Società italiana di economia pubblica

WORKING PAPER
No 394
Gennaio 2005

# TAX SYSTEMS AND TAX REFORMS IN SOUTH AND EAST ASIA: CHINA

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JEL CLASSIFICATION: H20, H24, H25, H77

KEYWORDS: Taxation, Tax Reforms, China

# TAX SYSTEMS AND TAX REFORMS IN SOUTH AND EAST ASIA: CHINA

by

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**Abstract**
This paper is part of a wider research on South and East Asia countries' taxation, carried on at the Department of Public and Environmental Economics of the University of Pavia, under the direction of L.Bernardi, A.Fraschini and P.Shome and the supervision of V.Tanzi. Since 1978 China has been carrying out a momentous series of reforms, which have radically changed the economic and social structure of the country - now the world's sixth-largest economy. The recent accession to the WTO will result in further trade and investment liberalization and will call for China to continue and strengthen its domestic economic transformations. The tax system is likely to play an important role in this process. The extensive 1994 reform has undoubtedly represented a positive step on the way towards a more modern tax structure, but has left open some relevant questions, which risk to hamper China's development and prevent the country from reaping the full benefits of integrating in the world economy. The ratio of tax revenue to GDP is still comparatively low and insufficient to accommodate increasing expenditure needs. Income taxes play a marginal role due to favor regime for foreign enterprises and a lot of other preferential treatments. As to indirect taxes, VAT should be extended to cover services now mostly subject to business tax. Further it requires to be changed from being production-based to being consumption-based. Most importantly intergovernmental fiscal relations should be re-examined with a view to improving revenue and expenditure assignments and reducing the resort to extra-budgetary funds. Local governments are almost entirely responsible for social spending, mainly on health and education, and their financial distress has often resulted in intolerably inequitable consequences.

***JEL Classification numbers**:* H20, H24, H25, H77
***Key words***: Taxation, Tax Reforms, China
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January 2005

# 1. Introduction, contents and main conclusions*

The People's Republic of China (PRC) is one of the largest countries in the world, extending over 9,561,000 sq km, and the most populous with almost 1.3 billion inhabitants, more than one third (37.7 percent in 2001) living in urban areas. Despite its size and the presence of ethnic minorities China is a unitary state, comprising twenty-two provinces, five autonomous regions and four municipalities directly under the central government (Beijing, Shanghai, Tianjin and Chongqing). Political power is held by the Communist Party of China: the National People's Congress (NPC) does not usually deviate from the directives of the party's politburo.

After more than two decades of central planning, in the late 1970s China inaugurated the so-called 'reform era' and at the same time started establishing a formal legal system; since then the areas of criminal, civil, administrative and commercial law have been codified. Domestic economic reforms have been supplemented with the gradual opening of the Chinese economy to the rest of the world, which culminated in the accession of China to WTO in December 2001. The spectacular economic growth of the country has been such that China has not been harmed by the recent East Asian financial crisis and indeed is promoting economic recovery in the region.

Economic growth, however, has not always resulted in sustained socioeconomic progress. In the second half of 1990s poverty reduction, especially in rural areas, seems to have slowed and, furthermore, the slowdown has coincided with a rise in inequalities (World Bank 2003).[1] Inter-provincial disparities are a major factor in explaining inequality (Wang 2001). During the 1990s, over 90 percent of all foreign direct investment (FDI) accrued to coastal provinces, while central and western regions still suffer from poor infrastructure and the absence or paucity of markets. Therefore, in March 2004 the NPC, in delineating the Government's priorities, set out a more balanced development agenda, aimed at reducing the rural-urban divide, promoting growth in western regions and in the old industrial bases in the northeast and laying more emphasis on health, education, social security reform and the protection of urban migrants (ADB 2004).

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* Financing from the *Fondazione Cassa di Risparmio delle Provincie Lombarde* is gratefully acknowledged.

[1] The Gini index, which had already risen from around 20 in the first half of the 1980s to 42 in 1993 (the fastest increase among all countries), even worsened in 1999-2000, reaching 43.7.

Such a change in fiscal policy will require that the Government rationalize the country's tax system, especially to further enhance tax collection and to rectify the present mismatch between expenditure responsibilities and revenue sources at the sub-national levels of government, by means of a more equalizing and targeted transfer system.

In this paper we intend to provide a brief introduction to the Chinese tax system. In section 2, after a quick look at China's recent macroeconomic developments and a concise description of the main items in public expenditure and their assignment to different layers of government, we will consider the level and composition of tax revenue in 2002, with a view to emphasizing the still inadequate ratio of tax revenue to GDP as well as the inappropriate reliance of the Chinese tax system on indirect taxation (mainly on VAT). We will then examine fiscal trends over the twelve-year period 1991-2002; the effects of the 1994 reform will be apparent with regard to both the level of tax revenue and its apportionment between the central government and the provinces. The institutional features (tax base, rates, exemptions and so on) of the chief direct and indirect taxes levied in China will be described in section 3. Though China has decidedly moved towards a uniform tax system and it will have to do so even more owing to its recent accession to the WTO (which requires compliance with the principle of 'national treatment'), there are still notable exceptions to equality of treatment of foreign and Chinese taxpayers. Disparities are present both in income taxation (where foreigners are allowed, for instance, more generous monthly deductions) and especially in corporate taxation (where the drive for modernization and the desire to attract FDI and favor technology transfer have led to preferential treatment for foreign-related enterprises). There also weaknesses in the design of indirect taxation, due to the simultaneous presence of a tax on gross turnover (the business tax) and of an almost standard VAT, engendering inefficient cascading effects. In section 4 an attempt is made to evaluate the Chinese tax system with regard to the efficiency of its design and the equity of its effects. It will be shown that the level of tax revenue is inadequate to the growing expenditure needs of China, even in comparison with other developing countries. Furthermore, income taxation and consumption taxation are not well balanced, with too heavy a reliance on the latter. The large weight of indirect taxes (especially VAT) has also inequitable effects, further widening the gap between the wealthier coastal regions and the northern and western provinces. This section ends with a brief outline of intergovernmental fiscal relations, with a special focus on the 1994 reform. Finally, section 5 records the notable improvements that China has notwithstanding managed to achieve in the design of its tax system. We will describe the reform carried out in 1994, a comprehensive package of measures that have affected every major aspect of taxation, bringing to the introduction of a modern VAT (based on an appropriate invoice mechanism) and to the almost complete unification of the income tax regimes for foreigners and Chinese citizens (with the caveats mentioned above). There is however room for further improvements and the final paragraphs examine some proposals for reform, especially with regard to the shift from the current production-based VAT to a consumption-based VAT.

To conclude, the chief weaknesses of China's fiscal system may be summarized in the following way: *a)* the tax revenue to GDP ratio is still low, even in comparison with other developing countries, and is insufficient in view of the direct and contingent (non-performing loans connected with banking system reform, unfunded pension obligations, restructuring of state-owned enterprises) liabilities[2] the government will face in the near future; *b)* the weight of indirect taxes is disproportionate and has adverse effects on both enterprises and households; *c)* the current production-type VAT should be replaced with a consumption-type VAT and extended to services now subject to the business tax; *d)* changes should be made to the personal income tax so as to fully exploit its potentially redistributive function; *e)* a better balance should be found between expenditure responsibilities and revenue assignments at sub-national level.

## 2. A broad view of the tax system and its developments from the early 1990s

### 2.1 A short reminder of Chinese economy and public sector outline

Though still a developing country with a relatively low per capita income (per capita GDP was CNY 8,999 in 2003 or around 1,087 US dollars), China has made remarkable economic progress since the late 1970s. The average growth rate of real GDP was 9.9 percent in the ten-year period 1986-1995 (compared to the average 7.7 percent for developing Asia countries)

[2] On these definitions see World Bank (2003), p. 59, note 77.

and, according to IMF estimates and projections for 2004 and 2005, it is predicted to be 8.2 percent in the ten-year period 1996-2005 (6.6. percent for developing Asia countries).[3] China's weight and role in the global economy has correspondingly widened: the country is now the sixth-largest economy in the world (at market exchange rates) and the fourth-largest trader.

