

Tax Reforms for Sustainable Economic Growth of the National Economy: Case of China

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Abstract

The paper provides characteristics of the tax reforms carried out in the People's Republic of China from the second half of the twentieth century. The practice of tax reforms in terms of building socialism with Chinese specifics is linked to the Rostow's Stages of growth model. The example of China illustrates how successful the tax targeting can be in the implementation of a consistent program of sustainable development of national economy. The objectives of the tax reforms in People's Republic of China differed according to the stage of economic growth: the simplification of the tax system in the traditional society, reducing the tax burden as a precondition for the take-off, increase of the tax burden on business at the stage of the take-off, the focus on social justice at the 'drive to maturity' stage.

Keywords: taxation, tax reform, stages of economic growth, China's tax system.

Introduction

Transformational shifts of economic systems are always accompanied by dramatic changes in national taxation. The implementation of the China's market-oriented economic reform that started in 1978 and pursuing an open foreign economic policy also led to profound changes in the tax system. The development of the non-state sector in the economy and improvement of state enterprises' economic independence dramatically narrowed the possibility of administrative redistribution for economic resources. In these circumstances, the taxes acquired a fundamentally new role: they have not only become an important channel for mobilization of financial resources by the state, but also one of the main economic regulators for the entire economic life of the country, deliberately built into the global economy not as a supplier of raw materials, but as one of its drivers. The PRC accomplishes a transformational shift from an extremely backward society to a post-industrial society, that wins in the fierce competition on the global markets, building up an unprecedented financial and economic potential, openly claiming the world leadership (China, 2013).

Despite the fact that China's economic growth has become an object of close attention from scientists around the world (Yueh, 2013; Singh, 2015; Zhao, 2015), the contribution of the tax system to the overall economic progress of the country is poorly reflected in the literature. At the same time the correlation between economic and a tax system is obvious: tax burden is a key component of country's investment climate, which constitutes the basis for economic growth.

The process of China's economic growth was not uniform. Economic development of modern China, in our view, may be considered in the framework of the Stages of economic growth model proposed by Walt Rostow (Rostow, 1960). Existing studies that link tax regimes with the stages of economic growth on historical examples (Einhorn, 2009) represent a worthy model for such an analysis of the tax reforms in modern China.

Methodology

The purpose of the paper is to study the experience of reforming the tax system of the PRC aimed at ensuring sustainable growth of the national economy in the context of the different stages of economic growth. A particular interest in this problem is caused by the fact that in the period of transition to a market economy the inherent features of the Chinese tax reforms were the gradualism and cautiousness as well as measured approach to the planned changeovers in the economic system. As a result, the successful tax reforms, along with other factors, laid a financial foundation for the future transformation of the national economic system in accordance with the requirements of adaptation to the global market.

The first phase of the study covers the analysis of the parameters and characteristics of the economic growth of the People's Republic of China from 1953 until present. As a result, the stages of economic development were distinguished and correlated with the stages of economic growth proposed by Walt Rostow.

The second phase of the study examines the impact of Chinese socio-economic reforms of 1953, 1978, 1994 and 2006 on national taxation. The gradual transformation of the national tax system is in the spotlight. On each of the distinguished stages of economic growth, we analyzed the direction of the tax reforms and tax systems structure. In particular the following topics were considered: 1) the list of taxes, 2) the details of the taxes that are key for fiscal revenues - their subjects, payers, rate structure, tax incentives, 3) periods and reasons for the levy and lifting of taxes; 4) the significance of particular taxes in the state's tax revenue system in dynamics; 5) tax revenues comparing to GDP in dynamics.

Growth stages

The Rostow's stages of economic growth are applied by researchers to the western as well as to the eastern economies (Arora, 2009; Ortolano, 2015). While the model itself is the subject of discussion (Kuznets, 1963), including the context of its applicability to the regions (Parr, 2001). Nevertheless, China's social and economic reforms carried out in the second half of the XX century (in 1953, 1978, 1994 and 2006) represent a vivid illustration of the Rostow's stages of economic growth.

