

China's emerging tax regime: Devolution, fiscal federalism, or tax farming?

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Abstract:

China like other transition economies needs to establish a tax regime compatible with a market economy. The paper singles out the general and China-specific features by which national legislation attempts to accompany economic transformation. Based on an empirical study in two provinces this paper shows that without including local government agencies and their budgets, China's fiscal federalism cannot be analysed. This paper argues that China's emerging tax regime depends on the institutional design that shapes the interaction between firms (as major tax payers at the local level), local government agencies, and the national tax administration

Keywords: Tax Regime, Fiscal Federalism, Tax Farming, China, Transition Economy

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Introduction

One way to assess the success of economic transformation is to look at the share of resources the state still controls. One expects a decline of the state sector due to privatisation and increasing private transactions as measured by government expenditure or government revenue in relations to national income (overview in Mueller 1989: 320-347; Mueller and Murrell 1985). Indeed the state's share of GDP in China declined from thirty one per cent in 1978, when reforms began, to a meagre eighteen per cent in 2002 (Appendix Table 1). Yet economic transformation needs to be accompanied by a change in the means for extracting resources from the economy. Generally speaking there are four ways for a state to achieve this: First, compulsory state enforced transfer of income of economic agents via taxation; second, exploitation of state owned (controlled) property or resources; third, forced loans; and finally, "printing money". Provided that a government is committed to macroeconomic stability as is evidently the case in China, economic transformation will be accompanied by major shifts in the first three extraction modes. Revenues from the operation of state controlled resources will decline due to privatisation, if not from shrinking profits of uncompetitive state firms; revenues from forced loans which in the socialist past took the form of compulsory transfers of the firms' cash flows and compulsory saving of private economic agents will decline when and if the government no longer fixes prices and wages. In contrast, revenues from taxation, which had been almost non-existing in the socialist past will increase.

This shift in state revenue generation points to the fact that *transition economies need to establish a market conforming tax regime* (an overview over the discussion on tax regimes and political or fiscal federalism in Russia can be found in Frye and Shleifer 1997; Hellman and Schankerman 2000; Litwack J. 2003; Inman and Rubinfeld 1998; Berkowitz and Li 2000; Gordon and Li 1997. The classical texts on fiscal federalism are Brennan and Buchanan 1980; and Oates 1972). One way to do so is to emulate tax systems found in functioning market economies and incorporate the concomitant legal changes in the initial reform package. This happened in European transition economies. China took an alternative course. In the course of on-going financial reforms, the emergence of a new tax

system followed economic development and reflects the interplay between the state, i.e. central government and national legislation, other public authorities to which the task of tax extraction and collection was delegated, and (potential) tax payers. So far this interplay resulted in what is called *de facto* fiscal federalism, a term which stresses the fact that in *China the federalist features in the multi-layered administrative system do not reflect the outcome of political reforms, but emerged as a side effect of financial reforms* (Qian and Weingast 1997; Qian and Roland 1998; Qian *et.al.* 1999; Montinola, Qian and Weingast 1995).

The emergence of China's tax regime has attracted surprisingly little attention. Descriptions can be found in the literature on "Central-local financial relations", most prominently in studies published by the World Bank (Wong 1997; 2002; Ma 1995a; World Bank 1994; Bahl and Wallich 1992. See also Wong 1991; 1992; Ma 1995b; Oksenberg and Tong 1991; Chung 1995; Park *et.al.* 1996; Bahl 1998; Tsui and Wang 2002; Wong, Heady and Woo 1995). Severely hampered by the availability of data, these interpretations (with the notable exception of Wong 2002) stop at the provincial level. Such a procedure neglects revenue generation by public authorities below the provincial level, in China's case at prefecture, districts, county and township level.

Conceptually, such an analysis treats sub-provincial layers of government as a black box. Analytically, this would only be justified if all these government agencies were homogenous units under complete hierarchical control. Yet, field studies have overwhelmingly shown that sub-provincial government agencies have the discretionary means to pursue their own economic policy and often enough form alliances with the local business sector in order to minimise tax transfer to the national tax administration (For example Bai *et. al.* 2003; Bao *et.al.* 2002; Blanchard, and Shleifer 2000; Hsu 1999; Krug and Hendrischke 2003; Wedeman 2003; Wank 1996; 1999; Walder 1995; Brandt *et.al.* 2002; Chen and Rozelle 1999; Goodman 2000). In the China-specific literature this gained prominence in form of the 'Neo-corporatism' hypothesis which claims that unlike Russia, where the old Leviathan hypothesis from the Public Choice literature re-appeared in the form of the "Grabbing Hand"-hypothesis (Krug and Zhu 2004; Frye and Shleifer 1997;

Shleifer and Vishny 1994; 1998), China is characterised by a “Helping Hand” (Oi 1992; 1995; Unger and Chan 1995. See also Nee 2000). In China, an unspecified local state contributes to economic development via tax concessions, subsidisation and facilitation of investment and work place generation. Leaving aside the flaws of the Neo-corporatist hypothesis, what matters is the empirical fact that the emerging national tax system is burdened with a severe principal agent problem because central political authorities have lost the ability to control local government agencies to which responsibilities such as tax collection were delegated. Field studies have further shown that the economic environment differs not only from province to province but also from county to county. Modelling all sub-provincial government agencies as a black box therefore overlooks the information necessary for analysing the causes of the variance in ‘local’ economic policy. This procedure also disregards the effects that such a decentralised governmental system has on the functioning of markets and the resulting prospect for future economic transformation and development (Krug and Hendrischke 2003; Smyth and Inder 2004; Berkowitz and Li 2000; Litwack 2003; Blanchard and Shleifer 2000).

In short, in what follows it is claimed that first, the emergence of and changes in China’s tax system are crucial to understanding China’s transition process, and second, that any analysis of the tax system, its emergence, changes and functioning needs to take into consideration government agencies at central and provincial as well as prefecture, county and township level.

In view of the lack of official statistical data, what follows is an attempt to provide an empirical base that will allow *comparative analysis once in future more data can be collected from different local jurisdictions*. The cases presented here offer the first insights in the working of taxation at the lowest level of government. Our presentation is based on extensive interviews with representatives of township governments and local and national tax administration bureaus in two townships in the two provinces of Jiangsu and Zhejiang in June 2004. The interviews (and the organisation of data below) single out three aspects of the tax system: first, the reach of the state (government size), by questioning what can be learned by including township governments in the analysis; second, effective tax rates,

specifically how far data collected by national and local tax bureaus reflect the procedures for translating tax rules into effective tax rates; third, the functioning of intergovernmental transfer system of taxation and other revenues sources. These three aspects form part of the ultimate research agenda, which is to better understand the *emergence of tax regimes in transition economies* (aside from historical studies, the literature focuses on taxation in democratic environments, e.g. Winer and Hettich 2003, or on general transaction cost considerations, such as North 1984; Williamson 1985; Levi 1988; Stinchcombe 1990; Kiser 1994).

