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CHINESE TAX POLICY AND THE PROBLEM OF FAIRNESS IN TAXATION¹

H. Vording

1. INTRODUCTION

In the 1990s China has introduced a complete Western-style tax system, consisting of (corporate and personal) income taxes, VAT, and excises. This new tax system is part of the transition to 'market socialism'. Thus far transition has proved an overwhelming success, as the inflow of foreign capital — now standing at 40 bln dollar a year — shows. Real GDP growth of 10 per cent or more has become normal, and apparently sustainable. In the near future China's economic attractiveness will no longer depend on low labour costs, but will have shifted to its huge consumer demand.

Tax revenues have not been able to keep the pace of growing prosperity.² In 1985, total tax revenue stood at 23.8 per cent of GNP. In 1993, on the eve of a comprehensive tax reform, tax revenues had declined to 13.6 per cent; and in 1996 the figure will probably be around 11.5 per cent. There seems to be a real risk of emerging 'private

¹ This article is an extension of my comments on Dr Y. Zhang's paper during the conference.

² Dali Yang, referring to the sum of budgetary and extra-budgetary revenues, stresses that China's 'extractive power may not be super-strong, but it cannot be characterised as weak or feeble'. But in a market economy, taxes rather than revenues from state property are the main source of income. See, Dali Yang, Reform and the Restructuring of Central-Local Relations, in, Jia Hao and Lin Zhimin, eds., *Changing Central-Local Relations in China: Reform and State Capacity*, Boulder, 1994, pp. 59–98.

prosperity and public poverty'. To illustrate the point one can think of public facilities such as roads, public transport, and general education. Perhaps even more important is the problem of providing basic economic security for some ten million unemployed in the cities, and over a hundred million ageing farmers without any old-age insurance. Clearly, more tax revenue is needed should the government want to address these typical market economy problems.

In a state-owned economy it is both easy and pointless to introduce a modern tax system. State-owned enterprises (SOEs) can be used as withholding agents for both income taxes and taxes on goods and services. At the same time, taxes are only an alternative way to extract the 'profits' of SOEs, as the government is in fact entitled to these profits. In official Chinese statistics, it is still customary to make no distinction between taxes paid by enterprises and (net) profits.

Table 1. Origin of government revenues, in per cent total revenue according to ownership and in per cent of GNP

	1980		1985		1993	
	<i>percentage of:</i>					
	total revenue	GNP	total revenue	GNP	total revenue	GNP
State-owned	85.4	20.7	73.2	16	65.1	10.6
Collective-owned	14	3.4	21.8	4.8	18	2.9
Individual	0.6	0.1	4.1	0.9	11.7	1.9
Other	0	0	1	0.2	5.2	0.8
Total	100	24.3	100	21.8	100	16.2

(*) excl. extra-budgetary revenues

Source: *China Statistical Yearbook 1994*

The transition from a state-controlled to a market economy has three implications for the design and implementation of a tax system. First, the introduction of explicit taxation has to take account of

remaining patterns of implicit taxation. One major 'implicit tax' in China is on savings, as I will discuss below. Second, a tax system is effective only to the extent that it is able to tax the private sector. Table 1 shows that government revenue in China drawn from the private sector is still small, though rapidly increasing.

Still, in 1993, more than 80 per cent of government revenues was generated by state-owned and collective-owned bodies. Of course, this simply reflects the fact that China's economy is still preponderantly state-controlled. On the other hand, it also suggests that the tax administration has had little experience in dealing with the 'hard to tax' private sector. Taking account of the fact that government revenue as a percentage of GNP has declined (from 24 per cent of GNP in 1980 to 16 per cent in 1993), the general impression is that revenues from the traditional, state-controlled sector of the economy are declining (and will continue to do so), while taxation of private prosperity does not yet offer full compensation.³

The third, and perhaps most important, implication is that in a state-controlled economy *equity goals* are dealt with by price and wage controls, while in a market economy they lie at the heart of tax policy.⁴ Thus, *fairness in taxation* becomes a new and vital requirement — and it has been accepted as such by the Chinese leadership.⁵ At the same time, the major tax reform of 1993 had the explicit goal to 'gradually increase the percentage of fiscal income in the gross national product (GNP)'.⁶ Though not necessarily identical to the effective taxation of emerging private prosperity, these requirements certainly call for a tax policy aimed at the private sector.

The decline of tax revenue that China has faced over the last decade, whatever administrative and economic explanations can be provided, also indicates that the government cannot find the means to increase the tax burden in an equitable way. In this paper I argue that

³ This is a feature of transition economies in general. See, World Bank, *World Development Report 1996*, Washington D.C., 1996, esp. p. 118.

