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China's Emerging Tax Regime: Local Tax Farming and Central Tax Bureaucracy

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China's emerging tax regime: Local tax farming and central tax bureaucracy*

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Abstract: China like other transition economies needs to establish a tax system compatible with a market economy, in particular, an efficient tax administration system with capable tax bureaucrats. The paper singles out the general and China-specific features by which central government attempts to accompany economic transformation via tax farming to tax bureaucratisation in tax administration. Based on empirical study in two provinces this paper shows that without including local government agencies and their budgets, China's fiscal federalism cannot be analysed and argues that China's emerging tax system depends on the institutional and organizational design that shapes the interaction between central government, local governments and economic agents.

Key words: Tax governance, Tax farming, Tax bureaucratisation, Fiscal federalism
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The decline of budget revenue as share of national income which dropped from 31 per cent of GDP (1978) to 18 per cent (2002) (CSY 2003) describes the withdrawal of the Chinese state from the economy, and therefore suggests a step forward in the country's transformation from a command to a market economy. Yet, economic transformation asks not only for less state appropriated of resources by the state, it also asks for a change of the *means* by which the state does so. Generally speaking, there are four ways to generate budgetary revenues: first, exploitation of state owned/controlled resources; second, taxation of assets and income or trade flows; third, forced loans on economic agents and finally, *seigniorage.* Given the commitment to price stability the Chinese reform policy forces the national government to rely on the first three revenue sources. Yet, privatisation, and shrinking profits of increasingly uncompetitive state firms translate into lower income from the state sector, while revenues from forced loans, i.e. compulsory transfers of the firms' cash flow and compulsory saving of private households decline following price and wage liberalisation. Subsequently, state expenditure depends increasingly more on taxation, which needs to be revised to comply with the reform course.

This shift in state revenue sources draws attention to the fact that *transition economies need to establish market conforming taxation.* Three aspects can be singled out. First, new tax codes need to include the re-emerging private sector, such as firms or investors, and foreign companies. Second, a new system of intergovernmental transfers needs to replace the old planning bureaucracy allowing for decentralisation. Third, a new tax bureaucracy needs to be established. In contrast to the European transition economies, which right from the beginning copied tax codes from neighbouring countries (or the EU), China opted for incremental reform of its tax system. In other words, economic transformation includes a thorough reform of the country's *public finances* asking for a separate analysis.

While the traditional public finance theory (see e.g. Musgrave 1959, 1969) propagating rational financial systems concentrate on the effectivity of taxation (and

spending) with respect to well-defined goals, the public choice literature treats the state as a Leviathan (see e.g. Brennan and Buchanan 1980; Mueller 1989) and sees fiscal federalism (see e.g. Oates 1972; Olson 1969) as institutional remedy. The trade off between rational taxation versus small government (expenditure) was taken up again in the discussion of institutional change in transition economies, where two opposing hypothesis define the conceptual and empirical discussion, namely the "Grabbing Hand"- hypothesis (Frye and Shleifer 1997; Shleifer and Treisman 1999) pointing to the risk that the Leviathan will survive economic transformation, and the "Helping Hand"- hypothesis (see e.g. Oi 1992; Walder 1995) stressing the benefit of continuing state intervention during the transformation period. The China specific dimension of this debate centres around three features, local autonomy, local diversity, and tax farming.

Local autonomy

The descriptive analysis of China's fiscal reform since 1978 concludes that fiscal decentralisation whether intended or not, generated local autonomy. Some studies attribute China's success to a market-preserving federalism that empowers local governments and offers them positive incentives for promoting local economic growth (see e.g. Montinola *et al* 1995; Weingast 1995; Qian and Weingast 1996, 1997; Qian and Roland 1998). For example, *local state corporatism* (Oi 1992, 1994, 1995) describes the local government as a business corporation which mobilizes resources *ad hoc*, offers preferential tax policy, or brokers bank credit as means to insure profitability of its tax base. Such form of corporatism based on a loosely coupled coalitions (Nee 1992, 1998) between local government agencies and the emerging private sector leads to minimised up-ward tax transfers and facilitates the privatisation from below (Naughton 1994) when the industrial base of a locality can be added to the local tax base.

In the case of Township and Village Enterprises (TVEs), local governments act as

quasi-owners when they claim residual profit and as quasi-tax-legislators when they levy taxes on TVEs provided these are registered as firms "outside the planned economy". Subsequently, this institutional setting not only secures local property rights in a weak market setting and uncertain institutional environment (see e.g. Weitzman and Xu 1994; Chang and Wang 1994; Li 1996), but also gradually releases resources from state control accompanied by a shift of revenue sources from direct expropriation of profit or cash flow to taxation of firms in the non-state sector.

Local diversity

Characterised by a severe principal-agent problem between the central government as the principal and local units as agents, fiscal decentralization must also lead to local diversity (Krug 2004a; Krug and Hendrischke 2003; Hendrischke 2003). First, the central government grants different "degrees" of independent decision-making to different local government agencies (Bird and Chen 1998) as in the case of Special Economic Zones. Second, different local government agencies react differently to the same central policy guidelines according to different local conditions, such as size, geography, the historical legacy and different resource endowments (Krug 2004b; Hsu 2004). Third, jurisdictional competition forces local governments to generate competitive advantages by offering preferential taxation and subsidies to its tax base (Walder 1995, 1996). Fourth, a co-operation between locally embedded firms and government agencies facilitates shirking of tax transfer obligations (Wedeman 2003; Shirk 1993; Wank 1996; Chen and Rozelle 1999; Goodman 2000)[1].

Tax farming

A crucial means to offer positive incentives to local government agencies is tax farming as established in the eighties already. The tax farming system widely used in the pre-modern states of England and France is well analysed in economic history and transaction cost literature (see e.g. Kiser 1994; Kiser and Kane 2001; O'Brien 1988;

Donald and O'Brien 2002; Weir 1989; White 1995, 2004)[2]. It was only after the Glorious Revolution and French Revolution that a centralized tax bureaucracy was developed in response to changing transaction costs, i.e. enforcement costs, and the expansion of financial markets, which offered an alternative means for financing state budgets. An economic analysis of tax systems argues that two factors influence institutional choice: the monarch's (state's) attitude toward (economic or political) risk and the incentives necessary to prompt lower administrative units to act as tax agencies (at low costs). In general, three different forms of tax systems can be singled out, usually described as contractual arrangements between the central state and the local agents put in charge of tax implementation, a *rent-based*, a *wage-based* and a *(crop-) sharing contractual arrangement* (see e.g. Stiglitz 1974; Sappington 1991; Allen and Lueck 1995). The first refers to a lump sum contract-type where the central state "farms out" tax authority to local governments in return for a guaranteed (low risk) fixed sum. By doing so, local tax agents become the residual claimant on tax revenue. The second wage-based arrangement refers to a professional *bureaucracy* which in return for a share of the national budget, fixed wages and promotion within the state bureaucracy "selflessly" implements central policy without bearing individually or organisational risks. The third form follows *cropshared contracs* in which both central as lesser and local governments as lessee share economic risk productivity gains in tax administration (cropping sharing contract).

