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Taxation

In 1994, China began to implement a new system of taxation, based on a clear destination between central and local taxes. This chapter presents a description of this new taxation system and its impact on private firms. It also analyses the regional differences in the implementation of the new system, and the effects of taxation and fees on private firms. The new system gives local governments considerable discretion in setting taxation policies in their own jurisdictions. As a result, large regional variations have emerged. In addition, a large chunk of a local government's revenue comes from fees rather than taxes. In some cases, a small city may have as many as 300 kinds of fees, accounting for more than 60 per cent of the city's annual revenue (Ren, 1999). One major problem with the fees is their irregularity, which has attracted a lot of complaints and criticism from enterprises.

China's new taxation system

Before 1994, China had a revenue contracting system to define the relationship between the central and local governments. Under this system, a province handed over a fixed amount of taxes to the central government and retained the rest. This gave the local governments large incentives to increase their revenues. Although the amount of taxes handed over to the central government had to increase by a fixed percentage each year, the central government's share in the nation's total tax revenues declined sharply to only 11 per cent by 1993. The new taxation system was designed to reverse this trend as well as to define a stable financial relationship between the central and local governments.

The new system requires the central government and each local government to collect their own specific taxes. As a result, the new system has been called *fenshuizhi*, or 'separate taxation system'. Currently, the central government collects 75 per cent of the value-added tax, special consumption taxes (on alcohol and tobacco products), and corporate income tax of firms owned directly by the central government.

A provincial government receives and collects 25 per cent of the value-added tax, sales tax, personal income tax, corporate income tax of firms that

are not owned by the central government, agricultural taxes, property tax, and other smaller taxes. The new system sets a clear distinction between central and local taxes. In addition, it has unified many taxes and reduced the number of taxes to only 15, simplifying tax collection and saving resources.

The new system has achieved the goal of increasing the central government's share in the nation's total revenue. This is because the two largest taxes, value-added and special consumption taxes, are overwhelmingly controlled by the central government. However, it has also led to new problems.

Decreased shares have caused large complaints from local governments. The central and western provinces are especially discontented because initial promises on transfers from the central government have not been met.

Each province was initially assigned a tax quota or revenue contribution with an annual growth rate. Although it was officially abolished, it has still been applied in many provinces and lower localities. The existence of a quota has placed a heavy pressure on local governments and ultimately on enterprises.

And most importantly, the new system has introduced a tension between a unitary state and a decentralised financial system. By law, only the central government can decide on taxation policies. With a huge territory and tremendous regional variations, a centralised taxation policy will not be effective in every province. In addition, there is a mismatch between taxation rights, and government resources and jurisdiction capacities. For example, the local branches of the central tax bureau collect the central taxes.

However, a case of tax evasion has to be taken up by a local prosecutor and tried in a local court, both of which do not have enough incentive to look after the central government's interests. Apart from that, the collection of local taxes is centralised to the provincial tax bureau. But the latter do not have enough capacity to collect the taxes and have to rely on local governments to fulfil the task. In poorer regions, local governments become the tax collector for the tax bureau (Yao, 1999).

Local governments' lack of the right to set their own taxes has been cited as an important reason for the proliferation of fees. Local governments are running on tight budgets. Yet, without the right to set their own taxes, they cannot use taxation to increase their revenue. However, the law does not forbid them to collect new fees. In addition, setting a new fee does not need to get the approval of the local legislators because it can be done as a government directive. One of the intentions of centralising tax legislation to control irregularities among local governments. In fact, centralisation has had exactly the opposite effect.

The centralisation of tax legislation itself is eroded by the central government's consent to local discretion in setting the rates of specific local taxes. The Survey revealed that each of the four cities covered in the first phase

has the right to set the rates of the local taxes attached to the central taxes. These attached taxes are levied as a proportion to the total amount of the central taxes. However, many localities do not stop at the attached taxes, but set different tax rates on other local taxes. The tolerance of the central government is its effective consent to local tax legislative rights.

Problems in the implementation of the current taxation system

There are problems in the implementation of China's new tax system, and they have a specific impact on the private sector.