⁴ A. Hussain and N. Stern, 'Economic Reforms and Public Finance in China', *Public Finance/Finances Publiques*, suppl. 1992 (47), pp. 289–317.

⁵ Tsang Shu-Ki and Cheng Yuk-Shing, 'China's Tax Reforms of 1994, Breakthrough or Compromise?', *Asian Survey*, (34) no. 9, September 1994, pp. 769–788.

⁶ Quoted from the Decision of the Third Plenum of the Fourteenth Central Committee, in Tsang and Cheng, p. 770. They provide a more general discussion of the impetus for tax reform in the political and economic context of 1993–94, as does Dali Yang.

fairness in taxation is required to achieve an effective tax system and an increase of tax revenue. In Section 2, I discuss the equity of tax burden distribution in China. In Section 3, I argue that a more effective taxation of increasing private prosperity will generate growing tax revenue (in GNP terms). In Sections 4 and 5, two other aspects of fairness in taxation — equal treatment of taxpayers, and fair administration will be looked at briefly.

2. EQUITABLE DISTRIBUTION OF TAX BURDENS

The current Chinese tax system poses an evident equity problem, as can be seen from Table 2.

Table 2. Composition of China's tax revenue, 1993

product tax	19.1
VAT	25.2
business tax	22.5
individual income tax	0.7
corporation tax:	17.4
– state owned enterprises	12.8
– collective owned enterprises	2.2
– private, foreign, etc.	2.4
agricultural tax	2.9
tariffs	6
rest	6.2
	100

Source: Chinese Ministry of Finance

In fact, Table 2 provides a snapshot of the pre-reform tax system. In 1994, a new VAT was introduced and the product tax was replaced by a consumption tax (actually, a set of excises), the sum of revenues being roughly equal to the old VAT and product tax. Thus, the major taxes in China are the VAT (a tax on commodities, not on services) and the business tax (a turnover tax in the services sector). Adding tariffs, the conclusion must be that at least three-quarters of the total tax revenue is

generated by indirect taxes (this is, by the way, quite a normal figure for developing countries). The main income taxes are on corporate income, and the major part is paid by state-owned and collective-owned enterprises. Individual income tax provides for less than one percent of tax revenue, though this figure may well have increased to two or three percent in 1996.

China's heavy reliance on broad-based VAT, business tax, and consumption taxes will definitely cause a regressive distribution of tax burdens because people with low incomes tend to consume them, while those with high incomes save part of these. In the recent reform of indirect taxes, achieving an equitable distribution of tax burdens has not been a primary concern.⁷

In Western countries, direct taxes, especially the personal income tax, offer compensation by their progressive nature. In the Chinese case the role of direct taxes is not that clear. Given the brief experience that China has with direct taxation and the heavy demands that direct taxes make on the quality of tax administration, the burden of direct taxes will probably be highest on those sectors of production that the tax administration can readily observe, such as SOEs and collective-owned agriculture. In fact, rural township enterprises in 1995 earned 23 per cent of China's GDP and paid one-third of all taxes — which implies that the tax burden of this sector exceeded the average of all other sectors by 60 per cent.

On the other hand, there is a considerable implicit tax on personal savings which will probably hit wealthier people hardest. At first sight, nearly all direct taxes are paid by state-owned enterprises. SOEs are still the backbone of the Chinese economy. In conjunction with the agricultural sector they contain an immense reservoir of hidden unemployment. Because most of these SOEs are in fact incurring heavy and sustained losses (at least according to Western accounting principles), they need government subsidies. The most important form of subsidization is the availability of loans from the state-owned banks at low interest rates. In fact, only recently has the central government forbidden SOEs to engage in banking activities.

⁷ Jinyan Li, 'Value-Added Tax in the People's Republic of China', *VAT Monitor*, (5) no. 3, May/June 1994, pp. 130–146. It should be noted however that VAT regressivity is probably tempered by an exemption for agricultural products (when traded by farmers), while the consumption tax, as a tax on luxuries, may even be slightly progressive.

The bill is paid by private investors. The direct loss of interest must be estimated at Rmb 100 bn⁸ at least, which is about one-sixth of total tax revenue and five or six times the individual income tax revenue. The indirect loss of investment in poor assets will only materialize in the next few decades. This implicit tax is probably progressive (in the sense that wealthier people have more savings) and may well, by its sheer size, compensate for the lack of progressivity of explicit taxes.