Interestingly enough, China had a Weberian bureaucratic system in the socialist era. However, starting at 1978, the Chinese government introduced tax farming, to be followed (in the nineties) by a sharing system and the re-introduction of a bureaucratic system, a phenomenon that asks for an empirical analysis. Does that kind of institutional choice follows the arguments offered by the analytical concepts? More precisely, what are the factors that prompted institutional change from one system to the other?

1. Normative considerations, such as taxing "equal activities equally";
2. Distributional considerations, most prominently the problem of regional

disparities;

3. Economic considerations, such as standardization gains or transaction costs in monitoring and enforcement;
4. Political considerations such as conflicting interests between the central and local government agencies, or setting incentives that ensure local government agencies to comply with the reform course.

As will be shown in what follows the different reforms aimed mostly at a mixture of all these motives. However, at the end the economic and political considerations prevailed.

A second set of questions refers to the present state of affairs: What is the effect of the tax reform in 1994? How did the local governments react? What is the *status quo* of the tax system at the local level at the lowest governmental level, the township? What can we say about the *de facto* as opposed to the *de jure* tax system?

In order to analyse local autonomy caused by taxation, and to answer the questions above, it is necessary to explore not only the recent history. Such an analysis needs also to *endogenise* formal and informal elements in actual tax policy. For this reason findings from fieldwork undertaken in Zhejiang and Jiangsu province 2004 and 2005 will be included in the part that deals with the actual functioning of the tax system at the township level.

The remainder proceeds as follows. The next section (sec. 1 - 3) presents a descriptive analysis of the different reforms since 1978. Each section will stress the causes of and effects of institutional change with respect to local autonomy and local diversity. The *status quo* analysis of present tax system (sec. 4) serves as an introduction to the analysis of how the present tax system and local autonomy interact at the lowest layer of government in China (sec. 5) in order to illustrate the difference between the intended functioning of the tax system and the actual interplay between the taxation

and the emerging market sector. The paper ends with summarising the empirical results and an general assessment of China' s tax system (sec. 6).

1. Rebuilding tax codes: shifting government revenue

In the pre-Reform era three categories of indirect taxes, the industrial and commercial i.e. tax, tariffs and custom duties, and the agriculture tax[3] were levied in China[4]. State-owned enterprises (SOEs) were subject to the industrial and commercial tax in addition to the compulsory transfer of "profit" and cash flow. Tax revenue (1978: 46 per cent) and profit remittance (1978: 51 per cent) were the two dominant resources of total revenue (MOF 2005). To increase productive efficiency while avoiding privatisation the reforms introduced first a "contract responsibility system" (*chengbao zeren zhi*) to be followed by a "tax-for-profit" scheme (*li gai shui*) in 1983 and 1984. Both reforms acknowledged the SOEs as independent economic actors entitled to part of profit which they could allocate internally to working capital, investment, wages, and bonus without state intervention as long as they fulfilled the contract quota. The share of after tax profit and the tax rate were subject to individual negotiations between the firm and the bureaucracy in charge of the firm and varied according to enterprise size, sectors and *ad hoc* situation. It quickly turned out that in response to the fuzzy property rights the SOE managers channelled undisclosed profit into their private pocket by establishing joint ventures with TVEs or by outsourcing production to new private firms rather than reinvest in productivity increasing change (the Ratchet effect; Weitzman 1980). That asset-stripping eroded the state sector's profitability further and ended in sharp increase of loss making SOEs. Yet, with a state sector still not liable to a hard budget constraint (Kornai 1986), the underperformance of the state sector directly translated into higher government expenditure in form of subsidies or loans necessary to "bail out" the bankrupt SOEs. The situation was further aggravated when the non-state sector started to out-compete the SOEs further reducing the latter's profit remittance and tax contribution. In 1985 already, subsidies for SOEs were eleven times higher than the revenues from SOEs (MOF 2005). Facing

such eroding revenue base the central government had incentive enough to search for a new broader tax base, namely one that included foreign enterprises and all forms of joint ventures.

Thus, direct (income) taxation made its re-appearance in China to which foreign enterprises, joint ventures, SOEs, collective enterprises and individuals became subject to. Simultaneously the reforms of indirect taxes started with introducing a VAT for twelve categories of products, such as machinery, steel, but also consumer goods, such as bicycles, electric fan, or sewing machines with rates between 6 per cent and 16 per cent. Other economic transaction were taxed by a product tax (270 items) subject to a flat rate varying from 3 per cent to 60 per cent (and salt a tax) in 1984. Such a diversified tax structure increased the monitoring and enforcement cost for tax collection and administration considerably. Unsurprisingly the 1994 reforms abolished the product tax, expanded VAT to all manufactured products with a standard rate of 17 per cent (and a reduced rate of 13 per cent for necessities), and levied a business tax on service industry but kept the consumption tax on 11 categories of goods.[5] Since then in total twenty-nine taxes have been levied on turnover, income, resource, property and behaviour[6]. Since then indirect taxes are the major revenue source of the Chinese state. At present (2003) the VAT, consumption tax, business tax and custom duties add up to 69 per cent of total tax revenue, the VAT alone providing 36 per cent of total revenue (SAT 2003).

All in all, the reforms of 1994 support the assumption that tax changes can (and will) follow transaction costs considerations, i.e. monitoring, collecting and enforcement costs when indirect taxes were introduced. As was pointed out elsewhere indirect taxation allows concentrating on few taxable assets thereby offering lower collection costs than a system that aims at assets or income of all (potential) tax payers (Kiser and Kane 2001; Ardant 1975). China's WTO entry in 2001 prompted further changes in order to comply with international standards. Foreign (15 per cent income tax) and domestic (25 per cent income tax) firms will no longer be treated differently by the

tax authorities (Mui and Jia 2002). The scope of VAT will be expanded to cover a broader range of products. A new social security and property tax are aim at better coping with economic transformation which includes employment insecurity and increase in wealth.

All in all, the institutional change within the tax systems reflect the attempt to define a tax base and establish tax codes compatible with a market economy. The description also shows that transaction costs played a major role when it came to designing and re-designing the tax base, and tax rates.

