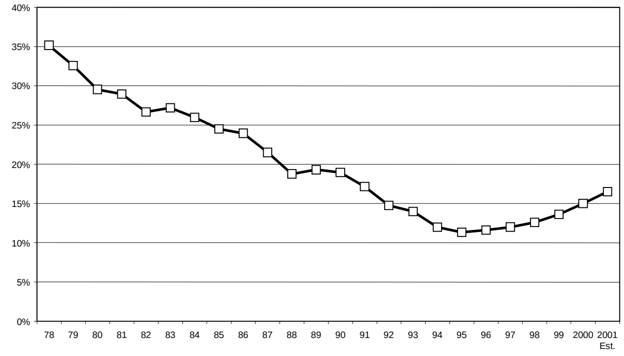
The Tax and Fiscal System

- China is a *de jure* “unitary state”
- But China resembles *de facto* federalism in some aspects
- Five administrative and fiscal budgetary levels
  - Central
  - Provincial (including four special cities)
  - Prefecture (including large cities)
  - County (including many new cities)
  - Township
  - (village is not a formal level of government)
- Three fiscal levels in most other large countries
  - U.S.: federal, state, county
  - Russia: federal, region, city

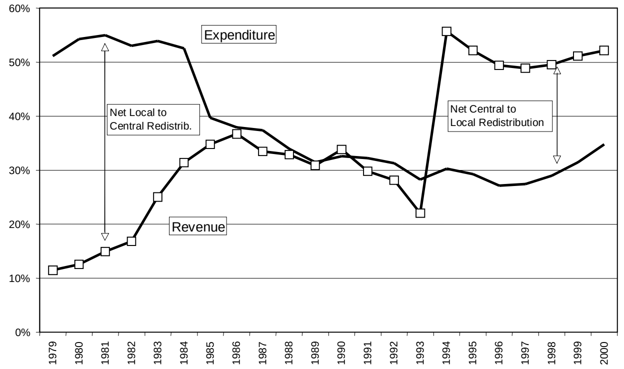
Categories of Government Fiscal Revenue

- Total revenue = budgetary revenue + extra-budgetary revenue + off-budget revenue
- Budgetary revenue: taxes
- Extra-budgetary revenue: fees
  - Examples: fees collected by public institutions and administrative agencies; contributions to social insurance funds
- Off-budgetary revenue: varieties of income

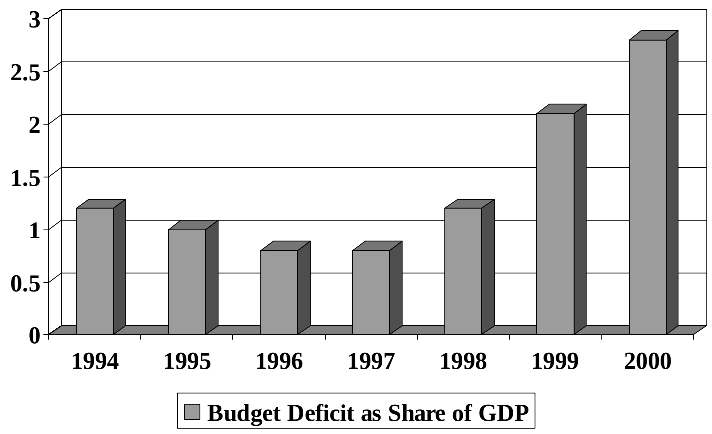
Government Fiscal Budgetary Revenue (Share of GDP)



Central Government Share of Budgetary Revenue and Expenditure



Government Budget Deficit



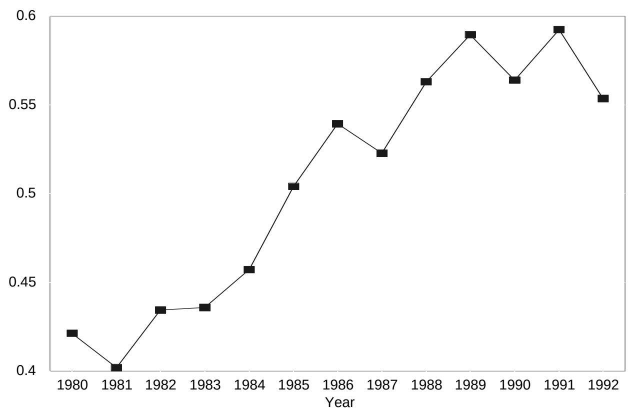
Government Debt

- On book: 20% of GDP
- Plus:
  - Bad bank loans: 25% of GDP
  - Recapitalization of Assets Management Companies: 20% of GDP
  - Unfunded pension liability: ?