China's remarkable economic performance has its roots in the sweeping structural reforms that begun in 1978 under the auspices of Deng Xiaoping. The changes occurred since then led to the gradual replacement of central planning by market mechanisms, to the opening of the economy to the rest of the world, to the transformation of the country's productive structure, with the secondary and tertiary sectors gaining ground at the expense of the primary one. It should be noted, however, that agriculture, being characterized by the scarcity of land in relation to labor and little mechanization, still employs around 44.0 percent of the country's workforce.

As regards China's public finances, during recent years there has been a marked reversal of previous trends. After declining until the mid-1990s, revenue and expenditures started expanding in 1996, the latter, however, has grown faster than the former, resulting in larger budget deficits (3.4 percent of GDP in 2002).

Revenue increases (1.1 percentage points of GDP in 2002) were chiefly the result of a large growth in tax collections (especially in VAT and income taxes), which, in turn, may be attributed to two main factors: the reform introduced in 1994 and the enhancements in tax administration (IMF 2004b). As to the latter, the implementation of the 1994 reform required to set up two separate channels for tax collection: under the auspices of the State Administration of Taxation (SAT). A National Tax Service was established, charged with collecting central and shared taxes, while local tax bureaus were made only responsible for collecting local taxes. This measure substantially reduced the opportunities for local governments to appropriate central revenue by manipulating tax assessments. Another important contribution to improved tax administration came from the computerization of VAT collection.

Expenditure, after reaching a minimum of around 13.0 percent of GDP in 1996, grew up to 21.7 percent of GDP in 2002 (see Table 1). The largest increase (in percentage terms)

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[3] IMF (2004a), Statistical appendix. Unless otherwise stated, data in this section is taken from the IMF publications.

concerned expenditure on pensions and social welfare programs, as state-owned enterprises were relieved of spending mandates in such social areas as pensions and the provision of education and health services, which have gradually become responsibilities of local governments. Expenditure on administration and defense more than doubled over the period, while the government expansionary fiscal policy (initiated in the wake of the late 1990s Asian financial crisis) and the development strategy for central and western regions pushed up capital expenditure, which rose by 1.7 percent of GDP. Spending responsibilities are highly decentralized: in 2002 the shares in total expenditure of central (31.3 percent) and local governments (68.7 percent) were in the proportion 1:2 (World Bank 2003).[4] As shown in Table 2 (which refers to 2001), there is a certain differentiation in expenditure assignments: the central government is entirely responsible (or almost so) for defense and debt service, while local governments are more or less exclusively in charge of spending on agriculture, culture, education and health, social relief and welfare.

[INSERT TABLES 1 AND 2 HERE]

## 2.2 The tax system

### 2.2.1 The current structure

The structure of the Chinese tax system in 2002 (last available data) is displayed in Table 3. Total revenue (CNY 1917.4 billion) amounts to 18.3 percent of GDP, while tax revenue (CNY 1763.2 billion) accounts for 16.8 percent of GDP and 92 percent of the total receipts. There are no social security contributions, since pensions and other social benefits are restricted to selected categories of workers, and 80 percent of the latter is not covered at all by any kind of social protection.

Taxes on income and profits make up a not irrelevant share of tax revenue (as compared with previous years), adding up to 25 percent of the total yield and to 4.2 percent of GDP. Contrary to most western countries, corporate taxes are the main item in this category, accounting for 17.1 percent of the total tax revenue. They are mainly levied on domestic

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[4] IMF (2004a), Statistical appendix, tables 26-27.

enterprises, since foreign investment enterprises benefit from generous preferential treatments. On the other hand, the individual income tax (assigned to local governments by the tax sharing system introduced in 1994) is only 7.9 percent of the aggregate tax revenue and 1.0 percent of GDP.

As one could suspect, the Chinese tax system is based mainly on taxes on goods and services, which add up to 67 percent of total tax revenue (11.3 percent of GDP). Apart from the value added tax (VAT), which alone accounts for around 7.3 percent of GDP (and more than 43 percent of total tax revenue), we should also mention the business tax - levied on services not covered by the VAT - and the consumption tax - an excise duty applying to particular categories of goods (most of them classified as 'luxury' goods). Even if the average tariff rate has substantially declined, as a consequence of the choice of the country to open its economy to the rest of the world (and it will be even more so after China's accession to the WTO), custom duties still stay at 4.0 percent of total tax revenue and at 0.7 percent of GDP.

Finally a few words on the other taxes, which account for 7.9 percent of the total tax revenue and 1.3 percent of GDP. The main items are the city maintenance and construction tax, the stamp tax, the house property tax and the urban real estate tax.

One of the top priorities of the 1994 reform was to enable the central government to increase its share in fiscal resources, which previously had substantially declined to the advantage of local governments. A new tax sharing system was established which resulted in the central government collecting 60 percent of the total tax revenue in 2002 (see Figure 1 below).[5] As a consequence, local governments, which are in charge of almost 70 percent of total expenditure (and in essential sectors such as health and education) (see Table 2 above), are forced to rely heavily on extra-budgetary funds.

### 2.2.2 A brief overview of the 1990s changes in the tax system and the 1994 reform

In reviewing and assessing the development of the Chinese tax system during recent years, one can but begin with the sweeping tax reform launched in 1994, which to some extent represented an expected corollary to the social and economic changes China had been experiencing since the beginning of the reform era in 1978. Several objectives were pursued,

[5] However, it should be added that a large share of central government revenue is transferred to provinces in consequence of the 'revenue returned' system (on which see below). That share averaged 40 percent of central government own revenue in the years 1996-2001 (Ahmad, Singh and Fortuna 2004).

a prominent one being that of countering the steady decline revenue had recorded since the peak attained in 1985. Actually, after reaching a minimum of 10.2 in 1996, the ratio of tax revenue to GDP has been rising since then up to 16.8 percent, as a consequence of an annual yield growth rate of 14.5 percent.

There has been some increase in the ratio to GDP of the taxes on income and profits, which in 1994 provided 20 percent of aggregate tax revenue, while they reached one fourth of the total in 2002. The 1994 reform introduced a revised personal income tax, which replaced the former one as well as some other previous levies. At the same time corporate taxation was made more uniform by abolishing the previous system, where enterprises were differently charged according to their ownership. Notwithstanding, foreign investment enterprises are still liable to a different tax than domestic businesses, benefiting from so-called tax holidays, i.e. tax exemptions and reduced rates.

However, the most notable changes probably involved turnover taxes, which during the years after the reform, increased at a 5 percent annual growth rate. More importantly, there has been a radical reallocation of the relative weights of the three levies which make up the bulk of indirect taxation. The scope of VAT has been substantially broadened so as to cover the production and distribution of goods, imports and the provision of some services. As the final outcome it currently amounts to near 70 percent of turnover taxes and is the single largest source of revenue for the government. Complementary to the VAT, the business tax is levied on most services; while losing ground to the advantage of its counterpart during the first years after the reform was launched, it has later shown an increasing trend at a growth rate of about 60 percent, when compared to the trough in 1994. On the contrary, a marginal role is played in China by excise duties, represented by the consumption tax (which replaced the older product tax). It is levied on cigarettes, alcoholic beverages, motor vehicles and some other ‘luxury’ goods, but its relevance dramatically reduced, since its share in GDP decreased of more than two thirds from 2.9 percent in 1991 to 0.9 percent in 2002, always hovering more or less around this value.

Our general description of the Chinese tax system would be incomplete, if we did not consider, though briefly, the development of intergovernmental fiscal relations. According to several indicators, China is a highly decentralized country. Local governments are responsible for essential public services such as education and health, but the assignment of resources established by the tax sharing system introduced in 1994 has put heavy pressure on their budgets which are often unbalanced. A clear evidence of this is provided in Figure 1, where we plotted the respective shares in tax revenue of central and local governments.

[INSERT FIGURE 1 HERE]

In 1993 only around 20 percent of tax revenue accrued to the central government, while in 2002 this proportion reached 60 percent. The result of the 1994 reform was immediate and the share of the central government jumped suddenly to more than one half of the total.