2. Tax farming: positive incentives and local autonomy

Fiscal decentralisation in China refers to taxation and intergovernmental fiscal relations, i.e. the allocation of revenue and expenditure across different government levels, based on a decentralisation of regulatory power or agreed upon transfers. The inherited centralised fiscal system relied on local government agencies to collect revenues for transfer to the national treasury. In return the central government assigned (expenditure) items financed basically by re-transferring revenues to local budgets. Labelled as "eating from the big pot (*chi da guo fan*)" local agencies had neither an incentive to promote the local economy, nor did they have the leeway to do so.

To redress this problem, the reforms started with transferring fiscal authority, i.e. the power to tax, to local governments. Several experiments were carried out, such as "fixed overall revenue sharing rate" in Jiangsu province in 1977, "dividing central, local and central-local sharing revenue" in Sichuan province in 1979 and "fixed lump sum transfer" in Guangdong and Fujian province in 1979, later (1980-1993) expanded to six types of contract arrangements (see e.g. Oksenberg and Tong 1991; Wong 1991, 1992). It is worth mentioning that these fiscal arrangements are modifications of tax contracting analytical models described earlier[7].

Empirical fieldwork suggests that the rental-based model quickly emerged as the dominant form. In this kind of tax contracting the central government negotiates a fixed share of revenue (in absolute terms, or as a ratio) leaving the local government the *de facto* residual claimant of revenue. From the local perspective, local disposible revenues were directly linked to economic growth and/or the attractiveness of the local economy for investment from outside (other jurisdictions or foreign companies). Yet, as suggested in the economic analysis of tax farming, three unintended consequences emerged: First is the principal-agent problem remains unsolved. Local governments profit from asymmetric information; hiding the correct information if not falsifying tax reports is an easy way to minimise the amount of tax revenue to be transferred to the contract partner whether the national treasury or any superior government agency. Second, re-negotiable contracts include an element of uncertainty in local budget planning as well as in anticipating budgeting across localities. With the length of contracts and the sharing formulas re-negotiable, future budgetary revenue depends less on economic trends but rather on the relative power position of the contract partners. Contract arrangements vary also with respect to sharing rates, or time period, or spatial factors, when some provinces, regions, or localities are granted special licences from the central government. Third, as all "agents" share the interest to minimise upward transfers and manipulate the tax base, the state's financial base eroded even further. Whether measured as total government revenue per GDP, or central revenue as share of total government revenue during the 1980-1993 period the trend is the same: The ratio of total government revenue to GDP fell from an already low 26 per cent in 1980 to 13 per cent in 1993. The share of the central revenue to total government revenue fell from 41 per cent (1984) to 22 per cent (1993) (Figure 1).

[insert figure 1 about here]

All in all, the introduction of tax farming reflects three considerations of the Chinese

government: First, to mobilise local support for the implementation of the reform course; second, to link the self-interest of local government agencies to the economic performance of their local jurisdictions and third to offer enough flexibility in the tax system that the widely differing local conditions can be taken care of.

3. Tax sharing: bureaucratising tax administration

In the face of shrinking revenue the central government attempted to re-centralise tax authority in the reforms of 1994 by building up a central tax bureaucracy regarded to more effectively implement tax collection. Yet, not much unlike the monarchs in Europe before them (Kiser and Kane 2001) the central government had to accept that local autonomy is not easily disposed of. The Tax Sharing System (*fen shui zhi*) (see e.g. Wong 1997; Wong *et al* 1995) aimed at replacing locally negotiated tax farming with a unified national system of taxation. Aside from the re-centralisation effort, the change was expected to address three further issues. An unified tax system would ensure equal taxation for equal transactions and tax base. A higher share of central revenue would ensure that distributional effects can be mitigated, as the system of local autonomy knew no provision (and no incentive) for inter-provincial transfers. (A third intention, namely the abolishment of extra- and off-budgetary revenue sources will be dealt with separately.)

The newly introduced tax sharing system does not refer to a separation of tasks between different layers of government to which specific sources of revenues (taxes) are allocated as in “Western” models of multi-layered government, such as federalist states or the EU for example. Instead, the tax revenue (and not tax legislation) are divided in such a way that some taxes are exclusively assigned to the central level, some are assigned exclusively to the local level, and some taxes are shared between both levels according to a fixed ration. It is worth stressing that the category of local revenues includes fees and other kinds of revenue which are manipulated by local

governments. As table 1 illustrates these local taxes encompass a variety of fees and taxes, which reflect the willingness and ability to tap local resources when they concentrate on the taxation of relatively immobile factors rather than following an economic policy of generating competitive advantages for a locality[8]. At first sight the tax sharing system seems to follow international practice in the sense that the two largest revenue sources, namely the VAT and income tax, are divided between the central and local level (see table 2). That revenues from tariffs go directly to the national coffer is also common standard. On the other hand the socialist legacy can be seen in the fact that the income taxation of foreign firms remains a concern of the central government.

[insert table 2 about here]

To better cope with the monitoring and enforcement problem the tax administration was split into two separate bureaucracies each of which with a distinctive line of command. The national tax bureau (*guoshuiju*, NTBs) subordinate to the State Administration of Taxation (SAT), which in turn is defined as a ministry (since 1993), was put in charge of central and shared taxes[9]. While the SAT is autonomous with respect to central taxes, its role changes when it comes to local taxes administered by local tax bureaus (*dishuiju*, LTBs), the second tax bureaucracy. As stipulated by the law, the SAT and local government “jointly” supervise the LTBs, which in the case of the SAT limits its role to operational guidance (*yewu zhidao*) and comment on nominations for tax personnel to the provincial LTBs (Figure 2). In other words, LTBs in particular below the provincial level are *de facto* subordinated to local governments leaving the institutional architecture of local autonomy as it were.

Unintended, the tax reforms established a *dual tax system* where a streamlined *Weberian* bureaucracy for central taxation (including those taxes whose revenue were to be shared with local units) and largely unreformed local tax farming co-exist. A closer look at the reforms indicates that the reason for such top down

bureaucratisation is to be found in the shortage of professional tax personnel able to run a modern centralised tax administration, and the lack of modern monitoring devices that would keep the costs of tax collection (and moral hazard)[10] low.

