China’s emerging tax regime: Local tax farming and central tax bureaucracy

Ze Zhu and Barbara Krug
EUR, Rotterdam and UTS, Sydney

1. Introduction

Economic transformation asks not only for less state appropriation of resources, it also asks for a change of the means by which the state does so. Generally speaking, there are four ways to generate budgetary revenues: first, exploitation of state owned/controlled resources; second, taxation of assets and income or trade flows; third, forced loans on economic agents and finally, seigniorage, i.e. printing money. Given the commitment to stability, the Chinese government is forced to rely on the first three revenue sources. Yet, privatisation and un-competitiveness of state-owned firms reduce the government revenue from the state sector; while revenue from forced loans, i.e. compulsory transfers of the firms’ cash flow and compulsory saving of private households, declines following price and wage liberalisation. Subsequently, state expenditure depends increasingly on taxation, which needs to be revised to comply with the reform course.

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

While the traditional public finance theory (see e.g. Musgrave, 1959; 1969) propagating rational financial systems concentrate on the effectivity of taxation (and spending) with respect to well-defined goals, the public choice literature treats the state as a Leviathan (see e.g. Brennan and Buchanan, 1980) and sees fiscal federalism (see e.g. Oates, 1972; Olson, 1969) as institutional remedy. The trade off between
rational taxation versus small government (expenditure) was taken up again in the
discussion of institutional change in transition economies, where two opposing
hypothesis define the conceptual and empirical discussion, namely the “Grabbing
Hand”- hypothesis (Frye and Shleifer, 1997; Shleifer and Treisman, 1999) pointing to
the risk that the Leviathan will survive economic transformation (the Russian case),
and the “Helping Hand”- hypothesis (see e.g. Oi, 1992; Walder, 1995) stressing the
benefit of continuing state intervention during the transformation period (the China
case). The China specific dimension of this debate centres around three features, local
autonomy, local diversity, and tax farming.

Local autonomy

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

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

*Local diversity*

Characterised by a severe principal-agent problem between the central government as the principal and local units as agents, fiscal decentralization must also lead to local diversity (Krug, 2004a; Krug and Hendrischke, 2003; Hendrischke, 2003): First, the central government grants different “degrees” of independent decision-making to different local government agencies (Bird and Chen, 1998) as in the case of Special Economic Zones. Second, different local government agencies react differently to the same central policy guidelines according to different local conditions, such as size, geography, the historical legacy and different resource endowments (Krug, 2004b; Hsu, 2004). Third, jurisdictional competition forces local governments to generate competitive advantages by offering preferential taxation and subsidies to its tax base (Walder, 1995; 1996). Fourth, an alliance between firms and local government agencies facilitates escaping national legislation, if not manipulating national tax legislation (Wedeman, 2003; Shirk, 1993; Wank, 1996; Chen and Rozelle, 1999; Goodman, 2000)\(^1\).

*Tax farming*

One unexpected component of decentralisation was the introduction of tax farming IN general, a tax farming system is connected to the pre-modern states of England and France (see e.g. Kiser, 1994; Kiser and Kane, 2001; O’Brien, 1988; Donald and O’Brien, 2002; Weir, 1989; White, 1995; 2004). It was only after the Glorious Revolution in the former and French Revolution that a centralized tax bureaucracy developed in both countries in response to changing transaction costs, and the
expansion of financial markets, which offered an alternative means for financing state budgets. An economic analysis of this change argues that two factors influence institutional choice: the monarch’s (state’s) attitude toward (economic or political) risk and the incentives necessary to make lower administrative units to act as tax agencies on behalf of the monarch. With respect to the incentive structure three different forms of tax systems can be singled out, usually described as contractual arrangements between the central state and the local agents put in charge of tax implementation, a rent-based, a wage-based and a (crop-) sharing contractual arrangement (see e.g. Stiglitz, 1974; Sappington, 1991; Allen and Lueck, 1995). The first refers to a lump sum contract-type where the central state “farms out” tax authority to local governments in return for a guaranteed (low risk) fixed sum. By doing so, local tax agents become the residual claimant on tax revenue. The second wage-based arrangement refers to a professional bureaucracy which in return for a share of the national budget, fixed wages and promotion within the state bureaucracy “selflessly” implements central policy without bearing individually or organisational risks. The third form follows crop-shared contracts in which both central as lesser and local governments as lessee share economic risk productivity gains in tax administration (cropping sharing contract).

While in the socialist era China had a Weberian-style of a bureaucracy, it started experimenting with tax farming in the eighties to be followed (in the nineties) by a widespread (tax) sharing system and the re-introduction of a bureaucratic system. This unusual phenomenon of different tax systems co-existing, asks for an empirical analysis. Does that kind of institutional choice follows arguments offered by the analytical concepts? Or which other factors that prompted institutional change can be singled out:

1. Normative considerations, such as taxing “equal activities equally”?
2. Distributional considerations, most prominently the problem of regional disparities?
3. Economic considerations, such as standardization gains or transaction costs in
monitoring and enforcement?

