Report No. 7605-CHA

# China:

# Revenue Mobilization and Tax Policy Issues and Options

(In Two Volumes) Volume I: Main Report

**June 15, 1989**

Country Operations Division
China Department
Asia Region

**FOR OFFICIAL USE ONLY**

**Document of the World Bank**

## CURRENCY EQUIVALENTS

The Chinese currency is called Renminbi (RMB).
It is denominated in Yuan (Y). Each Yuan is
1 Yuan = 10 jiao = 100 fen

| Calendar 1988 | June 1989 |
|---|---|
| US$1.00 = Y 3.72 | US$1.00 = Y 3.72 |
| Y 1.00 = US$0.27 | Y 1.00 = US$0.27 |

## FISCAL YEAR

January 1 - December 31

## WEIGHTS AND MEASURES

Metric System

## LIST OF ACRONYMS

| | | |
|---|---|---|
| MOF | - | Ministry of Finance |
| GTB | - | General Taxation Bureau |
| SRC | - | System Reform Commission |
| PBC | - | People's Bank of China |
| SAT | - | State Administration of Taxation |
| SOE | - | State-owned Enterprise |
| CMRS | - | Contract Management Responsibility System |
| AMRS | - | Asset Management Responsibility System |
| EMRS | - | Enterprise Management Responsibility System |
| GFS | - | Government Finance Statistics |
| VAT | - | Value Added Tax |
| PIT | - | Personal Income Tax |
| PIAT | - | Personal Income Adjustment Tax |
| CICT | - | Consolidated Industrial and Commercial Tax |
| ICIT | - | Industrial and Commercial Income Tax |

# CHINA

## REVENUE MOBILIZATION AND TAX POLICY

This report and its annexes are based on the findings of a mission which visited China in May-June 1988. In addition to interviews and discussions in Beijing, the mission visited Nanjing and Changzhou (Jiangsu Province), and Hefei (Anhui Province).

The mission consisted of Christine Wallich (Mission Leader); Pradeep Mitra coordinated the work on Tax Policy with inputs from Anthony Pellechio (Direct Taxes) and Christopher Heady (Consultant, Indirect Taxes); Roy Bahl (Consultant) was responsible for Provincial and Local Government Finance; Mario Blejer (IMF) for Macroeconomic Policies; Peter Driscoll (IMF) for Tax Administration and Heidi Hennrich-Hanson for Expenditure Policy. The Mission was also accompanied in Beijing, and benefited from inputs from Gyorgy Szapary (IMF).

The mission was conducted in collaboration with and accompanied in the field by a Chinese counterpart team from the Ministry of Finance's General Taxation Bureau and other agencies, sponsored by Mme Li Huizhong, Director, Budget Bureau, General Taxation Bureau, and led by Mr. Xu Shanda, Deputy Chief, Tax Research Division, General Taxation Bureau, Ministry of Finance. Members of the counterpart team included Gao Jian (MOF), Mme Gao Ying (MOF), Zhang Jungang (MOF); Xou Peiseng (SRC); Shi Yaobin (MOF); Shi Yajun (MOF); Mme Li Xiaojun (SAT).

# CHINA

## RESOURCE MOBILIZATION AND TAX POLICY

## ISSUES AND OPTIONS

### MAIN REPORT

### Table of Contents

TABLES IN TEXT



BOXES



FIGURES

## APPENDIX TABLES



## ANNEXES

# CHINA

## REVENUE MOBILIZATION AND TAX POLICY

### Summary and Conclusions

i. In 1979 the Chinese government set in motion a process of reform aimed at decentralizing production and investment decisions and letting the market influence these decisions as a strategy to improve allocative efficiency and promote modernization and growth of the economy. Reforms concentrated first on the rural sector, leading to its remarkable growth in the post-reform period.

ii. Beginning in 1984, reforms were initiated in the urban sector, with major changes in enterprise management and finance. A central element of the urban reforms was a reduction in the role of the government in the economy, both in determining the allocation of resources and their financing. Major emphasis was placed on a devolution of power to lower level entities, giving greater responsibilities to enterprises and provincial and local governments. These changing responsibilities have had a major impact on the role and size of the government budget, with the state's dominant role significantly reduced, as well as changed in nature and scope.

iii. In June 1988, a World Bank mission visited China to analyze, in collaboration with a Chinese counterpart team from several government agencies, China's tax system and recommend improvements. This summary provides a brief overview of the mission's findings and recommendations, discussed in detail in the following main report. A companion volume of three Annexes provides further analysis of tax policy questions, subnational finances and tax administration, as well as a detailed description of China's tax system itself.

### China's Tax System in International Perspective

iv. China's tax system differs significantly from other countries in its income group, both in terms of level and structure. Because of the major government role in the economy, China's tax to GDP ratio of 27% in 1985 was almost twice that of other countries at its income level. Even now, with a tax ratio just under 20%, the ratio remains higher than its comparator income group. China's tax structure is also unusual for a country with its per capita income, with direct taxes about 33% of the total in 1988 and indirect taxes 46%. In lower income countries, there is typically great reliance on taxes on international trade, while direct taxes are often lacking. In this respect, China resembles, not surprisingly, the socialist countries of Eastern Europe, where direct and indirect taxation of enterprises plays the major role. Moreover, China, like other socialist countries, levies almost no taxes on individual incomes.

Tax Reform and System Reform

v. Tax reform is an essential element of the microeconomic efficiency enhancing reforms based on decentralized decision making. Price reform is also crucial to this process. If these efficiency-enhancing goals are to succeed in China and for resource allocation to improve, prices must adjust to reflect economic scarcities. At the same time, price reform cannot be separated from tax reform, because changes in prices without changes in taxes would distort profitability. If price signals are to guide enterprise behavior, enterprises must also face a competitive environment. Specifically, enterprises must face an environment in which they can compete on an equal footing, a process to which China's current negotiated and personalized tax system does not contribute. The close relationship between taxes, prices and enterprise behavior implies that such system reform calls for coordinating progress in each of these areas.

vi. Tax reform is therefore inevitably linked with both enterprise and price reform. With respect to the link between tax and enterprise reform, the main idea behind enterprise reform is to make enterprises responsible for their profits and losses and thus increase the incentives for efficiency. The allocation of resources will not be efficient, however, even if incentives and relative prices are rightly aligned, unless a "hard" budget constraint is imposed on enterprises. This is because the lack of a hard budget constraint limits the incentive effects of tax policy. At the same time, the current approach to tax policy--and the presence of discretionary and enterprise-specific taxes that are subject to bargaining--itself softens the budget constraint in a manner that distorts economic decisions. A general hardening of the budget constraint on enterprises via a harder tax constraint and less negotiation and personalized contracting would support the aims of enterprise reform, while enterprise reform would strengthen the incentive effects of tax policy.

vii. Likewise, price and tax reform are also intimately linked. In the absence of price reform, there is an ongoing need to use the tax system to offset the producer preferences created by the current price regime's signals. Tax reform is thus partially constrained by the pace of price reform. By the same token price reform must be accompanied by tax reform, to prevent the tax rates designed for a "fix-price system" from creating new distortions.

viii. The VAT rate structure, for example, cannot be unified, in the absence of price reform, because of the continuing need to use indirect taxes to equalize sectoral profitability differentials arising from price distortions. It follows that initiating price reform would imply greater scope for using VAT and that tax and price reforms must be coordinated with each other. As price liberalization proceeds, it would be possible to simplify the rate structure of VAT and move towards a unified VAT structure similar to that of other countries. Such a VAT would have the advantage of minimizing distortions of the market prices, while fulfilling the major tasks of revenue-raising, protecting the living standards of the poor and discouraging socially undesirable consumption.

ix. In sum, the close relationship between taxes, prices and enterprise behavior implies that meaningful system reform will require simultaneous progress on all these fronts. At the micro level this means that many tax reforms cannot be implemented effectively prior to some progress in e.g., enterprise and price reform, while enterprise and price reform may be constrained in the absence of tax reforms.

## Coordinated Tax Policy, Administration, and Subnational Finance Reform

x. In China, the close links between tax policy, tax administration, and the revenue sharing and collection system between central and local governments also adds a "systemic" dimension to tax policy change. Although the following sections treat Tax Design and Structure, Subnational Finance and Tax Administration separately and in turn, the fact of local government responsibility for revenue collection and upward sharing, creates strong links between all three areas. It can be argued that, unless tax reform addresses all three areas, it is unlikely to accomplish its objective.

xi. A complex tax structure, as in any country, interferes with administrative ease. The decentralized administration in China, whereby local governments collect the central government's taxes, implies that unless the center can be assured that local governments administer tax policy as designed by the center, tax policy objectives may be compromised. Management information is crucial to ensuring this. Finally, the revenue sharing system itself creates incentives for tax system implementation at the local level, which may interfere with the achievement of the center's tax policy objectives. The package of tax policy reform, tax administration reform, and revenue sharing reform needs jointly to be considered, although for didactic purposes, each is treated separately in the Report.

## Reforming China's Tax System

### Improving the Efficiency of the Tax System: Tax Design and Structure

xii. In China as elsewhere, taxes are designed to raise revenue and promote efficiency in production. But the extent to which taxation can succeed in its latter objective is caught in the intricate web of relationships between the State and state-owned enterprises. The tax system which has emerged in China reflects the _ad hoc_ and experimental approach which has characterized tax and other reforms to date, and the fact that in this period, tax reforms have been directed toward many objectives. There remains as a result, a significant commingling in the design (and objectives) of the tax system of the government's role as owner of state-owned enterprises and its role as tax collector. For that reason, tax reform and enterprise reform are seen as being closely related. In addition, there are two specifically Chinese institutional characteristics that constrain tax reform: price controls and the absence of valuation or pricing mechanisms for fixed assets in state-owned enterprises.

xiii. Prior to reforms, most surpluses were generated by enterprises and transferred to the state via profit remittances. The move, in 1983, away from profit remittances to an enterprise income tax at 55% led to the bulk of tax revenue being collected from the three principal indirect taxes (product tax, VAT and business tax) and, to a significantly lower extent, from the enterprise income tax. Both direct and indirect taxes continue to tap the 'surpluses' in the enterprise sector which have accrued following the move from profit remittance. The reform of the enterprise income tax is seen as a way to improve incentives and raise productivity, a view that could explain the increasing popularity of the contracting system. Indirect taxes, on the other hand, fulfill a variety of roles. The existence of price controls affects sectoral profitability; product tax and VAT rates are therefore fine-tuned in an attempt to ensure equalization of such profitability across sectors (although concern for industrial policy may permit some differences in profitability). This fact accounts for the multiple rate structure.

xiv. However, such equalization is necessarily confined to the sectoral level. Equal treatment of enterprises within a sector is accomplished by levying, for enterprises with access to natural resources, a resource tax to compensate for differential natural resource endowments; and for industrial enterprises, the income adjustment tax. Inasmuch as these differentials are due to differences in (virtually) free capital endowments from the state, justification is thought to be provided for tailoring the income adjustment tax to the circumstances of the individual enterprise.

xv. The highly differentiated rate structures of the product tax, VAT and resource tax, together with the tailoring of the income adjustment tax on an enterprise-by-enterprise basis, introduce wide scope for discretion in the design, interpretation and implementation of tax policy. Such wide discretion runs counter to the spirit of system reform. In the area of direct taxes, tax remissions, by emphasizing discretion over rules, divert the attention of enterprises from lowering product cost and raising quality, and reinforce the symbiotic relationship between enterprises and their supervisory bureaus. Enterprise-specific variations in income and adjustment tax obligations, such as those characteristic of the contracting system, also make policy making difficult by removing "standard" contracts for purposes of evaluation. With regard to indirect taxes, in addition to the points made in the above paragraphs, administrative considerations argue against a complex VAT and product tax structure.

xvi. This report's recommendations for reform of tax policy are to be seen as an integrated package. They would restore to the tax system its primary role of raising revenue (and hence of aiding macroeconomic balance); reduce its scope for administrative discretion in favor of established rules; and, strengthen incentives for the more efficient use of fixed assets by state owned enterprises. Considerations behind this proposed policy package highlight the close relationship between taxes, prices and enterprise behavior, which implies that system reform requires simultaneous progress on all fronts.

xvii. The recommendations also seek to build on the strengths of the existing tax system in China, focussing on refinements and amendments to the major taxes now in place (such as the VAT and the contracting and other elements of the enterprise income tax) rather than recommending radical change or a wholly new structure. The major recommendations and their justification are summarized below.

xviii. Enterprise Taxation. With respect to enterprise taxation the report recommends:

(a) that the present enterprise income tax continue to apply to the profits of all state enterprises at its current flat rate of 55%. Consideration should not be given to lowering the enterprise income tax rate, and to unifying the tax treatment of different enterprise types, until after reform of the contractual responsibility system and its tax preferences have been brought under control;

(b) that no new contracts be initiated with respect to the payment of indirect taxes and the enterprise income tax;

(c) that contracting between state-owned enterprises and their owners should be permitted only on payments to the government/owner out of after-tax profits; and

(d) that repayment of loan principal should be disallowed as a deduction for purposes of the enterprise income tax on all new loans with a view to the full elimination of principal deductibility over time.

xix. Although consideration is being given to lowering the basic rate of enterprise income tax from its current level of 55%, there are two reasons why such a reduction should be postponed until after the tax preferences prevalent under the contractual responsibility system have been fully eliminated. First, the incentive effects of the tax depend not just on the statutory tax rate but also on the treatment of depreciation, amortization and interest. This argues for simultaneous consideration of all provisions of the enterprise income tax and not simply its statutory rate. Second, decreases in tax rates unaccompanied by revenue-raising measures would risk losing significant amounts of revenue at a time when fiscal policy must play an important part in overall macroeconomic management. Finally, reassessing the tax rate only after the full budgetary impact of reforms (e.g. in housing, social security, etc.) is known will preclude the possible need to make major upward revisions in tax rates as each reform proceeds.

xx. Maintenance of the basic rate of enterprise income tax at its current 55% level, pending reform of the contractual responsibility system, implies that it will not be possible to unify the tax treatment of state-owned enterprises with collectives and individual household enterprises. While unification may be a desirable longer-term goal, it is the report's view that taking control of the revenue base through the taxation of state enterprises should receive higher priority than unifying tax treatment between different organizational units. Abolition of tax preferences in the contractual responsibility system would offer the opportunity to implement a unified rate of enterprise income taxation. That rate would be set by the authorities with reference to revenue requirements. Lack of information precludes the report from making a recommendation on what a more appropriate longer-term enterprise tax rate might eventually be.

xxi. The report recognizes that incentives must be provided to State-owned enterprises to encourage efficient utilization of their fixed assets and return a dividend to the State. However, this should be done without eroding the tax base. Furthermore, the tax and contracting system should contribute to an important objective of enterprise reform, which is to distinguish between the roles of the State as tax authority and as owner of enterprises. It is therefore suggested that contracting occur out of after tax profits alone. This will mean discontinuing those aspects of the widely-used contracting forms that are conducive to tax remission.

xxii. The rationale for the report's recommendation that the deductibility of amortization of bank loans be disallowed effective now, beginning with borrowing for new investment, lies in the positive effects this would have on government revenue and, by raising the cost of capital, its dampening effect on investment. It would also bring enterprise taxation somewhat closer to international practice on the income tax. Greater efficiency of new investment would also be promoted, an objective which would also be supported by using more effective monetary and interest rate policies.

xxiii. Other Direct Taxes. With respect to other forms of direct taxation of enterprises, the report recommends:

(a) that the tax on extrabudgetary construction be phased out as and when interest rate and credit policy more effectively control investment; and

(b) that the income adjustment tax on state-owned enterprises be phased out.

xxiv. Such taxes on enterprises profits are common in socialist countries where they are intended to discourage excessive investment and encourage more rational use of capital by explicitly raising the shadow cost of capital to the enterprise. The report recommends that these taxes be phased out as and when macroeconomic levers and policies--most importantly interest rate and credit policy--have become more effective and when the cost of capital itself is sufficient to regulate investment decisions. The adjustment tax would effectively be replaced by the payment by the enterprise of a dividend to the State.

xxv. Resource Taxation. With respect to the Resource Tax and the taxation of resource-using enterprises, the report recommends that:

(a) the present enterprise income tax continue to be applied to all resource using enterprises;

(b) the resource tax be extended to all enterprises that have access to natural resources; and

(c) the resource tax (or a land use tax or fee) be applied to urban uses of land.

xxvi. The report recommends that the tax authorities charge for natural resources in much the same way as for fixed assets. The absence of a mechanism for valuing fixed assets in State enterprises is offered as an argument for the income adjustment tax which is levied on profits. Likewise, profits are used by the authorities as a surrogate for the value of resources, and the lack of a market in resources causes the resource tax to be levied as an "excess profits tax". Both types of tax, by failing to distinguish between sources of "excess profits", run the risk of penalizing more efficient enterprises. Thus, higher taxes on profits could penalize enterprises who earn those profits as a result of lower marginal costs of resource extraction, or greater skills in using fixed assets on behalf of the State.

xxvii. The arguments with respect to land taxes here are similar to those supporting the extension of the resource tax. It is important that the land use charges/or fee be set at a level that reflects land's social value so that an enterprise's use of this resource (in the absence of a market for the resource) reflects its value and incentives for improving its efficiency in use are correspondingly enhanced.

xxviii. Taxation of enterprise profits, together with a contracting on after-tax profits in the form of a dividend, and taxes on enterprises' use of resources and land would ensure that the enterprise's use of the three major factor inputs--capital, land and resources--(in the absence of markets for the latter) more truly reflects their social value and that incentives to improve efficiency in use are correspondingly enhanced. In the absence of such pricing of enterprise inputs, greater retention of earnings by enterprises is no guarantee of better resource allocation.

xxix. Personal Income Taxation. Finally, with regard to direct taxation of individuals, the report recommends:

(a) that the personal income adjustment tax be strengthened, with a view to the eventual elimination of the wage bonus tax.

xxx. As wages increase towards the exemption level of the personal income adjustment tax, its strengthening would allow tax policy to limit excessive inequality while continuing to serve the function of controlling macroeconomically unsustainable increases in consumption. Consideration should be given to including payments in kind in the base of the personal income adjustment tax.

xxxi. Indirect Taxes: VAT and Product Tax. It is recommended that with respect to indirect taxes:

(a) the VAT replace the product tax on those sectors still subject to it, and that the existing VAT and product tax be replaced by a value added tax of the consumption type as distinct from the "gross product" VAT currently in use;

(b) that the VAT be implemented via the "invoice method", rather than relying on presumptive crediting as at present.

(c) the proposed VAT would (i) apply to manufacturing and imports, (ii) exempt agriculture and services; and (iii) "zero rate" exports; and

(d) the rate structure of the reformed VAT on manufacturing and imports be simplified significantly, especially for intermediate goods, and moved towards a single unified rate in line with price reforms.

xxxii. Replacing the product tax with the VAT has two advantages: First, by removing the divergences (due to cascading) between the statutory tax rate and the actual tax borne by each sector, it makes the actual tax burden and effects of taxation more transparent. Second, it ensures that exporters enjoy the full benefits of "zero rating", increasing the competitiveness of Chinese exports.

xxxiii. A VAT of this kind recommended for China could be implemented even in the absence of price reform. Its implementation would be made easier with a more simplified rate structure; the adoption of such a rate structure depends among other things, on price reform. This is due to the use, in China, of the VAT to affect profitability of sectors producing goods subject to price controls.

xxxiv. These recommendations for simplifying the rate structure of VAT reflect both the requirement for administrative efficiency and the report's view that differentiated indirect taxation is an inappropriate method of implementing industrial policy and that tax policy should not be used as a substitute for correcting price distortions. The basic rates of VAT would be influenced by public revenue requirements. With the implementation of price reforms it would be possible to introduce a single, uniform VAT rate.

xxxv. The coverage of VAT would initially be confined to manufacturing and imports. It could eventually be extended to the retail level in the longer term, in line with the evolution of administrative capability. A consumption-type VAT would have the advantage of not discriminating against investment; control of investment is more efficiently achieved by interest rate policies, and on the fiscal side, by the measures recommended above for reform of principal deductibility under the enterprise tax.

xxxvi. A standard rate of VAT of 15%, supplemented by selective excises, the report estimates, could raise as much revenue as the existing product tax, VAT and excises. A higher revenue requirement (e.g. to reestablish macroeconomic control prior to price reform) could be accomplished through a temporary, across-the-board levy on indirect taxes on top of the VAT structure.

xxxvii. <u>Excises and Other</u>. With respect to the remaining <u>indirect excise taxes</u> the report recommends:

(a) that supplementary excises be levied on items such as tobacco and alcohol whose consumption the government wishes to discourage; on gasoline and diesel to charge for road use; and on selected luxury items; and

(d) that the business tax continue to be applied at the wholesale and retail level in the service sectors;

xxxviii. The imposition of supplementary excises on luxury goods and perhaps others goods is consistent with international practice and poses no administrative difficulties. Such excises will contribute to the revenue yield of indirect taxes (in such cases where the simplified VAT rates imply a lower tax burden). They can also enhance the equity of the tax system if higher rates are imposed on goods whose consumption is concentrated in better-off groups. The report's recommendation to maintain the present business tax has its roots in administrative considerations.

Strengthening Subnational Government Finances

xxxix. The overall reform process is changing the balance of revenues accruing to the central and local governments. Current revenue sharing arrangements have shifted in favor of the provinces, which now retain a larger fraction of collected revenues. This is consistent with the spirit of reforms, specifically the decentralization of responsibility to lower levels of government. However, the central government's failure to achieve corresponding reductions in expenditures has led to budgetary pressures. This appears untenable in the long run, and mechanisms need to be developed--some combination of new local taxes, a reassignment of existing taxes or redivision of the tax base--to serve better both central and local interests.

xxxx. The choice of a particular central-local fiscal relationship depends on how the government weighs the benefits of provincial responsibility for development versus less central control. If the central authorities wish to strengthen the management of the revenue system as a whole they will need to reduce, if not eliminate, the local government's power to administer the tax system, to implement tax policy, and the discretion to give special tax concessions. If, on the other hand, they retain the present somewhat unconstrained approach to decentralized implementation of tax policy, the central government will be less able to use tax policy to pursue macro stabilization and equalization goals. One cannot have it both ways. These issues are part of the more fundamental question of how far and in what manner to take government fiscal decentralization and this, ultimately, is what must be decided. In China, a difficult balance needs to be struck between centralizing the management and regulation of the tax system better to pursue macroeconomic objectives and increase the central government's equalizing capacity, and decentralizing to accommodate the diverse needs and preferences of the provinces.

xxxxi. Rather than recommending any one alternative, the report considers several models of central-local relations, seeking to address the questions: (a) What is the "appropriate" share of revenues to allocate to the local government sector and what is the "appropriate" way to distribute this amount among local governments; (b) How much fiscal autonomy should be given to local governments and in what form should this autonomy be given; and (c) Is it possible to continue the present system of centralized tax policy responsibility with local tax administration responsibility?

xxxxii. At one extreme is a centralized tax sharing approach under which major taxes such as the enterprise income tax and the product, business and value-added taxes would become fixed central revenues. Local governments would be given the minor taxes. Most local government revenues would come from a regular formula grant program, with the formula chosen to reflect certain criteria such as population, size, per capita income, infrastructure requirements, tax effort, etc. The main advantages to this approach are: (a) it facilitates the exercise of the national government's responsibility to ensure an appropriate balance between widely varying needs and resources between regions and/or provinces; (b) it puts the central government in a better position to use the tax system for macrostabilization goals; and (c) it makes possible the use of the tax system as a lever to achieve allocative goals. The biggest disadvantage is the reduced incentive for local government revenue mobilization. A more balanced version of this approach would give local governments relatively more revenue sources, and correspondingly fewer grants. This would give the center less flexibility than the centralized version of tax sharing.

xxxxiii. A third model would be based on tax base sharing. This arrangement would have local and central governments share in the base of the enterprise income and product, business, and value-added taxes. The central government tax would be fixed by the central government at a rate that met its revenue needs, and local governments would be permitted to elect (within a range) a surtax rate on each base. Local revenue administration might be retained, but local governments could not engage in any tax relief policies that would effect the base or rate of the central government tax.

xxxxiv. Finally, the report considered the possibility of reforming the present system to eliminate its most undesirable features while retaining its strengths: (a) the objective of giving the central government more control over the tax system better to pursue stabilization policy, would be served by eliminating or reducing local government discretion to give tax concessions or tax contracts to local enterprises, and reducing the retained shares of local governments; (b) the objective of equity among provinces would be served by replacing the present arrangements for distribution across provinces with more of a formula based on indicators of need and taxable capacity; and (c) the objective of separating the central and local taxing powers would be served by giving local governments some additional taxes.

## Tax Policy and Macroeconomic Balance

xxxxv. China's consolidated budgetary revenue has grown at about 8% p.a. since 1978 slightly less rapidly than expenditures. A deficit has emerged as reforms have led the government to yield control over pre-reform revenue sources (such as the enterprise profits and depreciation funds), without a corresponding degree of reduction in expenditures. A byproduct of this revenue shortfall has been pressures for a "claw-back" of enterprise profits through a variety of ad hoc tax increases and surcharges levied largely on enterprises, as well as the introduction of various off-budgetary financing arrangements and earmarked revenue sources to safeguard financing required for key central government projects. Hitherto, high levels of household savings, the rapid growth of GDP, and the low initial level of government debt in relation to GDP, have prevented the emergence of major macroeconomic or external imbalances and a modest deficit may well be sustainable in the near term. However, a continuing downward trend in revenues without expenditure restraint would heighten concern about the fiscal deficit.

xxxxvi. The macroeconomic problems in the post-reform Chinese economy highlight the need in the longer term, for a fiscal policy which supports domestic stabilization objectives. A strong fiscal policy tool should not be equated with a larger government role or share in the economy, but rather a tool which effectively provides the necessary flexibility to meet changing expenditure and macroeconomic requirements as reforms proceed.

xxxvii. At the same time that a more effective fiscal policy instrument is needed, a number of developments over the reform period have reduced the central government's ability to use fiscal policy to achieve macroeconomic goals. On the revenue side, the major elements are: (a) the development of the "enterprise tax contracting" system; (b) the decentralization of fiscal powers through the "provincial contract responsibility" system for provincial governments; and (c) the shift of resources to off-budgetary categories of expenditures financed by borrowing. That this is occurring at the same time that other government policies are contributing to the emergence of inflationary pressures, makes the reduced control and flexibility of the central government to use tax policy as a stabilization instrument ill-timed indeed, and is particularly problematic in China where for a variety of reasons, monetary and interest rate policy have not been used as an effective tool for macroeconomic management.

xxxviii. Looking to the future, on the expenditure side of the budget, it is important that the reforms planned by the authorities in areas such as social security, housing and pension reform be designed from the outset with budgetary costs in mind.1/ If such precautions are not taken, it will be necessary to raise additional funds via the tax system.

xxxix. To restore the fiscal lever as a stabilization tool, the report recommends that the inclusion of taxes in contracting be subject to serious scrutiny and that all new contracts exclude contracting for taxes. This will, as the old contracts phase out, eliminate the procyclical aggregate demand element which tax contracts introduce into tax policy, by leaving relatively more resources within enterprises, as production and profits grow to further fuel demand.

l. The report also suggests that, to enhance macro control, the central government limit local governments' *ad hoc* implementation of the central government's unitary tax code, especially their granting of tax relief at the expense of revenue transfers to the center, and that consideration be given to redesigning the provincial contracting system for provincial revenue sharing. This aspect of fiscal decentralization has reduced the stabilization properties of the tax system and reduced the central government's ability to use fiscal policy for stabilization purposes. As stated above, while the report makes no explicit recommendation on the appropriate balance of centralization vs decentralization it emphasizes that the government must weigh the benefits of decentralization against the costs of having less central capacity to manage and direct the system.

li. Finally, to conduct macroeconomic policy effectively through the fiscal system, the authorities must have a true picture of the impact of the budget on the economy. The report suggests that greater transparency be given to the Government accounts, and that extrabudgetary accounts be aggregated

---

1/ Two World Bank studies are planned for FY89, which will examine reforms in social security and housing finance and make recommendations as to their scope and financing.

with the budgetary accounts. This would ensure that the budget better reflects the true resource transfer to government and the actual tax burden on enterprises. It would also clarify the present situation in which the overall revenue collection is declining as a percent of GNP at the same time that the effective burden of taxes and nontax charges on enterprises appears to be rising. Under present orders of magnitude, and assuming such fees are not indeed user charges, the extrabudgetary revenues of government agencies are equivalent in tax terms to an increase in the enterprise income tax rate from its present level to more nearly 67%. Formal taxation, with the certainty and transparency it implies, is preferable.

lii. Further, and more importantly, the government should limit the introduction of additional off-budgetary financing or earmarking mechanisms for its expenditures. Such mechanisms erode the reliability of the budget as an indicator of the fiscal position and also make it more difficult to pursue stabilization using fiscal policy.

## Strengthening Tax Administration and Collection

liii. In contrast to other countries, the central government in China has no tax collection mechanism of its own, relying rather on local governments (mostly at the city and county level) for the collection of taxes and their remittance to the central authorities. Provincial and local governments are not at all monitored and their staffs are inadequately trained and not equipped to handle the enormous number of taxpayers and rates. Thus, decentralization to this degree has left the central government critically short of information about the workings of the tax system and without the means for bringing about increased efficiency or greater standardization of treatment. This, together with the unavailability to SAT of legal enforcement powers considered standard in most other countries also severs the link between tax policy set at the central level and its actual implementation. Legal shortcomings weakens tax policy in operations. The "tax levers" that the Central Government designs may be far different from the fiscal measures that are actually implemented.

liv. The present system which has been described as embodying the principle of "unified leadership, multilevel implementation", has considerable strengths from the point of view of the center, local governments and taxpayers alike and has served China's needs well in the pre-reform period. A local presence ensures local governments are responsive to local circumstances, and decentralization lessens the problems arising from the sheer size of the country.

lv. But the system's inherent ambiguities also give rise to problems. For example, significant variations in practice apply in different provinces and regions. Local tax officials are also answerable to two masters--the Tax Bureau immediately superior to them and the local government of which they are part. Likewise, local governments themselves play a dual role in relation to "their" enterprises--as owner and tax authority. The system also suffers from serious deficiencies as regards information flow and lack of uniformity and coordination. For the central government in particular this led to a general lack of control. At best, the effects of tax policy decisions might not be easily predictable. At worst, contradictions in tax policy occur.

lvi. Because reforms to the overall tax system and the system of local finance remain in flux, the report outlines two broad approaches to tax administration: (a) to introduce a "National Tax Service" run by the central government, along the lines of e.g., the Inland Revenue, or IRS and with Central Tax Bureaus at the local level; and (b) to standardize and strengthen the present administrative structure and to adapt it to the demands of changed circumstances.

lvii. A "National Tax Service" and a more centralized system should, for work-effectiveness, integrate the administration of VAT, business tax, resource tax and enterprise, joint venture and personal income tax (and any other taxes on these bases). Other taxes could be left to local administration. The report, however, sees this as a long-run option, in view of the enormous personnel shifts and staffing involved.

lviii. In the near term, strengthening the administrative system is essential. The report recommends creation of a specialized management unit within the State Administration for Taxation and the introduction of an integrated management information system to assist management at all levels. Further steps would include: strengthening personnel and training functions, and the internal audit system; establishing a central "organization and methods" unit; establishing a central automatic data processing unit and arranging to standardize administrative best practice.

lix. The report also considered microlevel reforms within the existing tax administration and identifies improvements which could be implemented regardless of whether the overall system is subject to greater centralization.

lx. The filing and payment system should be strengthened by reducing the frequency with which taxpayers make tax returns, and streamlining administration by requiring enterprises themselves to calculate and pay over income taxes. Such a change would need to be underpinned by more effective auditing and by credible penalties. At the same time it should be possible to simplify and rationalize the methods by which taxpayers actually pay their taxes. In the longer term, the introduction of a single tax account for each taxpayer bearing a unique taxpayer identification number would simplify the tax authorities' internal accounting system.

lxi. The report recommends also standard invoices and return forms--essential for the introduction of an invoice-method VAT. The personal income and personal income adjustment taxes would be more easily administered as an annual tax, with simplified withholding from employment income and annual returns in which taxpayers were responsible for calculating and paying correct tax liabilities.

lxii. The audit and checking systems at present involve an exceptionally high ratio of staff to taxpayers in part because of a practice of tax officials resident in enterprises, which the report recommends phasing out. The report also recommends a more selective approach to examinations and that more selective efforts be put into audit and enforcement in view of the low level of the additional tax collected in relation to international standards. For best effectiveness, the audit effort should be based on stratified sampling and concentrated on vulnerable areas. The regular amnesties for defaulters should not be continued.

# CHINA

## REVENUE MOBILIZATION AND TAX POLICY

### Preface

This report summarizes the findings and recommendations of a World Bank mission which visited China in June, 1988 to analyze, in collaboration with a Chinese counterpart team from the Ministry of Finance and other government agencies, the present status of China's fiscal system and, on the basis of this analysis, to make recommendations for further improvements. The mission benefitted from another, earlier, study of tax and expenditure developments, financial intermediation, and enterprise reforms, undertaken by another joint World Bank mission and counterpart team.2/ A companion volume of annexes provides more in-depth analysis and a full description of China's present tax system.

The focus of the Report is on China's tax system per se. Public sector pricing and user charges are not examined. Likewise, while the report is concerned with expenditure trends as an essential ingredient to formulating a sound tax structure and revenue adequacy, expenditure policy does not receive in-depth treatment. The report's main themes are the need for a more efficient set of tax instruments; the need for a more flexible revenue instrument, and the need to reform subnational tax, financial and administrative practices. The macroeconomic themes are discussed first in Chapter I which looks at China's tax policies and macroeconomic management issues relating to tax policy and the budget. Chapter II describes China's tax system at the present juncture, and discusses options for reforming the tax system in a way which promotes greater efficiency. Chapter III focuses on the present situation for provincial and local finance, and Chapter IV offers recommendations for the strengthening of tax administration.

2/ World Bank: China - Finance and Investment, Report No. 6445-CHA, June 1987.

# CHINA

# REVENUE MOBILIZATION AND TAX POLICY

## I. CHINA'S TAX SYSTEM AND MACROECONOMIC BALANCE

### Introduction

1.1 As a central element of its overall strategy to improve allocative efficiency and promote the modernization and growth of the economy, the Chinese government set in motion in 1979 a process of reform aimed at decentralizing production and investment decisions and subjecting them increasingly to market influences. Reforms in the rural sector contributed significantly to its remarkable growth in 1979-84. Beginning in 1984, reforms were initiated in the urban sector, with major changes in enterprise management and finance. The urban reforms reduced the role of the government in the economy, in determining both the allocation of resources and financing.

1.2 These reforms changed the government's expenditure responsibilities, its needs for revenue and the means for raising it. Taxation became a new element in the government's relation with enterprises, households, and provinces. Tax reform continues to be an important factor in the success of China's reform effort. Hitherto, the steps for addressing the balance of revenue and expenditure and the fiscal balance between central and local government have been largely experimental. Examples include the introduction of experimental enterprise taxation in 1979 and the introduction of contracting in 1986.

1.3 This chapter briefly reviews China's tax system and provides a preliminary assessment of key issues facing China as it develops its tax system as a fiscal instrument. Section A briefly reviews China's progress in tax reform to date, together with an international perspective. In Section B, recent developments in China's budget are discussed, including trends in revenue and expenditure, the deficit and its financing. Section C outlines the key macroeconomic features of China's tax system, including the implications of contracting, provincial finance and the reforms. The section concludes with an assessment of China's tax system in light of these macroeconomic considerations, while Section D previews other issues discussed in Chapters II through IV of the report.

### A. The Progress of Tax Reforms to Date

1.4 The reform process taking place in China since 1979 emphasizes a devolution of power to lower level entities, giving greater decision-making responsibility to enterprises and provincial governments. These changing responsibilities affect the role and size of the government budget. With greater autonomy given to enterprises and local governments, the central government's effectiveness in mobilizing resources and its role in financing investment and other expenditures has diminished, as well as changed in nature and scope. This shift is reflected in the trends in tax and nontax revenues mobilized by all levels of government in China, which have fallen from some

34% of GDP in 1978 to just under 20% in 1988 (as shown in Table 1.1).1/ This decline reflects a reclassification of revenues from the budget to the enterprise sector and parallels the decline in budgetary expenditures which has come about as a result of the devolution of expenditure responsibilities to enterprises. It also reflects structural inelasticities in revenue generation.

1.5 Shift in the Pattern of Revenue Generation. China's revenue system has undergone significant change since the reforms. Before 1979, government derived revenues by tapping sectoral surpluses through nontax means. Agricultural surpluses were tapped through price ceilings and procurement policies; wage policy reduced surpluses in the urban household sector; and enterprise surpluses were remitted to the budget. Indeed, until 1983, the bulk of government revenue, approximately 60%, was generated from the remittance of profits (that is cost-price margins) by state-owned enterprises to the government budget. In the early 1980s, this system began to be replaced, on an experimental basis, with taxation of enterprise profits in an attempt to provide state-owned enterprises with greater incentives for increasing efficiency. This experimental system featured, broadly, a statutory 55% enterprise tax rate (there was a separate tax for collectives and small scale enterprises, and for enterprises involved in natural resource extraction) and an "adjustment tax" which was intended to tax away "excess" profits (defined as profits as a return on sales) accruing to an enterprise as a result of factors external to the enterprise, such as the structure of administered prices in relation to input costs, in particular, raw materials costs and capital with which enterprises had been costlessly endowed by the State.

1.6 Commodity taxes were also restructured at the same time, with the previous "consolidated industrial and commercial tax" (CICT) divided into three separate indirect taxes: the VAT, the business tax (levied on enterprises in the services sector) and the product tax (levied on industrial sector enterprises). Commodity taxes were also designed to equalize profits. In the absence of a flexible price system, unequal profit margins caused by plan price distortions were thought to create artificial producer preferences, which could be inconsistent with those the authorities wish to signal. One objective of this indirect tax-cum-price mix was to ensure equalization of profits across sectors. Indirect taxes in China are therefore much more like

---

1/ All revenue and expenditure figures reported in this study have been adjusted to conform with conventional presentation of budgetary accounts as outlined in the IMF's "Government Finance Statistics GFS) Manual." See Chapter I, Box 1.1 for an elaboration of the differences between Chinese and GFS presentations.

direct taxes than indirect taxes.2/ However, with tax rates set by commodity, only equalization across sectors can be achieved. The adjustment tax was a refinement to equalize profits of enterprises within a sector as well as to increase revenue to the government which had fallen following the switch from profit remittance to tax. As illustrated in Chapter II, a major shortcoming is that the measure of profitability forming the basis for tax policy--an enterprise's return on sales--bears little relationship with profitability of investment. Thus heavy taxation of industries with "high profits" can reduce funds for expansion or for wage bonuses, which now come from retained earnings rather than government grants as in the past (see Box 2.1 on "Alternative Measures of Profitability").

Table 1.1: CHINA: BUDGETARY REVENUES, 1980-88
(% of GDP)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 (Budget) | 1988 (Actual) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| I. Direct taxes /a | 20.4 | 18.8 | 17.5 | 16.6 | 14.3 | 13.3 | 11.9 | 8.4 | 8.7 | 7.4 | 6.2 | n.a. |
| of which: remittances | (18.9) | (17.5) | (16.4) | (15.6) | (13.3) | (11.8) | (10.1) | (0.5) | (0.4) | (0.4) | (0.4) | |
| II. Indirect taxes /b | 12.0 | 11.7 | 11.3 | 11.4 | 11.7 | 10.7 | 10.5 | 12.1 | 11.7 | 10.5 | 8.8 | n.a. |
| III. Taxes on trade | 0.8 | 0.7 | 0.8 | 1.2 | 0.9 | 1.0 | 1.5 | 2.5 | 1.6 | 1.3 | 1.0 | n.a. |
| IV. Other tax and nontax /c | 0.8 | 0.7 | 0.8 | 1.2 | 1.1 | 3.4 | 3.2 | 3.5 | 4.0 | 4.2 | 2.9 | n.a. |
| V. Total Revenue | 34.0 | 32.1 | 30.4 | 29.9 | 28.0 | 28.3 | 27.1 | 27.5 | 26.0 | 23.4 | 19.0 | 19.5 |
| VI. Memo items: | | | | | | | | | | | | |
| Total expenditures | 33.8 | 37.3 | 33.7 | 31.2 | 29.4 | 30.0 | 28.7 | 28.0 | 28.2 | 25.7 | 21.2 | 22.0 |
| Deficit | +0.2 | -5.2 | -3.3 | -1.3 | -1.4 | -1.7 | -1.6 | -0.5 | -2.2 | -2.6 | -2.2 | -2.4 |

/a Includes taxes on state enterprises, the adjustment tax, all profit remittances from state enterprises up to 1984, profits tax on collectives (ICIT), and tax on extrabudgetary funds, construction tax, and other "direct" taxes.
/b Product tax, VAT, business tax.
/c Residual: includes depreciation funds and other taxes.

Source: Ministry of Finance and IMF.

2/ In China, reference is often made to "pure" indirect taxes, and "impure" indirect taxes, the former being those which are levied in market economies and designed to be taxes on consumption, and the latter, falling, in a fix-price environment, on profits. The distinction between direct taxes and indirect taxes is blurred in China due to the use of indirect taxes as tools for equalizing profitability. This discussion and the accompanying tables, follow the convention that direct taxes are those formally levied on profits and indirect taxes (such as the VAT) are on commodities. However, the reader should be aware that in China's fix-price environment, indirect taxes are designed to be levies on profits.

1.7 The results of experiments in direct and indirect taxation were closely watched and in 1984 China introduced a general tax reform. Broadly, the reform was fixed in outline by 1985 and comprised: (a) a series of corporate income taxes applied to all state enterprises and collectives, levied on net income, plus a "profits adjustment tax" to compensate for excess profits earned by some enterprises due to ongoing price distortions and the different capital endowments of enterprises; (b) the transformation of the commodity tax into separate retail and wholesale taxes on intermediate and final goods, and the introduction of a partial VAT to selected sectors of the economy; (c) various low-yielding "pre-reform" taxes--salt tax, slaughter tax, market tax, agriculture tax, etc.--which accrued to local governments, were left in place; and (d) a series of ad hoc taxes on extrabudgetary "construction", wage bonuses, and extrabudgetary funds were introduced to control enterprise expenditures in "unproductive" areas, in the absence of appropriate price signals and traditional tools of macroeconomic control such as interest rate and credit policies, and other demand management instruments.

1.8 Since 1986, tax reforms have focused on a more general application of a system of enterprise incentives known as the "contract system." Inaugurated selectively and experimentally from the late 1970's to the mid 1980's, it now applies to over 80% of enterprises. This system aims to develop enterprise performance responsibility by establishing clear criteria for profitability and accountability. While contracts differ in their details (four major types are described in Box. 1.2 on "The Tax Contracting System"), all establish a contract between government and enterprise determining profits or taxes to be remitted by the enterprise to the government.3/ The contract system has shes uniform taxation of enterprises.

1.9 In the area of indirect taxation, the coverage of the VAT has been broadened since the initial reforms and now covers all but three industrial subsectors. A number of low-yielding taxes have also recently been introduced, such as a "vehicle and ship usage tax", stamp tax, a banquet tax and housing, and land taxes in urban areas. A tax on "households engaged in enterprise" and a "personal income adjustment tax" have both been applied to individuals for the first time in 1988 in China. Some of these minor taxes have been assigned to local government in an attempt to increase their revenue sources. The housing and land taxes, although yielding little revenue now,

---

3/ A full description of the Chinese tax system, up to 1986, is to be found in Finance and Investment, (CHA #6445) Annex III.
A full description of reforms under the contract system is to be found in "Symposium on Enterprise Reforms in China," Diaoyutai Guest House, Beijing China, October 4-10, 1987; and Kochav, David; "China: Enterprise Management Report: Issues and Options;" October 18, 1988, AS3, IBRD, CHA-__, 1988.

represent an attempt by the government to begin to tap the growing surpluses arising in the household sector as a result of wage reforms and the responsibility system and establish direction for future reform.

1.10 As a result of these changes, China now has a significantly more formalized system of taxation than before, consisting in the main of corporate income and profits taxes (budgeted in 1988 to generate some 33% of total revenue); domestic indirect and commodity taxes (contributing 46%); and customs duties (6%). Agricultural sector taxation and personal income taxation together contributed an insignificant share (about 1.5%) of total revenue, while miscellaneous other low-yielding taxes contributed some 7% and nontax revenue contributed the remaining 6%. Table 1.1 showed how these revenue trends have evolved over time, and reflects both the striking declining share of revenues in GNP as well as the shift in reliance from direct to indirect taxes.

1.11 Changes in Revenue Sharing. Major changes have also taken place in the area of local government finance. China's fiscal system is a unitary one. In principle this means central government directs expenditure policy and determines all aspects of tax policy. All taxes, with few exceptions, are national-level central taxes formally accruing to the central government, which then shares them with provincial, lower level governments. Subnational governments have few revenue sources of their own. However, because taxes are collected at the local level, by local governments on behalf of the center, the central government's revenues in fact accrue in the first instance, to lower level governments.

1.12 In this regard, therefore, China differs from many other countries in that the central government collects very few of its own taxes. Rather, local government, typically municipal and county-level government, collects most revenues other than customs duties and selected excises. This reliance on local government for tax collection complicates analysis of the system because local governments have substantial effective control over the revenues they collect. From the perspective of tax collection, China is strikingly decentralized.4/

1.13 This revenue-sharing system is an outgrowth of earlier experiments beginning in 1980 that moved from the "big pot" system in which all revenue and expenditure authority was centralized, to revenue sharing based on the principle of "eating out of separate kitchens." These reforms attempted to devolve greater revenues as well as expenditure responsibility to provincial governments to establish better incentives for local revenue mobilization and expenditure control. The new system assigned some taxes to the central government or local governments exclusively, and other taxes were shared between levels of government along with a system of grants. One purpose was to develop a local government tax base. Refinement of the revenue sharing formula was to enable the provinces, in principle, to plan and budget over a multiyear period.

---

4/ Only in Brazil, Colombia and Nigeria, among developing countries, do subnational governments contribute significantly (25-35%). In most others, the subnational share of the total is in the 15-20% range, and in many it is 5% or less (See Chapter III for detailed table).

1.14 This initial reform program has undergone several changes since 1979. Under present arrangements, the central government has negotiated multiyear "revenue contracts" with many of the provinces, under which the provinces will remit a guaranteed level of revenues to the MOF. Some targets are fixed in nominal terms, others incorporate some revenue growth.

1.15 International Comparisons. China's tax system differs significantly from other countries in its income group both in level and structure. Because of the major government role in the economy, the level of revenues as a share of GNP has been relatively high, as shown in Table 1.2, almost twice that of other countries at its income level. China's tax structure is also unusual for a country with its per capita income, with direct taxes (see Table 1.3) making up about one-third of the total in 1988, compared with some 17% for other countries with similar per capita income. China shares this feature with the socialist countries of Eastern Europe, where a large fraction of total revenues come from the socialized enterprise sector. China collects a far higher proportion of its total revenue in indirect taxes than its comparators. Of total revenue, 46% comes from commodity taxes, more than any other country group. China is also unusual regarding trade taxes on which most low income countries rely heavily. In 1988, trade taxes contributed about 6% of total revenues in China and almost 30% of total revenues in other low-income economies.

Table 1.2 INTERNATIONAL COMPARISONS OF EXPENDITURE AND TAXATION

| Country Group | Per Capita Income ($) | Expenditure/ GNP (%) | Revenue/ GNP (%) | Deficit/ GNP (%) |
|---|---|---|---|---|
| China (1978) | 230 | 34.0 | 34.0 | +0.2 |
| China (1988) | 320 | 22.0 | 19.8 | -2.2 |
| Low income countries | 270 | 20.8 | 15.4 | -5.1 |
| Middle income countries | 1,510 | 27.5 | 24.0 | -5.8 |
| Industrial countries | 10,760 | 28.6 | 24.1 | -5.1 |
| Other Socialist countries | 2,000 | 65 | 62 | -3.0 |

Source: World Development Report, 1980, and 1988, Tables 23, and 24 (sample of 90 countries) and P.T. Wanless; Taxation in Centrally Planned Economies; Croon Helm Publishers, Beckenham, UK, 1985.

Note: For all country groups listed, data refer to central government revenue and expenditure only; for China: consolidated central and provincial revenue and expenditure on a GFS basis. Figures for socialist countries are unweighted averages and not strictly comparable.

1.16 A striking difference between China and other developing countries is also the near total absence of any personal income taxation, although to some extent in China and other socialist countries, wage and subsidy policies are akin to personal taxes. In most market countries, direct taxes are imposed on both personal and corporate incomes; on average, about 40% of direct tax revenues derive from the former and 60% from the latter. In China, the entire explicit burden of direct taxation is on the enterprise.

Table 1.3: INTERNATIONAL COMPARISON OF REVENUE STRUCTURE
(% of Total Revenues)

| Country group | Income and social security | Profits taxes | Commodity taxes | Trade taxes | Other tax and nontax revenues |
|---|---|---|---|---|---|
| China (1978) | -0- | 62.3 | 32.9 | 2.3 | 2.3 |
| China (1988) | -0- | 33.0 | 46.0 | 6.0 | 15.0 |
| Low income countries | n.a. | 16.8 | 32.2 | 28.1 | 19.8 |
| Middle income countries | n.a. | 25.7 | 25.5 | 8.3 | 22.5 |
| Industrial countries | 16 | 24.0 | 17.3 | 1.2 | 9.0 |
| Other socialist countries | 10 | 50-70 | 20-30 | n.a. | 1.0 |

Sources: World Development Report, 1988: Table 23, and P.T. Wanless; Taxation Centrally Planned Economies; Croon Helm Publishers, Beckenham, UK; 1985. Vito Tanzi; Quantitative Characteristics of Tax Systems in Developing Countries", in D. Newbery and N. Stern; eds. Modern Tax Theory for Developing Countries; Oxford University Press, for IBRD; 1986. Data for all countries are for 1985.

Note: Central government revenues only for country groups; consolidated central and local revenues for China on a GFS basis.

## B. Revenue and Expenditure Trends: China's Recent Budgetary Experience

1.17 Fiscal policy is a central instrument of macroeconomic management and stabilization policy. The design and implementation of tax policy is thus a crucial element in determining China's ability to carry out the macroeconomic policies and stabilization programs required to underpin the structural adjustments which China's economy is seeking to attain. In the pre-reform system, tax policy did not play a major role and government expenditure was the primary instrument of fiscal policy. Revenues were determined by profit remittances from enterprises and channeled back to enterprises through Plan investments, working capital allocations, and subsidies. During periods of overheating, administrative cutbacks in government expenditures--usually investment expenditures--were made to contain inflationary pressure. In the new economic system, the emphasis has moved towards the use of "indirect levers" and tax policy to regulate the behavior of increasingly autonomous economic agents.

1.18 China's budgetary revenues have grown at 8.3% since 1978, slightly less rapidly than expenditures. A modest deficit has emerged as reforms have led central government to surrender control over pre-reform revenue sources (such as the enterprise profits and depreciation funds) without a correspon-ding degree of reduction in expenditures.5/ Table 1.4 shows these recent budgetary trends, according to the standard presentation of fiscal accounts. Box 1.1 outlines differences between Chinese presentation of budgetary accounts and those more commonly used in other countries.