W. Rostow described *first stage* – the traditional society – as one whose structure is developed within limited production function. These societies, because of the limitation on productivity, had to devote a very high proportion of their resources to agriculture. Both in the longer past and in recent times the story of traditional societies was thus a story of endless change. However, the level of productivity was limited by the inaccessibility of modern science, its applications, and its frame of mind (Rostow, 1960).

This stage was present in People's Republic of China from 1953 to 1977. The defining attributes of building a planned economy in a society defined as "traditional" are: 75% of working population is employed in food production; national income is used mainly unproductively; political power is vested in central government.

The *second stage* of growth embraces societies in the process of transition; that is, the period when the preconditions for take-off are developed. Investment increases, notably in transport, communications, and in raw materials in which other nations may have an economic interest. The scope of commerce, internal and external, widens. In addition, here and there, modern manufacturing enterprise appears, using the new methods. Nevertheless, all this activity proceeds at a limited pace within an economy and a society still mainly characterized by traditional low-productivity methods, by the old social structure and values, and by the regionally based political institutions that developed in conjunction with them (Rostow, 1960).

The preconditions for the take-off were built in the People's Republic of China from 1978 to 1993 during the transition from a planned economy to a market economy (economic policy of "Reform & Opening up").

The *third stage* - the take-off - is the interval when the old blocks and resistances to steady growth are finally overcome. The forces making for economic progress, which yielded limited bursts and enclaves of modern activity, expand and come to dominate the society. Growth becomes its normal condition (Rostow, 1960).

The growth of investment rate, the significant increase in the output per capita, the rapid introduction of new technology in industry and agriculture from 1994 to 2005, testified to the take-off in modern China.

After take-off there follows a long interval of sustained if fluctuating progress, as the now regularly growing economy drives to extend modern technology over the whole front of its economic activity. The economy finds its place in the international economy: goods formerly imported are produced at home; new import requirements develop, and new export commodities to match them. (Rostow, 1960). The fourth stage - the drive to maturity – began in PRC from 2006.

Tax reforms on different stages of economic growth

1. Tax reforms in the traditional society (1953 to 1977). The modern tax system in the PRC began to take shape in the course of the first Five-Year Plan (1953-1958) aimed at the country's industrialization and gradual socialist reforming. A modification of the tax system was carried out in the process of its realization: were imposed industrial and commercial taxes, excise taxes on alcohol, wine, beer, matches, tobacco products and other goods; was corrected transport tax; were abolished special consumption tax, commodity circulation tax (table 1). In general, there was a significant reduction in the number of taxes and duties.

Table 1: Tax system of PRC in 1953

Taxes	Share in total tax revenues
Industrial and commercial tax	41%
Agriculture tax	23%
Transport tax	2%
Excise taxes	4%
Salt tax	3,9%
Business tax	6%
Tax on livestock	3%
Custom duties	4,2%
Stamp tax	1%
Vessel tonnage tax	11,9%
Slaughter tax	
Duty on the sale of real estate	
Special consumption tax	
Commodity circulation tax	
Interest income tax	
Urban real estate tax	
Other taxes	

Source: based on (Nai-Ruenn, 2009)

At this stage the thesis about tax system simplification was fulfilled. For this purposes the taxes on state and collective enterprises were consolidated, a unified industrial and commercial turnover tax started to be charged, tax rates and taxable items changed. The most indicative changes occurred with the industrial and commercial tax: from 1958 to 1977 it combined six types of taxes. Before 1978 one hundred four categories of taxable goods existed within the framework of industrial and commercial tax.

After gradual industrialization the share of tax revenue from agriculture in total fiscal revenue began to decline step-by-step; the industrial and commercial tax become a primary source of funding the needs of the Chinese government (table 2).

