, the general public budget revenue of Guangdong province was nearly 1.4 trillion yuan, whereas that of Gansu province was merely 100 billion yuan. The gap in expenditure between the two regions is even more substantial, reaching 1 trillion yuan. This difference not only influences the level of economic development but also deeply impacts the quality of public service provisions, for instance, education, healthcare, and social welfare, thereby further widening the inter-regional development gap in a seemingly unending vicious cycle. Regarding the local income gap, Myrdal categorizes the influence of a region's economic progress on adjacent areas into two distinct dynamics [2]. One is known as the 'Return effect,' which occurs when regional economic expansion triggers resource influx from neighboring areas. This, in turn, will decelerate peripheral development, expanding the inter-regional income disparity. The other is named the 'diffusion effect,' which manifests when a region's economic advancement stimulates simultaneous economic growth in surrounding areas, thereby narrowing the inter-regional income gap [2].

The worsening gap between the rich and poor can have far-reaching effects on society as a whole. Income distribution causes social discontent and social conflict, which undermines property rights and has a negative impact on investment and thus economic growth [3]. Moreover, inequality in primary distribution is detrimental to economic growth while redistribution is favorable to economic growth [4]. The tax system is an important means to regulate income distribution; however, in China, its role in regulating efficiency and equity is relatively limited. Against this backdrop, this paper, through a factual and literature-based description, focuses on the implications of China's tax system on economic inequality, mainly through investigating the tax structure and tax-sharing system. The second section of the article provides an overview of the current pattern of inequitable distribution of wealth in China, centering on a descriptive analysis of the development of urban-rural and regional inequality. The third section analyses the limitations of China's current tax system concerning income distribution and the impact of the tax system on economic disparities between regions. The fourth section evaluates China's proposed policies to address economic inequality.

2. Overview of economic inequality in China

Since the reform and opening-up, China's economy has sustained a high growth rate. Specifically, during the period from 1978 to 2012, the annual average growth rate of GDP reached 10 percent. Nevertheless, the rapid economic growth has also given rise to the issue of an excessive income distribution gap. According to the NBS, from 1978 to 1995, China's Gini coefficient ascended steadily from 0.16 to 0.39. However, commencing from 2003, the Gini coefficient began to increase rapidly, peaking at 0.491 in 2008. After 2011, the Gini coefficient exhibited a slight decline and has remained stable within the range of 0.46 to 0.47 in the ensuing years.

In China, the urban-rural income gap constitutes one of the principal sources of income inequality. During the planned economy period, with the aim of attaining rapid industrialization, the state highly tilted its economic resources towards the urban heavy industry sector. It furnished primitive financial support for industrialization via the policy of price scissors between industrial and agricultural products. Nevertheless, capital-intensive heavy industry has a restricted capacity for labour absorption. The household registration system, as a supporting management instrument, restricted the movement of population between urban and rural areas. Consequently, Chinese society developed a dual structure between urban and rural regions [5]. However, after the reform and opening up, this dichotomy has not been eradicated but rather has been maintained. The household registration policy continued to impede the participation of rural labour in high-productivity urban industries. Under the 'promotion tournament model' with GDP as the core assessment, local governments placed more

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development emphasis in cities where secondary and tertiary industries are concentrated [6]. As a result, the gap between urban and rural areas has been further widened. In 2010, the Gini coefficient for the entire nation was 0.481. At that time, the average Gini coefficient for urban and rural residents' income were both 0.30 [7]. This data implies that the gap between them serves as a crucial factor contributing to the overall income inequality across the country.

In China, inequality in income distribution also involves substantial regional differences. Since the 1980s, the State has been implementing a strategy of unbalanced regional economic development [8]. It focused on the eastern coastal region, with an emphasis on giving full play to the location advantages and industrial base of this region. This strategy led to the rapid development of the eastern region before the central and the western, bringing about increasing regional economic disparities. In response, the central government launched the 'Western Development' strategy to balance equity with the priority of efficiency. Today, however, in the context of economic transformation, the Northeast region, with its heavy-industry-based industrial structure, faces the risk of economic recession. According to the NBS, in 2015, per capita income in the Northeast was 21,008.4 yuan, compared to 28,223.3 yuan in the East, with a per capita income ratio of 0.744. By 2023, this figure dropped to 0.667, indicating that a new challenge of widening regional disparities is emerging.