1.19 Trends in Revenue. A salient feature of the evolution of government revenue since the onset of the reform is that consolidated government revenue as a ratio of GNP has been falling continuously, from 34% in 1978 to just under 20% budgeted for 1988 (Table 1.4).6/ The primary cause of this trend is the steady decline in direct tax revenue from the enterprise sector, which has grown nominally at less than 2% annually over the 10 year period, and declined from about 20% of GNP (60% of total revenues in 1978 when all enterprise profits were still remitted to the budget) to an estimated 6.5% of GDP in 1988 (32% of budgetted revenue). Enterprise income taxation with its emphasis on contracting has reduced the importance of profit remittances and taxes as sources of government revenue (see Box 1. 2 on "the Tax Contracting System"). Less than 1.6% of total revenue now derives from profit remittances, compared to 56% in 1978.

---

5/ All revenue and expenditure figures reported in this report have been adjusted to conform with conventional presentation of budget data as defined in the IMF's Government Finance Statistics Manual. See Box 1.1 for a discussion of the differences between Chinese budget statistics and GFS format.

6/ This reflects buoyancy of about 0.7. Buoyancy refers to the revenue yield of the tax system as a whole including the effects of discretionary modifications of the tax system. Algebraically, buoyancy can be calculated as:

$$\frac{Tn - To}{To} \div \frac{Yn - Yo}{Yo}; \text{ where}$$

To = tax collections in the first year of the period being measured, Tn = tax collection in the final year of the period, and Yo and Yn are GDP in the first and last years, respectively. Buoyancy can also be calculated as the coefficient of a log-linear regression equation regressing on the GDP (or some measure of the tax base) tax yield and a constant. Elasticity, by contrast, reflects only the revenue yield from tax(es) in the absence of any discretionary change in the tax (system). Given the major changes that the system has undergone in 1978-88, the buoyancy estimates are presented in Table 1.4 reflect important discretionary tax changes in addition to the underlying dynamics (or elasticity) of the tax system.

1.20 Receipts from the personal income tax are negligible because the vast majority of individuals are exempted, since their income is below the relatively high minimum taxable level of Y 400 per month.

Table 1.4: CHINA: DEVELOPMENTS IN GOVERNMENT REVENUE - CONSOLIDATED GOVERNMENT
1978-88 /a
(In % of GNP)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 Budget | Nominal Growth % 1978-88 | Buoyancy /f 1978-88 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Total revenue | 34.0 | 32.1 | 30.40 | 29.9 | 28.0 | 28.3 | 27.1 | 27.4 | 25.9 | 23.2 | 19.0/a | 8.3% | 0.71 |
| Direct Taxes/d | 20.4 | 18.8 | 17.5 | 16.6 | 14.3 | 13.3 | 11.9 | 8.4 | 8.7 | 7.4 | 6.2 | 2.1% | 0.11 |
| Profit tax | (1.5) | (1.1) | (1.0) | (1.0) | (0.9) | (1.1) | (1.4) | (8.4) | (8.8) | (7.4) | (6.2) | (1.6%) | (0.10) |
| Profit Remittance | (18.9) | (17.5) | (16.4) | (15.6) | (13.3) | (11.8) | (10.1) | -- | -- | -- | -- | -- | -- |
| Indirect Taxes | 12.0 | 11.7 | 11.3 | 11.4 | 11.7 | 10.7 | 10.5 | 12.1 | 11.7 | 10.5 | 8.8 | 11.1% | 0.95 |
| Product tax | -- | -- | -- | -- | -- | -- | -- | (7.2) | (5.8) | (4.9) | (3.8) | (-2.7%) | (-0.18) |
| VAT | -- | -- | -- | -- | -- | -- | -- | (1.8) | (2.5) | (2.3) | (2.3) | (31.7%) | (1.81) |
| Business tax | -- | -- | -- | -- | -- | -- | -- | (2.5) | (2.8) | (2.8) | (2.5) | (19.3%) | (1.23) |
| Agricultural tax | (0.6) | (0.7) | (0.6) | (0.6) | (0.6) | (0.6) | (0.5) | (0.5) | (0.5) | (0.5) | (0.3) | (5.5%) | (0.52) |
| Taxes on int. trade | 0.8 | 0.7 | 0.8 | 1.2 | 0.9 | 1.0 | 1.5 | 2.5 | 1.6 | 1.3 | 1.0 | 17.9% | 1.63 |
| Other taxes /b | | -- | -- | -- | 0.3 | 2.3 | 2.0 | 3.4 | 1.9 | 1.9 | 1.3 | 14.1% | 3.95 |
| Nontax revenue/e | 0.8 | 0.9 | 0.8 | 0.7 | 0.8 | 1.1 | 1.2 | 1.1 | 2.1 | 2.3 | 1.6 | 23.8% | 1.89 |
| Memo items: | | | | | | | | | | | | | |
| Extrabud. receipts: | | | | | | | | | | | | | |
| - of government | -- | -- | -- | -- | 0.8 | 0.9 | 0.8 | 0.6 | 0.5 | 0.3 | -- | -- | n.a. |
| - of public agencies /c | -- | -- | -- | -- | 2.5 | 2.9 | 2.9 | 3.3 | 3.1 | 3.6 | -- | -- | n.a. |
| Profit remittances | (18.9) | (17.5) | (16.4) | (15.6) | (13.3) | (11.8) | (10.1) | (0.5) | (0.4) | (0.4) | (0.4) | -- | n.a. |

/a Consolidated central, provincial and local governments. Data on disaggregated basis for 1988 actual revenues was not available. 1988 total revenue (actuals) was Y 281.4 billion, or 19.5% of GNP.
/b Includes taxes on extrabudgetary receipts, on extrabudgetary construction, and wage bonus tax.
/c Excludes enterprise retained earnings and depreciation funds.
/d Includes profit remittances 1978-84.
/e Includes profit remittances 1985-88.
/f Buoyancy calculated as the log linear form of: $T = aY^B + e$. All coefficients significant at 95% or above.

Note: Alternative specifications of some of the buoyancy coefficients were tested:
(i) Sales tax as function of retail sales = (0.8).
(ii) Indirect taxes as function retails sales = (0.8).
(iii) Trade taxes as a function of (x+m) = (1.1).
(iv) Agriculture tax as a function of GVAO = (0.4).
(v) Enterprise profits as a function of GVIO: (0.6) and not significant.

Source: Ministry of Finance. (Note: Adjusted according to GFS format, which differs from Chinese budget).

## Box 1.1: RECASTING THE CHINESE BUDGET

The Chinese State Budget consolidates the budgets of the central and local governments. Local government refers to all governments below the national level. Thus, provinces, municipalities, counties and townships are included. The state budget excludes the financial operations of state enterprises, as well as the so-called extrabudgetary funds.

The presentation of budgetary accounts in China differs from that found in most other countries.1/ Among the major differences are that: (i) revenue in the Chinese definition includes all proceeds from domestic borrowing (treasury bill issues and domestic bank financing) as well as foreign loan proceeds, whereas these are more typically classified as domestic and foreign financing; (ii) similarly, principal repayments on these borrowings are included as a form of expenditure rather than as a negative financing item; (iii) operating losses of state industrial enterprises are netted out of gross profits, (as were, until 1987, operating losses of commercial enterprises arising from the various subsidies for daily living necessities and agriculture inputs) thus including subsidies to state enterprises in revenue (as a negative revenue) rather than as an expenditure item; (iv) the failure to include some 3% of government (extrabudgetary) expenditures in the budget; and finally; (v) balances unspent in previous years (surpluses) may be spent, and are included in expenditures, but their drawdown is not shown under (increases in) financing. Cash from the sale of state assets (about which no information is available) is included in "revenues."

The table below provides a summary of the steps required to move from the national presentation of the State Budget in China to a definition closer to that found in the other countries. The exercise is instructive because it shows that, for the 1987 budget, China's deficit, shown in official statistics as being in the order of Y 8 billion, is in fact closer to Y 32 billion, or more nearly 2.7% of GNP than 0.7% of GNP.

There are five principal adjustments required:

(i) First, it is necessary to recognize subsidies explicitly (whether to cover the price differential between the procurement price of grain and its retail price (this has been done in the Chinese budget since 1987), or the operating losses of industrial enterprises) as expenditure. Since in the Chinese definition of revenues, such subsidies have been netted out from gross profit remittances, to include them explicitly as expenditure, these subsidies must be added both to revenue and expenditure.

(ii) Second, domestic and foreign borrowing must be subtracted from the Chinese measure of revenue and placed "below the line" as a financing item.

---

1/ IMF, A Manual on Government Finance Statistics, (Washington, D.C., June 1974).

(iii) Third, foreign and domestic loan repayments (amortization) must be subtracted from the Chinese definition of expenditure, and placed "below the line", as a reduction in financing.

(iv) Finally, to present a complete picture of the magnitude of public sector financial operations, the official budgetary tables should be adjusted for extrabudgetary transactions. While it is difficult to estimate either the precise magnitude of extrabudgetary expenditure, the overall financial balance on extrabudgetary accounts, or even the characteristics of the sources and uses of such funds, at the very least, the off-budget funds of local governments should be included. These are thought to constitute almost 3% of consolidated "unadjusted" budgetary expenditure. Therefore, budgetary expenditure accounts (and financing items) have been adjusted by an estimated Y 8 billion in 1988 of known extrabudgetary expenditure. The financing by "key construction bonds" is also included below the line as financing items.

(v) The drawdown of past surpluses, which in the budget is included as an expenditure item, should also be shown as an "addition to financing." The item is shown, but no data is provided.

In addition, and looking beyond the budget and extrabudgetary funds, there is the hidden "quasi-fiscal" deficit in the form of bad loans in the portfolios of state-owned banks and of subsidies to enterprises in the form of low interest rate loans. This is a very important point in assessing the stance of fiscal policies in a broader context. While precise quantitative estimates are difficult, it seems clear that the banking system is partly used as a fiscal agent, and that fiscal expenditures are underestimated in the published budget to the extent that loans are extended to support ailing enterprises. Estimates suggest that this "quasi-fiscal deficit" could be of the same order of magnitude as the deficit itself, and that together they amount to some 5-6% of GNP.2/

---

2/ See Bosworth, Barry, "Notes on Visit to Beijing", October, 1988.

Box Table : CHINA: REDEFINITION OF CHINESE STATE BUDGETARY OPERATIONS
(in billions of yuan)

| | | 1988 (Budget) |
|---|---|---|
| Total revenue: Chinese definition | | 255.5 |
| Less: | - foreign loan receipts | 12.8 |
| | - domestic loan receipts | -- |
| | - Treasury bond receipts | 9.0 |
| | - cash from sale of state assets | -- |
| Plus: | - subsidies for living necessities and ag. inputs | -- |
| | - operating losses of state-owned industrial enterprises | 40.7 |
| Equals: | Total revenue: recast format | 274.4 |
| Total expenditure: Chinese definition | | 263.5 |
| Less: | - foreign loan repayments | 4.5 |
| | - domestic loan repayments | -- |
| | - treasury bond repayments | 2.7 |
| Plus: | - subsidies for peoples' living necessities and ag. inputs | -- |
| | - operating losses of state-owned industrial enterprises | 40.7 |
| | - extrabudgetary capital construction | 8.0 |
| | - "past surpluses" a/ | -- |
| Equals: | Total expenditure: recast format | 305.0 |
| Overall deficit (-): Chinese definition | | -8.0 |
| Less: | - foreign loans received | 12.8 |
| | - Treasury bonds | 9.0 |
| | - "key construction bonds" issued | 8.0 |
| | - draw down of past surpluses a/ | -- |
| | - receipts from sale of state assets a/ | -- |
| Plus | - loan repayments (foreign) | 4.5 |
| | - loan repayments (domestic) | -- |
| | - loan repayments (treasury bond) | 2.7 |
| Adjusted overall deficit (-): recast format | | -30.1 |

/a No data available.

1.21 Since the mid-1980s, indirect taxes have been by far the most important revenue source, accounting for about half of total government revenue. However, while revenue growth from indirect taxes has been 12% over the ten year period, revenue as a percentage of GNP has decreased from just over 11% in 1978 to 9.0% budgetted in 1988. The policy of phasing out the product tax and replacing it with VAT is reflected in the respective growth rates of product tax (-2.7%) and VAT (31.7%). Revenue from the agricultural tax is low and has grown slowly, at about 5% p.a., and has declined as a percentage of GNP since the late 1970s. Behind this lies a political decision to maintain a minimal tax burden on agriculture with low tax rates intended to stimulate agricultural output. Poor tax administration has also played a part.7/

1.22 Trade taxes on imports and exports have exhibited the highest growth, at over 14% p.a. However, despite the rapid expansion of foreign trade and the greater openness of the economy, revenue from international trade taxes (essentially on imports) has been falling as a share of GNP since the mid-1980s. This has largely been the result of a shift in the composition of imports from higher-taxed consumer goods to lower-taxed raw materials and intermediate goods and a tendency to provide tax relief on customs duties in some contracts. Nontax revenues (which included until recently profit remittances from financial institutions) account for some 6-8% of total revenue.

1.23 In addition to tax and nontax budgetary revenues, the government receives so-called "extrabudgetary revenues" consisting of receipts of local governments and government institutions. Local surcharges on the general sales tax and other taxes and fees provide the bulk of extrabudgetary revenue for local governments. Other sources include rental income from public housing and charges for the use of parks and public health facilities. Taken together, these extrabudgetary revenues of government have not grown and have fallen from 0.9% of GNP in 1982 to 0.3% in 1987. Government agencies also collect revenues not reflected in the budget. Their "extrabudgetary revenues" account for about 3.5% of GNP.8/

1.24 Trends in Expenditures. The economic reforms had a profound impact on total budgetary expenditures, which as a ratio of GNP have declined from 34% in 1978 to an estimated 22% in the 1988 budget. Overall, expenditures have grown 9.6% per annum over the post-reform period from 1979 to 1988 and government revenues have grown 8.3%, making the decline in the expenditure/GDP ratio much less rapid than the decline in the revenue/GDP ratio. Table 1.4 outlines these trends. A major factor in the decline has been the declining

---

7/ The agriculture tax is classified as an indirect tax as it is levied on gross output.

8/ There are three types of extrabudgetary revenues: retained earnings and depreciation funds of enterprises (Y 162 billion in 1987); revenues of government agencies (Y 35 billion); and extrabudgetary revenues of the government (Y 4.5 billion). Only the latter two of these is referred to in the this para. About 80% of extrabudgetary revenues are accounted for by the first type, and 17% and 3% respectively by each of the latter.

## Box 1.2: THE CONTRACTING SYSTEM

The objective of the contract system has been to improve enterprise performance by strengthening financial responsibility, emphasizing profitability, and giving enterprises greater autonomy in decisionmaking. Though the specific nature of each contract differs in its detail, the system essentially revolves around an agreement between the management of the enterprise and its owner, that is, the central or local government or industrial bureau. The management contract covers a period ranging from 1 to 5 years and typically stipulates a minimum amount of profit to be realized and/or taxes to be paid each year to the Government. Indirect taxes, including customs duties, may or may not be included in the contract. Firms that fail to meet their minimum profit or tax objective may be forced to pay their tax obligation from "self-owned funds", that is, their past retained earnings. Four major types of contracts are in common use, designed in accordance with the size of the enterprise and its economic form:

(a) An "Enterprise Management Responsibility System" (EMRS) applies to medium- and large-scale state enterprises and calls for the enterprise manager to meet an agreed profit target for a specified number of years. The first year profit target is set at the same level of profits earned in the year prior to the implementation of the system, ensuring that the Government's tax revenues (55% of the agreed target profit) do not fall short of the level attained before the system was instituted. For subsequent years, the profit target may be raised incrementally, and any above-target profits earned are taxed at a lower, sometimes as low as 3% tax rate. Indirect taxes are sometimes included in the contract, with sales over a particular level exempted.

(b) A "Contract Management Responsibility System" (CMRS) is in use for about 60-70% of all medium- and large-scale enterprises, but is slightly different from the EMRS in that it operates on the principle of target tax remittance rather than target profits. In one variant, the enterprise manager contracts to remit a certain tax quota to the government supervisory unit which is increased annually, usually by 7%. No additional taxes are levied and above-quota profits are allowed to accrue in full to the enterprise. In another variant, the enterprise hands over a fixed direct and indirect tax quota each year, with the above quota profits accruing to the enterprise.

(c) The "Asset Management Responsibility System" (AMRS) variant of the contracting system puts the management of the enterprise up for bid, with managers indicating their estimate of the profits which they can achieve over the duration of the contract. Taxes under this variant are usually levied on the actual level of income earned in the period, with no remission of indirect or other taxes. This procedure can be used to value the enterprise: by taking the discounted value of the bid earnings stream (using as the discount rate, the interest rate on bank deposits) a value of enterprise net worth can be assessed.

(d) "The Leasing Arrangement System" applies mostly to small enterprises in the services sector. The enterprise manager commits to pay an agreed leasing fee, which usually comes out of after tax profits and the lease is secured by a mortgage on some personal assets of the lessee. In general, the lessee and employees are entitled to determine the disposition of the full residual income left over after payment of the appropriate level of taxes and the leasing fee.

From the point of view of taxation, generally, leasing and the AMRS do not allow remission of taxes, while the CMRS tends to undermine the tax system. The EMRS occupies an intermediate position.

An illustration of a typical EMRS contract's effect on an enterprise's and its decreasing tax rate is given by the Beijing Broadcast Equipment Industrial Corporation. The enterprise's 1986 profits were Y 10.6 billion and its contract stipulates a minimum of Y 10.6 billion in profits after 1986 to be taxed at 55%. This guarantees an income tax revenue to the government of Y 5.8 billion. Any excess of profit over Y 10.6 billion will be taxed at the rate of 27.5%, thereby reducing the marginal tax rate by half. Assuming profit growth of 20% per annum, the effective average tax rate is 46% in 1987, 39% in 1988, 32% in 1989, and 28% in 1990.

TAX CONTRACTS: EFFECTIVE TAX RATES

| Year | Profits Y | Base tax Y | Above quota profits Y | Tax on above quota profits Y | Total tax Y | Effective average tax rate (%) % |
|---|---|---|---|---|---|---|
| 1986 | 10.6 | 5.8 | - | - | 5.8 | 55.0 |
| 1987 | 12.7 | 5.8 | 2.1 | .06 | 5.86 | 46.1 |
| 1988 | 15.2 | 5.8 | 4.6 | .14 | 5.94 | 39.0 |
| 1989 | 18.3 | 5.8 | 7.7 | .23 | 6.03 | 32.9 |
| 1990 | 21.9 | 5.8 | 11.4 | .34 | 6.14 | 28.0 |

defense expenditures to GDP ratio, which fell from 4.6% in 1978 to 1.7% in 1988. Nondefense expenditures have grown more rapidly than total expenditures and have therefore not fallen as rapidly as a share of GDP as total expenditures, declining from 29.2% of GDP in 1978 to 20.3% of GDP in 1988. Within total expenditures, current expenditures grew far more rapidly, almost 13% p.a., than capital expenditures, which grew only 3.9% p.a. As a result, current expenditures as a share of total budget expenditures increased from 57% of total expenditures in 1978 to an estimated 74% of expenditures in the 1988 Budget.

1.25 The increase in current expenditures was mainly caused by subsidies which grew at more than twice the rate of total expenditures. Subsidies have increased from 9% of total expenditures in 1978 to 25% in 1988, and from 16% to 34% of current expenditure over the same period. To some extent, this increase can be linked to the reform process, and pressures to protect urban consumers from price shifts in the absence of wage reform. Of the three major subsidy categories, subsidies to cover losses of state-owned enterprises have increased most sharply, in particular since 1985, owing to losses of an increasing number of state-owned enterprises. Subsidies for daily living necessities have also risen sharply, especially since 1987, when the Government began to compensate urban consumers for increases in official procurement prices. "Culture, education and health" expenditures growing at 15% are also contributing to increased current expenditures. Major factors behind the latter increase are expanded college enrollment, vocational training, and the introduction of 9-year compulsory education. Since the beginning of the reform process, the shares of defense and economic services expenditures have decreased, from a peak of about 14% of total expenditures in 1978 in each case, to 7% and 9% respectively in the 1988 Budget. Reduced spending on economic services was mainly a consequence of the reduced role of government in providing working capital to state enterprises, now increasingly provided through the banking system.

1.26 Capital expenditures have grown at only 3.9%, and the share of capital expenditures in the budget therefore fell sharply, from 44% in 1978 to an estimated 26% in the 1988 budget. In terms of GNP, capital expenditures have fallen from 14.7% in 1978 to 5.6% in 1988. This decline occurred mainly as a result of reduced budgetary financing of state enterprises' capital investment (and consequent increased reliance by enterprises on their own retained earnings and domestic and foreign bank loans). At this stage in the reforms, budget sources finance less than 37% of total state sector fixed investment, compared to 79% in 1978. This decline in budget-financed capital expenditures goes along with profit retention permitting enterprises to keep a larger share of their earnings.

1.27 Developments in the Budget Deficit. In the initial years of the reforms, the budget was characterized by large deficits, as a result of the combination of enterprise profit retention, large consumer subsidies, and ambitious investment plans. A reduction of capital outlays relative to GNP and a decline in subsidies for daily necessities then narrowed the deficit. But since 1985 the deficit has been rising and is expected to be 2.2% of GNP in the 1988 budget (See Table 1.6). On the revenue side there is the slow growth of tax revenues whose causes were discussed previously. On the expenditure side, the main reasons are the growth in subsidies to loss-making enterprises and difficulties curtailing nondefense expenditures, especially capital outlays, due to pressing needs for investment in basic infrastructure, energy, and transport development.

Table 1.5: CHINA: STRUCTURE OF CONSOLIDATED GOVERNMENT EXPENDITURE, 1978-88 /a
(in % of total expenditure)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 budget | Nominal % growth 1978-88 | Real % growth 1978-88 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Total expenditure (% of GNP) | 33.8 | 37.3 | 33.7 | 31.2 | 29.4 | 30.0 | 26.7 | 28.0 | 27.9 | 25.8 | 21.1/a | 9.6% | 4.4% |
| Nondefense expenditures (% of GNP) | 29.2 | 31.6 | 29.2 | 27.6 | 25.9 | 26.9 | 26.0 | 25.7 | 26.0 | 23.9 | 19.4 | | |
| Capital expenditures (% of GNP) | 14.7 | 15.4 | 10.9 | 8.0 | 7.9 | 7.6 | 8.2 | 7.7 | 8.0 | 7.0 | 5.4 | 3.9 | -1.0 |
| Current Expenditure % of total | 56.5 | 58.7 | 67.7 | 74.2 | 76.3 | 74.8 | 71.2 | 72.3 | 71.3 | 73.3 | 74.4 | 12.6% | 7.3% |
| Administrative | 4.0 | 3.9 | 4.6 | 4.9 | 5.5 | 6.0 | 7.1 | 6.2 | 6.4 | 6.4 | 5.9 | 14.0% | 8.6% |
| Defense | 13.7 | 15.2 | 13.3 | 11.6 | 11.9 | 10.5 | 9.3 | 8.3 | 7.7 | 7.5 | 7.0 | 2.5% | -2.4% |
| Culture, educ. health | 9.2 | 9.0 | 10.7 | 11.8 | 13.3 | 13.2 | 13.6 | 13.6 | 14.5 | 14.4 | 14.7 | 14.7% | 9.3% |
| Economic services | 14.6 | 12.7 | 13.1 | 11.6 | 11.9 | 11.1 | 10.5 | 9.6 | 9.5 | 9.1 | 9.1 | 4.5% | -0.4% |
| Subsidies: | 9.3 | 13.3 | 18.7 | 25.6 | 25.1 | 25.1 | 21.1 | 21.8 | 21.5 | 23.8 | 25.1 | 21.0% | 15.2% |
| Daily necessities | (6.4) | (10.9) | (16.4) | (21.1) | (20.2) | (18.3) | (16.2) | (13.5) | (9.2) | (10.4) | (11.7) | (16.5%) | (10.9%) |
| Agricultural inputs/b | n.a. | n.a. | n.a. | (1.5) | (1.4) | (0.8) | (0.5) | (0.6) | n.a. | n.a. | n.a. | (-12.3%) | (-15.7%) |
| Enterprise losses | (2.9) | (2.4) | (2.3) | (2.9) | (3.5) | (6.1) | (4.4) | (7.7) | (12.3) | (13.3) | (13.3) | (27.4%) | (21.4%) |
| Other | 5.6 | 4.6 | 7.3 | 8.7 | 8.6 | 8.9 | 9.6 | 12.8 | 11.7 | 12.1 | 12.5 | 18.7% | 13.0% |
| Capital expenditure /c | 43.5 | 41.3 | 32.3 | 25.8 | 23.7 | 25.2 | 28.8 | 27.7 | 28.7 | 26.7 | 25.6 | 3.9% | -1.0% |
| Memo Item: Total Exp (RMB) | 122.5 | 146.9 | 146.4 | 144.4 | 148.3 | 169.0 | 193.9 | 232.4 | 262.2 | 281.45 | 305.0 | 9.6% | 4.4% |

/a Totals may not add up to sum of components because of rounding. Data on a disaggregated basis for actual 1988 expenditures were not available. Total expenditures in 1988 were Y 315.6 billion, or 22% of GDP.
/b Not listed separately in 1978-80; since 1986 included in subsidies for enterprise losses.
/c Includes 7 billion of extrabudgetary capital construction (1987) and Y 8 billion in 1988. No figures available in earlier years.

Source: Ministry of Finance. (Adjusted to GFS format.)

1.28 The deficit was mainly financed domestically in the early years of reform, by the People's Bank of China (PBC) and increasingly since 1981 by domestic bank and nonbank borrowing through bond allocations to banks, enterprises and households. Since 1986, foreign borrowing has been an increasing source of finance.

1.29 Although the economy experienced macroeconomic (especially external) imbalances at various times in the post-reform period, it is difficult to trace the cause of these disturbances to the budget deficit. In many countries, uncoordinated tax and expenditure policy, and the excess demand generated by the resulting budget imbalance lead to both price pressures and a balance of payments deterioration, with the relative extent of price and external pressures depending among other things, on the relative importance of tradable and nontradable goods and the manner in which the deficit is financed. The more open the economy--and China's economy until recently was relatively closed--the more likely the external spillover. China's heavy reliance on tariffs and import controls helped contain such pressures and enabled a fixed exchange rate policy to be maintained without pressures on foreign reserves.

1.30 With respect to domestic pressures, the excess demand created by the deficit was not reflected in rising prices, because of the public's apparent willingness to hold money and maintain high savings.9/ Because of the deficit's relatively small size in relation to GDP, the relatively low absolute level of debt, as well as the rapid growth of GNP, domestic financing pressures have been largely absent. With the issuance of Treasury bills in 1981, China, like other countries, had three choices in financing the deficit: borrowing from the public; borrowing from the banking system; and borrowing from the central bank. The financing of the deficit by domestic borrowing from the public and the banking system in most countries would have affected interest rates and investment, increased intermediation spreads and distorted the allocation of credit in the economy. In China, domestic financing was not allowed to push up interest rates which were maintained at low, administered levels, while domestic investment was able to expand thanks to accomodative monetary policy, and was allocated according to plan. Government borrowing from PBC to finance the deficit was not, up to 1986, a major contributor to monetary expansion.

1.31 In 1987 the financing situation changed, with PBC financing 37% of the deficit and accounting for about 40% of reserve money growth. In 1988 PBC was budgeted to finance 26% of a similar sized deficit; however, there was reportedly no PBC financing of overdrafts in the first half of the year, a policy which the government intends to maintain throughout the year, financing the deficit with bonds allocated to the banking system. However, the implications for monetary growth may not be much different than direct PBC financing, especially if specialized banks obtain additional PBC credit to finance their mandatory bond holdings.

1.32 All told, it appears that a deficit on the order of between 2-3% of GNP is modest, especially in view of the fact that this is not a deficit on current account. The problem, if there is one, is not so much with the present size of the deficit, as with the trend. If tax buoyancy is not

---

9/ The Country Economic Memorandum (CHA-7483) discusses the dynamics behind these shifts in savings in Chapter IV: "Investment Behavior and Domestic Resource Availability".

restored, the Government's development initiative that comes from command over a large pool of fiscal resources may be impaired, while a widening of the deficit will also impair stabilization efforts.

Table 1.6: CHINA: ..IE BUDGET AND ITS FINANCING

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 budget | 1988 actual |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | (In billions of yuan) | | | | | | |
| Revenue | 123.3 | 126.3 | 131.6 | 138.6 | 141.2 | 159.4 | 183.5 | 228.3 | 244.3 | 255.7 | 274.7 | 281.4 |
| Expenditure | 122.5 | 146.9 | 146.2 | 144.4 | 148.3 | 169.0 | 193.9 | 232.4 | 262.2 | 281.4 | 305.0 | 315.6 |
| Deficit | 0.8 | -20.6 | -14.6 | -5.8 | -7.1 | -9.6 | -10.5 | -4.1 | -17.9 | -25.7 | -30.3 | -34.2 |
| as % of GNP (%) | 0.2 | -5.2 | -3.3 | -1.3 | -1.4 | -1.7 | -1.6 | -0.5 | -2.2 | -2.6 | -2.2 | -2.4 |
| | | | | | | (As % of total deficit) /a | | | | | | |
| Financing: | | | | | | | | | | | | |
| Domestic: | 125.0 | 82.5 | 84.9 | 44.8 | 102.8 | 88.5 | 82.9 | 97.6 | 70.4 | 75.5 | 72.9 | n.a. |
| PBC | (125.0) | (82.5) | (84.9) | (-39.7) | (40.8) | (44.8) | (42.9) | (-51.2) | (39.7) | (37.0) | (26.1) | -- |
| Bank/Nonbank | (--) | (--) | (--) | (84.5) | (62.0) | (43.8) | (40.0) | (148.8) | (30.7) | (38.5) | (46.7) | -- |
| Foreign | -25.0 | 17.5 | 15.1 | 55.2 | -2.8 | 4.3 | 4.5 | -- | 7.0 | 9.6 | 7.8 | -- |

/a Totals may not add up to sum of components because of rounding.

Source: Ministry of Finance. (Note: All figures adjusted to GFS basis).

## C. Revenue and Expenditure Issues: the Macroeconomic Perspective

1.33 In China and other socialist economies, unlike in market economies, the stabilization aspect of tax policy has not been a major concern. This has been because the major sources of macroeconomic instability--unforeseen changes in investment, consumption and savings--were thought to be controlled in large measure by planners. However, as decision-making is decentralized and as submerged disequilibria emerge in the course of reforms, the socialist economy will also need to address macro imbalances. In the post-reform Chinese economy therefore, consideration needs to be given to the stabilization aspects of fiscal policy. In the short run, tax policy may not have a significant role to play in demand management. In the longer run, however, the central government needs stronger tax levers to supplement its reliance on administrative cutbacks in state investment expenditure as the primary fiscal tool. A stronger fiscal tool should not be construed as calling for a larger government role nor a higher level of taxes. Rather it suggests a set of revenue instruments sufficient for the government's revenue needs (these are likely to change in the course of reforms), which promotes its objectives of economic stability and growth.

1.34 From a macroeconomic point of view, and at a time when expenditure trends are difficult to predict, the reduced flexibility over tax policy emerging as a result of contracting and the decentralization of fiscal arrangements represent potentially worrisome developments. At the same time, the growth in extrabudgetary funds has made it difficult to ascertain the effective fiscal stance of the government and concern over inflation has led to hesitancy over further price (and tax) reforms. In this section, these issues are in turn discussed.

1.35 Contracting. The contract system was designed to stimulate enterprise production and investment. It will in the longer run result in an expansion of the tax base to the extent it is successful in promoting the growth and efficiency. However, even where the contracts are successful in stimulating output and efficiency, the "supply-side response" which is sought through these contracts may not materialize in the same years that revenue remission is granted, so that the authorities must coordinate revenue and expenditure policy.

1.36 Many forms of the contracting system, especially those that allow enterprises to retain a larger fraction of total profits when output and profits expand, (such as the CMRS--see again Box 1.2) impart an elasticity of less than unity to the enterprise profits tax, thereby reducing the proportion of total profits transferred to the Government, and reducing the average tax/GDP ratio. Contracts designed with a decreasing average enterprise tax rate introduce a strong pro-cyclical aggregate demand element into tax policy. As production, profits and the economy grow, relatively more resources are kept by the enterprises to further increase demand.10/ In contrast with other countries where the tax system is structured so as to restrain aggregate demand when the economy grows excessively rapidly, the stabilization effects of contracting in China could be said to be perverse. This would be less serious if, as noted earlier, the authorities had other effective macroeconomic instruments to control aggregate demand.

1.37 The contracting system in its widely applied CMRS version has also reduced the central government's flexibility to introduce new tax policies in a timely manner. This occurs because tax contracts--fixed for up to 5 years--set a nominal revenue level. Even if the contract itself were fixed for a shorter period (this could be undesirable in that it would increase uncertainty for enterprises), the fact is that most contracts are negotiated by the provincial and local governments which have no macroeconomic responsibilities, and which therefore pursue industrial, not stabilization objectives.

1.38 In the context of the present overheated economy, and especially because monetary instruments remain less than fully effective, the central government is vulnerable in this loss of control over fiscal policy. The government should refine the present tax contracting system, by building on its strengths while eliminating its weaknesses. The reform of tax contracting

10/ It could be said that these demand pressures exist whether the profits are reinvested or paid out as wages.

would seek to preserve those aspects serving microeconomic efficiency enhancing objectives. Chapter II offers an approach to the refinement of the contracting system. As old contracts expire, future contracting would be limited to sharing of after-tax profits only. This would be akin to the payment of a "dividend" to the unit of government owning the enterprise. This would be appropriate because some part of the enterprise after tax profits derive from equity, provided hitherto at no cost, by the government.11/ By limiting the contract to after-tax earnings, an important distinction of the government's two roles--as owner and as fiscal authority--would be achieved.

1.39 Decentralization. Fiscal decentralization has been a second factor affecting the control of the central government over tax policy for macroeconomic objectives. In China, the delegation to local governments of responsibility for tax administration, in the absence of effective central oversight, has put local governments in the position of setting tax policy and effective tax rates, through their authority to grant tax relief within their jurisdictions. This effectively severs the link between tax policy set at the central level, and the actual incentive effects of tax policy at the local level.

1.40 Moreover, because local authorities have an interest in stimulating economic activities within their territory, there are strong forces at work in the decentralized fiscal system against collecting tax revenues, particularly those that must be shared with the Center at a high rate, and in favor of keeping resources in the hands of locally owned enterprises through generous local tax exemptions. In this way, resources remain under local government jurisdiction which local authorities can tap through "voluntary" contributions that would not be shared with the central government. Thus, while the effective "tax burden" of the enterprise is not reduced, budgetary revenue of the central government is eroding.12/ While the quota arrangement can--if the above-quota share is low--provide increased local government incentives to collect revenue and improve tax effort, it does not eliminate the potential conflict of interest between local and central governments, and by locking in a base revenue level, deprives the central government of a flexible revenue source.

1.41 Like enterprise contracting, the quota arrangement introduces a procyclical bias to the fiscal system. This occurs because the revenue received by the central government under the "fixed remittance" quota system remains relatively constant regardless of the underlying growth of economic activity.

---

11/ The amount of after-tax profits which should be paid to the government (i.e., the after-tax contract share) is a complex matter and not dealt with in this report. The amount would depend, inter alia, on the value of the government's equity, risk, etc.

12/ This approach also undermines the ability of the Government to conduct any sort of consistent national industrial policy. As observed in an earlier Bank report on state enterprise management (op. cit), the sharing arrangement on the enterprise income tax is also inimical to interprovincial mergers between enterprises. (See Kochav; D. China: Enterprise Management Report: Issues and Options;" October 18, 1988 (AS3).)

Economic growth and activity affects only the revenues realized by the local governments (which feel the full fiscal impact of booms and busts). However since local governments do not have demand management responsibilities, they are likely to increase their spending when a booming economy produces higher revenues, and will not, as might the central government, try to dampen aggregate demand. In addition, the small above-quota revenue transfer that many contracts involve, and the fact that most are fixed in nominal terms have left an increased share of fiscal resources in the hands of local governments. This reduces the growth, and potentially the real volume, of resources in the hands of central government, a feature which as noted in Chapter III, must be coordinated with the respective expenditure responsibilities of the two levels of government.

1.42 The reforms appear also to have substantially changed the balance of revenues accruing to the central and local governments. Many indicators suggest that the revenue sharing system has led to a shift in favor of the provinces, which now retain a larger fraction of the revenues which they collect. While this too is in line with the spirit of reforms and the decentralization of expenditures to the lower levels of government, the failure to achieve corresponding reductions in the central government's expenditures has led to budgetary pressures.

1.43 The Chinese government must weigh the benefits of decentralization against the cost of having less capacity for central management and direction over tax policy. In order to gain more central management of revenue, expenditures, and stabilization policy, it will be necessary to reduce local governments' discretion over tax relief and monitor their tax administration. The status quo with regard to central and local finances appears untenable in the long run, and mechanisms need to be developed--some combination of new taxes for local governments, a reassignment of existing taxes or a different sharing of tax bases--to serve better both central and local interests. This is further discussed in Chapter III.

1.44 Finally, China's decentralized system of tax administration and collection weakens the effectiveness of the tax system as a tool for macroeconomic (or microeconomic) management. The decentralization of administration has left the government critically bereft of information about how the tax system actually works at the grass roots level. This means that the link between tax policy at the central level and the actual incentive effects of tax policy at the local level is severed. The "tax levers" the central government designs may be a far cry from the fiscal measures which are actually implemented, leaving the central government significantly weakened in its use of a fiscal policy instrument. These issues are further discussed in Chapter IV.

1.45 Expenditure Issues. The uncertainty about details and timing of ongoing and planned reforms make the future development of government expenditures difficult to predict. This is so not least because the government's decisions on how to respond to shifting distributional patterns following the reforms will themselves be important factors in determining the outcome. Likewise, one cannot place too much reliance on a cross-country analysis to gauge the future level of expenditures, because, in China, many economic and social functions which are usually the responsibility of the government, are now still carried out by enterprises. Much will depend on how many more responsibilities (such as investment financing) the government will relinquish to enterprises, and on whether and how soon the government will be pressured to take over new functions in the social area from enterprises. In this respect, the social security, housing and pension reforms should be designed from the outset with their budgetary costs in mind. If such precautions are not taken, it will be necessary to raise additional funds via the tax system to meet the higher expenditures.13/

1.46 Possible demands for government subsidy to such "social support systems" highlight a key feature of the reform process. Reforms of necessity will create gainers and losers. The government, in seeking to blunt the impact of reforms on e.g. workers, enterprises, or urban residents affected by the transition, could possibly blunt the intended objectives of the reforms. Subsidies can insulate economic agents from such changes and neutralize the reform signals. Subsidy policy is therefore a concern, quite apart from its impact on the budgetary accounts. There are in addition severe risks to permitting the budget to respond to these demands for subsidies because of the higher expenditure they will call for and the authorities should strongly resist these pressures. Many countries have found it difficult to phase out acquired "rights" to subsidies, even when such subsidies are clearly inappropriate. The choices the government faces, in this respect, will not be easy.

1.47 Extrabudgetary Revenues and Expenditures. In addition to resources from the budget, the Chinese government receives extrabudgetary revenues including the receipts of government units and government agencies that are not presently part of, and not consolidated with, the state budget. Extrabudgetary revenues of the government qua government were about Y 4.5 billion in 1987, or about 2-3% of total budgetary revenue and 0.5% of GNP (see Table 1.4 and footnote 8). These amounted to about 3.6% of GNP. These revenues give rise to a number of concerns. First, to conduct fiscal policy effectively the government must have a true picture of its resources and the impact of the budget on the economy. Extrabudgetary and off-budget accounts and nonstandard presentation of accounts in China make managing fiscal policy through the budget misleading. Improvements in the Chinese presentation of budgetary accounts mentioned in Box 1.1 would show, for example, that the accounting practice of including past surpluses in "revenues" to finance incremental expenditures adds to the deficit and is expansionary, (or that financing expenditures with "revenues" acquired through sales of the state-owned housing stock are also deficit enhancing). Thus, the recasting of the budget to include off budget and extrabudgetary items undertaken in Box 1.1 shows the deficit to be more nearly 2.3% of GDP than 0.5%, in 1988.

1.48 Second, consolidated extrabudgetary and budgetary accounts would better reflect the true tax burden on enterprises, the economy's resource transfer to the government, as well as the government's financing needs. The

---

13/ Two Bank studies are planned for FY89 which will examine the reforms in social security and housing and make recommendations as to their scope and financing.

present magnitude of the extrabudgetary revenues of government agencies helps to lend support to the allegation that while the accrual of formal taxes to the government has fallen, the actual burden of taxes together with these extrabudgetary charges on enterprises has not decreased, and that there may even be a significantly increased tax burden on enterprises. Indeed, at present levels, the extrabudgetary revenues accruing to government agencies are equivalent to an increase in the enterprise income tax rate from its present effective rate of about 49% to a rate more nearly 67%.14/

1.49 Tax Reform and Budgetary Correction. Rising inflationary pressures have highlighted the concern that corrective budgetary measures and the tax changes they could involve will add to costs as enterprises attempt to shift these forward to prices. This may create cost-push pressures throughout the economy, pressures which may be seen as enhancing rather than containing the inflation process.15/

1.50 A distinction between the price-level effects and the demand dampening anti-inflationary consequences of taxation must be drawn. Inflation is a continuous process arising from a steady pressure of aggregate demand over the available resources that may be rooted in or be compounded by a fiscal deficit and its financing. Fiscal measures aimed at reducing the budgetary gap, to the extent they significantly and permanently reduce the budget deficit, will reduce the continuous pressure on aggregate demand, with a consequent reduction in inflation. If in addition, fiscal reforms enhance efficiency and provide incentives to increase productivity--a major objective of tax reform in China--aggregate supply will be increased, further reducing inflation.

1.51 The distinction which should be drawn therefore is between constant and permanent upward pressure on the aggregate price level arising from fiscal imbalance and a once-and-for-all change in relative prices caused by corrective budgetary measures. In China as elsewhere, continuing deficits will exercise a constant pressure on the aggregate price level, and are likely to be inflationary, if not offset by monetary restraint. Tax changes that reduce budgetary imbalances will dampen inflationary pressures, not increase them. Certain tax reform measures, e.g., an increase in VAT rates, will result in a one-time rather than continuous price level increase provided appropriate monetary policies are pursued. This highlights the importance of maintaining the appropriate monetary policy at a time of structural change in China. Likewise, revenue gains must be accompanied by expenditure restraint so that any revenue gains are not offset by expenditure increases.

---

14/ To the extent that the extrabudgetary revenues represent fees and charges for services, they should be considered revenues from user charges, and would not reflect increased drawbacks from enterprises.

15/ Chapter II indicates that for goods sold in free markets, such forward shifting is likely.

## D. Conclusions

1.52 The analysis of budgetary trends suggests there are forces at work in the system that may bring about fiscal pressures. Looking ahead, on the revenue side the Chinese authorities may find it difficult to prevent a continuing decline in the tax/GNP ratio in a system in which taxes are subject to case-by-case negotiation as under the contract responsibility system. The negotiation process is likely to lead to declining effective tax rates since the enterprise will bargain only if it is likely to retain an increasing proportion of profits, that is, if it will do better than under the system of a fixed profit tax. Decentralization of fiscal authority has weakened collection effort. Consequently, unless measures are taken to reestablish the buoyancy of the tax system, the declining trend in revenue will continue. On the expenditure side, the consequences of the ongoing reforms are less clear. The outcome will depend in large measure on government's ability to resist pressures for higher subsidies vs. the rate at which expenditure responsibilities are divested to nongovernment units. An expenditure elasticity of much below unity is, arguably, not unlikely as a longer run estimate.

1.53 As China moves toward a market economy, the need for fiscal policy to play an effective macroeconomic and efficiency promoting role is increasing and therefore the erosion of flexibility and control over tax policy instruments inherent in the present system needs to be addressed. The authorities' objectives of stimulating growth, maintaining stability and enhancing equity can only be achieved by means of a system which is flexible and offers the certainty necessary to allow the tax system to be used as a policy instrument. The Chinese tax system is becoming perilously weak in this respect, and its enhancement as a policy tool for macroeconomic management needs attention.

1.54 This being said, by contrast with other developing countries, China's tax and expenditure system betrays few of the salient weaknesses exhibited by countries where fiscal deficits have been at the root of macroeconomic crisis, inflation, external indebtedness and trade disequilibria. However, it is at the microeconomic level that China's tax policy exhibits significant weakness. There are significant efficiency gains to be had from tax reform; these are reviewed below. The next chapter examines them in more detail.

1.55 China's tax system is complex and highly personalized. A negotiated basis for taxation is increasingly incompatible with China's emerging market system. Since reforms enhance the responsiveness of enterprises to tax incentives, the price signals given by the tax system are of increasing importance. Domestic tax-inclusive prices must be rational if decentralized decision-making is to be efficient. The continued commingling of government roles vis-a-vis the enterprise, exhibited by China's tax system must also be effectively separated. A system which effectively sets tax rates on an enterprise by enterprise basis is costly and increasingly inconsistent with certainty requirements under enterprise reforms, biasing the tax system in favor of random enterprises in an unpredictable way, and encouraging enterprises to focus on tax negotiation, rather than productivity, to produce profits. The profusion of indirect taxes also complicates the rebating of taxes on exports, and with accession to GATT in mind, Chinese officials are rightly concerned. The connection between price, tax and enterprise reform is further pursued in Chapter II.

1.56 In summary, China should not adopt a tax reform merely for revenue raising purposes alone--the most important benefit of a tax reform would come at the level of microeconomic efficiency including the efficiency gains to be derived from broader based taxation of state enterprises at lower rates. Some taxation of growing surpluses in the nonstate sector and the household and agricultural sectors is also essential not only for longer run equity objectives but for perceived fairness and burden sharing. Finally, the efficiency gains from a reduction in bargaining behavior by enterprises, in an environment where taxes are no longer negotiated, should not be underestimated.

# II. REFORMING THE TAX STRUCTURE

## A. Key Features of China's Present Tax System

2.1 China's tax system is a unitary one, meaning that taxes, the tax base and tax rates are determined by the central government and there is no taxing authority other than the central government. The main revenue raising indirect taxes are now the value added tax (VAT), product tax, and business tax. Indirect taxes that raise smaller amounts of revenue include customs duties, Resources Tax, Salt Tax, Urban Construction and Maintenance Tax, Fuel Oil Tax, Housing Tax, Livestock Sales Tax, Market Transaction Tax, Slaughter Tax, Real Estate Tax, and Vehicle and Boat Tax. Direct taxes raising significant revenue are the state enterprise income tax, transportation and energy charge, extrabudgetary construction tax, and collective enterprise income tax. The personal income adjustment tax raises little revenue but, as income rises, can be expected to become a more important component of the direct tax system.

2.2 This chapter examines the main revenue-raising taxes from the perspective of the key role that they play in the overall process of economic reform in China. Section A of this Chapter describes China's tax system as of 1988, while Section B analyzes the impact of the current fiscal regime on the (micro) economic decision-making in the economy. Section C outlines the report's recommendations for tax reform in the areas of indirect taxation, enterprise taxation, and taxation of individual incomes. The revenue and efficiency implications of the tax reforms are considered. A matrix summarizes the tax reform recommendations and highlights the fact that their introduction and sequencing depends on progress made in other areas of reform.

### The Tax System in 1988

#### The Structure of Enterprise Taxation

2.3 Prior to 1978 enterprises remitted all profits to the budget. Experiments with the taxation of state enterprises began in 1978 and involved the substitution of taxation for full profit remittance. Reforms in state enterprise profits distribution had as their main objective the improved efficiency of state enterprises. By 1980, the trial system of profit retention and taxation was being applied to over 6,000 enterprises, representing over 60% of the gross value of industrial output. As a result of these experiments, a system of direct taxation was introduced, implemented in two stages. First, and in parallel with the quota responsibility system of enterprise management, a formal income tax was imposed on all state enterprises, but "profit sharing" continued to be applied to the remaining after-tax profits. The second stage eliminated profit sharing altogether and put full reliance on the income tax, levied at a rate of 55%, for virtually all state enterprises by 1983/4.

2.4 In addition, an "adjustment tax" was imposed on the net after-tax profits of all medium and large state enterprises so that in its initial stages, the system remained similar in substance to profit remittance. The objective was to prevent excessive deviation of enterprise profit margins from their 1983 (prereform) levels. The adjustment tax helped to equalize profitability across enterprises within a sector, since, as noted in Chapter 1, the differential structure of VAT-cum-product taxes could only achieve equalization on an across-sectoral basis, and it was administratively determined for each enterprise on an individualized basis.

2.5 The changes in China's profits tax system were, in this respect, consistent with the changing role of taxation toward a "guidance," as distinct from "command," mechanism. The Chinese system, with its "adjustment tax," was distinctive, but the approach followed that of other socialist economies which, in the course of reform, have also had to adjust the division of profits between the state and the enterprises.

2.6 Direct taxation of enterprises at present varies according to the type of business organization being taxed. The taxes applying to the five main types of business--state enterprises, collective enterprises, individual household enterprises, joint ventures, and foreign enterprises--are described below. Taxation of profits varies according to type and size of the enterprise and, in certain cases, its location. State enterprise are also subject to various levies on after tax-earnings.

2.7 State Enterprise Income Tax. State enterprises are divided into three categories for tax purposes. Large and medium-sized enterprises pay, in principle, a flat tax rate of 55% on their taxable profits. Small enterprises use an eight bracket progressive structure with rates ranging from 10% to 55%. Industrial and commercial enterprises use different tax returns entailing differences in the calculation of taxable income. Enterprises engaged in catering and service trades, profit-making guest houses, restaurants and hotels used to pay a flat profit tax rate of 15%; they are now subject to the small-scale enterprise profits tax. Banks, until mid-1988, remitted most of their profits to the budget; they are now subject to profits remittance tax or a form of the contracting system described in Chapter 1.1/

2.8 Taxable income equals enterprise income minus "allowable business costs." Figure 2.1 shows how the definition of taxable income is reached, and indicates the allowable business costs and taxes which are deductible from income on arriving at the taxable base. Depreciation of fixed assets is an important deductible cost. Before 1985, a "comprehensive depreciation" method was used, where all fixed assets were depreciated at the same straight-line rate. In other words, no distinction was made between buildings, machinery, equipment, and vehicles. After 1985 the method of "categorized" depreciation was introduced on a trial basis with differentiated schedules according to type of asset. Depreciation in China is an actual cash expense, in that it must be paid into a "depreciation fund", maintained at the Industrial and Commercial Bank, where it must be held for a minimum of three years. This makes depreciation different from other countries where it is a noncash deduction from income.

---

1/ Specifially, banks are allowed to retain 7% of their profits; of the remainder 55% is taxed, 45% are remitted. Further details of each of the other types of tax can be found in Appendix Table 3. A complete schedule for the Chinese tax system is provided in Annex I.

**Figure 2.1:** ALLOCATION OF GROSS INCOME

Gross business income
plus other income

minus

Sales Tax
Technology Transfer Tax
Business management fee

minus

Product cost
Other expenses

minus

Interest on debt
Repayment of principal
Depreciation

equals

Taxable income

minus

Income Tax payable
Adjustment Tax for large and medium-sized enterprises

equals

After-tax income

plus

Contribution to depreciation fund

equals

Base for transport and energy charge

minus

Transport and energy use charge

equals

Funds available for Enterprise disposition and allocation of Net Income

(see Figure 2.2)

The depreciation fund is an important component of enterprises' "own funds". Repayment of loan principal (on investment loans) is also an important deductible cost. This allowance has its origins in the grant financing of investment which prevailed until 1981. When grant financing was superseded by loan financing the tax system was then used to accommodate the higher cost to enterprises by allowing full offset of principal repayments from tax.2/

2.9 The Contracting System for State Owned Enterprises. Income taxation of state enterprises can be substantially altered by the tax contracting system. The approach was modelled after the "responsibility system" for agriculture, and is an important instrument of industrial policy. Contracts are signed between the enterprise and the Finance Department and cover items such as profit or tax delivery, investment, innovation, and wage policy. It takes the four broad forms described in Chapter I (Box 1.2). The general idea of tax contracting--from the taxation perspective--is straightforward and in the CMRS variant, applying to some 60-70% of state enterprises, requires an enterprise to deliver a "tax or taxable profit quota," in lieu of income and adjustment tax. As described in Chapter I, the marginal rate on "above quota profits" or above quota taxes can differ across enterprises--some enterprises keep 100% of the excess. The contracted profit or tax amount is determined in various ways, and may be tied to previous year's profits or determined by competitive bidding.