Regional Decentralization and fiscal reform 1980-93

- Comprehensive decentralization from central to local governments
  - fiscal expenditure
  - regulation over local economies
  - supervision of state-owned enterprises
  - local government investment
  - local influence on bank credit

The Average Share of Local Expenditure in Total Expenditure (1980-92)



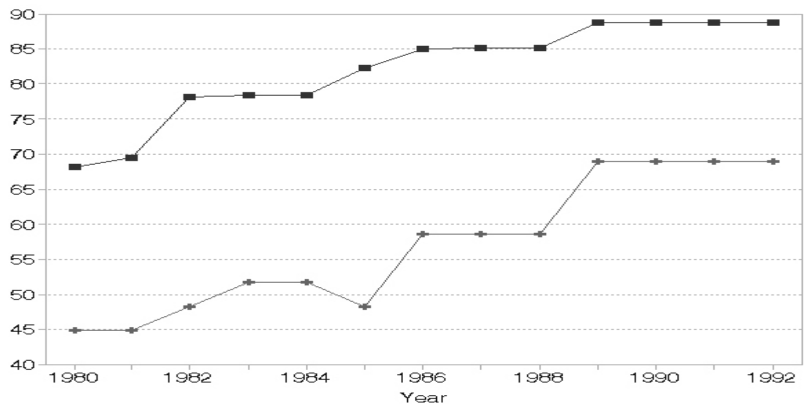
Fiscal Decentralization in China

- China has always been more decentralized than most other countries in terms of the share of local government expenditure in total government expenditure
- China (1970-79): 49%
- China (1982-91): 53%
- Average industrialized countries: 34%
- Average developing countries: 22%

Fiscal Contracting (1980-93)

- “Fiscal contracting system" between the central and provincial governments
  - Step 1: central fixed revenue
  - Step 2: sharing schemes applied to the rest
- Main features of the fiscal contracts
  - high *marginal* revenue retention rates
  - at extreme, 100% retention rate at the margin => "residual claimants"
  - intended to be long term (5 years) to minimize renegotiation

Provincial Marginal Retention Rates (*Ex Ante*)



- The upper line: average of marginal retention rates
- The lower line: share of the provinces with 100% marginal retention rates

Does Fiscal Contracting Strengthen Local Government Incentives (*Ex Post*)?

- 1970-79
  - Correlations between local government budgetary revenue and expenditure: 0.172
- 1982-91
  - Correlations between local government budgetary revenue and expenditure: 0.752
  - Correlations between local government extra-budgetary revenue and expenditure: 0.971

Does Fiscal Contracting Strengthen Local Government Incentives?

- Interpretations
  - Before the reform
    - almost all revenues were redistributed: no relationship between how much revenue generated and how much revenue to be used
  - After the reform
    - Local government is able to use about 3/4 of budgetary revenue generated from local economy at the margin ex post
    - Local government is able to use almost all of the extra-budgetary revenue generated from local economy

How Do Local Governments Respond to Fiscal Incentives?

- An increase in the marginal fiscal revenue retention rate in a province by 10 percentage points
- An increase of 1 percentage point in the growth rate of employment of non-state enterprises in that province (mean is 9 percent)
- Meaning: local fiscal incentives are important inducement for local economic development.

Fiscal and Tax Reform: 1994

- From “fiscal contracting” to “separating taxes”
- Separating “national taxes” and “local taxes”
- Separating “national tax bureau” and “local tax bureau”
- Resembles “fiscal federalism” in the U.S.
  - Federal taxes are collected by Internal Revenue Service
  - State and local taxes are collected by state tax bureaus
- Differences
  - In the U.S., state and local governments determine state and local tax rates
  - In China, only the central government can decide on tax rates
  - But local governments often decide on “fees”

Fiscal and Tax Reform: 1994

- New taxes
  - Value-added tax (VAT) of 17%
  - Individual businesses pay 6% sales tax instead of VAT
  - Corporate income tax of 25% regardless of ownership
- Major features
  - Simplification
  - Uniformity (but VAT has a lower rate for special products)
  - Broadening tax base

Central and Local Tax Assignment

- Central government taxes
  - Customs duties
  - Consumption taxes (on luxuries, cigarettes, alcohol etc)
  - Taxes on central government controlled sectors (railroads, financial institutions, etc)
- Shared taxes
  - VAT (75% central, 25% local)
  - Personal income tax
- Local government taxes
  - Corporate income taxes
  - Real estate and property taxes

What is VAT and why?

- VAT is a flat tax, levied at each stage of transactions
- VAT is a major tax in Europe
- Similar to sales tax in the U.S., but the difference is sales tax is only levied at final stage of transactions, I.e., retail sales
- VAT rebate for export (common practice)
- VAT is hard to evade
- VAT is relatively easy to collect than sales tax
- VAT likes consumption tax
- Complains about VAT: rich and poor same rates

Personal Income Tax in China

- Not a major tax yet, but the fastest growing tax
- Very hard to collect, entirely based on withholding, annual returns started in 2006
- Progressive rates on salary and wages
  - From 5% to 45%, with 5% incremental
  - Based on monthly income
  - But not consolidated
- Flat rate (20%) on interests and “one time income”