3. China's tax system and economic impact

3.1. Tax structure

In accordance with the conventional classification, China's taxes can be divided into two categories. Indirect taxes predominantly consist of value-added tax and consumption tax, while direct taxes mainly encompass income tax and property tax. Presently, China's tax system is still preponderantly led by indirect taxes, with direct taxes occupying a relatively small proportion.

In 2022, according to the NBS, China's indirect taxes constituted 49.99 percent of the nation's total tax revenue. However, a tax regime predominantly constituted by indirect taxes, that are mainly levied based on people's consumption outlays rather than their income levels, is generally regarded as unfavorable to the equitable distribution of the tax burden. As income levels ascend, the proportion of consumption expenditure to income typically declines, meaning that there exists a negative correlation between the indirect tax burden and the proportion of income. This implies that low-income individuals are more likely to bear a relatively heavier tax burden. Consequently, China's existing tax system, which is mainly characterized by indirect taxes, exhibits a regressive nature.

Concurrently, China's direct taxes accounted for 47.73 percent, and has witnessed a remarkable growth. From 2012 to 2022, China's total tax revenue represented a 65.6 percent increase, while direct taxes surged by 118.2 percent, a growth rate that significantly outpaced. The ratio of indirect taxes to direct taxes declined from 1.57 in 2012 to 1.05 in 2022, signifying that China's tax structure is progressively evolving towards greater rationality. Nevertheless, certain irrationalities still persist. Firstly, the personal income tax, which is levied on personal earnings, only accounts for 9 percent of the total tax revenue. This relatively low proportion implies that its efficacy in income distribution is rather limited. In contrast, in the United States, personal income tax has long been the primary source of tax revenue for the federal government, constituting more than 40 percent of federal tax revenue [9]. Secondly, the proportion of property tax remains disproportionately low, only accounted for 2.5 percent in 2022. In many developed nations, property tax serves as a significant means of wealth distribution. In China, nonetheless, it is still in a state of imperfection. The real estate tax, as the most prominent part of property tax is restricted in scope and has not been fully implemented across the board. Moreover, the absence of inheritance tax and gift tax further curtails its function of regulating the wealth. These weaknesses also have an adverse impact on the healthy development of the local government tax system. Property taxes are typically earmarked as specialized taxes for local

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governments and serve a significant role. For instance, in the United States in 2011, property tax accounted for 76.8 percent of local government tax revenue, with real estate tax making up over 75 percent of the total property tax revenue [9]. In China, however, property tax merely accounts for 22.5 percent of local government revenue. This situation leads to insufficient revenue sources for local governments, thereby causing them to rely heavily on land-based finance, which exacerbates various issues.

3.2. Tax-sharing system and regional disparity

The tax-sharing system that was introduced in 1994, includes three main parts: central taxes, local taxes, and central-local shared taxes. After the reform, the central government secured 75% of value-added tax proceeds, which is the largest revenue source. Moreover, it fully retained consumption tax, and implemented 50% sharing of income taxes from 2002 onward [10]. As a result, the central government's revenues have risen rapidly, and correspondingly, the proportion of local fiscal revenues has plunged, dropping from 78% in 1993 to 44.3% in 1994. While at the same time, its expenditure responsibilities persistently accounted for around 70% of total public spending [11]. The resulting 30% fiscal gap, stemming from centralized revenue allocation and decentralized expenditure mandates, compelled local governments to develop alternative financing mechanisms to fulfill public service obligations.

Land concessions constitute a critical mechanism for generating off-budget revenue within China's fiscal framework. Operating as the sole legitimate purchaser in primary land markets, local governments acquire agricultural land from rural collectives at below-market compensation rates, subsequently granting urban land use rights through market-oriented transactions. Especially since 2002, local government can let the right to use state-owned land through bidding, auctioning, listing transactions, and concession revenues has soared. According to NBS, in 2018 this figure reached 6.291 trillion yuan, equivalent to 64.3% of local governments' budgetary income. Thereby land sales can be regarded as a second fiscal pillar. This revenue structure exhibits pronounced spatial heterogeneity. For example, based on data from Provincial Departments of Finance of Jiangsu and Inner Mongolia, Jiangsu province's land transfer revenue in 2024 was 727 billion yuan, 17.7 times that of Inner Mongolia, reflecting core-periphery disparities in land marketization capacity.