[insert figure 2 about here]

Aside from the introduction of computer based monitoring devices, a system of merit-based recruitment and systematic training (0.4 million national and 0.35 million local tax officials in 2002 alone) is seen as the first necessary step for shifting toward a bureaucratic tax system at all levels of government. At the same time the personnel deployment policy which asks for out of place-of-origin appointments and job rotation is seen as a means to prevent corruption following stricter legislation as stipulated in the *Law on the Administration of Tax Collection* (1995) and the amendment to the *Criminal Law* which explicitly addresses the problem of tax collection and dereliction of duty on taxation (1997).

While the initial purpose to increase the financial means in control of the central state was achieved[11] the more detailed analysis shows that the system was rather ineffective with respect to establishing as rational unified tax codes and tax bureaucracy. Tax farming is still the dominant institutional architecture at the lower level of the state political and administrative system. Once more transaction cost considerations – and the need to compromise politically with local politicians and agencies, prevail in institutional choice.

4. The status quo of the tax system

It is worth emphasizing that all reforms in the last three decades were directed toward the provincial level, while sub-provincial government agencies were rarely mentioned. General recommendations, such as to "promote" local initiatives (*fangquan rangli*) or

to “adjust” for local conditions (*yindi zhiyi*) left the provinces with considerable leeway to modify central policy. Thus, for example the 1994 reform merely stipulates that provinces improve sub-provincial fiscal administration without giving further directions. This neglect needs to be interpreted as the political compromise in which in particular rich provinces or sub-provincial government agencies saw their discretionary power re-confirmed in return of compliance with other parts of the reform programme, as for example the building up of a national tax bureaucracy outside the reach of “local” control.

Ad hoc non-tax levies

One of the most striking difference between the Chinese and international tax systems are the so-called extra-budgetary revenues (EBRs) and off-budgetary revenues (OBRs), two devices inherited from the socialist past yet in the nineties re-invented for ad hoc taxation, and for legitimising the income from commercial activities (see e.g. Wong 1997, 1998; Fan 1998; Eckaus 2003).

Extra-budgetary revenues (EBRs) originated in 1950 as a means to search for more financial means for local specially earmarked expenditure. It includes three major parts: 1) government funds and surtaxes, such as agriculture surtax, and education surtax, levied on the income, consumption, profit or turnover base; 2) a hold up of special funds of SOEs, such as depreciation, major repair, and innovation funds; and 3) locally self-raised funds and administrative fees, such as road construction fund, public utility fee, road toll, and tuition fee[12]. OBRs on the other hand are public “voluntary” contributions made by individuals, firms or Overseas Chinese, various unregulated fees, and lately, profits from TVEs, and revenues from land sales (Fan 1998). Lacking uniform procedures with respect to computation, base, rate, or frequency means that in fact, EBRs (or OBRs) are quasi-taxes. Their ambiguous legal status adds support to the notion of strong local autonomy in today’s fiscal system (Wong 1998).

EBRs and OBRs were hardly worth mentioning if they had not been hijacked by local governments in the nineties for legitimising new revenue sources. As said before local governments have no tax legislation power and are only entitled to collect "local tax" legislated by the national government whose total amount cannot but add to a minor faction of local budgets (Table 3). Yet, driven by local self-interests and disposable revenues maximization, local governments are motivated to search for additional revenues sources whether entitled to do so or not. They sell state assets, invest in business activities, apportion mandatory contributions to local projects, issue local bonds, or levy (il-)legal service charges, the proceeds of which are listed as EBRs and OBRs in order to suggest legitimate revenue sources. As will be shown later (Figure 4 and 5) the revenues from commercial activities for which there is no precedent in the socialist era became the largest source for local income in particular in the rich East. Profit or local taxes on TVEs (or dividends) as well as proceeds from land deals and real estate management can make local government agencies independent from central budgetary control. EBRs and OBRs are used to legitimise revenue maximisation, a further evidence for the resistance of local levels to give up local autonomy.

[insert table 3 about here]

EBRs and OBRs remain a controversial issue in analytical studies. Some studies stress the negative influence on economic stabilization, state redistribution capacity and fiscal administration (see e.g. Wong 1998; Lee 2000), while others emphasize its positive outcome in form of local wealth as measured in the provision of local public goods and services, such as school or heath care (see e.g. Fan 1998). In some places, such as the less-developed inland regions, arbitrary EBR- or OBR-extraction led to rural protest and violence (Bernstein and Lü 2003; Tsui and Wang 2004). On the other hand, in costal and developed provinces, the advantages of EBRs or OBRs is seen in

the ability of local government agencies to quickly respond to local public needs, if not as a starting point for more civil participation in local policy formation (shown in Fan's (1998) field research).

Complicated intergovernmental transfer system

There is still no procedure how to co-ordinate intergovernmental transfers between the five layers of the administrative hierarchy: central, provincial, prefecture, county and township. The present tax sharing system only deals with the central-provincial level and leaves considerable discretionary power for sub-provincial transfer practices. Diversity within the sub-provincial intergovernmental transfer system is unavoidable. The 1994 reforms did not tackle the problem, to the contrary it became even more complicated by adding the new transfer modes of national taxation.

Under the previous tax farming system, local governments transfer the contracted lump-sum amount, a progressive sharing ratio on incremental revenue, or a fixed sharing ratio of overall revenues (or combination of all these). In return the central government re-transfer subsidies to the province according to the agreed upon fixed amount, earmarked purposes or *ad hoc* appropriation of local budget surpluses (*jiesuan*) at the end of fiscal year. Aside from the former negotiable transfer system, the present reforms introduced the rule-based transfer for the national taxes supervised by the SAT. For instance, local governments are entitled to the re-transfer of 25, 40 and 40 per cent of the VAT, corporate and individual income tax respectively.

In other words, the tax farming nature of sub-provincial intergovernmental relations is kept unchanged. Superior layers of government farm out taxation to lower layers. Such a tax contract describes the agreed upon share of tax revenue to be transferred to the superior level as well as the agreed upon provision of public services invested and

operated by the lower level. Negotiations between different levels of local governments on transfer and re-transfer of revenue became a constant feature of local intergovernmental relations. Regardless which version of tax contracting is chosen, two systematic features dominate the effects: First, as a "lessee" and residual claimant, each agency at the lower level attempting to maximize discretionary revenue will shift expenditure for public services upwards while manipulating the tax base to minimise upward transfers (Tsui and Wang 2004). Second, as will be seen presently, effective tax rates do not reflect tax legislation; they are rather the outcome of intergovernmental tax contracting, and the unsolved principal agent problem, or reflect the innovativeness of sub-provincial government agencies in finding new revenue generating resources.

