

Central Unification versus Local Diversity: China's Tax Regime, 1980s-2000s

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Central Unification versus Local Diversity: China's Tax Regime, 1980s-2000s*

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Abstract

This article firstly present a systematic overview on national tax regime by classifying China's tax regime into three broad phases in context of underpinning market-oriented institutional development during last two decades and, then, in supplement to previous literatures that largely stop at provincial level, unveil the complex and obscure local tax regime based on sub-provincial field research in Zhejiang and Jiangsu province. The authors observed dual existing tax regimes: the hard and standardized state tax regime under central custody versus *de facto* soft and flexible local tax regime under local promotion and argue that despite central persisting initiatives in unifying tax regime and recentralization, local variation and divergence continue to play indispensable role in implementation of central reform due to China's sheer size, geographical, cultural and resource endowment disparity as well as local state's self-interest seeking inevitably induces localized adaptation of central policy and, consequently, calls for further decentralization.

Keywords: tax regime, decentralization, China, transition economy

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As a historical symbol of new era after Culture Revolution in China, the Third Plenary Session of the Eleventh Chinese Communist Party (CCP) Central Committee adopted a momentous strategy: shifting working focus of the state to revive domestic economy and open up to the outside world, which has demonstrated its historical significance and far-reaching impact on the world. Since then, China has undergone a *gradual* (not a *big bang*) institutional transformation from a planning-economy based on political authoritarian, state ownership and central planning into a market-economy built on representative democracy, private property, market coordination and voluntary exchange. Yet, to what extent China has achieved her final objective warrants precise assessment and measurement.

At least, China's remarkable economic performance with average 8.3 percent of the per capita real GDP growth since 1978 and accounting for 25 percent share of global economic growth in 1995-2002¹ attracts numerous economists, political scientists and sociologists to trace the reason for China's success and explore the theoretical implication and significance. Among various explanations, the crucial role of *de facto* fiscal and administrative decentralization with compatible incentives for local state to foster local economic prosperity becomes pervasive², which, consequently, prompts a comprehensive retrospection and reappraisal of the central-local³ relations in

¹ World Bank, *Beyond Economic Growth*, (Washington: The World Bank, 2000), p.24; *The Economist*, "China's Economy Steaming", 15 November 2003, p.71.

² See e.g. Jean C. Oi, "Fiscal Reform and the Economic Foundations of Local State Corporatism in China", *World Politics*, Vol.45, No.1 (1992), pp.99-126; "The Role of the Local States in China's Transitional Economy", *The China Quarterly*, No.144 (1995), pp.1132-49; Chenggang Xu and Juzhong Zhuang, "Why China Grew: The Role of Decentralization", in Peter Boone, Stanislaw Gomulka, and Richard Layard (ed.), *Emerging from Communism: Lessons from Russia, China, and Eastern Europe*, (Cambridge: MIT Press, 1998); Barry R. Weingast, "The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development", *Journal of Law and Economic Organization*, Vol.11 (1995), pp.1-31; Gabriella Montinola, Yingyi Qian and Barry R. Weingast, "Federalism, Chinese Style: The Political Basis for Economic Success in China", *World Politics*, Vol.48, No.1 (1995), pp.50-81; Yingyi Qian and Barry R. Weingast, "China's Transition to Markets: Market-Preserving Federalism, Chinese Style", *Journal of Policy Reform*, Vol.1 (1996), pp.149-85; Yingyi Qian and Barry R. Weingast, "Federalism As a Commitment to Market Incentives", *Journal of Economic Perspectives*, Vol.11, No.4 (1997), pp.83-92.

³ See e.g. Michel Oksenberg and James Tong, "The Evolution of Central-Provincial Fiscal Relations in China, 1971-1984: The Formal System", *The China Quarterly*, No.125 (1991), pp.1-32; Christine P.W. Wong, "Central-Local Relations in an Era of Fiscal Decline: The Paradox of Fiscal Decentralization in Post-Mao China",

terms of incessant fiscal (tax) reforms.

As a critical and inherent component of general reform agenda, tax regime unavoidably is outcome of political and economic interweaving. This article firstly present a systematic overview on national tax regime by classifying China's tax regime into three broad phases in context of underpinning market-oriented institutional development during last two decades. Then, in supplement to previous literatures that largely stop at provincial level⁴, we probe into the puzzle of sub-provincial level⁵ to unveil the complex and obscure local tax regime based on our field research in Zhejiang and Jiangsu province. Our observation shows that two separated tax regimes exist: the hard and standardized state tax regime under central custody versus *de facto* soft and flexible local tax regime under local promotion. Diversified and divergent practices are undertaken by local government to compete for investments and enterprises. Then, an unfavourable result of severe scarcity of financial resources, together with *biting-off effect* on financial revenue from upper level jurisdiction, force local government to seek new revenue source and finance their soaring expenditure by themselves. Consequently, despite central persisting initiatives in unifying tax regime and recentralization, we draw our conclusion that local variation and divergence continue to play indispensable role in implementation of central reform in that China's sheer size, geographical, cultural and resource endowment disparity as well as local state's self-interest seeking problem inevitably

The China Quarterly, No.128 (1991), pp.691-715; "Fiscal Reform and Local Industrialization: The Problematic Sequencing of Reform in Post-Mao China", *Modern China*, Vol.18, No.2 (1992), pp.197-227; (ed.), *Financing Local Government in the People's Republic of China*, (Hong Kong: Oxford University Press, 1997); Jae Ho Chung, "Studies of Central-provincial Relations in People's Republic of China: A Mid-term Appraisal", *The China Quarterly*, No.142 (1995), pp.487-580; Albert Park, Scott Rozelle, Christine Wong and Changqing Ren, "Distributional Consequences of Reforming Local Public Finance in China", *The China Quarterly*, No.147 (1996), pp.751-78; Jun Ma, "Modelling Central-local Fiscal Relations in China", *China Economic Review*, Vol.6, No.1(1995), pp.105-136; Kai-yuen Tsui and Youqiang Wang, "Between Separate Stoves and a Single Menu: Fiscal Decentralization in China", *The China Quarterly*, No.177 (2004), pp.71-91 .

⁴ See footnote 2 and 3.

⁵ According to governmental administrative structure, China's taxation system has five levels. In 2002, below the central level are 23 provinces (*sheng*, including Taiwan), 5 autonomous regions (*zizhiqu*), 4 municipalities (*zhixiashi*) and 2 special administrative regions (Hong Kong and Macao), 332 prefectures, 2,860 counties, and 44,850 townships.

induces localized adaptation of central policy (*yin di zhi yi*) and, consequently, calls for further decentralization.

Phase 1: Exploring Market Economy, 1978-1991

The Third Plenary Session of the Eleventh CCP Central Committee convened in 1978 indicated the commencement of China's reform aimed at building a powerful and modern socialist state by adopting reform and opening-up strategy. Given political and ideological constraints, such progress, yet, zigzagged to explore a suitable road to economic development. In his opening address on the Twelfth National Party Congress in 1982⁶, Deng Xiaoping initially advanced the idea of building socialism with Chinese characteristics. Holding the principal of planning economy as dominant and market adjustment as supplement became the fundamental issue of economic reform at that time⁷. Two years later, a planned commodity economy based on public-owned (*yi gongyouzhi wei jichu de you jihua shangpin jingji*) was scheduled by CCP Central Committee, which stressed market mechanism but in a planned way⁸. While China formulated in the primary stage of socialism on the Thirteenth National Party Congress in 1987, market system received more endorsement and an enthusiastic urge to promote non-state economy and accelerate supportive reforms in various realms of planning, investment, materials and goods, finance, banking and foreign trade, etc., was laid out in order to establish the frame work of planned commodity economy (*jihua shangpin jingji*)⁹. Simultaneously, the first amendment to the Constitution was approved in 1988 that permitted the private sector to exist and develop within the limits prescribed by law¹⁰.

⁶ The Twelfth National Party Congress was convened in Beijing during 1-11 September 1982.

⁷ See Hu Yaobang's report on the Twelfth National Party Congress: *Quanmian kaichuang shehui zhiyi xiandaihua jianshe de xinjumian* (Well-rounded initiating a new phase of modernization construction of socialism), (1 September 1982).

⁸ *Zhonggong zhongyang guanyu jingji tizhi gaige de jue ding* (Decision of the CCP central committee on economic system reform), (20 October 1984).

⁹ See Zhao Ziyang's report on the Thirteenth National Party Congress: *Yanzhe you zhongguo tese de shehui zhiyi daolu qianjin* (Advance following the road of socialism with Chinese characteristic), (25 October 1987).