4. Political considerations such as conflicting interests between the central and local government agencies, or setting incentives that ensure local government agencies to comply with the reform course?

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

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

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

The remainder proceeds as follows. The next sections (sec. 1 - 3) present a descriptive analysis of the different reforms since 1978. Each section will stress the causes and effects of institutional change with respect to local autonomy and local diversity. The status quo analysis of present tax system (sec. 4) serves as an introduction to the analysis of how the present tax system, local autonomy and local diversity interact-formally and informally - at the lowest layer of government in China (sec. 5) in order to illustrate the difference between the intended functioning of the tax system and the actual interplay between the taxation and the emerging market sector. The paper ends with summarising the empirical results and a general assessment of
China’s tax system (sec. 6).

2. Rebuilding tax codes: shifting government revenue

In the pre-reform era three categories of indirect taxes\(^2\), i.e. the industrial and commercial tax, tariff and the agriculture tax, were levied in China\(^3\). State-owned enterprises (SOEs) were subject to the industrial and commercial tax in addition to the compulsory transfer of “profit” and cash flow. Tax revenue (1978: 46 per cent) and profit remittance (1978: 51 per cent) were the two dominant resources of total revenue (MOF, 2005). To increase productive efficiency while avoiding privatisation the reforms introduced first a “contract responsibility system” (chengbao zeren zhi) to be followed by a “tax-for-profit” scheme (li gai shui) in 1983 and 1984. Both reforms acknowledged the SOEs as independent economic actors entitled to part of profit which they could allocate internally to working capital, investment, wages, and bonus without state intervention as long as they fulfilled the contract quota. The share of after tax profit and the tax rate were subject to individual negotiations between the firm and the bureaucracy in charge of the firm and varied according to enterprise size, sectors and ad hoc situation. It quickly turned out that in response to the fuzzy property rights the SOE managers channelled undisclosed profit into their private pocket by establishing joint ventures with TVEs or by outsourcing production to new private firms rather than reinvest in productivity increasing change. That asset-stripping eroded the state sector’s profitability further and ended in sharp increase of loss making SOEs. Yet, with a state sector still not liable to a hard budget constraint (Kornai, 1986), the underperformance of the state sector directly translated into higher government expenditure in form of subsidies or loans necessary to “bail out” the bankrupt SOEs. The situation was further aggravated when the non-state sector started to out-compete the SOEs further reducing the latter’s profit remittance and tax contribution. In 1985 already, subsidies for SOEs were eleven times higher than the revenues from SOEs (MOF, 2005). Facing such eroding revenue base the central government had incentive enough to search for a new broader tax base,
namely one that included foreign enterprises and all forms of joint ventures.

Thus, direct (income) taxation made its re-appearance in China to which foreign enterprises, joint ventures, SOEs, collective enterprises and individuals became subject to. Simultaneously the reforms of indirect taxes started with introducing a VAT for twelve categories of products, such as machinery, steel, but also consumer goods, such as bicycles, electric fan, or sewing machines with rates between 6 per cent and 16 per cent. Other economic transaction were taxed by a product tax (270 items) subject to a flat rate varying from 3 per cent to 60 per cent (and salt a tax) in 1984. Such a diversified tax structure increased the monitoring and enforcement cost for tax collection and administration considerably. Unsurprisingly the 1994 reforms abolished the product tax, expanded VAT to all manufactured products with a standard rate of 17 per cent (and a reduced rate of 13 per cent for necessities), and levied a business tax on service industry but kept the consumption tax on 11 categories of goods. Since then in total 29 taxes have been levied on turnover, income, resource, property and behaviour (Table 1). Since then indirect taxes are the major revenue source of the Chinese state. In 2003 the VAT, consumption tax, business tax and custom duties added up to 69 per cent of total tax revenue, in which the VAT alone provided 36 per cent of total revenue (SAT, 2003).

[insert table 1 about here]

All in all, the reforms of 1994 support the assumption that tax changes can (and will) follow transaction costs considerations, i.e. monitoring, collecting and enforcement costs when indirect taxes were introduced. As was pointed out elsewhere indirect taxation allows concentrating on a few taxable assets thereby offering lower collection costs than a system that aims at assets or income of all (potential) tax payers (Kiser and Kane, 2001; Ardant, 1975). China’s WTO entry in 2001 prompted further changes in order to comply with international standards. Foreign (15 per cent income tax) and domestic (25 per cent income tax) firms will no longer be treated differently by the
tax authorities (Mui and Jia, 2002). The scope of VAT will be expanded to cover a broader range of products. A new social security and property tax are aimed at better coping with economic transformation which includes employment insecurity and increase in wealth.