Dual tax administration system

As said earlier, two tax systems co-exist in China. One is defined by national legislation which stipulates the tax base, tax rates, the procedure by which taxes are enforced, and how total revenue is shared between the central and local budgets (consolidated at the provincial level). The other one is characterized by provincial and sub-provincial discretion and tax contracting, *ad hoc* taxation, and unspecified procedures. This dual tax system has major implications: First, firms can calculate the effective tax rate 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 will differ in their revenue generating policy, subsequently contributing to the diversity in the local business environment. Finally, the national treasury or central government has only limited ways of controlling overall taxation. The most recent reform focused only on the revenue and central-provincial sharing side and cut off the link to the government spending. Moreover, the "tax-for-fee" reform launched since 2000 attempting to put an end to the practices of sub-provincial government agencies using *ad hoc* fees (Yep

2004) aimed at closer budgetary control, yet also on limiting the overall tax burden for overcharged peasant households, i.e. distributional purposes. The effect was minimal if not counterproductive as it forced local governments to generate even more revenue sources by embarking on commercial activities.

5. M and L Township: Budgets and intergovernmental transfer

Taxation in China is undoubtedly a bizarre institutional arrangement where different tax jurisdictions overlap and procedures are left unspecified, or burdened with a political rhetoric that confuses even the technical side of tax collection. How does this system work in practice? With only few information available at the local, i.e. prefectural, county and township, level, data need to be generated before a systematic analysis can be attempted. The authors decided to focus on the lowest level of the political and administrative hierarchy, namely the township, as this is the government agent, which meets the tax payer (in most cases firms)[13]. On the factual side we wanted to know how the dual tax system affects local budgets, and how intergovernmental transfer contributed to local revenues. At the behavioural side, we wanted to know how the effective tax rate for firms is calculated, how much disposible income townships have and how they make use of their disposible funds. Finally, we expected that the answers to this question would shed more insights on the problem of diversity and local autonomy. The interviews conducted between 2003 and 2005 cannot answer all these questions. Instead of offering general interpretations based on weak evidence (and much guessing), we decided to present two case studies which to the best of our knowledge offer the first complete picture of budgets and budgetary procedures in two townships, called M and L.

Revenues

The budgets of the two townships presented in Table 4 and Table 5, offer different

pictures which is partly caused by different ways to categorise revenue items. Township M classifies all revenue into two categories only, namely budgetary revenue and extra-budgetary revenue, while Township L is much more specific. In the latter case revenues as listed as budgetary revenue, budgetary fund revenue, earmarked fund revenue and "other revenue" (Table 4). This practice confirms the findings from the World Bank (2002, p. 64) that there is no standard procedure for reporting revenues at the local level.

[insert table 4 about here]

After reclassifying the revenue item (in Table 5), a direct comparison reads as follows: Township M depends much more on taxation (45.2% of total financial revenue) and extra-budgetary revenues (22.3%) than Township L (24.4% and 11.6%, respectively). To put it differently "other revenue" the category were revenue from commercial activities are listed, contributes 32.5% in Township M, yet 64% in Township L suggesting that the latter is more involved in land deals, TVE shareholding and other business activities. It is worth emphasizing the returns from TVEs (dividends or profit) contribute 9.9% of total revenue compared to the proceeds from land sales plus local tax on transaction, which add up to 53.6% of total revenue!

[insert table 5 about here]

Intergovernmental transfer

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. Instead the transfers follow the bargaining between government agencies, and between the township and firms. The interviews in Township M suggest three features that characterise transfer practice at the township level.

1) The Township M has to share revenue with four superior government layers of district (county level), prefecture, province and central. Interaction between these different layers of government agencies is partly *statutory*, i.e. based on legislation, and partly resulting from previous negotiations. At the time of the interview seven transfer modes were employed. Aside from the standardised sharing rules supervised by the SAT, a negotiated sharing of "excess" tax income, as for example more revenue from VAT than anticipated in the tax contracts for a budget year (see below). Other sharing formulas address "approved budgetary expenditure", "approved budgetary expenditure of financial department", "other shared tax items", "subsidy from superior units" and "remittance to the prefecture level". Each mode follows distinctive formulas such as quota-based, growth-based, progressive or regressive rates. For instance, in the tax contract for 2003 M Township agreed to collect 120 million RMB in VAT and consumption tax on behalf of the SAT. The actually collected amount added up to 160 million, which was not allocated according to the usual 75:25 percentage formula between the centre and the local units. Instead the M Township is entitled to a bonus based on the 40 million of "excess" revenue. The calculations follows a 'progressive' rate: 12% bonus for the first 12% of the excess revenue (1.73 million), 15% bonus for the following 12-15% of excess revenue (54 thousand) and 18% bonus for any excess beyond 15% (3.94 million). The total amount of the thus calculated bonus added up to 6.2 million considerably lower than the 10 milllion the local tax agencies would have been entitled to, if the usual tax sharing formula had been applied (Table 6).

[insert table 6 about here]

2) Superior government agencies, such as the province, prefecture or county can and will press for a sharing formula which squeezes the township of the tax income generated at the township level. All what is needed is a document called *hongtou wenjian*. This form of state capture (Hellman 1998) can be illustrated by the way the

bonus on VAT collection got allocated to different layers of government. For instance, Township M bonus whose calculation was described above was entitled to a share of 3.88% of total revenue of VAT and consumption tax generated in the township. Yet, Suzhou city superior to M township appropriated 0.6% of the total revenue, leaving M township with 3.28%. Even worse, for 2004 Suzhou plans to increase “its” share to 1.6%, which would cut Township M’s share to 2.06% (Table 6).

3) The general picture for Jiangsu province looks as follows. Out of the 25% which according to national legislation go to local units in case of the VAT and consumption tax, 50 per cent are claimed by the provincial government, 16 per cent are claimed at the prefectural level, 6.8 percent remain at the county level, and only 27.2 per cent remain in the township. Likewise, the actual division of total tax revenue collected by Township M in 2003 will be split as follows 40 per cent central budget, 27 per cent provincial budget, 10 per cent prefectural budget, 5 per cent district (county) budget and 18 per cent township budget. Unsurprisingly the local government officials in officials in Township M “lament that they are sacrificed for superior officials” . They as obviously most other townships search for alternative revenue sources via commercial activities, which after all are off-budgetary activities.

Expenditures

Only after looking at the revenue and expenditure side, can the complete picture of financial flows around the local tax system be seen. One major reason why the expenditure side needs to be integrated into the analysis of intergovernmental transfer and local budgets is the fact, that tax farming between the township and the tax payer shows up at the expenditure side. As said before the township cannot change or modify tax legislation, while at the same time having a strong incentive to cultivate a wealthy tax base, if not to expand the tax base by attracting additional investment. Thus, the tax contracts between the township and individual firms do not prescribe lower tax rates for example. Instead tax rebates or exemption, bonus, grants, subsidy,

or awards are negotiated which promise *ex post* reimbursement for taxes paid. These rebates are usually listed as means for supporting the locals economic sector.