2.10 Some enterprises do not meet the profit contracts specified. In such cases, the shortfall is supposed to be made up out of enterprises "own funds", that is, their accumulated past retained earnings and depreciation funds. In practice, enterprises do not always make up the shortfall. Banks may forgive, or forego payment on loans, and the Finance Department to whom the tax is owed may in certain cases absorb the budgetary shortfall. In addition, enterprises which fail to meet contract targets because of unfavorable price changes can appeal to the Finance Department for revision ex post of the contract, on "objective" grounds. Contracts can also include contracts for agreed losses.

2.11 Both these formal and other less formal adjustments to the contracts appear significantly to reduce the effective rate of income tax from the statutory 55%. Justification for such reduced income tax rates lies in the perceived need to provide tax preferences at the start-up stage, or for an enterprise for whom payment of taxes (direct or indirect) would otherwise mean losses.

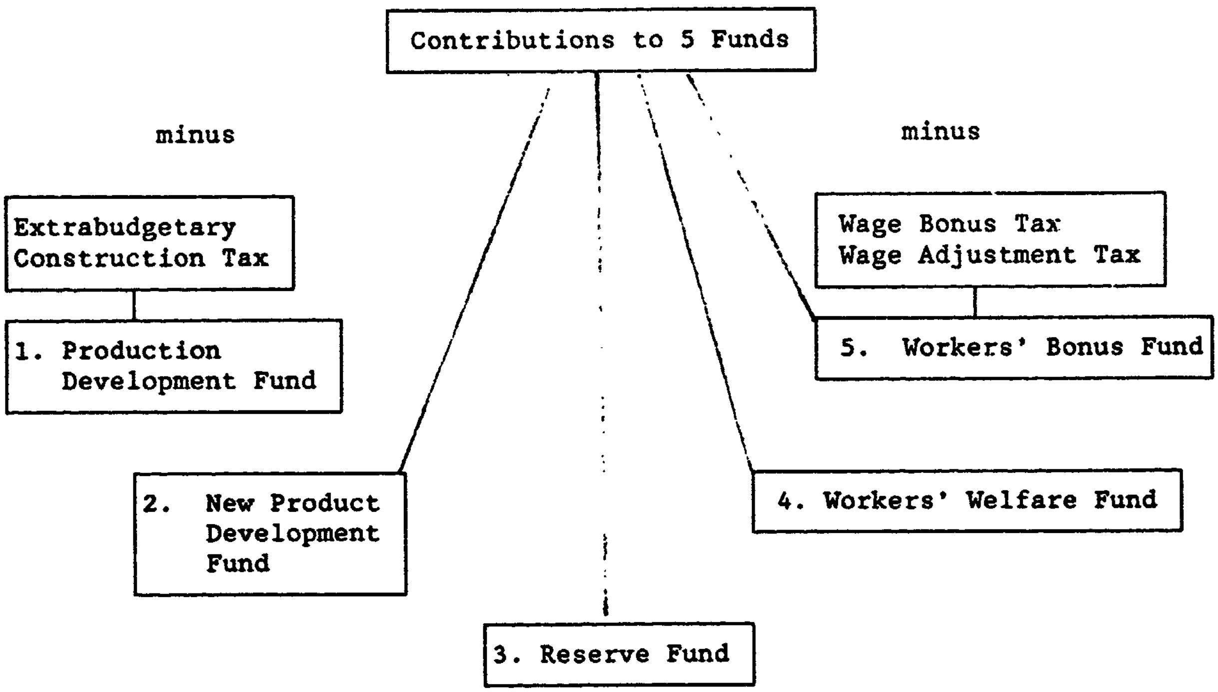
2.12 Adjustment Tax. Large and medium-sized enterprises face the "adjustment" tax that varies from enterprise to enterprise. It is intended to clawback from enterprises that part of their profits which accrue from distorted input and output prices, and unequal capital endowments. To the extent that excess profits arise from the latter it is therefore a proxy for dividends which enterprises endowed with state capital should pay. Although it was intended to be temporary and phased out beginning in 1986, the tax continues to be paid by many large state-owned enterprises not subject to contracts.

---

2/ Since 1987, the phasing out of this provision, beginning with "technical transformation" loans, has been under consideration.

Figure 2.2

Allocation of Net Income



2.13 Energy and Transport Charge (Also sometimes referred to as a fee or tax). Enterprises' earnings after payment of income and adjustment tax, are used to pay a transportation and energy tax or fee of 15% on the sum of after-tax earnings plus depreciation.

2.14 Other Taxes on Net Income. The enterprise's net after-tax earnings are subject to further taxes. To determine the actual taxes due, after tax earnings are divided among five funds: (i) a "new product development fund"; (ii) a "production development fund"; (iii) a reserve fund; (iv) a workers' welfare fund; and (v) a workers' bonus fund (See Figure 2.2). The main requirement is that 60% of after-tax earnings go to the first three funds, while not more than 40% may be paid into workers' welfare funds or bonuses; the actual percentage is usually more.

2.15 The extrabudgetary construction tax is levied at 10% on construction financed by enterprises' retained earnings and undertaken outside the state investment budget (mostly buildings). Certain construction is exempted from this tax, such as in energy and transport facilities, medical facilities, schools, and investments financed by joint ventures and foreign enterprises.

2.16 A progressive bonus tax is applied when bonuses exceed a certain proportion of wages, set at four months wages, in 1988. A progressive wage adjustment tax is also applied to wage increases exceeding a certain rate--7% in 1988. Both taxes are paid from the wage bonus fund, in that the contribution from after-tax earnings into the bonus fund is reduced by the amount of these taxes.

2.17 State Enterprise Income Tax: Small Enterprises. The profits tax on small SOEs is levied according to an 8-stage progressive scale with rates from 10 to 55%. As with all multibracket schedules, the tax rate is applied to each bracket of income separately, i.e. income in the lowest bracket is taxed at the lowest bracket rate of 10%, income of the next bracket is taxed at the next higher rate of 20%; etc.

2.18 The profits taxes on state enterprises are collected by local authorities (typically the county), and accrue in principle, to the level of government which "owns" the enterprise. While all state enterprises in China are, in principle, owned "by the whole people," in practice, this ownership is effected through government units at central, provincial and local levels. Thus, if the enterprise is owned by the central government, the county-level tax authorities will remit such taxes to the central government. If the enterprise is owned by the province, revenues will be remitted directly to the provincial authorities.

2.19 Collective Enterprises Income Tax. This was introduced in 1984. Taxable income equals collective enterprise income minus business costs and indirect taxes. Allowable business costs differ from those for state-owned enterprises. For example, repayment of loan interest and principal, though certain approvals may be required, are in practice deductible expenses for both capital construction and transformation loans, but usually only to the extent of 60%. Income tax is computed from an eight bracket progressive schedule, identical to that on small state enterprises, with rates ranging from 10% to 55%, and start-up tax holidays are common.

2.20 Individual Household Enterprises. The individual household enterprise income tax was introduced in 1986 and is designed to tax the wide and growing range of small private businesses which make up this sector. Individual household enterprises face a ten bracket progressive schedule with rates rising from 7% to 60% on taxable income which equals business income, minus costs and indirect taxes. A surtax of 10% to 40% of the tax liability is imposed on income exceeding Y 50,000.

2.21 Joint Ventures. The joint venture income tax is levied on net income derived by joint ventures, including income from branches inside or outside China. The income tax rate for the foreign partner is a flat 30% with an additional local surtax (on the tax liability) of 10%, bringing the total rate to 33%. A foreign tax credit is allowed for income taxes paid to other countries by joint ventures and their branches. Remitted profits are subject to a 10% levy. Generous tax holidays are provided in the initial years of operation. The Chinese partner is liable for the applicable enterprise income tax.

2.22 Foreign Enterprises. Foreign enterprises are those foreign companies, enterprises and other economic organizations having establishments in China engaged in independent business operation or joint production with Chinese enterprises. Income tax is calculated at progressive rates ranging from 20 to 40%. A local income tax of an additional 10% of taxable income is also levied, bringing the top marginal rate to 50%.

2.23 Resource Tax. The Resource Tax was introduced during the reform of enterprise taxation to equalize profitability between enterprises with different access to natural resources. In principle, all coal, oil, gas and minerals enterprises pay this tax, but in actuality it is applied to enterprises that use coal, oil or natural gas, at different rates for small and large enterprises (and according to collective and ownership). The provision for it to be applied to minerals has not been implemented. The rules currently exempt enterprises with a profit rate (defined as return on sales) below 12%, and tax earnings between 12% and 20% at 50%, those between 20% and 25% at 60%, and profits over 25% at 70%. Because of the volatility in profitability from year to year, the tax is in practice levied at enterprise-specific rates, relating to rate of extraction and resource quality. To the extent that this tax is levied on sales, it can be viewed as an indirect tax.

## The Taxation of Individual Incomes

2.24 The Personal Income Tax. The individual income tax law, introduced first in 1980, applied to both foreigners and Chinese citizens but was mainly designed to tax foreigners. Exemption levels were many times higher than the average Chinese wage. Generally, any individuals residing for one year or more in China are taxed on income gained within or outside China, although those resident for 5 years or less are taxed on foreign source income only if it is remitted. In practice, foreigners not intending to become permanent residents are not taxed on foreign-source income. Following the introduction of the PIAT (see below), this tax applies only to foreigners. Rates are progressive. Dividend or interest payments made abroad are subject to a 20% withholding tax. Dividends and interest received by foreign residents of China are not taxable.

2.25 The Personal Income Adjustment Tax. This new tax parallels the personal income tax described above and was introduced in September 1986 in order to address the growing numbers of Chinese citizens receiving substantial incomes. (In Beijing, 1% of all income earners now pay this tax.) It raises a small amount of revenue now but is expected to grow in importance. The tax is assessed on individuals, rather than households, and no allowance is made for the number of dependants. The tax is computed on a monthly basis with amounts above Y 400 per month taxable; income cannot be averaged between months. Income in kind is, in principle, subject to tax but since this is not administratively feasible, no attempt is made to do so. There are no plans, for example, to tax the cash housing subsidies that are being paid under housing reform or other reforms.

## The Structure of Domestic Indirect Taxation

2.26 Up to 1983 the indirect taxation of enterprises was carried out through the Consolidated Industrial and Commercial Tax (CICT), the precursor of the Product Tax, VAT and Business Tax. This tax, introduced in 1958 and simplified in 1972 was a turnover tax that was applied to industrial production, some agricultural sales, imports, retailing, transport and communications and services.

2.27 The CICT was replaced in 1984 by the Product Tax (a multilevel sales tax on manufactures), VAT, and Business Tax (levied on gross receipts in the service and selected other sectors). The restructuring of taxes on production was a consequence of the change from profit remittance to profit taxation for state-owned enterprises. Under profit remittance, the fact that prices did not reflect costs of production was not very important. However, under profit taxation enterprises kept a certain proportion of their profits, and since the pricing system could generate considerable profit differentials between enterprises, this had consequences for their investment and growth prospects. This inequality could have been reduced by price reform, but instead it was decided to use product taxes to offset the inequities arising from distorted prices. As the price of a good to its purchaser was fixed, an indirect tax could be used to reduce the price received by the producer and thus reduce excess profits. The main consideration in setting product tax rates in 1984 was to equalize profits (as a proportion of sales value) between products, with some modifications to encourage or discourage the production of particular goods. This approach led to a very large (over 260) number of different indirect tax rates. Product tax, VAT and business taxes continue to be the major indirect taxes. The VAT has increased in overall importance (it contributes 26% of all indirect tax revenue), and now covers all but three subsectors of the economy, largely supplanting product tax.

2.28 Product Tax. Product tax is levied on the manufacture and import of certain goods. The tax base is the value of goods sold, valued at the prices paid by the purchasers. Thus, the effective price received by the producer is equal to the purchase price minus the tax. This differs from normal international practice, where tax is expressed as a percentage of the producer price and then added to the producer price in order to determine the price paid by the purchaser.3/ This distinction is important in interpreting tax rates. To take an example, the tax rate on tobacco products is 60%, meaning that for every Y 100 paid by purchasers, Y 60 is paid in tax and Y 40 is kept by the producer. The tax paid is, therefore, 150% of the producer price and a 60% product tax rate translates into a sales tax rate (normally defined) of 150%.

2.29 The substantial variation in product tax rates is due to the use of the tax system to offset the effects of distorted prices and constitutes a major difference between the Chinese tax system of indirect taxes and the systems in use in other countries. Appendix Table 3 illustrates the range of rates which range from 3% to 60%. Notwithstanding this difference, the structure of rates shows certain similarities with international practice, with the application of especially high rates to tobacco and alcoholic beverages and gasoline. Taxes on these three groups of products raised 27% of total product tax revenue in 1986.4/

2.30 Value Added Tax. The Value Added Tax (VAT) is gradually replacing Product Tax as the major tax on manufacturing and imports. The replacement is carried out in such a way that while both taxes together cover all manufactureed goods, no product is simultaneously liable to both. VAT rates have been set on a product-by-product basis, with rates set to yield the same absolute amount of revenue as the Product Tax it replaced.5/ The nominal rates of VAT are correspondingly higher than the product tax rates, to maintain the same absolute level of tax liability and to prevent changes in profits from taking place as a result of the tax shift. This means that there is also a large number of VAT rates. VAT is not applied to agriculture, services, construction, transport, communications or wholesale and retail distribution. Exports are zero-rated in keeping with general international practice.

2.31 As with Product Tax, VAT is applied to the purchase price of a good, not its producer price. The difference from product tax is that under the VAT taxes paid on intermediate inputs into production are presumptively credited. VAT rates range from 12% to 45%. (See Appendix Table 3).

2.32 The coexistence of Product Tax and Value Added Tax is unusual: most countries that have adopted VAT have made a complete switch all at one time. The large number of different VAT rates is also unusual and, as with the

---

3/ The apparent reason for this is that the (controlled) purchaser price is known and fixed and therefore represents a clear benchmark on which to assess the tax.

4/ Calculated from data provided by the GTB.

5/ But see para. 2.78 on the use of taxes for industrial policy and the tax burden on textiles.

Product Tax, arises from the distorted price system. Both of these features of the Chinese tax system cause considerable difficulty in administration.

2.33 In principle, each enterprise should be credited with both the product tax and the VAT that has actually been paid on the intermediate inputs that it has bought. However, in practice, the credit for inputs that have paid Product Tax is made at a composite, or "presumptive" rate of 14%. For some enterprises this composite rate is extended to include all intermediate inputs, including those that have paid VAT. This practice--known as "presumptive crediting"--is administratively attractive when firms purchase a range of inputs that have paid product tax and VAT at different rates or when it is difficult to ascertain the taxes paid at earlier stages, as in China where invoices do not show taxes paid.6/ Thus, the operation of the Chinese VAT differs in several respects from the standard invoice method.

2.34 VAT in China does not allow credit for tax paid on purchases of fixed assets. In other words, the tax is gross-product based in contrast to the more widely used consumption-type VAT, and less widely used income VAT.7/ Exporters of manufactured goods receive rebates of VAT to effect the zero-rating of exports.

2.35 Business Tax. Business Tax replaced that part of the Industrial and Commercial Tax that applied to wholesale and retail distribution, construction, transport and communications and services, including financial services. It is levied as a turnover tax on gross receipts in all nonagricultural sectors apart from wholesale, where it is applied to the gross value of the markup (See Appendix Table 3 for rates). Because of the difficulty that China, like many countries, encounters in dealing with large numbers of small businesses, sales below a certain monthly figure are exempted. Additional exemptions are allowed on a discretionary basis, and some items are subject to half-rates. To facilitate administration, a surcharge is sometimes imposed on wholesalers in lieu of taxation of retailers.

Other Indirect Taxation

2.36 Agriculture tax is levied on agricultural households on the basis of the normal yield of their land. This normal yield is defined in terms of grain valued at the prevailing procurement price and based on the general land quality in the area. The tax rate is set by each province and, in the absence of frequent surveys, underassessment is common. Up to 1983, grain producers typically paid the tax in grain, while nongrain producers paid it in cash. Agricultural households are not liable for Personal Income Adjustment Tax, Individual Enterprise Income Tax, Product Tax, VAT or Business Tax. Because the tax is levied on gross output, it bears no direct relation to income,

---

6/ Presumptive crediting is also administratively attractive as it allows purchasers to credit tax which inputs should but may not have paid, due to the local policy of providing tax preferences and exemptions.

7/ Only Morocco and Finland apply the so-called "gross-product VAT," while only three developing countries apply the "income VAT;" See Tait, op. cit.

except that exemptions can be granted for exceptionally poor households and widows, and during natural disasters. Because the tax is based on normal grain yield, usually assessed based on crop-yields set in the 1950's, it takes no account of the fact that some land is more suitable for growing higher priced crops, such as vegetables. It is also, therefore, not equivalent to a tax on land value. Local government surcharges are levied on the agriculture tax and there is considerable variation between counties in the combined rate. In 1989, a tax on the value of nongrain output; with rates ranging from 10-30% was introduced. Accordingly, high-yield products which encroach on grain farming could be taxed as much as 30%.

2.37 Taxes on Imports. The "open door policy" was initiated in 1979 and a new customs policy was introduced in 1984 to encourage exports and imports of necessities, at the same time as protecting domestic industry and maintaining customs revenue. The new customs duty structure was designed to facilitate imports of major inputs that were not produced domestically, including raw materials, spare parts, fertilizers and equipment. It also protected domestic manufactured goods, especially those for which domestic production was regarded as important. Import duties range from 3% to over 100%, levied as a proportion of their c.i.f. price. Product Tax or VAT (as appropriate) is then applied to the duty-inclusive price of the import. The product tax and VAT rates are the same as for domestic production of the good concerned, and the tax is calculated to be the required proportion of the tax-inclusive price. The symmetric treatment of imports and domestic production accords with international practice. Exemptions from duty are sometimes granted to compensate enterprises for increases in world prices.

2.38 Taxes on Exports. Export duties are levied on the export of a few raw materials (foodstuffs, and more recently silk) where China has some monopoly power. Revenues from these duties amount to no more than 3% of total customs duties or 0.3% of total tax revenues.

## Other Minor Taxes

2.39 There are a number of other taxes that yield small amounts of revenue. Some of them are central government taxes, such as the Salt Tax and the Fuel Oil Tax. Others are purely local taxes, such as the Urban Construction and Maintenance Tax, Livestock Sales Tax, Market Transaction Tax, Slaughter Tax, Real Estate Tax and Vehicle and Boat Tax and Banquet Tax. In addition, there are surcharges on the joint venture income tax, the foreign enterprise income tax, and, as noted earlier, the agriculture tax. These taxes can produce important revenues for local governments but are not, from the overall revenue perspective, significant taxes. Together, they contribute less than 2% of total revenues. These are discussed in detail in Chapter III and Annex II.

## Implicit Indirect Taxes

2.40 The reform of indirect taxation was accompanied by the introduction of the dual pricing system in 1985/86. This allowed enterprises to purchase part of their inputs and sell part of their output at market prices. However, State enterprises must first deliver their plan quota at State list prices before selling output on the free market, and may also buy inputs necessary to fulfill plan targets at list prices. The proportion of consumer goods transacted at list prices has fallen from 97% to 47% over the period 1978-1986. Out of the 53% of transactions in consumer goods not occurring at State list prices, 19% took place at "guidance" prices and the remaining 34% at market prices. For intermediates as a whole, guidance and market prices currently make up about 40% of all sales and that the proportion is increasing.8/ The system of price controls can be seen to be an implicit subsidy to users, financed by an implicit tax on producers. Some illustrative orders of magnitude are presented in the following section.

## B. The Impact of the Current Fiscal Regime

2.41 This section examines the incentive, equity and other effects of the major tax categories in China: indirect (product and VAT) taxes; the enterprise income tax, and the resource tax. The effects of trade and personal income taxes are touched on briefly.

### Indirect Taxes

2.42 At a microeconomic level, taxes affect almost every decision enterprises make. Indirect taxes affect input and output prices faced by enterprises. However, the impact of such price changes on enterprise behavior and the effectiveness of indirect taxation as an indirect lever depends on a number of factors. First, there is the question of how much discretion the enterprise has in choosing output level, output mix and production techniques. Second is the proportion of its output the enterprise sells on the free and controlled markets. If all production choices are imposed by the planning authorities, the incentives offered by the tax or price system are irrelevant. For example, if the bulk of China's foreign trade continues to be determined by planning, the effect of customs duties on foreign trade corporations will be quite limited.

2.43 The evidence from enterprise studies suggests that state enterprises increasingly have the freedom to choose output levels and production techniques and that the change from profit remittance to profit taxation has increased their responsiveness at the margin, to profitability considerations

---

8/ Evidence on the extent of plan vs. market sales is fragmentary; selected data suggests that a large fraction of consumer goods is transacted at market prices, while for some intermediates free market sales are negligible; for intermediates generally, market prices appear to make up over 40% of all sales. See Annex I for the proportion of sales at free and official prices, and an extended discussion of the implications for tax shifting. Turning to individual items, selected data on consumer goods suggests that the proportion of retail sales transacted outside State-owned commercial departments ranged from (5%) for grain to (45%) for television sets in 1987. For universal intermediates, out-of-plan transactions appear to be virtually negligible for electricity and crude petroleum, between 15 and 20% for steel and coal and around 50% for cement.

and tendency towards behavior in accordance with market rules.9/ This is particularly true of sales on the free market. The market economy enhances the responsiveness of State-owned enterprises to tax instruments: inasmuch as State enterprises can sell additional output on the free market, it is the tax (or price) incentive on free market sales which will determine an enterprise's profit-maximizing choice. The incidence and incentives of the tax system therefore will be influenced by the combination of plan and market sales that characterize different sectors of the economy.

2.44 Implicit Subsidies. The system of price controls is an implicit subsidy to users, at the expense of producers. Price controls on final goods subsidize consumers at the expense of the producing industries, while price controls on inputs boost the profitability of consumer goods producing enterprises at the expense of those producing inputs. Since indirect taxes are levied within the overall framework of price controls, taxes and prices must be viewed as an integrated system.

2.45 The subsidy implicit in price controls on final goods can be tentatively calculated as follows: A broad estimate of the subsidy implicit in the difference in market and official prices is represented by the difference between officially reported "urban market prices" and "state list prices." On average, controlled prices were 8% less than prices for market "goods for daily use" and 30% below for "other goods" in 1987.10/ Since about 70% of "daily goods" were sold at state-list prices, under the assumptions above, the average price of all "daily use" goods is lower by 5.6%.11/ For "other goods", 60% of the sales took place at controlled prices 30% below market, so that average prices were lower by 18%. With "daily use goods" accounting for

---

9/ Evidence from enterprise studies suggests that managers "are driven by a desire to increase benefits to enterprise employees... The main avenue for pursuit of these ultimate objectives was increased profits." (quotation from Perkins, op. cit.) See also W. Byrd et. al. Recent Economic Reforms: Studies of two industrial enterprises. (World Bank Staff Working Paper No. 652, 1984) and W. Byrd and G. Tidrick, "Factor Allocation in Chinese Industry," Paper prepared for conference on Chinese enterprise management, Beijing, August 1985. The increase in the 1980s in the proportion of profits that enterprises are allowed to retain for their own use is seen as having contributed to such an orientation on the part of managers. Evidence from such studies also suggests that contracts increasingly call for a choice of production technique to be determined in the context of the contract. This suggests choice of techniques is an important feature in the contracting system, also and that there is some choice of techniques. See Perkins, D., "Reforming China's Economic System," Journal of Economic Literature, June, 1988.

10/ The discussion here focuses on nonagricultural goods only in as much as the analysis of indirect taxes addresses only nonagricultural goods. See Annex I for details.

11/ Seventy percent of these goods are underpriced by 8%; the remaining 30% are not under priced. Therefore the average rate of subsidy would be 5.6%.

approximately 10% of retail sales, while "other goods" account for approximately 36% of retail sales, the effect of controlling these prices on an index of retail prices is approximately 7%.

2.46 Impact on Profitability. The system of price controls and taxes also affects enterprise profits. With output targets specified and plan prices fixed, the State-controlled price system is an implicit tax on producers of goods subject to price control. Faced with these prices (and implicit taxes), the tax authorities then set indirect tax rates in order to generate producer prices (i.e., plan prices less explicit taxes) that allow enterprises to earn "reasonable" profits. This, in turn gives rise to China's sectorally differentiated structure of indirect tax rates. For plan sales, therefore, the differentiated indirect tax structure has no impact on purchaser or user choices; these will be influenced by the administered price system. The effects of indirect taxes are, in the first instance, confined to enterprise profitability alone. Indeed, tax rates are explicitly set to reproduce profit margins prevailing in 1983.

2.47 Second, in sectors subject to controlled prices, indirect taxes bear directly on enterprise profits. The 1984 tax reforms set those rates to equalize profitability on sales (ROS). However, profitability on sales that forms the basis for tax policy bears little relationship with profitability on fixed assets or returns on equity that market economies seek to equalize. For example, profits in the ferrous metal industry (defined as return on sales) are well above the national average, making that industry a candidate for heavy indirect taxation. In contrast, profitability in relation to assets is below the national average; thus, taxes set with reference to return on sales will make profits in relation to assets, and therefore funds for reinvestment and growth, unduly low in that industry.

2.48 The ROS measure of profitability is especially problematic when consideration is given to the principal uses to which after-tax profits in state-owned enterprises are put. An enterprise's need for retained funds for expansion depends on its capital-intensity and rate of growth; funds needed for worker benefits depend on the number of workers. Given that retained earnings financed some 38% of investment in 1986, equalizing sales profitability can starve capital-intensive industries of funds for expansion; indeed, this was observed to be particularly marked in railways and electricity, leading to the reduction in business tax on railways in 1986 and a change in the tax rules for electricity to allow more costs to be deducted for tax purposes. By the same token, labor-intensive industries have found it more difficult to afford bonuses than less labor-intensive industries.

Box 2.1: MEASURES OF PROFITABILITY, REINVESTMENT RATES AND THE INTERNAL GROWTH POTENTIAL OF ENTERPRISES

There are many criteria by which enterprise performance can be measured. Increases in sales, increases in gross output increases in profits can all be used. None of these measures alone, however, gives a comprehensive measure of enterprise performance. The reasons are easy to see: increases in sales are desirable only if they result in profits; the same is true of higher gross output. Increases in profits need to be related to the investment in capital goods which are used to generate those profits. Return on investment is therefore often used as a measure of profitability, and the effectiveness with which the firm uses the assets at its disposal to generate income.1/

In relating income earned to total assets managed by enterprise management, one can compare it to alternative uses of the same assets. As such, it is defined as:

$$\text{ROI} = \frac{\text{Net income}}{\text{Total assets}}$$

This measures the return obtained on all assets entrusted to the enterprises' management.

The concept of profitability most often used in China, and the one chosen by the authorities in the 1983 reform of the tax system as the profitability measure to be equalized, has been a different one, namely return on sales (ROS), that is the income generated on each Rmb of sales. To see how this measure fits into the broader concept of ROI, it is useful to breakdown the ROI into its two component parts:

$$\text{ROI} = \frac{\text{net income}}{\text{total assets}} = \frac{\text{net income}}{\text{sales}} \times \frac{\text{sales}}{\text{total assets}}$$

The relationship of net income/sales (ROS) measures the "gross profit margin", or the operating performance of the enterprise. The relationship of sales to total assets in turn measures "asset turnover", or the effectiveness with which assets are used to generate sales. It is quite clear that both profit margin per unit sold, and sales per Rmb of assets are important.2/ The following example shows why.

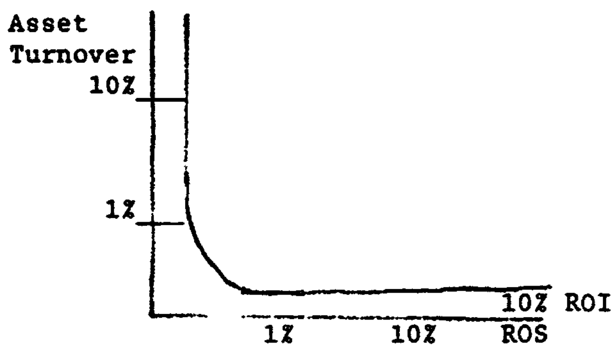
1/ Specifically, ROI measures the income generated by assets, before, and independently of, any payments to suppliers of capital, that is, before interest payments or dividend payments.

2/ Frequently, the ROI denominator is adjusted for so-called "unproductive" investments, or assets, such as surplus inventories, idle plant or buildings which do not generate income. This would include e.g. housing in most Chinese enterprises.

Box Table

| | Capital Intensive Enterprise A (steel) | Labor Intensive Enterprise B (retail) |
|---|---|---|
| Sales: | 5,000 | 10,000 |
| Net income: | 1,000 | 100 |
| Total assets: | 50,000 | 1,000 |
| Return on sales: | 20% | 1% |
| Asset Turnover: | 0.5 times | 10 times |
| ROI: | 10% | 10% |

Enterprise A realizes its income by means of a high profit margin and a low turnover of assets (extensive use of assets). Enterprise B obtains its return by means of a very low profit margin (ROS), but very intensive use of assets--that is, high asset turnover. A typical "type B" enterprise would be a retail establishment, which will accept a low profit margin because it has a very high turnover of assets--it has relatively low investments in buildings and inventories turn over quickly. On the other hand, capital intensive industries such as steel, chemicals, etc, which have heavy investment in assets (low asset turnover rates) will need a high net profit margin in order to obtain the 10% return on assets and the funds necessary to reinvest, replenish the capital stock, and most importantly, to grow.




The chart shows that there is in fact an infinite number of combinations of turnover and ROS, each of which will give rise to a 10% return on all assets deployed.

The return on investment is crucial for determining the internal growth potential of an enterprise, since net income is an important source of funds for reinvestment (in addition, of course to bank loans, and/or budgetary

3/ Rigorously, this holds only in an unleveraged (100% equity financed) enterprise or an enterprise where ROI=ROE.

grants for enterprises in China). In fact, the standard formula for the internal growth rate of an enterprise 3/ is defined by:

g = % income retained * ROI

Thus, an enterprise with a 10% ROI, which pays out (in taxes, in dividends, in bonuses or other payouts) 40% of its net income, will grow at a rate of 6%.

The important implications for Chinese enterprises of the choice of ROS as a profitability measure should by now be clear. By limiting the ROS to the same maximum level (by means of equalizing taxes and other measures) for all enterprises, those enterprises with a high ROS (but low asset turnover) are heavily taxed, and their ROI, and therefore ability to generate funds for growth, is constrained. To take the example of enterprise A: its 20% ROS would be viewed as "excessively profitable." Taxes such as the adjustment tax and a high product tax rate are designed to reduce the "profit rate" to a more acceptable level--say to 10%. However, with a 10% ROS, a 0.5% turnover rate and a 40% payout in bonuses and other nonproduction oriented investments, the enterprises' growth will be limited as follows:

g = ROI * retention ratio
  = [10 * 0.5] * 0.6
  = 3%

This was less serious in time when all funds for reinvestment were provided to enterprises by government: the 3% of earnings retained did not truly matter because any shortfalls from the desirable level would be made up by the government.

In the post reform period, however, it is a very serious matter. Enterprises which are capital intensive are not permitted the net income to reinvest and grow. To the extent that they borrow from banks to supplement their asset base, they are increasing their leverage (debt/equity ratios). These are not desirable tax-driven effects. The question of using the tax system to equalize profits has been discussed in the text. However, the use of the ROS measure of profitability has serious consequences

The difficulty of changing this approach lies in the fact that in China there is no obvious market mechanism for valuing assets. In the absence of asset value, determining the return on assets is clearly difficult. The AMRS version of the contractual responsibility system represents one possible approach to asset valuation. It has in fact been used to value the firm in accordance with the standard "dividend discount model", by discounting the value of the income stream predicted by the winning bid. This or other mechanisms will need to be further developed, before ROI can be strictly applied.

2.49 In contrast to the above, indirect tax rates have a very different incidence on transactions occurring outside the plan price system. For such transactions, a differentiated rate structure is likely to be shifted forward and reflected in consumer prices and thus discourage the purchase of relatively highly taxed goods. In those cases, the differentiated tax structure is likely to create adverse incentive effects. While some differentiation of the tax structure is desirable in a market economy (e.g., to tax luxury goods or socially harmful goods), the differentiation required on such grounds bears little relationship with that set by the Chinese tax authorities to equalize sectoral profitability. Objectives of differential taxation in market economies can usually be achieved by setting particularly high tax taxes on a small number of particular goods, rather than by highly differentiated taxes across the whole range of industrial products. Excessive sectoral differentiation in China has distortionary effects that depend inter alia on the proportion of sales transacted at market prices.

2.50 In sum, the effects of tax changes are very different on plan transactions and free market sales. A tax increase will reduce enterprise profitability to an extent that depends on the proportion of its output that it must sell at fixed prices. However, the tax increase on its free market sales will mainly be passed on to final prices and borne by final consumers unless the supply of the good is unresponsive to price changes (or demand is extremely elastic). Similarly, decontrol of a particular price that is seen as raising profitability above average levels will lead to the application of a higher product tax/VAT rate. However, since the higher rate applies to free market sales as well, firms will reduce sales on that market, raising the free market price. The extent of these effects depends once again on the responsiveness of supply and the importance of free market sales in the industry in question. However, with free market sales determining marginal behavior in State-owned enterprises, these effects of tax rate setting are assuming more importance than in the past.

2.51 The tax authorities indicated that they attempt to take the existence of the free market into account in setting tax rates. However, in practice, unless there are major changes in free market prices, state list prices provide the basis for setting the tax rate, with the choice of a tax rate guided exclusively by a concern for enterprise profitability.

2.52 Cascading. As in many developing countries, China's indirect tax system derives a significant amount of revenue from indirect taxation on raw materials and capital goods entering the production process. To the extent that enterprises increasingly choose techniques of production, taxes on such goods distort their choices and detract from efficiency in production. By adding to the costs of production, such taxes also increase the cost of exports, adversely affecting China's competitive position. The gradual replacement of Product Tax by VAT is still partial, and allowance is not made in the VAT for taxes paid on all inputs. Hence, the full tax burden borne by a commodity does not consist simply of the tax applied to final output, but also includes taxes paid on inputs, and on inputs used in producing inputs, all the way through the production process.

2.53 The analysis of the effects of cascading is made more complex in China because of the coexistence of VAT and Product Tax. Since an industry subject to VAT can reclaim taxes paid on inputs, a distinction must be drawn between industries subject to VAT and those subject to Product Tax. Also, the amount of taxation that has been borne by inputs into an industry subject to Product Tax will depend on whether those inputs were produced in an industry subject to VAT or in an industry subject to Product Tax. Cascading is also present in industries subject to VAT. While the tax paid on immediate inputs is refunded, this is not the case for taxes paid on inputs into the supplying industry (unless that industry is also subject to VAT). This point is of importance in the design of export rebates that typically, as in China, refund taxes paid only on first round inputs, thereby depriving exporters of the full competitive edge which would otherwise prevail. Nonetheless, it must be expected that the effect of cascading is less for goods produced in industries subject to VAT. The extent of cascading is shown in Table 2.1 which demonstrates the considerable differences between the statutory tax rate and the full tax burden. Some basic intermediates such as electricity, coal, coke and heavy chemicals suffer taxation that is double or triple their statutory rates. Cascading of this magnitude also characterizes the sectors statutorily subject to business tax. Sectors subject to VAT suffer less from cascading, although they are affected to some extent. (See Annex I for detailed discussion of cascading and calculation of cascading effects.)

2.54 To the extent that indirect taxes exhibit significant cascading effects, the system is less efficient than a single-stage sales tax or a value added tax. The calculations lend support to the notion that a VAT covering all sectors would, by eliminating much of the cascading effect of indirect taxes, make the incidence of taxation more closely approach that designed by policymakers in formulating the statutory rates of taxation. It would also provide a framework that ensures tax-free access to all inputs, direct and indirect, going into export production.

2.55 The extent to which the indirect tax system in China raises revenue efficiently has yet another dimension. The fact that product and VAT rates in sectors such as cement, crude oil and electricity vary directly with size of the taxed enterprise may be inappropriate. This policy has its genesis in attempts to use these taxes to equalize profitability across large and small producers. To the extent that profitability differentials are related to economies of scale, this approach could have the effect of switching production to less efficient enterprises.

2.56 Equity. Indirect taxes are not seen as an equity-enhancing instrument in China, except in the sense of equalizing profitability across enterprises.12/ Furthermore, as mentioned before, the equity impact of existing

---

12/ There is clearly some interaction between price setting and tax rates (i.e., coordination between the Price Bureau--which sets prices--and the SAT which sets tax rates); the joint tax cum price effect is designed with producer-impacts in mind and full backward shifting is assumed. Indeed, SAT frequently pointed out that tax changes were used instead of price changes to affect profits of enterprises. It is not, however, possible, to verify the extent to which the objective of profit equalization is met, as matching data for industrial profitability and taxes were not available.

Table 2.1: CHINA - THE EFFECTS OF TAX CASCADING
(in %)

| Sector | Type of tax | Average statutory tax rate | Cascading effect | Effective tax burden | Effective tax rate as % of statutory rate |
|---|---|---|---|---|---|
| Agriculture | Exempt | 0 | 4 | 4 | - |
| Forestry | Exempt | 0 | 1 | 1 | - |
| Animal husbandry | Exempt | 0 | 2 | 2 | - |
| Sideline | Exempt | 0 | 7 | 7 | - |
| Fishery | Exempt | 0 | 7 | 7 | - |
| Metallurgy | VAT | 14 | 3 | 17 | 120% |
| Electricity | Product | 5 | 5 | 10 | 200% |
| Coal and coke | Product | 3 | 6 | 9 | 300% |
| Petroleum | Product | 30 | 11 | 41 | 137% |
| Heavy chemicals | Product | 15 | 11 | 26 | 173% |
| Light chemicals | VAT | 20 | 4 | 24 | 120% |
| Heavy machinery | VAT | 14 | 2 | 16 | 107% |
| Light machinery | VAT | 16 | 3 | 19 | 119% |
| Construction materials | Product | 5 | 8 | 13 | 260% |
| Heavy forestry | Product | 10 | 8 | 18 | 180% |
| Light forestry | VAT | 14 | 3 | 17 | 121% |
| Food | VAT | 16 | 2 | 18 | 112% |
| Textiles | VAT | 18 | 2 | 20 | 111% |
| Clothing and footwear | VAT | 14 | 2 | 16 | 114% |
| Paper | VAT | 14 | 2 | 16 | 114% |
| Other manufacturing | VAT | 14 | 3 | 17 | 121% |
| Construction | Business | 3 | 10 | 13 | 433% |
| Transport | Business | 5 | 7 | 12 | 240% |
| Commerce and catering | Business | 3 | 6 | 9 | 300% |

Notes: These numbers should be regarded as illustrative for two reasons. First, the input-output table used in the analysis relates to 1981 and is therefore somewhat out of date. Second, the industry definitions are very broad and so group together goods subject to widely different tax rates (or even type of tax). Therefore, for each industry, it was necessary to decide which type of tax (VAT, Product Tax of Business Tax) applied to most of its output, and what rate of tax could be regarded as representative. Finally, the effects of cascading are underestimated because data did not permit incorporation of taxes paid on capital goods. The methodology underlying the calculation appears in the Appendix to Annex I.

taxes is complicated by the fact that taxes set with reference to intersectoral enterprise profitability, when shifted on to prices of free market sales, have different effects on households at different income levels. Data that would permit an analysis of the effects of taxes on market prices and thus on the distribution of real income among households are not available. However, two observations may be made. First, given the high proportion of food in the actual expenditures of almost all Chinese households, it is the exemption of most foods from Product Tax/VAT that has the greatest effect on distribution among consumers. Changes in taxes on other goods, that form a small proportion of household budgets, will have little effect. Second, luxury goods have high consumer prices, presumably partly for distributional reasons. This could not have been sustained after the replacement of profit remittance with taxes unless high product tax rates had been used to reduce the profitability of their production. Thus luxury goods are subject to high tax rates in China, as elsewhere. But when fixed consumer prices apply, their impact appears to fall on producers.

Business Tax

2.57 Incentives. Levied on gross receipts in all sectors except wholesale, where it is levied on markup, this tax has the potential for introducing allocative inefficiencies through distortion of input choices. These could be significant for industries such as transport and utilities that taxes are heavily used in interindustry transactions. Distortions are also likely in future in financial sector activities.13/

Enterprise Income Tax

2.58 Incentives. In common with other socialist countries, the system of taxation of State enterprises is characterized by a large number of taxes at every stage of production and distribution of earnings. The most noticeable characteristic of enterprise taxation in China is the important role of discretion in the interpretation of tax rules. These characteristics are manifest in deviations from the 55% income tax rate, the adjustment tax and various extrabudgetary "clawback" measures to profitable enterprises and, correspondingly, in the extension of subsidies and other preferences to finance wage increases and bonus payments in loss-making units. The impact of these "clawback taxes" on the effective marginal tax rate is shown in Table 2.2. The role of discretion has been heightened with the introduction of the contracting system, which provides a vehicle for extending significant tax preferences to enterprises that are able to bargain successfully with the authorities.

2.59 Customizing tax liabilities through contracting--almost on an enterprise-by-enterprise basis--is defended on grounds, inter alia, of encouraging efficient use of fixed assets and eliciting some payment to their owner, the State. Tailor-made contracts, the authorities argue, are necessary

---

13/ A tax on gross interest receipts raises the cost of lending and will increase intermediation spreads; this widens the wedge between deposit and lending rates. With all domestic institutions presently subject to tax, these effects will occur across all institutions. However, as China's financial sector and financial service sector become more diversified, an important competitive advantage may be conferred on e.g. foreign financial institutions and other financial institutions not presently subject to it, while domestic banks are placed at a competitive disadvantage by the tax-induced higher costs.

to adjust for the advantage which accrues to enterprises from free state capital endowments, and which varies from enterprise to enterprise. The role of discretion is heightened by the decentralization to provinces permitting provincial discretion in granting of tax preferences. The fact that many of China's social policy objectives, in housing, health care, pensions and education, are met through the activities of the SOEs, coupled with the fact that revenues raised through taxes often have to be shared with higher-level governments, provides a powerful incentive for local governments to provide tax preferences, thereby increasing enterprises' discretionary funds.

2.60 The substitution of rules by discretion, however, has a number of serious disadvantages. First, enterprise-specific variations in tax payments inhibit competition and delay incentives to restructure inefficient enterprises. Contracting on a case by case basis is therefore inconsistent with the goal of developing a competitive environment for enterprises. Contracts that do not embody uniformity in tax treatment move away from the goal of ultimately directing investment to its most profitable uses. In China, as long as the soft budget (and soft tax) constraint prevail, there will be no pressures from competition or for the allocation of investment to profitable uses such as exist in market economies where the capital market is a force for broad equalization of after-tax returns to equity across enterprises.

2.61 Second, as stated in Chapter I, the inclusion of tax payments in contracts removes an important instrument of macroeconomic management from central government controls.14/ The problem is exacerbated by the fact that such contracts typically run for 3 to 4 years, lengthening the period over which direct tax instruments become unavailable. The existing contracting system, while credible as an attempt to separate ownership and microeconomic management, does not distinguish clearly between the role of the government as owner of assets in SOEs and the role of the government as macroeconomic manager for the economy as a whole.

2.62 The contractual responsibility system can be expected to introduce a lack of buoyancy into the income tax, as appears to have been the case in 1987. Such an outcome is unsurprising in the short run. However, its recent introduction makes an assessment of its long run consequences premature. In principle, revenue could actually increase if the incentive-enhancing effects of the low marginal tax rate led the enterprise to generate more output and profits. Indeed, the rapid growth of enterprises subject to contracting indicates that contracting has positive incentive effects (and also lends weight to the hypothesis advanced earlier, that enterprises respond increasingly to incentives). Data that would allow the incentive effects (and therefore revenue impact) of the contracting system to be estimated were not available.

2.63 Contracts calling for enterprises to deliver some profit target would in principle result in no diminution in buoyancy of revenue provided the quota were set, not in terms of absolute profit, as is presently often the case, but in terms of another nominal magnitude (e.g., value of sales) which moves with inflation. Even in the extreme case of a zero marginal tax rate, extra revenue would be forthcoming from indirect taxes, unless these too were

---

14/ This is true, a fortiori, for the inclusion of other macroeconomic levers such as interest rates.

included in the contract, as they sometimes are. Current versions of the contract, however, make the tax base subject to inflationary erosion. This is so, a fortiori, for contracts calling for some absolute level of tax delivery.

2.64 Statutory and Effective Rates of Tax. The statutory rate of tax may be combined with depreciation allowances, interest and principal deductibility and other provisions to calculate how the cash flow from an investment project is affected by applying the rules of the enterprise income tax. The effect is summarized in the "marginal effective tax rate" (METR), estimates of which are presented in Table 2.2. These figures are best treated as illustrative. They also assume that taxes are applied in a uniform manner, as provided in the law, and not as typically happens, in China, applied in a discretionary manner by provincial tax administrators. Neither is the existence of contracting reflected in these figures. Contracting would be expected to significantly reduce the METR (See Box 1.2). However, the figures do serve to indicate the divergences between statutory and effective rates arising from interactions between taxation, inflation and the mode of financing of investment projects under these assumptions. The complexities of the institutional setup governing investment in China, together with the pressure from enterprises to invest, imply that the METR is but one determinant of incentives to invest, particularly in State enterprises. With a progressive hardening of the budget constraint, however, it can be expected to assume greater importance.

Table 2.2: CHINA: MARGINAL EFFECTIVE TAX RATES FOR INVESTMENT IN FIXED ASSETS BY TYPE OF ENTERPRISE IN CHINA /a
(In %)

| Enterprise | Statutory tax rate | 100% retained earning financing | 50% debt financing (principal deductible) |
|---|---|---|---|
| Large state enterprise | 55 | 87.3/b | 48.4 |
| - with extrabudget construction tax | 15 | (88.0) | (48.4) |
| - with wage bonus tax | - | (96.3) | (68.4) |
| Small SOEs & collectives | 35 | 50.3/b | 30.1 |
| Individual household enterprise | 40 | 57.7 | 34.6 |
| Joint venture | 33 | 46.2 | 26.8 |
| Foreign enterprise | 50 | 70.2 | 41.4 |

/a 20% inflation is assumed.
/b Includes energy and transport tax on extra budgetary funds.

Reference: Pellechio, Anthony J., "A Model for Analysis of Taxation of Capital Investment in Developing Countries," Provisional Papers in Public Economics No. 86-28; and Pellechio, Anthony J., Gerardo P. Sicat, and David G. Dunn, "Taxation of Investment in East Asian Countries," Provisional Papers in Public Economics No. 87-3, Development Research Department, World Bank.

2.65 Column (2) shows the METR on a project financed entirely by retained earnings with an inflation rate of 20%. Large State enterprises face the highest METRs because of their high statutory rate and the extrabudgetary transportation and energy fee. The advantages of debt financing are shown in column (3) for a project financed 50% by debt (and with allowance for full deductibility of principal payments) and 50% by retained earnings. The sharp decline in METR for all three types of enterprises is due to two reasons. First, the deductibility of nominal interest payments overstates true interest payments in the presence of inflation; the decline in the real debt balance implies that a portion of interest payments is actually implicit repayment of principal. Second, the fact that principal repayments are also deductible confers a significant tax advantage as well.

2.66 Equity. Equality between enterprises is a more difficult concept than equality between individuals because there is no natural way to define it. In the 1984 tax reforms it was taken to be profitability on sales and taxes were calculated to yield the same return on sales in each industry. However, this measure of profitability is arbitrary, and, as indicated in Box 2.1, does not account for different enterprises' needs for retained funds. This requirement of greater profitability on sales for more capital-intensive industries would still exist if enterprises relied less on retained earnings or grants, and were free to finance investment by borrowing, since those enterprises with high requirements for retained funds (and subject to high taxes) would become increasingly leveraged, were they to finance expansion by borrowing.

Extrabudgetary Construction Tax and Wage Bonus Tax

2.67 The extrabudgetary construction tax was designed as one of the indirect fiscal levers used by the state to control investment and, as a tax designed to influence enterprise behavior, is frequently referred to, together with the wage bonus tax as a "behavior tax." Both contribute an insignificant proportion to revenues. The effectiveness of these taxes is difficult to assess empirically. In view of the many factors contributing to investment hunger in China (low interest rates, principal deductibility, enterprise and financial system, liquidity, etc.) it is not surprising for such a tax to perhaps have a limited impact.

Resource Tax

2.68 Incentives. The resource tax was mainly adopted to reduce differences in profitability between enterprises arising from free access to natural resources. The fact that it is levied on profits relative to sales means that the production of some exhaustible resources (e.g., coal, oil and gas) are indeed discouraged by it. However, the rates of taxation are not calculated to reflect such exhaustibility.

2.69 Although the resource tax has the beneficial incentive effect of discouraging the production of some exhaustible resources, it is levied in a way that reduces the efficiency with which those resources are extracted. Efficiency in nationwide resource extraction requires that marginal costs of extraction (including transport costs) be equal for all enterprises. The controlled price system implies that more and less efficient enterprises can coexist within the same industry. Since the resource tax is levied at a higher rate on more profitable enterprises without distinguishing between enterprises with varying extraction costs, the tax system can perversely encourage (by taxing them at a lower rate) less profitable, higher cost producers to expand activity even if their marginal cost is higher than that of more profitable enterprises.

2.70 Finally, the effectiveness of taxes on resource use is reduced in the presence of price controls. In a market economy, a tax on resource extraction will discourage production, raise the market price and therefore discourage consumption of the resource. In contrast, when the price to consumers has been fixed, as in China, consumption is not discouraged. Instead, due to backward shifting of taxes, production will become less profitable, but if the planners decide that production must nevertheless meet demand despite low profitability, the resource will not be conserved. Alternatively, low profitability might reduce supply. With fixed consumer prices this would only create excess demand and some form of (possibly informal) rationing. This might conserve the resource, but would not ensure that it was allocated efficiently to those who could make the best use of it.

Agriculture Tax

2.71 Incentives. The Agriculture Tax, in theory, should have no incentive effects as it is paid regardless of the volume, or crop composition of output produced. The same is not true of the recently introduced tax on the value of output of nongrain products. The current practice of making the agriculture tax on grain farmers payable by grain farmers in grain valued at low official procurement prices, while other nongrain farmers pay it in cash, creates incentives against grain production. This practice causes grain farmers to pay an implicit tax arising from the income foregone as a result of being denied the opportunity to sell grain in the market at above-procurement prices to meet their tax liability.15/

2.72 Equity. There are two aspects of the distributional effects of the Agriculture Tax, which are straightforward to analyze. First, is the effect of the tax on the distribution between agriculture and nonagriculture; second, is its effect on distribution within agriculture. Since the early 1950s, Agriculture Tax has fallen as a proportion of total revenue and as a proportion of gross output value in agriculture (from 5.9% in 1952 to 1.1% in 1986). Thus agriculture has paid less taxes than nonagriculture as a proportion of output, and the extent of the difference has been growing larger. As agricultural incomes are generally lower than nonagriculture incomes, this has probably reduced overall income inequality. However, the 'surplus' in the agricultural sector has, throughout, been "taxed" by the imposition of low procurement prices and until recently, high delivery quotas.

