An Evaluation of China's Tax System: Insights for Future Reform

Yuhua Qiao, Missouri State University

Abstract: Discussion of how to develop a modern tax system is important for the Chinese government with China's urbanization and economic development and with the enlarged income gap among its population. This paper explores the strengths and weaknesses of China's tax system by applying the criteria that scholars use in judging revenue sources. The existing Chinese tax system is regressive, complex, and lacks revenue adequacy. To correct its weaknesses, several tax reform recommendations are made. This includes broadening individual income tax among top income individuals and expanding the circle gradually, expanding consumption tax, and eliminating unnecessary preferential tax treatments in all taxes.

Tax systems are critical for the functions of any nation. Although discussions of the need to develop modern income tax systems are often overshadowed by other policy discussions in less-developed countries (LDC) (Qian, 2004), the importance of addressing revenue issues comes to light with their economic development and the with the need to provide more public services.

This paper explores the merits and weaknesses of China's tax system. The discussion of China's tax system is particularly necessary at this time for two reasons. First, given its great economic achievements and its enlarged income gap, a tax system should play an important role in redistributing the gains from economic growth and in redistributing income.

Second, with China's urbanization and economic development, there has been an ever-increasing demand for public goods and services–health care, roads, public education, infrastructure development, 'safety net" programs for millions of the less fortunate, and old-age insurance for over a hundred million aging farmers. All of these services will require substantial amounts of revenue. Yet, the current tax revenue in China is about 18% of its GDP and is not able to generate the needed amount of revenue (Qian, 2004). The existing Chinese tax revenue system relies heavily on indirect taxes such as value-added tax (VAT), business tax, and tax on specific consumption goods. With the rapid increase of personal income and top-earners, personal income tax, which has a high tax-income elasticity, can produce more revenue to deliver services.

In order to explore the merits and weaknesses of China's tax system, this paper has three sections. In the first section, the author will discuss the criteria that scholars use in judging tax revenue sources. In the second section, the author will apply these criteria to China's taxation system. The paper ends highlighting several policy recommendations.

Taxation Evaluation Criteria

In *The Wealth of Nation,* Adam Smith (1937) identified four basic requirements for a good tax system:

- Equality. Every subject of a state should contribute to support government by paying a tax that is in proportion to his/her respective abilities. Tax thus designed leads to an equitable distribution of the cost of supporting the government.
- Certainty. Taxpayers should know when, where, and how much tax a subject needs to pay. These issues should not be arbitrary. They need to be clear and plain to all the taxpayers.
- Convenience. A tax should be levied at the time that is most convenient for taxpayers.
- Economy. A tax should have minimum compliance and administrative costs so as to generate maximum level of revenue for government.

Consistent with Adam Smith's tax principles, contemporary taxation scholars use the following major criteria to evaluate a tax: equity, collectability, revenue adequacy, and economic effect.

Equity takes two different approaches. One is the benefit-received principle. That is, the amount of tax should be based on the level of the service a taxpayer receives. Though this approach is appealing and goes well with the free market system, its application in the public sector is limited for two reasons. First, many public services and programs such as national defense, roads, highways, and public health are public goods. The benefit is spread to the entire community, and non-payers cannot be excluded from using the services. Second, government needs to perform a redistribution function, which defies the benefit-received principle (Mikesell, 2003).

The equity principle that is often used is the ability to pay. That is, the amount of tax should be based on one's ability just as Smith stated. There is vertical equity and horizontal equity. The former requires that individuals with different situations be treated differently. Those with a higher ability to pay should pay a higher percentage of their income in tax. Such a tax is also referred to as a progressive tax. If a tax takes away a higher proportion of the income of the poor than of the rich, it is called a regressive tax. Horizontal equity means that individuals in the same economic circumstances should be treated similarly (Mikesell, 2003).