## 3. Some quantitative and institutional features of the main taxes

### 3.1 Direct taxes

#### 3.1.1 Personal income tax

The personal income tax (PIT) was introduced by the 1994 reform and it applies in a uniform way to both Chinese nationals and foreigners. The tax is essentially schedular, since only certain listed types of income are taxed and the tax liability relative to each type is computed separately, without aggregation of an individual's different sources of earnings. Furthermore, there is no system of personal deductions nor aggregation of the income, or joint taxation, of spouses. Finally, income is taxed differently depending on its nature, either at progressive rates or at a flat rate.

An individual is liable to tax in China if s/he is domiciled in China or resides in China for a full year or else derives income from Chinese sources. An individual domiciled in China is taxable on his/her worldwide income; s/he is considered to be domiciled if s/he 'habitually' resides in China as far as evidence thereof is given by household registration, family or economic interests. In establishing whether or not a person is domiciled in China citizenship or nationality plays an important role, since Chinese citizens are generally required to have a household registration in China. However, since domicile entails habitual abode or permanent place of residence, citizens who live permanently abroad are not considered to be domiciled in China. On the other hand, even foreigners could be regarded as domiciled in China if they chose to make the country their permanent home rather than a place of work or temporary stay; however China has seldom granted foreigners permanent residence status. Therefore foreigners are usually taxed on the basis of residence, that is 'physical stay'. Their tax liability depends on the length of the period of residence, which is computed by counting the numbers of days of actual presence in China in a financial year.[6]

Chinese source income is defined to include income earned by an individual from a position, employment or fulfillment of contracts within China; income derived from letting or leasing of property for use in China; income from transfer of buildings, land-use rights or alienation of other property within China; income from royalties on technology used within China; interest, dividends and bonuses received from companies, enterprises, other economic entities and individuals located in China.

Tax on employment income is calculated on a monthly basis. Losses are not deductible, however a standard monthly deduction of CNY 800 is allowed. An additional deduction of CNY 3,200 is granted to the following specified categories of taxpayers: foreign employees who work in foreign-funded enterprises or foreign firms within China; invited foreign experts working in enterprises, institutions, social organizations and state organs in China; resident individuals who obtain wages and/or salaries from their post or employment outside China; others as determined by the Ministry of Finance. The tax payable by employees is withheld at source by their employers. The tax rates applicable to wages and salaries are displayed in Table 4.

[INSERT TABLE 4 HERE]

[6] Foreign individuals who live in China for one year or more are generally taxed on their worldwide income (so-called 'one-year rule'); however if their stay does not span a full five-year period, they may, upon concession, pay Chinese tax on foreign source income only if it is derived from a company, enterprise or individual in China. In applying the one-year rule, temporary absences are not subtracted if they amount to less than 30 days at one time or less than 90 days in total. Foreigners who reside in China for less than one year are liable to tax only on Chinese-source income. If their actual presence in China does not exceed 90 days, they are exempt from tax on any compensation paid by an employer outside China for services performed within China as long as the compensation is not borne by the employer's Chinese establishment. Double taxation treaties may modify the 90-day rule resulting in the exemption of a taxpayer's employment income if s/he is not in China for more than 183 days in a calendar year and the employer is a non-resident enterprise.

‘Remuneration for personal services’, that is consideration for providing such services as medical treatment, law practice, accounting, consulting, lecturing, intermediary services, agency, brokerage and other services, is taxed on a per-payment basis. Allowable deductions are as follows:

- if a single payment is CNY 4,000 or less, the deduction is CNY 800;
- if a single payment is more than CNY 4,000, the deduction is 20 percent of the payment.

Income from such professional services is taxed at a flat rate of 20 percent, however a surtax is charged for ‘abnormally high’ payments (exceeding CNY 20,000). The same tax regime applies to royalties (including author’s royalties).

The income derived by individual industrial and commercial households from production or business operations is taxed at progressive rates as shown in Table 5.

[INSERT TABLE 5 HERE]

Income from interest and dividends, income from the lease of property, income from the transfer of property, incidental income and other income are taxed at a flat rate of 20 percent . It should be noted that there is no imputation system to alleviate double taxation of dividends.

Some types of personal income are exempt from the income tax:

- monetary awards from provincial-level people's governments, the State Council's ministries and certain units of the People's Liberation army;
- monetary awards given by foreign international organizations in the fields of science, education, technology, culture, health, sports and environmental protection;
- subsidies and allowances paid in accordance with uniform state stipulations;
- welfare benefits, pensions for the disabled and for survivors and relief payments;
- military severance pay and decommission or demobilization pay for soldiers;
- family allowances, job discharge fees, retirement wages and supplementary retirement fees paid to cadres and workers in accordance with uniform state stipulations.

### 3.1.2 Agriculture tax

Our overview of personal income taxation in China would be incomplete if we did not mention the agriculture tax, which is levied on farmers. Farmers represent a separate category of taxpayers, being generally exempt from income tax and VAT or business tax. The agriculture tax is a mixed levy, having elements of both property and income taxation. The tax base is the normal yield for agricultural crops and gross production for other native agricultural products. The normal yield is the estimated average annual yield for grains determined on the basis of the natural conditions of the land, ordinary level of management and production level of normal years. Incentives for enhancing productivity are provided, since the base of assessment is left unchanged for 3 years if production increases on account of improvements in farming conditions (such as the construction of irrigation works) and for 5 years if the reason of the increase is better management or cultivating techniques. The average national rate is 15.5 percent, local governments however are free to set the actual rate, within the limit of 25 percent.

### 3.1.3 Corporate taxation

***Foreign investment enterprises***

Entities liable to the foreign enterprise income tax (FEIT) comprise: foreign investment enterprises (FIEs), foreign enterprises (FEs) with establishments in China, and foreign companies without establishments in China deriving income from Chinese sources. FIEs consist of Chinese-foreign equity joint ventures, Chinese-foreign contractual joint ventures and wholly foreign-owned enterprises formed in China. These are all legal persons under Chinese laws and residents for income tax purposes, having established their head office in China[7]; being residents, FIEs are taxed on their net worldwide income. FEs with an establishment in China are taxed on their Chinese sourced income. 'Establishment' is defined broadly to include management offices, business sites, offices, factories, places of natural resources extraction, sites for contracted projects such as construction, installation, assembly or exploration or for the furnishing of services, business agents. In addition to the income from the production and business operations of the establishments or places in China of FIEs or FEs, income from Chinese sources comprises any dividends, interest, rental, royalty and other income derived both inside and outside China that is actually attributable to those establishments or places. Finally, foreign enterprises without establishments in China are charged withholding taxes on the gross receipts of their passive income from Chinese sources.

[7] For corporate entities residence is determined according to the location of their head office defined as the chief establishment responsible for the operation, management and control of an enterprise.

Taxable income is generally income less allowable deductions and expenses. The relevant laws provide formulas for computing the net taxable income for businesses in different types of industries, such as commerce, manufacturing and service industry. Some expenses, however, are not deductible, including: expenditures on fixed assets; expenditures on intangible assets; interest on capital; income tax payments; royalties paid to head offices.

Fixed assets (valued at original cost) may be depreciated. Depreciation is calculated annually on a straight-line basis, assuming a residual salvage value of 10 percent of the original cost. Minimum depreciation periods (5 to 20 years) are prescribed for various classes of fixed assets. Accelerated depreciation may be conceded by the State Administration of Taxation (SAT) in a few specified circumstances, for example when machinery and equipment is in operation 24 hours a day throughout the year or when the fixed assets are contributed to a joint venture with an operation term shorter than the prescribed depreciation period of the assets and the Chinese party to the venture takes title to the assets upon termination of the joint-venture contract. Amortization of intangible assets (such as patents, proprietary technology, trademarks, copyrights, and site use rights) is also allowed on a straight-line basis, generally over a ten-year period.