Table 2: Tax system of PRC during the “cultural revolution” (1966-1977)

Taxes	Share in total tax revenues
Industrial and commercial tax	91,16%
Interest income tax	8,84%
Duty on the sale of real estate	
Agriculture tax	
Tax on livestock	
Urban real estate tax	
Custom duties	
Other taxes	

Source: based on (Sokolov, 2014)

In general, the tax system of those years was adequate to the existing economic system, which was dominated by the principle of egalitarian justice alongside with an extremely low level of consumption: the state's resources were equally divided between the citizens, the taxes were not numerous, and they were calculated by a simple scheme. At the same time, the established traditional economic system made it impossible for the country to develop. The main obstacle was the fact that China remained economically closed with its state-controlled economy without large-scale sources of investment, in the total absence of links with the international trade community. In the economic sphere the spirit of healthy competition was lost, the state provided support to all enterprises, regardless of their economic efficiency. As a result, many enterprises lost the incentives for further development; the growth of economic indicators was unstable.

2. Tax reforms as precondition for take-off (1978–1993). In 1978 was implemented a tax reform, after which a rejection of the simplification principle took place and some taxes and fees were restored.

To avoid a dangerous decrease in fiscal revenues and unreasonable increase of social payments by the state, the former method of payments from state enterprises' profit was replaced by a enterprise income tax, that became an important element of fiscal reform. Initially the enterprise income tax was levied in parallel with the payments from profits. Then the payments from profits were replaced by taxation, based on actual profits. Advantages of the new tax system are as follows:

- The companies stopped spending time on fighting for the fixed sum of the assignments to the budget and allocation rates, and started to make efforts to upgrade technical equipment, search for internal reserves, increasing the economic efficiency of their manufactures;
- After replacing the payments from profits by a income tax the enterprises began to pay an equal sums to central and local budgets.

During 1979-1993 the tax system was changed together with the development of the national economy. A modern legislative framework began to form, the structure of taxes was transformed, the tax administration improved.

However, the tax system had a significant disadvantage, which manifested itself in its duality. In practice, two tax systems worked simultaneously. The first system was applied to state, collective and private enterprises, while the second system, which included a privileged tax treatment, was functioning in the enterprises with foreign capital participation (table 3). In addition, the enterprises with foreign capital were subject to industrial and commercial tax according to the law of 1958, while the domestic state, collective and private enterprises paid production charges, tax on economic

activity. As a result, the domestic enterprises and enterprises involving foreign capital were in different economic conditions.

Table 3: Tax system of PRC during creation the precondition for take-off

Groups of taxes	Taxes in 1990	Tax rate	Beginning of imposition
1. Turnover taxes	Industrial and commercial tax	3%-60%	11.09.1950
	Production charges	3%-60%	01.10.1984
	Value added tax	0%; 3%; 13%; 17%	01.10.1984
	Business tax	3%; 5-20%	01.10.1984
2. Income taxes	State enterprises income tax	10%-55%	10.03.1985
	Collective enterprises income tax	10%-55%	01.10.1984
	Private enterprises income tax	35%	11.04.1985
	Household income tax	7%-60%	25.06.1988
	Income tax on enterprises with foreign investment and on foreign enterprises	15%-24% 33%	07.01.1986
	Individual income tax	5%-45%	10.09.1980
	Individual income regulatory tax	5%-25%	25.09.1986
	State enterprises regulatory income tax	5%-25%	01.10.1984
	State enterprise bonus tax	30%	28.06.1984
	Collective enterprises bonus tax	30%	24.08.1985
	State enterprise wages regulatory tax	30%	03.07.1985
3. Resource taxes	Resource tax	1%; (1+0.5)%; (1+0,6)%; (1+0,7)%	18.09.1984
	Salt tax	40-160 yuan per 1 ton	18.09.1984
	City and township land use tax	0,6-30 yuan per 1 sq. meter	27.09.1988
4. Property taxes	Housing property tax	1,2%; 12%	15.09.1986
	City maintenance and construction tax	1,2%; 18%	08.08.1951
5. Taxes for special purposes	City Maintenance and Construction Tax	1% ; 5% ; 7%	08.02.1985
	Farmland occupation tax	12,5-45 yuan per 1 sq. meter	01.04.1987
	Fixed assets investment orientation regulation tax	0%;5%;15%;30%	16.04.1991
	Vehicle and vessel usage plate tax	0,3-8 yuan; 0,2-1,1 yuan per 1 ton	13.09.1951
	Vehicle and vessel usage tax	0,3-8 yuan;15-80 yuan; 0,2-1,1 yuan per 1 ton	25.09.1986
	Stamp tax	0,005%;0,03%- 0,1%	06.08.1988
	Deed Tax	3%-5%	03.04.1950
	Slaughter Tax	10%; 8-12 yuan	19.12.1950
	Regulatory tax on oil and fuel oil	20-70 yuan per 1 ton	22.04.1982
Special consumption tax	5-40000 yuan 100-550 yuan	14.04.1989	