The paper proceeds as follows: The institutional perspective shows the changes in the tax system, concentrating on the definition of the tax base, the delineation of tax jurisdictions, and the design of tax administration. The description indicates that the *tax regime is facing a yet unsolved principal agent problem*. This problem is caused by a lack of institutions able to align the interests of national legislation (by central political authorities) with the interests of local agencies acting on behalf of sub-provincial governments (Section 2). A descriptive analysis of two township budgets underpins the under-institutionalisation assumption relating to the current tax regime [Section 3]. This raises questions with respect to the “reach of the state”, effective tax rates and intergovernmental transfer which are addressed in (Section 3). The paper concludes with some general remarks on the foundation of fiscal federalism and property rights (Section 5).

The institutional perspective

A description of the emerging tax regime in China faces problems such as differences in the classification of taxes, lack of information in particular about taxation at the sub-provincial level, and changes in taxation policy. These are caused on one hand by tax reforms in 1982, 1994, and 2001-03 (description in Tsang and Chen 1994; Lee 2000; Tung 2003; Yep 2004), and on the other hand by the changing behaviour of partners in tax contracting.

At the beginning of the reform the national treasury relied almost exclusively on (state)

firms as tax subjects, not on legally defined units (companies, corporations or individuals). Taxes aimed at extracting surplus and cash flow (Shleifer and Vishny 1994; 1998) while regulatory taxes supported planned allocation of goods and investment. The need to find alternative sources to aliment state budgets led to the tax registration of an expanding range of firms and the introduction of a European style consumption tax (VAT) with the major purpose of securing revenue for the national coffers. VAT, which replaced the many product taxes, broadened the tax base by making consumption taxable and turning consumers into tax payers. Personal income, wages, salaries, capital income and inheritance were all made taxable by 2002. Yet, by only taxing personal income above 800 RMB per month, personal income taxes still affect only a small percentage of income earners and amount to no more than seven per cent of national tax revenue (see Table 2).

The central government set up different national and local tax jurisdictions under its control, following the socialist administrative structure. Interested more in revenue and rate of growth, the central political leadership used devolution of regulatory power as an incentive to ensure that local government agencies would broaden the tax base and enforce tax legislation (Eckaus 2003, Tsui and Wang 2004, Wong 2002; Hsu 2004). The devolution of regulatory power left the central state with a serious principal-agency problem caused by the coexistence of two models of tax administration (Wong 2003; Chung 2001; Bean 1998a). Until today the emergence of a new tax regime in China depends as much on inter-governmental negotiation as on national legislation, let alone international 'models'.

Defining the tax base

The beginning of market conforming taxation implied an expanding reach for the state beyond the inherited state sector (The summary of the institutional frame follows the thorough descriptions in Wong 2002; the different contribution in Bean 1998, Gordon and Li 1997; 1999; Nee 2000; IMF 1994; Wong, Heady and Woo 1995). Firms other than state firms (SOEs) still controlled by state ministries needed to be included in the tax base. In the case of China joint ventures, foreign companies, private firms and 'township and village

enterprises' (TVEs), and peasant households were defined as tax payers subject to direct and indirect taxation. It is worth mentioning that agricultural production is still regarded as a special case, for which the Ministry of Agriculture is responsible. In a further step in the nineties, the many product taxes were abolished and replaced by one consumption tax, VAT, (and one business tax) which was expected to deliver high revenue at low tax rates for the national coffers. In a third step, the reach of personal income tax was broadened to include tax on capital gains, transfer of assets, and inheritance (2001-2003).

So far the Chinese tax regime is not too different from other countries. The China-specific features can be seen in the so-called extrabudgetary fees (and revenues), an inherited name which today describes what is taxed and how at the lower local government level. Reclassifying these fees is difficult so long as there are no clear indication which level of local government levies which fee, and procedures that forced local governments to report all fees (Wong 2002; Eckaus 2003; Holzer and Zhang 2004; Bean 1998; Gordon and Li 1999). As field studies rather than aggregated statistics have proved (for examples see Wong 2002; Bernstein and Lü 2003; Cai 2003; West and Wong 1995; Hsu 1999; 2000; Chen and Rozelle 1999; Oi 1992) often enough there is no difference between taxation linked to sub-provincial government agencies by national legislation (as for example stipulated as 'local taxes' in Appendix, Table 3) and fees levied by local agencies legitimised by devolution of regulatory power. Thus, for example, some fees are surtaxes, others are a flat rate tax on output or a per capita (per firm registration) tax. Lacking uniform procedures means that the same fee can differ from one locality to the other with respect to its rate and base. What complicates the reading of the consolidated tax/revenue statistics even more, is that some fees are indeed user charges to be paid by consumers of locally provided infrastructure or services, such as roads, schools, sewages systems, electricity and other public utilities.

In short, there are basically two tax systems in China. One is defined by national legislation which stipulates the tax base, tax rates, the procedure by which taxes are collected and compliance is monitored, and how total revenue is shared between the central budget and local budgets consolidated at the provincial level¹. The second tax system is characterised

by provincial and sub-provincial discretion and tax contracting, ad hoc taxation, and unspecified procedures. As the following will show this dual tax system has major implications: First, the effective tax rate can be calculated only ex post when the exact local rates and fees are known. This makes, second, the local government agencies the ultimate authority in defining effective tax rates. Third, local government agencies facing different (financial) needs and/or different political leverage in tax contracting (see below) will differ in their revenue generating policy, subsequently contributing to the diversity in the local business environment within one province. Finally, the national treasury or central government has only limited ways of controlling overall taxation. Subsequent reforms over the past fifteen years, in particular the so-called 'tax for fee'-programme have attempted to put an end to the practices of sub-provincial government agencies using (ad hoc) fees for balancing their budgets. Simultaneously, the reforms aim at limiting the overall tax burden for overcharged peasant households (Bernstein and Lü 2003) and producing effective and unified tax rates for firms. Yet, as will be argued in what follows these reforms can be of limited effect only so long as the basic problem, i.e. the co-existence of a national tax bureaucracy and tax contracting, is not solved

There is an obvious link between tax authority and unsettled property rights in China. So long as local government agencies find their claim over local resources uncontested, they will charge user fees for all assets under their control. For local governments to relinquish the right to charge fees in return for the right to tax, depends on positive incentives as much as on monitoring of tax policies in different tax jurisdictions. Likewise, so long as local government agencies are acknowledged as residual claimants of 'local' taxes, any attempt to better enforce tax compliance via the tax administration misses the crucial incentive structure.