The FEIT is levied at a (national) flat rate of 30 percent plus a local surtax of 3 percent on taxable income. However, in recent years China has lured foreign investors by granting them generous tax incentives. In order to qualify for these incentives some criteria must be satisfied. First, the investment must be carried out through a FIE or specially through an enterprise invested by Taiwanese or Hong Kong residents. Secondly, the enterprise must be engaged in a designated industry.[8] Thirdly, the location in which the enterprise is established (or going to be established), the operating period and the level of investment are all relevant factors.

Notable tax incentives are the so-called ‘tax holidays’, granted for periods varying from 3 to 10 years (a prolongation may be authorized for huge infrastructure projects); a ten-year tax holiday, for example, entails a tax exemption for the first 5 profit-making years and a 50 percent tax rate reduction for the following 5 years. An enterprise is eligible for a tax holiday as long as it is engaged in production or business operations for the specified minimum period of 10 or 15 years. In addition to tax holidays, the foreign income tax law provides for reduced

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[8] The list includes production orientated, advanced technology orientated and export orientated industries plus the financial industry; other sectors, such as infrastructure development as well as agriculture, forestry and animal husbandry, may also be designated.

tax rates of 24 percent and 15 percent for enterprises running a business in special areas of China. Furthermore, local governments normally waive their 3 percent surtax. Incentives are also available for profits reinvested in China in the form of a refund of the income tax paid on them.

A resident enterprise or company is generally exempt from income tax on dividends received from a resident company, while non-residents, whether or not they have an establishment in China, are liable to withholding tax at the rate of 10 percent (before 1st January 2000 it was 20 percent) on all dividends paid by resident companies. With regard to dividends received from foreign companies, resident companies are not entitled to exemption, but receive a credit for withholding tax paid and for tax levied on profits out of which the dividends are paid, up to the amount of the Chinese tax payable.

Resident enterprises are subject to tax on interest from all sources at the usual rate (20 percent). Non-resident enterprises are subject to income tax only on interest that has a Chinese source and is earned in carrying on business in China at or through an establishment. A non-resident foreign enterprise which derives interest from China without having a permanent establishment or place of business in China or, though having one, earns interest income that is unconnected to it is subject to withholding tax at 10 percent. The same provision also applies to royalties.

***Domestic enterprises***

The enterprise income tax (EIT) applies to state-owned enterprises, collective enterprises, private enterprises, joint-stock companies and other organizations which derive income from production or business operations. The taxable income is the gross income less allowable deductions and expenses. The taxpayer's total income includes income from production or business operations, income from interest, dividends, royalties and leases, income from the transfer of property, other income. Permissible deductions include: the interest on loans taken out for the benefit of production and business; the payments to workers' trade union funds, welfare funds and educational funds, for a maximum amount of 2 percent, 14 percent and 1.5 percent of total taxable wages respectively; donations to charities and relief funds, up to a maximum of 3 percent of annual taxable income. Losses may be carried over for five years. The tax rate is 33 percent.

### *Capital gains*

Capital gains are taxed as 'other income' at the regular rate (20 percent) when they are derived by a FIE, while non-residents are subject to withholding tax. In addition capital gains from the transfer of real estate are subject to the land appreciation tax. Since under the Chinese Constitution land is publicly owned and cannot be transferred, the tax is levied only on buildings and land use rights. In calculating the taxable gains one may deduct the amount paid for land-use rights; costs and expenses incurred on land development; costs and expenses on the construction of new buildings and related structures, or the assessed value of old buildings; taxes related to the transfer of real estate. Taxation is progressive, with rates varying from 30 percent to 60 percent.

### 3.1.4 Taxes on property

The revenue of property taxes accrues to local governments, but their amount is rather small (0.35 percent of GDP in 2001[9]). They are the urban real estate tax, the farmland use tax, the urban land use tax and the house property tax. The urban real estate only applies to FIEs, FEs, foreign individuals and overseas Chinese; for buildings the tax base is either the residual value after deducting 10 percent to 30 percent of the original value or the standard rental, while land is taxed on its assessed value variable with the location and condition of the land. Exemptions are allowed for newly constructed buildings and for renovating old buildings. The house property tax is levied on houses and other buildings, mainly on Chinese institutions and individuals. The urban land use tax applies to all units and individuals using land located in cities and towns; the tax rates depend on the size and location of cities and towns and may be reduced, upon approval, in less developed inland areas and autonomous regions. Finally, the farmland use tax (introduced in 1987) applies to all individuals, businesses and institutions using farmland for construction or other non-farming purposes with rates depending on the population density of the farmland location.

## 3.2 Indirect taxes

[9] See the Final statement of Government revenue by region (2001), in *China Statistical Yearbook* (2001).

### 3.2.1 Value-added tax (VAT)

The 1994 reform introduced in China a standard value added tax (VAT), whose implementation required the removal of price controls on most goods and services by the end of 1993. Taxable persons are all individuals and enterprises that either supply goods, provide specified services or are engaged in importing.

'Goods' comprise all tangible movable property, including power, heating and gas. Intangible property, on the other hand, such as patents, copyrights or proprietary technology, is exempt from VAT. In addition to industrial businesses, the new VAT applies also to primary producers in the sectors of agriculture, forestry, fishing and mining. However, agricultural products manufactured and sold directly by farmers (as opposed to agricultural enterprises) are exempt from VAT. As concerns services, taxpayers are liable to VAT only for the processing of goods and repair or maintenance services. Imported goods are charged, while services purchased from overseas are not, since they are not provided within China. For the purposes of taxation the special administrative regions of Hong Kong and Macau are both considered not to be part of China.

The tax base is the amount paid for the sale of goods or supply of services, including any additional fees received by the seller or supplier. The taxable value for imports is the customs value plus customs duty, consumption tax and insurance and freight costs incurred in delivering the goods to China.

A mechanism of input tax credit allows taxpayers to be refunded the VAT paid or payable on purchases of goods and services in China and on goods imported into China as long as the goods are used in producing taxable goods or services. For agricultural products that are exempt from VAT, the purchaser is notwithstanding entitled to an input tax credit equal to 10 percent of the purchase price. However, no input tax credits are available with regard to the following items:

- fixed assets;
- goods and services that are used in making non-taxable supplies such as non-taxable services, the transfer of intangible assets and the sale of immovable property;
- goods and services used in making exempt supplies;
- goods and services available to employees for personal consumption or welfare;

- goods and services for personal consumption.[10]

Some supplies are exempt from VAT, which means that the recipient does not have to pay tax on its purchase; at the same time, the supplier cannot claim any tax credit on the purchases of inputs used in the making of the exempt supply. Exempt supplies include:

- agricultural products manufactured and sold directly by farmers;
- contraceptive medicines;
- antique books;
- imported instruments and equipment for scientific research and educational goods or equipment given to the taxpayer by foreign governments or international organizations;
- used goods;
- other exemptions permitted by the State Council.

A simplified regime is provided for small taxpayers, that is wholesale or retail businesses with an annual turnover less than CNY 1.8 million; their tax liability is 4 percent of the total turnover, but they are not entitled to input VAT credits. In addition, individuals with a monthly turnover of less than CNY 2,000 from the sale of goods or less than CNY 800 from the provision of taxable services are fully exempt.

As concerns VAT rates, the standard rate of 17 percent applies to most taxable goods and all taxable services. A reduced rate of 13 percent is charged on the sale or importation of some goods that are considered to be essential.[11]

Exports are taxed at zero rate, which implies that, even if no output VAT is chargeable, input VAT is still creditable; here lies the difference from a business providing only exempt supplies, which cannot reclaim or recover input tax it has paid.

### 3.2.2 Business tax

The business tax is a local turnover tax payable by all domestic enterprises, FIEs, FEs, institutions and individuals engaged in taxable business activities. It is levied on gross revenue and input tax credits are not allowed. Business tax applies to the sale or transfer of

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[10] Fixed assets include machinery, transportation vehicles, equipment, instruments and appliances with a useful life of more than one year and goods worth CNY 2,000 or more with a useful life of at least two years. The Chinese VAT is therefore a product-type one; indeed when it was introduced China was experiencing a two-digit inflation and the government aimed at curbing capital investment.