	Tax on the sale of animals	5%	31.12.1982
	Banquet Tax	15-20%	22.09.1988
6. Agricultural taxes	Agricultural tax (tax on crop production)	5-25%	03.06.1953
	Tax on livestock	0,2-1 yuan	11.09.1950
7. Custom duties	total rate - from 0% to 8% up to 270%; the average rate of the customs tariff - 47%.		07.03.1985

Source: based on (Li, 1991)

By the end of 1993, China had almost no income taxation of individuals due to low income level of the vast majority of the population. Income taxation of individuals existed only in theory, being declared in tax legislation; the actual non-taxable minimum of the biggest part of population was higher than the average wage. The main payers of the income tax were the owners of private enterprises and foreigners.

Turnover taxes focused on fixed retail and wholesale prices and charged by the administrative order could not be effective in market economy. Therefore, on a trial basis in a number of provinces were introduced consumption tax, VAT, business tax instead of industrial and commercial tax. The VAT included in the price of goods was the most reliable in providing the fiscal revenue.

As a result, they established a tax system that was based on turnover taxes, enterprise income tax and personal income tax, while all other taxes were minor. The formed tax system laid the foundation for a tax reform of 1994 in the framework of the "take-off", focused on building a socially oriented market economy; and to start expanding the tax base.

Tax reforms at the 'take-off' stage (1994–2005). At the stage of the economic "take-off" a new tax structure (table 4) and a new system of national tax administration were created.

Table 4: Tax system of PRC at the "take-off" stage

Groups of taxes	Taxes in 2005	Tax rate	Beginning of imposition
1. Turnover taxes	Value added tax	0%; 3%; 13%; 17%	01.01.1994
	Consumption tax	3%-56%	01.01.1994
	Business tax	3%; 5-20%	01.01.1994
2. Income taxes	Enterprise income tax	15%-24%;33%	01.01.1994
	Income tax on enterprises with foreign investment and on foreign enterprises	15%-24%; (30+3)%	01.07.1991
	Individual income tax	5%-45%;5%-35%;20%	10.09.1994
3. Resource taxes	Resource tax	8-30 yuan per 1 ton; 2-15 yuan per 1,000 cubic meters.	01.01.1994
	Urban and township land use tax	0,2-10 yuan per 1 sq. meter	27.09.1988
4. Property taxes	Housing property tax	1,2%; 12%	01.10.1986
	Urban real estate tax	1,2%; 18%	08.08.1951
5. Taxes for special purposes	City maintenance and construction Tax	1% ; 5% ; 7%	08.02.1985
	Farmland occupation tax	12,5-45 yuan per 1 sq. meter	01.04.1987
	Fixed asset investment orientation regulation tax	30%-60%	01.01.1994
	Additional education tax	1-3%	01.01.1994

6. Behavior taxes	Vehicle and vessel usage tax	1,2-30 yuan; 360 yuan; 0,6-5 yuan per 1 ton	01.01.1994
	Vehicle and vessel acquisition tax	1,2-30 yuan;360 yuan; 0,6-5 yuan per 1 ton	01.01.1994
	Stamp tax	0,005%;0,03%-0,1%	06.08.1988
	Deed tax	3%-5%	03.04.1950
	Slaughter tax	10%; 12-30 yuan	01.01.1994
	Banquet tax	15-20%	01.01.1994
7. Agricultural taxes	Agriculture tax	8%	30.01.1994
	Tax on livestock	0,2-1 yuan	11.09.1950
8. Customs duties	Reduced tariffs on imports: agricultural products from 22% to 17%, vehicles – from 80-100% in 2001 to 25% by mid-2006. Eliminated tariffs on information technology products - by 2005.		