¹⁰ See new paragraph added into Article 11 of the Constitution of PRC approved by the Seventh National

Responding to the market reform pressed by polity, tax regime caught up with three reform stages roughly grouped into 1978-1982, 1983-1984, and 1985-1991. During the first stage, in line with opening-up strategy, an independent foreign tax system was firstly established to attract foreign direct investment (FDI) by promulgating laws and regulations in 1980-1982, such as *The Income Tax Law of PRC on Chinese-foreign Equity Joint Ventures*¹¹, *The Income Tax Law of PRC on Foreign Enterprises*¹², and their detailed rules for implementation, respectively, which provided considerable tax reduction or exemption. For instance, a joint venture registered for more than 10 years was granted an income tax exemption in the first two years after making profit and 50% reduction in the third through fifth year (*mian er jian san*)¹³. Meanwhile, in view of increasingly foreign employees and their income generated within China, the Third Session of Fifth National People's Congress enacted *The Individual Income Tax Law*¹⁴. In 1980, Shenzhen, Zhuhai and Shantou in Guangdong province were designated as Special Economic Zone (SEC) in which foreign enterprises and joint ventures enjoyed particular preferential tax policy¹⁵. Thereafter, 14 economic and technological development zones (ETDZs) were established along costal regions in succession¹⁶. As for domestic aspect, considering feeble rural economy then, numerous measures concerning alleviation of rural tax burden were issued to reactivate the domestic economy¹⁷. In addition, two new taxes,

People's Congress on 12 April 1988.

¹¹ Promulgated by the Third Session of the Fifth National People's Congress on 10 September 1980, and annulled on 1 July 1991.

¹² Promulgated by the Fourth Session of the Fifth National People's Congress on 13 December 1981, and annulled on 1 July 1991.

¹³ Article 5 of *The Income Tax Law of PRC on Chinese-foreign Equity Joint Ventures*.

¹⁴ Promulgated by the Third Session of the Fifth National People's Congress on 10 September 1980, firstly revised on 31 October 1993 and secondly revised on 30 August 1999.

¹⁵ Guangdong sheng jingji tequ tiaoli (Provisions of special economic zone in Guangdong province) (Approved by the fifteenth meeting of the Fifth National People's Congress Standing Committee, 26 August 1980).

¹⁶ From 1984-1988, 14 ETDZs, including Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Minhang, Hongqiao, Caohejing, Ningbo, Fuzhou, Guangzhou, Zhanjiang had been designated by the approval of the State Council.

¹⁷ See e.g. Guanyu jianqing nongcun shuishou fudan wenti de baogao (Report concerning alleviation of rural tax burden), (the State Council and Ministry of Finance, 2 December 1978).

VAT and special tax on burning oil ¹⁸, were levied with intention of expanding tax source and economizing oil resource by burning coal. New reforms were also introduced into fiscal regime modifying previous centralized system to mobilize local government to collect tax. Based on experiment carried out in Jiangsu province in 1977, which was labeled “fixed rate responsibility” (*guding bili baogan*) ¹⁹, the State Council implemented a new fiscal arrangement of “dividing revenue and expenditure along each level government with contract” (*huafen shouzhi, fenji baogan*) in 1980, decentralizing fiscal system and increasing autonomy and responsibility of local government. Under such system, total fiscal revenues were assigned into three types: central fixed revenue, including profit remittance of central SOEs, custom duties; local fixed revenue, consisting of salt tax, agriculture tax, animal husbandry tax, industrial and commercial income tax, local tax and profit remittance of local SOEs, etc.; and revenue shared by central and local, comprising profit remittance of central-local SOEs (shared with fixed rate) and industrial and commercial tax (shared with adjustment rate)²⁰.

Two remarkable elements of 1983-1984 stage were two steps of “tax-for-profit” (*li gai shui*) reform for SOEs and extensive reform of existing industrial and commercial tax system. In previous system, SOEs completely relied on state’s plan throughout enterprise management and subsidies as well as remitted profit, if any, to the state. Aimed to empower SOEs independent managerial right and balance responsibility, “tax-for-profit” reform intended to replace the profit remittance with tax. The first step in 1983 allowed SOEs to retain certain part of profit after income tax while remit the surplus to the government. The retainable ratio and income tax rate depended on

¹⁸ Special tax on burning oil was levied on 1 July 1982 and abolished on 1 January 1994; VAT on sewing machine, bicycle and electric fan were levied on 1 July 1982 with machinery and agricultural machinery added on 1 January 1983.

¹⁹ See Oksenberg and Tong, “The Evolution of Central-Provincial Fiscal Relations in China, 1971-1984”, pp.1-32 for detailed description.

²⁰ Guowuyuan guanyu shixing “huafen shouzhi, fenji baogan” caizheng guanli tizhi de tongzhi (Circular of the State Council concerning implementation of fiscal administrative system of dividing revenue and expenditure along each level government with contract), (1 February 1980).

enterprises' size, sectors and *ad hoc* situation²¹. In 1984, the second step furthered to consider SOE as an independent entity by merely levying tax on it, which, hence, triggered adjustments of tax item and levies of five new taxes: resource tax, urban maintenance and construction tax, real estate tax, urban and township land usage tax, and vehicle and vessel usage tax²².

As a prelude of tax reform 1994, the 1985-1991 stage was characterized by extensive regulations and improvements. To fine-tune the tax regime, the state levied around 15 new taxes, abolished one tax, modified two taxes, issued new regulation of custom duties²³ and unified foreign enterprise income tax with *The Income Tax Law of PRC on Enterprises with Foreign Investment and Foreign Enterprises*²⁴. After this phase of reform, China's tax regime comprised 37 taxes and 2 national funds (Table 1).

[insert table 1 here]

Phase 2: Establishing Market Economy, 1992-2000

Although reform pace once was impeded by crackdown of Tiananmen Square at home and dramatic changes of Eastern Europe and collapse of the Soviet Union abroad, Deng Xiaoping's inspiring talk during southern scout in 1992 swept off the political and ideological obstacle remained in top authorities. Thenceforth, the Fourteenth Party Congress took a courageous move by explicitly declaring the target of China's economic restructuring was to establish a socialist market economic system (*shehui zhuyi shichang jingji*)²⁵ and avowed the fundamental function of market mechanism in economy, which was institutionalised into the Constitution in 1993 and 1999²⁶. With regard to such reform target, a significant document, *Decision of the*

²¹ Caizhengbu guanyu guoying qiye li gai shui shixing banfa (Provisional measure of MOF concerning the tax-for-profit reform for SOEs), (24 April 1983).

²² Caizhengbu guanyu guoying qiye dierbu li gai shui shixing banfa (Provisional measure of MOF concerning the second stage of tax-for-profit reform for SOEs), (18 September 1984).

²³ Regulation of PRC on Custom Duties, issued by the State Council on 7 March 1985, firstly revised on 12 September 1987, and secondly revised on 18 March 1992.

²⁴ Promulgated by the Fourth Session of the Seventh National People's Congress on 9 April 1991.

²⁵ See Jiang Zemin's report on the Fourteenth Party Congress, 12 October 1992.

²⁶ See the second amendment to the Constitution of PRC approved by the Eighth National People's Congress on

CCP Central Committee on Issues Concerning the Establishment of Socialist Market Economic System (Decision 1993), outlined a reform package tackling multifaceted tasks in 1993, which pointed out to deepen fiscal reform by changing the current fiscal contracting system to a tax sharing system on the basis of a rational central-local authority division on one hand and improve tax reform adhering to principles of unifying tax laws, equalizing tax burden, simplifying tax system and rationally decentralizing authority (*tongyi shuifa, gongping shuifu, jianhua shuizhi, heli fenquan*) on the other hand²⁷. Two years later, the Fifth Session of the Fourteenth CCP Central Committee announced another document, *Suggestion of the CCP Central Committee Concerning Establishing the Ninth Five-year Plan of Economic and Social Development and 2010 Vision*, reemphasising the indispensability and urgency of fiscal and tax reform²⁸.

Due to the essentialness of tax reform 1994, a watershed in China's tax regime, the reform schema was unfolded progressively in prudence, namely pre-1994 preparation, 1994-1997 interim and 1998-2000 fine-tuning. In the end of 1993, a series of new laws, legal amendments, regulations, and measures were approved or issued to concretise the objectives in *Decision 1993* and prepare for the forthcoming tax reform 1994²⁹. The rationale for such reform is to arrest the national fiscal decline in terms of percentage in the gross national product (GNP) and raise the central fiscal revenue in terms of percentage in total fiscal revenue as well as strengthen and rationalize state's

29 March 1993, and the third amendment approved by the Second Session of the Ninth National People's Congress on 15 March 1999.