The second major criterion is adequacy of revenue production. Since the major purpose of taxation is to generate revenue for the government, a good tax system is one that can bring in a meaningful amount of revenue "at socially acceptable rates" (Mikesell, 2003, 297). Adequacy usually is determined both by the tax base and the tax rates. The broader the tax base, the more revenue a tax will produce. A higher tax rate does not always produce more tax revenue. The so-called Laffer curve—popularized and promoted by economist Author Laffer—states that to a certain point, when the effective tax rate is perceived to be too high, it will generate less, not more, tax revenue because it will discourage taxpayers' incentive to work and thus reduce that tax base.

Revenue adequacy is also measured in terms of its responsiveness or tax-income elasticity. During economic expansion periods, demand for government services increases significantly. For some taxes, revenue increases more rapidly than income. In this case, revenue elasticity or the elasticity of the tax base with respect to income—also referred to as tax-income elasticity—is bigger than 1 (Mikesell, 2003). A term that Vording (1997) uses to describe this relationship is "positive fiscal dividend" (p. 100). For taxes whose tax-income elasticity is smaller than 1, negative fiscal dividend is produced. To meet increasing service demands, it is better to design a tax system that has high tax-income elasticity (Mikesell, 2003) or positive fiscal dividends. According to ACIR (1977), personal income tax has the highest tax-income elasticity with the median of 1.75. The corporate income tax median ratio is 1.1, and the general sales tax median ratio is 1. Median property tax-income elasticity is only .87 and other selective sales taxes, such as motor-fuel tax and tobacco tax, are even lower.

The third taxation evaluation criterion is collectability. A tax should incur minimum administrative and compliance costs. "Revenues used in the collection of revenue provide no net service to society" (Mikesell, 2003, p. 301). Of the two types of costs, administrative and compliance, the former is the cost to run the tax collecting agencies and the latter is the cost that taxpayers bear in terms of time and money spent in keeping records and hiring tax attorneys. A simple tax, without tax preferences and with a single tax rate, is easy to collect and comply. However, modern taxes are rarely made simple. Governments often use tax breaks to achieve a wide range of policy goals.

Another major taxation evaluation criterion is economic neutrality. This criterion states that a tax should be neutral. It should not generate behavioral distortion in the marketplace if we believe in its efficiency. If the distortion cannot be not avoided, it should be kept to a minimum (Mikesell, 2003). Modern taxes can rarely remain neutral. Their efficiency effects are subtle and difficult to assess. They affect people's decisions concerning work, savings, education, consumptions, investments, or marriage and divorces (Stiglitz, 1988). The more tax breaks, the more distortion. The higher the tax rate, the more distortion there is.

In the following sections, the author will use these criteria to evaluate Chinese tax systems. The discussion will start with several major taxes and then move to the entire tax system. The evaluation of each major tax and the evaluation of the tax system as a whole are complementary. The former will reveal the strengths and weaknesses of each major tax. The latter will provide us with a whole picture of the tax systems.

China's Tax Systems

The current Chinese tax system was established in 1994 with the Tax System Reform Act, an effort to bring the tax system in alignment with the market system (Vording, 1997). Only a few modifications have been made since then. The current tax system has 25 types of taxes. They can be classified into eight categories:

1. Turnover taxes: This includes three types of taxes: value-added tax, consumption tax, and business tax. These levies are normally based on the turnover or sales of the taxpayers in the manufacturing, circulation, or service sectors.
2. Income tax: This includes both tax on businesses (either state-owned enterprises, privately owned, collectively-owned, or foreign enterprises) and individual income tax.
3. Resources taxes: This includes resource tax and urban and township land use tax. Resources taxes are applicable to the users of urban township land.
4. Property taxes: This includes house property tax and urban real estate tax.
5. Tax for special purposes: This includes city maintenance and construction tax, fixed asset investment orientation regulation tax and land appreciation, and farmland occupation tax. They are collected for special regulatory purposes.
6. Behavior taxes: This includes a wide range of taxes such as vehicle and vessel tax, vehicle and vessel usage license plate tax, stamp tax, deed tax, and banquet tax.
7. Agriculture taxes: This includes agriculture tax and animal husbandry tax, both of which are being eliminated in many provinces (Xing, 2005).