First, the progressive quota system has been set unrealistically in relation to the rate of economic growth. For example, Shunde is asked to increase its tax revenue by 10 per cent every year. This high growth rate puts great pressure on the Shunde government to enlarge its tax capacity. The group of firms hit most are those designated as small taxpayers who pay a fixed amount of taxes. Under the pressure of the growing quota, they are required to pay more taxes every year regardless of their actual performance. At the national level, to fulfil the national tax revenue target for 1998, many firms were forced to start paying their taxes for 1999 at the end of 1998.

Second, although the effective tax burden in China is not high compared with other developing countries, the design of some types of taxes is problematic. For example, the rate of the VAT is 17 per cent. The VAT does not allow a firm to account for its investments as a cost¹. This measure greatly discourages firms' technological progress.

In addition, there was a local tax called an adjustment tax on capital investment. Its purpose was to curb inflation by discouraging investment in certain areas. It was a local tax, therefore its rate varied from place to place. Joint ventures and foreign firms were exempted from this tax. As a result, many domestic firms tried to find foreign partners when they decided to make major investments. This element of the system has been eliminated by the central government recently, on the grounds that taxation should aim at supporting strong long-term economic performance, rather than at deflationary objectives.

Third, the law governing VAT forbids small taxpayers from receiving VAT receipts. As a result, small firms have difficulties in doing business with larger customers who need the VAT receipts for their VAT deductions. The central tax bureau issued a directive in 1994 to allow a county-level tax bureau to issue VAT receipts on behalf of small taxpayers to its customers. However, a small taxpayer can only get this privilege with the approval of the local tax bureau. Therefore, the transaction cost of getting the VAT receipts is high. As a result, most small taxpayers prefer buying the receipts from large firms that cannot use up all their receipts. Because the transfer of VAT receipts is illegal, many small taxpayers have difficulty in finding a large firm that is willing to sell their VAT receipts, so their competitive capacities are limited.

Fourth, the timing of the collection of the VAT does not match a firm's cash flow, often pushing the firm into a liquidity problem. Under current practices, the tax has to be collected at the time when a firm provides its VAT receipts to its buyer. However, because of the existence of arrears, the firm may not be able to get its payment back for some time. Even when there are no enterprise arrears, there is a grace period of three months for a firm's customer to pay. In the extreme case, the firm has to borrow money. A CEO from a fairly large private firm in Beijing forcefully pointed out this difficulty to the research team.

A way to solve the problem is for the firm to ask its customer to give it a grace period for providing the VAT receipts. However, this method only works if the customer maintains relatively good liquidity.

Fifth, tax and fee collections are still subjected to the arbitrary judgments of government officials. The weak supervision of local governments is the first factor to be blamed. However, the blame does not stop at the local level. Arbitrary judgments also arise as a result of local governments' adjustments to local conditions when they lack legalised local tax rights. For example, in more developed areas, several kinds of agricultural taxes such as a tax on special agricultural and forest products have very small tax bases, so the costs of collecting these taxes are very high. It is therefore understandable that local governments give up the collection of these taxes.

This is also true for some small local taxes (for example, property tax in underdeveloped areas). In addition, arbitrary behaviour is also encouraged by the laws governing business operations. For example, it is stipulated by law that a firm should be fined 10,000 to 50,000 yuan if it fails to undertake re-registration when its address is changed. This large range can also be found in other laws. It gives officials ample room for personal judgments.

Sixth, for private firms with a single owner or for partnerships, corporate income tax and personal income tax overlap each other. These two kinds of firm take unlimited responsibility for their liabilities. Therefore, the owners' income is not different from their firm's income. So the two kinds of income should be taxed jointly once. In fact, a *getihu* is only taxed once. The difference between a *getihu* and a sole ownership firm is that they have different numbers of employees.

Finally, the proliferation of fees has damaged the integrity of China's taxation system. In addition to increasing firms' burdens, fees cause unnecessary uncertainty because of their irregularity. In the CEO Survey, 73 per cent of the firms which provided usable answers said that fees were a moderate or serious hindrance to their business operation. The most frequent complaint was that the fees were unpredictable and overlapping with each other. As cited in the last subsection, the proliferation of fees is closely related to local governments' lack of legislative power in setting local taxes. Currently, it is a major endeavour for the central government to bring the fees under control.