Delineation of tax jurisdiction

Under conventional forms of fiscal federalism, specific taxes are assigned to the exclusive use of different levels of governments. In contrast, Chinese fiscal federalism refers to revenue sharing between jurisdictions. Total tax revenue is shared by the different levels of

government and based on tax contracts which makes coordination via tax farming *within one administrative hierarchy* another constituent feature of Chinese fiscal federalism. This is not reflected in Chinese budget reports and tax statistics where all sub-provincial jurisdictions are summarised as local.

Tax contracts describe the agreed upon share of tax revenue to be transferred to the superior level (or the national treasury) as well as the agreed upon provision of public services by the respective local government agencies. Tax contracts are a form of tax farming in which territorial units, such as provinces, prefectures, counties and townships negotiate tax volumes to be transferred upwards on behalf of the national government. The tax contract system reverses the order of the state bureaucracy by making the local level (the lessee) the residual claimant of tax revenue. Negotiations between different levels of local governments on transfer and retransfer of revenue became a constant feature of Chinese fiscal federalism. Government agencies at each level attempt to maximise discretionary revenue outside of the control of the superior unit, while shifting expenditure for public services downwards. Subsequently, effective tax rates do not reflect tax legislation; they are rather the outcome of inter-governmental contracting and transfer or reflect the innovativeness of sub-provincial government agencies in finding new revenue generating resources.

Superior government agencies as the lessors of the tax contracts displayed risk-averse behaviour when they negotiated a lump sum or a minor percentage of growth rates. For this reason lower level governments (the tax contracts' lessees) profited from high economic growth rates, and/or innovation rents generated in their jurisdictions. One response to this situation was the introduction of new national taxes, such as VAT. However, in order to ensure the compliance of sub-provincial government agencies, once more they were given a twenty five per cent entitlement of overall VAT revenue through the tax sharing system. Similar motivational devices can be found operating at various sub-provincial levels where specific sharing rates are negotiated for the several local taxes and fees. A cautious interpretation of the scarce information about the interaction between province, prefecture, county and township suggests the following bargaining game. The tax contracts are about

tax volume that each level of government regards as necessary for fulfilling its tasks. In case the outcome of the bargaining leaves a specific tax jurisdiction short of official tax revenue, the respective local government will adjust tax bases, or tax rates; or mobilise new revenue generating sources.

Thus, for example, more and more local government agencies comply with the tax for fee-programme by mobilising so-called 'off-budget' revenue. This term refers to the revenue local governments agencies appropriate by selling local resources, the most valuable of which is land, or by cashing in dividends from half-privatised incorporated companies.

Tax administration

The existence of two parallel tax systems is a characteristic feature of China that is not repeated in any other transition economy. The dual tax system finds its correspondence in a dual tax administration.

The Chinese mode of a decentralised financial administration (see Appendix, Figure 1) acknowledges the province as the central government's major local partner in tax policy. The province is entitled to an annually revised share of total tax revenue from national tax revenue and from the lower government agencies as negotiated in contracts. With the provinces entitled to grant tax concessions or change tax rates and being in charge of tax collection this system comes close to a tax farming system (Bahl 1998, see also Kiser 1994). This system leads to a situation in which local tax offices remain under dual subordination of the national tax administration on one side and the local government agencies on the other side. This system must create major agency and incentive problems. Unsurprisingly one reform addressed the incentive problem of the tax contracting system by assigning more exclusive taxes to the different layers of local government, by limiting the range of taxes with shared revenues, and last but not least by assigning 'mandatory obligations', tasks to the corresponding levels of government agencies. The reason was to limit opportunity and incentives for local government agencies to manipulate national

taxes in such a way as to minimise transfer to the national coffers (Tsui and Wang 2004; Wong 2002; Bernstein and Lü 2003). Simultaneously, the reforms addressed the principal agent problem by establishing an independent tax bureaucracy. The State Administration of Taxation (SAT) was separated from the Ministry of Finance in 1988, given full ministry status under the State Council in 1993, and put in charge of all tax policy. The new SAT established from 1994 onwards bureaus at each level of China's government agencies in charge of the monitoring and collecting national and shared taxes down to county and township level. These hierarchically organised was expected to function independent from any interference by local government agencies.

The creation of a new tax hierarchy needs to be interpreted as an attempt to solve the principal agent problem by establishing a Weberian kind of bureaucracy in which qualified professionals, on a fixed salary base, act on behalf of the "state", in fact the central government, as the principal. The local government agencies in turn copied, if not duplicated this tax administration system for their 'own' taxes, namely those local taxes, surcharges, fees and tax concessions stipulated at the sub-provincial jurisdictions and/or negotiated in the tax contracts with firms or other tax payers. While nominally these local tax offices were under dual leadership by the SAT and local governments (see Appendix Figure 1), individual local governments exercised dominant control over them. The central SAT could only interfere with local tax administrations down to province level and only through recommendations or in an advisory function; for example, by commenting on appointments or offering operational advice.²

Within this structure, sub-provincial government agencies remain the de facto residual claimants for taxes and fees not covered under the tax sharing system with the central government. In other words, their control of and leadership over local tax offices enabled sub-provincial governments at various levels to maintain their residual tax rights over the informal tax system. This relatively strong bargaining position of local governments and the weak institutional position of the central government in enforcing unified procedures has resulted in a complex transfer and retransfer system between local government levels from township upwards to province level. As there are not unified guidelines and because

of the informality of the processes involved, little has been written about this aspect of local taxation, even though it is perhaps the most important aspect for local enterprises.

The Local Perspective

The technicalities of local accountancy

To understand the often confusing use of terms it is important to distinguish between the authority to tax and the entitlement to (shares of) tax revenue at the different levels of government. Table 3 and 4 list all taxes based on national legislation, whose revenues are assigned to either the central (*guoshui*) or local (*dishui*) level, or are shared between the two layers of government. In a second step the province decides whether and how to re-transfer tax revenue to the subordinate levels at the prefecture, county or township level. In contrast, taxes that are exclusively assigned to provincial and sub-provincial government agencies are so-called local taxes (*dishui*). As stated above, local government agencies are entitled by national legislation to levy surcharge taxes and fees, which despite their tax-character are not listed as local taxes, but usually reported as extrabudgetary revenue (EBR).