2.73 As far as inequality within agriculture is concerned, the effect of the tax before the recent introduction of the nongrain tax was probably

---

15/ In addition to the agriculture tax, grain farmers pay a second implicit tax in the form of government procurement at a price below the market price.

somewhat regressive. It was levied on the basis of "normal grain yields" and thus would be a simple proportional tax if all farmers produced grain. However, the richer farmers typically produce more profitable crops, such as vegetables, and they were not required to pay higher taxes to reflect the suitability of their land for these more profitable activities. Such regressivity will be offset by the new nongrain tax. However, it continues to be true that grain farmers are subject to the "hidden tax" of agricultural procurement at below market prices.16/ Moreover, regressivity is further offset by the fact that households in severe financial difficulties can be exempted from the tax. Finally, it should be noted that the low rate of explicit tax means that the regressivity is not so serious in its consequences.

2.74 The fact that agricultural households are not liable for Individual Enterprise Income Tax or Personal Income Adjustment Tax does not produce significant inequity at the moment because most agricultural incomes are lower than nonagricultural incomes. However, if agricultural incomes continue to grow and reach urban income levels, their exemption from these taxes will cause horizontal inequality because Agriculture Tax is so low.

Personal Income Adjustment Tax

2.75 Equity. The taxation of personal incomes of citizens is in its infancy in China. While information that would permit an analysis of its impact was not available, it may be conjectured that the combination of global and schedular treatment, taxed at progressive and flat rates respectively, carries the potential for horizontal inequity. The fact that assessment is on individuals rather than households and the lack of allowance for dependents can create anomalies. Finally, it may be noted that the monthly nature of the tax and the prohibition of averaging across months can cause inequitable treatment of individuals (such as writers, performers and others) whose income is concentrated in particular periods of the year.

Taxes on External Trade

2.76 Incentives. The effects of customs duties on incentives in international trade are hard to evaluate because of the lack of discretion allowed to many foreign trade corporations. However, the trend towards greater freedom of action for trade corporations and other enterprises that engage in international trade, makes their impact worth considering. Internationally traded goods are subject both to customs duties and Product Tax/VAT. The equality of Product Tax/VAT rates between domestic products and imports accords withth international practice and ensures that these taxes do not discriminate against imports. Also, the zero-rating of VAT on exports and the development of bonded warehouses means that the intent of the domestic tax legislation is to avoid discouraging exports. This means that the only incentive effects are through the customs duties themselves, and these are predominantly levied on imports. The import duties are often substantial and apply to a very wide range of goods. The protective effects of these duties are recognized by the authorities, and indeed constitute a major justification for their existence.

---

16/ See RSAL Background Paper: "Agricultural Land Taxes in the Xinxiang Regional Reform," AS3AG, 1988; for fuller analysis of Agricultural Land Taxes.

2.77 An evaluation of whether such protection is desirable is beyond the scope of this report. In general, tariff reform can be considered separately from tax reform because of the small revenue contribution of customs duties. An earlier Bank report indicated that the present tariff structure, with rates ranging from 0-200% results in highly variable "effective protection" of different industrial subsectors.17/

Taxes and Industrial Policy

2.78 Industrial policy involves the promotion of particular industries, as well as particular enterprises. Taxes are a widely used instrument of industrial policy. At the level of the individual enterprise this take place through the granting of enterprise income tax, product and customs tax exemptions, often to enterprises that are in financial difficulties. In common with other countries, this approach does not always represent a coherent policy based on the evaluation of social costs and benefits, and may be guided by attempts to help a particular interest group. Local governments make significant use of "industrial policy" to assist "their" enterprises with the consequence that the central government is deprived of an effective tax lever. At the sectoral level, the choice of Product Tax and VAT rates often reflects industrial policy aims. For example, the recent switch of the textile industry from Product Tax to VAT was accompanied by a reduction in the industry's overall tax burden, apparently with the aim of promoting the industry.

2.79 The use of taxes to encourage or discourage particular industries can be quite effective in an economy with limited foreign trade. However, as foreign trade expands, the impact at the margin of these taxes can be expected to change. Since domestic production will differ from consumption (by the amount of imports) a distinction will have to be drawn between taxes that discourage production and those that discourage consumption. In the case of a commodity such as cigarettes, it is consumption which one would want to discourage, and this will only happen if taxes affect prices. In[illegible]sed taxes with fixed consumer prices will not affect consumption except to [illegible] extent that they affect free market sales. Second, taxes in an economy with trade will affect domestic producers as well as importers, and a tax reduction that stimulates production will also stimulate imports For both reasons, direct subsidies are preferred.18/

## C. Recommendations

2.80 Recommendations for tax reform focus on three major taxes in the present system--the system of indirect (product-cum-VAT) taxes; the enterprise income tax and to a lesser extent, the resource tax. This choice of emphasis lies in the fact that between them, these taxes contribute 85% of tax

---

17/ Report No. 6680-CHA: External Trade and Capital. IBRD, 1987.

18/ Producer subsidies have the advantages that they do not distort consumption choices and, as they involve a more obvious budgetary cost than variable tax rates tax reductions, they require more careful justification and are therefore more likely to be used wisely.

revenues, and that therefore the bulk of any revenue impact would come from modification of these taxes. Secondly, their allocative impact, as analyzed in Section B, is also significant, so that major benefits could be derived from modification of their design or application. Finally, reforming the system of taxation of enterprises and the rationalization of indirect taxes is essential for enterprise and price reforms to be deepened. This analysis hitherto has emphasized the desirability of viewing taxes and price controls as part of an integrated system. This implies that recommendations on the reform of taxation, especially indirect taxation, must be sensitive to assumptions made regarding the pace of price reform.

2.81 The recommendations also seek to build on the strengths of the existing tax system in China, focusing on refinements and modifications to the major taxes now in place (such as the VAT, contracting and other aspects of the enterprise income tax) instead of recommending radical change or a wholly new structure. In brief, the recommendations take as given the configuration of the tax system and seek to eliminate some of its weak issues.

2.82 Recommendations with regard to the remaining taxes, such as those on the agricultural sector and customs taxes (together contributing some 7-8% of revenues) are briefly summarized in paras. 2.140-2.150. These recommendations reflect the analysis of previous World Bank mission reports which have undertaken in-depth analysis of these sectors. The Report's recommendations are summarized in a matrix (Table 2.7 following page 76).

Indirect Taxes

2.83 Characteristics of the Recommended VAT. The mission recommends that the existing value added tax cum-product tax be replaced by a value added tax of the consumption type, implemented via the invoice method, that (a) applies to manufacturing and imports, (b) exempts agriculture and services and (c) "zero-rates" exports. Such a system would have the following characteristics. The tax liability of an enterprise under the VAT would be reduced by taxes already paid on raw materials as well as capital goods. Such a VAT, which includes tax payments on capital goods as well as on raw materials, is said to be of the consumption type. The enterprise under an "invoice method VAT" would be "credited" for taxes paid on inputs and would therefore send the authorities the difference between the tax liability on outputs and that already paid on intermediate inputs. This is a VAT utilizing the invoice method in its implementation.19/ The base for taxation would be the domestic or foreign value added of goods sold to final consumers in China. This would tax imports and exempt exports. Such a VAT is said to embody the destination principle and is permissible under GATT rules.

2.84 It is also recommended that tax rates be expressed as a proportion of producer, rather than purchaser prices. That is, rates should be set on a so-called "tax-exclusive" basis.

2.85 As noted in Section B, the system of indirect taxation currently ruling in China has many, though not all, of these characteristics. The

---

19/ The administrative advantages of the invoice method as distinct from other methods of calculating tax liability are discussed in Annex III.

authorities are aware of the production inefficiencies caused by the cascading of turnover taxes in the manufacturing sector (Table 2.1 indicated that there are significant differences between the statutory rate of tax applying to a sector and its full tax burden), and the gradual replacement of product tax by VAT is intended to alleviate this problem. Second, the taxation of imports and zero-rating of exports to the extent current circumstances permit implies that the VAT in China embodies the destination principle.

2.86 In not allowing credits for tax paid on fixed assets, the Chinese VAT discriminates against investment and deviates from prevailing practice in most countries.20/ In China, the need to control what is widely perceived to be "overinvestment" could make this seem an advantage in the present macroeconomic circumstances. Nevertheless it is preferable to deal with potential macroeconomic imbalances using monetary, interest rate and other macroeconomic tools, and by tightening the tax treatment of loan repayments (see para. 2.135 for discussion on this topic). This would ensure that existing distortions are addressed at source rather than by introducing other distortions into the indirect tax system. The changeover to a consumption-type VAT can be expected to encounter some transitional problems. These include the appropriate tax treatment of fixed assets that have already paid taxes before the changeover was introduced. Considerable experience is available regarding the methods used by various countries to efect a transition from a turnover to a consumption-type VAT.21/

2.87 The existing value added tax in China further deviates from best practice in developing and industrial countries by not employing the invoice method in its implementation and presumptively crediting inputs. Under the invoice method, the tax already paid by an enterprise on its purchase invoices is subtracted from the tax due on its outputs and the difference is forwarded to the tax authorities. The invoice method has a "self-policing" characteristic since any incentive on the buyer's part to overstate the tax paid on the transaction is offset by the opposite incentive (to understate tax paid) on the seller's part. Selective checking of invoices--to ensure they are identical--on the part of the tax administration is, however, usually still necessary to promote tax compliance. This will require strengthening of the audit function of the Tax Bureaux.22/

2.88 The VAT recommended in this report would apply equally to imports and to domestic production. Where the VAT is applied, current practice in China is consistent with this recommendation. Treating imports and domestic production alike ensures that customs duties and quantitative restrictions on

---

20/ VAT systems which disallow credit for taxes paid on capital goods--the so-called "income-type" VATs--are generally not used. Exceptions among LDCs are Argentina and Peru and, to some extent, Turkey. Such taxes do, however, credit taxes paid on capital goods when the latter depreciate.

21/ For more details of VAT and international experience on transition to VAT, see Tait, Alan A.; Value Added Tax International Experience and Problems. (Ref) 1987. See also Annex I.

22/ See Chapter IV for discussion of administering VAT.

imports play an unambiguously protective role and can be set in accordance with the requirements of industrial policy. The fact that customs duties account for only 9% of revenue implies that rate adjustments could be done without significantly adverse revenue consequences.

2.89 The VAT recommended by the report is of the manufacturing-cum-import type, and would therefore have the same scope as the current Product Tax and VAT. This has two implications. First, it would not extend through the wholesale and retail stages and would not therefore replace the Business Tax. The VAT extends through the retail stage in the countries of the European Community, in Hungary, in Latin America as well in Madagascar, Niger, Korea, Taiwan and Israel. The reason a retail VAT is not recommended for China at the present time is the administrative difficulty of bringing a very large number of retailers into the tax net. At the same time, the administration of the Business Tax should be tightened and consideration eventually given to a second stage of reform where the VAT would replace the Business Tax as well and extend through the retail level.

2.90 Second, the tax would not include sectors such as agriculture, services and financial institutions. The reason is again purely administrative. Registering a large number of agricultural units would be an extremely burdensome task in China. Agriculture would therefore be exempted (not zero rated). The exemption of agriculture implies that while agricultural sales themselves would not be subject to VAT, inputs used or imported by the agricultural sector would have paid taxes which could not be credited.

2.91 Exports would be zero-rated--i.e., exempted from taxes on outputs as well as inputs. Zero-rating implies that an exporting enterprise would qualify for refunds from the government unless it has tax liability on its domestic sales greater than the tax credit earned on exports. In many developing countries refunds from government departments in practice have proved time-consuming and it is accordingly recommended in China that refunds, when due, be made speedily.

2.92 Replacing the Product Tax with the VAT has two advantages: First, by removing the divergences (estimated in Section B) between statutory tax rates and the actual tax borne by each sector, it makes the effects of taxation clearer to the tax setting authorities. Second, it makes certain that exporters enjoy the full benefits of "zero rating", i.e., being refunded taxes not only on the direct inputs entering export production, but taxes on inputs entering into the production of those inputs. This increases the competitiveness of Chinese exports in world markets, while being consistent with GATT rules. Indeed, the methods used to calculate the extent of cascading in Section B, if applied to disaggregated data on exports, could be used to calculate the export subsidies required to compensate exporters for the effects of cascading under the present tax system.

2.93 The VAT of the kind recommended for China could be implemented even in the absence of price reform. Implementation would, however, be made easier with a more simplified rate structure. The adoption of such a rate structure depends, inter alia, on price reform. This is due to the use of the product tax/VAT to affect profitability of sectors producing goods subject to price control. International practice reflects a more limited range of rates than is found in China. The VAT used by most countries either has a zero rate or an exemption applying to necessities, a standard rate for the majority of sectors,and a higher rate applicable to luxury items and those goods whose consumption the authorities wish to discourage. Table 2.3 provides some examples. It shows the main rates of VAT and additional rates for limited categories of goods in the EEC countries (which have the longest experience of using VAT), other European countries, selected Latin American countries, and in New Zealand, Taiwan, Indonesia, and Korea. The rates shown are those that apply to domestic sales; virtually all of the countries zero-rate exports. The largest number of different rates is seven (in Belgium), but two or three rates are more common. In Asia, Indonesia has a single rate while Korea and Taiwan, China, which began with single rates, now have three rates.

Table 2.3: THE RATE STRUCTURE OF VAT IN SELECTED COUNTRIES

| | Main rate | Other VAT rates /a | Number of rates |
|---|---|---|---|
| Argentina | 18 | 9 | 2 |
| Austria | 20 | 10, 32 | 3 |
| Belgium | 19 | 1, 6, 17, 25, 33, 0 | 7 |
| Denmark | 22 | 0 | 2 |
| France | 18.6 | 2.1, 4.5, 5.7, 33.3 | 5 |
| Germany | 14 | 7, 2 | 3 |
| Greece | 18 | 3, 6, 36 | 4 |
| Hungary | 25 | 15 | 2 |
| Indonesia | 10 | - | 1 |
| Ireland | 25 | 2.2, 10, 0 | 4 |
| Israel | 15 | 6.5 | 2 |
| Italy | 18 | 2, 9, 38, 0 | 5 |
| Korea | 10 | 2, 3.5 | 3 |
| Luxembourg | 12 | 3, 6 | 3 |
| Netherlands | 20 | 6, 0 | 3 |
| New Zealand | 10 | - | 1 |
| Norway | 20 | 11.11 | 2 |
| Portugal | 16 | 8, 30, 0 | 4 |
| Spain | 12 | 6, 33 | 3 |
| Sweden | 23.46 | 3.95 12.87, 0 | 4 |
| Taiwan, China | 5 | 15, 25 | 3 |
| United Kingdom | 15 | 0 | 2 |

/a Note: Some countries having multiple VAT rates apply these rates to only one or two commodities, with the bulk of the VAT base taxed at a single rate.

Source: Value Added Tax: International Practice and Problems, A. A. Tait, Table 2-1, p. 40.

2.94 The imposition of supplementary excises on luxury goods and perhaps others is consistent with international practice, and poses no administrative difficulties. Most countries have additional taxes on particular commodities. These are separate from the VAT and are therefore not subject to refund. In the European Community these additional taxes are mainly in the form of excise taxes on tobacco, alcohol, gasoline and diesel oil. The rates vary widely from one country to another, but are often higher than the VAT levied on the goods in question. In Indonesia, the additional taxes are levied at either 10% or 20% on goods that are regarded as luxuries. In Korea, there is a Special Excise Tax that is levied at rates between 5% and 100% on selected goods.

2.95 International opinion is divided as to the appropriate tax treatment of luxuries and other goods whose consumption the government wishes to discourage. One option is to incorporate luxury rates <u>into</u> the VAT, with supplementary excises on special items. A second option is a single rate VAT, coupled with supplementary excise taxes <u>outside</u> the VAT. Since luxury rates would, in most cases, apply to final rather than intermediate goods, a supplementary excise does not raise issues of crediting which would normally create a preference in favor of the VAT. Another advantage of using supplementary excises is that they simplify the VAT administration. A supplementary excise at a rate higher than the standard rate of VAT on petroleum products, which have substantial intermediate uses, with the excess <u>not</u> being creditable under the VAT, is justified as follows. Because of the difficulty of charging directly for road use, it is desirable to tax inputs going directly into the road transport sector, and petroleum products are therefore a suitable tax base. To the extent that such taxes distort the use of petroleum by nonroad users, the level of taxation needs careful consideration. The experience of other countries can be used to develop guidelines in this area.

2.96 However, whatever method is chosen, supplementary rates should apply at the same rate to <u>both domestic production and imports</u>. Lack of such symmetry (i.e., taxing imports only) would have the unintended consequence of providing protection to domestic production of goods subject to such excises, such as tobacco, alcohol and petroleum products in China.

<u>Implications of Recommended VAT Changes</u>

2.97 The tax authorities have maintained that adopting a single rate VAT and supplementary excises is constrained by the existence of price controls. This point of view, and the extent to which price controls militate against adopting a VAT structure that accords with international practice can be understood by examining what effects the elimination of price controls would have on enterprise profitability. Enterprise profitability will be affected by eliminating price controls on both inputs and outputs. The following discussion analyzes these in turn. Because the tax proposals mainly relate to nonagricultural goods, the discussion is confined to the effects of eliminating price controls on nonagricultural goods.

2.98 <u>Impact of Retail Price Liberalization on Profitability</u>. The simplest assumption regarding the effects of eliminating retail price controls is that retail prices will rise to the current level of free market prices. It could be argued that free market prices might be reduced somewhat by the general reduction in households' real incomes, following withdrawal of the subsidy implicit in controlled prices, although this in turn could be offset by explicit subsidies to households. The simple assumption is adopted here. The impact of removing price controls depends therefore on the free market prices of commodities and on the proportion of sales that take place at controlled and free prices.

2.99 The analysis of the subsidy implicit in price controls (para. 2.43) may be adapted to show that price decontrol of final goods would raise retail prices of daily use and other goods by 5.6% and 18% respectively. With retail sales of "daily use" and "other" goods of Y 43.5 and Y 154.2 billion respectively, these price increases would yield income transfers to enterprises of Y 2.4 and Y 27.7 billion respectively, for a potential gain in profits of Y 30.1 billion, or 9% of total industrial value added. With a 15% VAT 23/ and an enterprise tax payable on this increment, enterprises would gain, after taxes, Y 12.5 billion in after-tax profits, to be distributed among investment and workers' remuneration funds according to existing guidelines. The government's revenue gain from VAT levied at 15% on Y 30 billion would be Y 4.5 billion, while the revenue from profits tax levied at 49% on Y 25.6 billion would equal Rmb 12.5 billion, for a total gain of Y 17 billion, or close to 20% of total Product Tax and VAT revenue.24/ The higher profitability will not accrue to all industries equally, and ranges from a low of 16% increase in profits as a % of value added for industries producing "daily use" goods, to a high of 38% for industries producing "other goods."

2.100 These changes in sectoral profitability in relation to value added could in principle be offset by suitable changes in the rates of VAT. However, this will typically require a differentiated structure of VAT rates. This illustrates an important point. The impact of price reform on sectoral profitability depends on the proportion of sales transacted at controlled prices, as well as the differential between controlled prices and free market prices. The profitability-offsetting moves in VAT rates then depend on the ratios of controlled sales to value added. Thus, while the existing product tax/VAT may have been set with reference to sales profitability considerations, the removal of price controls alone will not eliminate the sectoral profitability differentials just described, and will not permit complete simplification of the VAT rate structure on final goods. A uniform VAT on final goods must be accompanied by a charge or dividend on assets with which enterprises have been endowed by the State and by enhanced capital mobility in response to intersectoral profit differentials, if the remaining profit differentials are to be reduced or eliminated.

2.101 Impact on Profitability of Decontrolling Intermediate Goods Prices. Turning to the effects of relaxing price controls on intermediates, it has already been observed that eliminating price controls on inputs would cause their prices to rise to the current level of market levels. Under assumptions

---

23/ This is the VAT rate (calculated in para. 2.107) which would approximate the revenue from product tax.

24/ Data refer to 1986. Additional revenue would be forthcoming from the extrabudgetary energy and transportation fee and the wage increase and bonus taxes. (The detailed sectoral impact on profitability is calculated in Annex I).

of profit maximization 25/ and in light of the evidence that the dual pricing system has encouraged marginal enterprise decisions to be made on the basis of uncontrolled market prices,26/ the increase in input prices to free market levels will not affect the marginal cost of enterprises purchasing inputs on the free market. An increase in a controlled price to the higher, free market level, will be akin to the removal of a lump sum subsidy. In that case, relaxing price controls would have an effect on enterprise profits but no effect on consumer prices.27/ The effect of decontrolling intermediate goods prices is the reallocation of profits between supplier enterprises and purchasing enterprises. Some illustrative calculations using the 1981 input-output table are presented in Table 2.4. (More up-to-date data--not made available to the mission--could be used to get more accurate results.)

2.102 With liberalization of intermediate good prices then, it is assumed that all intermediate goods are sold at market prices, and that only sales to consumers are subject to price controls. Column 1 of Table 2.4 shows consumer sales in relation to value added (for each sector of the 1981 input/output table.) If VAT is shifted forward at every stage of production on all sales that take place at market prices, its negative impact on enterprise profitability (as a proportion of value added) will depend on the share of controlled price final sales, where forward shifting will not be possible.28/ Assuming that only sales to final consumers are subject to controls, and that these controls cover 50%,29/ the second column of Table 2.4 may be regarded as the effect on profitability of a 100% VAT.

---

25/ Evidence from enterprise studies suggests that managers "are driven by a desire to increase benefits to enterprise employees... The main avenue for purusit of these ultimate objectives was increased profits". (quotation from Perkins, op. cit.) The increase in the 1980s in the proportion of profits that enterprises are allowed to retain for their own use is seen as having contributed to such an orientation on the part of managers.

26/ cf. Perkins op. cit.

27/ If enterprises have objectives other than profit-maximization, the removal of the lump sum subsidy implicit in price controls on intermediate goods could lead to some increase in final goods prices.

28/ The assumption on shifting, in common with much applied work on tax incidence, postulates that the tax is fully forward shifted at every stage of production on that portion of sales that takes place at market prices. The full forward shifting assumption is justified (a) either if there are constant returns to scale and fixed factor prices; or (b) more plausibly, as a central case with imperfect market structures. See Stern, N. "Aspects of the General Theory of Tax Reform" in Newbery, D. and N. Stern (eds.) The Theory of Taxation for Developing Countries (Oxford University Press for the World Bank, 1987).

29/ The mission was informed by the Price Bureau that 47% of consumer goods were sold at State list prices in 1986.

Table 2.4: Effects of Value Added Tax Changes on Sectoral Profitability

| | Sales to Final Consumers as % of value added /a | Impact of 100% VAT on enterprise profitability /b |
|---|---|---|
| Metallurgy | 1% | 0.5% |
| Electricity | 9% | 4.5% |
| Coal and Coke | 26% | 13% |
| Petroleum | 5% | 2.5% |
| Heavy Chemicals | 2% | 1% |
| Light Chemicals | 92% | 46% |
| Heavy Machinery | 8% | 4% |
| Light Machinery | 137% | 68.5% |
| Construction Mats | 4% | 2% |
| Heavy Forestry | 33% | 16.5% |
| Light Forestry | 94% | 47% |
| Food | 248% | 124% |
| Textiles | 74% | 37% |
| Clothing | 180% | 90% |
| Paper | 39% | 19.5% |
| Other Manufactures | 66% | 33% |

/a Value of sales to consumers as a percentage of value added in 1981.

/b The effect of 100% VAT on industry profitability is expressed as a percentage of value added, on the assumption that 50% of sales to consumers are at state list prices. (Numerically, this is 100% x (sales to final consumers) x 0.5.) Figures are shown only for those sectors where VAT is levied or is likely to be levied. It does not include the full range of (24) sectors in the I-O table.

2.103 Many industries (such as metallurgy, heavy chemicals and construction materials) sell relatively small amounts to final consumers in relation to their value added. Therefore, only a small proportion of their sales would remain price controlled after intermediate good price liberalization, and a large change in their profitability is therefore likely to occur. To offset this increase in profitability would require impossibly large changes in VAT rates. (Even the 100% VAT shown in the table does not affect these sectors' profitability greatly). Thus, the changes in VAT on intermediate goods required for unification or simplification of the VAT--which would be far smaller than 100%--would have a very limited impact on profitability of many intermediate goods producing industries. The report therefore recommends that the VAT be simplified towards a common rate for most intermediates. It may be noted that while the assumption of intermediate goods price decontrol underlies the particular numbers shown in Table 2.4, the conclusion that VAT is a relatively weak tool for affecting the profitability of intermedate goods sectors holds more generally. Therefore, the recommendation that the VAT be simplified on intermediates would not be affected.

Unifying the VAT Rate

2.104 The preceding discussion shows that the VAT is a more potent instrument for affecting profitability in consumer goods than in intermediate goods industries. Simplification towards a common rate for most intermediates is therefore recommended. Unification (as district from simplification) is not possible at this stage, and would need to await price reform and appropriate pricing of fixed assets, with a view to broad equalization of after-tax rates of return on those assets. Thus, full reform of the VAT would proceed in two stages. While all other recommendations on the VAT should be currently implementable, the adoption of a single-rate VAT has been shown in the preceding discussion to depend on the pace of other reforms in the economy, specifically, price reform. The implications of a fully unified VAT are discussed below.

2.105 Implications of the Recommended Unified VAT Rate: Revenue. The "revenue adequacy" of a single rate VAT depends on whether such a VAT system could raise as much or more revenue as the product and other taxes it replaces. If one assumes that the change in tax rates has no effect on the output or value added in any industry, the calculation of the required VAT rate involves determining the revenue requirement or target, and the tax base: the rate is then obtained by dividing the revenue target by the tax base.30/

2.106 The unified VAT would have to raise some Y 66 billion (the revenues in 1986 from VAT and product tax, excluding those on liquor, tobacco and petroleum products) to replace revenues from the current VAT and product tax. The tax base from which this revenue will be collected under VAT consists of (a) industrial value added (excluding tobacco, alcohol and petroleum products); (b) imports; and (c) industrial purchases of agricultural products, since the latter are tax-exempt and cannot be deducted from enterprises' VAT liability. In 1986, these were Y 302 billion; Y 150 billion; and Y 37 billion respectively, making the VAT base (disregarding export refunds) approximately Y 489 billion. The tax rate needed to raise Y 66 billion is thus roughly 13.5%. Assuming that VAT on manufactured exports will be effectively rebated, and removing exports from the tax base reduces the tax base to Y 397 billion and the necessary tax rate rises to 16.6%.

2.107 These two estimates represent the upper and lower bounds on plausible VAT rates and it is not unreasonable to take an intermediate figure of 15% as representing the "best guess". This is broadly consistent with the current approach used by the SAT in setting VAT rates: 14% is taken as a standard rate that is used most often. Upward deviations from this figure are very frequent, and this is consistent with the fact that 14% is very near the lower end of the range calculated above.

---

30/ Full calculations of the revenue impact of this recommendation are given in Annex I. This "zero-elasticity" assumption is almost certainly inaccurate, but no data are available to estimate likely changes in output and value added. It is impossible to say *a priori* whether the use of this assumption results in the overestimation or underestimation of the required tax rate.

2.108 A uniform rate of VAT at 15% will need to be supplemented by excise taxes in the case of some industries, to capture the required revenues. Unifying the VAT on tobacco to a 15% VAT would raise only Y 2.1 billion, in contrast to the Y 11.3 billion currently collected from the product tax on tobacco products. A supplementary excise tax would therefore have to raise Y 9.2 billion. The base of such an excise tax would be total output value of the industry of Y 17.2 billion. To generate Y 9.2 billion, the excise tax rate on tobacco products would be 53%. For petroleum products, the excise tax would have to be 16%.31/

2.109 Implications of a Unified VAT Rate: Profitability. The effect of a uniform VAT rate on enterprise profitability (defined as return on sales) may also be illustrated. If the product tax on rubber products, to take an example, (which averages between 10 to 20%) were converted to a VAT in such a way that tax revenue (Y 1.6 billion on gross sales value of Y 15.4 billion) is preserved, the rate would have to be 32%, much higher than the unified VAT of 15%. (Y 1.6 billion on a 1986 value added of Y 5.05 billion). With the assumed, unified 15% rate, if all output is subject to price controls, enterprise profits will increase by the full extent of the VAT rate reduction, i.e. by 17% of the industry's value added, (32%-15%) or by Y 0.859 billion. Retained profits will increase (using the current 55% rate of enterprise tax) by Y 0.386 billion, equivalent--for the sake of perspective--to 21% of the wage bill.

2.110 The effect of this tax rate reduction on profitability will differ if the industry is not subject to price controls. In that case, the increase in profitability will encourage enterprises to expand output and, if the industry is profit maximizing and there is no shortage of supply, prices will fall until the level of profitability is the same as before. To estimate the extent of the price decline, note that at a VAT rate of 32% the enterprise receives Y 68 for every Rmb 100 of sales. At a VAT rate of 15%, after-tax sales revenue of Y 68 may be obtained at a sales price of 68/0.85 = Y 80 per unit. Therefore, competition among enterprises could lead to a 20% fall in free market prices. Total industry profits will rise if output rises in response to the increased demand generated by lower prices, but profits per unit of sales would continue to be the same.

2.111 If, in line with the average situation for intermediate goods, 60% of rubber goes for plan sales and 40% at guidance and market prices, the reduced VAT rate will increase the profitability of plan sales while for free market sales, output will rise, prices will fall, and profits per unit of sale remain unchanged. Ultimately, the profit increase is 60% of profits achieved when all sales take place at fixed prices, (Y 0.386 billion) or Y 0.231 billion.

---

31/ Value added in tobacco products is Y 14 billion so that a 15% VAT would yield Y 2.1 billion. This example is only an illustration of the principles involved as it neglects untaxed inputs into tobacco manufacturing and assumes that all tobacco products are taxed at the same rate. The data required for a more detailed analysis of tobacco products were not available. See Annex I for full details of tobacco and petroleum products excise taxation.

2.112 The same analysis can be applied to an industry whose taxation would increase following unification of VAT. The reduction in profitability will again depend on the proportion of output that is sold at fixed and free prices. In general, the effects of VAT unification on profitability will be smallest for industries that sell high proportions of output at free market prices, and largest for those selling their output at controlled prices.

2.113 Implications of a Unified VAT: Revenue Growth. Replacing existing indirect taxes by a single rate VAT and supplementary excises can be made revenue-neutral by suitable choice of rate, and, furthermore, that rate is close to that used in presumptive crediting under the existing VAT. While this is reassuring, it is essential that any tax changes proposed also ensure revenue growth from indirect taxes in line with GDP. This is a highly desirable feature of a tax system, since it does not require frequent changes in tax rates to ensure revenue growth. Such rate changes, as pointed out in Chapter 1, when introduced for purely budgetary reasons, typically pay insufficient attention to issues of efficiency and resource allocation, in addition to the uncertainty they introduce in decision-making for households and enterprises. Looking to the future, when Chinese enterprises will be more responsive to price signals, such ad hoc tax changes will have inefficient outcomes. It is therefore essential that modifications to China's tax system be undertaken with buoyancy in mind.

2.114 Theoretical arguments suggest that the VAT is an elastic tax. The VAT reform proposed in this report would move taxes away from the productive sector in China and towards households. This is the essence of consumption taxation. Since consumption is the single largest component of national income in China, as elsewhere, such a move ensures that tax revenues will move at least in line with gross domestic product. Revenue growth is further enhanced by the low rates of tax applied to necessities, whose consumption grows relatively slowly as income grows, and by higher rates applied to luxuries whose consumption grows relatively rapidly.

2.115 Empirically, the VAT has been a elastic tax, as Table 2.5 shows. Cross-country evidence as reported in that table shows that many countries have experienced an increase in revenue from VAT plus other taxes on goods and services as a proportion of GDP from 1975 to 1985. Exceptions are provided by Belgium, Denmark and Korea in the later part of the period and Italy in the earlier. Although this reflects a combination of changes in tax rates as well as the responsiveness of revenue from a fixed tax structure, the evidence suggests that countries contemplating the introduction of a VAT could in general expect to maintain growth of indirect tax in revenue at least in line with that in GDP.

2.116 The countries identified in the table have a VAT that extends through the retail level. This implies that the tax is levied on final consumers and is, therefore, a tax on final consumption. This is not true of the manufacturing-cum-import stage VAT recommended in this report, for China, which would not subject the wholesale and retail trades to VAT. Therefore, strictly speaking, the tax is not levied on final consumption. Nevertheless, inasmuch as the recommendations move the point of taxation closer to consumption, with the possibility of going through the retail level at a subsequent stage of reform, the evidence presented in the table is relevant in judging the buoyancy of tax revenues under the proposed VAT.

Table 2.5: GROWTH OF VAT REVENUE IN SELECTED COUNTRIES
(DOMESTIC TAX ON G&S AS % OF GDP)

| | First Year of VAT | 1975 | 1980 | 1985 |
|---|---|---|---|---|
| Argentina | 1975 | 3.5 | 5.9 | 7.8 |
| Austria | 1973 | 8.5 | 8.8 | 9.4 |
| Belgium | 1971 | 9.8 | 10.6 | 9.6 |
| Denmark | 1967 | 13.7 | 16.7 | 16.3 |
| France | 1968 | 11.7 | 12.2 | 12.3 |
| Germany | 1968 | 6.5 | 6.6 | 6.7 |
| Ireland | 1972 | 9.4 | 10.9 | 13.5 * |
| Italy | 1973 | 8.2 | 7.7 | 8.2 |
| Luxembourg | 1970 | 8.0 | 8.4 | 10.4 * |
| Netherlands | 1969 | 9.5 | 10.4 | 10.3 |
| Norway | 1970 | 16.3 | 16.2 | 17.4 |
| Sweden | 1969 | 9.3 | 10.3 | 11.9 |
| United Kingdom | 1973 | 8.4 | 9.8 | 11.5 |
| Israel | 1976 | - | 12.8 | 16.0 |
| Korea | 1977 | - | 8.2 | 7.9 |

* Figures for 1985 were not available so 1984 figures are reported.

Source: Government Finance Statistics; IMF, Washington, DC.

2.117 Introducing a Simplified VAT: Concluding Remarks. In summary, while simplification of VAT rates, particularly for intermediate goods, is feasible and is recommended under current circumstances, the implementation of a fully unified VAT must await price and enterprise reform. In the absence of such reforms, a VAT of the type recommended in the report would continue to be borne in part by the enterprise sector. With such reforms, the tax burden on enterprises would be eliminated because (a) inputs bought by enterprises would be credited; and (b) taxes on output would be shifted forward to the wholesale and retail trades and agriculture and, ultimately, rural and urban households.

## Taxation of Enterprises

2.118 Taxation and Contracting. Although revenue from the enterprise income tax is second only to indirect taxes, its growth has not recently kept pace with that of profit growth. As noted in Section B, it may be conjectured that this was mainly due to the increasing use of the contractual responsibility system in state enterprises, especially the Contract Management Responsibility System (CMRS), which, of all the forms of contracting, by contracting for tax delivery, most directly subverts the system of substituting profit taxation for profit remittances.

2.119 Enterprise reform is of critical importance in the process of overall reform in China. Hitherto, it has been guided by two important considerations. First, to provide incentives to enterprises to make efficient use of the fixed assets with which they have been costlessly endowed. And, second, to reduce the role of discretion in dealings between enterprises and their supervising bureaus in favor of rules. The goals of direct tax reform are overlapping, although not identical. They are first, to provide a stable source of revenue to the government; and second, to offer incentives to enterprises to expand output and profits.

2.120 The substitution of profit remittances by profit taxation constituted both enterprise reform and tax reform. The first was reflected in the transfer to enterprises of profits and choice of dispositions of profits; the second by the introduction of a government role qua formal fiscal entity. This underlines the close links between the two. Although the shift from remittance to retention caused a decline in budgetary receipts, the rapid growth of enterprises where it was experimentally introduced indicate that it had very positive incentive effects.

2.121 In contrast, some of the tax aspects of the contractual responsibility system in its most widely used variant, the CMRS, by subverting the substitution of taxation for profit remittance, contributes little to tax reform. In promoting discretion rather than rules, the CMRS has the potential for reducing enterprises' responsibility for their own decisions, thereby compromising the effectiveness of tax instruments as levers of economic policy. And, by allowing tax liabilities to be contracted virtually on an enterprise-by-enterprise basis, the symbiotic relationship between supervisory agencies and State enterprises is strengthened. Finally, the use of a quota that is either constant or grows at a rate less than that of the industrial sector, together with a marginal rate of tax that is significantly below the basic rate, could impair the growth of revenue.

2.122 Not all these concerns are present in equal degree in all types of contract. For example of the four major types, the AMRS is generally not associated with tax remission; leasing contracts likewise call for full tax payment. Moreover, the AMRS includes components that help value the net worth of State enterprises. Such valuation techniques are essential if asset markets or the introduction of dividends based on enterprise net worth are to develop. However, to date the ARMS is less widely applied than the CMRS and other approaches more associated with tax remission, so that, overall, tax reform has not been supported by contracting.

2.123 Some perspective on the tension between the enterprise income tax and the contractual responsibility system is provided by observing that, since 1978, the authorities have alternated between these systems. Profit remittances were replaced by profit taxation in 1983, following experiments initiated in 1978 adjudged a considerable success. 1981-82, however, witnessed the emergence of the Quota Responsibility system. To the extent that this system allowed--in the first steps of the tax reform--a substantial element of discretion and was vulnerable to ratchet effects, there was a move away from the quota responsibility system towards profit taxation, so that virtually all profit-making State enterprises came to be on the profit tax system by 1983/84. The contractual responsibility system, however, made a strong reappearance in 1986/87 and it was decided late in 1987 to implement the CMRS variant more widely. The alternation between these two systems, together with the types of contracts now in use, suggest a continuing tension between competing models of enterprise reform and are part of the background against which different tax proposals will be assessed.

2.124 Taxation Versus Ownership. The importance of the distinction between the State as tax collector and the State as owner of fixed assets in State enterprises is by now well recognized. The recommendations in this section of the Report urge that profit taxation be used as the instrument of the tax collector, while the contractual responsibility system serve the needs of the asset or resource owner. The following recommendations address that distinction. First, the Report recommends that the taxation of State enterprises occur via the system of profit taxation without exception and that all enterprises be subject to the basic rate of income tax. The basic rate of enterprise tax should be maintained concurrently with and pending the reform of the contracting system. As a transitional matter, it may be undesirable to alter contracts under which enterprises have assurances or have committed to profit transfers, prior to their expiration. Until the contracting is reformed, new contracts should follow the criteria outlined above with respect to exclusion of taxes in contracts and the maintenance of a basic 55% tax rate. Most contracts should have run their course by 1990 or 1991, so that by this time it would be expected that all enterprises would be paying the standard base rate of tax.

2.125 The Enterprise Tax Rate. Consideration is being given in China to lowering the basic rate of enterprise income tax from its current level of 55% in order to provide greater incentives to enterprises and to bring the rate in line with the generally lower corporate income taxes in other countries. The mission recommends that decreases in tax rates not be implemented until the tax preferences prevalent under the contractual responsibility system have been fully eliminated.

2.126 Two reasons argue against a reduction of the basic rate in the absence of other measures. First, the incentive effects of the tax depend not just on the statutory tax rate but also on the treatment of depreciation, amortization and interest. This theme, which was illustrated in the marginal effective tax rate calculations of Section B, argues for simultaneous consideration of all provisions of the enterprise income tax and not simply its statutory rate. Second, decreases in tax rates, unaccompanied by revenue-raising measures, should not be implemented until the tax preferences prevalent under the contractual responsibility system and other revenue-eroding aspects of the enterprise income tax, such as principal deductibility, can be phased out. To do otherwise would be to risk losing significant amounts of revenue at a time when fiscal policy must play an important part in overall macroeconomic management. Moreover, until the expenditure implications of reforms in social security, housing and other areas and their financing structure are known, reducing the tax rate is not recommended. Reassessing the tax rate only after the full budgetary impact of such reforms is known will preclude the possible need to make major upward revisions as each reform proceeds.

2.127 Maintenance of the basic rate of enterprise income tax at its current 55% level pending reform of the contractual responsibility system implies that it will not be possible to unify the tax treatment of State enterprises with collectives and individual household enterprises. While this unification may be a desirable longer-term goal, it is the report's view that taking control of the revenue base through the taxation of State enterprises should receive higher priority than unification of tax treatment across different organizational forms. Abolition of tax preferences in the contractual responsibility system would offer the opportunity to implement a unified rate of enterprise income taxation. That rate would be set by the authorities with reference to revenue requirements. Lack of information precludes the report from making a recommendation on what that rate might eventually be.

2.128 The report also recommends that new contracts under the contractual responsibility system henceforth not be used to permit any exemptions from indirect taxes or customs duties.

2.129 The report recognizes that incentives must be provided to State-owned enterprises to encourage efficient utilization of their fixed assets and return a dividend to the State. However, this should be done without eroding the tax base. It is therefore suggested that contracting occur out of <u>after tax</u> profits alone. This will mean discontinuing those aspects of the widely-used contracting forms that are conducive to tax remission.

2.130 With the maintenance of a basic enterprise income tax rate at 55%, the retained profits of the enterprises will still include surplus which owes itself to their endowment of capital from the State, received, in the past, costlessly through budgetary grants. It is the disposition of this after tax surplus as between the State and the enterprise which should be subject to negotiation. Determination of the appropriate payment to the State is a complex matter, since compensating the State by way of a dividend for the contribution its assets make to enterprise earnings requires the assets themselves to be valued, a process which must await price reform. With attempts to broaden bidding in the contractual responsibility system (as is now done with the AMRS), it can be expected that such contractual charges in the presence of capital market reform would begin to approach market-related valuations for enterprises.

2.131 Further developments in this direction will also allow for modification of the adjustment tax. The present adjustment tax on State enterprises is seen as a way of equalizing profits across enterprises within a sector, in part, to tax those profits enterprises earn attributable to their state capital. In some sense, it can be construed as a charge use of fixed capital. With the further attempts to refine bidding into contracting out of after-tax profits as recommended by the Report, together with capital market reform, market-related valuations for enterprises can be expected to emerge. At some time following these developments, it would be appropriate to phase out the adjustment tax altogether.

2.132 These recommendations are consistent with the substitution of rules for discretion emphasized in Section B, that is central to enterprise reform. At the same time, they respond to the important tradeoff between revenue and efficiency. The government's revenue base would be more adequately protected, and the advantages of the contractual responsibility system as a management device could be preserved and, where necessary, improved, but without prejudice to the interests of the tax collector.

2.133 These proposals attempt to retain the more attractive features of the enterprise income tax and the contractual responsibility system. While experimentation with different variants of the latter system has yielded valuable insights into its generic strengths and weaknesses, it is suggested that consideration be given to narrowing its range to a few "standard" after tax archetypes that would apply to all enterprises. Failure to do so would impede the development of competitive forces to which enterprises must ultimately be subject in the interests of enterprise reform and efficiency.

2.134 The Enterprise Income Tax. The enterprise income tax in China differs from international practice in one major respect, namely in the deductibility of amortization of bank loans from taxable profits. This is in addition to the deductibility of interest, a practice found in the corporate income tax of many countries. The tax-deductibility of principal and interest in China embodies part of the provisions of the comprehensive cash flow tax (described in Annex I)32/ but without including loan proceeds in the tax base as income. While the replacement of budgetary grants with bank loans has been consistent with enterprise reform, this generous treatment of amortization and interest is anomalous in general, and particularly so at a time when over-investment by enterprises is considered to be a serious problem.

2.135 The Report recommends that the amortization of bank loans be disallowed effective now, with borrowing for new investment as a deduction from taxable income. This would have a positive effect on government revenue and, by raising the cost of capital, exert a dampening effect on investment, while bringing enterprise taxation somewhat closer to international practice on the income tax. A broad estimate of its implications are outlined below.

2.136 Disallowing Principal: Implications for Revenue and Profitability. Most loans in China are amortized over five to ten years.33/ With loan financing of investment approaching 15% in state enterprises, the impact of including amortization in taxable income could be significant. Table 2.6 below presents an estimate of the possible impact on revenue and profitability, assuming all amortization were immediately taxable. These calculations can therefore be viewed as a 'steady state' revenue and profit equilibrium. If, instead, amortization were disallowed on new loans only, the profit and revenue impact would be much less in the initial year--amounting to a 3-4% revenue impact, and an impact on profits of a slightly smaller magnitude. Additional revenues would be raised in the second year, and the full impact on revenue and profitability would be felt only at the end of the amortization

---

32/ Zodrow, George R., and McLure, Charles E., "Alternative Methods of Taxing Consumption in Developing Countries," World Bank, Country Economics Department, January 1988.

33/ The formal amortization schedule calls for equal repayment over a 5-year period; however, the Finance Department at the provincial level and below (or the relevant industrial bureau) may authorize repayment over a longer period, up to 10 years.

period. Inclusion of amortization (calculated at Y 14.2 billion) in the tax base, therefore, leads to substantially higher taxable income of Y 148.3 billion which, taxed at the average prevailing effective rate of 49%, potentially increases government revenues by some 11%. The new treatment would lead ultimately to a differential of 10% in the after tax profits of state enterprises compared to what they would have been under the present system and a corresponding decline in their profitability, whether defined vis-a-vis fixed assets or sales.

Table 2.6: ELIMINATING PRINCIPAL DEDUCTIBILITY: REVENUE AND PROFITABILITY EFFECTS (Y billion)

| Present system | | After change in tax treatment | | |
|---|---|---|---|---|
| Taxable profit : | 134.1 | 134.1 + 14.2 | = | 148.3 |
| Taxes: /a | -65.2 | Taxes: | = | -72.0 |
| After tax profit | = 68.9 | After tax profit | = | 76.2 |
| | | LESS Amortization | | -14.2 |
| Net enterprise retentions | = 68.9 | Net enterprise retentions | = | 62.0 |

Revenue increase is: $\frac{72.0 - 65.2}{65.1} = 11\%$

Decline in retentions = $\frac{68.9 - 62.0}{68.9} = 10\%$

/a Using a rate of 49%. 8-year amortization assumed. This is the average effective tax rate, calculated as enterprise tax paid (Y 65.1 billion) divided by total profits (Y 134.1 billion). The tax figures include income and adjustment taxes. Tax rate is calculated as Y 65.15 ÷ Y 134.14 = 49%. Note that for this purpose, working capital loans are treated as "interest only" loans; there is no amortization. Cumulative amortization since 1981 has been calculated as Y 14.2 billion. For full details, see Annex 1.

2.137 These calculations embody a number of upward biases. First, disallowing amortization is likely to lead to a reduction in borrowing, so that the fixed base assumption used in the calculation overestimates both the revenue gain and the resulting decline in enterprise profitability. Second, since under the contract system, a number of enterprises in more recent periods are paying income tax at a statutory rate well below 55% (and an effective rate less than 49%), the revenue gain (and decline in profitability) from disallowing amortization payments is also over estimated. To the extent that the proportion of investment financed by loans has increased, these effects are underestimates. Nevertheless, even with downward adjustments in those calculations, it would appear that implementation of the recommendation to disallow amortization payments as an expense against the enterprise income tax would cause a significant change in income tax revenue and enterprise profitability. The report therefore recommends it be applied to all new borrowing for investment. The removal of tax deductibility of amortization would make it easier to introduce a consumption VAT without stimulating excessive investment.

2.138 The Report did not have the information necessary to quantify the extent to which the policy change recommended here, by raising the cost of borrowing, would restrain investment in enterprises. If state enterprises continue to be subject to a soft budget constraint, the worsening of their profitability position would lead to demands for subsidies that would eventually offset both the revenue gains and the altered profitability of State enterprises, hence nullifying the effect of the policy change. As mentioned before, available evidence from enterprise studies suggests that the reforms have led to some hardening of the budget constraint.34/ Furthermore, loss making enterprises do not constitute the majority of Chinese industries. For these reasons, the measure can be expected to have an impact on State enterprises. It will have a mixed impact on enterprises outside the State sector. On the one hand, 40% of their loan repayments are even at present paid out of after-tax incomes; on the other, such enterprises are not characterized by as soft a budget constraint.

Resource Tax

2.139 The report recommends that the tax authorities charge for natural resources in much the same way as for fixed assets. The absence of a mechanism for valuing fixed assets in State enterprises is offered as an argument for the income adjustment tax which is levied on profits. Likewise, profits are used by the authorities as a surrogate for the value of resources, and the lack of a market in resources causes the resource tax to be levied as an "excess profits tax". Both types of tax, by failing to distinguish the sources of "excess profits", run the risk of penalizing more efficient enterprises. Thus, higher taxes on profits could penalize enterprises who earn those profits as a result of lower marginal costs of resource extraction, or greater skills in using fixed assets on behalf of the State.

2.140 Efficiency in resource allocation ideally requires that enterprises be charged a price that reflects the social value per unit of resources extracted by them. Risks of exploration and development, where significant, should be efficiently shared between the State and enterprises engaged in resource extraction. This is to be seen not as a tax but as a cost per unit of resource use. The payment would represent a return to the State qua resource owner. The cost to the enterprise, being a payment to a factor of production, would normally be deductible from the enterprise income tax. However, the social value of a resource is often difficult to arrive at, given the lack of information about the volume and quality of natural resource deposits prior to exploration. Different countries have resorted to different arrangements in order to get a return on resources they own.

---

34/ Tidrick and Chen; China's Industrial Reforms. Oxford University Press, for IBRD, 1987.

2.141 Many, such as Bolivia (bismuth, silver, uranium), Chile (copper, uranium), Colombia (uranium, emeralds, platinum), Gabon (uranium), Jamaica (bauxite), Malaysia (iron ore), and Mexico (gold, silver, iron, coal), Nigeria (oil), Zaire (copper, oil), employ either a <u>specific</u> or <u>ad valorem royalty</u> on production or sales. Others, notably Papua New Guinea (copper) and Indonesia, levy <u>excess profits tax</u>, with the latter country charging ad valorem royalty as well.

2.142 In addition to the above, governments of some countries have equity participations in resource exploration. For example, State-owned enterprises are responsible for exploration in Zambia and Zaire (with the exception of petroleum). Another mechanism, that is used mainly in the US, is the auctioning of resource exploitation rights in return for a lump sum payment to the government. It is necessary to emphasize that the appropriate combination of instruments for securing payments for resources depends on the nature of the resource in question and importantly on the risks involved in exploration and development.

2.143 The mission did not study in detail the resource sector in China and is therefore not in a position to recommend how the types of arrangements outlined above could be adapted to its particular circumstances. But the following general point may be made. It is important to maintain the distinction between the State as tax collector and the State as owner, in this case, of natural resources. It is therefore recommended that enterprises engaged in resource extraction be subject to the income tax at the same basic rate applying to all State enterprises. In addition resource fees and royalties would in general be charged, and would accrue to the state as owner of the resource. (Such royalties would be allowable deductions against the enterprise income tax). Any sharing arrangements deemed appropriate for the State as owner of the enterprise's fixed assets, would apply to after-tax profits only. Thus, the State would receive: (a) taxes due under the enterprise income tax; (b) a payment for ownership of the fixed assets of the enterprise; as well as (c) a payment/royalty on the natural resources which it owns and which the enterprise is engaged in extracting.

2.144 The royalties, or charges for resource extraction, could be estimated in a number of ways. The AMRS variant of the contractual responsibility system, that values enterprise assets as the discounted value of the stream of profits forecast by the winning bidder, could be used as a model for valuing resource rights to enterprises extracting natural resources. That value, however generated, could be used to assign either a charge per unit of resource extracted or to design lump sum charges or profit-related sharing arrangements of the kind observed in other countries and described earlier. In the absence of such information, an excess profits tax or royalty could be applied, set at a "presumptive" rate based on the experiences of other countries. It is suggested that the details of such resource taxation be studied carefully in China.35/

---

35/ Conrad, Robert F., "Mining Taxation: A Numerical Introduction," <u>National Tax Journal</u>, December 1980, pp. 443-449.