One measure proposed is to convert most of the fees into taxes. However, without solving the tension between a decentralised financial system and a centralised tax system, the attempt of converting fees into taxes will be futile because uniform taxes cannot suit every locality's economic conditions and only induce local governments to use fees to fill the gap. In addition, the persistence of fees is also closely linked to the growing size of the local governments. To finance the enlarged government, local chief officials have to give tacit consent for their subordinates to set up and collect fees within their administrative spheres. That is why firms feel that many fees are overlapping with each other. Without genuine government reform, it will be difficult to cut down the size of the fees.

The distribution of tax burden

In China, government income can be grouped into three categories; budgetary, extra-budgetary, and non-budgetary. Budgetary income mainly comprises taxes. In 1997, tax income consisted of 9.3 per cent of China's GDP. Extra-budgetary income includes local government surcharges, user fees of public utilities and services, and profits of state firms. Non-budgetary income comprises extra fees and local government bonds. In 1996, extra-budgetary income was 40 per cent of budgetary income (Yang, 1998). However, there is no statistic showing the exact size of the non-budgetary income. According to Yang's estimate, this portion was about the same size as the budgetary income. The overall tax and fee burden in China is about 25 per cent of its GDP. This puts China in the upper tier of the developing countries in terms of tax burden.

The tax contribution of the private sector to total state tax revenue has increased steadily over the past ten years. As shown in Table 6.2, the private sector's contribution to total state revenue increased from 2.6 per cent in 1986 to 8 per cent in 1997. If the contribution of shareholding companies is added to this, the share of total revenue was 12.8 per cent in 1997.

In firms covered by the sample and providing usable data, on average, taxes represented 6.6 per cent of a firm's sales, and fees accounted for another 3.1 per cent. This makes the overall tax burden 9.7 per cent of sales. The data gathered from the Survey show that 302 firms reported their VAT for 1998 with the average tax being 904,900 yuan. Calculated on the basis of tax due, the average tax should be 1,111,900 yuan per firm. The tax due was calculated based on the VAT rate of 17 per cent over value-added for firms with a sales volume larger than 1 million yuan and the VAT rate of 6 per cent over sales volume for firms with a sales volume under 1 million. The differential standards for different size firms are set by the state tax code. Therefore, an average firm paid 18.6 per cent less than the amount of VAT due in 1998, equivalent to 0.9 per cent of the sales volume of the average firm. The differences between tax due and actual payment of VAT by firm size are also large (Table 6.2).

Two hundred and seventeen firms reported their corporate income tax for 1998. On average, a firm paid 423,000 yuan in income tax. At the rate of 33 per cent based on data provided by 103 firms, the average income tax should have been 3.4 million yuan. The differences between tax due and actual payment of corporate income taxes by firm size are large (Table 6.2). The differences can be partly attributed to various legal tax breaks firms enjoy. Smaller firms pay more taxes than they should, while larger firms pay less.

The Survey results show that differently sized firms have different attitudes towards the tax burden. While the three other groups of firms had a percentage between 64–66 per cent, 78 per cent of the firms with 51 to 100 employees regarded taxes to be moderately or very high. Did this distribution match the real tax burdens of these four groups of firms? The firm Survey shows that in 1998, the percentages of taxes in total sales for the four groups of firms, from smallest to the largest, were 6.2 per cent, 7.8 per cent, 6.9 per cent, and 5.7 per cent, respectively. This matches the intensity of complaints.

The reason that firms with no more than 50 employees had the lowest tax rate is that most of them are small taxpayers whose taxes are fixed quotas calculated by tax officials based on their estimated sales. Because firms tend to under-report their sales, their tax quotas were low. Starting with the group of firms with 51 to 100 employees, firms begin to qualify as regular taxpayers that pay taxes on a proportional basis.

Table 6.1 Tax contribution of the private sector: 1986–97 (billion yuan)

Year	Total	Pure private firms National & <i>getihu</i> *		Private, <i>getihu</i> and shareholding companies	
		Amount	Share (%)	Amount	Share (%)
1986	178.2	4.7	2.6	–	–
1987	183.2	6.1	3.3	–	–
1988	212.9	7.9	3.7	–	–
1989	241.2	12.1	5.0	–	–
1990	245.4	13.4	5.5	–	–
1991	266.5	15.5	5.8	–	–
1992	288.9	18.2	6.3	–	–
1993	380.9	27.0	7.1	30.3	8.0
1994	472.9	37.8	8.0	44.2	9.3
1995	551.6	43.6	7.9	56.7	10.3
1996	541.1	45.8	8.5	64.2	11.9
1997	686.1	55.1	8.0	87.5	12.8

Note: * It includes only private firms with single owner.