It must be noted that the distinction between direct taxes (on income) and indirect taxes (on commodities and services) is not clear-cut in China. Originally, the VAT was considered a tax on profits, and this certainly made sense as long as government set retail prices.⁹ And, as I will discuss below, over the last few years the VAT has been developing into a tax on exporters' profits. More generally, the distinction between direct and indirect taxes is not decisive as far as tax burden distribution is concerned. What matters is that some taxes are suited to taxing rich people and increasing prosperity, while others are not. An effective tax on, e.g., motor car imports may be a better way of taxing the rich than a poorly designed personal income tax.

There is another aspect to equitable distribution: the way in which the tax system affects regions and provinces. In the era of economic reform fiscal decentralization has severely limited the central government's capacity to redistribute income between regions and provinces.¹⁰ The incidence of economic growth has been uneven, and disparities have increased between the prosperous coastal provinces and the poor central areas. The 1993 tax sharing system is clearly an improvement,¹¹

⁸ Personal savings stand at Rmb 3,555 bn (June 1996), more than half of China's GDP. Interest rates range from 3 per cent on short-term deposits to 12 per cent on long-term, which only marginally exceeds the inflation level of 11 per cent (1996 forecast). SOEs typically borrow money at 11 per cent. See, The Economist Intelligence Unit, *China Report*, 3rd quarter 1996, London, 1996. Given the considerable risk that loans to SOEs will not (fully) be repaid, the return to savings is evidently below its proper market level. For each percentage point that the average return on savings can be deemed below its market level, the loss to savers is Rmb 35.55 bn.

⁹ World Bank, *China - Revenue Mobilization and Tax Policy*, Washington D.C., 1990, offers an economic analysis of China's indirect tax policy in the 1980s.

¹⁰ Christine P.W. Wong, 'Central-Local Relations in an Era of Fiscal Decline: the Paradox of Fiscal Decentralization in Post-Mao China', *The China Quarterly*, 1992, pp. 691-715.

¹¹ See, Zhang's contribution to this volume, and Tsang and Cheng. The failures of previous sharing arrangements have also been discussed by, *inter alia*, the World Bank 1990 report and Mario I. Blejer, 'China: Prolonged Reforms and the Weakening of Fis-

but it assigned the more buoyant taxes to the provincial and local governments. Typically, taxes in China are shared between levels of government. This goes for corporate income taxes, where tax bases are divided functionally (e.g., each level of government is entitled to tax those SOEs that are its property, but central government taxes all railways, banks, and steel production). It also holds for VAT, where central government takes 75 per cent of the revenue. The most important exceptions to these sharing arrangements are import duties and consumption tax (i.e., excises) where central government gets all the revenue, and the business tax and the personal income tax that flow to local governments. It seems that this distribution of taxing powers is to the advantage of local governments. The business tax is levied on all services as an alternative to VAT (that relates to commodities only). With China's economic activities still heavily relying on agriculture and industry, a secular increase in the share of services in GDP may be expected. Local governments will seize the additional tax revenue. Of course, central government may strike back by extending the scope of VAT at the expense of the business tax.¹² Compared to business tax revenue, personal income tax revenue is quite modest at the moment. But long-run prospects are bright, as the central government has become well aware. As long as the central government has no budgetary interest in increasing personal income tax revenues, it has no clear incentive to improve the quality and scope of the tax. The effective content of the law (what is taxed, and in what way) will then be decided at the local level. Such a development may prove harmful to tax performance, especially where sources of income between local jurisdictions are potentially mobile. From an equity point of view, a personal

cal Control', in V. Tanzi, ed., *Transition to Market, Studies in Fiscal Reform*, IMF Washington D.C., 1993.

¹² For small entrepreneurs, it may be attractive to be taxed under VAT rather than business tax. This will depend on both their branch of activity (which determines their business tax rate) and their treatment under VAT. As a rule, small enterprises under VAT are taxed at a low rate (6 per cent instead of 13 per cent or 17 per cent) without a claim on refund of input VAT. However, with reasonable bookkeeping a small entrepreneur may apply for normal VAT treatment. Thus, he will get a VAT refund on inputs that he would not be entitled to under the business tax. In principle, it would be interesting for the central government to seize the business tax base by the liberal admission of the self-employed to the normal VAT system. However, over the last few years the Chinese VAT has suffered from considerable problems in running the refund system (submitting 'fake invoices' can even lead to the death sentence).

income tax levied by the central government would be an attractive instrument for fiscal equalization between regions and provinces.

Of course, one can argue, to quote Musgrave,¹³ that in a developing economy the focus must be on economic growth, savings and investment, and conclude that 'fair distribution is a luxury that poor countries cannot afford'. On the other hand, Musgrave contends, fairness is obviously important when average income is low, and fairness is required to develop public support for the tax system.