[11] The list includes: grain and edible oil; running water, hot water, gas, residential coal products, air-conditioning and central heating; books, newspapers and magazines; feed, chemical fertilizers, pesticides, farm machinery as well as other goods stipulated by the State Council.

immovable or intangible property and to the following business activities: transportation (by land, air, water and pipe), communications, construction, banking and finance, insurance, post and telecommunications, cultural and sports activities, entertainment and services (such as agency, hotels, catering, tourism, advertising, leasing and warehousing). Major exemptions concern: services rendered by nurseries, kindergartens, welfare institutions for disabled people, old people's homes, matchmaking agencies and funeral homes; services rendered by disabled people; medical services provided by hospitals, clinics and other medical institutions; educational services; services related to agriculture including insurance; royalties paid to domestic scientific research institutions; income derived by FIEs, FEs and foreign financial institutions located in SEZs within 5 years after the establishment. Furthermore taxable business revenue below CNY 200 to 800 is generally exempt from business tax, the exact amount being determined by local governments.

Tax rates vary depending on types of business as shown in Table 6.

[INSERT TABLE 6 HERE]

### 3.2.3 Consumption tax

The consumption tax is an excise duty payable by domestic enterprises, FIEs, FEs, institutions and individuals producing or importing taxable goods that are held to be luxury goods. The tax is levied on 11 categories of products including petrol (CNY 0.2 per liter) and diesel (CNY 0.1 per liter), cars (with three rates of 3 percent, 5 percent or 8 percent depending on type and cylinder capacity) and motorcycles (10 percent rate), alcohol (25 percent rate) and tobacco (with two rates of 30 percent or 45 percent plus a fixed amount per 50,000 cigarettes), jewelry (5 percent on gold or silver jewelry and 10 percent on other jewelry).

### 3.2.4 Customs duties

Customs duties comprise export and import duties. Export duties are levied on a number of goods which are normally the raw materials restricted for export. In 2001 only 36 types of goods were subject to export duties, with five rates varying from 20 percent to 50 percent. Import duties are levied on most imported goods at either general or preferential tariff rates. The latter apply only to goods imported and originating from countries with which China has a trade agreement containing reciprocal favorable tariff clauses, while the general tariff rates apply in other cases. From 1st January 2002 the average import tariff rate is 12 percent.

# 4. The fiscal burden

## 4.1 Efficiency and equity of the Chinese tax system

In this section we offer a qualitative evaluation of the Chinese tax system, focusing on the efficiency of its design and the equity of its effects.

In a paper devoted to tax policy in developing countries (Tanzi and Zee 2000) Tanzi and Zee suggested that in evaluating a country's tax system from a macroeconomic perspective one should consider in the first place *a)* whether the overall tax level (generally defined as the ratio of tax revenue to GDP) is appropriate and *b)* to what extent the composition of tax revenue (usually in terms of the respective weights of income and consumption taxation) is well balanced. As explained by the Authors, the reason why these features are (or should be) of interest to both researchers and policy makers is the widespread belief that taxation entails the welfare costs of resource misallocation and affects income distribution. Lacking unequivocal and practical criteria from optimal tax theory for determining the optimal tax level and mix for a country, one may get some help from international comparisons. Looking at Chinese data, we observe that in 2002 - at the peak of an increasing trend following the 1994 reform - the ratio of tax revenue to GDP was 16.8 percent, still lower than the average figure (18.2) for a sample of developing countries[12] as measured in the three-year period 1995-97 and more than half the corresponding figure (37.9) for OECD countries (excluding the Czech Republic, Hungary, Poland, Korea and Mexico).[13] In addition, it should be noted that, while no significant changes had occurred in the ratio for the two groupings with respect to the three-year period 1985-87, China exhibits quite a different trend. Largely as a result of the 'fiscal contracting system' regulating intergovernmental fiscal relations, the ratio of tax

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[12] The sample consists of 8 African countries, 9 Asian countries, 7 Middle Eastern countries, and 14 Western Hemisphere countries.

[13] Tanzi and Zee (2000), p 8. For China refer to Table 3.

revenue to GDP declined continuously after the peak of 1985 (22.8 percent) until 1996 (when it reached the lowest value during the period: 10.2 percent), before rebounding when the 1994 reform started producing its effects.

Another important feature of a country's tax system is, as already mentioned, the composition of tax revenue. Both efficiency and equity considerations are relevant. As to efficiency, life-cycle models suggest that taxing consumption should be preferred to taxing income. Income taxes are usually levied on both labor and capital income and a labor tax, while equivalent to a consumption tax over the whole life-cycle, creates an additional distortion in savings decisions. Equity, on the other hand, comes into play as a corollary to the presumed more regressive nature of consumption taxes compared with income taxes, even if recent literature has shown that taxing consumption is far less regressive from a life-cycle perspective than it is the case in a static framework. Chinese data show that the ratio of income taxes to consumption taxes was 0.4 in 2002 and 0.3 in the three-year period 1995-97, quite lower than the prevailing figures for developing countries and especially for the subgroup of Asian developing countries (0.5 and 0.6 respectively) and utterly distant from the value of 1.2 for OECD countries (these figures all refer to the three-year period 1995-97).[14] Furthermore, in line with similar trends in developing countries, though to a much greater extent, also in China the revenue from corporate income taxes is larger than that from personal income tax (their ratio was 2.9 in 2002 and averaged 5.5 in the three-year period 1995-97). As observed by Tanzi and Zee (2000), this may depend on several factors including differences in wage income, the inadequacy of tax administration and the strong political influence from the richest deciles of taxpayers.

A negative effect of the composition of tax revenue is the relatively heavy burden on enterprises, which are the bulk of taxpayers in China. Data for Qinghai province shows that the tax burden on industrial enterprises increased by almost one third in the four-year period 1996-1999 (Bao 2003)[15]. In addition, the tax burden is not evenly distributed, since it is heavier on SOEs and domestic enterprises than on non state-owned enterprises and FIEs; it also increases with the size of the firm.

[14] Tanzi and Zee (2000), p. 13.
[15] However, we note that in the same period the overall tax level rose by 27.5 percent.

Furthermore, by considering that the Chinese tax system relies disproportionately on indirect taxes[16] largely not well linked to tax base values one would expect tax revenue to increase at a slower pace than GDP. However, an important result of the 1994 reform has been the enhancement of tax administration: the GDP elasticity of tax revenue has been almost always higher than 1.0 in the years after the reform, with an average value of almost 2.0.[17] The buoyancy of tax revenue may be also attributed to the higher growth rate of the services sector in comparison with that of GDP (Toshiki 2004). Tax revenue could be further increased if China succeeded in reducing the size of its underground economy. By using the so-called cash ratio method, which is based on the ratio of cash in circulation to bank deposits, it has been estimated that the underground economy averaged 15.3 percent of Chinese GDP in the eight-year period 1991-1998 (Bao 2001). Since during the same time the tax revenue to GDP ratio was on average 11.6 percent, annual tax revenue losses may be estimated at around 1.8 percent of GDP, that is more than 15 percent of actual tax receipts.

Unfortunately, adequate data are not available to assess the impact of taxes on income (re)distribution in China. A recent paper (Chu, Davoodi and Gupta 2000), which deals with changes in income distribution in developing countries from the 1970s through the 1990s and examines a large number of studies on the incidence of taxes and government spending policies in some of these countries, has only a single piece of information on China, relative to the before-tax Gini coefficient in the 1990s.

Anyway, income gaps have widened in China during recent years in both urban and rural areas (Wang 2001). As to urban households, the average income of the highest 20 percent was 4.2 times higher than that of the lowest 20 percent in 1990, while their ratio more than doubled in a few years, reaching the value of 9.6 in 1998. Indeed, the richest decile accounted for 38.4 percent of total income in 1998 in comparison with 23.6 percent in 1990. A similar trend, though not so marked, emerged also among rural households: in 1990 the ratio of the top quintile's average income to the bottom quintile's was 6.3, while it rose to 9.5 in 1998.