8. Customer duties: These are imposed on the goods and articles imported into the People's Republic of China. ("Overview of China's Tax System")

China's tax system is highly centralized. All the tax laws are passed by the central government. Local governments only have those tax powers that are delegated from the central government. Tax revenue can be classified into central tax revenue, local tax revenue, and tax revenue shared between the central and local governments. About 70% of tax revenue goes to the central government (see Table 1). "Taxes are designated to be local if their revenues are accrued exclusively to the local governments." (Fulton, Li, and Xu, 1998, p. 13). Central tax revenue includes domestic consumption tax, customs duties, VAT, and consumption tax collected by Customs on behalf of the central government. Local tax revenue includes individual income tax, city and township land use tax, farmland occupation tax, fixed assets investment orientation regulation tax, land appreciation tax, house property tax, urban real estate tax, inheritance tax (not yet legislated), vehicle and vessel usage tax, vehicle and vessel usage license plate tax, deed tax, slaughter tax, banquet tax, agriculture tax and animal husbandry tax, and local surtaxes ("Overview of China's Taxation").

Central and local governments share several tax revenues: domestic VAT (75% goes to the central government, and 25% goes to the local government); business tax; enterprise income tax; income tax on enterprises with foreign investment and foreign enterprises; resource tax; city maintenance and construction tax; and stamp tax ("Overview of China's Taxation").

The 1994 tax reform set up an indirect taxation system with VAT as the core and business and consumption taxes as the accessories. At the same time, more weight was given to the direct tax on enterprise income and individual income. Table 1 shows the amount of revenue that each of the major taxes generates and its share of the total during the years 1995-2005. VAT has been the largest tax revenue generator, but over the years its and consumption tax's share have declined. The share of income tax (enterprise business income, foreign enterprise income tax, and personal income tax) is still small but has been growing.

Evaluation of China's Major Taxes

In this section, the above discussed criteria will be applied to several major taxes. They are VAT, business tax, consumption tax, enterprise income tax, and individual income tax.

VAT

Before the 1994 tax reform, VAT was applied only to a few select items. The reform expanded the tax base by applying "to all individuals and entities that are engaged in the sales of goods in China, the provision of repair or processing services in China, or the importation of goods into China" (Fulton, Li, and Xu, 1998, p. 18). VAT is widely used in the world. While retail sales tax such as the one used in the U.S. applies tax to the final stage of the production-distribution process, VAT applies tax to the added value of production in each stage. While both retail sale tax and VAT have the same broad tax base in theory, the VAT system does a better job of collecting revenue, since retail sales tax puts all tax eggs in one basket (e.g. the final stage) while VAT can collect at least some of it (Mikesell, 2007). Besides its revenue adequacy, VAT has another advantage in terms of its collectability. Businesses have to keep and present their documented receipts to prove the amount of tax they have paid in order to get a tax refund. Thus, VAT has a high level of compliance.

In terms of equity, since VAT is a tax on consumption, it tends to be regressive just like the general retail tax used in the U.S. This flat tax rate takes away a higher percentage of income from low-income families than from the high-income families. Thus it imposes a higher burden on the lower income families.

What about its economic impact? There are two types of VAT. One is production-oriented, and the other is consumption-oriented. The one China uses is production-oriented, which taxes the fixed assets producers buy. Business cannot claim tax deductions for purchases of fixed assets such as equipment and machinery. Industrialized nations use the consumption-type, in which tax paid for fixed-assets is deductible. The consumption-type is more neutral in its impact on market behaviors. It does not distort any choice of production. Production-oriented VAT has negative economic impact. It hinders business' technological advancements and investments.

In July 2004, China started an experiment to convert its VAT in the northwest of the country to the consumption-oriented tax to "invigorate its so-called rust belt" ("China says its experiment with VAT reform well underway") by encouraging investment in machinery and equipment and phasing out outdated equipment. The reform would be extended to other parts of the country in subsequent years. The downside of this conversion is revenue decline, as the consumption-based VAT has a narrower tax base. But Xie Xuren, the head of the State Administration of Taxation, stated that reform will stimulate enterprise investment, optimize industrial structure, and enhance competitiveness of Chinese enterprises. Thus, in the long run, economic growth will result in more tax revenue.