Source: based on (China, 2005)

Due to the expansion of the tax base, since 1995, a trend of relative increase in tax revenue to the budget appeared (figure 1).

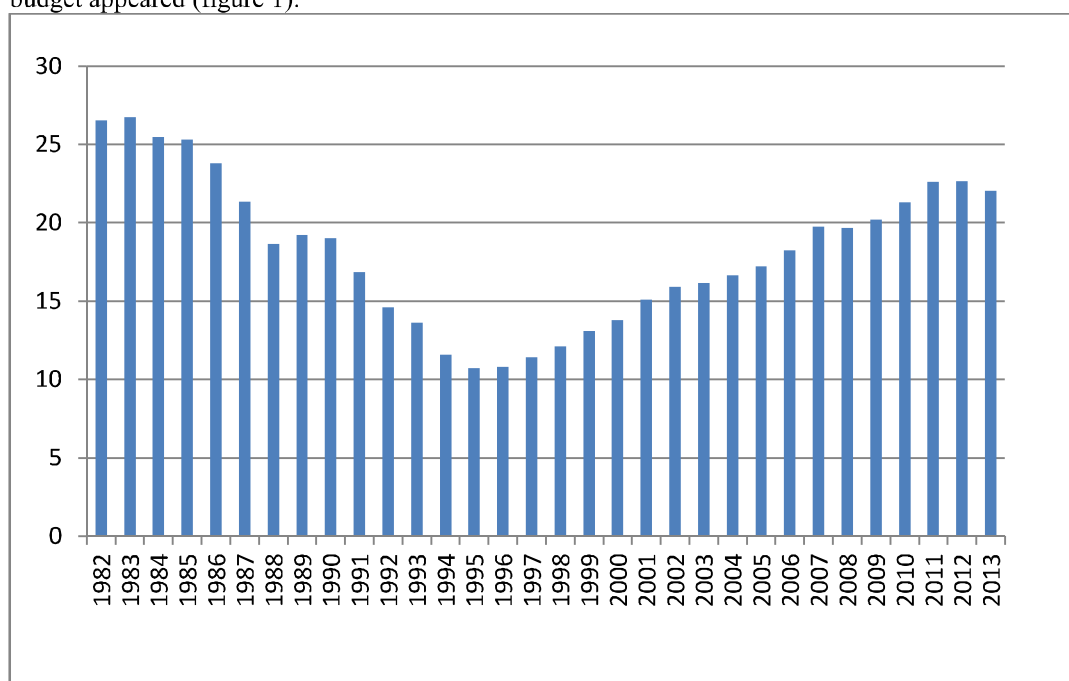


Figure 1: State revenues in PRC, % of GDP

Source: based on (China statistical yearbook, 2014)

Although the tax reform of 1994 led to significant results, due to which the Chinese tax system provided the growth of fiscal revenues, it contained certain disadvantages. Vestiges of the old system (collection of the enterprise income tax in accordance with the administrative subordination) hampered the free movement of capital between different areas, so it was necessary to take measures for eliminating these barriers. It was also important to improve the system of tax differentiation to standardize the rates and put right the administration of new taxes, such as individual income tax.

In light with China's course for accession to the WTO since 1994, the government began to implement a reform of the new tax system based on international standards and principles of globalization. After having joined the WTO on December 11, 2001, China first of all had to cancel the vast majority of non-tariff barriers. The most important task of the tax reform after an adaptation

period (5 years) was not only a change in the tax system in accordance with international standards, but also a maximum protection and support of weak industries.