From budget practices the categories look differently. Local budgets list as revenue (*difang shouru*) not only the local share of the mixed taxes, or local taxes, but also EBRs, and to some degree also further informal revenues sometimes called extra-system revenue (*tizhiwai shouru*) and translated as off-budget revenue (OBR); for a description see Wong 1998; 2002; Eckaus 2003). The classification of *EBRs* follows the inherited administrative structure rather than information and monitoring needs of the tax state. Part of the EBRs, the so-called surcharges, are taxes, using the same income, consumption or profit tax base, as the original tax. Part of the fees are taxes on output using a flat tax rate, such as fees “in support of” (such as poverty relief, or construction), while other fees, such as the one for public security or the police are per capita taxes, or a tax on each registered firm. Finally part of the fees are user charges, which should not show up in the local budget as they are paid directly to the local provider of infrastructure, such as schools or public utilities. The

present round of tax reform with its 'tax for fee'-programme intends to put an end to the mushrooming fees. Unlinked to economic performance, these fees offered an effective anti-cyclical financial tool, but could also lead to predatory charges. In particular in the countryside, such fees have the potential to unleash rural protest and violence (see the meticulous study by Bernstein and Lü 2003; also Tsui and Wang 2004. It is worth mentioning that in the most careful definition, EBRs accounted for 20 per cent of all revenues in 1982 and increased to over 50 per cent in 1996, see Eckaus (2003, Table 1, 74). OBRs refer basically to revenues from village-owned firms, such as TVEs, or proceeds from land sales. In short they are returns from the operation and exploitation of resources under control of the village (or other sub-provincial government agencies).

The case: a comparison of two township budgets

Legally speaking, provinces enjoy considerable discretionary power when it comes to distributing local tax revenue and devolving regulatory power to different levels of intra-provincial government agencies. The fact that this happens mostly through negotiations means at the same time that lower levels in the local government hierarchy have also considerable power to defend their interests. These features alone can explain a great part of the diversity of tax regimes at the lowest levels of local government. Another factor contributing to the diversity of sub-provincial budgets are the EBRs as defined and collected by lower government agencies, and the OBRs, i.e. returns from township owned industrial assets (TVEs) or land. Empirical studies have shown the spread of the latter two factors, albeit at the provincial consolidated level to be considerable, amounting to fifty per cent of consolidated local revenue (Eckhaus 2003, Table 5 and 9, 79 and 85). Finally, intergovernmental transfer between different levels of local government agencies are an additional dimension determining local revenue. The question remains what this means for the lowest level of local government, i.e. the township level.

Not surprisingly, the two townships, M and L whose budgets are presented in Appendix Table 5 and Table 6, offer different pictures. A direct comparison between recent budgets of Township M and Township L documents the differences in both budgeting procedures

and revenues sources. As shown in Table 5, Township M lists budgetary revenue as well as EBR. EBR include user charges which should not be part of the township budget, subsidies and proceeds from land sales and capital income, i.e. interest rates. Township L lists different sub-items, such as budgetary revenue, budgetary fund revenue, earmarked fund revenue (equivalent a previous version of EBR) and other revenue. While this confirms Wong (2002, 64) that there is no standard procedure for reporting revenues, the two townships differ widely with respect to sources of revenues (see Appendix, Table 6).

Township M depends much more on taxation (45.2 per cent of total financial revenue) than Township L (24.4 per cent). As the item ‘Other’ in the category of EBRs suggests, Township M seems to use fees (22.3 per cent of total revenue) charged by the providers of public utilities for ‘balancing’ the budget. Township L clearly is the more entrepreneurial township: extrabudgetary revenue adds up to not more than twelve per cent, while “off budget” revenue is sixty four per cent of total revenue. It is worth emphasizing that in this case *returns from village-owned companies in form of dividends or profit transfer contribute ten per cent of total revenue. Proceeds from land sales, sales plus local tax on transaction, however, provide fifty per cent of total township income.*

Yet, we find also some common features between the two townships. Aside from the remarkable degree to which local budgets depend on entrepreneurial activities of resources that are still controlled or ‘owned’ by townships, both budgets list revenues re-transferred from superior administrative agencies. The retransfer depends on formulas, which are part of the fiscal contracts that define the effective sharing ratio. Total re-transfer refers to a fixed remittance linked to the township’s annual tax-task (70 per cent national coffers and 30 per cent ‘local’) and a bonus based on excess tax revenue. Both townships receive additional subsidies from superior state agencies (see Table 5). In short, the *township budgets depend on off-budget revenues plus intergovernmental transfer and retransfer of tax revenue.*

Intergovernmental transfer of taxes at the township level

Information about intergovernmental transfer of taxes is not published but needs to be generated by interviewing three to four groups of economic agents: representatives of the national and local tax administration, representatives of the local government, and firms. This fact alone indicates that tax revenue transfer does not follow standardised procedures. To the contrary, as will be shown in what follows, the transfers cannot be standardised so long as the intergovernmental transfer is used as a tool to align the interests of the state tax bureaucracy insisting on compliance with rules and the interests of local state government agencies as lessees in tax contracts insisting on their right to negotiate volume of retained tax revenue. The interviews allow singling out four specific features that characterise transfer practice at the township level.

- (1) *Tax revenue is not simply transferred to the next superior administrative level. Instead townships share tax revenue with four different levels, namely the centre, the province (via the guoshui tax), the prefecture and the county. This is the case for Jiangsu Province, while in Zhejiang Province the prefectural level could be bypassed. Interaction between these different levels of government agencies is partly statutory, i.e. based on legislation, and partly resulting from preceding negotiations. Tax items that follow statutory sharing formulas are “fixed shares” of local and national taxes, plus “bonus” when actual transfer exceeds the ex ante agreed upon transfer (see below), “expenditure [overhead] for the financial departments”, a rather unspecified “remittance to the prefectural level” (in the case of M Township) and “earmarked subsidies from superior levels”.*
- (2) *Statistics reporting figures from the national tax administration offer a misleading picture. They overestimate the central government’s share (60 per cent in Table 7) because they are not adjusted for tax refunds (see below). Tax statistics also do not provide information on how tax revenue is shared between the different layers of local government agencies, let alone between local government and firms (see Table 8). In the case of M Township the actual split between national (central) and local tax revenue for the first half of 2003 looks as follows:*

Table 7: Total Tax Revenue collected by M Township, Jan.-Jun. 2003

(RMB)

Item	Actual amount	Per cent	Per capita
Central tax revenue	72,266,200	60.52	1364
Local tax revenue	47,136,300	39.48	889
Total	119,402,500	100	2253

Notes: The population was 53,000 at the end of 2003.