Another issue with VAT related to economic impact is its rate. The common rate for VAT is less than 20%. The current VAT rate in China is 17%. Wang (no date) argued that since China's VAT is a production-type, the 17% is equivalent to 23% of consumption-based VAT. Therefore, VAT's rate should be reduced.

Table 1. China's Tax Revenues in Selected Years (in 100 million Yuan)

	1995	1997	1999	2001	2002	2003	2004	2005
Total	5,973.70	8,225.50	10,315.00	15,165.50	16,996.60	20,466.10	25,718.00	30,865.83
Tax/GDP*	9.63%	10.70%	12.09%	15.04%	16.61 %	17.53%	18.84%	N/A
Central Gov Tax	4,376.90	5,628.20	7,002.90	10,194.30	11,324.30	13,688.20	17,854.30	21,334.49
State/local tax	1,596.80	2,597.30	3,312.10	4,716.30	5,308.70	6,303.60	7,863.70	9,531.34
VAT	3,038.60	3,910.00	5,032.10	7,090.80	8,141.20	10,096.30	12,588.90	10,698.29
Consumption tax	566.00	715.10	854.60	946.20	1,072.50	1,221.70	1,550.50	1,634.31
Business tax	869.40	1,353.40	1,696.50	2,084.70	2,467.60	2,868.90	3,583.50	4,231.42
Enterprise income tax	753.10	931.70	1,009.40	2,121.90	1,972.60	2,342.20	3,141.70	4,363.13
Foreign enterprise tax	74.20	143.10	217.80	512.60	616.00	705.40	932.50	1,147.69
Individual Income tax	131.50	259.90	414.30	996.00	1,211.10	1,417.30	1,737.10	2,093.91
Resource tax	55.10	56.60	62.90	67.10	75.10	83.10	99.10	142.63
Fixed Assets Investment-oriented adj	53.60	78.30	130.50	15.60	8.00	4.80	3.40	-
City maintenance & Construct tax	212.10	272.30	315.30	384.40	470.90	550.00	674.00	796.02
Property tax	81.70	123.90	183.50	228.60	282.40	323.90	366.30	435.90
Stamp tax	46.80	266.30	282.30	337.00	179.40	215.00	290.20	226.75
Urban land use tax	33.60	44.00	59.10	66.20	76.80	91.60	106.20	137.33
Land appreciation tax	0.30	2.50	6.80	10.30	20.50	37.30	75.10	140.02
Vehicle & Vessel Usage Tax	13.40	17.20	20.90	24.60	28.90	32.20	35.60	38.89
Vehicle purchasing tax	.	.	.	254.80	363.50	474.30	533.90	557.62
Other taxes	44.30	51.10	29.00	24.80	9.90	2.30	-	1.85
	Share of total tax revenue by source (%)							
	1995	**1997**	**1999**	**2001**	**2002**	**2003**	**2004**	**2005**
Central Gov Tax	73.27	68.42%	67.89	70.52%	66.63%	66.88%	69.42%	69.12%
State/local tax	26.73	31.58%	32.11	29.48%	31.23%	30.80%	30.58%	30.88%
VAT	50.87	47.54%	48.78	48.55%	47.90%	49.33%	48.95%	34.66%
Consumption tax	9.47	8.69%	8.29	6.93%	6.31%	5.97%	6.03%	5.29%
Business tax	14.55	16.45%	16.45	14.89%	14.52%	14.02%	13.93%	13.71%
Enterprise income tax	12.61	11.33%	9.79	11.41%	11.61%	11.44%	12.22%	14.14%
Foreign enterprise income tax	1.24	1.74%	2.11	2.57%	3.62%	3.45%	3.63%	3.72%
Individual Income tax	2.20	3.16%	4.02	5.21%	7.13%	6.93%	6.75%	6.78%
Resource tax	0.92	0.69%	0.61	0.50%	0.44%	0.41%	0.39%	0.46%
Fixed Assets Investment-oriented adj tax	0.90	0.95%	1.27	0.36%	0.05%	0.02%	0.01%	0.00%
City maintenance & Construct tax	3.55	3.31	3.06	2.78%	2.77%	2.69%	2.62%	2.58%
Property tax	1.37	1.51%	1.78%	1.65%	1.66%	1.58%	1.42%	1.41%

Sources: "Tax Revenue Statistics" State Administration of Taxation http://www.chinatax.gov.cn/data.jsp
* The ratios for 1995-2004 are from "Research on taxation that can promote employment."