²⁷ Zhonggong zhongyang guanyu jianli shehui zhiyi zhichang jingji tizhi ruogan wenti de jue ding (Decision of the CCP central committee on issues concerning the establishment of a socialist market economic system), (Approved by the Third Session of the Fourteenth CCP Central Committee, 14 November 1993)

²⁸ Zhonggong zhongyang guanyu zhiding guoming jingji he shehui fazhan "jiuwu" jihua he 2010 nian yuanjing mubiao de jianyi (Suggestion of the CCP central committee concerning establishing the ninth five-year plan of economic and social development and 2010 vision), (28 September 1995)

²⁹ See e.g. Law of PRC on Individual Income Tax, (Revised on 31 October 1993), Rules for Implementation of PRC on the Administration of Tax Collection, (Issued on 4 August 1993), Interim Provision of PRC on Business Tax, Interim Provision of PRC on VAT, Interim Provision of PRC on Consumption Tax, Interim Provision of PRC on Income Tax on Enterprises, Interim Provision of PRC on Land Appreciation Tax, (Issued on 13 December 1993).

macroeconomic control capacity and means. Under 1985 “fiscal contracting system”, central government suffered a diminishing share of consolidated fiscal revenue, including tax revenue and extra budgetary revenue. As shown in table 2, the share of the central government revenue had undergone a continuous shrink during 1985-93, which dropped 16.4 percent from 38.4% to 22%. The ratio of total fiscal revenue to GDP fell from 22.4% in 1985 to 12.6% in 1993. Aimed to fulfill such objectives, the reform package rebuilt the tax regime into 29 taxes³⁰ (Table 3) by extending the value-added tax (VAT) to all turnovers, eliminating product tax and adjustment taxes, merging minor taxes, ushering new taxes (e.g. consumption tax), unifying income tax on domestic enterprises and individual income tax, broadening resource tax, and, essentially, introduced the Tax Sharing System (TSS, *fen shui zhi*)³¹ under which the central government possessed their independent tax base and tax items, such as consumption tax (including collected by the customs), customs duties, income tax on FIEs and FEs, VAT (collected by the customs) and vehicle acquisition tax while local fixed revenues of tax covering business tax, resource tax, urban and township land usage tax, urban maintenance and construction tax, occupied farmland tax, real estate tax, urban real estate tax, land appreciation tax, vehicle and vessel usage license tax, vehicle and vessel usage tax, vessel tonnage tax, deed tax, slaughter tax, banquet tax, agricultural tax, tax on special agricultural produce, animal husbandry tax. Fixed rates of shared arrangement, whereas, were pre-set on the shared taxes through the negotiation between the central and local within a certain period³²(Table 4).

[insert table 2,3, and 4 here]

In contrast to pre-1994 during which the tax collection was delegated to local government causing a tax-revenue-withholding problem, the 1994 reform set up state

³⁰ In fact, total tax items are 26 not 29 because inheritance tax, security transaction tax and fuel tax are not levied yet.

³¹ See e.g. Tsang Shu-ki and Cheng Yuk-shing, “China’s Tax Reforms of 1994: Breakthrough or Compromise?”, *Asian Survey*, Vol.34, No.9 (1994), pp.769-88 and Wong, (ed.), *Financing Local Government in the People’s Republic of China*, for detailed description.

³² Guowuyuan guanyu shixing fenshuizhi caizheng guanli tizhi de jue ding (Decision of the State Council concerning implementation of tax sharing fiscal administrative system), (15 November 1993)

taxation bureaus (*guoshuiju*, STBs), vertically led by the State Administration of Taxation (SAT), as an independent agency responsible for collection of central taxes and central-local shared taxes³³. Accordingly, the collections of local taxes were subject to local tax bureaus (*dishuiju*, LTBs)³⁴ (Table 5), which functioned as local taxation authority under the direct leadership of the local government. SAT only provided operational guidance to provincial LTB and comment on its personnel nomination to local government³⁵(Figure 1).

[insert figure 1 here]

[insert table 5 here]

A few interim arrangements were enforced to compensate local government from 1994 to 1997 so as to conciliate them, especially those rich provinces, and win their support for the new tax reform, which would impair their vested interests and power. The central government committed to rebating local government an amount equal to their loss in the new tax sharing system (TSS) based on a formula and promised them a share in the growth of VAT and consumption tax each year³⁶. Meanwhile, some important laws and regulations were enacted to codify and standardize reform practice and tax administration. For instance, *The Law of PRC on the Administration of Tax Collection*³⁷ was revised and its rule for implementation³⁸ was issued to reinforce tax collection on the revenue side and *The Budget Law of PRC*³⁹ was promulgated to

³³ The shared tax would be transferred to local government based on the shared ratio.

³⁴ The Customs collected customs duties, partial VAT and consumption tax. Before 1996, Ministry of Finance (MOF) collected occupied farmland tax, deed tax, agricultural tax, tax on special agricultural produce and animal husbandry tax. However, State Administration of Taxation (SAT) has taken over them since 1996 except MOF remained the collection in some regions.

³⁵ Guowuyuan guanyu zujian guojia shuiwu zongju guanli zai gedi de zhishu shuiwu jigou he difang shuiwuju youguan wenti de tongzhi (Circular of the State Council on issues concerning establishing vertical led tax branches of SAT and local tax bureaus), (16 November 1993)

³⁶ Guowuyuan guanyu fenshui zhi caizheng guanli tizhi shuishou fanhuan gaiwei yu bendiqu zengzhishui he xiaofeishui zengzhanglv guagou de tongzhi (Circular of the State Council concerning linking tax rebate and growth rate of VAT and consumption tax under tax sharing fiscal administrative system), (24 August 1994)

³⁷ Promulgated by the twenty-seventh meeting of the Seventh National People's Congress Standing Committee on 4 September 1992 and firstly revised on 28 February 1995.

³⁸ Promulgated by the State Council on 4 August 1993.

³⁹ Promulgated by the Second Session of the Eighth National People's Congress on 22 March 1994.

enhance the control on the expenditure side. To defeat the rampant tax evasion and taxation official corruption, amendment to *Criminal Law of PRC* with new article of violating tax collection and dereliction of duty on taxation was approved in March 1997⁴⁰.

The Fifteenth National Party Congress convened in September 1997 suggested following fine-tuning stage 1998-2000. The report, *Hold High the Great Banner of Deng Xiaoping Theory for an All-round Advancement of the Cause of Building Socialism With Chinese Characteristics into the 21st Century*⁴¹, addressed by Jiang Zemin fully summarized the success of tax reform 1994 and, then, appealed for further regulation on excessively high incomes and tax evasion, improvement of the individual income tax system, introduction of new taxes like inheritance tax⁴², and standardization of income distribution so as to narrow widening income gaps. In addition, due to unprecedented setback of the Asian Financial Crisis and international economic fluctuation, wide-ranging preferential tax policies had been actively employed to stimulate domestic demands, encourage investment and expand export. For instance, interest tax was levied in 1999⁴³. Orientation adjustment tax on investment in fixed asset was reduced 50% in 1999 and suspended in 2000⁴⁴. Stamp tax on security transaction was reduced from 5‰ to 4‰ in 1998⁴⁵. An investment tax credit program was firstly introduced to promote FIEs' investment in technological renovation and R&D and purchasing domestic equipments⁴⁶. Hi-tech

⁴⁰ Amendment in Chapter 3 (new article 121), and Chapter 9, promulgated by the Fifth Session of the Eighth National People's Congress on 14 March 1997.

⁴¹ Gaoju Deng Xiaoping lilun weida qizhi, ba jianshe you zhongguo tese shehui zhuyi shiye quanmian tuixiang 21 shiji (Hold high the great banner of Deng Xiaoping theory for an all-round advancement of the cause of building socialism with Chinese characteristics into the 21st century), (12 September 1997)

⁴² Hitherto the inheritance tax has not been levied.

⁴³ Guowuyuan guanyu dui chuxu cunkuan zhengshou geren suodeshui de shishi banfa (Measures for implementation of the State Council concerning levying interest tax on individual saving), (30 September 1999).

⁴⁴ Guojia shuiwu zongju guanyu zuohao guding zichan touzi fangxiang tiaojieshui tingzheng gongzuo de tongzhi (Circular of SAT on issues concerning suspending orientation adjustment tax on investment in fixed asset), (28 March 2000).

⁴⁵ Guowuyuan guanyu tiaozheng zhengquan (gupiao) jiaoyi yinhuashui shuilv de tongzhi (Circular of the State Council concerning adjusting stamp tax on security transaction), (11 June 1998).

⁴⁶ Guojia shuiwu zongju guanyu waishang touzi qiye caigou guochan shebei tuishui guanli shixing banfa

enterprises were entitled to a tax preferential package⁴⁷. In 1998-2000, several adjustments on exported VAT refund rate increased average rate from 8.29% in 1996, 10% in 1998 to 15% in 1999, respectively⁴⁸. Furthermore, in order to carry out the development of China's vast western regions, considerable tax incentives were announced in 2000⁴⁹.

Phase 3: Strengthening Market Economy, 2001-2020

China's accession to World Trade Organization (WTO) in 2001 represented a historic breakthrough in reform and opening up and entailed brand new prospects for China's economic, political and cultural progress. In 2002, the Sixteenth National Party Congress proclaimed that the socialist market economy had initially taken shape and vowed to strengthen and complement it by improving legal system for protecting private property rights and deregulating all sectors in economy⁵⁰. Correspondingly, the fourth amendment to the Constitution added a clause: "Citizens' lawful private property is inviolable."⁵¹ Later, the *Decision of the CCP Central Committee on Issues Concerning the Improvement of Socialist Market Economic System (Decision 2003)*⁵² charted the major tasks to further improve the market economy to build a well-off

(Interim provision of SAT concerning tax refund on FIEs' purchasing domestic equipment), (20 September 1999)

⁴⁷ Caizhengbu guojia shuiwu zongju guanyu guanche luoshi 'zhonggong zongyang guowuyuan guanyu jiaqiang jishu chuangxin, fazhan gaokeji, shixian chanyehua de jue ding' youguan shuishou wenti de tongzhi (Circular of MOF and SAT on taxation issues concerning implementation of 'decision of the CCP central committee and the State Council on strengthening technological innovation, developing hi-tech, realizing industrialization'), (2 November 1999).