Source: Respondent 24

However, the actual division of tax revenue collected by M Township and divided between all different levels of government agencies during the whole year of 2003 shows the following distribution (for the whole year of 2003):

Table 8: Actual Distribution of total tax revenue raised by M Township

Level of Government	Percentage share of total tax revenue collected by M Township
Central government	40
Provincial government	27
Prefecture government	10
District/County government	5
M Township	18

Source: Respondent 24

The difference between the two sets of figures, in particular the small share that remains with the township government, is the result of different tax (fee) rates and tax refunds. These depend on the political leverage the township has in negotiating its tax contracts.

- (3) Individually negotiated shares of tax revenues and fees at the sub-provincial level contribute to the diversity in tax system that can be observed between and within provinces in China. The sharing formulas also contribute to the opacity of the tax system as the following example shows. In 2003 M Township had contracted to collect

120 million RMB in VAT and consumer tax on behalf of the SAT. The actually collected amount added up to 160 million, entitling the M Township to a bonus for the 40 million in “excess” revenue. The bonus was calculated on the basis of a ‘progressive’ rate: twelve per cent for up to twelve per cent of the excess revenue, fifteen per cent of the following 12 - 15 per cent of excess revenue and eighteen per cent for any excess beyond fifteen per cent. The total amount of bonus added up to 6 million or fifteen per cent.

As the interviews showed, each local tax, fee or surcharge is subject to different and changing sharing formulas. For example M Township could retain 38.8 per cent of the surcharges for education, 64 per cent of the land appreciation tax, 20 per cent of the urban and township land usage tax, and 100 per cent of the occupied farmland tax and surplus of urban maintenance and construction tax in 2003. The point to note here is that the province, prefecture or county can arbitrarily change ratios or even sharing rules by issuing an official document (*hongtou wenjian*). For instance, Suzhou prefecture in 2003 had increased the remittance ratio of total financial revenue of M township from 0.6 per cent in 2003 to 1.6 per cent in 2004. Whereas for the township this constitutes confiscation, for Suzhou prefecture it is part of the on-going negotiation of tax volume in general.

- (4) Tax refunds are not limited to intergovernmental transfers of tax revenues but include refunds to the tax payer on the basis of tax contracts between firms and local government agencies. Contrary to what statistics and official reports indicate, intergovernmental transfers do not only refer to the sharing of tax revenue with government agencies that are entitled by administrative norms or contracts. The tax system also knows re-transfers of tax revenue downwards, back to a range of tax payers, as the example of the bonus system showed. Aside from such bonuses, the local tax office and the local finance bureau offer re-transfers in the form of grants, awards, and subsidies. Remarkably, the township government as the main contracting party in tax contracts can offer informal refunds and other tax concessions to firms. Thus for example, L Township grants all firms established

since 2001 a three-year exemption from VAT, corporate income tax or business tax in form of a reimbursement from its own discretionary funds. Likewise, firms investing more than 10 million RMB in technological innovation also enjoy a three-years tax refund. These refunds show up in the expenditure side of the L Township (Appendix, Table 9) under mandated expenditure for education and infrastructure for 2003. The figure that interests us here is the expenditure on “industry and transportation”, which adds up to 38 million RMB or twenty per cent of the total. This item stands for tax refunds to firms and indicates the volume of discretionary funding the township governments enjoys within the seemingly formal and bureaucratised structure of the tax system. In fact, this example indicates that the local finance offices have to be included in the analysis of the tax system, as they administer most of the discretionary funding. The fieldwork also reveals that tax refunds and price concessions for land are the main tools of townships in attracting outside investment and settlement of new firms. Townships prefer these discretionary and flexible incentives to formal subsidies which are subject to legislation,. Thus, L Township rather proudly reported that amongst the 83 firms established in 2003 within the township’s jurisdiction, forty had come from outside attracted by the advantageous business environment in L township.

In such a system it cannot come as a surprise that townships turn to extrabudgetary or any other revenue source outside the formal control of the tax administration. In response, the national government strives to harden the budget constraints for provincial and sub-provincial government agencies by expanding its formal reach , e.g. by revising sharing rules for personal income tax or re-assigning certain tax revenue to higher level budgets³. Yet, each of these attempts, as the fieldworks proves, led to further searches for revenue generating opportunities. Thus, for example M Township does not rely on the sales of land only. It has established its own development corporation which developed industrial sites with buildings that are now rented out to private companies. Lease and rent income are regarded as a necessary additional and secure income source.

To sum up, the system of tax contracting with firms on the one side and superior

government agencies on the other undercuts the intention to use a ‘detached’, Weberian-type bureaucracy for collecting, monitoring and enforcing tax legislation. The consequence is that *at township level tax administration and tax policy cannot be separated*. Despite all the technical formulae used within the tax sharing process, the budget procedure at the township level follows three rather straightforward steps. The township first estimates the total sum needed the mandatory tasks, operate the township government, and keep the agreed commitments to different groups of tax payer, basically firms. While non-monetary promises include complimentary investment in infrastructure and support in the lobbying effort for specific subsidies, monetary promises refer to favourable tax rates or other tax concessions. In a second step, the township negotiates with all other local government agencies the volume of tax revenue to be transferred and re-transferred. In this context, it is worth emphasizing that national taxes (*guoshui*) are no longer disputed but acknowledged as a hard constraint and therefore not part of the negotiation. The consecutive bargaining explains why the actual transfer of revenue from the township tax administration to the superior jurisdiction cannot be calculated in advance but shows only up at the end of the fiscal year. Yet the township knows from past experience the range of transfers and re-transfers. In case of an expected deficit it will therefore, in a third step, search for additional revenue sources outside the bureaucratic tax system (see Appendix, Figure 2).

To overstate the case, *the township is not forced to adjust expenditure to revenue available, but adjusts revenue to expenditure planned and contracted*. The system implies further that *the more the central state attempts to harden the budget constraint the more will townships turn entrepreneurial, by embarking on business activities outside the reach of bureaucratic control*.

Findings

The reach of the State

As said at the beginning the decline of state revenues - the state's share of national income

- is only a weak indicator for economic transformation. The decline needs to be accompanied by a shift in revenue sources indicating a switch from an “ownership state” to a “tax state” (Campbell 1996: 45-84). Leaving aside the question of macroeconomic stability via money supply, what is expected is that taxation becomes the major revenue source. Revenue from the exploitation of state ‘owned’ or controlled resources needs to decline, as should revenue from ‘forced loans’ (Brean 2003: 30-34).