Conrad, Robert F., "A Framework for Analysis of Mineral Tax Policy in Sub-Saharan Africa," World Bank, Country Economics Department, August 1988.

2.145 The Report recommends that the State, which presently levies the resource tax only on coal, oil and gas, charge also for mineral resources. The tax should not, however, vary as it does at present, by size of enterprise.

2.146 Urban Land Tax. Finally, the same arguments establish the desirability of charging for land, in the absence of a rental market. Current proposals envisage such charges for land converted from agricultural use. It is important that the land use fee or tax be set at a level that reflects land's social value. A recent Bank study outlined these issues in greater detail.36/ The Land Tax--to be applied in urban areas--in order to compensate the government as owner of land is in keeping with both of the fundamentals of reform; which are (a) to increase the claim of government as owner of the resource; and (b) to require enterprises endowed with resources from which they derive rents, to be charged accordingly. The tax as it presently stands is (i) too low to have an effect on land use decisions; (ii) does not adequately reflect the value of the government's claim on the land resource; and (iii) has been set too low to provide the government with adequate revenues. The Bank study recommended that the land tax rates be raised, and that the land tax base be assessed to the extent possible, by more accurately valuing the land and its location value. As land markets develop, observed land exchange prices could be used. If the base is indexed, the land tax could become a robust source of local government revenues.

2.147 Taxation of enterprise profits, together with a contracting on after-tax profits in the form of a dividend, and taxes on enterprises' use of resources and land would ensure that the enterprise's use of the three major factor inputs--capital, land and resources--(in the absence of markets for such inputs) more truly reflects their social value and that incentives to improve efficiency in use are correspondingly enhanced. In the absence of such prices for enterprise inputs, greater retention of earnings by enterprises is no guarantee of better resource allocation.

## Other Taxes

2.148 Trade Taxes. The distortions and highly differentiated effective protection arising from China's current customs regime led an earlier Bank report 37/ to recommend that tariff rates should be made more uniform. Based on the trade situation in 1986, the report recommended that tariff rates be confined to within a 10-50% range and that the widespread duty exemptions for imported machinery and capital goods that result in a penalty for domestic producers should also be eliminated. The present mission did not have occasion to focus on the trade sector, and to extend or modify these conclusions.

2.149 Personal Income Taxation. Although this tax currently plays a very modest role in the tax system, it has the potential of being progressive in

---

36/ Land Use Taxation in China; Roy Bahl and Zhang Jun; INURD Working Paper; May 1988.

37/ Report No. 6680-CHA, External Trade and Capital. IBRD, 1987.

incidence and, hence, of attenuating the pre-tax inequalities in income that accompany liberalization. Such developments must however await improvements in tax administration. The experiments underway in Beijing and Shanghai on strengthening the withholding system are a useful step. The mission was informed that the proportion of revenue from the PIAT raised through self-compliance increased from 15% in 1987 to 22% in the first quarter of 1988. While this is encouraging, consideration should be given to further improving incentives for self-compliance. The report also recommends making the PIAT an annual, not monthly, tax, and proposes that, to the extent feasible from an administrative point of view, the tax be applied on global income, and on income in kind, especially cash and near-cash subsidies.

2.150 Business Tax. The report recommends that the Business Tax continue to be applied to all service sectors, pending the extension of the VAT through to the retail level.

2.151 Agriculture Tax. China has undertaken a number of experiments in the taxation of agriculture notably under the regional development programs (RDP) in areas selected for reforms.38/ Two features of the reforms are noteworthy. The first is a significant increase in the tax rate itself, in some cases a doubling. This is intended to increase revenues to the government, while its burden to peasants will be more than offset by their sales of produce at market prices. A second is the payment of the agricultural tax in grain valued at market prices; or alternatively, the payment by grain farmers in cash. This is intended to eliminate the bias against grain producers, who are liable for tax in grain, valued at below-market prices, and thus subject to an additional "hidden tax", equal to the opportunity cost of foregone market sales of their produce. Putting an end to this hidden tax would restore some of the profitability of grain production vis-a-vis specialty crops, an important consideration for China at present. An earlier Bank report recommended that consideration be given to widening these reforms. The present mission did not have occasion to focus on agriculture taxation and to modify or extend these conclusions.

2.152 Agriculture Land Transformation Tax. China is also concerned about the loss of productive farmland to urban uses, and a new one-time tax on the conversion of such land is intended to discourage such conversion. While the mission did not have the opportunity to study this in detail, further moves to extend such a tax more broadly call for further study of land use more generally, especially in and around urban areas.

2.153 Extrabudgetary Funds, Extrabudgetary Construction, and Wage Bonus. Taxes such as those on extrabudgetary funds and extrabudgetary construction are frequently used in socialist countries. Their purpose is to discourage excessive growth of investment and encourage more rational use of capital by implicitly raising the shadow cost of capital to the enterprise. The report recommends that these taxes be phased out as and when macroeconomic levers and policies--most importantly interest rates and credit policy--have become effective and when the price of capital itself is sufficient to regulate investment decisions. The wage bonus tax should be phased out as wages reform

---

38/ These were described in "Agricultural Land Taxes in the Xinxiang Regional Reform" RSAL Working Paper.

proceeds and replaced with the personal income tax whose reach extends to the level of a larger number of urban income earners.

The Reform Package and its Revenue Implications

2.154 This chapter has argued that maintenance of revenue from product tax and VAT could be achieved by a single rate VAT in the neighborhood of 15%,39/ if price reform were to be undertaken as well. In the absence of price reform, it was shown that simplification in the VAT rate structure for intermediate goods was desirable. If more revenue were needed in order to reestablish macroeconomic control prior to price reform, the authorities could resort to a temporary across-the-board levy in indirect taxes on top of the VAT without disturbing the exempt status of agriculture and the zero rating of exports. Cross country evidence was used to argue that VAT-cum-luxury excises would be a buoyant source of revenue.

2.155 With respect to indirect tax revenue, the effect of tax-cum-price reform can be summarized as follows: Decontrolling intermediate goods prices will reallocate profits between intermediate goods producing enterprises and final goods enterprises, both of which are in principle taxed at the same rate. The decontrol of retail prices would however transfer income from final consumers and increase profits of enterprises producing those goods. It was estimated that the additional profits from retail price decontrol could approach Y 30.1 billion, which would be subject to both VAT and enterprise tax.

2.156 The revenue accruing from the increases in enterprise profitability was estimated to approach Y 17 billion, or 20% of total product tax and VAT revenue.40/ 41/ The revenue deriving in the steady state calculation from eliminating principal deductibility was estimated to be some Y 6.8 billion, or 11% of total enterprise tax revenues (and 3% of total revenues). Phased in on new investment only, the revenue could be some Y 2 billion in the first year, or about 3% of enterprise tax revenues (and 1.3% of total revenues).

The Phasing of Tax Reform: A Summary

2.157 The Report has recommended reforms in three broad areas, including enterprise taxes and contracting, the VAT and resource taxes, with lesser

---

39/ Data on demand responses that would permit refining this estimate were not available.

40/ Depending on the applicable contracting tax rate, the revenue yield was estimated in the text to be: (a) from the VAT: Y 30.1 billion x (.15) = Y 4.5 billion; plus (b) Y 25.66 billion x (.49) = Y 12.5 billion or Y 17.0 billion total.

41/ It is worth being reminded of the "fixed base" nature of these calculations. Data on household expenditures and demand patterns would allow better estimates to be made. Likewise, these estimates are based on a one-time decontrol of all prices, and assume that 49% enterprise income tax is applied to incremental profits. It must also be emphasized that these are first round, or impact effects.

focus on the personal income tax, agriculture tax and custom duties. Clearly, not all recommendations can be implemented immediately, and this chapter has sought to indicate which of the reforms can be undertaken even in the absence of reforms in other areas must be coordinated with progress in reforms in the areas.

2.158 Taking VAT as an example, in the absence of price reform, unification of the VAT rate structure is prevented because of the continuing need to use indirect taxes to equalize sectoral profitability differentials arising from price distortions. It follows that initiating price reform would imply greater scope for using VAT and that tax and initiating price reforms must be coordinated with each other. As price liberalization proceeds, it would be possible to simplify the rate structure of VAT and move towards a unified VAT structure that is similar to other countries.42/ Such a VAT would have the advantage of minimizing distortions of the market prices, while fulfilling the major tasks of revenue-raising, protecting the living standards of the poor and discouraging socially undesirable consumption.

2.159 Similar coordination is called for with the natural resource tax. A reduction in price control will remove some distortions but not those differences in profitability due to differential access to natural resources. Indeed, more widespread use of the price mechanism makes it more important that enterprises should face the entire costs of their activities, including their use of natural resources. The resource tax or similar resource charges should therefore be extended as price reform proceeds, to cover the major natural resources. It is, however, difficult to reform fully in the absence of any price reform.

2.160 The matrix in Table 2.7 summarizes the phasing of tax reforms recommended in this report. Even in the absence of further changes in enterprise or price reforms, the Report recommends, (i) introducing VAT through the manufacturer-cum-importer stage at a more limited range of rates (say 3-5) than now applies on intermediate goods; (ii) selective excises to supplement VAT; and (iii) fully eliminating any remissions of indirect taxes in new contracts. In the longer run, VAT could be applied at a single, uniform rate and the Report recommends unifying VAT rates on final goods as price reforms proceed.

2.161 With respect to direct taxes, the report recommends (i) eliminating contracting on pretax profits in any new contracts being negotiated, and maintaining the present 55% enterprise tax rate on taxable income; (ii) phasing in the elimination of deductibility of loan principal beginning with borrowing for new loans, and (iii) building on the strength of the contracting system by contracting for a dividend to be paid to the state as owner of fixed assets. In the longer term, the enterprise income tax may be

---

42/ Indirect taxes could no longer be seen as falling entirely on the producer or on profits, but would be borne mainly by consumers, except for products where supply is unresponsive or inelastic to price changes. Therefore, differential taxes would not be able to carry out one of their main current aims: the equalization of profitability between industries. Indeed, in those industries where competition is reasonably strong, the relaxation of price controls would remove one of the major causes of unequal profitability.

unified across types of enterprise and steps could be taken to reduce the rate of this tax, if consistent with future revenue needs.

2.162 In the near term, resource extracting enterprises should (i) be made subject to the enterprise income tax, (ii) royalties or fees for each resource type should be applied to encourage more effective production of resources, and (iii) as for other enterprises, contracting should be permitted only on the enterprises' after-tax profits, to compensate the state as owner of the enterprise assets (as distinct from owner of the natural resource). Over the longer term, royalties and extraction rights would be set by competitive bidding and the tax extended to all resources.

2.163 With regard to other taxes such as the PIT, the annualization of the personal income tax payments and strengthening of administrative arrangements for wage withholding could be initiated immediately. In the longer run, the wage bonus tax could also be phased out as personal income taxation based on withholding gains ground. Finally taxes such as those on extra budgetary funds, and construction, could be phased out as macroeconomic tools are made more effective.

2.164 The Report cited the recommendations of an earlier Bank report that agriculture tax reforms--well underway as experiments in certain areas--be extended. These included (i) increasing the tax rate, and (ii) allowing grain and other producers able to meet a cash tax liability. In the longer run, the value of agricultural land should be reassessed by localities.

2.165 With respect to trade taxes, the Report also cited the conclusion of an earlier Bank report to eliminate exemptions on customs duties in contracts; and (ii) eliminate exemptions on capital goods imports. In the longer term, that report also recommended reducing the range of import duty rates.

Table 2.7: SUMMARY OF RECOMMENDATIONS

| Recommendation | Near Term Steps | Medium Term |
|---|---|---|
| I. Indirect Taxes | | |
| 1. VAT | - Introduce VAT through manufacturer/importer stage at a more limited range of rates prior to price reform. | - extend VAT to retail level at uniform rate following price reform. |
| | - unify VAT rate for intermediates | |
| | - No remission or contracting of indirect taxes in new contracts | |
| | - Maintain supplementary excises | |
| 2. Business Tax | - strengthen administration of business tax | - replace with VAT in some service sectors. |
| II. Direct Taxes | | |
| 1. Enterprise income tax | - eliminate tax remission in new contracts and contracting forms (CMRs) which contract for pre-tax profits | - reduce rate to below 55%, if this is consistent with revenue objective |
| | - maintain present 55% rate pending reform of contracting | |
| | - introduce contracting on after tax profits only | - develop into dividend policy |
| | - begin to eliminate deductibility of principal on new investment | - full elimination of principal repayment deductibility: follows automatically |
| 2. Personal Income Tax | - annualize personal income tax and base on household income | - introduce broadly and phase out wage bonus tax |
| | - strenthen wage withholding aspects of PIT | |

| | | |
|---|---|---|
| III. Resource Tax | - eliminate tax remission in new contracts and contracting forms (CMRs) which contract for pre-tax profits for source-extracting enterprises | - extend to mineral resources |
| | - maintain present 55% rate pending reform of contract system | |
| | - introduce royalties/ fees on presumptive basis | - introduce valuation of resource rights |
| | - contract on after tax profits only | |
| | - consider extension of the Resource Tax to land | |
| IV. Customs | | |
| 1. Import Duties | - reduce number of tariff rates as recommended in Trade Report | - narrow duty range (as recommended in Trade Report) |
| | - no exemption of customs duties in contracts. | |
| V. Agricultural Taxes | - reassess tax rate and other recommendations as per RSAL Report. | |
| VI. Other Taxes | | |
| Extra-budgetary Funds Tax<br>Extra-budgetary Construction Tax | - | - eliminate as and when macro-economic levers (interest rates) are strengthened |
| Wage Bonus Tax | | - phase out and replace with personal income tax. |

## III. CENTRAL-LOCAL FISCAL RELATIONS AND REVENUE SHARING

### Introduction

3.1 The tax structure and the system of intergovernmental fiscal relations are inextricably linked in the Chinese fiscal system. The laws of taxation and the powers and responsibilities of the various levels of government are laid down by the central government, and subnational governments are responsible for tax administration, share in revenue collections, and have a substantial amount of latitude in awarding tax preferences to enterprises. The development of the system--perhaps better characterized as a series of arrangements--of tax administration and central/local relations has given provincial and local governments increasing freedom to alter the fiscal system to meet their own objectives. Among the more important implications of this arrangement is that the "tax levers" the central government designs may be different from the fiscal measures actually implemented at the local level. Yet the success of any central government tax reform will depend on the implementation by subnational governments.1/ A successful tax reform program in China will almost certainly have to be accompanied by changes in the system of intergovernmental relations. Section A below reviews the experience, principles and criteria for decentralized and centralized fiscal systems. In Section B, China's system of intergovernmental relations is described. An initial assessment is outlined in Section C, while Section D develops options for reform. One option is in keeping with the present centralized model, but strengthens it in numerous ways; another is a decentralized model. The choice between these two depends on the Chinese authorities' desire for macro-control and equalization capability, compared with the benefits of decentralization.

### A. Fiscal Decentralization and the Role of Local Government: Principles, Criteria and the International Practice

3.2 In China and in virtually every other country there is debate about the "proper" way to organize the public sector to deliver and finance services. Most of the debate centers around which level of government should provide which public services, how much fiscal autonomy should the local government have, and the relationship between the revenue base given to local governments and their expenditure responsibilities. This section is meant to develop a framework for thinking about such questions in China.

### Fiscal Centralization vs Fiscal Decentralization

3.3 The arguments for fiscal centralization and decentralization relate to the major tax objectives of government--stabilization policy, equity between units of government and resource allocation and growth. Where the flexibility to pursue stabilization policy is especially important (such as in low income economies "exposed" to international fluctuations, variations in

---

1/ In China, and in this report, all Provinces and Cities with provincial status are referred to as provincial governments (including the cities which have Province status; Shanghai, Beijing and Tianjin), while cities and counties are referred to as "local" governments. Where both levels of government are referred to, the report indicates "subnational."

commodity prices, etc.) central government control of the major tax and borrowing instruments would be called for. It is sometimes thought that the implementation of economic growth policy also argues for fiscal centralization. Where investment capital is short, its mobilization and direction by the central government can help maximize returns.2/ If local governments are given access to major tax bases, they may "compete" with the central government and therefore limit the amount that is available for the central government. On the expenditure side, more centralization allows the government to steer the allocation of public resources in the direction of goods and services with national benefits, whereas more local autonomy would inevitably produce more localized benefits.

3.4 Income distribution arguments also support the case for fiscal centralization. In most developing countries, regional, and/or rural-urban disparities in income and wealth are pronounced, and may be accentuated by fiscal decentralization because the already wealthier urban local governments will benefit most from increased local government taxing powers. A centralized fiscal system will enable the central government to provide transfers to poorer provinces. Finally, central governments are thought to have a superior capacity in the areas of tax administration. A corollary to this argument is that skilled fiscal managers--analysts, accountants, valuers, collectors--are in too short supply in LDCs to be shared between the central and local governments.

3.5 There are also good theoretical arguments for a decentralized structure of local governance in LDCs. Perhaps the most compelling is that local governments because of their proximity, are able to reach the growing taxable capacity in urban areas more easily than could the central government. An increased rate of national resource mobilization could occur. It is very difficult for central governments to capture much of this fiscal surplus. Neither central government income nor consumption taxes typically reach small firms, workers in smaller firms or outside the larger cities, or the self-employed. Local government business and occupation licenses, sales taxes, permits and property taxes have a much better chance.

What Revenue Raising Powers For Subnational Governments?

3.6 Theory does not provide a guide to the "right" share of national revenues and expenditures for local governments. Beyond the obvious conclusion that revenue responsibility and expenditure assignment should be in balance, little guidance can be offered as to the optimal division of revenues among central and subnational governments. Neither may China look to some international norm for guidance in deciding on which revenue sources should be allocated to Provincial and local governments. One valid generalization which can be made is that the proper mix of subnational government revenues depends in part on the expenditure responsibilities which are assigned to subnational governments. In fact, for a given set of expenditure responsibilities, an appropriate revenue mix may be chosen largely on efficiency grounds.

---

2/ Note that this does not argue for a larger role of government *per se*, but only for a larger share of the center, vis-a-vis local governments.

3.7 For publicly provided goods and services, where the benefits accrue to individuals within a jurisdiction and where the exclusion principle can be applied in pricing, user charges are most efficient.3/ This is the case particularly for public utilities such as water supply, sewerage, power, and telephone, but also for public transit and housing. Other local services, such as general local administration, traffic control, street lighting and security, are local public goods whose primary benefits accrue to the local population but where the exclusion principle in pricing cannot be applied. These are most appropriately financed by taxes whose burden is local.

3.8 Provincial or national intergovernmental transfers should contribute to financing services such as health and education where substantial spillovers into neighboring jurisdictions occur. Purely local financing tends to underprovide these services from a regional or national perspective. Finally, borrowing is an appropriate source of financing capital outlays for infrastructure with long-lasting benefits. This is the case particularly for public utility and road infrastructure expenditure. Expenditures of an infrastructural nature, or others with broader provincial or national benefit are appropriately financed at the provincial or national level.

3.9 The assignment of taxes to national and subnational governments varies widely. Taxes usually levied at the national level include resource taxes, and personal and corporate income taxes because of their important role in stabilization and distribution policy. Customs duties are also almost always national-level taxes because of their strategic importance. Sales taxes are often levied at the provincial level. Excises and surcharges are also often provincial taxes, as their revenue growth is stable.

3.10 There are many exceptions to these patterns: Switzerland and the United States permit local jurisdictions to levy corporate income taxes as well as personal income taxes and natural resource taxes. By contrast, in Australia and Canada the provinces are prevented from using sales or other indirect taxes. In Nigeria, until recently, export duties accrued to local governments, and, in Malaysia, natural resource taxes are local. The actual practice of revenue assignment may be explained by a variety of factors, both historical and political, and by the relative tax capacities of specific levels of government (and the differing availability of tax bases at the local level). The relative administrative strength of the national and subnational governments is also important in determining the outcome, as is the division of expenditure responsibilities between them, itself usually related to the capacities of national and local-level governments.

## Intergovernmental Transfers

3.11 Whatever the outcome of the tax assignment, it often leaves one level of government with insufficient revenues. Many countries have resolved the revenue/expenditure imbalance between central and lower level governments and the division of taxing authority with a system of central government transfers--shared taxes, various types of grants and even loans--to subnational governments. This permits central governments to retain the authority

---

3/ See Roy Bahl and Johannes Linn; Urban Finance in Developing Countries; forthcoming.

to levy taxes on the more productive bases, but it gives provincial or local governments a flow of revenues. This is a step toward fiscal decentralization in that it provides financing for subnational government services, but the degree to which it gives subnational governments more autonomy in their budget decisions depends on how the system is structured.

3.12 The design of a program of intergovernmental transfers should be led by the objectives the government wants to achieve. But which level of government should define the objectives? Because objectives such as equity, revenue elasticity and neutrality often conflict, establishing priorities is difficult. These questions raise an important but frequently misunderstood feature of intergovernmental transfer systems: even with the best of design, any system has advantages and disadvantages. On the one hand, a formal (formula) program of intergovernmental transfers can broaden the resource base of local governments and provide for a growing source of revenue if transfers are related to the growth in a more elastic central government tax base (e.g., if transfers are a share of sales or income taxes). A transfer program has the added advantage of avoiding the high administrative costs which can be associated with local government tax assessment and collection. On the other hand, transfers and shared taxes can make subnational governments less accountable for their fiscal decisions (they may now increase spending without increasing taxes); hence, there will be less incentive to improve the efficiency of subnational government operations. Likewise, when transfers are large, subnational governments will have less incentive to search for new revenue sources or to improve the efficiency of collection from existing bases, and their tax effort may be dampened.

3.13 Other "advantages" and "disadvantages" are much less clear-cut. For example, an important issue in the design of transfer systems is the choice of whether and how the transfers will be controlled by the center. A disadvantage of central control, from the point of view of the subnational governments, is that transfer allocations may be political decisions and the flow of funds will be uncertain in amount from year to year. This makes fiscal planning very difficult for local governments. On the other hand, central control can enhance the budget flexibility of the central government, and in that sense is a great advantage for the center's macroeconomic management. Another example is that in some countries transfers carry "matching requirements", meaning that local governments must match a portion of the central transfer. This can distort subnational government expenditure choices if they are encouraged to spend because of the low "tax price" of certain types of outlay. Viewed from the central government's point of view, however, such conditions attached to the receipt of such transfers may help accomplish national goals.

3.14 In fact, transfer policies are always controversial from some point of view. Indeed, conclusions about the advantages and disadvantages of any particular program of central transfers to subnational governments depends on whether a national or a subnational government point of view is taken. Uncertainty for one level of government about the regularity and adequacy of transfer flows is the other level of government's budgetary flexibility.

3.15 Depending on their priorities, governments make use of many different types of transfer grants. Shared taxes, distributed on a basis of origin of collections, are an effective way to support the public finances in urban areas and to stimulate their tax compliance. "Formula grants" are typically used to distribute funds according to a formula based on expenditure needs and fiscal capacity. There are usually two objectives of transfer policy: (a) correcting "vertical imbalances," that is the misalignment of expenditure responsibility and tax capacity among levels of government; and (b) reducing geographical or "horizontal" differences between rich and poor provinces to permit a more equal level of expenditures among regions.

3.16 In order to pursue horizontal equity, shared taxes are not always allocated to local governments in the same proportion as they are collected. Instead, revenue sharing may allocate shared taxes on the basis of population, urbanization, per capita incomes, etc. Grants allocated on a basis of per capita income or another index of need may also be used to offset local governments' low tax capacities. Grants are also often given for specific purposes and special programs ("earmarked grants") to address deficiencies in public expenditures in specific expenditure categories. In general, the two objectives of revenue adequacy and horizontal equity cannot be met with only one approach.

3.17 Some transfer or revenue-sharing systems are also designed to encourage local tax effort or, at least, not to impair the local governments' incentives to raise taxes. For example, in India, 10% of the allocation to provinces through formula grants, is given on the basis of tax effort. Box 4.1 shows the range of approaches to formula grants.

3.18 Each of the basic transfer approaches has disadvantages, and none will satisfy all the objectives of an intergovernmental transfer system. One solution is to mix the approaches in a single system. For example, many countries such as India and Brazil use both equalizing and revenue stimulative transfers in the same system.

## China in an International Context

3.19 There is no "normal" share of expenditures made by subnational governments. Political considerations, regional realities, constitutional requirements and administrative elements are all crucial to understanding the development of different systems. The most basic issue on the tax side is the command over resources by the various levels of government and the resultant independence (or lack thereof) of each governmental unit in meeting its expenditure goals. The financial resources of each level of government depend on the division of tax powers. Because revenues and expenditures do not usually match, fiscal transfers are required to match resources with each level of government's expenditure responsibilities. Some countries find it to their advantage to give more fiscal powers and responsibilities to local governments, while others chose to rely on the different forms of intergovernmental transfer outlined above. This section explores how China fits the international patterns and what it can learn from the experience of other countries.

## Box 3.1: FORMULA GRANTS

Four basic approaches to allocating central revenue resources among local governments are: (i) tax sharing, (ii) *ad hoc* distributions, (iii) reimbursement of the costs of specified undertakings, and (iv) by formula.

Formula grants are popular because they are objective and easily understood, and because they give the central government the opportunity to target the distribution of funds among local governments in a way consistent with national policy. An added advantage is that as local governments outgrow their needs for revenue sharing, or as their needs change relative to other local governments, the grant distribution is automatically adjusted by the formula and no discretionary government action is called for.

Formula grants are usually pointed towards either a recognition of variations in expenditure needs or of differences in fiscal capacity, i.e., in the ability to raise revenue while making an average effort. Expenditure needs are proxied in many ways including per capita income, population, infrastructure adequacy, and the like. Examples include the following:

The distribution of education grants in Colombia is based primarily on the population size of each Province. Philippine general purpose grants are distributed according to population and land area. Transportation grants to Brazilian state and local governments are allocated according to population, land area, and the consumption of imported fuels. The distribution of India's excise tax grant has made use of a poverty index. Grants to compensate some provinces for low income and low fiscal capacity are often distributed partially by the reciprocal of per capita income. This is done in Brazil and India. Yet other formula grant systems have explicitly included a tax effort measure to induce Provinces to increase their rate of revenue mobilization. (Examples are the US, Nigeria, India.)

The disadvantages to the formula grant are that the choice of the grant elements can be influenced by politics. Moreover the choice of a formula may be limited to what data are available, and as such may reflect neither true expenditure need or fiscal capacity. Moreover, detailed and timely data are almost never available at the local government level.

Source: Roy Bahl and Johannes Linn; *Urban Public Finance in Developing Countries*; forthcoming.

3.20 On average, subnational governments in industrial countries account for about 30% of all government expenditures, compared to 15% in the LDCs. This pattern has not changed significantly during the past two decades. It is difficult to say how China fits into this international pattern. The subnational share of government expenditures (about 55%) and revenues collected (about 65%) are well above these averages. However, taking the revenues which actually represent local revenues (a far smaller fraction than revenues collected, because almost all taxes in China are collected at the local level) the proportion of "own revenues" is closer to 15% of total revenue.4/ Table 3.1 shows the range of experiences.

3.21 The Chinese system probably gives less formal fiscal autonomy to local governments than is the case in other countries. In most other countries the fiscal powers of local governments are limited, although local fiscal independence is greater in industrial than developing countries. In developing countries, the tax bases available to local governments and maximum rates are usually fixed. Similar arrangements usually hold for adjusting user charges for most major services, e.g., water rates, bus fares, rents. Most LDC central or state governments have approval powers over local government budgets, and the extent to which this process reduces local fiscal autonomy depends on the tightness of the review process. Local government budget autonomy is also commonly hampered by central government expenditure mandates. The borrowing powers of local governments are quite limited in most LDCs. Though credit is made available to subnational governments under a variety of schemes, most local governments are given little discretion over the amount or purpose of the loan, the source of the funds, or the terms of repayment.

3.22 Another important limitation in defining local autonomy has to do with the nature of selecting local officials. For example, it may matter little that local governments have a broad range of fiscal powers if all subnational financing and governance decisions rest in the hands of centrally-appointed officials. Again, a broad range of practices is followed, but central governments frequently make these appointments.

---

4/ Own sources are defined as those revenues collected by local government for its own use, plus those taxes unconditionally assigned or which accrue automatically to local government. Own revenues include the agriculture tax; income tax from collectives and state enterprises owned by the subnational government; and a sales tax surcharge, plus a variety of smaller taxes.

Table 3.1 : IMPORTANCE OF LOCAL GOVERNMENT REVENUE SHARE, SELECTED COUNTRIES (% of total revenues)

| Country | Local government "own" revenues as % of total government revenues (%) | Country | Local government "own" revenues as % of total government revenues |
|---|---|---|---|
| Nigeria | 26.5 | Israel | 11.4 |
| Tanzania | 21.7 | Syria | 5.7 |
| Uganda | 20.0 | Turkey | 2.2 |
| Kenya | 16.2 | | |
| Zambia | 6.8 | Colombia | 47.7 |
| Malawi | 3.7 | Brazil | 36.1 |
| | | Venezuela | 5.5 |
| | | Dominican Republic | 5.4 |
| Korea | 16.4 | Panama | 5.2 |
| Philippines | 11.2 | Costa Rica | 4.2 |
| Sri Lanka | 4.2 | Peru | 4.0 |
| Indonesia | 1.6 | | |
| Australia | 25.0 | US | 36.0 |
| Germany | 55.0 | China /a | 11.0 |
| Canada | 51.0 | China /b | 63.0 |

/a Measured on a accrual basis and includes only "own" revenues; i.e., those that accrue to local government before any sharing takes place. If data were presented on a "collection" basis, local government collections would amount to about 65% of total government revenues.
/b Collection basis.

Notes: Data for countries other than China: 1970s. China: 1985.

Source: R. Bird, "Intergovernmental Fiscal Relations in Developing Countries"; IBRD, 1976/1977. Data for industrial countries: Hunter, 1977, p. 104.

3.23 China provides significant formal limits to local government autonomy. There is virtually no local discretion as regards revenue raising; indeed purely local taxes cover less than one fifth of their expenditures, as Table 3.2 shows. Yet because the system gives local governments responsibility for administering and thus implementing the fiscal system, there is room for local governments to gain fiscal discretion by using informal methods, such as the granting of preferential tax treatment for enterprises.

3.24 Most large countries in the world are organized as federalisms: India, Nigeria and Brazil are examples among the developing countries, and the United States, Canada and West Germany are examples from among the industrialized countries, but China is not. This system, typically but not always, transfers controls over local finances from the central government to an intermediate level of government such as the State, Province, or Department.

3.25 There are strong arguments for and against the federal form. In populous and large countries where local preferences and needs vary widely, e.g., India and Brazil, it enables the central government to avoid direct dealings with a large number of urban governments. For example, the central government can use grant formulas to recognize broad differences in needs and preferences without having to take into account the specific needs of individual cities, or it may simply assign responsibility for local finances to the provincial government.

## B. The Present System of Subnational Finance in China

3.26 Despite its size and diversity, China has chosen a unitary system of government in which the Constitution does not expressly delineate the powers and responsibilities of the various levels of government. Yet the central, provincial and local levels of government have distinct powers and responsibilities, and in many respects the Chinese system functions as a federalism. Fiscal behavior varies enough across provinces to contravene national uniformity in China.

3.27 China's system of intergovernmental transfers is an important component of total public financing, perhaps more so than in any other country. China's shared tax system based on sales and profits taxes makes revenue in principle responsive to growth in income and prices. The distribution of tax shares among Provinces is changing from a broad formula-based approach with an equalizing intent to an ad hoc approach characterized in recent years by substantial negotiation and a variety of special purpose discretionary grants. The Chinese system does not make use of categorical or cost reimbursement grants to stimulate spending for particular purposes, and while there are special purpose grants, there are no formula-based grants which take account of the population characteristics of Provinces. China does use matching grants.

### Provincial Government Finances

3.28 In the Chinese system, the central government has direct relations with Provincial governments. This system is roughly described in Figure 3.1. All governments within a Province report directly (or indirectly) to the Provincial government, and carry out their duties subject to Provincial regulations. This system of vertical relationships creates a setting within the Province allowing a degree of fiscal decentralization to the local government level. For example, in Zhejiang Province at the end of 1985, there were 8 provincial cities (municipalities), 66 counties, 5 county-level cities, 3 prefectures and 508 towns.

3.29 In some ways, the Chinese fiscal system is as decentralized as its governmental structure. Municipal and county governments' tax bureaus directly assess and collect about 70% of all taxes.5/ Expenditure responsibility is less decentralized in that provincial and local governments account, on average, for over 50% of total direct expenditures. Only a few countries in the world can claim as great a degree of expenditure or revenue decentralization and none can claim this degree of decentralization in tax administration.6/ Table 3.2 shows recent trends in the revenues and expenditures of central and subnational governments.

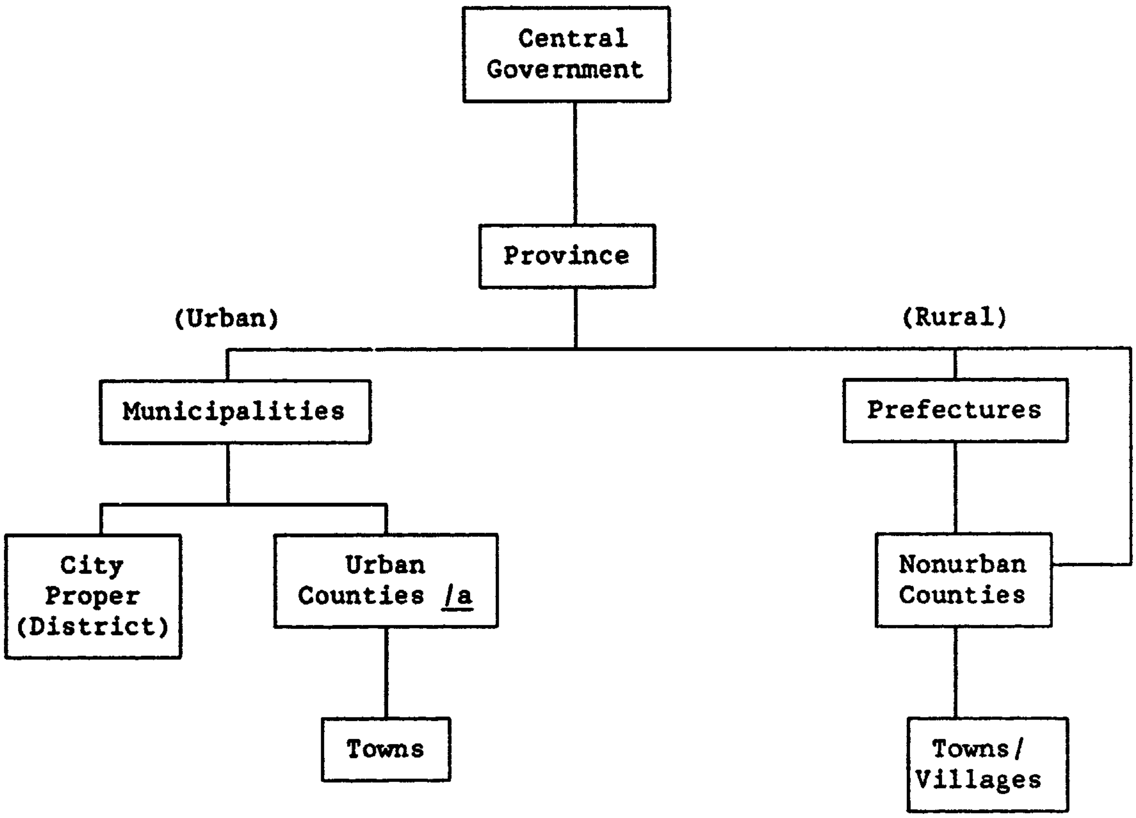
3 30 The central government spends more than it collects. Central government expenditures, until recently, amounted to half or more of publicly budgeted outlays. The central government's major areas of expenditure responsibility are defense, foreign affairs and foreign aid, national universities and research, central ministries, general administration, and large investment projects. In addition, the central government provides revenue transfers to poor provinces.

---

5/ Note that no information is available on revenues which actually accrue to subnational governments, after sharing with the Center.

6/ The comparable ratios for the United States--which is a decentralized fiscal system by world standards--are 43% of taxes collected and 42% of expenditures made by state and local governments. The ratio of subnational to central government expenditure exceeds 75% in Denmark, Australia, Switzerland, Italy and Canada, but subnational government revenue autonomy is more limited. Roy Bahl, "The Design of Intergovernmental Transfers in Industrialized Countries," Public Budgeting and Finance, Winter 1986, Volume 6, Number 4, pp. 3-22.

Figure 3.1: GOVERNMENT STRUCTURE IN CHINA




/a In some provinces, and in some special cases, urban counties may be directly subordinate to the Provincial government.

Table 3.2: Tax Collection and Expenditure of Central and Local Governments, 1980-86 /a
(Billions of Yuan)

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 |
|---|---|---|---|---|---|---|---|---|
| Centrally collected revenue | 21.0 | 22.5 | 25.8 | 37.2 | 52.4 | 69.0 | 91.7 | - |
| Central government expenditures | 65.0 | 60.2 | 57.5 | 64.2 | 72.8 | 81.9 | 96.2 | - |
| "Collections Deficit" | -44.0 | -41.7 | -31.7 | -27.0 | -21.4 | -12.9 | -4.9 | - |
| Local government collections/b | 87.5 | 86.4 | 86.6 | 87.7 | 97.7 | 117.6 | 134.3 | - |
| Local government expenditures | 56.2 | 51.3 | 57.8 | 65.8 | 80.8 | 104.6 | 136.8 | - |
| "Collections Surplus" | 31.3 | 31.5 | 28.8 | 22.7 | 16.9 | 13.0 | -2.5 | - |
| Local government "fixed" revenue (est.) /c | 11.8 | 11.6 | 12.5 | 15.3 | 15.9 | 19.0 | - | - |

/a The difference between the local governments' surplus and the central government's deficit is the central government's foreign borrowing and domestic budget deficit.
/b Central and local government collections are before transfer from local governments to the central government.
/c Defined according to the specifications of the system fixed for 1985-87. Includes the collectives' income tax, the agriculture tax, and estimated profits taxes on locally owned enterprises. These three taxes are the major "fixed local revenues" fixed in the 1985-87 reform of the revenue sharing system. In practice, many of these revenues are shared with the central government (see para. 3.44).

Source: MOF. According to national definitions of revenue and expenditure, and before any transfers or subsidies.

3.31 The responsibilities of the provincial and lower-level authorities include their own investment projects, and most, but not all, public expenditures on education and health, local administration (and tax collection), culture, science and agricultural support, including irrigation, agricultural research, extension activities, and other rural expenditures. Since the inception of the economic reforms, there has been a gradual trend towards decentralizing expenditures, with the central government's share in total outlays declining and a corresponding increase in the expenditure share of local governments. Consequently the center's share of total expenditures has been declining from about 50% of total expenditures to 41% (Tables 3.2 and 3.4). Little is known, however, about the types of expenditure shifts which have taken place.

3.32 Degrees of Autonomy: Revenues. Revenue collection and expenditure disbursement are not the only dimensions of fiscal decentralization and one can find many areas where fiscal decisions are subject to substantial central control and direction. By comparison with most countries in the world, subnational governments in China have little formal, or legal independence in matters of structuring their tax system or deciding on the level and composition of expenditures. All tax rates and bases are set centrally and so there are no truly local taxes--defined as those whose rate or base the subnational government can unilaterally fix--at the subnational level.7/ Moreover, the central government determines, for each province, a share of taxes to be turned over to the center. In effect, subnational tax collections in China are central government taxes whose revenues are allocated among provinces, municipalities and the central government.8/

3.33 Even with this degree of centralization in the rules, subnational governments have an important impact on spending level and on the amount of revenues raised within their provincial jurisdiction. This follows because Provinces design and implement the system of intergovernmental relations between the province and local governments. In particular, provinces determine the share of tax collections that will be retained by each local government. The allocation of loans to local enterprises and the distribution of grants to local governments are also determined by the provincial government. Moreover, because provinces can set the tax sharing rates for each local government, they may also indirectly affect the relative rate of tax collection or tax effort the local administration makes. This in turn gives local governments a substantial degree of autonomy to affect the level and composition of taxation, public service delivery and capital investment. This autonomy arises from the fact that they control tax collection and assessment with apparently a minimum of direct central or even provincial supervision. Responsibility for implementation of the tax system is a very powerful policy instrument in the hands of local government and indications are that they use it.

3.34 Expenditure Autonomy. Autonomy on the expenditure side of the budget is limited for provinces. Subnational government budgets are determined as part of a consolidated central, provincial and local budget and as such must satisfy the (negotiated) fiscal targets laid down by higher level government. The budgetary choices of provincial governments are further limited by expenditure rules, mandates and monitoring by higher level government.

3.35 Within the province, there is more room for discretion. At the local level, provincial governments are responsible for approving the budgets and financial plans of municipal and county governments. This means they can control the spatial distribution of expenditures within the province. There appears to be great variation in the system of province-local relations across provinces, suggesting that provincial governments have significant room to

---

7/ Local governments are entitled to set surtax rates on a variety of taxes, as described in Annex I. Local governments can also design and collect a set of extrabudgetary fees, and charges.

8/ It also should be noted that a number of other important financial measures and regulations are strictly prescribed by the central government and are followed with little variation, such as the allocation of foreign exchange earnings between the general government and enterprise sectors.

adjust fiscal decisions to accommodate local needs and preferences within the parameters set by the central government. (Provincial/local relations are described in paras. 3.58-64.)

3.36 Within the system of "vertical" responsibility, each province must account to the center for its activities. In this process of vertical accountability, the following principles restrain, or guide, budgetary choices of provincial governments: (a) there cannot be a deficit; (b) current expenditures to maintain infrastructure have the highest priority among urban construction-related expenditures; (c) the provision of social overhead facilities such as education, scientific research institutes and hospitals take a high priority; expenditures on culture and education are mandated to increase by at least the same rate as total expenditures; (d) employment levels and wage rates are fixed by the central and provincial governments; (e) all revenues from the urban maintenance and construction tax must be spent for urban maintenance and construction, i.e., for public utilities and public facilities.

Budgeting and Financial Planning

3.37 In theory, China has a unified system of budgeting--covering all accounts--in which all the financial plans and accounts of the central and subnational governments are jointly presented.9/ Because the Chinese budget consolidates the budgets of all three levels of government, no budgetary breakdown has been made available showing central revenues separate from those of the provinces. Each provincial government in principle also has a budget which includes the budgets of all lower level local governments, but, at least in the provinces visited for this work, it is not fully unified, being neither detailed nor complete.

3.38 Because government budgets are not fully unified in the sense of including all revenues and expenditures, it is difficult to construct an estimate of the total amount of revenues raised or expenditures made by the subnational governments or in particular local areas.10/ For example, extrabudgetary revenues and expenditures (nonplan) are reported in the budget, along with budgetary receipts and outlays. However, departmental revenues and grants received are generally not reported in the accounts. The transfers between, and overlaps among, the budgets of the government, the SOEs and public utilities are not apparent, especially for local government: Some examples include those transfers to the SOEs which are included under "technical transformation" in the provincial budget (without distinguishing grants and loans). Other transfers to cover SOE losses are shown as an expenditure in the general provincial budget and not as a transfer, unless the loss is "unplanned," in which case it is shown as negative profits tax revenue

---

9/ "Unified" budgeting is used here to mean a budget which incorporates all accounts of the government unit. "Consolidated" uses the Chinese terminology and reflects the joint presentation of the budget of all levels of government.

10/ This absence of a unified budget at the local level has its parallel in the Consolidated Budget of the MOF in which a variety of extrabudgetary expenditures, revenues and accounts are not reflected (see Chapter I and Box I.2 on "Recasting the Chinese Budget").

(i.e., it is subtracted from revenues, paralleling the approach in the consolidated MOF Budget described in Box. 1.2). Grants to provincial and local governments do not appear to be shown separately in the budget.

3.39 With regard to the distinction made in some countries between capital and current budgets, each local (urban) government has a regular budget and a construction budget, but these do not correspond to a division of current and capital expenditures, and there is no separate reporting of capital financing.

Tax Administration

3.40 Provincial governments cannot vary the nominal rates of tax, nor may they redefine the legal tax base. However, they have almost complete autonomy in assessing and collecting taxes, and along with the lower level county government can and do give tax relief without having to seek approval from the Center. One could fairly say that subnational governments can substantially alter the level and pattern of effective tax rates paid by enterprises.

3.41 The organization of tax administration in China centers around the activities of two organizations: the Tax Bureau and the Finance Department. In theory, these bureaus are at the same time organs of the central and local governments. There are separate Tax Bureaus and Finance Departments at the city, county and province levels. The functions of the Tax Bureau and the Finance Department seem clearly distinguishable in principle. The Finance Department conducts tax policy allowed by law at the provincial and local levels, and manages the expenditure side of the budget. The Tax Bureau is responsible for implementing central tax law and collecting taxes. In practice, the division of responsibility is not so clear, and the directives given to the Tax Bureau by the central government and its subnational government are not always consistent. Many of the Tax Bureaus' actions in the provinces visited for this work suggest substantial tension as a result of this system of "dual leadership". Also it appears the Tax Bureau is more likely to act as an agent of the provincial or local governments than of the central government. The Finance Bureau clearly plays a leadership role within the provincial and local governments.

3.42 Provincial and local governments have a surprising amount of discretion in granting tax relief. Their activities in this regard are referred to as the policy of "stimulating enterprise through tax expenditures" where three methods of granting preferences are used. First, if the provincial government wants to promote a new product or a pioneer industry, it may authorize a reduced tax rate or a tax holiday for a number of years (usually not to exceed five years). Second, the Finance Bureau may enter into a contract arrangement with an enterprise for payment of a negotiated amount of taxes. These were described in Box 1.1 on the Contracting System. Third, the Tax Bureau may grant ad hoc tax relief to enterprises on a case-by-case basis depending on the needs of the enterprise. There is every indication that they use this discretion to promote the economic development of the local area, even though the preferences granted sometimes do not conform with the objectives of the central government and seriously impair its revenue.

Provincial and Local Revenues

3.43 Provincial governments have four revenue sources: shared taxes, extrabudgetary funds, user fees and capital finance. China's revenue sharing system is primarily a division of sales and profit taxes among the central, provincial, and local governments. Whereas in most countries the taxes are collected by the central government and then allocated to the lower level subnational governments, in China they are collected by the local governments and "shared-up" to the higher levels. The amount of shared tax revenue finally going to the provincial government budget depends on the tax base and rate, tax administration, and the sharing formulae. The amount finding its way into the central budget depends on provincial receipts, and the sharing formula between center and province. The sharing formulae, therefore, has two elements: the proportion of revenues from any given tax shared between center and the province, and the sharing method for the tax and its distribution amongst local governments within the province actually doing the collecting. To understand the revenue-sharing system in China, one must understand all of these dimensions.

3.44 Tax Revenues. By law, there are three categories of revenues--"fixed central government revenues," "fixed local government revenues" and "shared revenues." Box 3.2 shows the principal taxes in each of these categories prior to the 1988 proposed changes. Revenues collected from local taxes are, in principle, assigned fully to the local government and are referred to as "local fixed revenues." Rate determination and base definition, however, are not under local control. In practice, however, most "local fixed" and "shared" taxes have been subject to sharing apparently because adherence to these categories caused a revenue shortfall to the central government. Since the mission visited China in May/June 1988, certain minor changes have taken place in the allocation of these taxes to different levels of government. Because these are minor taxes, it is unlikely that these shifts would affect the report's analysis or recommendations.11/

11/ Exceptions are the UMCT and a few other local taxes, which are retained locally. The detail on the proportion of each tax that is shared, central, or local is provided for 1987 and 1988 in Annex II, Tables 3 and 4.

## Box 3.2: REVENUE ALLOCATION AND TAX SHARING

I. "Fixed Central Government Revenues:"

1. Income and adjustment tax of all central government enterprises.
2. Business tax from railroads, bank and insurance company headquarters.
3. Profit remittances by all enterprises producing arms.
4. Price subsidies paid to producers of grain, cotton and oil (treated as a negative revenue of the central government).
5. Fuel oil special tax.
6. Income taxes, sales taxes and royalties from offshore oil activities of foreign companies and joint ventures.
7. Treasury bond income.
8. 70% of the three sales taxes collected from enterprises owned by the Ministry of Industry, the Ministry of Power, SINOPEC, and the China Nonferrous Metals Company.
9. All customs duty and all VAT and product taxes collected at customs.
10. Tobacco Tax and Business Tax on Tobacco.
11. Product tax on liquor and tobacco.

II. In 1985-87, the "local fixed revenues" were as follows:

1. Income tax and adjustment tax of locally-owned enterprises.
2. Income tax from collectively owned enterprises (ICIT).
3. Agriculture tax.
4. Rural market trading tax levied on private sector traders.
5. Local government grain trading loss (a negative tax).
6. Fines for delinquent taxes.
7. The Urban Maintenance and Construction Tax (UMCT).1/
8. Housing tax.2/
9. Vehicle utilization tax.
10. 30% of the sales tax revenues collected from enterprises owned by the Ministry of Power, SINOPEC, and the China Nonferrous Metals Company.
11. Individual income tax.
12. Wage bonus tax.
13. Self-employed Entrepreneurs Tax.
14. Slaughter Tax.
15. Cattle Trading Tax.
16. Contract Tax.

III. Taxes shared between the central and local governments:

1. All sales taxes (value-added, business, and product) revenues from all enterprises, except those expressly excluded as described above under I.6, I.9, I.10.
2. Natural resource taxes.
3. Construction tax.
4. Salt tax.
5. Industrial and commercial tax, and income tax, levied on foreign and joint venture enterprises.
6. Energy and transportation fund tax.

---

1/ The UMCT is set at 7% of total sales tax liability for municipalities (5% for towns and 1% everywhere else).

2/ Private, owner-occupied housing and government buildings are exempt and the Housing Bureau pays at a preferential rate of 12%. Payments by enterprises are deductible from adjustment tax liability. On foreigners, it is called the "real estate tax" and is equal to 18% of rental value or 1.2% of capital value. Land is not taxed, only the buildings.

3.45 Extrabudgetary Funds. Other sources of revenue for provincial governments, earmarked for capital purposes, are extrabudgetary funds.12/ Extrabudgetary revenues of the government itself are relatively small compared to other provincial and local revenue sources, and account for only 3% of total extrabudgetary funds (enterprise retained earnings are about 80% and extrabudgetary revenues of government agencies are about 17%) and less than 1.6% of government budgetary revenue.

3.46 User Charges. Though the public utility enterprises attempt to recoup a portion of costs through user charges, there has been no strong sentiment to raise rates to efficient (marginal cost) levels. Cost recovery is a much bigger matter than simply raising the level of the user charge. Water, sewerage and gas (LPG) charges, bus fares and housing cannot be adjusted independent of national wage and price policy and enterprise and tax reform policy. Perhaps as important, but less widely recognized, is the relationship between increasing the rate of user charge and the sharing of revenues among the three levels of government. An increased user charge--paid by enterprises or by individuals and compensated by an increase in wages--will lower the profits and therefore the tax liability of enterprises. The result will be a shift in revenue power (a) from the central to the local level because the whole of the user charge "stays at home," and (b) from the general government to the public utility enterprises. Unfortunately, no data are available for making a good estimate of the percentage of total costs recouped by user charges, but it is probably quite low. Residential user charges have changed little since Liberation, though there has been some movement in rates charged the enterprises. Within limits set by the central government, local governments can increase rates, and have done so for commercial and industrial users.