⁴⁸ Chinese Academy of International Trade and Economic Cooperation, Ministry of Commerce, PRC, <http://caitec.mofcom.gov.cn>

⁴⁹ Guowuyuan guanyu shishi xibu dakaifa ruogan zhengce cuoshi de tongzhi (Circular of the State Council concerning several policies on carrying out the development of China's vast western regions), (26 October 2000).

⁵⁰ Quanmian jianshe xiaokang shehui, kaichuang zhongguo tese shehui zhuyi shiye xinjumian (All-round build well-off society and initiate new phase of socialist cause with Chinese characteristics), (Jiang Zemin's report on the Sixteenth National Party Congress, 8 November 2002).

⁵¹ See the revised Article 13 in the fourth amendment to the Constitution of PRC approved by the Second Session of the Tenth National People's Congress on 14 March 2004.

⁵² Zhonggong zhongyang guanyu wanshan shehui zhuyi shichang jingji tizhi ruogan wenti de jue ding (Decision of the CCP Central Committee on Issues Concerning the Improvement of a Socialist Market Economic System), (Approved by the Third Session of the Sixteenth CPC Central Committee, 14 October 2003).

society in terms of narrowing the gap between urban and rural areas, promoting coordinated development of different regions, establishing a unified, open and orderly modern market system, improving macro-control, administration and economic legal systems, improving employment, income distribution and social security systems, and building a mechanism to promote sustainable social and economic development⁵³.

With regard to tax field, the *Decision 2003* demanded a new round of tax reform in progress mainly covering export tax refund, unified income tax on enterprise, VAT, individual income tax, and tax-for-fee (*fei gai shui*) reform under the principles of simplifying tax system, broadening tax base, reducing tax rate and tightening collection and administration (*jianshuizhi, kuanshuiji, dishuilü, yanzhengguan*). Given the exacerbated arrears of export tax refund and pressure of fiscal deficit of central government, the export tax refund system was reformed in 2003 by lowering average tax refund rate of 3%, central-local shared shouldering the tax refund, and adjusting tax refund incentives to export product structure⁵⁴. Unifying income tax regime on enterprises became more necessary to equalize the tax burden, regardless of their ownership structure or capital sources, because the present effective tax rate was 15% for FIEs and 25% for domestic enterprises⁵⁵, which was inconsistent with national treatment stressed by WTO conventions and a level playing field for all enterprises. As a primary tax contributing 35.88% of total tax revenue in 2003 (Table 6), the VAT reform concentrated on shifting from “production-based” to “consumption-based” and widening the scope of VAT and consumption tax to reduce the negative impact of current VAT on enterprise’ ability and willingness to renew and upgrade technology and equipment. The tax officials and experts had reached a common consensus to restructure and tighten individual income tax system in that it should become a major tax and exert important redistribution role in the future. New social security tax and property tax were under designing to accommodate rapid social and economic growth.

⁵³ See Xinhua News, 21 October 2003, www.chinaview.cn

⁵⁴ Guowuyuan guanyu gaige xianxing chukou tuishui jizhi de jue ding (Decision of the State Council concerning reform on existing export tax refund system), (13 October 2003)

⁵⁵ See Matthew Mui and Ian Jia, China Reforms for the World Stage, *International Tax Review*, 1 March 2002

[insert table 6 here]

The uppermost important focus was the tax-for-fee reform, particularly, in rural region⁵⁶. Solving problems of agriculture, farmers and rural area (*sannong wenti*) were claimed as the top priority task of the state⁵⁷. Hailed as one of the most important documents this year, the CCP Central Committee and the State Council jointly issued the No.1 Document on increasing farmer's income, the sixth No.1 document since 1982⁵⁸ which demonstrated the willingness and practical measures of central authority to improve and solve the rural problems. The tax-for-fee reform was attributed to the essential part of the whole reform for rural problems. To release rural tax burden and balance urban and rural development, Anhui province preceded by pilot experiment in 2000, namely, "three abolishment, two adjustments, and one change" (*sanquxiao liangtiaozheng yigaige*) which stood for 1) abolishing five township fees and surcharges (*wutong*)⁵⁹, raised fund for rural education, and slaughter tax; 2) adjusting agriculture tax with taxable agricultural output-base and agricultural tax rate subject to 7%, and tax on special agricultural produce with tax computation and rate; and 3) reforming village levies and financial management in terms of abolishing three levies (*santi*)⁶⁰ and financing village by unified surcharges to agricultural tax. Based on Anhui's experience, the State Council announced a

⁵⁶ See e.g. Ray Yep, "Can 'Tax-for-fee' Reform Reduce Rural Tension in China? The Process, Progress and Limitations", *The China Quarterly*, No.177 (2004), pp.42-71 for detailed discussion.

⁵⁷ See Premier Wen Jiabao's government work report on the Second Session of the Tenth National People's Congress, 5 March 2004.

⁵⁸ For five successive years from 1982 and 1986, the central authority issued five No. 1 Documents on agriculture, rural regions and farmers to boost rural development. The sixth No. 1 Documents, Zhonggong zhongyang guowuyuan guanyu cujin nongmin zengjia shouru ruogan zhengce de yijian (Document of the CCP Central Committee and the State Council on issues concerning increasing farmer's income), was jointly issued by the CCP Central Committee and the State Council by on 8 February 2004.

⁵⁹ *Wutong* are five township fees for expenditure on rural education, birth control, welfare for veterans, militia training and transportation.

⁶⁰ *Santi* are three village fees: 1) accumulation fund (*gongjijin*) for collective investment such as irrigation construction, collective enterprises, etc., 2) commonweal fund (*gongyijin*) for collective welfare such as asylum for old people, almsgiving for poor family, etc., 3) and administrative fee (*guanlifei*) for salary of village cadre and running expenses.

circular to press ahead the pilot experiment⁶¹ and, thus, expanded the test into 20 provinces in 2002 and national wide in 2003⁶². Additionally, on a national conference for rural tax-for-fee pilot reform, Premier Wen Jiabao advanced three improving measures calling for further alleviating rural tax burden in grain producing areas, abolishing tax on special agricultural produce, and fixing ceiling rate of agricultural tax and its surcharges⁶³ and reiterated them in his government work report to the Second Session of the Tenth National People's Congress in 2004 in which he also depicted that “all taxes on special agricultural products will be repealed except for tobacco, thus reducing the financial burden on farmers by 4.8 billion yuan annually. Beginning this year, the agricultural tax rate will be reduced by more than 1 percentage point per year on average, and agricultural taxes will be rescinded in five years. The agricultural tax burden on farmers will be reduced by 7 billion yuan this year. The central government will appropriate 39.6 billion yuan this year from its budget for transfer payments to support the reform of rural taxes and administrative charges.”⁶⁴

What happens at sub-provincial level

Despite numerous changes of national tax regime during last two decades, its influence, for the most part, effected on the provincial level because of the guideline of devolution of central authority and promotion of local incentives (*fangquan rangli*). For instance, during the overhaul of tax reform 1994, the central government issued documents⁶⁵ to explicitly stipulate administrative and tax-shared rules on

⁶¹ Guowuyuan guanyu jinyibu zuohao nongcun shuifei gaige shidian gongzuo de tongzhi (Circular of the State Council concerning furthering rural tax-for-fee pilot reform), (24 March 2001).

⁶² Guowuyuan guanyu quanmian tuijin nongxun shuifei gaige shidian gongzuo de yijian (Circular of the State Council on guidance concerning well-round furthering rural tax-for-fee pilot reform), (27 March 2003).

⁶³ See Wen Jiabao's talk on national conference for rural tax-for-fee pilot reform, 3 April 2003.

⁶⁴ See Xinhua News, 16 March 2004, www.chinaview.cn

⁶⁵ Guowuyuan guanyu shixing fenshuizhi caizheng gaunli tizhi de jueding (Decision of the State Council concerning implementation of tax-sharing fiscal administrative system), (15 December 1993); Shixing “fenshuizhi” caizheng tizhi hou youguan yusuan guanli wenti de zanxing guiding (Provisional regulation on issues concerning budgetary administration under tax-sharing fiscal administrative system), (Jointed issued by Ministry of Finance, the People's Bank of China and SAT on 18 December 1993).

central-provincial level whereas simply suggested provinces improve sub-provincial fiscal administration in line with tax-sharing system⁶⁶. Thus, provinces were endowed with considerable discretionary power in implementations of central policy and took full advantage of such leeway to achieve local interests. Aiming at sub-provincial diversity, our field research covers provincial, prefecture, county and township level in Zhejiang and Jiangsu province, among which we mainly focuses on township level since it is the lowest governmental administrative level directly interacting with the local economic regime and shouldering heavy task assigned from superior. Moreover, as a base of pyramidal governmental system, the fiscal function of township determines the stability of national macro-economy⁶⁷. Based on two cases of M⁶⁸ and L⁶⁹ township and in-depth interviews with officials, scholars and entrepreneurs, we perceive two separated tax regimes at sub-provincial level, especially at township level, presents effective considerable diversities in terms of various preferential tax policies which diverge from a unified one promulgated by the laws and regulations. Actually, a circle of tax revenue inflow and budgetary expenditure outflow shapes the local tax regime due to local incentives encouraging economic development. Meanwhile, under current financial management system, upper jurisdictions biting off lower level's financial revenue exacerbates the latter's financial strain and, then, compels lower level government to accumulate revenue through new sources and means.