To start with the latter, forced loans exist in China, yet cannot be verified via local budgets. Regardless of whether they take the form of deferred payments to agricultural producers, forced loans from banks for financing the working capital of state-owned firms or deferred salaries of teachers, all forced loans result from activities by government agencies at national or provincial level (Bahl 2003: 141).

With respect to the declining share of revenue from state-owned resources, the two township budgets presented above point to a more complex picture. Even though the trend of EBRs to systematically outgrow tax revenue could be stopped and brought down to less than fifty per cent of total tax revenue (Eckaus, 2003, Table 1, 74), this did not result in the emergence of a tax state. In particular, land became the dominant resource in the hands of these local government agencies which came to rely on lease or sale of land to alimnt their local budgets. In terms of *economic transformation* this development has its economic rationale, provided the revenues from land sales implicate a transfer of private property rights. As was shown above, the township more than the national budget give evidence of a privatisation of unprecedented scale and consequence in China’s history. Nevertheless, the reach of the (local) state will remain large and will only end in its present form when most land is in private hands. With respect to the *emergence of a tax system*, local control over land allows postponing reforms that would force local government agencies to offer public services on the basis of tax revenue alone. So long as townships face ‘entrenched property rights’ over (valuable) land, they control a resource that directly translates into discretionary means for pursuing their own public and business interests. In the near future, it can thus not be expected that revenue from state controlled resources will disappear in local budgets.

Effective tax rates

Effective tax rates in the Lucas (Lucas 1990) concept measure the total tax burden, i.e. tax base and tax rates adjusted by tax credit, exemptions and deductions which can cause different tax payers in different jurisdictions to pay different amount of taxes despite the same tax rate. Aside from the problem that in transition economies economic transformation needs to be accompanied by frequent changes in taxation, this concept cannot tackle the problem of dynamic institutional change caused by the interaction between the emerging private sector and local state authorities (Krug and Mehta 2004). While the models assume that the state is the only “innovator” when it comes to designing tax regimes, which moreover remain stable over a considerable time, the fieldwork in China points to another systematic factor. Here effective tax rates are composed of one defined formal part and one informal part negotiated on an annual base, often in the form of contracts between firms and local tax authorities.

The fieldwork showed further that formal, national taxation was (no longer) disputed. The definition of the tax base and tax rates were accepted, and procedures established that ensured “detached” monitoring and enforcement. The revenue side of local budgets and tax legislation can however only partly explain the variance in after-tax income of firms (of otherwise equal performance). Our interviews with firms in the preceding years point to another indirect way of subsidization, not reflected in the local budget, and more related to local government’s control over local development corporations and other commercial ventures.

As empirical studies in other transition economies have shown, in order to assess effective tax rates across localities, tax payments by firms need to be adjusted not only for subsidies (total amount and percentage of firms reporting subsidization), but also for tax arrears (total amount and percentage of firms reporting) plus soft loans, arrears of payments of loans, and “trade credit”, when firms agree to deferred payments (see also Kornai *et. al.* 2003). To focus on local budgets is crucial, yet not sufficient. This requires the inclusion of

firms into the research agenda on emerging tax systems.

Intergovernmental Transfer

Our fieldwork illustrates that the present tax regime blurs the distinction between tax administration and tax policy at the township level because local government agencies vacillate between being a “subordinate” agent of the national tax system and being a rather independent lesser of tax contracts. Such a design generates a dilemma with respect to monitoring and incentives, the solution of which is attempted by the peculiar institution of intergovernmental transfers of tax revenue. Better monitoring, including improved auditing procedures, can increase tax collection per tax. It will, however, not change the ability of local government agencies to extract resources from the economic sector by the way of EBRs and off-budget revenues. On the other hand, the system of tax contracting has served Chinese economic development well. It offered enough incentives for local government agencies to implement tax reforms by making them claimant of residual tax revenue. The discretionary means local government agencies can generate in such a system were used for designing individual tax policy and led to a variety of different business systems that make fiscal federalism and jurisdictional competition (however limited) an economic reality.

Conclusion

For a systematic analysis of China’s emerging tax regime, information from sub-provincial jurisdictions is crucial. Neither the diversity of business systems within China and within its provinces nor the progress of economic transformation can be explained unless townships as the resource owners and their local government agencies as the architects of tax policy are included in the analysis.

A cautious interpretation of the empirical results points to two factors that play a role in the emergence of China’s tax regime which deserve further attention. One is that, indeed, transaction cost considerations play a role in deciding what and how to tax. VAT and the

Chinese form of corporate income tax were introduced because they were regarded as easy to enforce and to administer. Yet, the dominant factor for explaining the emergence of a tax regime is the allocation of property rights for resources and tax revenue. Unlike all other transition economies, China's economic reforms were accompanied by an entrenchment of property rights. There seems to be a broad consensus that townships, represented by their local government agencies, are the 'legitimate' owners of land. Likewise, there seems also to be a consensus within the political arena that sub-provincial government agencies are the legitimate residual claimant of tax revenue. This at least is not contested by the central government.

It is tempting to argue that this consensus reflects pre-20th century imperial Chinese tradition rather than a deliberate attempt to create new economic or political institutions. The devolution of power is subsequently less an attempt to introduce (fiscal) federalism than a politically expedient measure that enables aligning the interests of the legitimate local political agents with the reform policy as defined by the political centre.

Appendix

Table 1: Consolidated Financial Revenue: 1978-2002

Year	Central revenue (as percentage of total revenue)	National revenue (as percentage of GDP)
1978	15.5	31.2
1980	24.5	25.7
1985	38.4	22.4
1986	36.7	20.8
1987	33.5	18.4
1988	32.9	15.8
1989	30.9	15.8
1990	33.8	15.8
1991	29.8	14.6
1992	28.1	13.1
1993	22.0	12.6
1994	55.7	11.2
1995	52.2	10.7
1996	49.4	10.9
1997	48.9	11.6
1998	49.5	12.6
1999	51.1	13.9
2000	52.2	15.0
2001	52.4	16.8
2002	55.0	18.0

Note: National Revenue refers to the consolidated budgets of all government agencies. Domestic and foreign debts are excluded.