In 1978-2005 one of the objectives was to create a system for attracting foreign direct investment, so the particularity of the tax regulation was to develop a system of tax incentives for companies with foreign capital and their legal registration. Tax credits, tax exemptions on a territorial basis (for example, registration of the enterprise in special economic zones) were set for companies with foreign capital. The national capital, as a rule, could not benefit from these privileges.

With the course of time, the success of the tax reform of 1994 identified the need to improve the model of tax differentiation and tax rates standardization primarily in the sphere of individual income tax.

Tax transformation at the drive to maturity stage. Since 2006, the purpose of the tax reform is to ensure the social justice. Reforming of the tax system in China at this stage is aimed at creation of equal tax conditions for companies both with national and foreign capital. In addition, the Chinese government introduced amendments to the Individual Income Tax Law and raised the level of incomes that are exempt from personal income tax that created a favorable tax climate for the overall internal and external activities of the domestic small and medium enterprises.

To increase the competitiveness of the national economy and improve the economic situation the tax system was mainly focused on the enterprise income tax, the VAT and the individual income tax (table 5). In general, the “drive to maturity” was politically formalized as a movement in the direction of market economy with Chinese specifics.

Table 5: The transformation of the tax system for building a market economy with Chinese characteristics

Groups of taxes	Taxes from 2012	Tax rate
1. Turnover taxes	Value added tax	0%; 3%; 4% 6% 11% 13%; 17%
	Consumption tax	3%-56%
	Business tax	3%; 5-20%
2. Income taxes	Enterprise income tax	15%-20%; 25%
	Individual income tax	5%-45%;5%-35%;20%
3. Resource taxes	Resource tax	0,3-60 yuan; 5%-10%
	Urban and township land use tax	0,6-30 yuan per 1 sq. meter
4. Property taxes	Housing property tax	1,2%; 4%,12%
	Vehicle and vessel usage tax	60-5400 yuan 4-6 yuan per 1 ton
5. Taxes for special purposes	City maintenance and construction tax	1% ; 5% ; 7%
	Farmland occupation tax	5-50 yuan per 1 sq. meter
	Fixed asset investment orientation regulation tax	30%-60%
	Additional education tax	3%
6. Behavior taxes	Stamp tax	0,005%;0,03%-0,1%
	Deed tax	0%; 1%; 3%-5%
7. Custom duties	The number of custom products in 2012 increased to 7977. The average customs tariff rate in China was 9,8%. The average tariff rate on agricultural products - 15.2%. The average rate of tariffs on industrial goods - 8,9%.	

Source: based on (Gao, 2015)

The global financial and economic crisis created an opportunity for domestic economic growth, advanced the China's economy in the direction of the fifth stage - the age of high mass consumption. In general, a shift was made from the proposal on the international market to the domestic demand,

from export production to national consumption. This set up a problem and broke the ice in shifting the focus of taxation from production to consumption and starting the development and introduction of environmental taxes.

The ongoing tax reforms in China were reflected in the structural changes in tax revenues (table 6).

Table 6: Tax revenues in PRC, % of GDP

	Total	Value added tax	Consumption tax	Business tax	Enterprise income tax	Individual income tax
1985	23%	2%	-	2%	8%	n/a
1986	20%	2%	-	3%	7%	n/a
1987	18%	2%	-	3%	6%	n/a
1988	16%	3%	-	3%	4%	n/a
1989	16%	3%	-	3%	4%	n/a
1990	15%	2%	-	3%	4%	n/a
1991	14%	2%	-	3%	3%	n/a
1992	12%	3%	-	2%	3%	n/a
1993	12%	3%	-	3%	2%	n/a
1994	11%	5%	1%	1%	1%	n/a
1995	10%	4%	1%	1%	1%	n/a
1996	10%	4%	1%	1%	1%	n/a
1997	10%	4%	1%	2%	1%	n/a
1998	11%	4%	1%	2%	1%	n/a
1999	12%	4%	1%	2%	1%	0%
2000	13%	5%	1%	2%	1%	1%
2001	14%	5%	1%	2%	2%	1%
2002	15%	5%	1%	2%	3%	1%
2003	15%	5%	1%	2%	2%	1%
2004	15%	6%	1%	2%	2%	1%
2005	16%	6%	1%	2%	3%	1%
2006	16%	6%	1%	2%	3%	1%
2007	17%	6%	1%	2%	3%	1%
2008	17%	6%	1%	2%	4%	1%
2009	17%	5%	1%	3%	3%	1%
2010	18%	5%	2%	3%	3%	1%
2011	19%	5%	1%	3%	4%	1%
2012	19%	5%	2%	3%	4%	1%
2013	19%	5%	1%	3%	4%	1%