Given the Chinese government's stated goal of reducing income inequality by means of taxation, there is clear reason for concern. It will be virtually impossible to increase VAT rates, because this tax tends to enlarge income inequality. Moreover, the statistical data available suggest that income inequality in China is fairly moderate yet increasing.¹⁴ Given the fact that the Chinese government cannot control incomes earned in the private sector, achieving fairness in taxation is the main instrument by which to narrow the gap between the rich and the poor. Apparently personal income tax is being assigned the major role. The Decision of the Fifth Plenum of the Fourteenth Central Committee (September 1995),¹⁵ when addressing the issue of 'narrowing too big gaps in social distribution by means of taxation', only specifies measures to improve the collection and administration of the personal income tax.

3. STATE REVENUES AND TAX POLICY

The budgetary success of the introduction of a modern tax system in China seems to have been dubious so far. Returning to Table 1, one can observe that an increasing portion of tax revenue is generated in the market sector. Because the data in Table 1 refer to *total* government revenue (including for example profits from SOEs) the contribution of the private sector to *tax* revenue may well be over 20 per cent in 1993, which is roughly in line with the private sector's contribution to GDP. Over the same period, industry lost its role as the main source of

¹³ Richard Musgrave, 'Tax Reform in Developing Countries', in D. Newbery, N. Stern, *The Theory of Taxation for Developing Countries*, Oxford 1987, pp. 242-263.

¹⁴ In 1990, the top 10 per cent in China received 24.6 per cent of total personal income, two years later they received 26.8 per cent. See, the World Bank's *World Development Report*, 1993 and 1996. Washington D.C., 1993, 1996.

¹⁵ Quoted from the excerpt published in *China Daily*, October 5th, 1995.

government revenue (its share declining from 83 per cent to 38 per cent, while commerce increased its share from 2 per cent to 26 per cent). Moreover, the share of taxes in total revenue increased from 53 per cent to 84 per cent, and revenues from enterprises declined from 40 per cent to 1 per cent of total revenue. All these data suggest that China's tax system has been able to cope with a rapidly changing economic environment. On the other hand since the mid-1980s, total tax revenue is declining in GNP terms, and the 1993 tax reform has brought no improvement to date.

As Table 3 shows, tax revenue¹⁶ is still lagging behind GNP growth.¹⁷ The main explanation is China's heavy dependence on VAT. In fact, personal income tax does quite well, and taxes on business (corporation income taxes and business tax) seem to perform reasonably.

Table 3. Increase in GNP and in industrial & commercial taxes, 1993–1996

	1993–1994	1994–1995	1995–1996(*)
GNP	38.4	30	19.2
PIT		54.9	80.8
CT & VAT	25.1	13.9	19.1
BT & CITs	22.7	n. a.	
total	25.4	18.3	22.4

(*) January-June

Sources: Economist Intelligence Unit, State Tax Bureau press releases

Generally, heavy reliance on indirect taxes produces a negative 'fiscal dividend'. This means that the share of taxes in GDP has a natural tendency to decline as GDP increases. As people become more

¹⁶ Taxes referred to are the so-called industrial and commercial taxes, which generate about 85 per cent of total tax revenue, the remainder consisting of, *inter alia*, stamp duty, agricultural tax.

¹⁷ The year 1996 may prove the first exception, although the January-September increase of tax revenue is reported to be slightly lower than GNP growth. But the increased reduction of VAT refund on export from January 1, 1996 onward may well account for 5 per cent increase of total tax revenue.

prosperous, they can save more money. The share of consumption in GDP declines, and so does the revenue of taxes levied on consumption. In contrast, countries with a heavy reliance on (progressive) income taxes will enjoy a positive fiscal dividend: as people get to earn more, their tax payments will steeply increase. Selected taxes on luxury commodities can also contribute to fiscal dividend.

This leads to a clear cut policy conclusion. Countries with a negative fiscal dividend, such as China, cannot ensure increasing tax revenues (in GNP terms) without constantly increasing tax rates and introducing new taxes. On the other hand, countries with a positive fiscal dividend, such as most Western countries, can keep their tax revenue intact and still reduce tax rates. From this perspective, there is a clear relationship between accomplishing fairness in taxation, budgetary revenues, and tax policy. To achieve a tax system that generates increasing revenue, it is necessary that China's new prosperity be taxed effectively.

Can this be achieved by personal income taxation? Increasing income inequality suggests that the high-income individuals' ability to pay taxes is increasing as well, and probably at considerable speed. As mentioned earlier, the Chinese leadership expects to reduce income inequality by means of the personal income tax. And though its revenue is low (some 0.3 per cent of GDP), it has been rapidly increasing over the last few years. The Chinese government seems to consider this a significant success, presuming that the tax is being paid by an increasing number of high-income earners from the market sector, but this is doubtful. Since 1994, the personal income tax rate structure has not been adjusted for inflation. This causes a considerable, inflation-driven fiscal dividend in income tax — people who were in the personal income tax in 1994 will pay far more in 1996 even if their taxable incomes just kept up with inflation. Table 4 provides a numerical example for four persons who respectively had wage incomes of 850, 1,000, 1,200, and 2,000 Yuan a month at the beginning of 1994 and whose wage increase since has been equal to consumer price increases over 1994 and 1995.