In addition, the distribution of fiscal resources across provinces has worsened (World Bank 2002). Even though market reforms and the development strategy for attracting FDI that

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[16] Including customs duties, they accounted for more than two thirds of tax revenue in 2002 and their share averaged almost 70 percent in the twelve-year period 1991-2002 to which data in Table 3 refer.

[17] These figures are our own calculations based on the 2000 and 2001 editions of the *China Statistical Yearbook* as well as on the Statistical appendix in (World Bank 2003).

favored coastal regions are the main reason for growing horizontal imbalances, the fiscal system - far from countering these unequalizing factors - has contributed to the growth of regional disparities. For example, comparing the ratio of per capita expenditure to the national average for selected provinces in 1990 and 1998, we note that in Shanghai it rose from 2.4 to 4.5 and from 2.5 to 3.1 in Beijing, while it fell from 0.85 to 0.61 in Gansu and even halved in Hebei (from 0.48 to 0.24).[18] Over the same period, while the percentage of revenue collection for the five richest provinces declined from 26.0 percent to 23.0 percent, it fell from 12.3 to 9.8 percent for the five poorest ones. These widening disparities are a serious cause for concern, since local governments, as shown in Table 2, account for almost 70 percent of budgetary expenditure. Social spending in poor provinces is so low that most basic services such as health care and education are provided at extremely insufficient levels.

### 4.2 Intergovernmental fiscal relations

China has a five-tiered administrative structure: apart from the central government, there are 31 provincial level units (22 provinces, 5 autonomous regions and 4 municipalities directly under the central government); 331 prefectures and municipalities at the prefectural level; 2,109 counties, autonomous counties and cities at the county level; 44,741 townships, towns and city districts.

One of the main objectives of the 1994 reform was to revamp intergovernmental fiscal relations. Consequently a new tax sharing system (TSS) was established which fundamentally changed the apportionment of tax revenue between the central and provincial governments. Taxes were classified into three categories: central fixed taxes, local fixed taxes and shared taxes. Tax revenues assigned to the central government included mainly those from: customs duties, VAT and excise taxes on imports; consumption tax; income tax on all centrally owned state enterprises; enterprise income tax collected from banks, insurance companies and other financial institutions. Local governments were assigned revenues from: personal income tax; income tax on locally owned state enterprises, collectives and private firms; urban and rural land use tax; farmland occupation tax; land appreciation tax; house property tax; urban real

[18] See Table 2.5 in (World Bank 2002). There was also an increase in the coefficient of variation of provincial per capita expenditure.

estate tax; agricultural and animal husbandry taxes. Shared taxes included: VAT (75 percent central, 25 percent provincial); the securities exchange tax (88 percent of the revenues from stock transactions to the central government; all the rest to provincial governments); the natural resource tax (almost entirely local). To implement the new revenue assignment the tax administration was split: the bureaus of the State Administration of Taxation were charged with collecting all central and shared taxes, while local taxes were left to the responsibility of local tax bureaus.

Despite the introduction of the TSS provincial governments were not given any significant degree of tax autonomy, since they can only set the rates of a few minor taxes, while every other revenue decision is to be taken at Beijing.

The reform of intergovernmental relations was completed by redesigning the system of transfers, with a view to introducing a more rule-based mechanism. Now there are four types of grants in China: the 'fixed subsidies under the old system' serve to provide local governments with the same (nominal) level of revenue as in 1993,[19] the 'revenue returned' is intended to allow provinces to share in the increase in the revenue from VAT and consumption tax; the specific-purpose grants (or earmarked transfers) are administered by individual ministries and have a regulatory function, forcing local governments (which are also required to match the grants received with local funds) to comply with policy priorities set by the center; finally, the transitional transfers, introduced on a pilot basis in 1995, are designed to equalize fiscal resources across provinces. In view of the unique redistributive purpose of the latter, we look at them in more detail.

The respective weights of each of these types of transfers in the five-year period 1997-2001 are shown in Table 7.

[INSERT TABLE 7 HERE]

Fixed subsidies are a minor component of total transfers and their share halved from almost 4 percent in 1997 to 2 percent in 2001. Earmarked transfers amounted to more than one third of total transfers in 2001 and they have nearly doubled in relative terms during the period involved; their increasing importance is the result of the proactive regional policy of

[19] It should be added that 'fixed subsidies under the old system' include also transfers from local governments to the center.

the central government in recent years and of the necessity to respond to particular emergencies (the Asian financial crisis, the inadequacy of resources for local spending on social protection, the rise in pension benefits), however, in the absence of effective monitoring mechanisms to control how these funds are really used, they may be diverted by local governments to their own priorities. Transfers based on the 'revenue returned' mechanism, though continuously declining, still represented almost 40 percent of total transfers in 2001 and, in view of the regressive nature of the formula for determining their amount (which favors the wealthier coastal provinces), their predominance is an enduring obstacle to the equalization of fiscal resources. Finally, general purpose grants (a composite item including the transitional period transfers) more than tripled their share of total transfers (from 7.5 percent in 1997 to 24.5 percent in 2001), however, the transitional period transfers are still a minor component, accounting for just around one tenth of the total in 2000.

# 5. Tax reforms

## 5.1 Macroeconomic and budget outlook[20]

Economic growth in China even accelerated from 8.0 percent in 2002 to 9.1 percent in 2003. Growth in 2003 was driven mainly by investment, with public sector investment (mostly by local governments) accounting for 72.1 percent of total investment. The upsurge in investment in conjunction with rising prices of raw materials and shortages in electricity and oil have raised concerns about an overheating of the Chinese economy, threatened also by the rapid increase in bank lending, particularly in real estate. The buoyancy of domestic demand and a rise in oil prices resulted in imports growing more than exports, causing a decline in the trade surplus and a current account balance equaling 2.2 percent of GDP. There was a marked slowdown in the growth of foreign direct investment (FDI), depressed by the SARS outbreak and the global economic downturn.

[20] Data in this section is taken from ADB (2004).

The consumer price index rose by 1.2 percent in 2003, reversing the 2002 deflationary trend and the rate of inflation is forecast to hover around 3.0 percent in both 2004 and 2005. Official statistics recorded an increase in the registered urban unemployment rate from 4.0 percent in 2002 to 4.3 percent in 2003; however, including laid-off SOE workers who had not been reemployed would have given an adjusted figure of around 8.0 percent.

Contrary to targets and estimates of the government, which had planned a rise by 8.0 percent in both revenues and expenditures in 2003, fiscal revenues increased by 14.7 percent (slightly less than in 2002, when the increase was by 15.4 percent), partly as a result of the buoyancy of the economy; public expenditures, on the other hand, grew by 11.6 percent. The deficit therefore amounted to 2.7 percent of GDP - a slightly better result than targeted by the government (2.9 percent of GDP); there is, however, a general belief that official figures largely underestimate the real deficit. The proactive fiscal policy the government has adopted in recent years with a view to bolstering domestic demand and promoting employment is expected to be phased out in the near future; signs of the government's intentions were already visible in 2003: spending on capital construction declined, while there was a sharp rise in expenditures on administration, social security and health care (partly due to measures to contain the SARS epidemic).

In 2004 and 2005 GDP is expected to grow respectively by around 8.3 percent and 8.2 percent; however, the dependence of economic growth on public sector investment may be an obstacle to its continuance in the long run. Greater stimulus from private consumption, on the other hand, would facilitate the phasing out of the expansionary fiscal policy that government has initiated in the wake of the Asian financial crisis. Fiscal deficit in 2004 is targeted at CNY 319.8 billion, the same as in 2003, which would lower the deficit-to-GDP ratio to 2.5 percent (as against 2.7 percent in 2003). Furthermore, government spending will be directed mainly to economic restructuring and social development rather than economic growth. In any event, in 2004 the issue of special long-term treasury bonds should be worth only CNY 110 billion, less than in 2002 and 2003 (CNY 150 billion and CNY 140 billion respectively).