3.47 Capital Grants and Borrowing. China has no regular, formula grant program to support capital projects; all grants are on an ad hoc basis. There is no mechanism or formal program for lending to local governments, and there is no formal mechanism that guides local governments in developing beneficiary financing schemes. Capital financing is done from some combination of current revenues, planned loans or grants, special exceptions to the restrictions on borrowing, and creative, ad hoc approaches to benefit financing.

3.48 Provincial and local governments in China cannot borrow. However, there appear to be ways to avoid these restrictions. Short-term borrowing (less than one year) and even some longer term credit financing does occur. In some cases, municipally owned enterprises borrow for infrastructure projects and in some cases the municipal government has pledged its general revenues to secure loans to its enterprises.

---

12/ This figure excludes the extrabudgetary funds (retained profits) of the SOEs. These include a set of taxes and charges that are controlled by the local or provincial Finance Department, the most important of which is the public utility surcharge--a 10% tax on the utility bills of consumers. There also are some minor taxes and charges in this category, including the surcharge on the agricultural tax, revenues received from public housing and public property, and some institutional income that accrues to the various city enterprises.

3.49 The "price" of capital construction is high because it must be financed from current revenues rather than loans, i.e., by current rather than future beneficiaries; and by the general public rather than direct beneficiaries.

Intergovernmental Fiscal Relations

3.50 There are three important dimensions to the system of intergovernmental fiscal relations in China. The first is the system of tax sharing, outlined above, which determines the amount of resources that will be allocated to the subnational government sector. The second is the distribution of these funds among provinces, and includes both the tax sharing formulae and the flow of grants and subsidies. The third is the system of horizontal fiscal relations within the province, the method by which the provincial government allocates fiscal resources among its counties and municipalities.

3.51 Central-Provincial Transfers. The central government fixes and adjusts the tax sharing arrangements with the provinces. The system in China is essentially a sharing of revenues from a specified set of taxes, almost all of which are collected by the local governments. The total amount of the distributable pool is determined primarily by the amount collected from these taxes, but the distribution among provinces is determined by a combination of (a) origin of collections, (b) formula, and (c) negotiation and *ad hoc* decisions. The latter has given rise to the so-called "provincial contracting system" in which most provinces contract with the central government to permit an agreed revenue amount or proportion.

3.52 The basic retention formula was most recently amended in 1988. The retention rate may be either positive or negative and determines, in principle, whether the province remits a share to the center or receives a subsidy.13/ Some provinces do not operate under a retention ratio, but contract with the Center for a fixed delivery quota. This was part of the

---

13/ The formula planned for 1988 is:

$$\text{Retention Ratio 88} = \frac{(L86 + S86)\,(\text{RATIO } 83) - T88}{(L86 + S86) - T88}$$

where S86 = shared revenue in 1986
L86 = "local fixed revenue" in 1986
T88 = the 13 taxes assigned to local governments in 1988
Ratio 83 = Allowable expenditures in 1983 ÷ Actual revenues collected in 1983.

This simplifies to

$$\text{Retention Ratio 88} = \frac{(E83)(1+r) - T88}{S(86) + (L86 - T88)}$$

This formula has been adapted a number of times since 1984. Full details of these changes are provided in Annex II. Among the reasons for the change are the transfer of enterprises from provincial to central ownership.

reform of the system begun in 1988, under the name of "provincial contracting". The results of applying the retention rate are described in Table 3.3. For example, Beijing in 1987 would be able to retain 49.5% of its 1987 collections from shared taxes. This system was intended to give provinces an incentive to collect taxes on behalf of the Center, by giving them a larger fraction of total collections. Of course, all fixed central government revenues would be turned over to the Center. As may be seen from the Table (Col. 3), 13 provinces had a "collections surplus" in 1987, i.e, shared plus local fixed revenues exceeded allowable expenditures and the tax sharing ratio was unity or less.

**Table 3.3: CHINA: REVENUE-SHARING SYSTEM BETWEEN THE CENTRAL AND PROVINCIAL GOVERNMENTS, 1985-1987**

| Provinces and regions | Fixed percentage of total revenue collected is retained by Province (%) | | | Province retains all revenue collected and receives agreed amount from the Center /a (In millions of yuan) | | | Province retains all own revenue and pays agreed amount to the Center | | | Fixed or contract delivery |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1985 | 1986 | 1987 | 1985 | 1986 | 1987 | 1985 | 1986 | 1987 | 1988 |
| **North China** | | | | | | | | | | |
| Beijing | 48.2 | 49.55 | 49.55 | | | | | | | ** |
| Tianjin | 39.5 | 39.45 | 39.45 | | | | | | | ** |
| Hebei | 69.0 | 72.00 | 72.00 | | | | | | | ** |
| Shanxi | 97.5 | 97.50 | 97.50 | | | | | | | N.A. |
| Inner Mongolia | | | | 1,783* | 1,961.74 | 2,059.83 | | | | N.A. |
| **Northeast China** | | | | | | | | | | |
| Liaoning | 51.1 | 52.66 | 52.66 | | | | | | | N.A. |
| Jilin | | | | 397 | 396.62 | 396.62 | | | | |
| Heilongjiang | 96.0 | | | | | | | 142.70 | 142.0 | N. . |
| **East China** | | | | | | | | | | |
| Shanghai | 26.0 | 23.54 | 23.54 | | | | | | | ** |
| Jiangsu | 39.0 | 41.00 | 41.00 | | | | | | | ** |
| Zhejiang | 55.0 | 55.00 | 60.81 | | | | | | | ** |
| An Hui | 80.1 | 80.10 | 80.10 | | | | | | | |
| Fujian | | | | 235 | | 234.86 | 234.86 | | | N.A. |
| Jiangxi | | | | 239 | | 239.46 | 239.46 | | | N.A. |
| Shandong | 59.0 | 77.47 | | | | | | 75.0 | | N.A. |
| **Central/South China** | | | | | | | | | | |
| Henan | 81.0 | 81.00 | 87.1 | | | | | | | N.A. |
| Hubei | 66.5 | 100.00 | 100.00 | | | | | | | N.A. |
| Hunan | 88.0 | 88.00 | 88.00 | | | | | | | N.A. |
| Gangdong | | | | | | | 772.00 | 778.08 | 778.00 | ** |
| Guangxi | | | | 716* | | 788.03 | 827.43 | | | |
| **Southwest China** | | | | | | | | | | |
| Sichuan | 89.0 | 100.00 | 100.00 | | | | | | | N.A. |
| Guizhou | | | | 743* | 817.57 | 858.45 | | | | N.A. |
| Yunnan | | | | 637* | 925.88 | 972.17 | | | | N.A. |
| Tibet | | | | 750* | 825.32 | 866.59 | | | | N.A. |
| **Northwest China** | | | | | | | | | | |
| Shaanxi | | | | 270 | 270.26 | 270.26 | | | | N.A. |
| Gansu | | | | 246 | 245.60 | 245.60 | | | | N.A. |
| Qinghai | | | | 611* | 671.88 | 705.47 | | | | N.A. |
| Ningxia | | | | 494* | 543.14 | 570.30 | | | | N.A. |
| Xinjiang | | | | 1,450* | 1,594.85 | 1,674.59 | | | | N.A. |

/a Asterisk indicates subsidies were to increase by 10% per year after 1985.
/b Two asterisks indicate quota contract delivery, also known as "provisional" contracting.
N.A. Information not available for the province's arrangements with the Center for 1988.

Source: Data Supplied by MOF

3.53 The remainder of the provinces were, in 1987, deficit provinces (see Column 6). The eight autonomous regions, the provinces with heavy minority populations and those least developed are singled out for special treatment. They receive a subsidy equal to their calculated deficit and this amount was to be increased by 10% per year, a figure taken roughly to approximate needed revenue growth. This system is known as the "minority budget system". In four other cases, the provinces under a "deficit province system" were allowed to retain all fixed and shared revenue collections and the central government paid a subsidy equivalent to the size of their 1986 deficit.

3.54 A "provincial fixed contracting quota", or "incremental sharing rate" on revenues above a target level applies in some provinces. Since 1988, it has been applied in provinces including Jiangsu, Zhejiang, Hebei, Beijing, Tianjin, Guangdong and Shanghai (see Column 10). Under this system, a base quota of shared revenues must be transferred to the central government while all (or part of the) revenues collected over and above this quota may be kept by the province. The purpose of this special program, which can provide for up to 100% retention of above-quota collections, is to give these provinces--seen as keystones of China's development because of their outward orientation --greater incentive to collect tax and scope for growth. Within this group, Guangdong and Shanghai are among those to receive this special treatment. Guangdong is allowed to retain all taxes collected, after it remits to the Center a fixed quota. Shanghai remits Y 10.5 billion to the Center and retains any excess. Five other provinces (shown with ** for 1988 in Table 3.3) are also under this "provincial contracting system", but the contract targets are not known for these provinces.

3.55 While the provincial contracting arrangements can--if the above-contract share is low--provide increased incentives to collect revenue, they do not eliminate the potential conflict of interest between local and central governments, nor does it alleviate a crucial problem associated with decentralization, that is, the loss of control and flexibility by the Center over the use of tax policy for macroeconomic purposes referred to in Chapter I.

3.56 Moreover, the provincial contracting system, if more widely applied, can lead to severe revenue consequences. The fact that most contracts are fixed in nominal terms has left an increased share of fiscal resources in the hands of local governments. This reduces the growth and, potentially the real volume, of resources in the hands of central government. Finally, as noted in Chapter I, like enterprise contracting, the provincial contract arrangement introduces a pro-cyclical bias to the fiscal system. This occurs because the revenue received by the central government under the "fixed remittance" contract system remains relatively constant regardless of the underlying growth of economic activity.

3.57 Implementation of the System. While the formulas themselves are not very complicated, the revenue sharing system is not simple to administer. Three problems are worth considering. First, implementation of the system requires reporting a substantial amount of detailed fiscal data by the province and verification of accuracy by the central government. Provinces do not appear to gather detailed fiscal data from their local governments, and the central government does not have a good mechanism for monitoring available data. Second, and contrary to government intentions, the sharing rates are not fixed for a specified number of years and negotiation and barter by the provincial governments are possible. Third, the actual transfer of the funds poses an administrative problem. Under the present system the People's Bank appears to be the fiscal collection agent and deposits the monthly or quarterly amounts to the appropriate central, provincial or municipal/county accounts, based on the sharing formulas.

Tax Sharing Between Provinces and Their Local Governments

3.58 Provincial governments set the general rules defining revenue sharing among local governments within their jurisdiction. They receive no guidelines from the Central Government for setting the sharing rates and are constrained only by their own economic plans, the total amount available for sharing, and provincial politics. Not surprisingly, provincial governments have developed many different systems.

3.59 Revenue Sharing. The approaches taken in Jiangsu and Anhui Province illustrate some of the differences. Jiangsu Province shares with each local government a flat percentage of its tax collections that varies across localities.14/ The sharing rate is determined on an *ad hoc* basis for each of the 11 cities and is reported by provincial officials to be equalizing, with cities in the poorer southern parts of the Province and those in more remote locations having higher retention rates.

3.60 The city governments in Jiangsu in turn determine the tax sharing rates for their urban counties, though the Province may stipulate the average sharing rate for an entire urban region. For example, the average retention rate for Nanjing and the counties under its administration may not exceed 22%. Changzhou, where the provincial government assigns the county retention rates directly, is the one exception to this general rule that cities determine the urban county tax retention rates.

3.61 Jiangsu has a special fiscal arrangement with the Provincial capital, Nanjing. Because it is the highest income city in the province, its basic retention rate of 17.5% is the lowest in the Province, but Nanjing is allowed to retain 30% of collections above the previous year's amount. It is noteworthy that although Jiangsu has benefitted from the increased provincial/central "incremental retention" rate in the last two years the Nanjing incremental retention rate has *not* been increased.

3.62 Anhui Province offers another example of the complexity of provincial relations. The local government's base year 1983 revenues and expenditures are used to fix the revenue retention ratio (E/R). However, an "incremental formula" applies to local revenue collections above the base level, where the local government retained share is lower and the provincial share *higher* than the basic ratio. Clearly, this system does *not* give local governments an incentive to increase their rate of revenue mobilization. A subsidy is paid to the local government if base expenditure exceed revenues. Apparently, the province attempts to allocate resources amongst local governments on an

---

14/ Some provinces, such as Zhejiang, have a different sharing rate for each tax.

equalizing basis. The counties surrounding Hefei have an incremental retention rate of 80%, nearly 90% of the counties retain all revenues collected and receive a subsidy, and smaller cities have a higher incremental retention rate than larger, and presumably higher income, cities.

3.63 Like Jiangsu, there is a special arrangement for the provincial capital of Hefei based apparently on a special contract basis. The city's basic retention rate is 14.93%, and its incremental retention rate is 27%, for an average retention of about 22% of total shared tax collections in 1987.

3.64 Provincial Grants. The other dimension of Provincial finance is grants to the local governments. The concept of a grant-in-aid (as distinct from a price subsidy for agricultural products) to a local government is not one with which provincial officials in China are accustomed to working. There is no regular, formula-based program of grants to local governments. Three classes of grant appear to be used: (a) earmarked grants for purposes such as capital construction projects, natural disasters, and special assistance for underdeveloped regions; (b) grants for "year-end reconciliations," e.g., to compensate local government for a change in ownership of an enterprise during the year; and (c) subsidies to particular local governments for special purposes, including deficit grants. Apparently, the total amount allocated and the distribution among local governments is determined on an ad hoc basis rather than by formula.

## C. Initial Assessment and Issues

3.65 The Chinese system of intergovernmental relations is complex, and very responsive to provincial interests. The ostensible objectives of the system are to improve resource mobilization, to improve provincial tax effort, and to achieve fiscal equalization. How well the system achieves these goals --in the context of balancing local and central command over resources--is discussed below.

3.66 Shifting Fiscal Balance. The fiscal balance between the central government sector and the provincial-local government sector appears to have shifted. Table 3.4 shows recent trends in the collections and expenditures of central and local governments. Inasmuch as data were not made available on the actual division of revenues between local and central governments, the discussion below focuses on collections. The central government's share of collections has been increasing, from about 23% of total collections in 1982 to 40% in 1986 (line 1 of Table 3.4). This shift resulted in part from the transfer to the Center of state enterprises in certain sectors whose profit taxes now accrue directly to the Center. Also contributing to this shift were the centralization of certain indirect tax revenues (petroleum, petrochemicals, nonferrous metals, and electric power) and the rapid growth of import duties.

3.67 The shift in the Center's share of total expenditures and revenues is a very important change. The result is that the provincial-local sector is becoming increasingly independent, and "revenue entitled", in that the revenues previously passed on to the Center are now retained at the local level. Whereas in 1982, provincial-local governments passed an amount equivalent to about one-third of what they collected (line 5), by 1986 the transfer was 2% less than total collections. Or to put it another way, they spent 66% of their collections in 1982, while in 1986, they spend more than they collect.

3.68 The central government, on the other hand, was spending 2.28 times the amount it collected in 1982, that is, it was then highly dependent on revenue transfers passed up from the provinces, but it spent only 1.04% of collections in 1986. This decline comes partly from the central government increasing its share in revenue collections (through the shifts described earlier), in the context of a marked overall decline in total collections but also because of the reduced local transfers to the Center (line 5). The implications for central expenditures are shown in line 2, which shows there has been a shift away from the central sector in favor of provincial-local government expenditures. Overall, the Center's expenditure capacity has thus been curtailed. Indeed local expenditures have grown at an annual rate of 13%, compared to a rate of 4% for central government. (No data is available on the type of expenditures accounting for these changes.) If provincial and local governments had been held to their 1982 transfer ratio of one-third, the central government would have had an additional Y 46 billion available in 1986.

Table 3.4: Changing Fiscal Importance of The Central and Subnational Government Sectors (%)

| | 1982 | 1983 | 1984 | 1985 | 1986 |
|---|---|---|---|---|---|
| 1. Central Gov. share of collections (% of total) | 23.0 | 29.8 | 34.9 | 37.0 | 40.5 |
| 2. Central Gov. share of expenditures (% of total) | 49.9 | 49.6 | 47.8 | 43.3 | 41.3 |
| 3. Center expenditures as % Center collections | 222.8 | 172.5 | 141.0 | 115.7 | 104.9 |
| 4. Subnational expenditures as % subnat. collections | 66.7 | 74.1 | 82.7 | 88.9 | 101.8 |
| 5. Subnational transfer as % Subnat. collections | 33.3 | 25.9 | 17.3 | 11.1 | -1.8 |
| Ratio of Collections to GDP: | | | | | |
| 6. Provincial Government | 17.1 | 15.6 | 14.4 | 14.1 | 13.3 |
| 7. Central Government | 5.1 | 6.6 | 7.8 | 8.3 | 9.7 |

Source: Ministry of Finance.

Note: The figures refer to centrally (and locally) collections and not to actual revenues, by each level of government, before grants and revenue transfers. "Revenues" and expenditure are by national, not GFS definitions and therefore differ from the figures shown in Chapter I.

3.69 These statistics suggest a number of conclusions and raise a number of policy questions. First, the Chinese system has become increasingly centralized on the collection side (line 1). A second observation is that the system is becoming increasingly decentralized on the expenditure side (line 2). Is the revenue decline by design or is it because local revenue efforts are flagging? Provincial and local government collections have fallen as a percent of GDP from 17% in 1982 to 13.3% in 1986 (Table 3.4). This could be a result of increased preferential treatment by local tax administration officials, but it also could be due to central government pricing or quota policies that reduce enterprise profits and gross receipts. The central government's share in collections, meanwhile, has increased from 5% to 9.7% of GDP. Is the decentralized expenditure shift due to reform priorities or due to a constrained central revenue system, due to declining transfers?

3.70 A third observation is that whether by design or not, each sector is now spending about what it collects. One is tempted to conclude that locally collected (as distinct from actual accrued revenues) taxes--the shared and local fixed taxes plus the local government tax collections from central enterprises--are the "right" revenue volume for subnational governments. This needs only be supplemented (as it is now) with some system of horizontal transfers among the provinces.

3.71 An important implication of these shifts in favor of the subnational government sector is that the central government's ability to use discretionary policy to redistribute among provinces, or to centralize national finances, is much more limited.

3.72 Fiscal Disparities between Provinces. There are wide disparities in per capita revenue collections among the provinces, ranging from Y 1,492 in Shanghai to Y 52 in Guangxi and Y 40 in Tibet, with an average of Y 169 in 1985 (see Appendix Table 4). What causes such great disparities in per capita collections among the provinces? The answer almost certainly is that higher levels of revenue mobilization are related to higher levels of economic activity, and perhaps to a higher rate of urbanization. The four provinces with highest per capita income collected the greatest per capita revenue amounts, while low income provinces collected the least. The relationship between per capita revenue and per capita gross output is so strong that the four provinces with the highest level of per capita output (Shanghai, Beijing, Tianjin, and Liaoning) collected 31% of revenues even though they account for 6.4% of the national population. This relationship is confirmed in a more systematic way by estimating the relationship between per capita collections and per capita gross value of output, holding constant population and urbanization (see equation (1) of Table 3.5).15/

3.73 Disparities are also pronounced on the expenditure side, with a per capita variation around average expenditures of Y 152 ranging from Y 346 in Shanghai and Y 344 in Beijing to Y 63 in Sichuan and Y 66 in Anhui. The same four high income provinces account for 15.2% of expenditures. Higher income provinces are able to spend more because of some combination of a greater demand for public services (proxied by urbanization), and the ability to raise more "local fixed" and extrabudgetary revenues (proxied by per capita output;

---

15/ Ordinary Least Squares estimates. See Annex II for a detailed discussion.

see equation 2 of Table 3.5). Revenues appear to stay where they are generated. Populous provinces spend significantly less on a per capita basis, even after controlling for the amount of gross value generated and the demand for public services (as proxied by the rate of urbanization). One interpretation of this result is that more services are provided in the less populous as well as in the more urban provinces, and that the second, urbanization, variable does not adequately control for the large rural population.

3.74 Examining the equalization features of the tax-cum-transfer system shows some interesting results. The relationship between the expenditure-collections ratio 16/ and output and urbanization variables shows this ratio is lower in high income or urban provinces (see equation 3 of Table 3.5). Thus, the transfer system helps to equalize in some sense the expenditure capacity (as proxied by this ratio) between rich and poor provinces although it does not, of course, equalize expenditure levels, as shown by the results of equation 2 above. As equation 3 shows, moreover, the retention rate also appears to be lower in provinces with large populations, cet. par., and this may not be equalizing. As measured by the gini coefficient, the disparity across provinces in per capita expenditures (.34) is less than the disparity in per capita collections (.54).

Table 3.5: OLS REGRESSION RESULTS FOR CHINESE REVENUES AND EXPENDITURES AGAINST SELECTED INDEPENDENT VARIABLES: BY PROVINCE FOR 1985
REGRESSION COEFFICIENTS /a

| Equation | Dependent Variable | Logarithms (L) or Linear (N) | Constant | Per Capita Output (100 RMB) | % of Population Living in Urban Areas | Population | R2 | N |
|---|---|---|---|---|---|---|---|---|
| 1. | Per Capita Collections | L | -5.608<br>(7.06) | 1.391<br>(11.790) | 0.314<br>(2.241) | 0.053<br>(1.052)... | 0.91 | 29 |
| 2. | Per Capita Expenditures | L | 5.433<br>(11.38) | 0.436<br>(6.154) | 0.106<br>(1.362) | -0.443<br>(-14.783)... | 0.93 | 29 |
| 3. | Ratio of Expenditures To Collections | L | 6.739<br>(11.322) | -0.558<br>(6.315) | -0.168<br>(1.728) | -0.308 ...<br>(8.242) | 0.82 | 29 |
| 4. | Ratio of Collections to Total Output Value | N | 0.059<br>(6.454) | 1.514 (E-05)<br>(5.168) | 0.0002<br>(0.600) | ... ... | 0.63 | 29 |

/a T-statistic shown in parentheses below the regression coefficient.

16/ This ratio might be viewed as an approximation of the global retention rate on revenues collected. It should not be confused with the formal tax retention rate. The retention rate we calculate here includes fixed local revenues and collections from central government

3.75 In summary, there are very great fiscal disparities among the Chinese provinces. Revenue collections are highly concentrated (41% of collections in five provinces) and per capita collections in the highest province are 37 times that in the lowest. The transfer system helps to equalize expenditure capacity in that the expenditure-collection ratio varies from over 400% in Qinghai and over 100% in 14 other provinces, to 12% in Shanghai. However, it does not fully equalize expenditures and there remains a significant disparity in per capita expenditures, with higher income provinces spending significantly more. The fiscal expenditure differentials can be expected to increase as a result of the provincial contracting system. Under this system, better off provinces retain more revenues, generated by their growing tax base, while poorer provinces will not benefit from growth in transfers from an increasingly constrained and revenue-poor central government.

3.76 Tax Effort. An analysis of the level and growth of collections across provinces shows that, on average, tax collections are higher in Provinces where income is higher (Appendix Table 5). This finding stops short, however, of indicating whether higher income provinces also make a greater tax effort, i.e., whether they raise more or less revenue than might be expected given their economic base, level of urbanization, etc. For example, of the ten provinces with the highest levels of per capita output, six had below average revenue growth during this period. Conversely, of the ten provinces with the lowest level of per capita output, nine had above average growth in revenue collections. For policy purposes, the Chinese government wants to know not only which provinces have a greater capacity to finance, but how extensively they use this capacity. Otherwise, there is the risk of subnational governments using increased "central" resources to substitute for what otherwise would have been increased local government revenue mobilization.

3.77 The ratio of collection to gross output is one measure of collection effort. This ranges from 18% in Shanghai to 5.4% in Shandong. In a province as poor as Gansu, it is to 9.8% (see Table 3.6). Much of this variation is to the expected, because of differences in these provinces' taxable capacity. Hence this result cannot be used to infer that higher income Shanghai exerts more than twice the revenue effort as does lower income Gansu. In fact, as is shown below, Gansu actually makes a greater collection effort than Shanghai. The problem with straightforward comparisons of collection-output ratios to infer tax effort is that proper account is not taken of differences in taxable capacity.

3.78 If the taxable capacity of the province is a function of its income level and its degree of urbanization, the higher level of per capita income--proxied here by the per capita gross value of output--should imply a greater capacity to collect taxes. Urbanization may also contribute to taxable capacity because urban economic activities are more easily reached by the administrative system (they provide better "tax handles") than do rural activities.

3.79 Using per capita income and urbanization as indicators, each province's taxable capacity has been estimated and is shown in Column 2 of

---

enterprises in the denominator, and it includes all budgetary expenditures in the numerator.

Table 3.6.17/ For example, based on the average practice and its own level of per capita output and urbanization, we would "expect" Beijing's collection ratio, or taxable capacity, to be 12.78% of output.

Table 3.6: Comparisons of Taxable Capacity and Tax Effort: By Province

| Province | Ratio of Collection to Gross Output, 1986 | Estimated Taxable Capacity 1986 | Tax Effort Index /a | Tax Effort Ranking |
|---|---|---|---|---|
| Beijing | 15.24 | 12.78 | 1.19 | 5 |
| Tianjin | 14.42 | 13.30 | 1.08 | 8 |
| Hebei | 7.52 | 8.00 | 0.94 | 15 |
| Shanxi | 8.93 | 8.48 | 1.05 | 9 |
| Inner Mongolia | 7.87 | 7.92 | 0.99 | 13 |
| Liaoning | 9.75 | 10.57 | 0.92 | 15 |
| Jilin | 7.75 | 9.09 | 0.85 | 18 |
| Heilongjiang | 7.82 | 9.09 | 0.86 | 17 |
| Shanghai | 18.06 | 17.95 | 1.01 | 11 |
| Jiangsu | 6.30 | 9.49 | 0.66 | 19 |
| Zhejijng | 7.93 | 9.18 | 0.86 | 17 |
| Anhui | 6.49 | 7.55 | 0.86 | 17 |
| Fujian | 9.35 | 8.05 | 1.16 | 6 |
| Jiangxi | 7.10 | 7.59 | 0.94 | 15 |
| Shandong | 5.44 | 8.70 | 0.63 | 20 |
| Henan | 7.45 | 7.42 | 1.00 | 12 |
| Hubei | 7.63 | 8.49 | 0.90 | 16 |
| Hunan | 8.06 | 7.73 | 1.04 | 10 |
| Guangdong | 8.51 | 8.33 | 1.02 | 11 |
| Guangxi | 8.90 | 7.43 | 1.20 | 4 |
| Sichuan | 7.18 | 7.52 | 0.96 | 14 |
| Guizhou | 8.79 | 7.18 | 1.23 | 3 |
| Yunnan | 12.35 | 7.28 | 1.70 | 1 |
| Tibet | 6.02 | 6.97 | 0.86 | 17 |
| Shaanxi | 7.86 | 7.84 | 1.00 | 12 |
| Gansu | 9.86 | 7.76 | 1.27 | 2 |
| Quinhai | 7.85 | 7.69 | 1.02 | 11 |
| Ningxia | 8.61 | 7.74 | 1.11 | 7 |
| Xinjiang | 6.25 | 8.14 | 7.68 | -- |

/a Ratio of Tax capacity to actual collections.

---

17/ The method used here follows the approach developed in Roy Bahl "A Regression Approach to Taxable Capacity"; see 1970 IMF Staff Papers. Equation 5 of Table 3.5 shows the relevant coefficients. Tax capacity is positively related to per capita income (B1=1.54) and to urbanization B2=.0002.

## Box 3.3: REVENUE SHARING AND TAX EFFORT

The effect which revenue sharing has on the tax effort of recipient provinces is an important concern. For example, if transfers from the central government cause the provinces' own tax collection efforts to decline, little has been gained in terms of increased support for expenditure programs. It is important, therefore, that revenue sharing consider tax effort, at least implicitly, in determining allocations among provinces. China's system does so via its emphasis on "responsibility" and the incentives provided through the incremental retention schemes.

The effectiveness of this approach is difficult to judge. Generally speaking, the first step in assessing "tax effort" is to measure "taxable capacity." Tax capacity, intuitively, is determined by such factors as the level of income, the presence of easily taxed activities, the degree of urbanization, and so on. An estimate of taxable capacity can be made in China, by estimating the potential tax base of each province, and then applying an average tax rate to this potential base.1/ Tax effort is measured by comparing the actual taxes collected in a province to the estimate of its taxable capacity.

Why are these questions important in China? In the first place, one of the explicit objectives of the Chinese revenue-sharing system is to encourage the provinces' own tax efforts; and, indeed, the central government has made substantial revenue concessions to the provinces to stimulate tax effort. In the absence of some estimation along the lines just described, it is difficult to know whether these measures are having the desired effect, or whether some poorer provinces may need additional transfers, because even a major tax effort (in relation to a small base) generates insufficient revenues.

In India, tax effort is used as one element of the formula for revenue equalization. In West Germany and Canada, tax capacity and tax effort have long been used as integral parts of the revenue equalization formulas. In Germany, for example, the average tax capacity of all states taken together is used as a yardstick of the minimum expenditures which the central government would like to be carried out in each state. The difference between this average per capita tax capacity and a province's actual tax capacity is calculated, and the difference (which may be either positive or negative) is paid into an "equalization fund" by the surplus provinces, or withdrawn from this fund by the deficit provinces.

The German system, like the Chinese system, therefore, transfers resources from surplus provinces to deficit provinces. Whereas, in most countries, transfers are made from the central government, in Germany there is a settlement between the provinces, and in Germany, the amount transferred by

---

1/ The average or "effective" tax rate is defined as the revenue raised from a given tax in all provinces, as a percentage of the tax base across all provinces.

more prosperous provinces is exactly equal to the amount transferred to deficit provinces.

The German approach makes less-than-average tax effort costly, because tax sharing is based on estimates of the province's tax capacity. Thus, any province where tax effort is not commensurate with tax capacity will not be compensated for this below-average effort.

In China, the revenue-sharing system, in all three of its variants, is designed to give incentives to the provinces to increase their tax collection. The sharing system in place in the majority of provinces, and the fixed quota delivery systems accomplish this by giving certain provinces a proportional share in all additional revenues that they collect. In the "responsibility" system, the province retains 100% of incremental revenues collected over a certain quota. Likewise, in both variants of the "minority budget" system, provinces retain 100% of any revenue collected, transferring nothing to the central government.

Strictly speaking, however, the incentive is being given for increased tax collection, not tax effort. There is no way of knowing, in the absence of estimates of taxable capacity, how a province's collection relates to its taxable capacity. Thus, increases in tax collections may result from rapid increases in the tax base, while tax effort in relation to this base in fact declines.

Under the current system of collection, the central government relies heavily on the tax effort of local governments. If the central government moves to collect its own taxes in the future, its reliance on the tax efforts of lower-level governments would of course be reduced. However, in the interest of balanced revenue growth, and to insure that the provinces' own collection efforts are not negatively affected, China may want to incorporate tax effort criteria into the revenue-sharing formula. One alternative would be a bonus paid to those provinces whose tax effort increased relative to changes in the average tax effort of all provinces.

3.80 Tax effort is the extent to which a province uses this capacity, and may be measured as the ratio of the actual collection rate to estimated taxable capacity. Thus Beijing's predicted tax capacity is 12.7% of output (column 2), but the province actually raised 15.2% (column 1). This shows above average tax effort--specifically an effort which is 19% above average as is shown by the "tax effort index" (column 3). Shanghai, by contrast, in spite of its large absolute volume of actual collections makes only an average tax effort.

3.81 The ranking of provinces making stronger and weaker revenue collection efforts reflects interesting factors. In general, many of the higher income provinces make a lower level of revenue effort, e.g., Jiangsu, Zhejiang, Shandong and Liaoning all make below average efforts and Shanghai is just about average. Therefore, the system the Central Government has designed to "encourage" revenue collection does not appear to be effective in encouraging those provinces where taxable capacity is highest to make the greatest effort. In fact, richer provinces are not always associated even with more rapid budgetary revenue growth. Box 3.3 discusses tax effort in an international context.

<u>Other Problems and Issues</u>

3.82 The economic reform program will bring important changes to the role of the subnational government sector in China. First, with more enterprise autonomy in management decisions and responsibility for financing their own operations, the provinces and local governments will shift emphasis from directly productive investments to general infrastructure development. Second, as enterprises become more independent in their management and record keeping, and as smaller enterprises and collectives grow in number, there will be a need to increase the efficiency of the tax administration system. Third, as markets become integrated, provincial and local governments eventually may find themselves competing for enterprise activity, possibly on a basis of public service levels and effective tax rates. Finally, local governments may look to the retained earnings of enterprises as a new source of infrastructure capital financing; over time this could lead to use of more formal benefit charges and borrowing relative to general taxation.

3.83 How well equipped are provinces and local governments to handle this new role and to take advantage of these new opportunities? What problems muct they overcome in order to fully support the system reform? The answer, partly, is that there are some difficult problems to be resolved: a revenue base that may not be growing adequately, a system of implicit prices that compromises some of the objectives of a "good" system, weaknesses in tax administration, encouragement of informal approaches to local government fiscal autonomy, and inadequate fiscal accounting and planning.

3.84 The present fiscal structure may not give provincial or other levels of government an adequate revenue flow to meet their expenditure requirements. Because there is no forecast or projection of expenditure needs, nor a clear statement of expenditure responsibilities of respective levels of government, the target income elasticity for expenditures is taken to be unity. The present system may not meet this target, though data limitations prohibit us from drawing a firm conclusion here. A number of pieces of evidence of revenue inadequacy might be cited. A substantial backlog of infrastructure needs is believed to exist. Eliminating this backlog is a future problem, along with the budgetary pressures of large increases in urban population. The profits tax, an important overall revenue source and major source of financing for provincial and local governments, does not have an income elastic base (partly because of contracting--see Chapter I), is cyclically variable in yield, and is sensitive to central government decisions about pricing and wage policy. Moreover, the continuing shift of the economic structure towards collectives and household firms expands the profits tax base to include activities taxable at a lower rate and harder-to-tax activities. The turnover tax may be more income elastic and more stable than the profits tax in the long run but, again, only a portion of its revenues accrue to subnational governments.

3.85 To answer this set of problems concerning revenue adequacy, the elasticity of the tax base will have to be increased. The best route for such improvement may be tax simplification so that compliance and monitoring are easier (as outlined further in Chapter IV) and strengthening administrative procedures and staff skills. An increase in the elasticity of the tax system, achieved by taxing the growing surpluses in the household and other sectors (as suggested in Chapters I and II), does not conflict with government objectives of increasing the financial strength or efficient performance of enterprises.

3.86 A second set of problems has to do with the structure of the provincial and local financing system and the incentives such tax sharing may provide for undesirable behavior by local governments. First, a potentially important problem area, where local governments may not be stimulated to maximum efficiency, is tax administration. The incentives for avoiding full tax payment may be substantial: tax rates are high and the overall tax share retained through sharing or incremental quota arrangements by the municipality can be low. This alone suggests that local governments benefit little from higher collections and may not make a full effort. In addition, a principal component of the tax base is the sales and profits of municipally owned enterprises. The local government would prefer to see such enterprises flourish, (and if necessary levy <u>ad hoc</u> charges which may be fully retained) rather than subject them to a shared tax.

3.87 Possibly more important are the efficiency costs associated with not giving local governments some degree of autonomy. The governance system is decentralized in terms of the administration of public services, but formal local fiscal autonomy is limited. Legal tax rates do not vary significantly among communities or even within urban areas (although specific enterprises may be able to reach agreement on a preferential treatment). If diversity in tax rates is not allowed, the goal of making local officials more accountable for their actions and thereby improving the efficiency of the delivery of local public services becomes very difficult to achieve. Moreover, interregional tax rates reflecting location rents and/or the costs of urbanization will not be developed and the tax system will not contribute to improving the spatial distribution of economic activity. The uniformity of the tax/subsidy system and the absence of a land tax probably promote a concentration of economic activity in the urban core (versus the outlying areas) as well as an inefficient use of land.

3.88 Finally, provincial and local officials will react to the absence of formal autonomy by taking "back-door" approaches (negotiating, bargaining, "experimenting") which may have effects that run counter to the goals of government policy (as discussed in Chapter I). The development of the system of tax administration and central-local relations since 1983 has given provincial and local governments just such freedom to shape the fiscal system to meet their own objectives. If a tax rate on an enterprise seems onerous, it may be lowered by a contract negotiated with local authorities; if an enterprise is to be encouraged, it may receive special tax treatment; if a local government is mobilizing increased resources, its retention rate might be lowered; and "favored" provinces may be more able to negotiate a special rate with the central government.

3.89 These back-door approaches destroy the concept of a fiscal system because they break the link between structure and implementation. The tax "levers" that the central government designs may be vastly different from the fiscal measures that are actually implemented at the local level. And even were it not for these "back door measures," the administrative system may not be sophisticated enough to enable this "fine tuning" to achieve the desired objectives. These "levers" are wasted by an assessment and collection system that has not yet caught up, and by offsetting actions of provincial and local governments.

3.90 Another general concern--reflected throughout the report--is tax administration. There are incentives and opportunities for provincial and local governments to assist enterprises in tax avoidance. Moreover, the system is complicated and difficult to administer, it requires a highly qualified staff for efficient administration, and books of account for smaller firms may be inadequate to the task of determining sales and profits tax activity. This problem will grow as smaller collectives and private businesses become more important.

3.91 In addition, there are problems with the way in which provincial and local governments marshal financial information to plan and control their fiscal activities. It is not possible to construct a unified budget of local government finances or of total capital expenditures in the urban areas, or to net out transfers between the municipal government and the enterprises or even between the provincial and municipal government. There is no multiyear budgetary forecasting and no capital budget. In general, the budget does not appear to be used for planning purposes.

3.92 A more general problem seems to be growing up with the reform. With the switch from direct controls to "levers," there may be a tendency to try and do too much with the tax and transfer system. Example of some of its incentives include: (a) the phasing out of the adjustment tax depends in part on the amount of capital investment a firm makes; (b) property tax is deductible from adjustment tax; (c) the construction tax rate varies by type of construction, e.g., plant expansion versus new plant; (d) there are more than 60 sales tax rates; (e) there are many ad hoc tax exemptions and "experimental" treatments, e.g., wage tax bonus is sometimes treated as a business cost; and (f) in some provinces there is a different local-provincial sharing formula for each tax, e.g., the distribution of taxes among the central government and the provincial, municipal and subdistrict governments in Zhejiang requires the application of 12 different formulae. It is not clear that the tax system can achieve all these goals.

## D. Options for Reform

3.93 The first step in a reform program is for the government to decide on the role it wants to assign the provincial and local government sector. In particular, the questions are whether provincial, municipal and county governments will be given some degree of revenue-raising autonomy, whether tax administration can remain a local government responsibility, and whether the intergovernmental transfer system will include a formula-based grant program.

3.94 The choice of a particular central-local fiscal relationship will depend on how the government weighs the benefits of decentralized economic development policies against the costs of having less effective central fiscal management. There are strong forces justifying more fiscal centralization in China at the present time. Inflation and a budget deficit suggest a need for more central control over the budget for stabilization policy purposes. Moreover, the economic system reform relies heavily on the use of tax policy as an instrument to influence economic decisions, and local control over the implementation of the tax system can (and probably has) compromised some of the objectives of central government tax policy. In order to gain more central control over the revenue system, it will be necessary to reduce if not eliminate the provincial and local government power to allow contracting of types involving tax remission or special tax concessions.

3.95 To centralize the fiscal system, however, sacrifices possibilities of vesting more budgetary decision-making powers in local governments and to reduce the revenue-raising incentives of provincial and local governments, which are goals of system reform. Fiscal centralization vs. fiscal decentralization is a hard choice and each has benefits that the government does not want to sacrifice. Yet, one cannot have it both ways.

3.96 If the decision is in favor of increased fiscal decentralization in China, then three possible models can be developed; each with differing implications for administration, and the extent and nature of the autonomy given to provinces.

### Limited Tax Sharing

3.97 This approach would call for separate central and provincial taxing powers, and the abolition of the shared tax system. The two questions to resolve would be which taxes to give to each level of government and what to do about tax administration. At one extreme is a very centralized approach under which the enterprise income tax and the product, business, and value added taxes would become fixed central revenues. Provincial governments would be given the minor taxes (e.g., the 13 "fixed local taxes" assigned to them in 1988). There would have to be separate central and subnational tax administrations because it would not be reasonable to expect that local governments would aggressively collect central taxes when they would not receive a share (see Box 4.5 in Chapter IV).

3.98 If this solution were adopted, provincial and local governments would be unable to finance all services for which they are now responsible, and one of two courses of action would be called for. One possibility would be for the central government to assume direct responsibility for provision of certain services. This is not an attractive option because one tenet of the system reform is increased decentralization, and because China is simply too large and diverse a country for a centralized public expenditure system to be managed efficiently. A more likely solution is to create a regular program of central grants to provincial governments to make up for the revenue shortfall. The grant could be distributed on a formula basis, with the elements of the formula chosen to reflect need. For example, the grant distribution among provinces might be based on some combination of per capita income level, population size, some indicator of infrastructure needs, urbanization, etc. Provinces would then develop their own formulas for allocations among the local governments (see Box 3.1 on Formula Grants).

3.99 The very great advantage of the centralized version of the local autonomy approach is that it enables a maximum of central control over interregional equalization and the sectoral composition of investment. It also puts the government in a better position to use the tax system for macrostabilization goals, and, because it merges responsibility for tax structure and tax administration, it makes possible the use of the tax system to achieve allocative goals. The latter point is especially important: the tax 'levers' that the central government designed would be implemented. The biggest disadvantages to this approach are the loss of provincial and local control over the tax system, the reduced incentive for revenue mobilization by local governments, and the increased expense associated with two separate tax administration machineries and with the maintenance and operation of a grant system. This centralized approach has been adopted by most low income countries that have unitary forms of government.

Balanced Tax Sharing

3.100 There is also a more decentralized, or balanced version of the separation of powers approach. The subnational governments could be given access to one of the productive tax bases--namely control over the sales tax 18/ or the profits tax. Revenues could be large enough, at least for the highest income provinces, that a supplementary national grant scheme would not be necessary. Under this solution, provincial governments would have a considerable amount of discretion in determining the level of revenues and expenditures, and "the size of government" in the local area. When policy analysts and economists speak about fiscal decentralization, this is the version they usually have in mind.

3.101 The assignment of broad provincial and local taxing powers works in the United States and in the developing world, in Brazil, Colombia and Nigeria, in which between 25% and 50% of all taxes are local. There are reasons why it also could work in China. Chinese local governments have broad expenditure responsibilities and this would make the revenue raising authority

---

18/ Note that if the VAT were made into a provincial tax, allowing differential rather than uniform rates in all provinces, raises special administrative problems.

commensurate. Certainly local governments now have as much skill as the Center in administering a broad-based consumption or income tax.

3.102 There are also problems with this solution. Consider the problem of which of the two major taxes to choose. The profits tax would be a good choice because it is revenue productive, but it is also cyclically unstable and can be effected dramatically by central government policies, e.g., price changes for raw materials, a new wage policy, quota reductions, alteration in foreign trade policy. The sales tax would be more stable, but it is unlikely that the central government would agree to give up so productive a revenue source. The recently introduced urban land tax is a natural choice for a local government revenue source, but its revenue yield is unlikely to be significant. Another problem is that if the profit or sales tax were to be assigned to local government, then the two taxes would almost certainly have to be administered by separate central and local government tax administrations. This would be inefficient because book audits would be duplicated, enterprises would have to double their reporting requirements, and economies of scale in tax administration training and computerization would be lost. Finally, such a program would be counterequalizing in that the highest income provinces would generate the greatest amounts of revenue and a program of compensating grants would have to be developed.

Base-Sharing Model

3.103 A third model might be sharing of the tax base, not the tax revenues. This arrangement would have subnational and central governments share in the base of the enterprise income and product, business, and value-added taxes. This would differ from the present system in two important ways. First, the central government tax would be fixed and totally independent of the local tax, and second, provincial governments would be permitted to elect (within a range) a surtax rate on each base. For example, a basic rate (say 20%) on the enterprise income tax would belong to the central government as fixed revenue, and the provincial government could elect an additional rate of 10% (minimum) or 20% (maximum).19/ For indirect taxes, the subnational rate might be an additional charge levied as a percentage of the central government product tax liability, in much the same way as the present urban construction and maintenance tax is levied. In fact, the UCMT offers some precedent for this approach, except that the present 7%, 5% and 1% surtax rates are fixed by the Center rather than chosen by lower level governments.

3.104 In the case of turnover taxes the addition of a local surcharge poses few conceptual or practical difficulties provided the bases for the two taxes are indeed the same (i.e. if the surcharge is truly a surcharge). An invoice-based VAT could raise some difficulties under this approach. One problem is that provinces specializing in intermediate goods would almost certainly prefer to "export" taxes to other provinces rather than zero-rate their own "exports". A true destination VAT would require some kind of adjustment for taxes on "imported" goods, as will now be the case in EEC countries. However

19/ In practice, the exact rates would be worked out based on the division of expenditure responsibility between the central and local governments. In the case of the VAT, this could mean that VAT sur-rates, if surcharges were permitted, would have to be identical across provinces.

it is doubtful local (provincial) governments would wish to give credit for "foreign" taxes on inputs suffered on purchases from suppliers in other provinces. In Brazil, for example, the VAT is a provincial tax, but the federal government sets maximum rates.20/ While the experience of VAT harmonization in European Community offers some parallels here,21/ it appears unlikely a regionally rate-differentiated VAT could operate satisfactorily in China without central control.

3.105 Would revenues be adequate to meet provincial and local government expenditure needs under such a program? If the surtax limits were set to reflect expenditure needs, the higher income provinces could generate adequate revenues but the lower income provinces could not. Two kinds of compensating formula grant programs would be required. One is an equalizing program to reflect the low fiscal capacity of some provinces. This is really no different in principle from the present system which supplements tax sharing with transfers to deficit provinces. The other needed grant program would be to stimulate expenditures on projects with national significance, and all provinces would participate.

3.106 Local revenue administration might be retained under a base-sharing program, but provincial and local governments would not be permitted to engage in any tax relief policies that would affect the base or rate of the central government tax. If provincial governments chose to contract with enterprises or provide tax preferences at the cost of reducing their own tax base, they could do so; hence the decentralization advantages would not be lost and some degree of responsibility would be built into the system. They could not, however, give preferential treatment on the central government tax. The system is described with an example in Box 3.4. Compared to the limited tax sharing and balanced tax sharing models discussed above, this approach implies less central governance and management of the tax revenue base and considerably more fiscal self-determination.

---

20/ See Ved Gandhi; "Tax Assignment and Revenue Sharing in Brazil, India, Malaysia and Nigeria", in C. McLure, ed. Tax Assignment in Federal Countries; ANU Press, 1983.

21/ See Tait, Alan, VAT: International Experiences and Problems; 1986.

## Box 3.4: PROFIT AND SALES TAX SHARING UNDER A BASE-SHARING MODEL

The simple numerical example here describes one version of how an enterprise would be treated under such a system. We have assumed fixed central sales and profits tax rates of 10% and 20%, respectively, and to make matters simple have assumed that the tax bases are gross sales and gross profits, respectively. In case A, the provincial government chooses rates of 5% and 15%, with no preferential treatments, with the result that it collects Y 950 from this enterprise by comparison with Y 1,600 for the Central Government.

| | Case A | Case B |
|---|---|---|
| Gross Sales | 10,000 | 10,000 |
| Central Sales Tax @ 10% | 1,000 | 1,000 |
| A. Provincial Sales Tax @ 5% | 500 | |
| B. Provincial Sales Tax @ 3% | | 300 |
| Less Production Expenses equals | 5,500 | 5,500 |
| Gross Profits | 3,000 | 3,000/a |
| Central Profits Tax @ 20% | 600 | 600 |
| A. Provincial Profit Tax @ 15% | 450 | - |
| B. Provincial Profit Tax @ 10% | - | 320 |
| Total Central Revenue | 1,600 | 1,600 |
| Total Local Revenue | 950 | 620 |

Now let us assume that the provincial government offers a preferential treatment to this enterprise and limits the sales and profits tax rates to 3% and 10%, respectively. Central revenues could not be affected, Y 1,600 is still raised in Case B, but local revenues would be reduced to Y 620 because of the tax abatement.

/a Note that sales tax relief would affect the definition of local government taxable profits, (since sales taxes are normally a deductible expense) but not central government taxable profits.

3.107 There are disadvantages to this shared base approach. Provinces with a stronger economic base would have an advantage and the supplementary grant program would have to be created and maintained. The local tax administration system would have to be carefully monitored by a better Management Information System (MIS) than presently exists, to ensure proper collection of the Center's tax share. Another disadvantage is that the central government would give up some control over the tax system and therefore would have less leeway in using tax policy to pursue stabilization and macroeconomic goals.

3.108 Despite the disadvantages, one might be able to make a good case that this is an appropriate approach for China. It provides fiscal decentralization and the option to continue to allow provincial governments to follow local industrial policy, if this were considered desirable, while allowing the central government to retain some control over the level of taxation and complete control over the definition of the tax base. This system would give the local governments a significant incentive to improve the efficiency of their tax administration and of their public service delivery system. It might also be argued that, by comparison with the present system, central government macroeconomic control would not be compromised markedly.

Patching Up the Present System

3.109 The above are radical reforms calling for eliminating the existing tax sharing system, giving local governments some rate-setting autonomy, creating a grant system, and changing the nature of responsibility for tax administration. Another possibility is that the decentralization of the economic reform will have to go more slowly, and the first step should be to patch up the present system. The objective is to eliminate some of the most objectionable features of the present system while retaining its strengths. The areas where reform is most needed are: (i) changes in the system of central-provincial revenue sharing; (ii) rationalizing the system of provincial-local relations; (iii) bringing the implementation of central tax policy under control; (iv) improving the system of capital financing, and (v) modernizing the system of tax administration and financial management.

3.110 Central Provincial Relations. The following changes should be made in the system of central-provincial relations:

(a) If the tax sharing system is to be retained at all, the sharing ratios should be determined on some objective basis rather than in an ad hoc way. The 1983 base year approach should be replaced. If Zhejiang's retention rate, for example, is to be lower than Anhui's, the difference should be based on some objective indicators. The government may want to substitute a formula for the present negotiated and judgemental approach, to compensate for lower fiscal capacity or greater fiscal need, or to reward greater revenue mobilization.

(b) The tax sharing ratios should be fixed for a number of years to provide provincial governments with some certainty, and to discourage the central government from allowing the sharing ratio to become a subject of annual negotiation. One possibility would be to set up a "grants commission" along the lines of those in India and Australia, to study and recommend a fixed, 5-year program of revenue sharing.

(c) The provincial and local governments should know the sharing ratio well before the beginning of the fiscal year, to ensure better fiscal planning and so that any incentive effects might be realized. At present, such information is given to the provinces well into the fiscal year. Increased tax effort cannot be expected to result.

(d) The present approach to grants to provincial governments should be rationalized, perhaps converted to a regular grant program with a known pattern of distribution--and coordinated with the shared tax system.

3.111 The objective of making subnational governments more responsible for their actions would be served by giving subnational governments some taxing powers, though likely candidates for generating significant revenues are not apparent. Among the possible revenue sources for local governments, in addition to the list of 13 approved in 1988, are agricultural taxes, the land tax or charge, and the dividends paid to local governments by state owned enterprises for the use of assets. The latter were proposed in Chapter II as a way of separating the roles of government as owner and tax collector. While this would give local governments some independent revenue raising power, it would be far from adequate for covering the expenditure responsibilities undertaken by local government.