Central and local governments shared several tax revenues; domestic VAT (75% goes to the central government, and 25% goes to the local government); business tax; enterprise income tax; income tax on enterprises with foreign investment and foreign enterprises; resource tax; city maintenance and construction tax; and stamp tax. ("Overview of China's Taxation")

The 1994 tax reform set up an indirect taxation system with VAT as the core and business and consumption taxes as the accessories. At the same time, more weight was given to the direct tax on enterprise income and individual income. Table 1 shows the amount of revenue that each of the major taxes generates and their share of the total during the years 1995 to 2005. VAT has been the largest tax revenue generator, but over the years its and consumption tax's shares have declined. The share of income tax (enterprise business income, foreign enterprise income tax, and personal income tax) is still small but has been growing.

Business Tax and Consumption Tax

Business tax is a levy on revenues from service industries, including communications, transaction, construction, financial and insurance businesses, post and tele-communications, culture and sports, entertainment, services, transfer of intangible assets, and sales of immovable properties. While VAT provides credits for taxes paid on business inputs, business taxes do not. Tax liabilities are based on the gross business turnover, not the net profit. Rates range from 3% for transportation, construction, and postal communications to 5% for services, transfer of intangible assets, and sales of immovable properties. Tax rates for entertainment runs from 5% to 20% ("Overview of China's Taxation"). While this tax base is more limited compared with VAT, its economic impact is not a concern. The long list of exemptions from the tax hinders its enforcement. Who bears the business tax burden is not certain. Though the producers pay the tax, the tax burden can be shifted forward to consumers or backward to workers or to the shareholders. If the first two cases are true, then the tax is a regressive tax. If the last case is true, it is a progressive tax. The same analysis of tax burden applies to corporate income taxes.

Consumption tax is an excise tax applied to certain luxury goods and goods made of exhaustible resources, or goods that are not beneficial to human health or social ecology. This rate varies from 3% to 45%. Consumption tax is levied in addition to VAT. Taxable commodities include tobacco, liquor, fireworks, firecrackers, gasoline, diesel, tires, motorcycles, and automobiles (Fultion, Li, and Xu, 1998). From April 1, 2006, consumption taxes were applied to luxury goods including yachts, golf balls and clubs, high-end watches, wooden disposable chopsticks, and wooden floors. More oil products will be subject to consumption taxation. At the same time, the consumption tax will be removed from shampoo, hair conditioners, and skin moisturizers that middle–income families often use. According to the Chinese Central Government official web portal, "Our country made significant adjustment to consumption items and rates" (March 3, 2006).

The consumption tax levied in China has a limited tax base. Revenue growth is slow because its specific set rates cannot capture the economic growth. Substantial revenue increases require a change in statutory rates and bases. It took twelve years for China to adjust its consumption tax for the first time since the tax was levied. On the other hand, China's luxury goods market is big and is growing. It is the world's third largest and will grow by 20% in the coming three years. The sales volume is expected to top $11.5 billion by 2015 (Tang, 2005). So if China's government wants to expand its consumption tax, it can do so.

In terms of collectability, consumption tax imposes a higher collection cost than the general retail sales tax and VAT, because the tax is applied to specific items. When consumption tax is applied to luxury goods, it is a progressive tax. But taxing tobacco and liquor makes the tax regressive since low-income individuals tend to consume more the tobacco and liquor. In terms of economic effect, it is obvious that the consumption tax is designed to influence people's behaviors in the marketplace.