## 5.2 Tax reforms of recent years, underway and planned

The most important tax reform carried out in China in recent years occurred in 1994.[21] Despite the radical changes to the tax system introduced in the 1980s, several obstacles in the way towards a structure more in keeping with the workings of an expanding market economy needed to be removed. Domestic enterprises were subject to different regimes with regard to income taxation depending on their ownership; furthermore, their tax treatment differed considerably from that applying to foreign invested enterprises. Both these circumstances resulted in iniquity and created distortions in resource allocation and competition between firms. Indirect taxation, on the other hand, was complicated by the existence of four categories of taxes (product tax, value added tax, business tax and salt tax) and the coverage of VAT was quite limited.

The government launched the 1994 reform with the declared intention of 'raising the two ratios', *i.e.* the revenue to GDP ratio and the central share in total revenue. Other important factors were the need for a simplification of the tax system and harmonization of tax regimes as well as the necessity of establishing new, more rule-based, criteria for apportioning revenues between the central and local governments.

Major changes concerned VAT. The coverage of the tax was broadened so as to comprise every industrial product, commercial sales, import of goods and some specified services, to which the Chinese legislation refers collectively as 'processing, repair or maintenance services'. Tax rates were reduced to three: apart from the standard 17 percent rate and the zero percent rate on exports (the latter in line with general international practice), a 13 percent rate was provided to apply to a restricted group of goods regarded as essential. In addition, since every enterprise dealing with taxable goods or services would be subject to the reformed VAT, the consolidated tax on industries and commercial entities, which had been levied until then on foreign-related enterprises, was abolished.

Other important changes affected corporate taxation for domestic enterprises and personal income taxation. A unified 'enterprise income tax' was introduced with a standard rate of 33 percent applying to all domestic enterprises regardless of ownership; however, preferential treatments for foreign invested enterprises were retained. The 'individual income adjustment tax', which applied to individuals, the 'tax on private businesses in urban and rural areas' (also known as the 'urban and township individual industry and commercial income tax'), which was levied on household businesses, and the former 'individual income tax' were

[21] For a description of the tax system in the 1980s and until the mid-1990s, see Heady and Mitra (1992).

all replaced by a simplified 'personal income tax', applying in a more or less uniform way to Chinese citizens and foreigners.

As concerns changes introduced more recently, the main ones were designed to alleviate the so-called 'peasant burden'. The 'tax-for-fees' reform was launched in 2000: it should lead to the elimination of several unofficial fees levied by local governments and to the replacement of the remaining ones with taxes subject to ceilings mandated by the central government. In the past four years up to 20 provinces have adopted this policy, which is estimated to have reduced the financial burden of 620 million farmers by at least 30 percent.[22] Since the majority of the country's poor live in rural areas, these measures are expected to result in a parallel decline in poverty; furthermore, as remarked in (IMF 2004b), they should improve budget management through the reduction of extra-budgetary funds. Starting in 2004, the agricultural tax rate will be reduced on average by more than 1 percentage point a year and agricultural taxes will be removed in five years.

Planned reforms involve mainly VAT. The government is reported to be on the verge of launching an experimental reform of VAT in the three north-eastern provinces of Liaoning, Jilin and Heilongjiang, moving from the current production-type VAT to a consumption-type VAT in eight main industries, including chemicals, metals, oil and the automotive industry.[23] It should be added, however, that such a reform in the VAT structure has been repeatedly announced (and postponed) in the recent past and that in the present circumstances the central government has behaved in a somewhat cautious and passive way, since the chief taxpayers in northeast China are large SOEs and revenues collected from them accrue largely to the center.

Evidence of another prospective reform may be viewed in the decision taken in October 2003 by the third plenum of the 16th Central Committee of the Chinese communist party to introduce in the near future a unified property tax, which would replace several fees on real estate transactions.

## 5.3 Suggestions for further improvements

[22] See ADB (2004). Unless otherwise stated, information on tax reforms included in this section is taken from this ADB's publication.

[23] This news is from an article appeared in the *China Daily* issue of 22nd July 2004. It is worth noting that reforms in China are usually tested through extensive pilot projects (Ahmad, Li and Richardson 2000).

One of the top priorities in reforming the Chinese tax system should be the replacement of the current production-type VAT (P-VAT) with a consumption-type VAT (C-VAT). The distinguishing feature of a P-VAT is that the tax paid on purchases of capital goods is not creditable; when VAT was introduced in 1994, China was experiencing a double-digit inflation (with a peak of 27 percent in late 1994) and thus the government opted for a P-VAT with the intention of restraining capital investment and reducing the risk of an overheating of the economy (OECD 2002). Since then, however, there have been a rapid decline in inflation and even two episodes of deflation (during the years 1998-99 and 2001-02) (IMF 2004b), which have removed the chief reason for the adoption of a P-VAT. On the other hand, maintaining a P-VAT would perpetuate a situation that penalizes capital-intensive industries and blocks investment in research and development, which is of paramount importance for economic growth, especially in view of the increasing international competition to which domestic firms will be exposed after China's WTO accession (Toshiki 2004). It may therefore be useful to illustrate the likely effects of the move to a C-VAT, on the basis of the simulations presented in Ahmad, Singh and Lockwood (2004). These Authors use data from the *China Statistical Yearbook* to estimate the losses in VAT revenue for each Chinese province consequent on the introduction of a C-VAT.

The Authors' calculations show that the revenue losses expressed as a ratio to VAT revenue in 2001 would vary from a minimum of 13.7 percent for Beijing to a maximum of 53.9 percent for Hubei province, with an average of 30.9 percent and a coefficient of variation of about 0.3 (these values refer to the hypothesis of 100 percent efficiency in revenue collection). Losses to the central government would amount to CNY 125.6 billion (under the same hypothesis). Then the Authors weigh the pros and cons of the possible compensatory mechanisms: increasing the share of the VAT revenue accruing to provinces so as to leave their *aggregate* revenue unchanged or raising the standard VAT rate to the same effect.

Another reform which is widely regarded as desirable on grounds of economic efficiency is the replacement of the business tax, which is currently applied to most services, with VAT (OECD 2002; World Bank 2002). The business tax is levied generally on gross turnover and is not creditable against VAT, thus producing a cascading effect and generating distortions in the choice of inputs; this, in turn, leads to an arbitrary pattern of effective tax rates on different consumer goods (Ahmad, Singh and Lockwood 2004).

In their paper Ahmad, Singh and Lockwood examine the consequences of the extension of VAT to services (excluding finance and insurance, due to the difficulties in levying a value-added tax on transactions in this sector) and the simultaneous (partial) cancellation of the business tax (which would continue to apply to the finance and insurance sector). Such a reform would result in severe losses for the provinces,[24] since the business tax is a local tax and provinces only get 25 percent of VAT revenue, while the central government would gain considerably[25] and could use this additional revenue to compensate the provinces.

The personal income tax could also be profitably reformed (OECD 2002). In the first place, in calculating the amount to be paid by a taxpayer it would be advisable to aggregate all of his/her different sources of income and tax them together. Secondly, it is widely believed that the threshold for taxation should be lowered: actually the monthly deduction of CNY 800 for employment income is around 1.3 times greater than the twelfth part of per capita income in 2002; an exceedingly high personal exemption could prevent the statutory progressive rate structure from generating a really progressive pattern of taxation (Tanzi and Zee 2000). Finally, the World Bank (World Bank 2002) has judged the current assignment of the PIT to provinces to be inappropriate in view of the redistributive function of such a tax and its role in macroeconomic stabilization. It has therefore suggested that the PIT be split into two new taxes: a progressive one assigned to the central government and a proportional one allotted to local governments and piggybacking the national tax. Such a change could also provide the opportunity for giving a certain degree of tax autonomy to local governments, which could be allowed to set the flat rate of their PIT between minimum and maximum rates legislated at the national level.