The pre-2015 fiscal architecture constrained local governments from direct bond issuance, prompting innovative off-balance-sheet financing through Local Government Financing Vehicles, particularly Urban Investment Corporations. These state-owned platforms leveraged implicit government guarantees to access credit markets, with land assets serving dual collateral functions. Firstly, land assets are the primary security for bank loans and bond issuances, and secondly, they serve as future revenue streams underpinning debt service through anticipated land value appreciation [12]. This financial engineering essentially securitized projected land premiums, creating self-reinforcing cycles in high-demand regions while exposing less-developed areas to debt crisis.

Regional divergence manifests in two distinct debt dynamics. Eastern coastal provinces exhibit virtuous cycles where land price inflation enhances collateral values and refinancing capacity. In contrast, this model confronts financial predicament in central and western regions. Stagnant land markets with land depreciation cannot sustain the development cycle, but has plunged less developed regions into debt crisis. Guizhou and Gansu provinces sustain debt ratios exceeding 60%, compared to sub-20% ratios in Guangdong and Jiangsu province. This mismatch between debt obligations and revenue generation capacity poses risks to regional fiscal sustainability.

This huge difference in fiscal capacity further exacerbates the imbalance in the level of public services and infrastructure development between regions. According to the NBS, Guangdong's fiscal expenditure in 2023 was 1,852.703 billion yuan, while this figure of Gansu province was only 452. 182 billion yuan, accounting for only 24.4 percent of that of Guangdong. The inequality in fiscal

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expenditure directly affects the balanced development of public service supply capacity. This gap is particularly prominent in the field of education. In 2023, the expenditure on education of the Shenzhen, a mega city of Guangdong province, exceeded 100 billion yuan. According to the data released by the Shenzhen Education Bureau, over the past 10 years, 6 institutes of higher education have been established. At the same time, however, the western region has been in a situation of net brain drain. Economically developed regions are attracting talents, capital and other productive factors through higher level of public services. While less developed regions are trapped in a vicious circle due to weak financial capacity and subsequent public services, which limit their development potential.

4. Policies

4.1. The rural revitalization strategy

The rural revitalization strategy, put forward at the nineteenth Communist Party of China National Congress, is a systematic project to address the imbalance between urban and rural development. Its core lies in building a new pattern of urban-rural interaction [13]. The achievement of this goal requires a shift from an urban-biased development strategy to one that prioritizes rural development. In the process of China’s urbanization, cities have shown a strong siphoning effect on the countryside, with a large number of labour, capital and other factors of production flowing from the countryside to the cities. Correcting this inertia necessitates reorienting resource allocation mechanisms through increasing financial inputs and tilting policies. Priority should be given to addressing deficiencies in rural infrastructure and public services, while comprehensively enhancing the quality of education, healthcare, and cultural services in rural communities.

Fundamentally breaking the constraints of unidirectional resource flows demands the integration of urban and rural development through structural reforms to break the dual structure. This transformation calls for institutional innovations, particularly in household registration systems and rural land management policies, so as to realize the two-way flow of resources between urban and rural areas. The emphasis is on market-oriented rather than administratively controlled resource distribution mechanisms, with the ultimate objective of creating a sustainable development model.

4.2. Property tax reform

China opened a pilot property reform in Shanghai and Chongqing in 2011, which was seen as a prelude to the full implementation of property tax in China, but a nationwide implementation is yet to be realized until 2025. As a local tax, the implementation of property tax should have been supported by local governments, but in China, local governments have become one of the biggest resistances to the implementation of it. As mentioned earlier, land sale revenue is one of the major sources of finance for local governments. After the implementation of land auctions, land prices and property prices are closely linked. Under such circumstances, local governments may deliberately keep property prices at a high level to heat up the property market. However, the collection of property tax will lead to a fall in housing prices, thus affecting the real estate market and further local government land sale revenues. This will undoubtedly make local governments a natural resistance to promote property tax reform. Moreover, due to the ‘promotion tournament model’ with GDP as the core assessment, local governments pay great attention to the economic indicators brought by the real estate industry [6]. Real estate pulls the upstream and downstream industry chain, contributing greatly to economic growth.