Table 4. Fiscal dividend in the Chinese Individual Income Tax: an illustration

	1994	1995	1996
consumer price inflation	24.2	16.9	
wage income			
tax payment (Yuan per month)			
850	2.5	12.79 (+412%)	21.71 (+70%)
1,000	0	22.10 (+121%)	40.19 (+82%)
1,200	20	44.04 (+120%)	69.23 (+57%)
2,000	95	143.40 (+ 51%)	190.57 (+33%)

Source: author's own calculations

Non-adjustment of income tax brackets for inflation can well explain the actual increase of tax revenue, which was 55 per cent in 1994 and 81 per cent in 1995. In other words: the strong increase in personal income tax revenue does not, in itself, justify the conclusion that an increasing number of people is being taxed. And with decreasing inflation, this fiscal dividend will soon dwindle.

This performance should be considered in the proper perspective of a developing country. Most developing countries do have some kind of personal income tax — often with rather high rates, even — but these generate little revenue. They are paid primarily by civil servants, the employees of state enterprises, and foreign corporations. Workers in agriculture and small firms, and the self-employed are not effectively being taxed.¹⁸ In addition, income thresholds are generally high. As a result, high top rates combine with low revenue. The Chinese personal income tax is certainly no exception to this general impression of weak performance.¹⁹ Some improvement may be possible. Under the

¹⁸ R. Burgess and N. Stern, 'Taxation and Development', in *Journal of Economic Literature* (31), June 1993, pp. 762–830.

¹⁹ W. Easterly and S. Rebelo, 'Marginal Income Tax Rates and Economic Growth in Developing Countries', *European Economic Review*, 37 (1993) 2-2, pp. 409–417, pro-

existing assignment of taxing powers, lower levels of government are entitled to its revenue. It is very attractive for local governments to devote their efforts to personal income tax, because they do not have to share the revenue. Presuming that local governments are in a better position to acquire information on personal incomes, it may be wise to leave it that way for some years to come. The current structure of tax rates may be revised for that purpose. The first rate is now only 5 per cent, which means that local governments have little incentive to look for new taxpayers whose income has just exceeded the basic exemption. A first tax rate of, say, 15 per cent might well double or triple personal income tax revenue.

But generally, the personal income tax cannot solve the Chinese government's budgetary problems. To do so, it would have to transform the tax from a 'class tax' into a 'mass tax'. The coverage of the tax should be extended to include the average worker level (which means that the basic exemption should be halved). The technique — a wage withholding tax — is quite feasible in China, because most workers are employed in state-owned enterprises.²⁰ But this is exactly what makes such a tax pointless, as long as the state is prepared to back up SOEs losses.

The basic issue of how to tax increasing private prosperity may tend to be obscured rather than clarified by looking at the feasibility of income taxes. It is quite easy to predict how Chinese people will use their increasing wealth in the next decade. First, they will use part of it to increase their savings (keeping in mind that pension provisions are lacking, or unreliable should a SOE be involved). And secondly, they will buy TV and PC sets, videos, all kinds of electrical equipment, and motor cars.

Taxation of savings does not seem to be feasible now or in the near future. As noted above, savings are in fact taxed implicitly because of the state monopoly in the domestic savings market. What remains then is the taxation of 'conspicuous consumption'. The purchase of

vide data on personal income tax performance in (among other countries) India, Indonesia, and Pakistan. These countries all achieve a personal income tax revenue of about 1 per cent of GDP, as compared to 0.3 per cent in China. Part of the explanation may be that these countries' tax rates exceed China's. But at least, there is no indication that China is more successful in running a personal income tax than other comparable countries.

²⁰ Hussain and Stern.

consumer durables and cars is only just beginning; and should China's economic growth proceed at the current pace, an enormous increase of these markets can be expected. In other words, increasing prosperity can be taxed by indirect taxes on durables, cars, and fuel.