[insert figure 4 about here]

Thus for example, L Township grants all firms established since 2001 a three-year exemption (via *ex post* reimbursements from local budget) from VAT, enterprise income tax and business tax. Likewise, firms investing more than 10 million RMB in technological innovation enjoy a three-years tax refund. These refunds show up in the expenditure side of the Township L (Table 7) under industry and transportation item in 2003, reaching 38 million RMB at 20.9% of Township L's total financial expenditure. In addition to tax preferential treatment, Township L invested in 46 million RMB (25.6% of total expenditure) in infrastructure and 65 million RMB (35.9% of total expenditure) in education to improve investment environment. Another means for jurisdictional competition are land prices, which at a discounted rate can be used for attracting investment. As township L claims it was this policy, which enabled them to attract 83 new established enterprises in 2003, out of which forty enterprises were from other localities.

[insert table 7 about here]

To sum up, tax faming at the lowest administrative level defines the *effective tax rate* for firms, i.e. by far the largest taxpayer. The effective tax rate can be calculated only ex post, as the rate depends on reimbursement in the following year. Jurisdictional competition between lower level government agencies exists and thrives; yet alimented by local returns from commercial activities of government agencies rather than by “tax design”. Intergovernmental transfer is renegotiable and a way how in particular the middle-layers of government, such as prefecture and county can appropriate a share on tax revenue. 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 amount needed for fulfilling the mandatory tasks, keeping the agreed upon commitments to different groups, such as firms and the money needed for running local government. In a second step, the township negotiates with all other local government agencies the volume of tax revenue to be transferred and re-transferred. As the township knows from past experience the range of transfers and re-transfers it can kind of anticipate a deficit or surplus. The township will simultaneously, in a third step, search for additional revenue sources outside the bureaucratic tax system. In short, *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.

6. Conclusion

China's tax system is unique. We don't know of any other case where a national tax bureaucracy and local tax farming co-exist. It would however be misleading to interpret this co-existence as a case where the socialist legacy prevails. To the contrary, the institutional change in taxation is the deliberate response to the political and economic development in China's economic transformation.

First, aside from the rhetoric, the *reforms were driven by transaction cost considerations* and political compromises. Each reform step reveals the search for a broader tax base, and enforcement mechanism, which increase the administrative efficiency. Second, the tax system and its changes *serve as a means to better align the interests between* the different layers of government agencies. Unlike other countries where taxation defines hard (budget) constraints and state enforcement agencies, China's tax system offers positive incentives for its tax agents which in return for

compliance to the national tax codes, if not the whole reform programme, are entitled to residual tax revenue. Third, tax farming harnesses local autonomy. I*t offers townships a resource base outside central control.* It is worth stressing that local autonomy in China is not the consequence of a constitutional separation of power, but the consequence decentralisation, i.e. the transfer of regulatory power to local agencies, and the transfer of resources that enable local jurisdictions, such as the township to finance local policy. Fourth, unsurprisingly then, tax farming must contribute to diversity in economic outcomes as well as diversity in the institutional architecture at the local level. It is hard to find evidence which would support the Grabbing Hand -or state seizure-hypothesis (Northrup and Rowan 1963; Fry 2002) on the one hand and the Helping Hand- or state capture hypothesis (Hellman 1998) on the other hand which claim that over time the central state will increasingly appropriate more resources in the case of the former; or that the alliance between the business community and local government agencies will over time subvert the institutional architecture to better serve their own self-interest. Both would imply the emergence of informal if not illegal organisations and institutions, while the tax farming bargaining game is part of the official tax system. From this point of view the local *tax farming can be seen as an ex ante device for limiting, if not even legitimising, ex post opportunism* (of the tax agents). Finally, jurisdictional competition seems to work, limiting overall taxation. This does not mean however that China can expect a corporatist state with as many local business and tax systems as townships or counties. As the interviews indicate, imitation of good (tax) practices in neighbouring localities will lead to a at least regional convergence of the *de facto* tax systems, if not tax practices.

Table 1: **China's Tax Codes after 1994**

	Taxes
National tax	Consumption tax, Tariff, Income tax on FIEs and FEs [a], Vehicle acquisition tax
Local tax	Business tax [b], Agricultural tax, Tax on special agricultural produce, Animal husbandry tax, Resource tax [c], Urban and township land usage tax, Occupied farmland tax, Real estate tax [d], Urban real estate tax [d], Land appreciation tax, Urban maintenance and construction tax [e], Deed tax, Vehicle and vessel usage license tax, Vehicle and vessel usage tax, Vessel tonnage tax, Slaughter tax [f], Banquet tax [f], Orientation adjustment tax on investment in fixed asset [g]
Shared tax	Value-added tax (VAT), Enterprise income tax [h], Individual income tax, Stamp tax

Notes:

a. Enterprises with foreign investment (FIEs) include Chinese-foreign equity joint ventures, Chinese-foreign contractual joint ventures and wholly foreign-owned enterprises; Foreign enterprises (FEs) include foreign companies, and other economic organizations that are not Chinese legal entities, but operate in China. The nominal income tax rate on FIEs and FEs is 33% of which 30% are allocated to the central, and 3% to the local government.

b. Business taxes on railway, headquarters of banks or insurance companies go to the central government.

c. The resource tax on ocean and petrol companies go to the central government.

d. Domestic enterprises and Chinese citizens are subject to the real estate tax while FEs, FIEs and foreigners are subject to the urban real estate tax.

e. Urban maintenance and construction tax of the Railway Administration, the headquarters of banks and insurance companies go to the central government.

f. According to State Council circular (Guofa[1994]No.7) local government are expected to abolish the slaughter tax and banquet tax.

g. 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.

h. Income tax of the enterprises subordinate to the central government, local banks, foreign-funded banks and non-bank financial institutions are allocated to the central government.

Source:

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

Table 2: **Central-local Taxes: Sharing Formula**

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

Notes:

a. Before 2002 the "corporate income tax" on domestic enterprises was a local tax, since then it is a shared tax.

b. Taxes on capital gains go to the central government. Before 2002 the personal income tax was a local tax, afterwards it became a shared tax after.