Source: China Statistical Yearbook 2003 (Beijing: China Statistics Press, 2003)

Table 2: Composition of National Tax Revenue, 2003

Tax Items	Per cent
Indirect Taxes	
Value-added tax (VAT)	35.88
Consumption tax	5.78
Business tax	14.02
Customs duties	13.63
Direct Taxes	
Enterprise income tax	11.44
Enterprise income tax on joint ventures and foreign companies	3.45
Personal income tax	6.93
Real estate tax	1.58
Other Taxes	7.29

Source: State Administration of Taxation, PRC, www.chinatax.gov.cn

Table 3: Allocation of Tax Revenue, 1994-2000

Classification	Tax Item	Central	Shared	Local
Turnover Taxes	Value-added tax (VAT)		X	
	Consumption tax	X		
	Business tax			X ^a
	Customs duties	X		
Income Taxes	Enterprise income tax		X	
	Enterprise income tax on joint ventures and foreign companies	X		
	Individual income tax		X	
	Agricultural tax			X
	Tax on special agricultural produce			X
	Animal husbandry tax			X
	Resource Taxes	Resource tax (other than off shore oil)		
	Urban and township land usage tax			X
	Occupied farmland tax			X
Property and Incentive Taxes	Real estate tax (domestic)			X
	Urban real estate tax (foreigners)			X
	Land appreciation tax			X
	Urban maintenance and construction tax			X
	Stamp tax		X	
	Deed tax			X
	Vehicle acquisition tax	X		
	Vehicle and vessel usage license tax			X
	Vehicle and vessel usage tax			X
	Vessel tonnage tax			X
	Slaughter tax (to be abolished)			X
	Banquet tax (to be abolished)			X
	Orientation adjustment tax on investment in fixed asset (to be abolished)			X

Note: ^a Business taxes of enterprises subordinated to the Ministry of Railway, of headquarters of banks, and headquarters of insurance companies belong to central state while the rest belong to local state.

Source: State Administration of Taxation, PRC, www.chinatax.gov.cn

Table 4: Tax Collection by Authorities, since 1994

Collection Authority	Items
State tax bureaus	Consumption tax, VAT, enterprises income tax ^a , enterprises income tax on joint ventures and foreign companies, stamp tax on security transaction, vehicle acquisition tax
Local tax bureaus	Business tax, personal income tax ^b , resource tax, urban and township land usage tax, urban maintenance and construction tax, real estate tax, urban real estate tax, land appreciation tax, vehicle and vessel usage license tax, vehicle and vessel usage tax, slaughter tax, banquet tax, other stamp taxes
Customs	Customs duties, VAT in import and export, vessel tonnage tax
MOF/LTBs	Agricultural tax, tax on special agricultural produce, animal husbandry tax, deed tax, and occupied farmland tax.

Notes: ^a For those enterprises established before 1 January 2002, the enterprise income tax is still collected by the local tax bureau; while the state tax bureau collects income tax of those companies established afterwards.

^b Personal income tax became central-local shared tax after 2002 but it is still collected by the local tax bureau.

Sources: Certified Public Accountant (CPA) Committee, Ministry of Finance (MOF), *Taxation laws*, (Beijing: Zhongguo Jingji Chubanshe, 2003); State Administration of Taxation, PRC, www.chinatax.gov.cn

Table 5 Comparison Budget of M- and L-Township

M township	'original tax base'	L township	'original tax base'
Budgetary revenue	Income, output	Budgetary revenue	Income, output
Bonus remittance of taxes		Bonus remittance of taxes	
Fixed remittance of taxes		Fixed remittance of taxes	
Earmarked subsidy		Earmarked subsidy	
Extrabudgetary revenue		Budgetary fund revenue	
Surcharges to taxes for education	Income, output	Surcharges to taxes for rural education	Income, output
Fee for garbage collection	user	Surcharges to taxes for education	Income, output
Fee for sewage disposal	user	Earmarked fund revenue	
Fee for public security	p.c., per firm	Profit of TVEs	
Fee for public utility	user	Fee from administration agencies	User, p.c.
Water rates	user	Water conservancy construction fund	p.c., per firm
Fee for family planning	p.c.	Proceeds of education-assets-sale	
Banking interests		Other subsidy	
Other subsidy		Other revenue	
Proceeds of land-sale		Proceeds of land-sale	
Fee for land transaction		Fee for land transaction	
Other		Other	

Note: Not all fees are included in the local budgets, as most of user charges form revenues of those administrative units that provide the service (see Eckaus 2003, 78)

Source: Respondent 24 & 26

Table 6: Composition of M and L Township Revenue, 2003 (per cent of total)

Items	M	L
Total financial revenue	100	100
Budgetary revenue	45.23	24.40
thereof		
Bonus remittance of taxes	31.90	18.20
Fixed remittance of taxes	12.78	4.58
Earmarked subsidy	0.55	1.62
Extrabudgetary revenue	22.28	11.65
thereof		
Surcharges to taxes for education	4.08	5.44
Fees charged by administration agencies	6.51	1.63
Other	11.69	4.58
Other revenue	32.49	63.95
thereof		
Proceeds of land-sale	26.99	44.58
Fees for land transaction	5.24	8.98
Profit of TVEs or governmental investments	0.03	9.85
Other	0.69	0.54