Source: Based on *Taxation Yearbook of China: 1992–98*.

The decreasing tax burden with increased firm size could result from the greater leeway for larger firms to evade taxes, or from larger tax privileges. Tax privileges are more important. Almost all the tax reductions promised by the central and local governments are biased towards large firms. Since larger firms usually maintain better and more open accounting records, tax evasion is usually harder for them.

As an example of tax privileges, the central government stipulates that firms in high-tech industries (defined as firms that produce certified high-tech products) can be exempted from corporate income tax for three years, and after the initial three years, the income tax rate is only 15 per cent. In addition, firms with products that are designated as provincial new products can also get tax breaks. Only larger firms with certain technological capacity can qualify for these preferential treatments. As a result, larger firms have lower effective tax rates. For example, in Shunde in 1998, only 6 per cent of the benefits of tax privileges went to small sole-ownership private firms.

The size distribution of the complaints about excessive fees is more even than for taxes. Firms with 51 to 100 employees still had the highest percentage of 89 per cent, but the percentages of the other three groups of firms were distributed in the range from 67 to about 78 per cent. For 112 firms with valid data, the average fee rate was 3.1 per cent of sales volume. For the four groups of firms, from the smallest to the largest, the fee rates were, respectively, 4.8 per cent, 1.7 per cent, 2.4 per cent, and 1.9 per cent. Since many fees are collected on firms regardless of their size, the higher rate for the smallest firms makes sense. The differences among the three other groups are small. Therefore, it is paradoxical that not the smallest but the second smallest firms had the strongest complaints. One explanation is that members of the latter group of firms were describing their total burden of taxes and fees.

Table 6.2 Difference between tax due and actual payment by firm size (1,000 yuan)

Firm size	VAT		Income Tax	
	Difference	Firms	Difference	Firms
<51	-191.3	104	107.4	39
51-100	-788.3	31	-1,436.5	23
101-500	89.5	29	1,484.7	28
>500	17,986.6	10	40,103.9	10

Source: From the survey data

In terms of geographical distribution, the tax rates in 1998 were 5.9 per cent in Beijing, 11.8 per cent in Shunde, 5.6 per cent in Chengdu, 8.6 per cent in Wenzhou, 6.0 per cent in Mianyang, and 5.9 per cent in Deyang. The fee rates for the six cities, in the same order, were 4.0 per cent, 4.9 per cent, 2.1 per cent, 2.6 per cent, 1.3 per cent, and 2.9 per cent, respectively. Shunde had the highest tax and fee rate. It also had more firms complaining about high tax rates. The CEO Survey shows that 80 per cent of the firms in Shunde complained that tax rates were moderately, or very, high. However, the city with the lowest percentage of complaints was not Chengdu, but Wenzhou. Only 53.8 per cent of the firms in Wenzhou had the same complaints while the percentages in other cities were all over 60 per cent.

In terms of the intensity of the complaints about excessive fees, the order did not match that of the actual fee rates at all. The city that had the highest percentage of firms regarding fees as moderately or highly excessive was Deyang. An estimated 93 per cent of the firms in that city had a complaint. In addition, Mianyang had the lowest actual fee rate, but there were 87 per cent (second highest) of its firms had the complaint. This shows that firms' complaints on fees were not directed to the size of the fees, but rather to the ways that the fees were collected.

Regional differences in the tax burden can be created by two factors. One is the difference in tax rates; the other is the effectiveness of enforcement. Shunde was ranked high for both factors. Let us look at the first factor, examining the local attached taxes that are levied as percentages of the central taxes a firm pays. The central government allows local governments to use the attached taxes for local public services such as education, urban construction, transportation, military reserves, flood control, and other items that local governments think are necessary. The rate of all the taxes added together is 16 per cent in Shunde, and 14 per cent in Chengdu. However, both are high compared with a district in Shanghai where the rate is only 9 per cent. In particular, the added education tax is 11 per cent in Shunde, but only 3 per cent in Chengdu and Shanghai.