Source:

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

Table 3: **Tax Collections by Authorities**

Collection Authority	Items
National tax bureaus (NTBs)	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	Tariff, VAT (collected by Customs), consumption tax (collected by the Customs), vessel tonnage tax
MOF/LTBs [c]	Agricultural tax, tax on special agricultural produce, animal husbandry tax, deed tax, and occupied farmland tax

Notes:

a. The local tax bureau collects corporate income tax of those domestic firms established before 1 January 2002. The SAT collects the same tax of younger firms. Corporate income tax on central government owned enterprises, ministry of railway, headquarters of banks, ocean and petrol companies are also collected by the SAT.

b. Individual income tax became shared tax in 2002 but it is still collected by the local tax bureau.

c. Before 1996, Ministry of Finance (MOF) collected occupied farmland tax, deed tax, agricultural tax, tax on special agricultural produce and the animal husbandry tax, to be replaced bay local tax bureaus.

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 4: **The revenue side of M and L Townships' Budgets**

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	
Extra-budgetary 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: User charges asked by those units that provides the service, i.e. usually public utilities, are not fees in budgetary terms but charged by the providers directly (Eckaus 2003, 78)

Source: Respondent 24 & 26 (2004)

Table 5: Composition Revenue, 2003: M and L Township

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
Extra-budgetary 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 (2004)

Table 6: **A case of state capture: Sharing VAT and Consumption Tax Revenue M township, (2003 -2004 in mil. RMB)**

No.	Item	2003	2004	Remarks
1	VAT and consumption tax	160	210 [a]	Total tax revenue collected.
2	Revenue target	120	160	Total tax revenue collected in last year.
3	Growth part above revenue target	39	49	3=1-2
4	Share based on 0-12% part of growth part	1.73	2.31	Shared ratio 12%; 4=2*12%*12%
5	Share based on 12-15% part of growth part	0.54	0.72	Shared ratio 15%; 5=2*(15%-12%)*15%
6	Share based on above 15% part of growth part	3.94	4.66	Shared ratio 18%; 6=(3-2*15%)*18%
7	Township entitlement to share	6.21	7.69	7=4+5+6
8	Remittance to prefecture level	0.96	3.36	8=1*remittance ratio; (0.6% 2003, 1.6% 2004)
9	Actual shred revenue	5.25	4.33	9=7-8
10	Actual shared percentage (%)	3.28%	2.06%	10=9/1

Note:

a. predicted figure based on revenue task 2004.

Source:

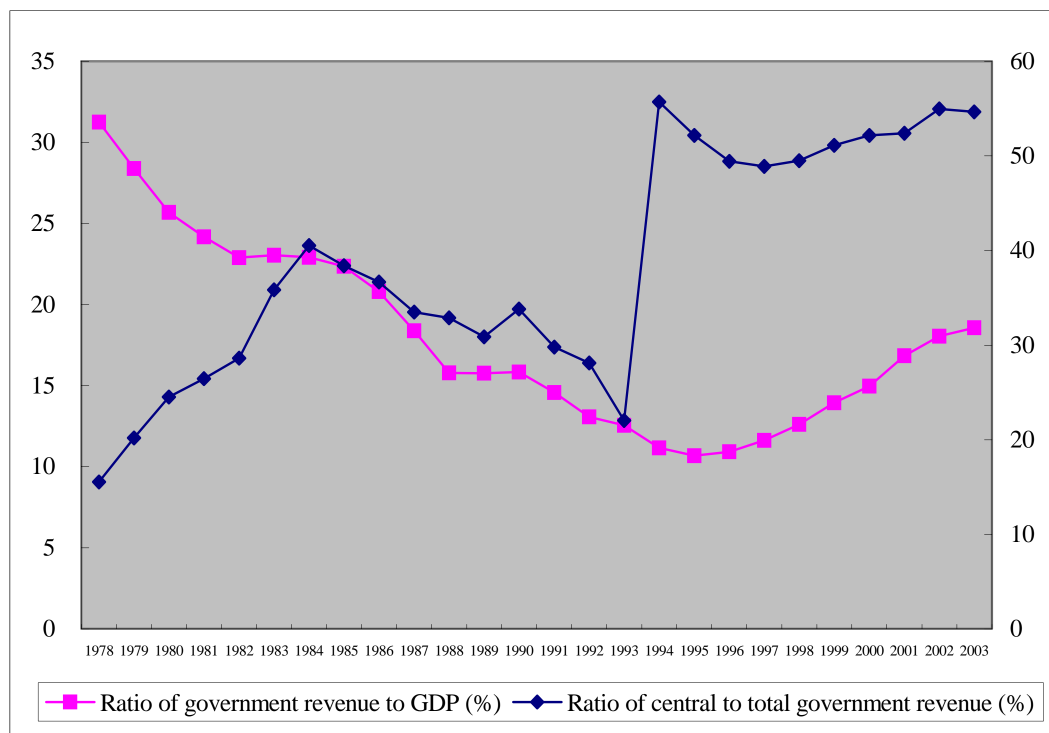
Respondent 24 (2004)

Table 7: The Expenditure Side of L Township' Budget, 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 (2004)

Figure 1: **Ratio of government revenue to GDP and central to total government revenue**



Notes:

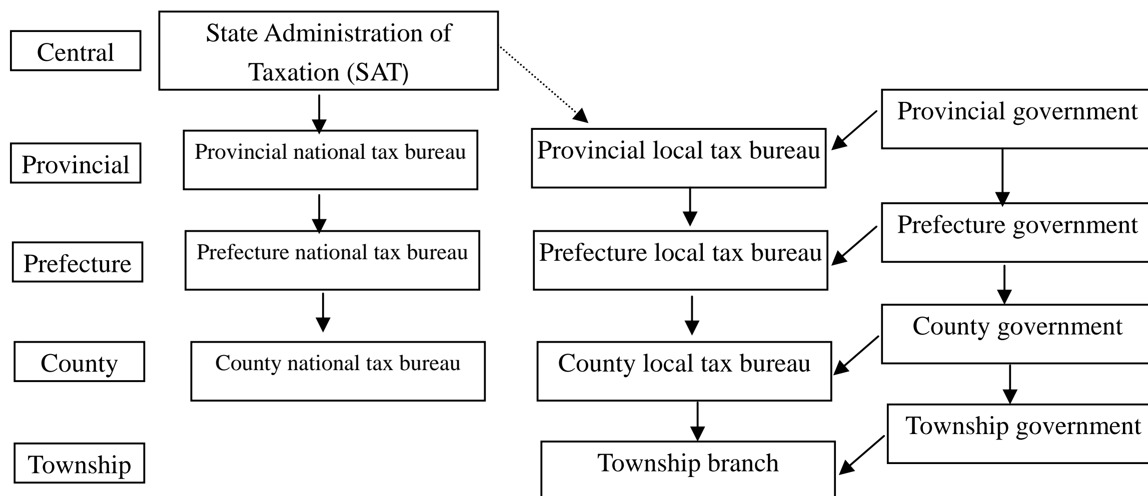
a. The government revenue refers to budgetary revenue.

b. Domestic and foreign debts are excludes.