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

3. Tax farming: positive incentives and local autonomy

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

To redress this problem, the reforms started with transferring fiscal authority, i.e. the power to tax, to local governments. Several experiments were carried out, such as “fixed overall revenue sharing rate” in Jiangsu province in 1977, “dividing central, local and central-local sharing revenue” in Sichuan province in 1979 and “fixed lump sum transfer” in Guangdong and Fujian province in 1979, later (1980-1993) expanded to six types of contract arrangements (see e.g. Oksenberg and Tong, 1991; Wong, 1991; 1992). It is worth mentioning that these fiscal arrangements are modifications of tax contracting analytical models described earlier^6.
Empirical fieldwork suggests that the rental-based model quickly emerged as the dominant form. In this kind of tax contracting the central government negotiates a fixed share of revenue (in absolute terms, or as a ratio) leaving the local government the de facto residual claimant of revenue. From the local perspective, disposable revenues were directly linked to economic growth and/or the attractiveness of the local economy for investment from outside (other jurisdictions or foreign companies). Yet, as suggested in the economic analysis of tax farming, three unintended consequences emerged: First is the principal-agent problem remains unsolved. Local governments profit from asymmetric information; hiding the correct information if not falsifying tax reports is an easy way to minimise the amount of tax revenue to be transferred to the contract partner whether the national treasury or any superior government agency. Second, re-negotiable contracts include an element of uncertainty in local budget planning as well as in anticipating budgeting across localities. With the length of contracts and the sharing formulas re-negotiable, future budgetary revenue depends less on economic trends but rather on the relative power position of the contract partners. Contract arrangements vary also with respect to sharing rates, time period, or spatial factors, when some provinces, regions, or localities are granted special licences from the central government. Third, as all “agents” share the interest to minimise upward transfers and manipulate the tax base, the state’s financial base eroded even further. Whether the trend measured as total government revenue per GDP, or central revenue as share of total government revenue during the 1980-1993 period is the same: Ratio of total government revenue to GDP fell from an already low 26 per cent in 1980 to 13 per cent in 1993. The share of the central revenue to total government revenue fell from 41 per cent (1984) to 22 per cent (1993) (Figure 1).

[insert figure 1 about here]

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

4. Tax sharing: bureaucratising tax administration

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

The newly introduced tax sharing system does not refer to a separation of tasks between different layers of government to which specific sources of revenues (taxes) are allocated as in “Western” models of multi-layered government, such as federalist states or the EU for example. Instead, the tax revenue (and not tax legislation) are divided in such a way that some taxes are exclusively assigned to the central level, some are assigned exclusively to the local level, and some taxes are shared between both levels according to a fixed ration. It is worth stressing that the category of local revenues includes fees and other kinds of revenue which are manipulated by local
governments. As Table 1 illustrates these local taxes encompass a variety of fees and taxes, which reflect the willingness and ability to tap local resources when they concentrate on the taxation of relatively immobile factors rather than following an economic policy of generating competitive advantages for a locality. At first sight the tax sharing system seems to follow international practice in the sense that the two largest revenue sources, namely the VAT and income tax, are divided between the central and local level (see Table 2). That revenues from tariffs go directly to the national coffer is also common standard. On the other hand the socialist legacy can be seen in the fact that the income taxation of foreign firms remains a concern of the central government.

[insert table 2 about here]

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

Unintended, the tax reforms established a dual tax system where a streamlined Weberian bureaucracy for central taxation (including those taxes whose revenue were to be shared with local units) and largely unreformed local tax farming co-exist. A closer look at the reforms indicates that the reason for such top down
bureaucratisation is to be found in the shortage of professional tax personnel able to run a modern centralised tax administration, and the lack of modern monitoring devices that would keep the costs of tax collection (and moral hazard) low.

[insert figure 2 about here]

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

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

5. The status quo of the tax system

It is worth emphasizing that all reforms in the last three decades were directed toward the provincial level, while sub-provincial government agencies were rarely mentioned. General recommendations, such as to “promote” local initiatives (fangquan rangli) or to “adjust” for local conditions (yindi zhiyi) left the provinces with considerable
leeway to modify central policy. Thus, for example the 1994 reform merely stipulates that provinces improve sub-provincial fiscal administration without giving further directions. This neglect needs to be interpreted as the political compromise in which in particular rich provinces or sub-provincial government agencies saw their discretionary power re-confirmed in return of compliance with other parts of the reform programme, as for example the building up of a national tax bureaucracy outside the reach of “local” control.