Of course, China does have a system of excises ('consumption tax') focused primarily on luxuries. Taxable items include automobiles, fuel, cosmetics, alcohol, and tobacco. But tax rates are generally low (starting with 3 per cent for non-luxury cars, and a maximum of 45 per cent for top-quality cigarettes; fuel tax rates amount to \$0.02 for petrol and \$0.01 for diesel). There is clear scope for rate increases here. On the other hand, we (again) find problems of tax co-ordination. The tax burden on the purchase of a new car seems to be close to 100 per cent (quite comparable to European countries), due partly to local governments levies. Moreover, it should be noted that limited administrative capacity implies low (or at least not too high) tax rates. It is reported that half of China's (admittedly low) car imports from Japan is smuggled. Yet, the basic point remains that indirect taxes on specific commodities may do more to achieve a fair distribution of tax burdens than personal income tax as it functions now.

4. NON-DISCRIMINATION OF TAXPAYERS

Non-discrimination or equal taxpayer treatment has strong roots in political theory. There are two points involved. First, the requirement of non-discrimination forces government not to grant any tax privileges. Taxpayers can be made to pay different amounts of tax only to the extent that they themselves differ in circumstances and characteristics. There is an important political side to non-discrimination. As Buchanan²¹ has pointed out, general and uniform taxation offers few opportunities for lobbyism and clientelism. Conversely, a system containing many special provisions and exceptions creates ample scope for negotiations between politicians, tax administration, and taxpayers. Secondly, non-discrimination can also be considered a restriction on governments' ability to use tax incentives (and penalties) for socio-economic purposes.

²¹ J. Buchanan, 'The Political Efficiency of General Taxation', *National Tax Journal*, XLVI, no. 4 (1993), pp. 401-410.

China's recent tax reforms have explicitly been aimed at improving equal treatment.²² However, it is difficult to say what 'equal treatment' means in a transition economy. I will illustrate this point with two examples.

First, the new personal income tax. China has a schedular personal income tax. Taxation of wage income is progressive with a threshold of 800 Yuan per month (more than twice the average income in urban areas) and nine rates up to 45 per cent. Business income faces a top rate of 35 per cent, several other components of income are taxed at a flat rate. Interest received from a state bank is tax exempt.

This schedular tax reflects both administrative and economic problems in applying income taxation. Non-wage income is hard-to-tax, which may justify lower rates. And state banks have a monopoly position on the savings market, while paying below-inflation interest. This may well justify tax exemption. It should be noted that reportedly a large amount of savings flows out of China illegally, mainly to Hong Kong and Taiwan. This indicates that domestic savings cannot be invested in a reasonable way, and have to escape the country, probably to return disguised as foreign investment. Thus, given the large implicit tax on savings, it is not feasible to tax personal income uniformly income irrespective of its source.

The second case to be discussed is corporate income taxation, where domestic Chinese investors may face a tax burden far in excess of that of foreign investors'. Despite important simplifications in corporate income taxation, China still has a separate corporate income tax for profits on foreign-owned investment. In principle, both taxes use the same tax rate of 33 per cent (including a 3 per cent local surcharge). However, in the Special Economic Zones (SEZs), where more than 80 per cent of foreign investment is located, the standard rate is 15 per cent. For enterprises qualifying as 'export-oriented' the rate is normally 10 per cent, and a refund up to 100 per cent is available when profits are reinvested in the establishment or expansion of an export-oriented or technologically advanced enterprise.²³ Moreover, time and again the central government has forbidden local tax authorities to apply their own exemptions and rate reductions.

²² Zhang, in this volume, discusses the unification of income taxes from this perspective.

²³ International Bureau of Fiscal Documentation, Taxation and Investment in the People's Republic of China.

As a result, China's system of corporate income taxation discriminates heavily between domestic and foreign enterprises. This can easily be seen from corporate tax revenues (Table 2). While SOEs are responsible for a small and declining part of total corporate profits (for 1996 no more than 1 per cent) they pay the lion's share of corporate taxes. Corporate tax revenue from foreign-owned (and private) enterprises equalled no more than 0.3 per cent of GDP in 1993.

There are three problems involved. One is a matter of policy choice. Low corporate taxation of foreign investment is a deliberate strategy, meant to attract foreign investment and, probably, to be abolished as soon as foreign investment has gained impetus. And indeed, Chinese tax policy is now explicitly facing the question of how and when to increase the corporate tax burden on foreign-owned investment. On the other hand, it should be noted that the overall tax burden on foreign investors is by no means low. It is quite clear that many foreign enterprises in China incur high costs in paying all kind of (local) contributions, levies, and fees. According to China's Minister of Foreign Trade the tax payments of foreign-funded enterprises account for 10 per cent of China's total tax revenue. This is due mainly to limited VAT refunding at export. In principle, the Chinese VAT is destination-based: VAT paid on production inputs is deductible upon export. In practice, and mainly for budgetary reasons, this rebate has been almost halved over the last few years. The VAT thus works out as an export tax, and on the presumption that exporters face a competitive world market this constitutes a tax on exporters' profits. Its revenue by far exceeds the corporate tax revenue on foreign-owned enterprises.²⁴