Source:

State Administration of Taxation, PRC, China Statistical Yearbook 2003 (Beijing: China Statistics Press, 2003)

Figure 2: **Structure of Taxation Administration**



Notes:

c. The hierarchy of taxation administration is corresponding to government administrative structure.

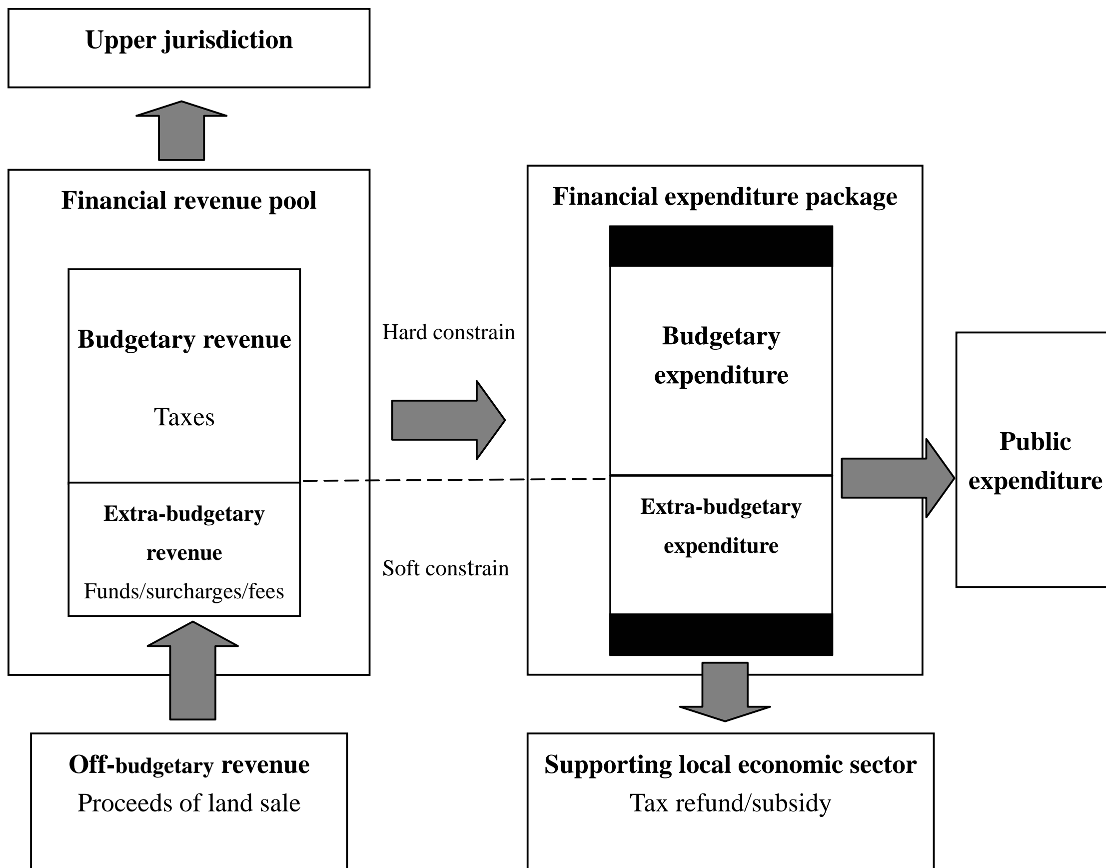
d. The black line refers to vertical leadership.

e. The dashed line refers to operational guidance.

Source:

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

Figure 3 **Financial Revenue and Expenditure at Township Level**



Note:

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

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1 There is a measurement problem. With the notable exception of World Bank (2002), most studies stop at provincial level (see e.g. Wong 1991, 1992, 1997; Wong et al 1995; World Bank 1990, 1993, 1995; Brean 1998; Ma 1995; Oksenberg and Tong 1991; Chung 1995; Lee 2000; Tsui and Wang 2004; OECD 2005) due to the lack of statistical data to the effect that a systematic analysis across provinces, prefectures, counties (districts) and townships is missing.

2 The French as well as the tax farming system in Imperial China "farmed out" tax authority not only to lower administrative levels but also to private persons.(Lit ChinaXXX)

3 Totally 13 taxes were levied after 1973 which were industrial and commercial tax, consolidated industrial and commercial tax, industrial and commercial income tax, tariff, cattle transaction tax, bazaar transaction tax, urban real estate tax, vehicle and vessel usage license tax, vessel tonnage tax, slaughter tax, agricultural tax, animal husbandry tax, and deed tax.

4 Except the urban real estate tax and industrial and commercial income tax.

5 Consumption tax encompasses eleven tax items and often enough serves as an educational tax discouraging the consumption or use of luxury products, such as cigarettes, liquor, cosmetics, jewellery, firework, gasoline, diesel oil, car tyre, motorcycle, and cars.

6 In fact, total tax items are 26 not 29 because inheritance tax, security transaction tax and fuel tax are not levied yet. An illustration of the tax system can be found in table 1.

7 For those rich provinces, they may keep certain portion of increment revenue based on preset shared ratio or formula while those poor provinces received subsidies and grants from the central government.

8 This is known in public finance as Ramsey rule (1927): immobile factors are more vulnerable to tax as the exit option can be considered at high costs only.

9 The shared tax would be retransferred to local government based on the shared ratio.

10 Thus, for example in order to prevent fraud of VAT invoices, a computer network connecting the SAT and its branches down to the county (district) level, the so-called Golden Taxation Project, - was launched in 1994. By the end of 2002, it had installed 1.4 thousand servers, 25 thousand PC servers and 0.4 million PCs, staffed 26 thousand computer technicians and covered approximately 0.6 million units, i.e. about 45% of taxpayers (SAT 2003)..

11 The ratio of total government revenue to GDP increased from 13% in 1993 to 19% in 2003. The share of the central government revenue to total revenue in 2003 (55%) is about two times of that in 1993 (22%), as shown in Figure 1.

12 Major changes of composition of extra-budgetary revenue in 1993 and 1997 excluded the innovation fund, the major repair fund and government funds.

13 The following findings form part of the larger research project on local autonomy. Both authors want to thank Hans Hendrischke for generously providing us with some findings of his interviews on 2004 and 2005.

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