Ad hoc non-tax levies

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

Extra-budgetary revenues (EBRs) originated in 1950 as a means to search for more financial means for local specially earmarked expenditures. It includes three major parts: 1) government funds and surtaxes, such as agriculture surtax, and education surtax, levied on the income, consumption, profit or turnover base; 2) a hold up of special funds of SOEs, such as depreciation, major repair, and innovation funds; and 3) locally self-raised funds and administrative fees, such as road construction fund, public utility fee, road toll, and tuition fee\textsuperscript{11}. OBRs on the other hand are public “voluntary” contributions made by individuals, firms or Overseas Chinese, various unregulated fees, and lately, profits from TVEs, and revenues from land sales (Fan, 1998). Lacking uniform procedures with respect to computation, base, rate, or frequency means that in fact, EBRs (or OBRs) are quasi-taxes. Their ambiguous legal status adds support to the notion of strong local autonomy in today’s fiscal system (Wong, 1998).
EBRs and OBRs were hardly worth mentioning if they had not been hijacked by local governments in the nineties for legitimising new revenue sources. As said before local governments have no tax legislation power and are only entitled to collect “local tax” legislated by the national government whose total amount cannot but add to a minor faction of local budgets (Table 3). Yet, driven by local self-interests and disposable revenues maximization, local governments are motivated to search for additional revenues sources whether entitled to do so or not. They sell state assets, invest in business activities, apportion mandatory contributions to local projects, issue local bonds, or levy (il-)legal service charges, the proceeds of which are listed as EBRs and OBRs in order to suggest legitimate revenue sources. As will be shown later (Table 4 and 5) the revenues from commercial activities for which there is no precedent in the socialist era became the largest source for local income in particular in the rich East. Profit or local taxes on TVEs (or dividends) as well as proceeds from land deals and real estate management can make local government agencies independent from central budgetary control. EBRs and OBRs are used to legitimise revenue maximisation, which is further evidence for the resistance of local levels to give up local autonomy.

[insert table 3 about here]

EBRs and OBRs remain a controversial issue in analytical studies. Some studies stress the negative influence on economic stabilization, state redistribution capacity and fiscal administration (see e.g. Wong, 1998; Lee, 2000), while others emphasize its positive outcome in the form of local wealth as measured in the provision of local public goods and services, such as school or health care (see e.g. Fan, 1998). In some places, such as the less-developed inland regions, arbitrary EBR- or OBR-extraction led to rural protest and violence (Bernstein and Lü, 2003; Tsui and Wang, 2004). On the other hand, in coastal and developed provinces, the advantages of EBRs or OBRs are seen in the ability of local government agencies to quickly respond to local public needs, if not as a starting point for more civil participation in local policy formation.
(shown in Fan’s (1998) field research).

Complicated intergovernmental transfer system

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

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

In other words, the tax farming nature of sub-provincial intergovernmental relations is kept unchanged. Superior layers of government farm out taxation to lower layers. Such a tax contract describes the agreed upon share of tax revenue to be transferred to the superior level as well as the agreed upon provision of public services invested and operated by the lower level. Negotiations between different levels of local governments on transfer and re-transfer of revenue became a constant feature of local
intergovernmental relations. Regardless which version of tax contracting is chosen, two systematic features dominate the effects: First, as a “lessee” and residual claimant, each agency at the lower level attempting to maximize discretionary revenue will shift expenditures for public services upwards while manipulating the tax base to minimise upward transfers (Tsui and Wang, 2004). Second, as will be seen presently, effective tax rates do not reflect tax legislation; they are rather the outcome of intergovernmental tax contracting, and the unsolved principal agent problem, or reflect the innovativeness of sub-provincial government agencies in finding new revenue generating resources.

*Dual tax administration system*

As said earlier, two tax systems co-exist in China. One is defined by national legislation which stipulates the tax base, tax rates, the procedure by which taxes are enforced, and how total revenue is shared between the central and local budgets (consolidated at the provincial level). The other one is characterized by provincial and sub-provincial discretion and tax contracting, *ad hoc* taxation, and unspecified procedures. This dual tax system has major implications. First, firms can calculate the effective tax rate only *ex post* when the exact local rates and fees are known. This makes, second, the local government agencies the ultimate authority in defining effective tax rates. Third, local government agencies facing different (financial) needs and/or different political leverage in tax contracting will differ in their revenue generating policy, subsequently contributing to the diversity in the local business environment. Finally, the national treasury or central government has only limited ways of controlling overall taxation. The most recent reform focused only on the revenue and central-provincial sharing side and cut off the link to the government spending. Moreover, the “tax-for-fee” reform launched in 2000 attempted to put an end to the practices of sub-provincial government agencies using *ad hoc* fees (Yep, 2004) and aimed at tighter budgetary control, yet also on limiting the overall tax burden for overcharged peasant households, i.e. distributional purposes. The effect
was minimal if not counterproductive as it forced local governments to generate even more revenue sources by embarking on commercial activities.

6. Township M and L: Budgets and intergovernmental transfer

Taxation in China is undoubtedly a bizarre institutional arrangement where different tax jurisdictions overlap and procedures are left unspecified, or burdened with a political rhetoric that confuses even the technical side of tax collection. How does this system work in practice? With only little information available at the local, i.e. prefecture, county and township, level, data need to be generated before a systematic analysis can be attempted. We decided to focus on the lowest level of the political and administrative hierarchy, namely the township, as this is the government agent, which meets the tax payer (in most cases firms)\textsuperscript{12}. On the factual side we wanted to know how the dual tax system affects local budgets, and how intergovernmental transfer contributed to local revenues. At the behavioural side, we wanted to know how the effective tax rate for firms is calculated, how much disposable income townships have and how they make use of their disposable funds. Finally, we expected that the answers to this question would shed more insights on the problem of diversity and local autonomy. The interviews conducted between 2003 and 2005 cannot answer all these questions. Instead of offering general interpretations based on weak evidence (and much guessing), we decided to present two case studies which to the best of our knowledge offer the first complete picture of budgets and budgetary procedures in two townships, called M and L\textsuperscript{13}.