Another example is corporate and personal income taxes. They are 1 per cent and 0.2 per cent of a firm's sales, respectively in the district of Shanghai, but are 1.5 per cent and 0.3 per cent in Shunde. Chengdu implements the national standard of levying the income taxes based on the profit and income a private owner earns. Income is divided into three groups: less than 30,000 yuan, between 30,000 yuan and 100,000 yuan, and more than 100,000 yuan. The tax rates are 18 per cent, 27 per cent, and 33 per cent, respectively. China's income tax interval is not one year, but one month in most cases. For irregular income, tax is levied when the income is realised. Obviously, people will be taxed at an artificially high rate if they get their whole yearly income in one instalment.

In addition to regular taxes, Shunde also created a tax called a resource usage tax that is levied on land used by a firm. Many firms have purchased 60 to 70-

year land use rights in the process of privatisation. To maintain township governments' revenue, the municipal government allowed them to levy the resource usage tax, levied at the high rate of 2.1 yuan/m² per month. For a medium-size firm with 10,000 m² of land, the annual tax amounts to 249,600 yuan (Box 6.1).

Third, the Shunde government is consciously using high effective tax rates as a tool to change its industrial structure. The demand for changing its industrial structure comes from two sides. On the one hand, the Shunde government intends to upgrade the city's industrial structure from labour-intensive to knowledge-intensive. After 15 years of development, Shunde has gradually lost its competitiveness in labour-intensive industries, but has gained the necessary physical and human capital to move to more capital and knowledge-oriented industries. On the other hand, people's demand for a better environment has increased with their income.

Therefore, it is a high priority for the municipal government to induce the closing of small and polluting firms. High tax rates force firms with small margins of value-added, usually firms in the traditional labour-intensive industries and small firms, to move out of the city or simply close. This policy seems to be working as the research found that a number of firms had moved to the neighbouring city of Zhongshan.

However, the adverse effects of high tax rates on small firms may create problems for the city, especially in the area of employment. Currently, small firms with sales volume less than 100 million yuan account for more than 60 per cent of the city's total workforce, although their output accounts for less than 40 per cent of the total. Although it is a right direction to provide a fair competitive environment for all firms, data provided by this study show that large firms have an advantage over small firms in terms of effective tax rates because of the tax privileges that only larger firms can obtain. Some measures have to be taken in order to provide small firms with a level playing field.

It is noteworthy that Shunde was the best among the cities covered in the first phase of the Survey in terms of arbitrary behaviour in tax and fee collections, although it had the highest tax and fee rates. This had much to do with the government reform carried out in Shunde in 1993. A detailed account of the reform will be presented in Chapter 10. Here we emphasise that the reform has greatly limited government officials' rent-seeking behaviour by eliminating many functional departments and constraining the powers of the remaining departments. In addition, the management of government income and expenditure is centralised. Any fees collected by any departments have to enter the centralised account, and departmental budgets are controlled by a single office. This measure has had a great effect in curbing rent-seeking behaviour.

Other cities generally have not done as well as Shunde. In the CEO Survey, more incidences of arbitrary behaviour were found in other cities than in Shunde. For example, in Chengdu, the tax bureau suspected that a firm had been evading tax. It not only arrested the firm's owner, but also searched the firm and closed all its accounting records. In the course of these actions, the tax officials said: 'I can let a guy die if I say so!' It turned out that the firm did not evade tax. The tax bureau took the action only to punish the owner who had not shown enough respect to tax officials. The owner thus told the research team that it was a matter of 'life or death' whether a firm maintained a good relationship with the government.

In Chengdu, the behaviour of the city's technical standard inspection authority was also arbitrary. For example, by law a fee can be imposed only if the product inspected has defects. In order to impose the fee, the inspectors often exaggerated defects. To settle with the agency, firms often ended up making a lump-sum payment each time it sent an inspector. In Beijing, the research team learnt from local tax officials that there was enormous scope for personal

Box 6.1 Firm S's local taxes and fees

Firm S is located in Shunde. Its main products are plastic tubes for road, sewage, and communication constructions. It was a township-owned firm before 1997, but has been privatised recently. The overall burden of taxes and fees is not large, only about 5 per cent of the firm's total sales revenue. However, it complained that there were too many kinds of local taxes and fees. Here is a list of its local taxes and fees (may not be complete).