3.112 The central government must rationalize its delegation of powers to provincial governments, and the latters' control over local governments, with China's overall national development objectives. What is to be done when provincial policy runs counter to national objectives? The hard choice to be made here is between accepting this outcome as an unavoidable cost of decentralization and compromising the autonomy of provincial governments in controlling their fiscal structure. The view here, and perhaps the prevailing view in China, is that the enterprise contracting system is one area where the cost of decentralization has become too great and central regulation or limits are necessary. Another such area is the method of provincial-local tax sharing and whether this reinforces or offsets central fiscal objectives.

3.113 Provincial-Local Relations. Regardless of the local autonomy issue, the government should urge a reform in the system of provincial-local relations. In particular, the present system of interprovincial revenue sharing is unduly complicated, perhaps inconsistent with national goals, and will present some major problems as system reform progresses. It can also be argued that the national revenue mobilization objectives are not well served by the provincial-local arrangements. Three changes might be considered. First, all taxes should be shared at a uniform rate. Second, provincial governments might consider increasing the municipal tax-sharing percentage for larger cities. If the retention rate were increased above its present level (usually less than one-third), an important incentive to improve administration would be provided in exactly those cities where revenue-raising potential is greatest. However, this action would drain provincial government resources and could come at a cost of less fiscal equalization within the province.

3.114 More generally, provincial governments should rationalize the intraprovincial tax-sharing system. The sharing percentages should not vary across local governments in an *ad hoc* manner and the merits of a system of horizontal transfers--perhaps a capital grant system--should be considered. In any case, the distribution of grants and tax-sharing subsidies within provinces should be carefully, empirically studied to determine whether it measures up to the equalization and development goals of the Regional Economic Plan. This begs a bigger issue, namely whether the central government should play a direct role in the formulation of policy by provincial governments with respect to their local governments. Central governments in other large countries have done this when provincial policies became out of step with national goals (e.g., the United States, Brazil, and Nigeria) and China may be approaching a similar situation. However, this would be yet another step back from fiscal decentralization.

3.115 Local Discretion in Tax Administration. Perhaps the most important reform area is whether provincial and local governments should have the authority to give special tax treatment to enterprises. Clearly, the objective of giving the central government more control over the tax system to better pursue stabilization policy and allocative goals would be served by eliminating or reducing local government discretion for giving tax concessions or tax remission contracts to enterprises. One option, argued in Section II above, is for the central government to limit such provincial and local government discretionary power to contracting out of after tax profits. Another is the "balanced tax sharing" version of revenue sharing discussed above, which places responsibility for paying for tax preferences directly on the unit of government granting the preference. Either way, an evaluation of the options will come down to the question of how important it is for provincial/local governments to play a role in forming industrial policy. The central government must also put in place a central data system to monitor the effectiveness of local collection and assessment activities.

3.116 Capital Financing. There are good possibilities for mobilizing more resources for infrastructure finance. A formal mechanism for borrowing and benefit financing could permit local governments to finance capital projects by tapping the willingness-to-pay of project beneficiaries. Likewise, a more formal and appropriately designed program of provincial government capital grants should replace the present ad hoc system.

3.117 Tax Administration and Financial Management. Subnational budgets can be recast as more effective planning tools. The objective should be to regularly produce a unified local area budget, fully identify capital construction and maintenance spending and financing, and trace out all inter-account transfers. Multiyear budgetary forecasting and capital budgeting should be a regular part of the planning process. The government needs to accept and act on the proposition that local government fiscal planning must be integrated with the long-term economic plan for an area.

3.118 Potential improvements in tax administration are an important consideration. Without a full survey of administrative problems, it is difficult even to suggest the elements of a reform program. Among the possible needs, developed further in the next Chapter, are the introduction of taxpayer identification numbers and a master file, more staff training, simplification of the tax structure itself, improved collections and assessment, and computerization. An even more important underlying question is whether the tax administration system should be more centralized and whether the administrative problems are as much related to the structure of the tax system as to its operation. Short of a thorough study of all these issues, it would seem ill-advised to consider the creation of a separate central and local government tax administration.

# IV. TAX ADMINISTRATION AND COLLECTION

4.1 This chapter discusses tax administration in China. Section A outlines principles, criteria, and international best practice for the design and application of administratively feasible tax systems, including the structure of the administration, and its practices at the micro-level. Section B reviews China's current system of tax collection. Issues relating to current practice are outlined in Section C. The concluding Section D recommends reforms of national administration, current administrative hierarchy, and administration in provincial and local governments and outlines some near-term administrative reforms that would improve tax operation now.

## A. An International Perspective on Principles of Administration

4.2 The levying of taxes is a central function of government in all countries and, while systems and methods vary widely according to the political, economic and social characteristics of individual countries, the requirements for a sound administration remain broadly the same. This is so whether one is concerned with the application of sophisticated corporate tax laws to multinational conglomerates or with the levying of bicycle taxes by local government. In the end, an administratively sound system of taxation is one that is: (i) simple and coherent so that taxpayers and tax administrators know where they stand; (ii) fair and seen to be fair; and (iii) efficient in that the right tax is collected at minimum cost to the state and to the taxpayer. The principles of simplicity, fairness and efficiency must be reflected in the design of the tax, its codification in law, and in its administration.

4.3 These characteristics are not ends in themselves but represent criteria for judging whether the administrative system will be able to meet the demands placed on it by tax design and by tax policy-makers. Ultimately, the payment of taxes depends on cooperation between the administration and the taxpaying community and, while few taxpayers ever volunteer to pay taxes, their willingness to comply will be enhanced if they have confidence in the system with which they have to deal.

4.4 Simplicity. International best practice outlines the importance of "simplicity" of the tax policy instrument, suggesting the advantages of reliance on key, broad taxes for revenue generation, the avoidance of "nuisance taxes" and the need to prevent overburdening of any one tax (or the system as a whole) with too many objectives. Simplicity of codified law is also essential if a tax code is to be implemented in the way that tax policy-makers intend. Good tax laws are both consistent and transparent so that a taxpayer entering into transactions can predict their tax consequences. Over-elaborate laws and regulations that are understood by no one will be obeyed by no one; worse, they will be resented and lead to a loss of confidence in the system. Therefore, while simplicity has, in the first instance, to do with tax policy, it has also important implications for administration.

4.5 Tax administrations need to provide clear information about the tax laws and how they are administered. Taxpayers need to be made aware of their rights and obligations and the consequences of their failing to meet them.

They need to know where to turn to for advice, how to make payments, how to reclaim tax overpaid. International experience has shown that it is possible to provide accessible information about even relatively complex provisions and systems. Authorities producing such material do so out of enlightened self-interest: A well-informed taxpayer will facilitate the tax administration's own work and effectiveness.

4.6 Fairness. International experience has shown that the willingness of taxpayers to cooperate (the "standard of compliance") is generally higher when tax laws are perceived to be just and fair. Taxes that are perceived to be fair are more likely to be paid. Fairness has several dimensions. It implies not only "vertical equity," so that tax liabilities are borne by those who can best afford them, but also "horizontal equity," in which taxpayers in the same or similar circumstances pay the same or similar taxes. Authorities need to encourage voluntary compliance, whether this be the compliance of the taxpayer himself or, in the case of taxes withheld from wages, collaboration from the employer acting as an unpaid agent for the tax authority, or compliance of the business collecting indirect tax on behalf of the tax administration. Nonetheless all tax laws include, or should include, penalties for taxpayers who evade or otherwise fail to comply with their responsibilities.

4.7 The objective of fairness can best be achieved if taxes are imposed and administered only in accordance with published and properly constituted laws. Most countries have found it desirable to ensure that the right of authorities to impose a tax is enshrined in primary legislation passed by the country's highest law-making body. Although administrative procedures may be governed by lower-level legislation ("decrees", "orders" and "regulations"), it is generally accepted that explicit authority for such rules and procedures should be provided in primary legislation. Tax systems that depend on ad hoc administrative action rapidly become discredited and imperil compliance. But, if such rulings are given--and some experts would question whether they should be--there is a growing consensus that they must be made public.

4.8 To encourage compliance it is equally important that tax authorities administer the law fairly. This implies both an absence of arbitrary or corrupt behavior on the part of officials, and "normative standards" to ensure that the same laws are applied and administered in standard fashion across the board. Indeed, a major responsibility of a national tax administration is to ensure that all taxpayers dealt with by a given official are accorded similar treatment and that all officials dealing with a given taxpayer would accord the same treatment. Plainly, this task will be harder in a large country with a highly decentralized organization than in a small country or within a compact headquarters office.

4.9 Finally, to enforce these "normative standards", taxpayers should, in the case of disputes with the authorities, have access to independent arbiters. Preferably, the process of appeal should be quick and inexpensive. In many systems, a "first appeal" against administrative decisions can be made to some higher-level authority at the regional or national level of the tax administration itself. However, it is usual for taxpayers ultimately to have access to a truly independent forum. In some countries such as Mexico, the U.S., and West Germany, the law provides for specialized "tax courts".

## Efficiency in Administration

4.10 Why Efficiency Matters. The functions of tax administration are (i) the collection of taxes; (ii) the auditing of tax returns of enterprises and individuals; (iii) the recovery of tax underpayments; (iv) the investigation of fraud; and (v) the enforcement of penalties in cases of evasion or default. The requirement of efficiency is, of course, not confined to the administration of taxation--it is common to all areas of government. But because the costs of collecting taxes go well beyond the surface cost of employing and equipping tax collectors, efficiency in tax administration is especially important. Such costs include also the "compliance costs" incurred by enterprises and individuals in carrying out their responsibilities under the law and the costs incurred by enterprises who are required to act as tax withholding agents for the authorities. In the U.S. it has been estimated 1/ that filing of a standard individual taxpayer's return can take some eight hours annually in terms of the taxpayer's "lost time" and in many cases compliance costs equal or exceed those incurred by the official tax authority administering the law.2/ The "economic cost" of taxes incurred by the diversion of goods and services from their optimal pattern of use in the community was already described. Enforcing tax law at a minimum cost to the government means making use of modern office techniques and effective management. Keeping compliance costs low for taxpayers depends on the mix of taxes and the taxpayer's role in payment. The costs of collecting taxes on individuals are usually higher than those on corporations. For example, in 1987 the percentage cost (as a percent of revenues collected) of collecting United Kingdom corporation tax was 0.52%, less than one-quarter of the cost of collecting income tax for individuals (2.29%). In the U.S.A.--where collection costs are relatively low and self-compliance is high--all individual taxpayers are required to file a tax return each year and average costs are 0.49% of revenues collected.

4.11 Effective Use of Administrative Resources. No tax administration ever has the financial resources it would ideally wish to have. Among its responsibilities of collection, audit, recovery, enforcement and control, some could be performed better or more promptly if more resources were available. This means that the administration must define its priority tasks, assess the resources that should be devoted to a particular task and determine how those resources may best be deployed to secure the optimal revenue yield. Often, this means that administrative resources (both staff and hardware/software) should be allocated where they will produce the highest marginal revenue. If, in a given country, experience shows that an extra $1 spent on audit will raise $10 in revenue, while the same $1 spent on pursuing delinquent accounts would raise only $3, then the presumption will be in favor of improving the authority's audit effort.

4.12 Efficient resource allocation presupposes adequate management information to allow rational decisions to be taken and like most large organizations, tax administrations depend heavily for their success on the quality of their management information systems (MIS). Such a system is designed to give

---

1/ Arthur D. Little, Inc., IRS Fact Sheet FS-88-5, 31 August 1988.

2/ See, for example, C.T. Sandford "Hidden Costs of Taxation", London: Institute for Fiscal Studies, July 1973.

managers at different levels information on which to base their decisions. In general, this information will be expressed in numerical (quantitative) terms but it may need to be supplemented by narrative reports from managers evaluating and amplifying the statistical data supplied (qualitative reports). Such a MIS would not necessarily call for computerization but for adequate information and reporting to the central tax authorities.

4.13 For greatest efficiency in collection, a choice has to be made between "assessed" and "self-assessed" taxes. Assessed taxes are those where a tax official undertakes the work of calculating the tax liability. Self-assessed taxes require the taxpayer himself to quantify his liability and pay the tax. Both types of assessment must be accompanied by effective audit programs. Sales taxes are almost always self-assessed. International practice in relation to taxes on enterprise profits and incomes of individuals varies, but there is a clear trend towards self-assessment as countries seek to deploy scarce administrative resources in the most cost-effective way. Countries with self-assessment for corporations include Canada, Japan and the U.S. The same countries have also had self-assessed personal income taxes for many years. Hungary introduced the latter in 1988. By contrast, land taxes are almost always assessed.

4.14 With respect to actual payment of taxes, many countries use a withholding system to ensure prompt payment. Withholding typically applies to payments of wages and salaries, interest and dividends. In this system, the tax liability is the income recipient's, although tax is payable by the payer of that income.

4.15 Audit and Other Techniques for Ensuring Compliance. The basis for ensuring satisfactory compliance, whether taxes are "assessed" or "self-assessed," is a balanced audit program. Tax audits to be effective, should be selective and based on a system of stratified sampling that selects (i) taxpayers likely to have made significant understatements of liability; and (ii) other cases likely to involve small amounts but representative of a cross-section of taxpayers where combined amounts will be significant. Auditing the first group puts appropriate focus where revenue yield is likely to be high, while auditing the smaller taxpayers carries an important "deterrent" effect. Countries have adopted this selective approach primarily because auditing resources are limited; if every case were examined only superficial examination would be possible and few errors would be discovered. (See Box 4.1).

## BOX 4.1: Audit Programs

A typical selective audit program involves both "desk audits" and "field audits", depending on whether the auditor carries out his work at his own desk or visits the taxpayer in the "field".

Desk audits can vary in their intensity but typically begin with a review by the auditor of all the information he has about the taxpayer from various sources. Where the taxpayer is in business on his own account the auditor will usually invite him to attend the office and bring his business books and records for examination. Desk audits will be appropriate in the case of employed individuals with part-time earnings and other secondary sources of income and in the case of larger enterprises where issues of tax law rather than the adequacy of record-keeping are at stake.

In the case of a field audit, again the auditor will begin with a review of his information but will then follow this up with an on-site inspection of the taxpayer's premises and his business books and records. Generally, field audits will be made of the affairs of traders, farmers and other "self-employed" people such as professionals where questions of fact can only be resolved by a physical inspection of trading premises, processes and primary records.

In some countries (for example, the United Kingdom and the United States, an audit is, at least initially, confined to the results of one year. In others, (for example, France and West Germany) it invariably covers a number of years, usually all previously unaudited years not excluded by the country's statute of limitations. In practice, this means that transactions of up to five or six years may be the subject of a single audit.

In either type of audit, where shortcomings or irregularities are discovered the result of the exercise will almost always be an interview with the taxpayer at which the reasons for those shortcomings or irregularities will be discussed and any additional tax and/or penalties will be quantified.

Audit coverage varies widely, but many countries try to audit every entity at least once within the period of statutory limitations. It will be desirable to audit some enterprises every year. This would apply, for example, to major financial or industrial enterprises with complex commercial relationships, international connections and frequent changes in investments. Likewise, it will generally be desirable to audit newly-established businesses and those where the proprietor is ceasing to trade or is transferring the trade to a successor. In other cases, where, for example, a trader in a mature business shows steadily increasing turnover and profits consistent with those in a similar line of trade, and in the absence of any other indication of irregularities, it might be felt that little would be obtained from going through the motions of an audit.

A number of countries (Canada and the U.S.A. among them) have developed more or less sophisticated statistical models for selecting cases for investigation. Criteria include: gross and net profit ratios out of line with the norms for that business; abnormally low or abnormally high personal expenditure; the acquisition of luxury or expensive personal assets; failure to respond to routine correspondence; failure to claim reliefs or allowances to which the taxpayer is entitled (these last two criteria may suggest that the taxpayer is avoiding contact with the tax authority). In some countries, computers are used to identify cases for possible investigation. Usually, however, computer selection is supplemented by the judgment of the head of the investigating office or unit who will review each case personally before an audit is authorized.

Critical to the success of any audit program is the way in which it is managed. Besides the need to select the right cases for audit it is necessary to ensure that individual audits are properly conducted in every respect and that the work of auditors is satisfactorily monitored. This calls for managers who themselves have experience in audit work and who have received adequate training. Audit program managers will usually accompany staff in a number of audits and observe at first hand how they are conducted.

An important part of the cycle in some countries is the follow-up report which is designed to inform management of the effectiveness of the audit program. Besides statistical data, such reports should contain a qualitative evaluation which will indicate good or poor investigative technique, information and training needs and any data that would be of use in future audits. These reports would be part of a comprehensive MIS (see text, para. 4.12). In some countries (the USA and the United Kingdom among them) a percentage of all audits are "inspected" to guarantee the proper conduct of investigations.

The following table shows the audit rate achieved in a number of countries in recent years:

Box Table: International Comparisons of Audit Coverage

| Country | Tax | Year | Taxpayers | Audit rate (% coverage) |
|---|---|---|---|---|
| Barbados | Income tax | 1978 | 58,581 | 11.2 |
| Fiji | Income tax | 1984 | 50,000 | 1.0 |
| New Zealand | Income tax | 1988 | 1,029,000 | 1.8 |
| | VAT | 1988 | 386,000 | 8.6 |
| South Korea | Corporate tax | 1987 | 45,078 | 5.7 |
| United Kingdom | Corporation tax | 1987 | 641,032 | 1.1 |
| | Income tax | 1987 | 2,178,746 | 2.2 |
| | VAT | 1986 | 1,505,000 | 28.0 |
| USA | Corporate taxes | 1986 | 3,666,937 | 2.2 |
| | Income tax | 1986 | 184,175,609 | 1.1 |

4.16 Cost-efficiency concerns have also led a number of countries to adopt systems of "presumptive" taxation for types of activity that are particularly difficult to tax. Perhaps the best-known of these systems is the French "forfait" system which applies to small farmers and, to a lesser extent, to some professionals as well. Presumptive methods may encourage economic activity because any excess over the average will be taxed at zero marginal rate. However, use of presumptive methods must be exercised with care to avoid inequities that can occur if the average tax rate borne by regular taxpayers, such as wage-earners, exceeds that borne by those subject to the presumptive method,

## Machinery of Government

4.17 Countries have adopted different approaches for locating the tax policy-making and tax administration functions within the government. In most countries the tax policy-making function is located within the Ministry of Finance. In others (including the United Kingdom and China) it is located in a semi-autonomous board or service, also responsible for tax administration and often operating under the political authority of the Ministry of Finance. This arrangement reflects the highly specialized nature of tax policy work and its close links with tax administration. However some control must be exercised to make sure tax policy developments are in line with macro-economic policies of the overall government.

4.18 A larger number of countries (the USA, Canada, Hungary among them) have established semi-autonomous agencies to handle tax administration. In each case political responsibility remains with the Ministry of Finance, but operational matters are the responsibility of the tax administration authority. In general, countries see two main sets of advantages in this separation. First, the creation of a separate authority insulates the administration of taxes from political pressures. This enhances the status of the administration by allowing it to be seen as independent of the politicians responsible for enacting tax legislation.

4.19 The separation also recognizes the fact that the function of tax administration is different from the rest of the largely policy-oriented work of the Ministry of Finance. Apart from the fact that tax administration is ultimately about individual cases, it also involves the employment of a large number of specialists whose background and training, career requirements, and perhaps even pay, may differ from those of regular Ministry officials.

## The Organization of the Tax Administration: Centralization vs Decentralization

4.20 Whether responsibility for tax administration is retained exclusively by the central Finance Ministry (as it often is), or delegated to provincial governments (as in West Germany) or to a semi-autonomous board (as Hungary), its organization will depend on a series of factors unique to each country. Whatever the institutional arrangement, it is essential that tax administrators have easy access to taxpayers and vice versa.

4.21 In most systems there is a clear division of responsibilities between offices at different levels of the hierarchy. Headquarters staff set and interpret policy and lay down standards for operational offices, including procedures for collection, tax return filing, audits, enforcement and litigation. Regional staff are responsible for monitoring the performance of local operational offices, for dealing with complaints, personnel matters and for ensuring that norms set by Headquarters are applied. Operational staff handle actual cases, issue, receive and process tax returns, carry out audits and pursue delinquent taxpayers. Taxpayers turn to these offices in the first instance for information and assistance.

## B. Tax Administration and Collection in China

### The Institutional Background

4.22 In China, the imposition and levying of taxes on enterprises and individuals is the responsibility of bodies at various levels of government. At the national level, there are the Ministry of Finance (MOF) and the State Administration for Taxation (SAT). At the subnational level, the provincial and lower-level city and county governments each have their own Tax Bureau and Finance Bureau. The roles and relationships of these various bodies are described in greater detail in Annex III.

4.23 While the central government in China deals with tax policy, it does not, in general, collect tax revenues. Unlike most other countries, the central government has no nationwide tax collection administration. Instead, provincial and county Tax Bureaus are responsible for the day-to-day work of assessment and collection throughout the country. The great bulk of tax collection takes place at the local level, with the central government relying on local governments for the implementation of central tax policy and for the remittance of tax revenues. Important exceptions are: customs duties, collected by the Customs Bureau; taxes relating to the extraction of China's offshore petroleum reserves handled by the Offshore Oil Taxation Bureau, formerly within the GTB and now within the SAT; and the tax affairs of certain large state enterprises such as the State railway companies, the state airlines, the specialized banks, and the People's Insurance Company, whose income taxes are paid directly to the SAT.

4.24 National Level Organization. The Minister of Finance is personally responsible to the nation's State Council for tax policies and for tax collection. Within the Ministry of Finance, the General Taxation Bureau (GTB) has been responsible for tax policy and administration and for supervising the assessments and collections by local tax bureau officials employed by provincial and lower-level governments. To fulfill these responsibilities, the GTB had just 345 staff at end 1987, most of whom are new recruits.3/ This reflects in part the turbulent history of tax administration in China, including the merging of Tax Bureaus with other organs of government and their suppression during the cultural revolution.

4.25 Following a major reorganization of MOF in mid 1988, the General Taxation Bureau (GTB) was taken out of MOF and its functions placed with the newly constituted State Administration for Taxation. SAT was established on June 1, 1988 and is a quasi-Ministry insofar as its head reports directly to

---

3/ At the end of 1976, the staff of the GTB consisted of only 36 persons.

the State Council, while acting "under the guidance" of the Minister of Finance. SAT has a degree of autonomy not previously enjoyed by GTB. The main tasks of SAT are listed in Box 4.2. Following this reorganization, there are no officials within MOF directly concerned with formulating current tax policy or with tax administration and collection. A small unit concerned with tax reform analysis remains.

4.26 Table 4.1 outlines the range of taxpaying entities in China for which the SAT is ultimately responsible. The 32 million, mostly business, taxpayers in China represents a large number by any international standard. The state-owned enterprises and collectives are charged with the use of public funds and assets and expected to keep detailed records. The work of auditing and assessing such enterprises requires staff with considerable training and experience. The township enterprises and individual/household businesses represent the rapidly expanding "private sector" of the economy. In such cases the tax authorities can expect to rely on alternative techniques, including the use of estimates of turnover and profitability, to establish liabilities. In addition, the volatility of this sector imposes a heavy administrative burden on the authorities in identifying, registering and monitoring potential taxpayers to ensure compliance and payment of tax. There are, in addition, insignificant numbers of employed individuals paying personal income tax and personal income adjustment tax.

Table 4.1: CHINA: TAX-PAYING ENTITIES BY TYPE OF TAXPAYER - 1988

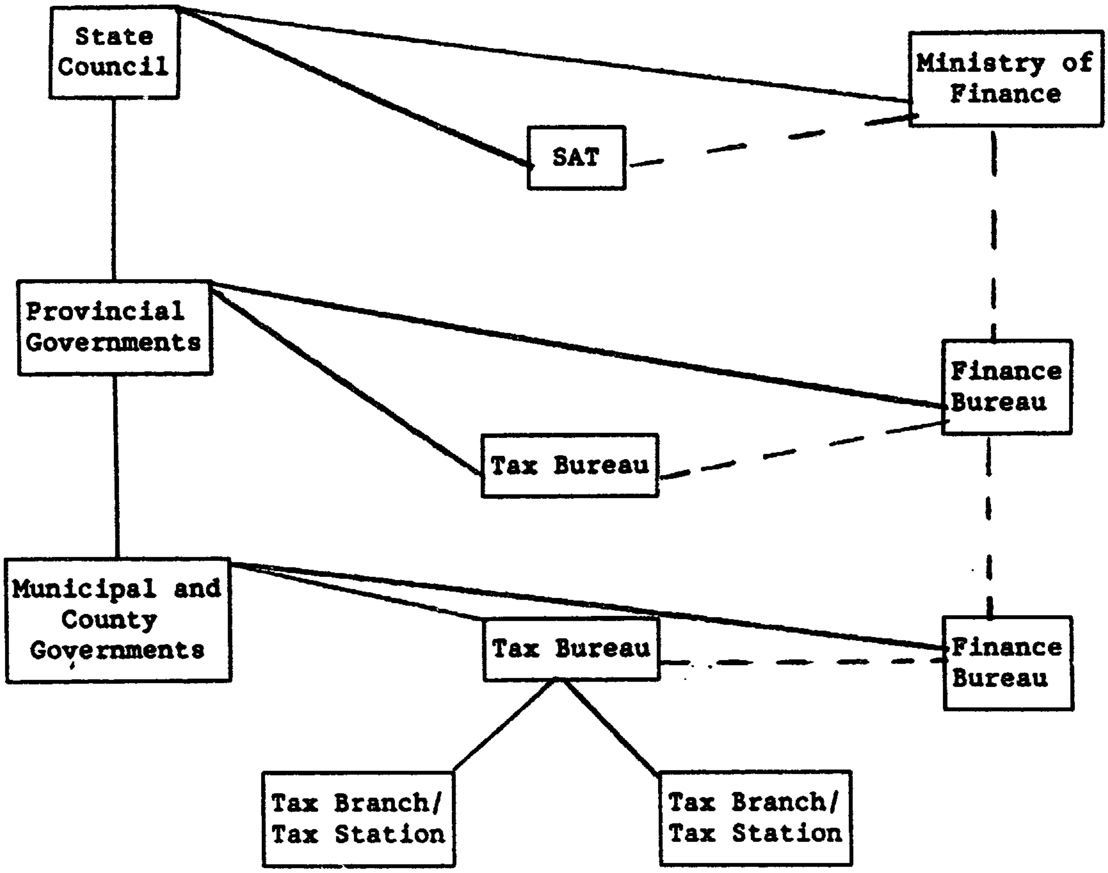
| Type of Entity: | Millions |
|---|---|
| State-Owned Enterprises | 0.4 |
| Collective enterprises | 1.6 |
| Township enterprises | 15.0 |
| Individual/household businesses | 15.0 |
| Total Taxpayers | 32.0 |

Source: SAT.

4.27 Provincial Governments: Organization and Functions. Immediately below the central government stand the governments of 26 provinces and autonomous regions and three cities with the status of provinces, Beijing, Shanghai and Tianjin. All the governments at this level are referred to collectively in this chapter as "provincial governments" or "provincial administrations". Each provincial government has a Tax Bureau with responsibility for overseeing the work of the lower level bureaus at the city and county level.

4.28 Provincial Tax Bureaus are organs of the provincial government whose directors report horizontally to the provincial Finance Bureau and hierarchically to the SAT for implementing official tax policy and delivering tax revenue. These relationships are illustrated in Figure 4.1. In theory, the appointment of a provincial Tax Bureau director requires SAT approval. The tasks of a provincial Tax Bureau may be summarized as follows: define the tax law for its subordinate administrations; collect the appropriate taxes; grant (within its authority) certain exemptions and relief; coordinate with related agencies; and supervise in turn lower-level governments.

Figure 4.1: THE HIERARCHY OF TAX AND FINANCE BUREAU



## BOX 4.2: Tasks and Responsibilities of the State Administration for Taxation (SAT)1/

1. Major Responsibilities of the SAT:

- implementation of the taxation objectives of the State Council;
- administration of national taxes;
- tax policy;
- the drafting of national tax laws;
- the drafting and issue of administrative regulations;
- the collection of (national) tax revenues;
- the use of taxation as a macro-economic lever;
- the management of tax cadres within provincial governments;
- training and coordination within the tax system;
- negotiation with foreign governments and representation of China in international bodies; and
- administration of taxation on offshore oil reserves.

2. The National Taxes for Which the SAT is Responsible:

| | | |
|---|---|---|
| (a) | Turnover taxes : | Product tax<br>VAT<br>Business tax |
| (b) | Income taxes : | on SOEs<br>on collectives<br>on individual and household enterprises<br>Personal income tax<br>Personal income adjustment tax |
| (c) | Resources taxes: | |
| (d) | Special purpose taxes : | construction tax<br>bonus tax<br>fuel consumption tax<br>vehicle tax<br>real estate tax<br>slaughter tax<br>salt tax |
| (e) | Taxes on foreign-owned enterprises | |

1/ Note: This is not an exhaustive or official list of SAT responsibilities.

4.29 The regulations currently governing tax administration in China were issued in 1986 by the State Council, and empower provincial governments in turn to issue amplifying supplementary regulations. Provincial regulations cover the establishment of time limits for certain actions by taxpayers and assignment of responsibilities for tax administration to different levels.

4.30 Municipal and County Tax Bureaus and Offices. Below the provinces stand the cities and counties with 2,600 Tax Bureaus and some cities incorporating a number of counties in addition to their own jurisdiction. These are the lowest level of government employing tax officials not only at city or county headquarter offices but also at smaller suboffices. Suboffices of city governments are known as "branches" numbering 1,800; sub-offices of county bureaus are known as "tax stations" numbering 25,300. Over 240,000 persons, more than 60% of all staff engaged in tax administration, work in these "tax stations". The remainder largely work in the "branches". A small minority is therefore engaged in supervisory activities at the provincial level or at the SAT.

4.31 At both provincial and municipal/county level, Tax Bureaus are matched by Finance Bureaus, whose task it is to draw up and administer the provincial or municipal budget and handle the jurisdiction's financial relations with superior and subordinate governments. Finance Bureaus formally represent the government as "owners" of the jurisdiction's SOEs. In addition to being responsible for "industrial policy", they have a strong interest in the granting of preferential tax reliefs for enterprises in their jurisdiction. Within the provincial hierarchy, the Tax Bureau is a relatively junior department and its director has a lower status than his counterpart in the Finance Bureau, equivalent to the latter's deputy and therefore carrying less weight. At the municipal level, the Tax Bureau and Finance Bureau have equal status.

4.32 In the pre-reform period, the Finance Bureaus were responsible for the entire range of regulation of local enterprises, including profit remittance. With the move away from profit remittance, however, formal responsibility for enterprise taxation has passed to the Tax Bureaus. Nonetheless, in some cases, and contrary to official regulations, taxes paid by SOEs continue to be credited to the accounts of Finance Bureaus instead of to those of Tax Bureaus. All in all, there is tension between "industrial policy" and standardized tax administration. Some Tax Bureaus, for example, do not collect data on SOE profit taxes to finance bureaus. This runs counter to the concept of integrated budgeting and undermines the functional responsibility of the Tax Bureaus.

4.33 A decentralized system will generally involve a three-tier hierarchy of administration--headquarters, regional office, and local offices. From the point of view of management control, this structure enables managers at the regional level to be close enough to the work of local offices to be fully conversant with local conditions. It also means that such regional managers can have realistic "spans of command" in that only a reasonable number of local officials report directly to them. A clean division of responsibilities between offices at different levels is needed. In China, however, it is not clear that higher level offices have adequate controls over lower level units.

Tax Collection Machinery and Practice in China

4.34 With respect to methods of tax collection, China has an extreme form of the "assessment" system, even with regard to the Business, Product and Value-added taxes. Enterprises assume little or no responsibility for computing their own profits or indirect tax liabilities and virtually all the work of calculating net income, determining applicable tax rates and establishing tax liabilities is done by Tax Bureau officials. No manuals or publications are available for guiding taxpayers. This practice effectively allows taxpayers to abdicate responsibility for paying the correct amount of tax.

4.35 Moreover, China is exceptional in relying on tax officials, resident in large enterprises, to administer the tax law. These resident tax officials assist it in assessing the tax consequences of enterprise transactions and advise on potential tax incentives available to the enterprise. Any claim for tax incentives must be accompanied by a recommendation from the resident tax official. These are in an ambiguous position. On the one hand a resident official is supposed to review the enterprise's tax liabilities in an objective way. On the other hand, as an on-the-spot representative of the owner of the enterprise, he is supposed to look for ways the tax system can be operated in favor of the enterprise. A possible outcome, given the "dual leadership" of the Tax Bureau is that the latter duty supplants the former and objectivity is lost.

4.36 With respect to methods of tax payment, enterprises pay direct tax and indirect taxes assessed by the Tax Bureau inspector to the enterprise's bank. This is done in a cumbersome way, specifically, payment vouchers are six-part forms. China has adopted the system of withholding taxes (PIT and PIAT) for some wage and salary payments. Withholding is also used for payments of dividends and other passive income, such as interest, royalties and rent, made to foreign enterprises. However the growing number of double taxation treaties signed by China reduces the impact on foreign investors.

4.37 The audit system in China involves reviewing all tax returns each year, plus a second in-depth review of a large sample of cases. Because this extensive review cannot be at the same time very intensive, in general, only cursory (e.g. arithmetric) checking is generally possible. Resources currently employed on "front-end" tasks of calculating income and tax, described in paras. 4.34 - 4.35, could be more effectively used in carrying out "back-end" auditing, concentrating on areas where the revenue yield is most at risk.

4.38 Additional tax collected as a result of the enforcement efforts of the various tax bureaus in China seems disproportionately small. An estimated Y 1.76 billion, or 0.6% of total revenues, was recovered in 1987. This is particularly worrisome because the ratio of staff to taxpayers in China is high by international standards.

## C. Analysis and Issues

### How China's System Compares

4.39 Measured by the criteria of simplicity, fairness and efficiency, China's tax system, and its laws and administration, fall short in a number of respects. Many countries have systems that are less than perfect, but in a number of areas China's practice is far out of step with international best practice.

4.40 The most striking feature of the Chinese tax system is the multiplicity of taxes. There are 28 taxes (plus 2 levies) being administered by the SAT alone. (In addition, the agriculture tax and cultivated land occupancy tax are administered by Finance Bureaus). Leaving aside the dozen or so special taxes on specific transactions, resources or expenditures, the system is differentiated according to both economic sector (agriculture, commerce, industry) and form of ownership (state-owned, collective, household/individual, Chinese, foreign). Consequently, an SOE engaged in textile manufacturing pays a different income tax and a different turnover tax than a collective enterprise engaged in wholesale textile distribution. This creates administrative difficulties, apart from tax policy considerations.

4.41 The rate structure of many taxes, notably the turnover taxes, are highly complex. In most countries the taxpayer determines the appropriate rate for his particular activity from a published list. China's complex system requires requires that even this preliminary determination be done by the Tax Bureau. This multiplicity of rates is not only expensive to administer but is also prone to error as taxpayers and officials alike misinterpret and misapply the law.4/ The more complicated a system becomes the greater the probability that it will not be implemented as its designers intended. And, as noted, the SAT has no means to assess this.

4.42 On fairness, there are several factors in China that tend to undermine the integrity and credibility of the system. The first is that only three of the 28 taxes administered by the SAT have the full status of laws passed by the People's Congress.5/ These three laws apply to foreigners who are accustomed to the certainty of properly constituted laws, although this is undermined by the large number of ad hoc local interpretations and deviations from the law that apply in practice. The rest have the status of decrees or are covered by "provisional" laws.

4.43 A second factor undermining the fairness of the system is the regional variation in tax administration. A third factor is the apparent absence of formal legal and appeals procedures, and, more importantly, the practice of the authorities of increasing previously settled tax liabilities if further amounts are deemed payable. In China taxpayers are generally obliged to accept decisions by the tax authorities as final, although they may

---

4/ The rationale behind the multiplicity of rates, its relation to equalization of profitability were each discussed in Chapter II.

5/ These are the Foreign Ventures Income Tax, the Joint Ventures Income Tax and the Individual Income Tax.

raise complaints to higher levels of government. The absence of a formal legal appeals process has the risk on the one hand of placing ad hoc power in the hands of individual officials. At the same time, the absence of legal and enforcement powers of SAT officials, which in most countries would be taken for granted (such as the right to examine bank accounts, and goods depots or vehicles) seriously weaken the administration.

4.44 At present, MOF and the SAT operate under a number of handicaps impeding greater efficiency in tax administration, the greatest being an almost total lack of data reporting that their counterparts in other countries would regard as indispensable. Financial data are available centrally on total tax collections and on expenditures through the compilation of Treasury accounts at PBC in the context of budget planning. However, there are no figures and no reporting available to SAT on collection costs, the effectiveness of audit work or any other functions of the tax administration and actions undertaken in local Tax Bureaus. This makes it virtually impossible for the SAT to gauge where incremental efforts, such as withholding and auditing, should be deployed.

4.45 Tax collection costs in China may be excessive because of a large number of minor, nuisance taxes and inefficient procedures. Administrative and compliance cost of numerous minor taxes are considerable, and they are subject to wide discretion by tax collectors. Collection costs in modern tax systems will range between 0.5 and 2.5% of total revenues; comparable figures for China are not known.

4.46 The description in Box 4.3 of the steps in turnover tax administration indicates just how difficult it is for an enterprise to pay its tax and fulfill its other obligations towards the tax authorities. In particular, the enterprise is required to have frequent contacts with the Tax Bureau and numerous copies of forms (invoices, payment vouchers) are produced. PIT and PIAT are administered monthly, making taxpayers contact Tax Bureaus more often (the norm appears to be twelve times) than in most countries where a worker might expect to contact the tax office only once a year.

## Machinery of Government

4.47 China has followed a practice adopted in many countries of placing responsibility for tax administration with a semi-autonomous authority. The decision to include in the SAT responsibility for tax policy carries with it the risk that, whatever the arrangements for coordination between MOF and the SAT, those responsible for tax policy and those responsible for other economic and budgetary policies will not coordinate their work.

## Centralized vs Decentralized Administration

4.48 Strengths of the Present Administratively Decentralized System. The devolution of responsibility for tax administration from the center to the lower-level governments carries with it a number of advantages: China is a very large country and communications are not good. Similarly, economic and social conditions vary enormously so that matters important in one province may be quite insignificant in another. By having provincial governments responsible for a wide range of tax administration, the central authorities in

Beijing have been able to avoid the task of assembling and interpreting the huge amounts of information for administering the required entire tax system from the center.

**BOX 4.3: The Steps in Turnover Tax Administration**

---

**Step 1** The enterprise registers at the Commercial and Industrial Bureau and is given a registration number. The enterprise then takes the number and the completed registration form to the Tax Bureau.

**Step 2** The enterprise completes a tax registration form at the Tax Bureau. A copy of this form is sent to the other tax offices and a certificate is issued to the firm.

**Step 3** With this license, the firm can purchase sales invoices (receipts). There is a very strict control of these documents. Each invoice bears a tax stamp impressed by the tax bureau, and they must be used with all transactions. Invoices can only be purchased on production of the license, but they can be printed outside with approval of the Tax Bureau. Each invoice consists of five copies.

**Step 4** The enterprise or resident advisor must fill in background information for turnover tax purposes. The enterprise headquarters fills in the form for whichever of the three taxes for which it is liable, calculates the kinds of tax rates that are applicable, and then returns the form to the tax bureau. The Tax Bureau headquarters then transfers information from this background sheet to another form which shows the approved rates, etc. that will be applicable to the enterprise.

**Step 5** The enterprise completes a declaration form when it is prepared to pay the tax. The form allows computation of sales tax, urban maintenance and construction tax, and the education surcharge. This declaration form is then brought to the Tax Bureau where the tax officer examines it and recalculates the tax amounts. The taxpayer makes out a six-part payment form. This must be done before the 7th of each month.

**Step 6** The enterprise takes the payment form to the bank, and the bank withdraws the money from the enterprise's account and sends payment directly to the appropriate treasury account. The bank verifies the enterprise account and follows the prescribed priority for payment: (a) taxes, (b) loan repayment, (c) raw material purchase, and (d) profit.

**Step 7** The Industrial and Commercial Bank sends a full copy of the proceeding to the People's Bank with instructions about which treasury accounts are to be credited. Three copies of the payment statement go via the People's Bank to the Tax Bureau. There is a late payment fee of 0.5% daily.

---

4.49 Whatever the drawbacks of combining taxation and industrial policy (and there are many), the fact that the Tax Bureau is part of the same local government implementing industrial policy simplifies the administration of that policy. The synthesis of local government tax and industrial policy under one tier of government has permitted coordinated operations in the two policy areas, albeit at the cost of uncoordinated national and local government tax policies.

4.50 Finally, the involvement of local governments reduces remoteness of the tax authorities from taxpayers. For SOEs owned by cities and counties, the tax authority has usually been a department of the level of government that owns them. This enables the tax authority to keep informed about other aspects of their affairs such as trade licences, land occupancy rights and the like.

4.51 Weaknesses of Present System. However, there are disadvantages in the system. First, the absence of a direct central government presence in cities and provinces has enabled the latter to pursue independent industrial and other policies through the tax system. This can cause a shortfall in revenue and reduce the transparency of the tax system as implementation of tax policy deviates from the intentions of policy-makers. Moreover, the extent of this shortfall is not known by the central government, in the absence of a management information system.

4.52 The position of the directors of the various Tax Bureaus is ambiguous. These officials have to account to higher-level authorities for tax collection and tax policy implementation but are appointed by, and dependent for employment and promotion on the local governments. The close involvement of local governments with individual taxpayers may lead to a loss of objectivity. In 1989, a State Council decision to allow the SAT to nominate Provincial Tax Bureau directors, should help strengthen the "vertical" administration of the tax administration.

## Assessment

4.53 Clearly the task at hand for the local tax authorities is very large, given the large number of potential taxpayers. These taxpayers are subject to a large number of different taxes, tax categories and tax rates. Some taxes, such as the adjustment tax, require individual consideration. In view of this, the number, organization and skills of the administration personnel requires careful attention. Almost half a million tax cadres administer the major taxes such as the profits and turnover taxes, and the smaller taxes such as those on market transactions, real estate and the slaughter of animals. A single tax cadre may be responsible for two or three villages, with a number of rural enterprises and as many as 10,000-20,000 inhabitants. With the growth of the household sector and the increasing significance of the PIAT, this needs to be monitored.

4.54 There are problems in the areas of accounting and audit. There is only scant supervision of the local cadres who implement central policy by the central government. As a result, it is not clear how closely the actual tax system resembles the tax system desired by the center.

4.55 In China the system under which the SAT "shares responsibility" for tax administration with provincial and lower-level governments may be seen as an attempt to come to grips with the problem of remoteness in administration. However, the way in which this system works is such that the SAT has formal responsibility but little prospect of influencing administration. A symptom of SAT's relative lack of means lies in the fact that it has just 345 staff compared with between 400,000 and 500,000 employed by lower-level governments in tax administration. This makes it very difficult for SAT to ensure taxes are applied uniformly. In most unitary countries the central government directly employs its own tax administration and collection staff who are responsible for levying all central taxes. Moreover, the same is true for such major federal countries as the USA and India. A notable exception is West Germany where the tax offices are run by the States (Laender).6/

4.56 The local collection of central taxes creates a number of potential problems noted elsewhere in the report. Interpretation and implementation of tax policy may vary widely across jurisdictions, leading to unintended inequities and distortions. Secondly, if local jurisdictions do not apply the same tax effort as might be applied under a unified collection system, the control over actual revenue collections may be impaired. Special incentives provided by the central government in the new revenue-sharing system with local governments suggest a problem with tax effort. These incentives for "tax effort" by local governments may themselves lead to an erosion of the revenues available to the central government. The next section discusses these problems in greater depth, and outlines some possible near- and medium-term options for strengthening tax administration.

## D. Recommendations and Reform Options for the Present System

### I. A National Tax Service

4.57 Immediate efforts have to be concentrated on exploring ways of improving the present administration and eliminating its least satisfactory aspects. The full and complete operation of an "IRS" or "Inland Revenue" type operation appears a long-term option but steps should be initiated in the near term to design its future structure. However, the role of a "National Tax Service" would be difficult to define in advance of a decision on the allocation of taxes (or tax bases) between the central and local governments. Chapter III discussed four possible models for intergovernmental financing. Briefly, these were: (a) A centralized shared tax; (b) a balanced tax sharing model; approach under which the enterprise income tax and the product, business and value-added taxes would become fixed central revenues and local governments would be given only minor taxes; (c) Shared base, under which local and central governments would share in the base of the enterprise income and product, business, and value-added taxes; and (d) a reform of the present system which eliminated local government discretion to give tax concessions and standardized the retained shares of local governments.

4.58 A centralized tax sharing model effectively requires a separate NTS, as local bureaus cannot be relied on to collect taxes where they do not

---

6/ But there exist complex mechanisms to ensure that responsibility is truly shared and that taxes are administered in a uniform manner.

benefit from collection. In this case the NTS would collect the "central" taxes, with the local government collecting the "local taxes." This would involve the NTS in collecting most of the central taxes, now collected by local Tax Bureaus, and would call for a large, well integrated organization. It is unlikely that there would be any advantage in an NTS collecting any purely local taxes, unless these were on overlapping tax bases.

4.59 The "shared base" model does not make the NTS more or less feasible, per se, but its functions would differ considerably from an NTS under the centralized model. The NTS (or a better coordinated decentralized (provincial) administration) could collect taxes on behalf of the central government, or could administer central and local taxes jointly. A number of countries have both central and local income taxes that are charged on essentially the same base. Canada is an example of a country in which both federal and provincial governments levy a tax on corporate profits. Both taxes are collected by Canada's National Revenue Service, but because the bases for the two taxes are broadly comparable, a single tax administration can collect both and account for them to the respective authorities.

4.60 In China, while it would also be possible under the <u>shared base model</u> to consider two separate tax administrations, each collecting taxes on behalf of its unit of government, such an approach would imply substantial duplication and, given China's scarce administrative manpower, would be undesirable.[7] A "reform of the present system" is consistent with an NTS, but does not require it. As noted later in this chapter, present administrative arrangements, with substantially strengthened MIS and control would also support such a reform.

4.61 In the meantime, certain key steps towards improving the present arrangements urgently need to be taken, including: (a) strengthened personnel and training; (b) a modern management information system (MIS) to strengthen the central management role of the SAT; (c) organizational changes within SAT itself, described below; (d) steps to strengthen the organization and staffing of local Tax Bureaus; and (e) administrative changes to improve the filing and payments system, and the assessment and audit procedures.

## II. Near-Term Steps to Strengthen the SAT

4.62 Immediate efforts must be concentrated on making the present system work better and eliminating the leas satisfactory aspects of present arrangements. The key to improving the present arrangements lies in (i) the establishment of a modern management information system (MIS), and (ii) the strengthening of the management role of SAT. To make this effective, a number of organizational changes will be needed within SAT itself.

4.63 <u>Review of SAT Structure and Organization</u>. The SAT inherited the organization of the former General Taxation Bureau of the MOF, which was essentially a policy-making unit. As it stands, the SAT is not staffed or equipped to identify and analyze the sorts of organizational and management

---

7/ As pointed out in Chapter III, the "shared base" model could be administered by local government, who would, as at present, collect taxes on behalf of the central government.

problems confronting it. Early formation of a specialist organization and management unit within the SAT, with responsibility for reviewing the current organization of SAT, making recommendations for reform and implementing those recommendations (if approved by management), is essential. There are a number of areas where, on the basis of data already available, the case for early action in strengthening SAT seems clearcut. These are:

4.64 Personnel. Strengthening the central SAT functions via recruitment of people with appropriate skills is essential. The staff of SAT has expanded rapidly in recent years, with large numbers of new graduates being recruited each year, and as a result the level of experience is relatively low. At the same time, there is no regular interchange of people between SAT and provincial governments, although such an interchange would benefit both the SAT and the provinces by creating a body of personnel with experience and understanding of work at both levels. Interchange of officials between provincial Tax Bureaus and SAT, as well as a rotation of the provincial officials themselves, should be introduced.

4.65 Training. An especially important task would be training, including the preparation of materials for in-house training and the identification of SAT's training needs and of the resources that would be required. In most countries, tax authorities find it desirable to supplement in-house training with outside materials and courses. In the case of SAT it seems likely that, at least initially, considerable use would need to be made of outside training facilities--particularly in specialized areas such as computers and modern audit, filing and work management techniques.

4.66 Management Information Systems. One of the main problems faced by SAT in its supervision of tax administration in China is the absence of data about the activities of the provincial, municipal and county areas and tax bureaus, reflected in the limited information in Section B of this chapter. Some figures are available centrally at SAT, on, for example, total tax collections and on the educational backgrounds of tax administration personnel. But few data are available on the activities or economic status of the major taxpaying enterprises--large state enterprises--and no attempt is made to obtain systematic evidence on the effectiveness of activities undertaken by provincial bureaus such as the examination of tax returns, or of the new policy of "tax expenditures" described in Section B. Such data are indispensable if SAT is to control effectively the way national level taxes are administered. Therefore, design and installation of a modern management information system (MIS) is a priority task of the SAT.

4.67 The MIS would provide up-to-date information about the local tax base, enterprise activity and collections in the local Tax Bureaus area. It would show the progress in filing assessing, and auditing of returns and the results of work of local Tax Bureaus, and would highlight areas where intervention is desirable. It would provide both quantitative and qualitative data with statistical reports amplified by narrative reports.

4.68 Internal Audit Unit. To strengthen control over tax administration, the SAT should also establish an Internal Audit Unit staffed by specialist auditors the training of whom should now be initiated. Initially, the function of this unit would be to advise provincial Tax Bureaus on measures they should take to improve internal security and apply national administrative standards, and to offer an internal audit service to the provincial governments. At a later stage, this function could be expanded to cover the provision of internal audit throughout the tax administration, probably through a network of provincial offices.

4.69 Standardizing Systems and Procedures. SAT should also play an active role in designing and enforcing standardized administrative systems and procedures. At present, there is considerable diversity of administrative practice throughout the country in areas where a more coordinated approach would produce improved results. For example, the design of tax forms and filing procedures should be standardized across localities. Such standard forms would be a virtual necessity, for an invoice-based VAT, for example. A "Standard Systems and Procedures Unit" within SAT would have responsibility for devising standardized, efficient and effective procedures, for designing filing forms and for collating and disseminating administrative "best practice" throughout the tax administration. The work of such a unit would also extend to reviewing the way in which local Tax Bureaus were organized and recommending changes to ensure an appropriate internal structure for local offices.

4.70 Automatic Data Processing. The volume of data that has to be handled by local Tax Bureaus makes the introduction of ADP not only desirable but, ultimately, inescapable. The number of possible applications is very large and it is likely that it will be desirable to introduce computers at all levels of the work. A central ADP unit within SAT would be needed to coordinate and guide this work at the local level.8/

4.71 Implications for SAT Role and Organization. The above measures would alter dramatically the influence and structure of SAT. But this must be the case if SAT is to tackle successfully the tasks it faces as coordinator at the national level of local government tax administration. Figure 4.2 is a very tentative organization model that might be adopted following the recommended management review. The large number of new tasks points to an additional deputy director post governing all the new functions. Responsibility for all operational work (except for the control of the Offshore Oil Taxation Bureau for which no change is envisaged), would lie with the additional post. The appropriate number of departments and divisions, and their respective functions, would be matters for the proposed management review.