Revenues

The budgets of the two townships presented in Table 4 and Table 5, offer different pictures which is partly caused by different ways to categorise revenue items. Township M classifies all revenue into two categories only, namely budgetary revenue
and extra-budgetary revenue, while Township L is much more specific. In the latter case revenues are listed as budgetary revenue, budgetary fund revenue, earmarked fund revenue and “other revenue” (Table 4). This practice confirms the findings from the World Bank (2002, p. 64) that there is no standard procedure for reporting revenues at the local level.

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

**Intergovernmental transfer**

Information about intergovernmental transfer of taxes is not published but needs to be generated by interviewing three to four groups of economic agents: representatives of the national and local tax administration, representatives of the local government, and firms. Instead the transfers follow the bargaining between government agencies, and between the township and firms. The interviews in Township M suggest three features that characterise transfer practice at the township level.
1) The Township M has to share revenue with four superior government layers of
district (county level), prefecture, province and central. Interaction between these
different layers of government agencies is partly statutory, i.e. based on legislation,
and partly resulting from previous negotiations. At the time of the interview seven
transfer modes were employed. Aside from the standardised sharing rules supervised
by the SAT, a negotiated sharing of “excess” tax income, as for example more revenue
from VAT than anticipated in the tax contracts for a budget year (see below). Other
sharing formulas address “approved budgetary expenditure”, “approved budgetary
expenditure of financial department”, “other shared tax items”, “subsidy from
superior units” and “remittance to the prefecture level”. Each mode follows distinctive
formulas such as quota-based, growth-based, progressive or regressive rates. For
instance, in the tax contract for 2003, M Township agreed to collect 120 million RMB
in VAT and consumption tax on behalf of the SAT. The actually collected amount
added up to 160 million, which was not allocated according to the usual 75:25
percentage formula between the centre and the local units. Instead the M Township is
entitled to a bonus based on the 40 million of “excess” revenue. The calculation
follows a ‘progressive’ rate: 12 per cent bonus for the first 12 per cent of the excess
revenue (1.73 million), 15 per cent bonus for the following 12-15 per cent of excess
revenue (54 thousand) and 18 per cent bonus for any excess beyond 15 per cent (3.94
million). The total amount of the thus calculated bonus added up to 6.2 million
considerably lower than the 10 million the local tax agencies would have been entitled
to, if the usual tax sharing formula had been applied (Table 6).

[insert table 6 about here]

2) Superior government agencies, such as the province, prefecture or county can and
will press for a sharing formula which squeezes the township of the tax income
generated at the township level. All what is needed is a document called hongtou
wenjian. This form of state capture (Hellman, 1998) can be illustrated by the way the
bonus on VAT collection allocated to different layers of government. For instance,
Township M was entitled to a due share of 3.88 per cent of total VAT and consumption tax generated in the township. Yet, Suzhou city superior to Township M appropriated 0.6 per cent, leaving M township with 3.28 per cent. Even worse, for 2004 Suzhou increased “its” share to 1.6 per cent, which would cut Township M’s share to 2.06 per cent (Table 6).

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

*Expenditures*

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

[insert figure 3 about here]

Thus for example, L Township grants all firms established since 2001 a three-year exemption (via *ex post* reimbursements from local budget) from VAT, enterprise income tax and business tax. Likewise, firms investing more than 10 million RMB in technological innovation enjoy a three-year tax refund. These refunds show up in the expenditure side of the Township L (Table 7) under industry and transportation item in 2003, reaching 38 million RMB at 20.9 per cent of Township L’s total financial expenditure. In addition to tax preferential treatment, Township L invested in 46 million RMB (25.6 per cent of total expenditure) in infrastructure and 65 million RMB (35.9 per cent of total expenditure) in education to improve investment environment. Another means for jurisdictional competition are land prices, which at a discounted rate can be used for attracting investment. As Township L claims it was this policy, which enabled them to attract 83 new established enterprises in 2003, out of which 40 enterprises were from other localities.