Enterprise Income Tax

The 1994 tax reform law created two different types of corporate income taxes: enterprise income tax that is applied to domestic enterprises, and income tax on enterprises with foreign investment and foreign enterprises. Thus, there are two sets of tax rules, with different rates and incentives, for domestic and overseas-funded enterprises. The latter is given much more preferential treatment in term of tax exemptions, tax reductions, and lower effective tax rates. Actual income tax rates have remained 14% for overseas-funded businesses, as compared with 24% for domestic enterprises (Xinhua News Agency, 2006).

When judged by the major taxation evaluation criteria, the corporate income tax has the following strengths and weaknesses: It has a positive fiscal dividend as its tax revenue is responsive to economic growth. The most important equity concern is the preferential treatment given to overseas enterprises. The preferential treatment intended to attract foreign investment, which has been successful ("China to unify corporate income tax," 2005). But these policies have also had a negative impact on China's economic development. First, they encourage foreign investment to focus on short-term and small projects with a short input-output time period, lower capital requirements, and quick returns in service and light industries, not in the high technology and infrastructure industry. Second, they have put domestic enterprises in unfair and less advantageous positions to compete (Yin and An, 1998).

According to official Chinese statistics, in 2004 foreign firms' profits soared by 25.5% to 345.5

billion yuan. Yet the top 100 foreign businesses paid virtually the same level of tax of 62.78 billion yuan (U.S. $7.74 billion). This is in contrast to the country's double-digit growth in overall tax revenue in 2004. It is also in contrast to the fact that corporate income tax collected from domestic enterprises increased by one third to $314.2 billion from the previous year. As market-oriented reform has realigned the Chinese economy with international standards, favorable tax treatment for foreign enterprises is less justifiable. The Chinese government announced a unification of income tax on businesses ("China to unify corporate income tax," 2005). The various exemptions to different businesses also make the tax system complex and hard to enforce.

Individual Income Tax

Individual income tax applies to those who "are domiciled in China, reside in China, or derive income from Chinese sources" (Fulton, Li, and Xu, 1998, p. 15). They include both Chinese citizens with their household registration in China or foreigners who reside in China or earn income in China. China's individual income tax has a narrow tax base. Income is classified into different categories according to the nature of the income: wages and salaries, remuneration for personal services, rents, royalties, interest and dividend income, capital gains and incidental income, and other income. The rates for different categories are different and the tax liability is computed and taxed separately (Fulton, Li, and Xu, 1998). Different withdraw methods are used for different types of income. Wages are taxed on a monthly basis. Other income is on an annual basis. Wages are taxed at a nine-level progressive rate ranging from 5% to 45% after a 1,500 yuan deduction. The income from businesses, contracts or leasing is taxed at a five-level progressive rate ranging from 5% to 35% after deductions of related costs, expenses and losses. All others are taxed a flat rate ("Overview of China's Taxation").

Individual income tax, particularly the wages, salaries, and income from businesses, contracts and leases, is a progressive tax. Those who have more financial means are taxed more. Other segments are not. In practice, tax collected by schedule reduces its progressiveness for two reasons. First, taxing wages and salaries on a monthly basis does not allow an individual's annual taxable income as a single sum for tax purposes. Second, some taxpayers, especially the rich, can easily manipulate different types of income and transfer one type of income into another to evade taxes.

In terms of revenue adequacy, China's individual income tax has a narrow base. The tax is still an elite tax, not a mass tax. As indicated in Table 2, the share of personal individual income tax is still low but has grown over the years. With economic development and the rapid increase of average income, individual income is a big potential source of tax revenue. Individual income tax with its schedular[1] nature is complex for collection purposes. In addition, many exemptions in the tax not only undermine the tax base, but also make enforcement difficult. The withholding system and banking information systems are not fully established in China. China has a long way to go to make its individual income tax system comparable to those used in developed nations. In terms of economic impact, since it is not a major tax, its impact on the market place has not been a concern. But it can cause significant concern when its share increases.

Evaluation: China's Taxation as a Whole

After briefly evaluating each of the major taxes, let's put everything together and take a look at the whole system. Since China has a central tax system, evaluating the system as a whole is meaningful.