A second, and perhaps related, problem is the distribution of taxing powers. Basically, lower levels of government have too large a role in the taxation of corporate profits. Any local government that wants to compete with the SEZs has to convince foreign investors that the statutory tax rate of 33 per cent will not be applied fully (which may be achieved by tax rebates, lax tax enforcement, postponed tax payment and the like). Thus, it will be difficult for China to get more corporate tax revenue out of foreign investment without transferring the power to tax to the central level. Given this state of affairs, taxing foreign

²⁴ This can be loosely estimated at Rmb 60 to 70 bn in 1996, which is equal to 10 per cent of China's total tax revenue and 1 per cent of GDP. In Beijing — a host to many foreign corporations, of course — more than half of local tax revenue stems from foreign enterprises.

enterprises by limiting VAT refunds on exports may be the best option available to the central government.

The third problem is tax administration. SOEs may have reasons to resort to tax evasion, but their average size is conducive to a reasonable level of tax auditing. Foreign and private-owned enterprises, because of their smaller average size, can escape profits taxation more easily.²⁵ This administrative consideration strengthens the case for limited VAT refunding. After all, private enterprises have a clear incentive to report the size and value of their exports, even with limited VAT refunding. The practical conclusion, however, is that the Chinese VAT is developing into an (origin-based) sales tax.

Still, what remains is that domestic enterprises face far higher corporate taxes. The point is of course that most of these enterprises are SOEs and enjoy large (implicit) subsidies, especially soft loans. In a sense, this allows them to pay corporate taxes. Taxation of SOEs nowadays in China serves the particular function of siphoning money from the domestic savings market to the treasury. It does not seem wise to accord SOEs the favourable corporate tax treatment that foreign enterprises receive, unless subsidies to SOEs are stopped (and the return to personal savings taxed at high explicit rates to pay for unemployment benefits to redundant SOE-workers). And on the other hand, the hesitation of the Chinese leadership to put an end to preferential tax treatment for foreign enterprises is quite sensible. In other words, in the presence of important implicit taxes and subsidies, the requirement of equal treatment of taxpayers cannot be considered in isolation.²⁶

A related general question is to what extent the government should be allowed to provide economic incentives and disincentives through the tax system. In Western countries, there is no clear and general answer to this question. On the one hand, taxation is regarded as an

²⁵ See, Dali Yang at p. 70. Blejer states the Chinese government has been trying to tax private sector incomes and that 'receipts from personal income taxes, as well as receipts from foreign-related enterprises [i.e., through corporate income taxation, HV] ... have increased in importance after 1987'. The 1993 data show that these increases must have been very modest.

²⁶ Jinyan Li, 'Domestic Enterprise Income Tax', in, *Bulletin IBFD*, February 1995, pp. 81-94 argues that a higher tax rate on domestic enterprises is no longer justified as 'all these enterprises compete openly on the market'. SOEs, however, can rely on the state to cover their losses. In the end, privately funded domestic enterprises pay the bill under the current system: they cannot obtain tax preferences available for foreign investment yet have to compete with foreign enterprises.

intervention in (if not a violation of) private property rights. On the other hand, it is acknowledged that taxation is a part of the government's socio-economic policies.

In China, the issue is perhaps even more troubled for two reasons. First, the relation between politics and market sector (and the scope for political interventions in market decisions) is unclear. Secondly, taxes have only recently been introduced and have no traditional roots in China. As a consequence, it seems that Chinese government has few (if any) inhibitions about using large-scale tax incentives for promoting investment and economic growth, or to direct such incentives to specific zones and economic activities.

5. FAIR TAX ADMINISTRATION

Fairness in taxation does not relate only to the distribution of the tax burden; it also requires that tax liabilities be assessed according to acceptable rules. Modern tax theory is based mainly on the 'social contract' philosophy: governments' power to tax depends on their citizens' consent. Thus, government is only entitled to lay its hand on private property when it uses general, promulgated rules that apply equally to all — that is to say, tax laws. Only by so doing can governments make the crucial step from state-organized looting to taxation (though probably no government succeeds in convincing every citizen that it has indeed taken that step). This requires transparent tax law, fair and capable tax administration, a reliable and accessible system of judicial review. Though it would be difficult to submit empirical proof, it seems clear that people are more willing to pay taxes when they feel that the same rules are applied to all, and that taxpayers enjoy legal rights to be enforced through independent courts. Such requirements pose evident problems in developing countries and China is no exception.