[insert table 7 about here]

To sum up, tax farming at the lowest administrative level defines the *effective tax rate* for firms, i.e. by far the largest taxpayer. The effective tax rate can be calculated only *ex post*, as the rate depends on reimbursement in the following year. Jurisdictional competition between lower level government agencies exists and thrives; yet alimented by local returns from commercial activities of government agencies rather than by “tax design”. Intergovernmental transfer is renegotiable and a way how in particular the middle-layers of government, such as prefecture and county can appropriate a share on tax revenue. At the township level tax administration and tax policy cannot be separated. Despite all the technical formulae used within the tax sharing process, the budget procedure at the township level follows three rather
straightforward steps. The township first estimates the total amount needed for fulfilling the mandatory tasks, keeping the agreed upon commitments to different groups, such as firms and the money needed for running the local government. In a second step, the township negotiates with all other local government agencies the volume of tax revenue to be transferred and re-transferred. As the township knows from past experience the range of transfers and re-transfers, it can anticipate a deficit or surplus. The township will simultaneously, in a third step, search for additional revenue sources outside the bureaucratic tax system. In short, the township is not forced to adjust expenditure to revenue available, but adjusts revenue to expenditure planned and contracted. The system implies further that the more the central state attempts to harden the budget constraint the more will townships turn entrepreneurial, by embarking on business activities outside the reach of bureaucratic control.

7. Conclusion

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

First, aside from the rhetoric, the reforms were driven by transaction cost considerations and political compromises. Each reform step reveals the search for a broader tax base, and enforcement mechanism, which increase the administrative efficiency. Second, the tax system and its changes serve as a means to better align the interests between the different layers of government agencies. Unlike other countries where taxation defines hard (budget) constraints and state enforcement agencies, China’s tax system offers positive incentives for its tax agents which in return for compliance to the national tax codes, if not the whole reform programme, are entitled to residual tax revenue. Third, tax farming harnesses local autonomy. It offers
townships a resource base outside central control. It is worth stressing that local autonomy in China is not the consequence of a constitutional separation of power, but the consequence decentralisation, i.e. the transfer of regulatory power to local agencies, and the transfer of resources that enable local jurisdictions, such as the township, to finance local policy. Fourth, unsurprisingly then, tax farming must contribute to diversity in economic outcomes as well as diversity in the institutional architecture at the local level. It is hard to find evidence which would support the Grabbing Hand -or state seizure-hypothesis (Northrup and Rowan, 1963; Fry, 2002) on the one hand and the Helping Hand- or state capture hypothesis (Hellman, 1998) on the other hand which claim that over time the central state will increasingly appropriate more resources in the case of the former; or that the alliance between the business community and local government agencies will over time subvert the institutional architecture to better serve their own self-interest. Both would imply the emergence of informal if not illegal organisations and institutions, while the tax farming bargaining game is part of the official tax system. From this point of view the local tax farming can be seen as an ex ante device for limiting, if not even legitimising, ex post opportunism (of the tax agents). Finally, jurisdictional competition seems to work, limiting overall taxation. This does not mean however that China can expect a corporatist state with as many local business and tax systems as townships or counties. As the interviews indicate, imitation of good (tax) practices in neighbouring localities will lead to a at least regional convergence of the de facto tax systems, if not tax practices.
<table>
<thead>
<tr>
<th>Taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>National tax</strong></td>
</tr>
<tr>
<td>Consumption tax, Tariff, Income tax on FIEs and FEs ³, Vehicle acquisition tax</td>
</tr>
<tr>
<td><strong>Local tax</strong></td>
</tr>
<tr>
<td>Business tax ², Agricultural tax, Tax on special agricultural produce, Animal husbandry tax, Resource tax ³, Urban and township land usage tax, Occupied farmland tax, Real estate tax ⁴, Urban real estate tax ⁴, Land appreciation tax, Urban maintenance and construction tax ⁵, Deed tax, Vehicle and vessel usage license tax, Vehicle and vessel usage tax, Vessel tonnage tax, Slaughter tax ⁷, Banquet tax ⁷, Orientation adjustment tax on investment in fixed asset ⁸</td>
</tr>
<tr>
<td><strong>Shared tax</strong></td>
</tr>
<tr>
<td>Value-added tax (VAT), Enterprise income tax ⁹, Individual income tax, Stamp tax</td>
</tr>
</tbody>
</table>

**Notes:**

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

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

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

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

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

f. To be abolished (Guofa 1994. No.7).

g. To be abolished (Caishuifa 1999, No.299).

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

**Source:**

State Administration of Taxation, PRC, [www.chinatax.gov.cn](http://www.chinatax.gov.cn)
Table 2: **Central-local Taxes: Sharing Formula**

<table>
<thead>
<tr>
<th>Shared Taxes</th>
<th>Central</th>
<th>Local</th>
</tr>
</thead>
<tbody>
<tr>
<td>VAT</td>
<td>75%</td>
<td>25%</td>
</tr>
<tr>
<td>Enterprises income tax (^a)</td>
<td>50%(2002)</td>
<td>50%(2002)</td>
</tr>
<tr>
<td></td>
<td>60%(2003)</td>
<td>40%(2003)</td>
</tr>
<tr>
<td>Individual income tax (^b)</td>
<td>50%(2002)</td>
<td>50%(2002)</td>
</tr>
<tr>
<td></td>
<td>60%(2003)</td>
<td>40%(2003)</td>
</tr>
<tr>
<td>Stamp tax</td>
<td>94% of taxes on security transaction</td>
<td>6% of taxes on security transaction</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Other stamp taxes</td>
</tr>
</tbody>
</table>

**Notes:**

a. Before 2002 the “corporate income tax” on domestic enterprises was a local tax, afterwards it is a shared tax.