Equity

In terms of equity, China's system tends to be regressive for three reasons. First, it relies heavily on VAT, business tax, and enterprise income tax. All of these might shift the tax burden to consumers. When consumers bear the tax burden, taxes take a larger share of income from low-income families than from high-income families. In industrialized nations, direct taxes, particularly individual income tax with its various brackets, are used to achieve progressiveness in the tax system. But this share in China's tax system is still very small. So is tax on luxury goods. Second, the existing tax system has created and maintained regional inequity. Since the system assigns more income-elastic taxes to provincial and local governments, the coastal regions that have had the greatest prosperity from the economic reform reap more tax revenue than the less developed area where there is more need for public and social services. Another aspect of inequity in China's tax system is the different treatment of domestic enterprises and oversees enterprises.

Regressiveness of the tax system is an even bigger concern when we consider the ever-enlarging gap between the rich and poor that comes with economic development. For instance, the top 10% income share rose from 17% of GDP in 1986 to almost 26% in 2001 (Qian, 2004). Yet, their tax share remains small. According to many economists, China's rich bear the smallest tax burden in the world.

Revenue Adequacy

In terms of revenue adequacy, according to Xie Xu Ren, the director of China's State Administration of Taxation, China tax revenue has grown rapidly at an annual rate of 19.5% during 2000-2005. Nationwide annual tax revenue was over 1,500 billion yuan in 2001, over 2,000 billion in 2003, over 2,500 billion in 2004, and 3,086.6 billion in 2005. For the past five years, tax revenues, except tariff and agriculture tax, totaled 10,921.7 billion yuan ("State Propaganda Department and other departments held joint trend reporting press").

As a matter of fact, Wang (no date) showed that tax growth has surpassed GDP growth, and its elasticity in China has been larger than during 1997-2000.[2] Three factors contributed to these abnormal increases. The first was sustained economic development, which contributed to 55.2% of the tax revenue increase during 1998-2001. The second factor was tax policy changes. Some preferential tax treatments given to foreign enterprises and joint venture enterprises affiliated with schools expired. This explains 19.2% of the tax revenue increase. The third factor was rigorous tax enforcement and management. The central government called for "strengthening administration, blocking loopholes, penalizing corruption and rectifying arrears." This principle was strictly carried out at all levels of government. The result was a 25.6% increase in tax revenue (Wang, no date). Wang (no date) stated that given the current Chinese tax structure, in which tax on sales and services predominates, this tax growth is abnormal. This growth comes from "a policy of tax increase' (p. 7) not from a tax structure that has built-in positive feasible dividends, which will be further explained shortly.

When measured in terms of percentage of its GDP, the revenue adequacy of China's tax system is a concern. The tax/GDP ratio has declined from 39% in 1978 to 10% in 1994 and then bounced back to 18% in 2004. The low tax/GDP ratio is normal for developing nations (Xu, 1998). While China's 18% was the highest among the developing countries, it is still much lower than industrial nations that collect 30-40% of GDP in taxes. "Economic development and social stability require strong public finance" (Brean, 1998, p. 47). To meet this challenge, Brean (1998) suggested, among other things, improving the coverage and compliance of the Value Added Tax and diversifying the individual income tax.

Economists agree that indirect taxes such as VAT, retail sales tax, or consumption tax produce a negative fiscal dividend. That means the share of taxes in GDP will decline as GDP increases. When people become rich, they tend to save more. Their spending, even if it increases in dollar amounts, will become a smaller proportion of their income. Consumption tax on selected luxury commodities can contribute to a positive fiscal dividend. Income taxes produce a positive fiscal dividend. As income goes up, tax payments will increase. Therefore, countries with a negative fiscal dividend, like China, cannot ensure increasing tax revenue (in percentage of GNP) 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. It is necessary to tax China's new prosperity effectively (Vording, 1997).

China's individual income taxation is a good candidate for this change. Facing the increased gap between the rich and poor, China's leadership has promised to reduce income inequality by means of the personal income tax. While the amount of personal income tax is small, it has rapidly increased in the past decade and has moved ahead of consumption tax since 2001. However, like other developing nations, China's personal income tax is applied only to high-income people at a high rate. For it to fully show a positive fiscal dividend, its tax base needs to be expanded. To do so, the tax would have to be transformed from a "class tax" to a "mass tax." This would hurt common people and reduce equity. So turning personal income tax into a "mass tax" is not a good option in the near future (Vording, 1997). What can be done is to expand the tax among top earners and reduce the tax burden for low-income individuals by raising the value of the standard deduction and adding some other deductions to favor low-income families (Cao, 1998). At a certain point in the far future, the income tax can be applied to the general population.