Source: based on (China statistical yearbook, 2014)

The tax reforms performed on the stages led to reduction in tax revenues in absolute terms, as well as in the structure of budget revenues and with respect to the gross domestic product (the smallest figure of tax revenue relative to GDP for the period was observed in 1996). What is more, this progressive reduction in tax revenue was carried out at the expense of direct business taxes, while the revenues from indirect taxes increased. Beginning from 1997 the growth in tax revenues was accompanied by a decrease in revenues from indirect taxes (especially the VAT) and the growth of direct taxes, especially the taxes on financial results of the business. The importance of the individual income tax is much less than that of the enterprise income tax.

The evolution of China's tax system is correlated with the global trend of reducing the share of indirect taxes and increasing the share of direct taxes. At the same time, the role of indirect taxes in generating revenues for the state is still high.

Also in the course of the reforms a trend of increasing the number of tax incentives and deductions in taxation of both individuals and enterprises appeared. Tax incentives are a tool against economic instability and one of the factors attracting foreign investment.

From a long-term perspective, the aim of tax structure improvement of the PRC should be in bringing the tax system in line with the tax structures of the advanced countries (Brys, 2013; Yang, 2011) through optimization, creating a high-performance, reasonable tax system, in which the central role would be given to the VAT, but the enterprise income tax and individual income tax would be of equal importance.

Conclusions and Discussion

The most important features of the tax reforms held in the period of building the market economy in China is their uniformity, consistency and gradualism.

It is a common practice in China when the viability of any new idea is firstly tested on the example of a single province. If experiment is successful, the relevant amendments to the legislation are made, and the changes will be applied to the entire state. This ensures a uniformity of the impact of changes in the tax system on the economy as a whole. It should be mentioned that the importance of the economic experiment is manifested in the fact that the measures of tax incentives are implemented on the zones of economic and technological development.

The China's tax reforms of the second half of the twentieth century are a good example of how the tax system can put no obstacles to the development of the economy and even to promote the rapid and successful passage of the stages of economic growth. Depending on the stage of economic growth, the goal setting changes in tax targeting as follows:

- The simplifying of tax system is a reference point in the *traditional society*,
- A part of the taxes is re-established on the background of the overall decrease in tax burden as a *precondition for the take-off*,
- A new structure of tax system is formed, which leads to the increase in tax revenues at the stage of *take-off*.
- The '*drive to maturity*' stage is focused on social justice.

In the process of reforming the tax system of the PRC we could always see the effect of such factors as the huge working-age population with limited domestic energy resources and other raw materials, the dominant role of public enterprises in the national economic structure, and others. Despite the evident peculiarity of China, the taxation factor in the rapid economic growth can serve as a subject for scrutiny and be implemented on transition economies of Russia, Belarus and Ukraine in particular along with monetary policy (Mishchenko, 2015).

Despite the record economic growth over the last 35 years, the emerging market economy of China has accentuated very acute social problems, such as the significant dependence of economic development on exports, increasing income inequality, the excessive growth of house prices, etc. In the process of reforming the tax system there are still unsolved problems that significantly worsened during the global financial crisis. For example, a tax reform aimed at the division of taxes paid to local and central budgets is still not completed; the structure of local taxation is inefficient; unfair distribution of the tax burden between economic entities still exists. These problems remain a significant deterrent to structural transformation of the national economy and an obstacle in the creation of the preconditions for sustainable economic growth in all regions.

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