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

**Source:**

Table 3: **Tax Collections by Authorities**

<table>
<thead>
<tr>
<th>Collection Authority</th>
<th>Items</th>
</tr>
</thead>
<tbody>
<tr>
<td>National tax bureaus (NTBs)</td>
<td>Consumption tax, VAT, income tax on enterprises (^a), Income tax on FIEs and FEs, stamp tax on security transaction, vehicle acquisition tax</td>
</tr>
<tr>
<td>Local tax bureaus (LTBs)</td>
<td>Business tax, individual income tax (^b), resource tax, urban and township land usage tax, urban maintenance and construction tax, real estate tax, urban real estate tax, land appreciation tax, vehicle and vessel usage license tax, vehicle and vessel usage tax, slaughter tax, banquet tax, other stamp taxes</td>
</tr>
<tr>
<td>Customs</td>
<td>Tariff, VAT (collected by Customs), consumption tax (collected by the Customs), vessel tonnage tax</td>
</tr>
<tr>
<td>MOF/LTBs (^c)</td>
<td>Agricultural tax, tax on special agricultural produce, animal husbandry tax, deed tax, and occupied farmland tax</td>
</tr>
</tbody>
</table>

**Notes:**

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

b. Individual income tax though being a shared tax in 2002 but is still collected by the local tax bureau.

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

**Sources:**

## Table 4: The revenue side of M and L Townships’ Budgets

<table>
<thead>
<tr>
<th>M Township</th>
<th>Original tax base</th>
<th>L Township</th>
<th>Original tax base</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Budgetary revenue</strong></td>
<td>Income, output</td>
<td><strong>Budgetary revenue</strong></td>
<td>Income, output</td>
</tr>
<tr>
<td>Bonus remittance of taxes</td>
<td></td>
<td>Bonus remittance of taxes</td>
<td></td>
</tr>
<tr>
<td>Fixed remittance of taxes</td>
<td></td>
<td>Fixed remittance of taxes</td>
<td></td>
</tr>
<tr>
<td>Earmarked subsidy</td>
<td></td>
<td>Earmarked subsidy</td>
<td></td>
</tr>
<tr>
<td><strong>Extra-budgetary revenue</strong></td>
<td></td>
<td><strong>Budgetary fund revenue</strong></td>
<td></td>
</tr>
<tr>
<td>Surcharges to taxes for Income, output education</td>
<td></td>
<td>Surcharges to taxes for rural Income, output education</td>
<td></td>
</tr>
<tr>
<td>Fee for garbage collection user</td>
<td></td>
<td>Surcharges to taxes for Income, output education</td>
<td></td>
</tr>
<tr>
<td>Fee for sewage disposal user</td>
<td></td>
<td>Surcharges to taxes for Income, output education</td>
<td></td>
</tr>
<tr>
<td>Fee for public security p.c., per firm</td>
<td></td>
<td>Profit of TVEs</td>
<td></td>
</tr>
<tr>
<td>Fee for public utility user</td>
<td></td>
<td>Fee from administration agencies</td>
<td></td>
</tr>
<tr>
<td>Water rates user</td>
<td></td>
<td>Water conservancy p.c., per firm construction fund</td>
<td></td>
</tr>
<tr>
<td>Fee for family planning p.c.</td>
<td></td>
<td>Proceeds of education-assets-sale</td>
<td></td>
</tr>
<tr>
<td>Banking interests</td>
<td></td>
<td>Other subsidy</td>
<td></td>
</tr>
<tr>
<td>Other subsidy</td>
<td></td>
<td><strong>Other revenue</strong></td>
<td></td>
</tr>
<tr>
<td>Proceeds of land-sale</td>
<td></td>
<td>Proceeds of land-sale</td>
<td></td>
</tr>
<tr>
<td>Fee for land transaction</td>
<td></td>
<td>Fee for land transaction</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td>Other</td>
<td></td>
</tr>
</tbody>
</table>