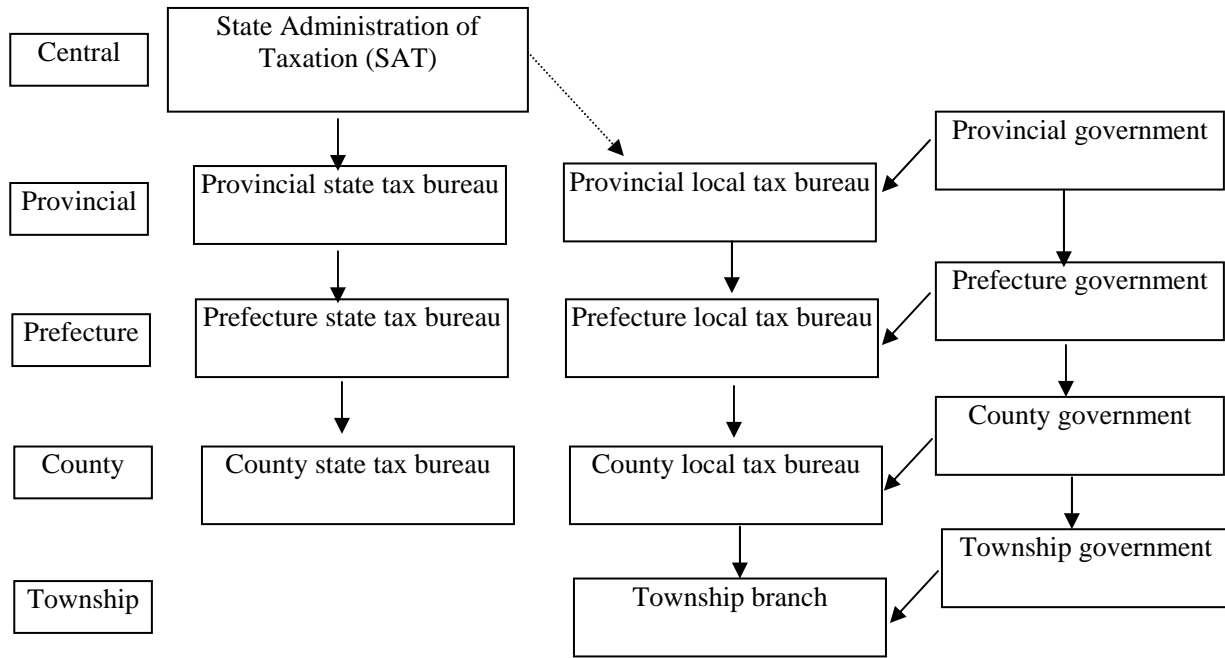
Source: Respondent 24 & 26

Table 9: Expenditure of L Township, 2003

Items	Amount (million RMB)	Per cent
Total financial expenditure	181	100
Agriculture	4	2.5
Industry and transportation	38	20.9
Infrastructure	46	25.6
Education	65	35.9
Culture	8	4.5
Health	3	1.9
Social	4	2.4
Administration	10	5.4
Other	2	0.9

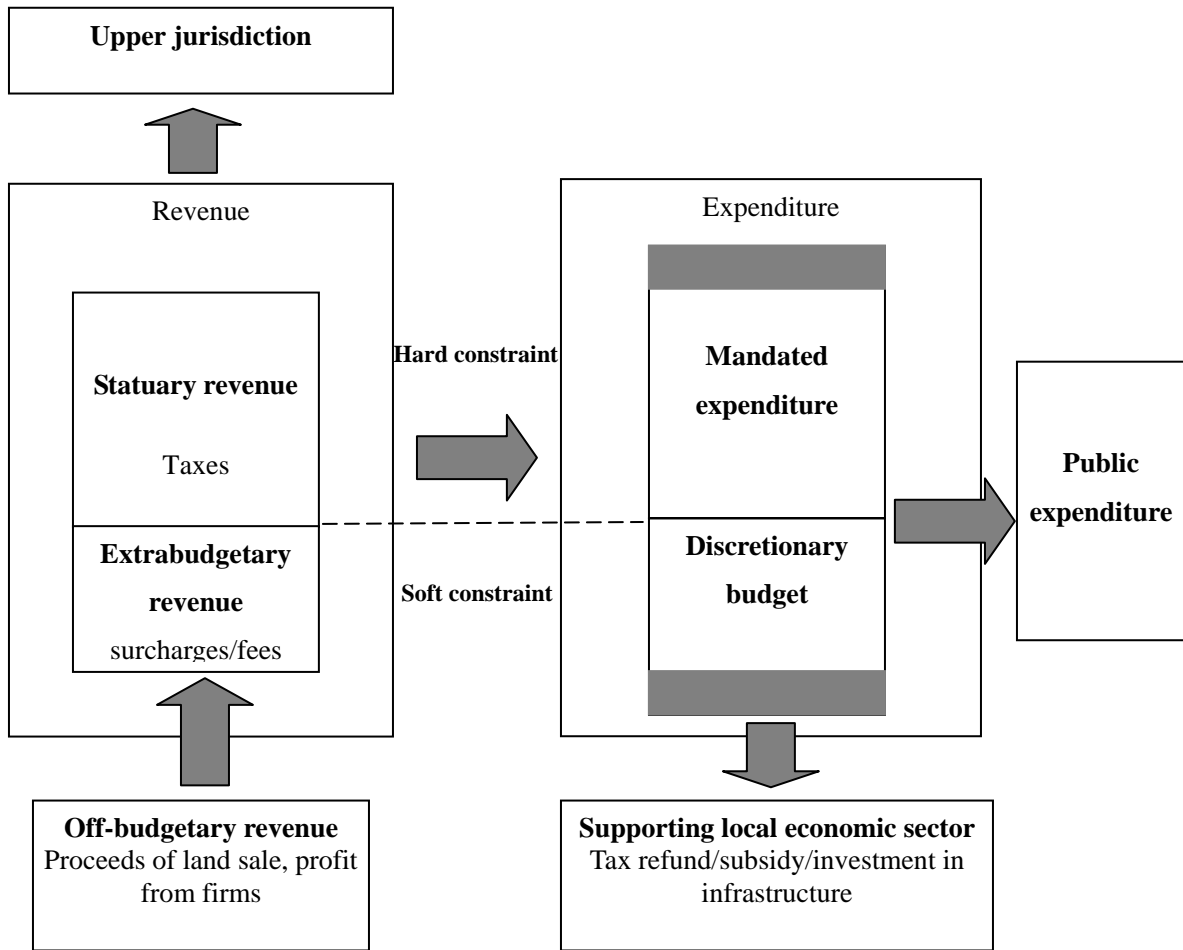
Source: Respondent 26

Figure 1: Structure of Taxation Administration, 2004



Source: State Administration of Taxation, PRC, www.chinatax.gov.cn

Figure 2: Revenue and expenditure at the township level



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¹ The formula for the three basic taxes looks at follows:

	Central	Local
VAT	75%	25%
Enterprise Income Tax ^a	50% (2002), 60% (2003)	50% (2002), 40% (2003)
Personal income tax ^b	50% (2002), 60 % (2003)	50% (2002), 40% (2003)

Notes: ^a Enterprise income taxes on Firms subordinate to the Ministry of Railway, headquarters of banks, and headquarters of maritime and petrol companies transfer their income taxes to the central only. ^b Before 2002 all Personal income tax was local.

Source: Certified Public Accountant (CPA) Committee, Ministry of Finance (MOF), *Taxation laws*, (Beijing: Zhongguo Jingji Chubanshe, 2003)

² See the Circular of the State Council "On issues concerning establishing vertical led tax branches of SAT and local tax bureaus", 16 November 1993).

³ See for example the Circulars of the State Council "concerning enforcement of taxation administration and restrict control of taxation rebate and exemption", (23 July 1993); "concerning legal enforcement of taxation administration and restricting taxation authority", (12 March 1998); and "concerning redressing local government's tax refund policy", (11 January 2000).

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