⁶⁶ Caizhengbu guanyu wanshan sheng yixia fenshuizhi caizheng guanli tizhi yijian de tognzhi (Circular of the Ministry of Finance on issues concerning improving sub-provincial fiscal administrative system under tax-sharing system), (26 March 1996).

⁶⁷ See e.g. Gang Zhu, Yuanhong Zhang and Jun Zhang, *Jujiao Zhongguo Nongcun Caizheng (Focus on Rural Finance in China)*, (Shanxi: Shanxi Jingji Chubanshe, 2000); Tanzhen Sun, *Xiandai Zhongguo Nongcun Caizhwng Wenti Yanjiu (Study on Rural Fiscal Problems in Modern China)*, (Beijing: Jingji Kexue Chubanshe, 1995).

⁶⁸ Situated at 10 minutes distance to Suzhou, Jiangsu province, M township covers 34 square kilometers with population of 53,000 in 2003.

⁶⁹ L township is located at 15 kilometers away from Hangzhou, capital of Zhejiang province and covers 43 square kilometers with population of 60,000 in 2003.

Stretching tax regime in hidden ways

As fiscal reach of the state, the sub-provincial tax regime not only covers conventional taxes, including central, local and central-local shared taxes, but also stretches into extrabudgetary revenue, a supplement to formal budget system in names of funds, surcharges and fees, and a new off-budgetary revenue source, proceeds of land-sale⁷⁰. Such revenue elements of taxes, quasi-taxes and extraction of ownership indicate the local state still on the march of transformation from old “owner-state” surviving upon controlled and owned production means and resources⁷¹ to modern “tax-state” depending upon tax ability to extract surplus from economic sectors⁷².

Currently, 26 taxes are imposed on the economic sector to extract surplus for the state. According to tax collection division, the central taxes and shared taxes are firstly accumulated into central account by state tax bureau and local taxes into local account by local tax bureau. Then, under tax-sharing system, part of central and local tax revenues are allocated into township level ordinary budgetary revenue (We will discuss it later.). Table 7 shows the total tax revenue at the M township of 129,082,000 RMB in the first-half-year 2003 and the per capita is 2253 RMB where central tax revenue dominated by 60.52%.

[insert table 7 here]

Extrabudgetary revenue originated in 1950 initiatively to finance local government’s earmarked expenditure and remained a minor revenue resource before 1980. However, it experienced a vicious spiral and became a major part of local revenue entering 1980s that induced central state’s enforcement of control and overhaul on it.⁷³ According to legal definition⁷⁴, the budgetary revenue is composed

⁷⁰ In China, due to public ownership of lands, the transaction is carried out in an alternative way of transferring usage right for certain period, e.g. 20, 30 or 50 years.

⁷¹ John Campbell, “An Institutional Analysis of Fiscal Reform in Postcommunist Europe”, *Theory and Society*, Vol. 25 (1996), pp. 45-84.

⁷² Joseph A. Schumpeter, “The Crisis of Tax State” (1918), in Richard Swedberg (eds.), *Joseph A. Schumpeter: The Economics and Sociology of Capitalism*, (Princeton: Princeton University Press, 1991).

⁷³ See e.g. Christine Wong, *Financing Local Government in the People’s Republic of China*, (Hong Kong: Oxford University Press, 1997); “Fiscal Dualism in China: Gradualist Reform and the Growth of Off-budget Finance”, in Donald J. S. Brean (eds.), *Taxation in Modern China*, (New York: Routledge Press, 1998); Gang Fan,

of tax revenue, proceeds from state-owned assets, special revenue and other revenue while extrabudgetary revenue consists of administrative service charges, funds, and surcharges on taxes which are either levied by laws and regulations or authorized by the State Council, the provincial government or corresponding financial and price regulation departments. And these two sorts of revenues are subject to on-budgetary administration. With regard to above characteristics, the current extrabudgetary revenue is the same as tax with legal coercion and obligation in nature. Regardless of significant difference of specific names and items listed on the budgetary sheet (Table 8 and 9), they similarly function as the extraction of the state from economic sector. Therefore, the tax regime spread out over extrabudgetary revenue in non-tax means. In the first-half-year 2003, extrabudgetary revenue of M township reached 28.23% of total tax revenue and 54.77% of total financial revenue with 36,437,500 RMB (Table 8). L township presented extrabudgetary revenue of budgetary fund revenue, earmarked fund revenue and other revenue and held a striking high ratio of actual extrabudgetary revenue (136,797,300 RMB) to total financial revenue (180,950,100 RMB) at 75.60% in 2003 (Table 9).

[insert table 8 and 9 here]

As off-budgetary revenue, proceeds of land-sale are kept in a separated account and partly allocated into the financial revenue pool under extrabudgetary account to finance extra expenditure (We will discuss it later.)⁷⁵ according to the need of budget balance in that local financial department are forbidden to make deficit. Faced tightening administration and supervision on extrabudgetary revenue, township government, to a greater extent, appeal to proceeds of land-sales as a hidden and safe

“Lun gonggong shouzhì de xingüifan (New Norms of Public Revenue and Expenditure)”, *Jing Ji Yan Jiu (Economic Studies)*, Vol.6, (1995), pp. 34-43; “Market-oriented Economic Reform and the Growth of Off-budget Local Public Finance”, in Donald J. S. Brean (eds.), *Taxation in Modern China*, (New York: Routledge Press, 1998) for detailed discussion

⁷⁴ *The Budget Law of People’s Republic of China* (Promulgated by the Second Session of the Eighth National People’s Congress on 22 March 1994); Guowuyuan guanyu jiaqiang yusuanwai zijin guanli de jue ding (Decision of the State Council concerning enforcement of administration on extrabudgetary capital), (6 September 1996)

⁷⁵ The county, prefecture or provincial (not township) land resource bureau is the authority to sanction and operate land transactions. The proceeds stay on a separated account in corresponding financial bureau.

revenue source via market transaction of usage right of lands. In fact, the wave of privatising state-owned or collective-owned assets (SOEs, TVEs, etc.) has already released most resources controlled by township government and made land a sheet anchor of them in hand for remaining direct influence in economic sector and extracting economic rents. Unsurprisingly, the proceeds of land-sales become the backbone of extrabudgetary revenue. As in M township, the proceeds of land-sale shows up 49.27% of actual extrabudgetary revenue (Table 8) and in L township, this ratio hit 83.24% in 2003 (Table 9). In addition to profits on one-off land transaction, some township government like M township establish special business company to develop lands and buildings and, then, lease them to private enterprises so that such rents form sustainable income source and, particularly, stay under off-budgetary management for township.

Complex tax-sharing system with biting-off effect

Compared to relative simple and rule-based central-provincial tax sharing system, the sub-provincial one is much more complex and arbitrary. As showed in table 10, the M township in Suzhou, Jiangsu province play with complicated rules of the game which consists of 7 sections: shares of central tax revenue, shares of growth part of local tax revenue, ratified budgetary expenditure, ratified budgetary expenditure of financial department, monomial shared tax items, subsidy from superior and remittance to prefecture level. Each section adopts distinct calculations and surrenders to different principles, such as quota-based, growth-based, progressive or regressive sharing, etc.

[insert table 10 here]

Such complex system facilitates superiors to bite off lower level's tax revenue and yields astonishing encroachment. The province, prefecture or county are able to arbitrarily adjust shared ratios and alter shared rules by issuing official documents (*hongtou wenjian*). For instance, as for growth-based shared tax revenue from central taxes, i.e. VAT and consumption tax, in 2003 (Table 11), M township obtained due shared revenue of 6,209,812 RMB at 3.88% of total two taxes revenue. After Suzhou,

superior of M township, grasped 0.6% remittance ratio from M's small cake, the latter merely got 3.28%. In addition, Suzhou increased their bite-off ratio to 1.6% in 2004, which would cut M township's share to 2.06%, optimistically predicted. The division of local shared part (25%) of VAT in Jiangsu province is also unfavourable to lower jurisdiction for the ratio of province, prefecture, district (county) and township is 50:16:6.8:27.2. Obviously, the township still keeps a small share.