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

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

<table>
<thead>
<tr>
<th>Items</th>
<th>M (%)</th>
<th>L (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total financial revenue</strong></td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td><strong>Budgetary revenue</strong></td>
<td>45.23</td>
<td>24.40</td>
</tr>
<tr>
<td>thereof</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bonus remittance of taxes</td>
<td>31.90</td>
<td>18.20</td>
</tr>
<tr>
<td>Fixed remittance of taxes</td>
<td>12.78</td>
<td>4.58</td>
</tr>
<tr>
<td>Earmarked subsidy</td>
<td>0.55</td>
<td>1.62</td>
</tr>
<tr>
<td><strong>Extra-budgetary revenue</strong></td>
<td>22.28</td>
<td>11.65</td>
</tr>
<tr>
<td>thereof</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Surcharges to taxes for education</td>
<td>4.08</td>
<td>5.44</td>
</tr>
<tr>
<td>Fees charged by administration agencies</td>
<td>6.51</td>
<td>1.63</td>
</tr>
<tr>
<td>Other</td>
<td>11.69</td>
<td>4.58</td>
</tr>
<tr>
<td><strong>Other revenue</strong></td>
<td>32.49</td>
<td>63.95</td>
</tr>
<tr>
<td>thereof</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Proceeds of land-sale</td>
<td>26.99</td>
<td>44.58</td>
</tr>
<tr>
<td>Fees for land transaction</td>
<td>5.24</td>
<td>8.98</td>
</tr>
<tr>
<td>Profit of TVEs or governmental investments</td>
<td>0.03</td>
<td>9.85</td>
</tr>
<tr>
<td>Other</td>
<td>0.69</td>
<td>0.54</td>
</tr>
</tbody>
</table>

*Source: Respondent 24 & 26 (2004)*

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

Note:

a. Predicted figure based on revenue task 2004.

Source:

Table 7: The Expenditure Side of L Township’ Budget, 2003

<table>
<thead>
<tr>
<th>Items</th>
<th>Amount (million RMB)</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total financial expenditure</td>
<td>181</td>
<td>100</td>
</tr>
<tr>
<td>Agriculture</td>
<td>4</td>
<td>2.5</td>
</tr>
<tr>
<td>Industry and transportation</td>
<td>38</td>
<td>20.9</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>46</td>
<td>25.6</td>
</tr>
<tr>
<td>Education</td>
<td>65</td>
<td>35.9</td>
</tr>
<tr>
<td>Culture</td>
<td>8</td>
<td>4.5</td>
</tr>
<tr>
<td>Health</td>
<td>3</td>
<td>1.9</td>
</tr>
<tr>
<td>Social</td>
<td>4</td>
<td>2.4</td>
</tr>
<tr>
<td>Administration</td>
<td>10</td>
<td>5.4</td>
</tr>
<tr>
<td>Other</td>
<td>2</td>
<td>0.9</td>
</tr>
</tbody>
</table>

*Source: Respondent 26 (2004)*
Figure 1: Ratio of government revenue to GDP and central to total government revenue

Notes:

a. The government revenue refers to budgetary revenue.

b. Domestic and foreign debts are excluded.

Source:

Figure 2: Structure of Taxation Administration

Notes:
c. The hierarchy of taxation administration is corresponding to government administrative structure.
d. The black line refers to vertical leadership.
e. The dashed line refers to operational guidance.

Source:
State Administration of Taxation, PRC, www.chinatax.gov.cn
Figure 3 Financial Revenue and Expenditure at Township Level

Financial revenue pool

- Budgetary revenue
  - Taxes
- Extra-budgetary revenue
  - Funds/surcharges/fees

Off-budgetary revenue
- Proceeds of land sale

Financial expenditure package

- Budgetary expenditure
  - Supporting local economic sector
    - Tax refund/subsidy
- Extra-budgetary expenditure

Note:

a. Black part of expenditure refers to extra expenditure of actual amount.
References


Routledge Press.


Walder, A.G. 1995. Local Governments as Industrial Firms: An Organizational
Analysis of China’s Transitional Economy. American Journal of Sociology 101:
263-301.


Wedeman, A. 2003. From Mao to Market: Rent-Seeking, Local Protectionism, and

Federalism and Economic Development. Journal of Law and Economic


White, E.N. 1995. The French Revolution and the Politics of Government Finance,

White, E.N. 2004. From Privatised to Government-administered Tax Collection: Tax

China. Hong Kong: Oxford University Press.

Off-budget Finance. in Brean, D.J. S. (ed.) Taxation in Modern China. New York:
Routledge Press.


* The paper relies on fieldwork that forms part of the ‘Shift in Governance’-programme (450-02-460) of the Netherlands Organisation for Scientific Research (NWO). The generous support by the NWO, the ERIM Research School and the Trustfonds of the Erasmus University, Rotterdam are gratefully acknowledged.

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

2 Except the urban real estate tax.

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

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

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

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

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

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

9 Thus, for example in order to prevent fraud of VAT invoices, a computer network connecting the SAT and its branches down to the county (district) level, the so-called Golden Taxation Project, - was launched in 1994. By the end of 2002, it had installed 1.4 thousand servers, 25 thousand PC servers and 0.4 million PCs, staffed 26 thousand computer technicians and covered approximately 0.6 million units, i.e. about 45% of taxpayers (SAT 2005).

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

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

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

13 Close to Suzhou, Jiangsu province, Township M covers 34 square kilometres with population of 53,000 in 2003. Township L is located at 15 kilometres away from Hanghzou, capital of Zhejiang province and covers 43 square kilometres with population of 60,000 in 2003.