- Local value added taxes (levied on the value of the VAT):
- Education: 11 per cent
- Urban construction: 5 per cent
- Flood control: 1.5 per cent
- Land usage tax: 2.08 yuan/m².month (the firm has 10,000 m²)
- Street cleanup fee: 300 yuan/month
- Trash transportation fee: 300 yuan/quarter
- Crime control fee: 0.1 per cent of electricity usage (stopped in 1999)
- Temporary resident certificate for outside workers: 200 yuan per person per year
- Management fee for outside university graduates: 80 yuan per person per year plus one-time payment of 600 yuan.

Shunde is also the city that maintains the most intensive implementation of tax collection. To a large extent, its firms' high tax burden is related to its rigorous implementation of the tax system. This was emphasised by the local officials and confirmed by interviews with firms. The purposes of such rigorous implementation are several. First, it creates a relatively fair competitive environment for all the firms. In fact, this is one of the aims that the Shunde government sets for its government reform. Second, it responds to the progressive demand of the higher authority for Shunde to increase its tax revenue.

Box 6.2 Fees collection and government corruption

Many firm managers complained about the unregulated government collection of fees and government corruption. Here are some examples.

- a. The XX township government formally employs 102 persons, when 50 would be enough. Moreover, it actually employs more than 400. Employees don't have many things to do, beyond reading newspapers and playing cards in working hours. The government budget of 4.5 million yuan is not enough even for the wage bill. The total annual expenditure exceeded 10 million. The additional funds came from selling land, fines, and fee collection. Each firm has to pay something. In addition, you have to dine government officers two or three times a month for no benefits. For normal business dealing with a government department you have to entertain them. These have been a heavy burden to firms (CG).
 - b. A main problem firms face is that government departments overuse their power to intervene in firms' business. Any government department, such as a bureau of labour administration, central and local taxation, urban programming, land administration, public security, industry and business administration, or environment protection, may come to a firm at any time for inspection. Officials try to find flaws in the firm's activity without providing any help. The labour bureau required that for each employee a firm had to pay a 20 yuan service fee per year to the bureau, but it provided service to firms and employees. The more people who are employed, the higher the charge. This is a penalty on providing employment. Our company pays a 4,000 yuan 'security fee' per year to the police station, but the police never take care of the firm's security problems. Recently a worker stole 40,000 yuan from the company and was reported to the police, but they said that the amount of money was too small to be registered. Even worse is that government officials ask for bribes and would make trouble for firms if they did not get what they sought (HDL).
 - c. Each time the firm develops a new product it has to pass an 'examine-and-accept' conference. It does not matter whether the quality of the product is good or not, you still have to give presents and entertain the examiners. The environment protection bureau charges 20 yuan for each machine for 'exceeding the noise pollution standard', without any test of the noise. However, after entertaining the inspectors, all charges are exempted. Many government officers are of a low quality, poorly trained and poorly disciplined. (DL)
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discretion in deciding a firm's tax quotas or whether a firm be treated conveniently. In Wenzhou, many firms complained about the arbitrary fees. For example, the environmental protection office could go to a factory to measure the noise of its equipment. The intention of the office was to impose a fine on the factory. The factory owner then began to negotiate with the officials. It usually ended up with the owner paying the office a reduced amount of fine.

Concluding remarks

China's taxation system still needs major adjustments in order to solve the tension created by the decentralised income rights and centralised tax legislation. There are many unsolved problems in the implementation of the current taxation system. To solve these problems, China needs to take bold steps to improve the consistency and effectiveness of its laws, transform the role of its local governments, and strengthen the supervision of public servants. The differences found for the effective tax rates of firms of different sizes are caused by the firms' size-dependent capacities to get tax privileges. The regional differences in the effective tax rate are related to the degree of local government reforms as well as local governments' intention to use taxation as a tool to fulfil certain economic goals.

Note

1. There are three types of VAT in the world. One is production type that does not deduct capital investment from the VAT base. One is income type that deducts capital investment from the VAT base by distributing its value in its depreciation cycle. The last one is expenditure type that deducts capital investment as outlays are increased. Most industrial countries adopt the last type of VAT. China adopted the first type.