4.72 The ultimate goal of reforms of SAT structure and organization may be the establishment of a National Tax Service to administer all central and shared (as distinct from local) taxes, staffed entirely by employees of the

---

8/ Among its functions would be: (i) Although the creation of a monolithic centralized computer system is premature, even at early stages the exchange of data requires compatibility in computer hardware and software and the nature and form of data inputs. A central ADP unit would be responsible for design and compatibility standards within the provinces' systems. This would also ensure that obsolete hardware is not purchased by local areas. (ii) Insofar as the tax administration developed its own software, a central unit would carry out and monitor that work, provide a forum for the exchange of information, and function as a resource center for the entire administration.

central government. This service would set up its own Tax Bureaus throughout the country and take the administration of certain national level taxes from the provincial and lower-level governments altogether. Paradoxically, by ensuring a uniform tax environment, such centralization would facilitate decentralization of decision-making to enterprises. They would operate within a regime of certainty. However such a National Tax Service is not a realistic goal in the near or medium term.

## III. Organization and Strengthening of Provincial and Lower-level Offices

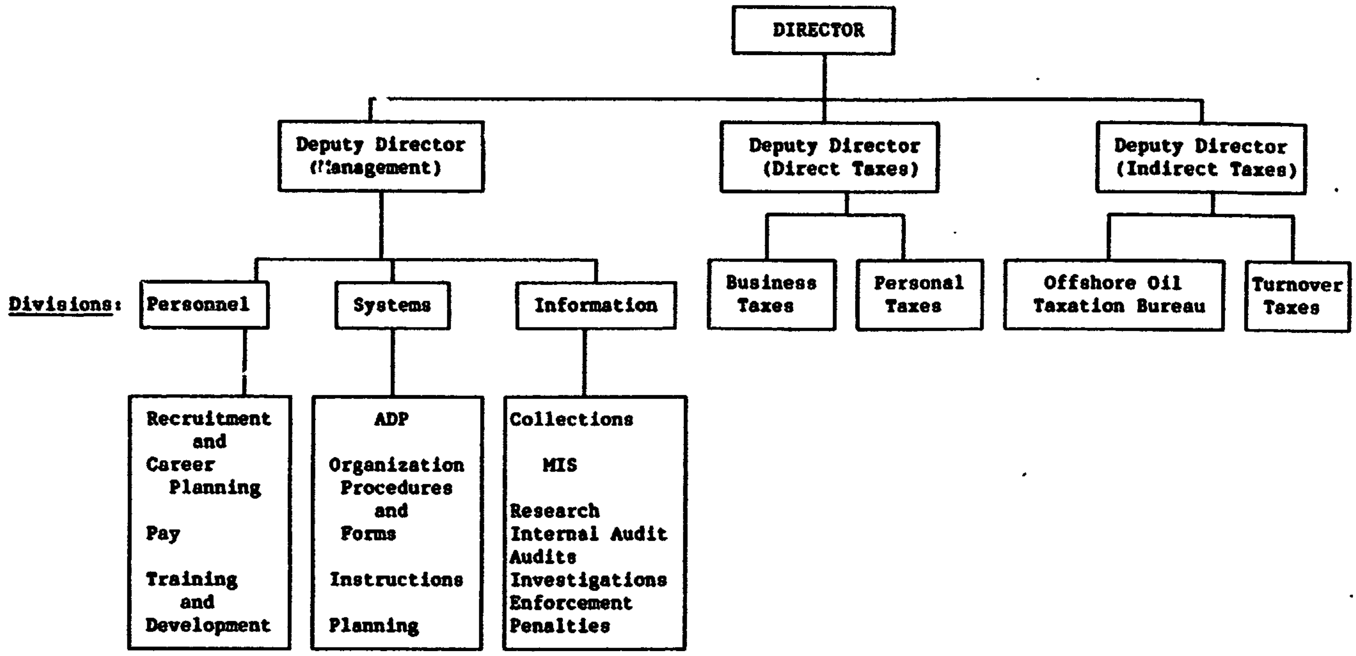
4.73 Role of Provincial Tax Bureaus. The present pattern of provincial Tax Bureaus supervising the work of bureaus at city and county level has many good features. However, it is desirable that some of the functions performed by provincial bureaus (for example, tax policy functions and the task of devising and publishing administrative regulations) should be performed only at the center by SAT.

4.74 Resolution of "Dual Leadership" Problems. Major ambiguities arise in the existing hierarchy of tax bureaus. These relate firstly to Tax Bureaus directors--and secondly to "Affiliated Counties". The position of the Tax Bureaus directors at all levels should be clarified so that they are responsible only to one superior authority. In the interests of enhancing uniformity of tax administration treatment and objectivity of administration the hierarchy should be: (i) SAT for provincial Tax Bureaus; and (ii) the provincial Tax Bureaus for municipal and county tax bureaus. The "dual responsibility" of provincial (or local) Tax Bureaus to the provincial (or local) Finance Bureau should cease. Likewise, it is desirable that the position of "affiliated counties" should be clarified so that they are other fully integrated within and responsible to city tax bureaus. Their present "half-way" status is unsatisfactory. The "vertical" management approach proposed to be introduced in 1989, in faced achieves this as between the SAT and provincial Tax Bureaus.

4.75 City and County Tax Bureaus. At the city and county level, what is possible is severely constrained by difficulties in communications. The present system of tax bureaus with their satellite "branches" and "tax stations" appears to be justified by the need to provide a presence in distant towns and villages. However, it also leaves many officials remote from their immediate superiors, making it difficult--in the absence of an MIS--to control the way they work, and leaving local tax officials vulnerable to pressures from taxpayers and local government officials. The practice of posting "resident tax officials" within enterprises makes this especially acute and gives major cause for concern. Such officials run the risk of identifying too closely with the enterprise they are supposed to monitor.

4.76 Resident Officials and Staff Rotation. SAT officials in Beijing have spoken of encouraging the rotation of resident officials every couple of years or so to reduce their exposure to pressure from individual enterprises. However, while this step will undoubtedly be of some value, it will do nothing to remove the inherent ambiguities in the officials' terms of reference. A way needs to be found of separating the two functions, restoring to the tax administration the objectivity that is essential if the tax system is to work as policy-makers intend.

FIGURE 4.2: Tentative Organization Chart of the SAT following a Management Review



4.77 Indeed, the Chinese authorities might consider building on the strengths of "resident tax officials" in order to develop the accounting profession. For example, assuming enterprises will in future be responsible for filing their own returns and for making tax payments without the need for official assessments, some of the resident officials could be transferred to the employment of individual enterprises as internal accountants. Resident advisors could also become employed by independent "tax advisory enterprises" that were in the business of giving tax advice. They would offer their services on an agency basis and in return for a fee they could also prepare tax returns and other tax documents on behalf of the enterprise. To be successful, the resolution of the resident official's role must achieve a complete separation of the function of tax official/auditor and representative of the government/owner of the enterprise and, for the purpose of conducting tax audits, replace the system of resident officials with one that ensures an objective evaluation both of tax liabilities and of tax expenditures.

## IV. Near Term Administrative Reforms: Micro-Level Administrative Measures

4.78 While any full reform of the tax administration system will take time, action in a number of areas seems immediately feasible and could contribute significantly to the efficiency of the tax operation now.

4.79 Laws and Regulations Should Take Account of Administrative Feasibility. Often "tax administration *is* tax policy".9/ Practical administration of the tax system should be in the forefront of policy decisions, suggesting simplicity, fewer different tax regimes, fewer rates and the elimination of negotiated preferences. One approach that has been adopted with some success in developing countries is the use of "presumptive" measures of income for certain groups whose precise income is difficult to measure (see Section A).

4.80 Make PIT and PIAT Annual Taxes, Reduce the Number of Formal Returns. Second, all income taxes should--as they are in virtually all other countries--be annual taxes (at present the PIAT and the PIT are monthly based) with supporting returns and accounts rendered just once a year (at present, such documents are submitted and checked up to 12 times a year, each time a tax payment falls due). Besides permitting a simpler set of computational rules for the personal taxes, this approach would greatly reduce the administrative burden for tax bureaus and taxpayers alike.

4.81 Simplify Payment of Taxes; Standardize Forms. Third, and implicit in the above proposals, is a simplification and standardization of the arrangements under which taxpayers actually pay their taxes. The present system depends on the generation, in the Tax Bureau, of the six-part payment notice matched by entries in the Tax Bureau's records for the taxpayer. Under the arrangement for tax payment and self-assessment described above, the taxpayer would himself complete a standardized, pre-printed form (designed by SAT), and submit one copy to the Tax Bureau and one or more copies to the bank. There seems little reason why more than one copy of the form should then go from the bank to the Tax Bureau because there will be only one open

---

9/ See M. Casanegra de Jantscher: "Problems of Administering a Value-Added Tax in Developing Countries," IMF FAD WP/86/15, p. 18.

entry to be closed off. For the payment of VAT, the standard invoice form should show the VAT actually paid. This is essential to move away from the present system of presumptive crediting to a system of invoice-based VAT.

4.82 Unique Taxpayer Numbers. In most countries standardized pre-printed forms on which taxpayers notify tax offices of their liabilities bear a unique taxpayer identification number. In the US, for individuals, this is the "social security number". For enterprises, it is usually an assigned number, used by the enterprise in all of its dealings with all types of officials; that is, the same number is used for trading licences, subsidy applications, and other tax-related forms. This enables tax authorities to keep a full record of all tax payments with an enterprise's tax liabilities. The number can also be used on invoices issued by traders and on employers' and contractors' records. This enables the tax authorities to trace payments, to ensure that taxable amounts are properly included in tax returns, and to ascertain that tax reclaimed has actually been paid. Although the fullest benefits of unique taxpayer identification numbers are obtained in fully automated systems, many benefits can be realized in a manual system. The Chinese government should consider introducing a system of unique taxpayer identification numbers.

4.83 Introduce Self-assessment for Turnover Taxes and Income Taxes. Fifth, all turnover taxes should be paid automatically each month or quarter without the submission of detailed returns or accounts. This would considerably reduce the volume of paper handled by Tax bureaus. Each monthly or quarterly period could be regarded as an entity in itself, without the need for an annual reconciliation. (Tax over- or underpaid in any given period would be adjusted when/if errors or new information came to light). Self-assessment could also, in time, and as expertise develops, apply to taxes on enterprise profits and other income so that taxpayers took responsibility for calculating their own liabilities and the role of tax administrators was confined to monitoring and auditing taxpayers' performance.

4.84 Direct Payment to Tax Bureau of Taxes Due. At present, enterprise taxes are remitted via the taxpayer's bank to the Tax Bureaus, giving rise to large numbers of transactions between the Tax Bureaus and the banks. In the absence of advanced computerized accounting systems, the payment of tax directly to Tax bureaus might, by substantially reducing the number of transactions between banks and tax bureaus, offer considerable administrative advantages.

4.85 Methods of Tax Collection and Audit: The Need for Selectivity. It was noted earlier that China's tax collection procedures are especially weak in terms of incremental revenue yield for additional collection efforts. This disappointing performance may be traced to the apparent absence of selectivity in tax audit and examination. The limited scrutiny possible, if every case has to be examined, means the ability of tax administration to detect serious offenders is greatly hampered. To improve the effectiveness of the current audit effort, the application of systematic management must be brought to bear in ways it can be most effective. At the same time, it is desirable to make the best use of trained and experienced personnel.

4.86 The proposal for self-assessment outlined above will, by making taxpayers increasingly responsible for making their own tax returns, release tax bureau staff for more productive work and provide an opportunity to introduce over a period of two or three years a well-balanced program of selective audits. While bearing in mind that, in the transition period, staff would still have to operate the old system, such a timescale would permit at least key personnel to undergo training in suitable techniques and allow time for the collection of data on which selection would be based.

Transition: Some General Considerations

4.87 The near term measures for streamlining of filing and tax payment procedures outlined above would result in a very substantial reduction in the amount of paperwork to be handled by the local tax administrations. While there would be a risk that some taxpayers would fail to comply with their responsibilities, leading to a loss of revenue, careful preparation ought to ensure that that risk was minimal. There are a number of precautions that could be taken.

4.88 Provide and Enforce Penalties. At the same time as the relevant regulations were being drawn up, a review should be undertaken of the provisions for penalties for taxpayers who deliberately or negligently fail to meet their proper tax liabilities. In some countries late-paid taxes automatically attract a significant financial penalty and while the 1986 Tax Management Regulations provide for a 0.5% daily surcharge payable in case of late payments it appears that this provision is rarely enforced.

4.89 Allow Time for Adjustment. It is essential that adequate time be allowed to enable both tax administration and taxpayers to prepare for the new procedures. Experience has shown that a minimum period of between one and two years is required to devise and print new forms, to train staff and to educate taxpayers. In this respect it should be remembered that in the preparatory period both taxpayers and tax administration will continue to operate the old system as well as learning about the new one.

4.90 Publicity and Taxpayer Education are of key importance. A factor to stress here would be that in the new regime it would be the taxpayer who would bear responsibility for making prompt and accurate returns and payments. Accurate, accessible and well-timed information can greatly improve voluntary compliance and most tax administrations find that expenditure in this area can quickly pay for itself in terms of improved tax collections and lower administration costs.

4.91 Support Development of an Audit/Public Accountancy Profession. Enterprises would be expected to ensure that they had access to the expertise necessary to enable them to fulfill their duties. In some cases this might mean that they recruited specialist personnel. In other cases, it might be more expedient for them to establish contacts with other entities that had such personnel. These might include both other industrial or commercial concerns and specialist firms of consultants or advisers. The tax authorities should consider it part of their function to set minimum standards for the training and testing of enterprise tax specialists.

4.92 Run Pilot Schemes. It is highly desirable that all the new procedures be tested by SAT in at least one pilot area, chosen to be as representative as possible. This would enable both the procedures and the training and education techniques to be evaluated by the SAT and allow the SAT to make any improvements needed before they were applied by the SAT nationwide. The time needed to mount and evaluate the pilot could be used to begin the task of familiarizing taxpayers and tax administrators in the rest of the country with the principles of the proposals, thereby permitting a gradual adjustment to the new rules.

**Table I: STATE BUDGET REVENUE, 1978-88 /a**
(In billions of yuan)

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 Budget | 1988 Actual | Growth Rate 1978-88 | Buoyancy |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Tax revenue /b /c | 120.6 | 122.7 | 128.1 | 135.4 | 136.8 | 153.5 | 175.5 | 218.8 | 224.8 | 231.0 | 251.5 | 258.0 | 7.6% | 0.65 |
| Taxes on income and profits | 74.0 | 73.7 | 75.6 | 77.1 | 72.1 | 75.1 | 80.6 | 69.7 | 81.9 | 81.5/d | 90.8 | -- | 2.1% | 0.11 |
| Enterprises income tax | 74.0 | 73.4 | 75.4 | 76.7 | 71.6 | 72.6 | 78.0 | 69.7 | 81.9 | 81.5 | 86.4 | -- | 1.6% | 0.10 |
| Collectives /e | (5.4) | (4.5) | (4.5) | (4.4) | (4.8) | (6.0) | (6.2) | (10.1) | (...) | (...) | (...) | -- | 9.4% | 0.83 |
| State enterprises /f | (68.6) | (68.9) | (70.9) | (72.3) | (66.8) | (66.6) | (71.8) | (59.6) | (...) | (...) | (...) | -- | -2.0% | -0.13 |
| Other | -- | 0.3 | 0.2 | 0.4 | 0.5 | 2.5 | 2.6 | -- | -- | -- | 4.4 | -- | 34.8% | |
| Taxes on goods and services | 43.7 | 46.4 | 49.1 | 52.8 | 58.6 | 60.2 | 71.4 | 100.5 | 109.6 | 114.1 | 125.1 | -- | 11.1% | 0.95 |
| General sales taxes /g | 39.5 | 42.5 | 45.4 | 49.1 | 54.7 | 55.9 | 66.9 | 95.3 | 104.0 | 108.7 | 124.4 | -- | 12.2% | 0.96 |
| Product tax | (...) | (...) | (...) | (...) | (...) | (...) | (...) | (59.4) | (54.7) | (53.6) | (54.8) | -- | -2.7% | -0.18 |
| Value-added tax | (...) | (...) | (...) | (...) | (...) | (...) | (...) | (14.8) | (23.2) | (25.0) | (33.8) | -- | 31.7% | 1.81 |
| Business tax | (...) | (...) | (...) | (...) | (...) | (...) | (...) | (21.1) | (26.1) | (30.1) | (35.8) | -- | 19.3% | 1.23 |
| Salt tax | 1.1 | 1.0 | 0.9 | 0.9 | 1.0 | 1.0 | 1.0 | 1.0 | 1.1 | 0.4 | 0.7 | -- | -4.4% | -0.38 |
| Agricultural tax | 3.1 | 2.9 | 2.8 | 2.8 | 2.9 | 3.3 | 3.5 | 4.2 | 4.5 | 5.0 | ... | -- | 5.5% | 0.52 |
| Taxes on int'l trade | 2.9 | 2.6 | 3.4 | 5.4 | 4.7 | 5.4 | 10.3 | 20.5 | 15.2 | 15.0 | 15.0 | -- | 17.9% | 1.63 |
| Other taxes | -- | -- | -- | 0.1 | 1.4 | 12.8/h | 13.2 | 28.1 | 18.1 | 20.4 | 20.6 | -- | 114.1% | 3.95 |
| Of which: | | | | | | | | | | | | | | |
| Tax on extrabudgetary receipts | -- | -- | -- | -- | -- | 9.3 | 12.2 | 14.7 | 15.7 | 17.5 | 18.1 | -- | 14.2% | n.a. |
| Tax on extrabudgetary construction | -- | -- | -- | -- | -- | 0.2 | 1.0 | 2.3 | 2.4 | 2.9 | 2.5 | -- | 65.7% | n.a. |
| Nontax revenue | 2.7 | 3.6 | 3.5 | 3.2 | 4.4 | 5.9 | 8.0 | 9.5 | 19.5 | 24.6 | 22.9 | 25.4 | 23.6% | 1.89 |
| Gross profit remittances from state enterprises /i | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 4.4 | 4.2 | 4.2 | 4.6 | -- | 1.5% | n.a. |
| Depreciation funds | 2.4 | 2.5 | 2.7 | 2.6 | 2.6 | 2.7 | 2.7 | -- | -- | -- | -- | -- | 2.0% | n.a. |
| Other | 0.3 | 1.1 | 0.8 | 0.6 | 1.8 | 3.2 | 5.3 | 5.1 | 15.3 | 20.4 | [illegible] | -- | 50.8% | n.a. |
| Total revenue /i | 123.3 | 126.3 | 131.6 | 138.6 | 141.2 | 159.4 | 183.5 | 228.3 | 244.3 | 255.7 | [illegible] | 281.4 | 8.3% | 0.71 |
| Memorandum item: | | | | | | | | | | | | | | |
| Total gross profit remittances from state enterprises | 68.6 | 68.9 | 70.9 | 72.3 | 66.8 | 66.6 | 68.7 | 4.4 | 4.2 | 4.2 | 4.6 | -- | n.a. | n.a. |

/a This includes all government revenue, with the exception of extrabudgetary receipts of the various levels of government. No detail is available on a disaggregated basis for 1988 actual revenues.
/b Proceeds of the profit tax on state enterprises introduced in 1983 are classified under profit remittances, as the breakdown of enterprise payments in 1983 and 1984 between profit tax and profit transfers is not available. Beginning with 1985, profit taxes on state enterprises are included under tax revenue.
/c Chinese definition of tax revenues plus energy and communications tax.
/d Residual: 231.0 less all identifiable items below.
/e Until 1985, the industrial and commercial income tax levied on collective enterprises. Beginning in 1986, official data no longer separately identify income tax on collectives.
/f The profit tax and adjustment tax on state enterprises, gross profit remittancies from state enterprises until 1984.
/g The consolidated industrial and commercial tax.
/h Includes Y 1.9 billion from the tax on crude oil consumption introduced in 1982.
/i According to the definition contained in IMF, Manual on Government Finance Statistics (GFS), 1986.
/j Until 1984, included in income tax on state enterprises, as of 1988, only banks and financial institutions are subject to remittance.

Source: Ministry of Finance and World Bank/IMF estimates.

APPENDIX Table II

**Table II: STATE BUDGET REVENUE, 1980 CONSTANT PRICES**
**(In billions of yuan)**

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | Growth Rate |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| GPD Deflator | 92.9 | 96.6 | 100.0 | 101.8 | 102.8 | 104.2 | 109.3 | 119.1 | 124.7 | 137.1 | 150.9 | - |
| Taxes Revenue | 129.8 | 127.0 | 128.1 | 133.0 | 133.1 | 147.3 | 160.6 | 183.7 | 180.3 | 168.5 | 166.7 | 2.5% |
| Taxes on Income Tax | 79.7 | 76.3 | 75.6 | 75.7 | 70.2 | 72.0 | 79.7 | 58.5 | 65.7 | 59.5 | 60.2 | -2.8% |
| Enterprises income tax | 79.7 | 76.0 | 75.4 | 75.3 | 69.6 | 69.7 | 71.4 | 58.5 | 65.7 | 59.4 | 57.4 | -3.2% |
| Collectives | 5.8 | 4.7 | 4.5 | 4.3 | 4.7 | 5.8 | 5.7 | 8.5 | - | - | - | 5.5% |
| State enterprises | 73.8 | 71.3 | 70.9 | 71.0 | 65.0 | 63.9 | 65.7 | 50.0 | - | - | - | -5.4% |
| Agricultural tax | 3.3 | 3.0 | 2.8 | 2.8 | 2.8 | 3.2 | 3.2 | 3.5 | 3.6 | 3.6 | - | 1.0% |
| Other | - | -0.3 | 0.2 | 0.4 | 0.5 | 2.4 | 2.4 | - | - | - | 2.9 | 28.3% |
| Taxes on goods and services | 47.0 | 48.0 | 49.1 | 51.9 | 57.0 | 57.8 | 65.3 | 84.4 | 87.9 | 83.2 | 82.9 | 5.8% |
| General sales taxes | 42.5 | 44.0 | 45.4 | 48.2 | 53.2 | 53.6 | 61.2 | 80.0 | 83.4 | 79.3 | 82.4 | 6.8% |
| Product tax | - | - | - | - | - | - | - | 49.9 | 43.9 | 39.1 | 36.3 | -10.0% |
| Value-added tax | - | - | - | - | - | - | - | 12.4 | 18.6 | 18.2 | 22.4 | 21.7% |
| Business tax | - | - | - | - | - | - | - | 17.7 | 20.9 | 22.0 | 23.7 | 10.2% |
| Salt tax | 1.2 | 1.0 | 0 9 | 0.9 | 1.0 | 1.0 | 0.9 | 0.8 | 0.9 | 0.3 | 0.5 | -8.9% |
| Taxes on int'l trade | 3.1 | 2.7 | 3.4 | 5.3 | 4.6 | 5.2 | 9.4 | 17.2 | 12.2 | 10.9 | 9.9 | 12.3% |
| Other taxes | - | - | - | 0.9 | 1.3 | 12.3 | 12.1 | 23.6 | 14.5 | 14.9 | 13.7 | 2.1% |
| Of which: | | | | | | | | | | | | |
| Tax on extrabudgetary receipts | - | - | - | - | - | 8.9 | 11.2 | 12.3 | 12.6 | 12.8 | 12.0 | 6.1% |
| Tax on extrabudgetary construction | - | - | - | - | - | 0.2 | 0.9 | 1.9 | 1.9 | 2.1 | 1.7 | 53.9% |
| Nontax revenue | 2.9 | 3.7 | 3.5 | 3.1 | 4.3 | 5.7 | 7.3 | 8.0 | 15.6 | 17.9 | 15.2 | 18.0% |
| Profit remittances state enterprises | - | - | - | - | - | - | - | 3.7 | 3.4 | 3.1 | 3.0 | -6.2% |
| Depreciation funds | 2.6 | 2.6 | 2.7 | 2.6 | 2.5 | 2.6 | 2.5 | - | - | - | - | -0.7% |
| Other | 0.3 | 1.1 | 0.8 | 0.6 | 1.8 | 3.1 | 4.8 | 4.3 | 12.3 | 14.9 | 12.1 | 43.7% |
| Total revenue | 132.3 | 130.7 | 131.6 | 136.1 | 137.4 | 153.0 | 167.9 | 191.7 | 195.9 | 186.5 | 181.8 | 3.2% |

Source and Notes: Same as Appendix, Table I.

SUMMARY OF THE TAX SYSTEM: STATE BUDGET, 1988

| Tax | Nature of tax | Exemptions and deductions | Rates |
|---|---|---|---|
| I. <u>Taxes on Net Income and Profits</u><br>Taxes on companies, corporations and enterprises<br>1. Income tax on state-owned enterprises | (a) A tax on profits of large and medium state-owned enterprises. Different provisions apply for small enterprises. | (a) For profits realized in 1988 by the taxpayer, appropriate adjustments should be made in the balance of the increased or decreased profits caused by changes in the rates of the product tax, the value added tax, and sales tax or by the levy of a resource tax. For low-profit enterprises that are not able to retain the reasonable appraised amount of profit, the levy of income taxes may be exempted for a period of three years.<br><br>(b) Regarding the incomes earned by subsidiary enterprises of government agencies, institutions, the military and social organizations, if such incomes are spent to offset institutional expenditures, they should be exempt from income tax for the time being; if not, they should be levied an income tax as required.<br><br>(c) Regarding the industrial plants set up by commercial establishments (including those set up by grain-handling establishments), which specialize in the production of soy sauce, vinegar, soy products, pickles, bean paste, smoked foods, pastries, food for children, sweets, preserved fruits, fruit juices and jams, dried vegetables and condiments (but not including MSG), and regarding feed processing plants, the appropriate tax rates should be applied to levy an income tax but only half of the amount due should actually be collected within the time periods specified.<br><br>As regards those plants that specialized in the products mentioned above set up by other sectors, the same rule applies but may be modified according to circumstances. | (a) Medium and large enterprises are taxes at a rate of 55%. In addition, a variable readjustment tax is levied on excess profits arising from factors external to enterprises, such as the price structure.<br><br>(b) Small enterprises are taxed according to the same progressive scale as applied to collective enterprises under the industrial and commercial income tax. |

| ..x | Nature of tax | Exemptions and deductions | Rates |
|---|---|---|---|
| 1. (cont'd) | | In the case of new food processing plants, income taxes should be exempt for three years; in the case of some types of new food processing plants, the exemption period should be one year. After the exemption period is up, if the taxpayer still has difficulties, tax reductions for a fixed period may be granted, pending appeal and approval in accordance with set procedures.<br><br>(d) Extraordinary circumstances such as natural disasters including high winds, fire and floods where tax reductions or exemptions are needed, the tax agency, following the authority vested in it by these Regulations, may either grant a one-time reduction or exemption or periodic reductions and exemptions. When the exempt period is up, normal taxation should be resumed.<br><br>(e) When the tax agency determines tax reductions or exemptions, it generally adopts the approach of reducing or exempting a certain amount of income tax. With regard to the large or medium civilian trading enterprises, construction and installation firms, film release and projection companies, enterprises in the culture, education, and publishing systems, and other types of culture and education enterprises that have already had their tax rates lowered due to special considerations for those sectors--a unified income tax rate should first be applied to work out the tax amounts due; then, a certain proportion of tax reduction may be granted. The following equation should be used for computing the tax reductions:<br><br>Proportion of reduction = (55% - tax rate)/55% x 100%<br><br>Tax due = taxable income x 55% x (1 - proportion of reduction) | |

| Tax | Nature of tax | Exemptions and deductions | Rates |
|---|---|---|---|
| 1. (cont'd) | | (f) In the case of enterprises eligible for tax reductions or exemptions, if they are subject to a regulatory business tax, this regulatory tax must first be reduced or exempted following the procedure for such reductions or exemptions. If, after such reductions and exemptions, the amounts still fall short, the income tax due may then be reduced or exempted.<br><br>(g) When the taxpayer suffers losses in a certain year, a certain amount of tax credit may be granted against his incomes for the following year, pending reporting and approval in accordance with state-specified procedures. If the amount of tax credit allowed is not sufficient to cover the losses, the balance may be carried forward to the year following. However, carrying foward the tax credit may not exceed three years at the maximum. When there are realized profits left after claiming the tax credit, income tax needs to be paid on that amount in accordance with the regulations for income tax levying purposes. | |
| 2. Transportation and energy tax | (a) Earnings after income and adjustment taxes, together with depreciation, are subject to a transportation and energy fee at a rate of 15% on after-tax earnings plus depreciation. | | |
| 3. Tax on extrabudgetary construction | (a) An extrabudgetary construction tax at 10% is levied, usually on buildings, on construction undertaken outside the state investment budget. | (a) Exemptions include construction in energy and transport facilities, medical facilities and schools. | |
| 4. Tax on bonuses | (a) A bonus tax is applied when bonuses exceed a certain proportion of wages. Bonuses equaling 2-1/2 months' wages are taxed at 30%, bonuses of 4 to 6 months' wages are taxed at 100%, and larger bonuses at 300%. The tax is paid out of the bonus fund in that the contribution from after-tax earnings into the bonus fund is reduced by this tax. | | Marginal tax rates: On bonuses<br>Up to 4 months of basic wages — Exempt<br>4-5 months — 20%<br>5-6 months — 50%<br>6-7 months — 100%<br>Over 7 months — 200% |

| Tax | Nature of tax | Exemptions and deductions | Rates |
|---|---|---|---|
| 5. Regulatory tax wages | (a) A wage tax is also applied to wage increases exceeding 7%. The tax is 30% of wage increases if the increase is 7 to 12%, 100% if the increase is 12 to 20%, and 300% for increases over 20%. Like the bonus tax, this tax is paid out of the bonus fund. | | Marginal tax rates: / Deduction <u>rate</u><br>Wage payments exceeding the norm by less than 7% — Exempt<br>7-12% taxes at 30 % — 2.1<br>12-10% at 100% — 10.5<br>Over 20% at 300% — 50.5 |
| 6. Industrial and commercial income tax | (a) This tax is applicable to the income derived by <u>collective</u> enterprises, <u>mixed</u> enterprises and <u>private</u> enterprises. Separate taxes apply to the income of state-owned enterprises, foreign enterprises and joint ventures, and enterprises in Special Economic Zones.<br><br>(b) Taxable income is assessed annually on net revenue as calculated according to the principles of the accrual method viz., the tax is applied to the difference between the net worth of the enterprise at the end of fiscal year and at its beginning. No distinction is made between the various items of income and therefore no specific capital gains tax is necessary. Possible profits from the dissolution of hidden reserves form part of taxable income.<br><br>(c) Taxable income (net revenue) equals gross revenue less the sum of: (1) production costs, (2) administrative expenses, (3) other expenses, (4) industrial and commercial consolidated tax paid. | <u>Exemptions</u><br><br>(a) New industrial enterprises having financial problems.<br><br>(b) New industrial enterprises in frontier or autonomous areas.<br><br>(c) New feed production enterprises.<br><br>(d) Township and village enterprises directly engaged in production of chemical fertilizer, pesticide, or in maintenance and repair of agricultural machinery.<br><br>(e) Enterprises using liquid or gas waste, etc. as raw material in production.<br><br>(f) Enterprises suffering natural disasters and having difficulties in paying taxes.<br><br>(g) Other enterprises approved as tax-free by the Ministry of Finance. | <u>Annual Income</u> / <u>Rate (%)</u> / <u>Deduction (Y)</u><br>Up to Y 1,000 — 10 — 0<br>Y 1,000- 3,500 — 20 — 100<br>Y 3,500- 10,000 — 28 — 380<br>Y 10,000- 25,000 — 35 — 1,080<br>Y 25,000- 50,000 — 42 — 2,830<br>Y 50,000-100,000 — 48 — 5,830<br>Y 100,000-200,000 — 53 — 10,830<br>Above 200,000 — 55 — 14,830 |

| Tax | Nature of tax | Exemptions and deductions | Rates |
| --- | --- | --- | --- |
| 7. Foreign enterprise income tax | (a) Levied on the incomes derived from production, business and other sources by any foreign enterprise operating in China. Capital gains are taxed on an accrual basis.<br><br>(b) Enterprises not actively involved in undertakings in China are taxed on their passive income (e.g., dividends, interests, royalties, rents).<br><br>(c) Taxable incomes, loss carryover, and depreciation provisions are the same as for joint ventures. | (a) Long-term undertakings are tax exempted in the first profit-making year, and a 50% exemption is granted in the second and third profit-making years if engaged in farming, forestry, animal husbandry, deep wells, coal exploitation, and other low-profit operations. A 15-30% tax rebate can be granted by the Ministry of Finance for ten years following the end of the above-mentioned incentive period.<br><br>(b) An exemption can be granted for low-profit operations with incomes less than Y 1 million by local government. | (a) For enterprises operating in China, marginal income tax rates are:<br><br>Incomes less than<br>Y 250,000 — 20%<br>Y 250,000-500,000 — 25%<br>Y 500,000-750,000 — 30%<br>Y 750,000-1,000,000 — 35%<br>Over Y 1,000,000 — 40%<br><br>In addition, 10% of taxable income is payable as a local tax.<br><br>(b) Income of entities not active in China is subject to a 20% withholding tax. |
| 8. Joint venture income tax | (a) Levied on incomes derived from production business and other sources by any joint venture with Chinese and foreign investment in China.<br><br>(b) Taxable income is defined as the net income in a tax year, after deduction of costs, expenses and losses in that year.<br><br>(c) Losses may be carried over to the next tax year and made up with a matching amount drawn from that year's income. Losses may be carried forward year by year over period not exceeding five years.<br><br>(d) Income taxes paid by branch institutions to foreign countries will compensate for that paid by their head institutions and in accordance with agreements on avoiding dual taxation concluded between China and foreign governments.<br><br>(e) Depreciation will normally be computed on a straight-line basis. In special circumstances, quicker depreciation of fixed assets will be allowed than is generally stipulated. | (a) New joint ventures scheduled to operate ten years or more may, upon approval of tax authorities, be exempted from the tax in the first profit-making year and allowed a 50% deduction in the second and third years.<br><br>(b) A participant in a joint venture reinvesting its share of profits in China for a period of not less than five years may, upon approval of the tax authorities, obtain a refund of 40% of the income tax paid on the reinvested amount.<br><br>(c) Joint ventures in farming and forestry that make less profit than others or which are located in remote areas where the economy is underdeveloped may be allowed a 15-30% reduction in income tax for another ten years following the expiration of exemptions sanctioned in (b) above. | (a) 30% rate on all joint ventures (other than for ventures exploiting petroleum, natural gas, and other resources), plus a local surcharge of 10% on the tax payable, for a total of 33%. For certain joint ventures in 14 coastal cities, the combined tax rate is reduced to 15%.<br><br>(b) 10% tax on the amount of profits remitted by a foreign participant. |

| Tax | Nature of tax | Exemptions and deductions | Rates | % |
|---|---|---|---|---|
| II. <u>Indirect Taxes</u> | | | | |
| 1. Product tax | (a) A product tax imposed at a variable rate on all industrial enterprises. | (a) Those goods whose production for export is encouraged by the State, and which are exported directly by the production units are exempt. | Tobacco products | 35-60 |
| | | | Beers, wines and spirits | 10-50 |
| | | | Rubber products | 10-20 |
| | | | Building materials | 3-12 |
| | | | Minerals | 3-12 |
| | | (b) Raw gold, gold, and birth control devices are exempt. | Electric power | 5-25 |
| | | | Coal and coke | 3-5 |
| | | | Gas | 3-15 |
| | | (c) New products, which are in the State experimental plan, are granted deductions or exemptions for a certain period of time. | Gasoline | 40 |
| | | | Diesel | 10 |
| | | | Kerosene | 25 |
| | | | Other petroleum products | 3-35 |
| | | | Chemicals | 3-25 |
| | | (d) Products using liquid or gas waste as raw material are granted deductions or exemptions for a certain period of time. | Metals | 3-15 |
| | | | Tea | 10-25 |
| | | | Luxury foods | 35 |
| | | | White and black fungus | 5 |
| | | | Timber, bamboo and lacquer | 5-15 |
| | | (e) Minority-specific goods in autonomous regions for which there are difficulties in paying taxes are granted deductions or exemptions for a certain period of time. | Meat | 3 |
| 2. Value added tax | (a) A value added tax imposed on all units and individuals engaged in production and importation within the territory of the People's Republic of China. | (a) Those goods whose production for export is encouraged by the State, and which are exported directly by the production units are tax-exempt. | Textiles | 14-23 |
| | | | Clothing and footwear | 14-20 |
| | | | Enamel products | 20 |
| | | | Glass and glass products | 14-28 |
| | | | Medicines | 14 |
| | | (b) Birth control medicines are exempt. | Household machinery | 14-43 |
| | | | Electrical appliences | 14-20 |
| | | (c) New products, which are in the State experimental plan, are granted deductions or exemptions for a certain period of time. | Electronic appliences | 14-16 |
| | | | Machinery | 12-14 |
| | | | Steel | 8 |
| | | | Steel products | 14 |
| | | | Paper | 14-30 |
| | | | Stationery | 12-30 |
| | | | Household chemicals | 14-45 |
| | | | Ceramics | 12-20 |
| | | | Processed food and beverages | 14-30 |
| | | | Leather | 14-20 |
| | | | Furniture | 14 |

| Tax | Nature of tax | Exemptions and deductions | Rates |
|---|---|---|---|
| 3. Business tax | (a) A business tax levied on sales or operating revenues of commercial and other services enterprises and individuals: the rate is generally 3 to 5%, but is 15% for a few highly profitable businesses. | (a) Income of State grain enterprises from selling grain and edible oil at State-listed prices are exempt.<br>(b) Machine-driven plow income from agricultural machinery stations, and irrigation and drainage income from irrigation and drainage stations are exempt.<br>(c) Income from medical care, child day care, match making, funeral services, and agriculture and animal husbandry insurance are exempt.<br>(d) Ticket income from museums, gymnasiums, exhibition centers and public parks are exempt.<br>(e) Other tax exemptions of business income must be determined by the Ministry of Finance. | %<br>Retail 3<br>Wholesale 10<br>Transport 3-10<br>Construction 3<br>Banking and insurance 3<br>Telephones and telecommunications 5<br>Publishing 3<br>Utilities 3<br>Entertainment 3<br>Other services 3-10 |
| 4. Selective excises<br>(a) Salt tax | | (a) Exempts salt used in agriculture and industry and exported salt. | (a) Rates vary from Y 40 - Y 100 per ton. |
| (b) Oil tax | (a) A tax on enterprise consumption of crude and heavy oil. | | (a) Y 70 per ton burned. |

| Tax | Nature of tax | Exemptions and deductions | Rates |
|---|---|---|---|
| III. <u>Taxes on Individuals</u><br>1. Individual income tax | (a) Levied on the income gained within or outside China by any individual residing for one year or more in China. For individuals not residing in China or residing less than one year, the tax is levied only on the income earned in China.<br><br>(b) The following income categories are taxable: (1) wages and salaries; (2) compensation for personal services; (3) royalties; (4) interest dividends and bonuses; (5) rental income from property; (6) any other income specified as taxable by the Ministry of Finance. | (a) Nontaxable incomes include (1) prizes and rewards for scientific, technological or cultural achievements; (2) interest on savings deposits in State banks and credit cooperatives in China; (3) welfare benefits, survivors' pensions and relief payments; (4) insurance indemnities; (5) military severance pay or retirement pay for cadres, staff members and workers; (6) salaries of diplomats in China; and (7) incomes approved as tax-free by the Ministry of Finance.<br><br>(b) For income from compensation for personal services, royalties or lease of property, a deduction of Y 800 shall be allowed for expenses if the amount in a single payment is less than Y 4,000; for single payments in excess of Y 4,000, a deduction of 20% shall be allowed. | Marginal tax rates applicable to wage and salary income in following brackets (in %):<br><br><u>Monthly Income</u> — <u>General</u><br>Up to Y 800 — Exempt<br>Y 801-1,500 — 5<br>Y 1,501-3,000 — 10<br>Y 3,001-6,000 — 20<br>Y 6,001-9,000 — 30<br>Y 9,001-12,000 — 40<br>Y 12,001 and over — 45<br><br>Income from interest, dividends, bonuses, personal services, royalties or lease of property (net of deductions): flat 20% rate (15% for individuals working in SEZs). |
| 2. Personal income adjustment tax | (a) The Personal Income Adjustment Tax applies to Chinese resident citizens. Taxable income is divided into Global Income and Schedular Income. Global income includes wages and salaries, incomes from contracts and subcontracts, incomes from services and income from leasing property. The rate structure is based on the concept of "base income," which is 100 yuan per month in Beijing but can be 105, 110 or 115 in less developed areas where wages are set higher to attract employees. Income up to four times the base income is free of tax. The rate of tax between four and five times base income is 20%; between five and six times is 30%; between six and seven times is 40%; between seven and eight times is 50%; income over eight times the base income is taxed at 60%. | (a) Agricultural households and those that pay the household enterprise income tax do not pay the Personal Income Adjustment Tax.<br><br>(b) Certain categories of income are exempt from tax. These include scientific and research awards from provincial or central government; interest on state bonds, bank securities, bank accounts and postal savings; subsidies, such as food subsidies, that are paid monthly provided they are within government guidelines; income from welfare funds and pensions. Income received in kind is, in principle, subject to tax but this has proved very difficult to administer. | |

| Tax | Nature of tax | Exemptions and deductions | Rates |
|---|---|---|---|
| 2. (cont'd) | (b) Examples of schedular income are: (i) patent and royalty income and income from writing and translation, where a tax rate of 20% is levied on income minus cost (which is calculated at 20% of income or 800 yuan, whichever is higher); and (ii) interest and dividends, where a tax rate of 20% is levied on income without any cost deduction.<br><br>(c) The tax is assessed on individuals, rather than households, and no allowance is made for the number of dependents. It is calculated monthly and does not normally permit averaging across months. An exception is, however, provided by the treatment of workers in collectives who receive much of their income at the end of the year. There is a provision that allows such workers to deduct 4,400 yuan from their end-of-year payment for tax purposes, with the remainder taxed according to the schedule as if it had all been earned in one month. | | |

| | | | |
|---|---|---|---|
| IV. Subnational Governments | | | |
| 1. Local surcharge on the industrial and commercial income tax | (a) Based on the amount of the industrial and commercial income tax. | | (a) Ranges from 10% to 100% with the rate depending on the degree of development of the region. |
| 2. Local surtax on the joint venture tax | (a) Based on the amount of the assessed joint venture income tax. | (a) Exemptions may be granted by the province, municipality, or autonomous region in which the joint venture is located. | (a) 10%. |
| 3. Local surtax on the agricultural tax | (a) Based on the amount of the agricultural tax. The tax is fixed for a certain number of years (usually five). | | (a) The surcharge rate is locally set with a maximum of 22%. |
| 4. Local surtax on the foreign enterprise income tax | (a) Based on taxable income of foreign enterprises. | | (a) 10%. |
| 5. Local surtax on the consolidated industrial and commercial tax | (a) Based on the amount of consolidated industrial and commercial tax | | (a) 1-7%. |
| V. Taxes on Property | | | |
| 1. Urban real estate taxes | (a) Levied annually as a local (municipal) tax on the value of real property. The applicable base value depends on various factors, e.g., the location, condition, etc., of the real property. | (a) Exemptions for certain real property owned by governmental, public, or religious bodies. | (a) Buildings: 1.2%. |
| | (b) Applies to owners, renters or users of real property located in urban areas. | | |
| 2. Net wealth tax | (a) None | | |
| 3. Death and gift taxes | (a) None | | |
| 4. Other<br>(a) Slaughtering tax | (a) Levied when the slaughtering of certain livestock takes place. | (a) Slaughter for one's own consumption is exempt. | (a) Levied according to actual weight after slaughtering; the rate is 10%. |

Source: A Compilation of Basic Provisions on Industrial and Commercial Taxation, Tax Bureau, the Ministry of Finance, 1987.

Table IV: Collection and Expenditure Disparities Among Provinces 1985

| | Collections | | Budgetary Expenditures | | Percent of Total Population | Ranking: Per Capita Nat'l Income |
|---|---|---|---|---|---|---|
| | Per Capita Amount (Rmb/person) | Percent of Total | Per Capita Amount (Rmb/person | Percent of Total | | |
| Beijing | 609 | 4.97 | 344 | 3.15 | 0.92 | 2 |
| Tianjin | 597 | 4.10 | 334 | 2.58 | 0.78 | 3 |
| Hebei | 81 | 3 84 | 75 | 3.98 | 5.33 | 14 |
| Shanxi | 95 | 2.[illegible]2 | 135 | 3.40 | 2.52 | 12 |
| Inner Mongolia | 72 | 1.22 | 170 | 3.27 | 1.93 | 16 |
| Liaoning | 231 | 7.24 | 154 | 5.44 | 3.54 | 4 |
| Jilin | 94 | 1.84 | 150 | 3.30 | 2.21 | 8 |
| Heilongjiang | 98 | 2.76 | 135 | 5.27 | 3.18 | 5 |
| Shanghai | 1,492 | 15.43 | 346 | 4.02 | 1.17 | 1 |
| Jiangsu | 135 | 7.14 | 81 | 4.83 | 5.97 | 6 |
| Zhejijng | 145 | 4.95 | 93 | 3.57 | 3.87 | 7 |
| Anhui | 58 | 2.56 | 66 | 3.24 | 4.95 | 21 |
| Fujian | 92 | 2.13 | 113 | 2.93 | 2.61 | 17 |
| Jiangxi | 56 | 1.66 | 81 | 2.68 | 3.32 | 22 |
| Shandong | 88 | 5.74 | 67 | 4.90 | 7.39 | 10 |
| Henan | 63 | 4.16 | 64 | 4.73 | 7.41 | 25 |
| Hubei | 102 | 4.27 | 88 | 4.17 | 4.74 | 11 |
| Hunan | 70 | 3.33 | 71 | 3.83 | 5.40 | 19 |
| Guangdong | 112 | 5.92 | 107 | 6.41 | 6.01 | 9 |
| Guangxi | 52 | 1.71 | 77 | 2.84 | 3.72 | 28 |
| Sichuan | 57 | 4.[illegible]9 | 63 | 6.13 | 9.79 | 26 |
| Guizhou | 49 | 1.23 | 80 | 2.28 | 2.85 | 29 |
| Yunnan | 80 | [illegible].33 | 108 | 3.51 | 3.27 | 27 |
| Tibet | 40 | 0.07 | 517 | 0.98 | 0.19 | 18 |
| Shaanxi | 68 | 1.72 | 92 | 2.63 | 2.88 | 24 |
| Gansu | 81 | 1.40 | 118 | 2.29 | 1.96 | 23 |
| Quinhai | 60 | 0.20 | 248 | 0.96 | 0.39 | 15 |
| Ningxia | 70 | 0.25 | 237 | 0.94 | 0.40 | 20 |
| Xinjiang | 62 | 0.72 | 210 | 2.73 | 1.31 | 13 |
| Mean | 169 | | 152 | | | |
| Gini coefficient | .546 | | .348 | | | |

Table V: Percent Increase in Revenues and Expenditures, by Provinces for 1983-1986

| | Budgetary Collections | | | Budgetary Expenditures | | |
|---|---|---|---|---|---|---|
| Province | Percent Increase | Relative (average = 100) | Rank | Percent Increase | Relative (average = 100) | Rank |
| Beijing | 125.75 | 111.92 | 8 | 61.05 | 127.30 | 18 |
| Tianjin | 70.08 | 62.38 | 27 | 40.68 | 84.83 | 22 |
| Hebei | 90.38 | 80.44 | 22 | 40.62 | 84.69 | 23 |
| Shanxi | 71.47 | 63.61 | 26 | 18.59 | 38.77 | 26 |
| Inner Mongolia | 92.25 | 82.10 | 21 | 129.18 | 269.38 | 2 |
| Liaoning | 120.98 | 107.68 | 10 | 12.49 | 26.05 | 28 |
| Heilongjiang | 100.16 | 89.15 | 17 | 109.07 | 227.43 | 5 |
| Jiangsu | 104.89 | 93.36 | 15 | 119.67 | 249.53 | 4 |
| Shanghai | 199.26 | 177.35 | 1 | 15.86 | 33.06 | 27 |
| Zhejiang | 132.22 | 117.68 | 5 | 32.40 | 67.55 | 24 |
| Anhui | 126.59 | 112.67 | 7 | 64.18 | 133.83 | 15 |
| Shandong | 109.63 | 97.57 | 14 | 58.33 | 121.63 | 19 |
| Henan | 130.21 | 115.89 | 6 | 135.57 | 202.70 | 1 |
| Hubei | 104.87 | 93.34 | 16 | 77.75 | 162.14 | 12 |
| Hunan | 158.22 | 101.91 | 11 | 21.15 | 44.10 | 25 |
| Sichuan | 112.10 | 124.13 | 3 | 50.71 | 105.75 | 20 |
| Jilin | 158.22 | 140.82 | 2 | 42.38 | 88.38 | 21 |
| Jiangxi | 112.10 | 99.77 | 13 | 62.79 | 130.94 | 16 |
| Shaanxi | 89.21 | 79.40 | 23 | 125.74 | 262.19 | 3 |
| Gansu | 93.24 | 82.99 | 20 | 81.64 | 170.24 | 9 |
| Fujian | 114.36 | 101.78 | 12 | 62.74 | 130.82 | 17 |
| Guangxi | 124.10 | 110.45 | 9 | 88.88 | 105.33 | 8 |
| Yunnan | 96.88 | 86.23 | 18 | 74.96 | 156.30 | 13 |
| Tibet | 52.55 | 46.77 | 29 | 85.42 | -178.12 | 29 |
| Qinghai | 65.36 | 58.17 | 28 | 65.68 | 136.96 | 14 |
| Ningxia | 72.95 | 64.93 | 25 | 81.28 | 169.50 | 10 |
| Xinjiang | 88.72 | 78.96 | 24 | 108.44 | 226.13 | 6 |
| Guangdong | 137.85 | 122.69 | 4 | 105.62 | 220.24 | 7 |
| Guizhou | 96.43 | 84.94 | 19 | 81.17 | 169.27 | 11 |

Table VI: Changes in the Ratio of Expenditures to Collections For 1983-1986 by Province

| Province | Ratio 1983 | Ratio 1986 | Change 1983-1986 |
|---|---|---|---|
| Beijing | 0.52 | 0.73 | 0.21 |
| Tianjin | 0.53 | 0.64 | 0.11 |
| Hebei | 0.78 | 1.05 | 0.27 |
| Shanxi | 0.99 | 1.44 | 0.45 |
| Inner Mongolia | 3.27 | 2.74 | -0.53 |
| Liaoning | 0.39 | 0.76 | 0.37 |
| Jilin | 1.37 | 1.70 | 0.33 |
| Heilongjiang | 1.42 | 1.29 | -0.13 |
| Shanghai | 0.12 | 0.32 | 0.20 |
| Jiangsu | 0.43 | 0.67 | 0.24 |
| Zhejijng | 0.53 | 0.74 | 0.21 |
| Anhui | 0.91 | 1.30 | 0.39 |
| Fujian | 1.42 | 1.29 | -0.13 |
| Jiangxi | 1.28 | 1.52 | 0.24 |
| Shandong | 0.63 | 1.09 | 0.46 |
| Henan | 0.82 | 1.26 | 0.44 |
| Hubei | 0.70 | 1.01 | 0.31 |
| Hunan | 0.86 | 1.14 | 0.28 |
| Guangdong | 1.04 | 1.09 | 0.05 |
| Guangxi | 1.36 | 1.67 | 0.31 |
| Sichuan | 0.89 | 1.30 | 0.41 |
| Guizhou | 1.78 | 1.85 | 0.07 |
| Yunnan | 1.40 | 1.58 | 0.18 |
| Tibet | 12.25 | 128.14 | 115.89 |
| Shaanxi | 1.29 | 1.48 | 0.19 |
| Gansu | 1.42 | 1.52 | 0.10 |
| Quinhai | 4.80 | 3.81 | -0.99 |
| Ningxia | 3.90 | 3.28 | -0.62 |
| Xinjiang | 3.31 | 3.44 | 0.13 |