There are reasons to expect special problems in China. One is the extremely rapid pace of tax reform over the last few years — practically all taxes plus the tax administration have been touched. Over the last few years, the tax administration has been split up into local and state tax bureaus, the latter reporting to national government. These new bureaus had to implement new corporate and personal income taxes, a new VAT refund system and new excises. In combination with the experimental nature of tax law (often embodied in temporary State

Council regulations rather than formal law), many Chinese taxpayers must be confused as to what their tax obligations now are. In such a climate, tax officials can easily engage in corruption and extortion. Recently, one of China's vice-premiers publicly warned local officials to refrain from collecting illegal (i.e., non-existing) fees from peasants, and the State Council has decided that fees should not exceed 5 per cent of farmers' net income. And local tax administrations, facing difficulties in VAT enforcement, are reported to use their own ways of assessing tax liabilities (such as imposing fixed-amount payments). Though the speed of reform may be understandable in political terms,²⁷ it seems that both tax administration and taxpayers could use some rest and some simplification.

At first sight, Chinese tax law does look very simple. For example, the income tax is a very concise piece of law (14 clauses in about four pages), compared to its Western equivalents. But this simplicity implies that many regulations are required that clarify concepts and procedures. These regulations are partly concluded by local governments and not always publicized. Moreover, in many cases the tax administration is exclusively authorized to interpret tax regulations. As a result, conflicts between taxpayers and tax administration are settled by administrative review. There is no tradition of judicial appeal.²⁸ Thus, the legal position of taxpayers is generally weak, and the review system seems to lack a built-in mechanism to provide for uniform interpretation of national tax laws and regulations.

6. CONCLUSIONS

In this paper I have discussed the relevance of *fairness in taxation* as a requirement to tax policy in China.

The Chinese leadership wants to use the tax system to reduce growing income inequality and to increase government revenue. It attaches great value to non-discrimination — more precisely, to the merger of hitherto separated taxes. It also emphasizes that taxes should be levied according to law.

In this paper I have argued that personal income tax in China is not suited to achieving a meaningful shift of the tax burden to high-income

²⁷ See, Tsang and Cheng.

²⁸ IBFD, *Taxation and Investment in the PRC*, offers a short description and comment on the Chinese review system.

taxpayers. Instead, the problem of equitable distribution should be addressed within the system of indirect taxes, especially VAT and consumption tax. There are several reasons not to expect a major role for personal income taxation in the near future. The most general argument is that developing countries as a rule do not succeed in making the personal income tax a significant source of revenue. In the Chinese case, additional considerations are (1) the presence of a heavy implicit tax on savings which, in a fairly arbitrary way, functions like a progressive capital income tax and (2) the fact that most workers are in SOEs, which implies that a wage withholding tax would increase the SOE's demand for government subsidies and loans.

In its search for increasing revenue, the Chinese government faces serious restrictions. To increase the taxes paid by SOEs is useless. The return on foreign investment is now being taxed quite considerably to the extent that profits are earned on exports; somewhat surprisingly (from a Western point of view) the instrument is not corporate income tax but VAT. It seems that VAT and excises are the main potential sources for additional revenue. In other words, the role of direct (income) taxes in China is marginal. And it seems that there is little scope for improvement as long as economic reform stops short of SOE and banking reform.

For the same reasons, 'non-discrimination' is not a very useful concept in China's tax policy, though clearly a consideration in current tax policy. It is hard to say what non-discrimination means in a transition economy. The favourable tax treatment of one sector can be undone by implicit taxes, and on the other hand heavy taxation and subsidization may occur jointly. One sector that may be discriminated against in a real sense is privately-funded domestic enterprises. These do not enjoy the preferential corporate tax treatment awarded to foreign-funded enterprises, but they do suffer from limited VAT refunding at export.

The criterion of fair administration requires special attention because of the breath-taking speed of tax reform. Also considering limited administrative resources, some tax simplification may be needed. A natural candidate would be the VAT, that seems to suffer large administrative problems (especially relating to the refund of input VAT). A retail sales tax might well prove far easier to handle and generate the same tax revenue. The system of excises could be used as the most feasible way to improve both equity and revenues.

It should be noted though that the distribution of taxing powers over levels of government seems to dominate all other issues in tax policy. Perhaps central government has regained the initiative over the last few years, but a reversion of fiscal decentralization seems improbable. In such circumstances, the distribution of tax burdens may well become wholly uncoordinate and very uneven. Those tax bases that cannot escape or respond to high levels of taxation will be taxed by every level of government; tax bases that are very mobile between jurisdictions will be taxed by none. Much of this can already be observed in present-day China.

Thus, the future of China's tax system depends both on further progress towards a market economy and on the distribution of fiscal powers over the levels of government.