[insert table 11 here]

Dual tax regime: tightened versus loosed

Being crucial measure of tax reform 1994, a dual system of taxation management--the state tax bureau and local tax bureau--was introduced to curb central tax revenue shrinkage and resolve the local-tax-revenue-withholding problem. On one hand, state tax bureau collect both central taxes and central-local shared taxes so as to ensure central government's tax revenue; on the other hand, depending on its own agencies, central government are able to effectively enforce central taxation policy and effect regulation and supervision. Thereby, the state tax regime is much more tightened and rigid than local tax regime which is mainly manipulated by local government to serve local interests in spite of nominal compliance with central taxation laws, regulations and policies. The local tax regime is not only flexible of various preferential taxation policies, such as tax refund, rebate, break, exemption, holiday, etc., but also accommodating for negotiable taxable base or duty. In 1993, 1998 and 2000, the central government successively issued circulars to reinforce taxation administration and restrict local preferential taxation policy.⁷⁶ In 2002, the central government even shifted the enterprise income tax and individual income tax that previously belonged to local taxes into central-local shared tax in order to impose

⁷⁶ Guowuyuan guanyu jiaqiang shuishou guanli he yuange kongzhi jianmian shuishou de tongzhi (Circular of the State Council concerning enforcement of taxation administration and restrict control of taxation rebate and exemption), (23 July 1993); Guowuyuan guanyu jiaqiang yifa zhishui yange shuishou guanli quanxian de tongzhi (Circular of the State Council concerning legal enforcement of taxation administration and restricting taxation authority), (12 March 1998); Guowuyuan guanyu jiuzheng difang zixing zhiding shuishou xiangzheng houfan zhengce de tongzhi (Circular of the State Council concerning redressing local government's tax refund policy), (11 January 2000)

hard constrain on them⁷⁷. To some extent, these efforts achieved the proposed purpose. State tax bureaus streamline their administrative structure by scientific labour division of collection, administrative and supervision branch in horizontal level as well as reduction of administrative hierarchy in vertical level, simplify tax registration, declaration and payment procedure by internet service and transparentize taxation policies and administration by periodical news release, online survey, hotline service, and the like. So do local tax bureaus.

Yet, local tax bureau, on the surface, conduct standardized and normative operation in accordance with state tax bureau and central regulations and policies. Indeed, they are only one slice of revenue side of township government. If encapsulate expenditure side, we would hold a complete picture of capital circle for tax regime in effect. As showed in Figure 2, revenues of taxes, funds, surcharges, fees and land-sales flow into financial revenue pool from which partial capital float up to superior and the remainder to finance expenditure package. Besides public expenditure, such as state payrolls, public projects, education, etc., a considerable amount is allocated to supporting local economic sector in names of bonus, grants, subsidy, award and the like in that local governments are forbidden to entitle tax rebate or exemption to enterprises according to central policy, which results in alternatives of changing tax preferential forms into *ex post* reimbursements from local financial department which is out of SAT's administration and even out of Ministry of Finance. Since 1999, L township has enforced various local policies other than central preferential tax policies to promote local economic prosperity and, especially, they intensified promotion measures in 2001 because of increasing pressure of competition for investment between different jurisdictions. Those new enterprises established in 2001 are entitled to *de facto* three-years-exemption of local tax, including VAT, EIT, business tax, etc. For those old enterprises investing in technology innovation above 10 million RMB, they enjoy a three-years tax refund equals to growth part above tax payment in 2001 as a base. In 2003, the tax refund to enterprises under item of

⁷⁷ Guowuyuan guanyu yinfa suodeshui shouru fenxiang gaige fangan de tongzhi (Circular of the State Council concerning issuing reform scheme of income tax sharing), (31 December 2001)

expenditure for industry and transportation reached 37,691,100 RMB at 20.86% of L township's total financial expenditure. Supplementary to single tax preferential treatment, L township invested in infrastructure of 46,309,700 RMB (25.63%) and in education of 64,911,300 RMB (35.93%) to improve investment environment (Table 12). Discounted, or even gratis, land price is another crucial instrument to succeed in jurisdiction competition for investment. Consequently, 40 enterprises from other localities were attracted to L township among 83 new established enterprise in 2003.

[insert figure 2 here]

[insert table 12 here]

Conclusion and policy implication

This article has identified the sub-provincial, particularly township level, diversity and divergence of tax regime from national one and presented comprehensive analysis of findings from field research.

The transformation of local state from “Campbellian owner-state” to “Schumpeterian tax-state” would continue until various funds, surcharges and fees are sorted out by abolishing, integrating, or transforming into tax according to constitution and law. Furthermore, such restructure of local revenue would solve the problem of the tragedy of the commons⁷⁸ that overlapping bases of taxes, funds, surcharges, fees and ownership-extraction serve as a common pool resource overgrazed by various vertical-level governments and, also, transparentize effective tax burden of economic sectors.

To simplify and standardize the sub-provincial tax sharing system is imperative for economic stability in that current complex and arbitrary tax-sharing scheme and confiscatory behaviour of superior would frustrate lower level government and force them misbehave in revenue raising. The arbitrary tax adjustments and inappropriate transfers cause the “ratchet effect”⁷⁹ which spoils lower level government's

⁷⁸ H.S. Gordon, “The Economics of a Common Property Resource: The Fishery”, *Journal of Political Economy*, Vol.62 (1954), pp.124-42; Garrett Hardin, “The Tragedy of the Commons”, *Science*, Vol.162, No.3859 (1968), pp.1243-4.

⁷⁹ Martin L. Weitzman, “The ‘Ratchet Principle’ and Performance Incentives”, *The Bell Journal of Economics*,

incentives to foster local economic development and, thus, increase tax revenues. While less rule-based sharing system would yield the “tax theft problem”⁸⁰ that drive subordinate government to steal shared tax revenue by squeezing revenue from shared to local pool or, even, actively seeking off-budgetary revenue out of national budgetary administration.

On the premise of ensuring unification and authority of taxation law nationwide and the first place of central tax revenue, the sub-provincial government should be granted more power and autonomy over taxation. With consideration of increasing allocation, distribution and stabilization function in context of market economy, the balance between responsibility and budgetary or tax authority should be stroked along various levels of sub-provincial government. To finance their soaring public expenditures and fulfil diversified and growing local demands for public goods, special region-based local taxes instead of nationwide applicable should be levied and authorized by corresponding local government whom are entitled to set tax bases, adjust tax rates, stipulate tax scope, etc., within the limits provided by law. Meanwhile, to endow local government limited right to enforce preferential tax policy would facilitate administration on such effective practice and prevent localities from “racing to the bottom”⁸¹ for investments and enterprises.

In short, based on diverse natural endowments, historical legacies, and current development status, variation and divergence of sub-provincial tax regime are not only unavoidable but also necessary to effect central reform, boost local economic prosperity and stabilize national macro-economy. Simultaneously, local self-interest seeking inevitably drive local government to exploit such disparity and policy leeway in ways of localized adaptation of central policy (*yin di zhi yi*) and, consequently, call for further decentralization.

Vol.11, No.1 (1980), pp.302-8.

⁸⁰ Andrei Shleifer, and Daniel Treisman, *Without a Map: Political Tactics and Economic Reform in Russia*, (Harvard: MIT Press, 2000).

⁸¹ Christopher Grandy, “New Jersey Corporate Chartermongering, 1875-1929”, *Journal of Economic History*, Vol.49, No.3 (1989), pp.677-92.

Table 1: **China's Tax Regime, 1978-1991**

No.	Tax Item
Turnover Taxes	
1	Value-added tax
2	Product tax
3	Business tax
4	Consolidated industrial and commercial tax
5	Particular adjustment tax
6	Customs duties
7	Special consumption tax
Income Taxes	
8	Income tax on state-owned enterprises
9	Income tax on collective enterprises
10	Income tax on individual unit of industry and commerce
11	Income tax on foreign enterprises
12	Income tax on Chinese-foreign Equity Joint Ventures
13	Income tax on foreign business enterprises
14	Income tax on private enterprises
15	Individual income tax
16	Adjustment tax on individual income
17	Tax on bonus of state-owned enterprises
18	Adjustment tax on wage of state-owned enterprises
19	Tax on bonus of collective enterprises
20	Tax on bonus of non-profit enterprises
21	Agricultural tax
22	Tax on special agricultural produce
Resource Taxes	
23	Resource tax

24	Occupied farmland tax
25	Urban and township land usage tax
26	Special tax on burning oil
27	Salt tax
	Property and Behaviour Taxes
28	Real estate tax
29	Urban maintenance and construction tax
30	Vehicle and vessel usage license tax
31	Stamp tax
32	Deed tax
33	Slaughter tax
34	Banquet tax
35	Livestock transaction tax
36	Bazaar transaction tax
37	Orientation adjustment tax on investment in fixed asset
	National Funds
38	Funds for key construction of energy and transportation
39	Adjustment funds for budget

Source:

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

Table 2: The Central and National Financial Revenue in GDP (%), 1978-1993

Year	Central /National Financial Revenue	National Financial Revenue/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

Note:

Domestic and foreign debts are excluded.