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[24] These losses would vary from a minimum of CNY 44.3 billion (based on 2001 data) to a maximum of CNY 88.4 billion depending on the level of efficiency in revenue collection.
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*Table 1* - General government expenditure, 1997-2002 (in percent of GDP)

| | *1997* | *1998* | *1999* | *2000* | *2001* | *2002* |
|---|---|---|---|---|---|---|
| *Total expenditure and net lending* | *14.0* | *16.1* | *18.3* | *18.9* | *20.1* | *21.7* |
| Current expenditure, of which: | 11.5 | 12.6 | 13.7 | 14.7 | 16.1 | 17.3 |
| Administration and defense | 2.7 | 3.8 | 4.1 | 4.4 | 4.9 | 5.5 |
| Culture, education, public health and science | 2.7 | 2.7 | 3.1 | 3.2 | 3.6 | 4.0 |
| Pension and social welfare relief | 0.2 | 0.2 | 1.0 | 1.7 | 2.0 | 2.5 |
| Capital expenditure | 2.2 | 2.6 | 3.5 | 3.3 | 3.6 | 3.9 |
| Unrecorded expenditure | 0.3 | 0.9 | 1.2 | 0.8 | 0.4 | 0.4 |

*Source*: IMF (2004b), Table 5.3.

*Table 2* - Shares of central and local governments in selected budget expenditures, 2001

| | Share of Center (in percent of item) | Share of local govts. (in percent of item) |
|---|---|---|
| Total | 30.5 | 69.5 |
| Culture, education, science and health | 10.8 | 89.2 |
| Capital construction | 34.3 | 65.7 |
| National defense | 99.2 | 0.8 |
| Administration | 2.7 | 97.3 |
| Agriculture | 10.9 | 89.1 |
| Policy subsidies | 40.3 | 59.7 |
| Social security and welfare | 0.7 | 99.3 |
| Debt service | 100.0 | 0.0 |

*Source*: IMF (2004b), Table 6.3 and World Bank (2003), Statistical appendix, Tables 26-27.

*Table 3* -Structure and developments of consolidated General Government revenue, 1991-2002 (In percent of GDP)

| | *1991* | *1992* | *1993* | *1994* | *1995* | *1996* | *1997* | *1998* | *1999* | *2000* | *2001* | *2002* |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| *Total revenue* | *17.0* | *14.7* | *13.7* | *11.9* | *11.1* | *11.3* | *12.1* | *13.0* | *14.3* | *15.3* | *17.1* | *18.3* |
| *Tax revenue* | *13.8* | *12.4* | *12.3* | *11.0* | *10.3* | *10.2* | *11.1* | *11.8* | *13.0* | *14.1* | *15.7* | *16.8* |
| Taxes on income and profits, of which | 3.8 | 3.0 | 2.3 | 2.2 | 2.2 | 2.2 | 2.1 | 2.0 | 2.3 | 2.9 | 4.0 | 4.2 |
| Enterprises income tax | 3.4 | 2.7 | 2.0 | 1.5 | 1.5 | 1.4 | 1.3 | 1.2 | 1.5 | 1.9 | 2.7 | 2.9 |
| Personal income tax (other) | … | … | … | 0.2 | 0.2 | 0.3 | 0.3 | 0.4 | 0.5 | 0.7 | 1.0 | 1.0 |
| Agricultural income tax | 0.4 | 0.3 | 0.3 | 0.5 | 0.5 | 0.5 | 0.5 | 0.4 | 0.3 | 0.3 | 0.3 | 0.3 |
| Taxes on goods and services, of which | 7.4 | 7.7 | 8.3 | 7.4 | 6.8 | 6.9 | 7.1 | 7.7 | 7.8 | 9.8 | 10.3 | 10.6 |
| Product/Consumption tax | 2.9 | 2.6 | 2.4 | 1.1 | 0.9 | 0.9 | 0.9 | 1.1 | 1.0 | 0.9 | 1.0 | 0.9 |
| Value added tax | 1.9 | 2.6 | 3.1 | 4.9 | 4.4 | 4.4 | 4.4 | 4.6 | 4.7 | 5.1 | 5.5 | 5.9 |
| Business tax | 2.6 | 2.5 | 2.8 | 1.4 | 1.5 | 1.6 | 1.8 | 2.0 | 2.1 | 2.1 | 2.1 | 2.2 |
| VAT and excises on imports | | | | | | | | | | 1.7 | 1.7 | 1.6 |
| Customs duties | 0.9 | 0.8 | 0.7 | 0.6 | 0.5 | 0.4 | 0.4 | 0.4 | 0.7 | 0.9 | 0.9 | 0.7 |
| Other taxes | 1.8 | 0.8 | 0.9 | 0.8 | 0.8 | 0.7 | 1.5 | 1.7 | 2.2 | 0.5 | 0.5 | 1.3 |
| *Non-tax revenue* | *3.2* | *2.4* | *1.4* | *0.9* | *0.8* | *1.1* | *1.0* | *1.2* | *1.3* | *1.2* | *1.4* | *1.5* |
| *Administrative level*[a] | | | | | | | | | | | | |
| Central government | 3.6 | 3.2 | 2.6 | 6.1 | 5.5 | 5.1 | 5.7 | 6.1 | 7.0 | 7.7 | 8.6 | 10.1 |
| Local governments | 10.2 | 9.2 | 9.7 | 4.9 | 4.8 | 5.1 | 5.4 | 5.7 | 6.0 | 6.4 | 7.1 | 6.7 |

[a] The following figures refer to tax revenue.

*Source*: Author's calculations based on World Bank (2003), Statistical appendix, Tables 1, 18, 19, 20.

*Table 4* - PIT rates on employment income, 2002

| *Monthly taxable income (CNY)* | *Tax rate (%)* |
|---|---|
| Up to 500 | 5 |
| 501 - 2.000 | 10 |
| 2.001 - 5.000 | 15 |
| 5.001 - 20.000 | 20 |
| 20.001 - 40.000 | 25 |
| 40.001 - 60.000 | 30 |
| 60.001 - 80.000 | 35 |
| 80.001 - 100.000 | 40 |
| Over 100,000 | 45 |

*Source*: IBFD

*Table 5* - PIT rates on household business income, 2002

| *Annual taxable income (CNY)* | *Tax rate (%)* |
|---|---|
| Up to 5,000 | 5 |
| 5.001 - 10.000 | 10 |
| 10.001 - 30.000 | 20 |
| 30.001 - 50.000 | 30 |
| over 50,000 | 35 |

*Source*: IBFD

*Table 6* - Business tax rates, 2003

| *Business activity* | *Rates (%)* |
|---|---|
| Transportation, construction, post and telecommunications, cultural and athletic activities | 3 |
| Transfer of intangible and immovable property, service industry, banking and insurance services | 5 |
| Entertainment | 5-20[a] |

[a] The applicable rate is determined by local governments

*Source*: IBFD

*Table 7* - Intergovernmental transfers, 1997-2001

| | *1997* | *1998* | *1999* | *2000* | *2001* |
|---|---|---|---|---|---|
| | | | *(In percent of GDP)* | | |
| Transfers from the central government to local governments | 3.8 | 4.2 | 5.0 | 5.2 | 5.8 |
| Revenue returned | 2.7 | 2.7 | 2.6 | 2.6 | 2.3 |
| Fixed subsidy under the old system | 0.2 | 0.1 | 0.1 | 0.1 | 0.1 |
| General purpose grants | 0.3 | 0.3 | 0.5 | 0.9 | 1.4 |
| Earmarked transfers | 0.7 | 1.1 | 1.7 | 1.6 | 2.0 |
| | | | *(In percent of total transfers)* | | |
| Transfers from the central government to local governments | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Revenue returned | 70.5 | 62.7 | 53.0 | 48.9 | 38.9 |
| Fixed subsidy under the old system | 3.9 | 3.4 | 2.9 | 2.7 | 2.0 |
| General purpose grants | 7.5 | 7.5 | 10.2 | 17.9 | 24.5 |
| Earmarked transfers | 18.1 | 26.4 | 33.8 | 30.6 | 34.6 |
| Transfers from local governments to the central government | | | | | |
| Fixed subsidy under the old system | 0.8 | 0.8 | 0.7 | 0.7 | 0.6 |

*Source*: Ahmad, Singh and Fortuna (2004)

Figure 1 - The distribution of tax revenue