However, with the gradual cooling of the real estate market, it is the general trend of local governments relying less on it. Moreover, the real estate downturn has brought about a chain reaction of local debt mines. Under the pressure of debt, local governments urgently need to open up new tax sources. Perhaps, it will compel local governments to be the main impetus for the implementation of property tax.

The majority of urban commercial housing owners are another major resistance to property tax reform. According to the data released by China Economy Information Net, China’s housing income ratio reached 8.71 in 2022, which has been long above the internationally considered reasonable range of 4 to 6. This suggests that house prices in China as well as relatively high, and there is a certain element of bubble. However, consumers not only have to bear high housing prices, but also additional costs such as deed tax, maintenance funds and renovation expenses in the transaction process. Excessive expenditure pressure before moving into commercial housing in China, seriously overdraws the ability to pay taxes in the retention segment. Under these circumstances, even if the property tax is universally implemented, it will still retain the limitations of a narrow scope and a small amount.

4.3. Financial transfer payment

The fiscal transfer payment system constitutes a crucial instrument for coordinating balanced regional development. Through vertical revenue redistribution, this system mitigates economic disparities and facilitates resource reallocation. According to the NBS, in 2024, the total central-to-local transfer payments amounted to 872.23 billion yuan, while local general public budget expenditures reached 2,438.92 billion yuan in the same period. This indicates that 35.8% of local fiscal operations rely on central transfer payments. Such substantial funding is widely regarded as vital for narrowing fiscal capacity gaps between regions and advancing equal access to basic public services.

However, the current transfer payment system faces significant challenges. First, fiscal over-dependency is prominent. In western regions, the mismatch between expenditure responsibilities and revenue capacities, coupled with weak local fiscal capabilities, has resulted in excessive reliance on transfer payments—accounting for a disproportionately high share of total local fiscal revenue. This model not only undermines incentives for local governments to cultivate endogenous revenue sources, but also drives unsustainable expansion of fiscal expenditures. Second, soft budget constraints induced by transfer payments exacerbate local debt risks. Under the existing framework, local governments often assume implicit guarantees from the central government, fostering expectations of bailouts and encouraging reckless borrowing. Consequently, debt risks may force central authorities to intervene, further straining central fiscal deficits and amplifying systemic vulnerabilities.

The root cause of this dilemma lies in the vertical imbalance between expenditure responsibilities and fiscal capacities across government tiers. Addressing this requires institutional reform of local tax systems and transforming transfer payments into a more fiscal self-reliance mechanism that realizes sustainability.

5. Conclusion

Despite China’s sustained high-rate of economic growth, the nation confronts persistent dual challenges of income disparity and inter-regional developmental imbalances. This paper focuses on the implications of China’s tax regime on economic inequality. By analysing China’s current tax system, it is found that the current tax structure dominated by indirect taxes has aggravated income inequality through its regressive nature. Concurrently, the underdevelopment of direct taxation mechanisms, notably in property tax implementation, has substantially constrained the redistributive capacity of fiscal policy to mitigate wealth concentration. Moreover, after the reform of the tax-sharing system, local governments are facing serious mismatch between the administrative obligation and fiscal capacity. This institutional incongruence leads them to adopt land-financing strategies and leverage localized debt instruments. In addressing these inequalities, the state has introduced relevant measures. This paper mainly evaluates three policies. The first is rural revitalisation. Deepening urban-rural integration is the fundamental path to dismantle the urban-rural dichotomy, necessitating market-driven mechanisms for factor mobility to ensure sustainable socioeconomic convergence. The second is property tax pilots. As an indispensable component of progressive tax restructuring, property tax experimentation confronts numerous implementation barriers. The third is financial transfer payments system. In order to alleviate the mismatch between the administrative responsibility and limited financial capacity, the fiscal transfer mechanism has largely eased the fiscal burden of local governments. However, at the same time, it has brought about problems such as over-dependence and debt accumulation, particularly in fiscally vulnerable regions.

This study presents a qualitative exploration of the relationship between China's tax regime and economic inequality through a novel theoretical lens. While offering conceptual insights, the analysis remains confined to a descriptive analytical framework, lacking robust quantitative empirical validation. Future research could prioritize the systematic collection of the provincial-level datasets, particularly those linking real estate market dynamics to individual income patterns, to further evaluate the feasibility of property tax in China and the direction of future reforms.

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