Source:

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

Table 3: China's Tax Regime, 1994-2000

No.	Tax Item	Central	Shared ^a	Local
Turnover Taxes				
1	Value-added tax (VAT)		X	
2	Consumption tax	X		
3	Business tax			X ^b
4	Customs duties	X		
Income Taxes				
5	Enterprise income tax		X	
6	Income tax on FIEs and FEs ^c	X		
7	Individual income tax		X	
8	Agricultural tax			X
9	Tax on special agricultural produce			X
10	Animal husbandry tax			X
Resource Taxes				
11	Resource tax			X ^d
12	Urban and township land usage tax			X
13	Occupied farmland tax			X
Property and Behavior Taxes				
14	Real estate tax ^e			X
15	Urban real estate tax ^e			X
16	Land appreciation tax			X
17	Urban maintenance and construction tax ^f			X
18	Stamp tax		X	
19	Deed tax			X
20	Vehicle acquisition tax	X		
21	Vehicle and vessel usage license tax			X
22	Vehicle and vessel usage tax			X

23	Vessel tonnage tax	X
24	Slaughter tax ^g	X
25	Banquet tax ^g	X
26	Orientation adjustment tax on investment in fixed asset ^h	X

Notes:

- a. The taxes in the category of shared mean they will be shared by the central and local government based on predetermined formulas.
- b. Business taxes on Ministry of railway, headquarters of banks, headquarters of insurance companies belong to central state while the rest belong to local state.
- c. Enterprises with foreign investment (FIEs) include Chinese-foreign equity joint ventures, Chinese-foreign contractual joint ventures and wholly foreign-owned enterprises established in China; Foreign enterprises (FEs) include foreign companies, enterprises and other economic organizations that are not Chinese legal entities, but have establishment or places in China and are engaged in production or business operations. The nominal tax rate of income tax on FIEs and FEs is 33% in which 30% belongs to central state and 3% local state.
- d. Resource tax on ocean and petrol companies belong to central state while the rest belong to local state.
- e. Real estate tax is applicable to domestic enterprises and Chinese citizens; while urban real estate tax is applicable to FEs, FIEs and foreigners.
- f. Urban maintenance and construction tax on Ministry of railway, headquarters of banks, headquarters of insurance companies belong to central state while the rest belong to local state.
- g. According to a circular (Guofa[1994]No.7) issued by the State Council, local government should decide to remain or abolish the slaughter tax and banquet tax.
- h. The Ministry of Finance (MOF), State Administration of Taxation (SAT) and National Development and Reform Commission (NDRC) jointly issued a circular (Caishuifa[1999] No.299) to suspend levying the orientation adjustment tax on investment in fixed asset.

Source:

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

Table 4: **Central-local Shared Taxes and Shared Rate**

Shared Taxes	Central	Local
VAT ^a	75%	25%
Enterprises income tax ^b	50%(2002)	50%(2002) ^c
	60%(2003)	40%(2003)
Individual income tax ^e	50%(2002)	50%(2002)
	60%(2003)	40%(2003)
Stamp tax	94% of taxes on security transaction	6% of taxes on security transaction
		Other stamp taxes

Notes:

- a. VATs collected by the Customs are excluded.
- b. Enterprise income taxes on Ministry of railway, headquarters of banks, ocean and petrol companies belong to the central government. The EIT on other domestic enterprises was local fixed tax before 2002 while became the shared tax after then.
- c. The shared rates change based on central government's decision.
- d. Taxes on individual interests belong to the central government. The IIT was local fixed tax before 2002 while became the shared tax after then.

Source:

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

Table 5: Tax Collections by Authorities

Collection Authority	Items
State tax bureaus (STBs)	Consumption tax, VAT, income tax on enterprises ^a , Income tax on FIEs and FEs, stamp tax on security transaction, vehicle acquisition tax
Local tax bureaus (LTBs)	Business tax, individual 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 (collected by Customs), consumption tax (collected by the Customs), 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 (domestic) are collected by the local tax bureau; while for those after that the EIT are collected by the state bureau. EIT on central government owned enterprises, ministry of railway, headquarters of banks, ocean and petrol companies are also collected by the state bureau.
- b. Individual income tax became shared tax in 2002 but it is still collected by the local tax bureau.

Sources:

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

Table 6 Composition of National Tax Revenue, 2003

Tax Items	Percentage
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%
Income tax on FIEs and FEs	3.45%
Individual income tax	6.93%
Real estate tax	1.58%
Other Taxes	7.29%

Source:

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

Table 7 Total Tax Revenue Raised by M township, Jan.-Jun. 2003 (RMB)

No.	Item	Actual amount	Percentage (%)	Per capita ^c
1	Central tax revenue ^a	72,266,200	60.52	1364
2	Local tax revenue ^b	47,136,300	39.48	889
3	Total	119,402,500	100	2253

Notes:

- a. Item 1 is VAT and consumption tax collected by state tax bureau.
- b. Item 2 excludes taxes collected by local financial department, i.e. agricultural tax, occupied farmland tax, deed tax, etc.
- c. The population was 53,000 in the end of 2003.

Source:

Respondent 24

Table 8 Total Financial Revenue of M township, Jan.-Jun. 2003 (RMB)

No.	Item	Actual amount	Percentage (%)
1	Total financial revenue ^a	66,526,500	100
2	Budgetary revenue	30,089,000	45.23
3	Shared tax revenue from superior	21,223,200	
4	Reimbursement of revenue target	8,500,000	
5	Earmarked subsidy	365,800	
6	Extrabudgetary revenue	36,437,500	54.77
7	Fee for sanitation&landscaping	475,700	
8	Fee for land transaction	3,487,900	
9	Fee for sewage disposal	3,400,000	
10	Surcharges on education fee	2,716,700	
11	Other revenues ^b	26,357,200	
12	Fee for public utility ^c	-	
13	Water rates ^c	-	
14	Fee for family planning	35,200	
15	Banking interests	23,000	
16	Tax refund from superior	7,576,800	
17	Subsidy from superior	200,000	
18	Proceeds of land-sale	17,952,200	49.27 ^d
19	Fee for public security	420,000	
20	Other revenue	150,000	

Notes:

- a. 1=2+6
- b. 11=12+13+14+15+16+17+18+19+20
- c. Item 12 and 13 are transferred to financial department in the end of the year.
- d. Proceeds of land-sale are 49.27% of extrabudgetary revenue.

Source:

Respondent 24

Table 9 Total Financial Revenue of L township, 2003 (RMB)

No.	Item	Actual amount	Percentage (%)
1	Total financial revenue	180,950,100	100
2	Budgetary revenue	44,152,800	24.40
3	Shared tax revenue from superior	32,930,500	
4	Reimbursement of revenue target	8,288,200	
5	Earmarked subsidy	2,794,100	
6	Other subsidy	140,000	
7	Budgetary fund revenue	9,848,400	5.44
8	Surcharges on rural education fee	8,348,400	
9	Surcharges on education fee	1,500,000	
10	Earmarked fund revenue	25,972,300	14.35
11	Revenue from owned enterprises ^a	11,000,000	
12	Revenue from departments/institutions ^b	2,314,200	
13	Water conservancy construction fund	632,300	
14	Proceeds of education-assets-sale	3,740,000	
15	Other	8,285,800	
16	Other revenue	100,976,600	55.80
17	Proceeds of land-sale	80,668,400	83.24 ^f
18	Fee for land transaction	16,256,100	
19	Revenue from welfare enterprises ^c	3,075,900	
20	Agriculture subsidy	976,200	

Notes:

- a. Township government gains dividends based on shares owned in the enterprises.
- b. Some governmental departments or institutions are authority to charge fees for certain service.
- c. Some of welfare enterprises are public enterprises that hire disabled people.
- d. $1=2+7+10+16$
- e. Extrabudgetary revenue= $7+10+16=96,907,479$ RMB, 75.60% of total financial revenue.
- f. Proceeds of land-sale are 83.24% of extrabudgetary revenue.

Source:

Respondent 26

Table 10 Shared Scheme of Tax Revenue at M township, 2003 (RMB)

No.	Item	Amount	Remarks
1	Shares of central tax revenue	6,209,900	Three brackets of progressive shared ratio based on the growth part of VAT and Consumption tax; 1=7+8+9
2	VAT and Consumption tax	160,078,800	2=3+4
3	VAT	159,606,100	
4	Consumption tax	472,700	
5	Revenue target	120,172,100	Total tax revenue of VAT and Consumption tax in 2002
6	Actual growth part	39,906,700	6=2-5
7	Shares based on 0-12% part of item 5	1,730,500	Shared ratio 12%; 7=5*12%*12%
8	Shares based on 12-15% part of item 5	540,800	Shared ratio 15%; 8=5*(15%-12%)*15%
9	Shares based on above 15% part of item 5	3,938,600	Shared ratio 18%; 9=(6-5*15%)*18%
10	Shares of growth part of local tax revenue	42,076,700	10=15*shared ratio+16*(1-20%)*shared ratio; Shared ratio is 50% in 2003. The 20% here is the share of provincial level and the rest is shared between township and county level.
11	Local tax revenue	96,846,200	11=local tax revenue-urban maintenance and construction tax-urban and township land usage tax-land appreciation tax + income tax (2001)*60%+deed tax*90%+other
12	Revenue target	11,333,700	Task assigned by superior
13	Revised revenue target	12,467,100	13=12*110%
14	Actual growth part in 2003	84,379,100	14=11-13
15	Actual growth part in 2000	13,122,700	The calculation is the same as the 14.
16	Surplus	71,256,400	16=14-15
17	Ratified budgetary expenditure	8,575,300	According to document issued by Wuzhong district financial department.
18	Budgetary expenditure of financial department	425,000	According to document issued by Wuzhong district financial department.
19	Monomial shared tax items	5,662,400	19=20+21+22+23+24+25

20	Urban maintenance and construction tax	3,645,300	20=UMCT in 2003-UMCT in 2000
21	Urban and township land usage tax	81,900	21=Urban and township land usage tax in 2003*20%
22	Land appreciation tax	349,600	22=Land appreciation tax in 2003*(1-20%)*80%
23	Tax on special agricultural produce	-	
24	Occupied farmland tax	975,000	24= Occupied farmland tax in 2003
25	Surcharges on urban education	610,600	25=Surcharges of urban education in 2003*(1-3%)*40%
26	Subsidy from superior	3,754,500	e.g. subsidy for agriculture tax from the central state
27	Remittance to prefecture level	1,701,600	26=total revenue*0.6%; Suzhou possess 0.6% of total revenue from township level.
28	Total shared tax revenue	65,002,100	28=1+10+17+18+19+26-27

Source:

Respondent 24

Table 11 Actual Growth-based Shared Revenue from VAT and Consumption Tax at M township, 2003 and 2004 (RMB)

No.	Item	2003	2004	Remarks
1	VAT and consumption tax	160078800	210000000 ^a	Total tax revenue of VAT and Consumption tax collected.
2	Revenue target	120172100	160078800	Total tax revenue of VAT and Consumption tax collected in last year.
3	Growth part above revenue target	39906700	49921200	3=1-2
4	Share based on 0-12% part of growth part	1730478	2305135	Shared ratio 12%; 4=2*12%*12%
5	Share based on 12-15% part of growth part	540774	720355	Shared ratio 15%; 5=2*(15%-12%)*15%
6	Share based on above 15% part of growth part	3938559	4663688	Shared ratio 18%; 6=(3-2*15%)*18%
7	Due shared revenue	6209812	7689178	7=4+5+6
8	Remittance to prefecture level	960473	3360000	8=1*remittance ratio; (0.6% 2003, 1.6% 2004)
9	Actual shared revenue	5249339	4329178	9=7-8
10	Actual shared percentage (%)	3.28%	2.06%	10=9/1

Note:

- a. This is the predicted figure based on revenue task 2004.

Source:

Respondent 24

Table 12 Total financial expenditure of L township, 2003

No.	Item	Actual amount	Percentage (%)
1	Total financial expenditure	180,655,300	100
2	Agriculture	4,439,400	2.46
3	Industry and transportation ^a	37,691,100	20.86
4	Recreation and cultural	8,146,700	4.51
5	Education	64,911,300	35.93
6	Health and hygiene	3,457,200	1.91
7	Financial and statistic departments	220,000	0.12
8	Social protection	4,144,200	2.29
9	Retirement pension for administrative departments	209,800	0.12
10	Administrative expenditure	9,561,700	5.29
11	Urban maintenance and construction	46,309,700	25.63
12	Other expenditure	1,564,200	0.87

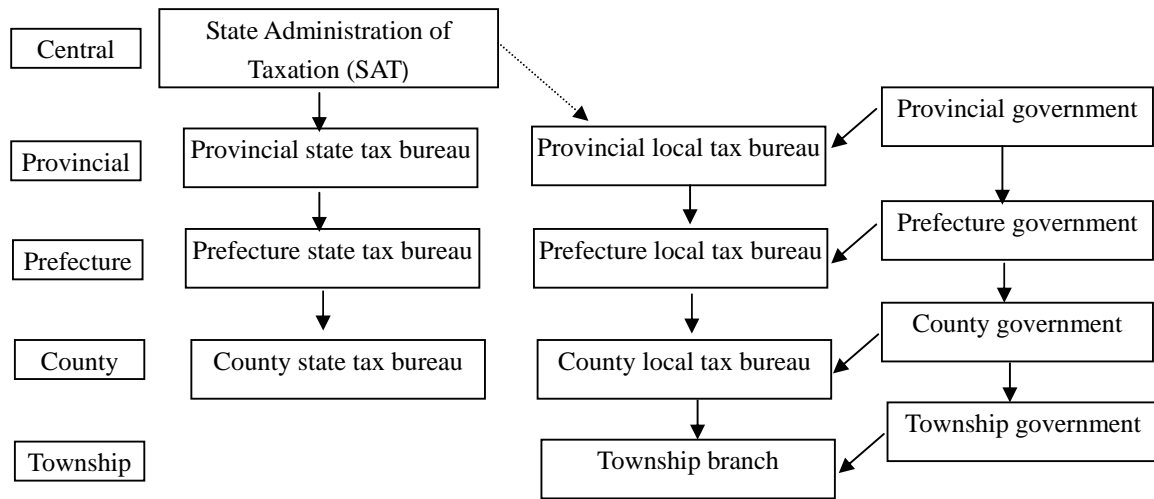
Note:

- a. Such expenditure actually is local tax refund of L township to enterprises.

Source:

Respondent 26

Figure 1: **Structure of Taxation Administration**



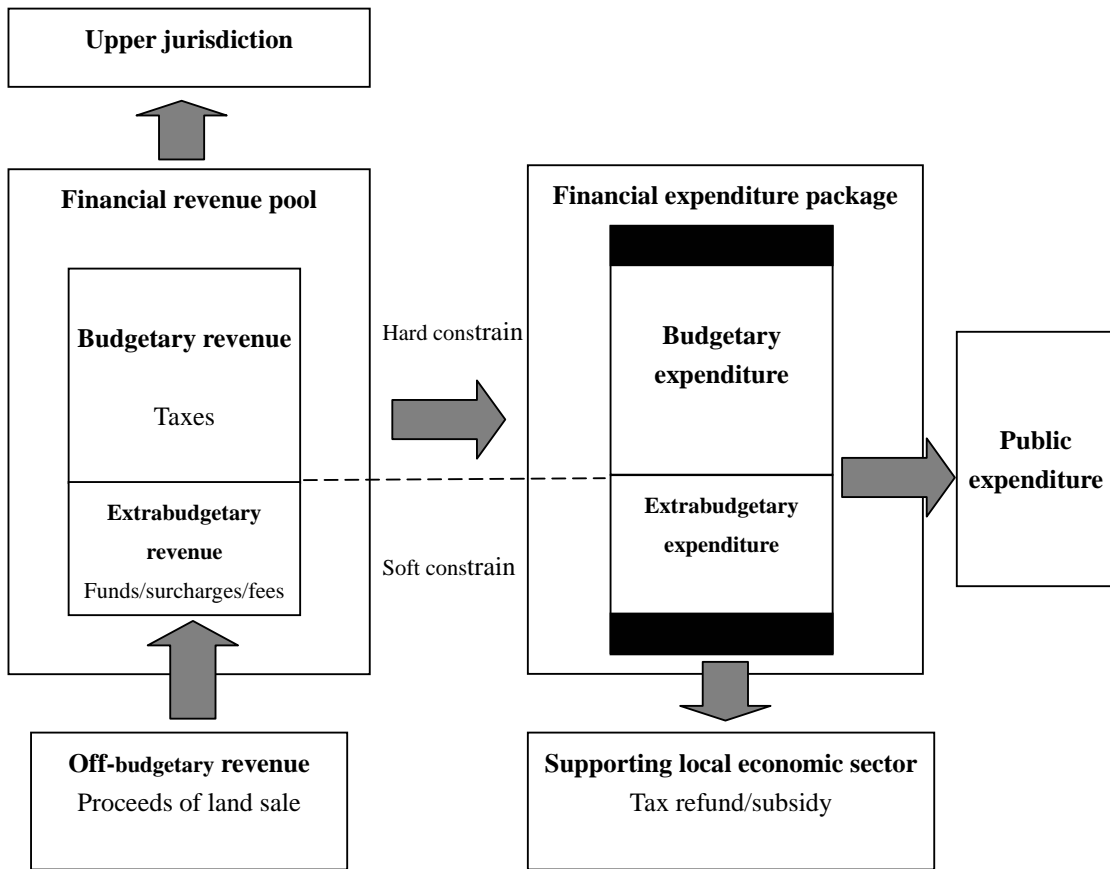
Notes:

- a. The hierarchy of taxation administration is corresponding to government administrative structure.
- b. The black line refers to vertical leadership.
- c. The dashed line refers to operational guidance.

Source:

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

Figure 2 **Financial Revenue and Expenditure at Township Level**



Note:

- a. Shadow part of expenditure refers to extra expenditure of actual amount.

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