The second suggestion is to expand consumption tax, particularly the luxury tax. The Chinese spend a great deal on durable goods such as houses and cars. Tax should be levied on these durable goods. When sales tax is applied to specific commodities such as luxury commodities, it may do more to achieve a fair distribution of the tax burden than personal income tax as it functions now. The current scope of the consumption tax is too narrow to fully bring out its role of income distribution adjustment. It should be further broadened.

Economic Impact

In terms of its economic impact, China's tax system has not suffered as many criticisms as the tax system in the U.S. The major reason is its relative small tax/GDP share and the relatively low rates for most of China's taxes. The major exception is China's production-oriented VAT. As the experiment to convert it into consumption-based VAT is underway, this flaw should be corrected. In its tax reform, China should avoid overusing tax breaks in any tax, since these will sooner or later distort people's behaviors. China should also keep any of its tax rates reasonable. Any tax, when overtaxed, will have undesirable consequences.

Collectablity

The collectability of China's tax system is a concern. This is due to problems in the system's design, as well as inefficient and weak administration. The 1994 reform made the current tax system simpler and more standardized than before the reform (Yin and An, 1998). But it by no means lacks complexity. The schedular personal income tax is a good illustration. In addition, every tax has a long line of exemptions and preferential treatments. In recent years, to deal with the large number of unemployed workers from state-owned enterprises, the government authorized and implemented various tax preferences (either exemptions or reduced tax rates) to the self-employed and to those who hired a certain number of the unemployed (State Administration of Taxation, Department of Labor, and Department of Social Security, no date; Finance Department of China and State Taxation Administration, 2002).

The complexity of the tax structure, inefficient tax administration, and the Chinese cash economy has resulted in severe tax losses. The area that has the most severe tax loss is income tax. In recent years, many of China's rich, such as entertainment stars, have been caught in scandals of tax evasion. According to the No. 4 Report of China's National Audit Office (CNAO) (2004), tax losses among the 788 enterprises that it audited were estimated to be around 25 billion yuan out of the 221 billion yuan of taxes. There are four major reasons for this tax loss: "manipulation of taxation schedules and plans, false or erroneous declarations in a bid to avoid or evade tax, irregular practices by local governments, and ineffective tax collection" (CNAO, 2004. p.1).

In terms of corporate taxation, the report estimated that about 12.69% of corporations filed erroneous tax reports, or took advantage of preferential tax policies for tax evasion purposes. The situation is worse for enterprises funded by local governments. In a survey among 35 cities, 19 local governments intervened in tax collection in one way or another, or overreached their authority in granting tax breaks. Nearly half of the 788 enterprises surveyed indicated using preferential tax treatments granted by local government. Local governments also provided unauthorized tax rebate policies to attract foreign investment, in violation of tax laws and State Council Regulations (CNAO, 2004. p.1).

China has a long way to go to simplify its individual income tax by re-examining the existing tax breaks and keeping them as few as possible, by replacing schedular income tax with one set of rates for total annual income, and by keeping tax rates as flat as possible. At the same time, there is also the need to further improve tax administration and enforcement, even though great progress has been made in this area in the past few years.

Conclusion

After decades of rapid economic development, the Chinese government needs to transform its role "from an economic growth oriented one to a public service oriented one" (CIRD, 2003). That means that government needs to shift its emphasis from managing and administrating the economy to providing public goods and services. There is a huge demand for public goods and services such as roads, public safety, public health, public education, and social security programs for China's vast citizenry both in rural and urban areas. To satisfy these needs requires the establishment of a public fiscal system that is fair, that can produce adequate revenue, that can easily be administrated, and that will not impair the economy. This paper is an attempt to explore such a public fiscal system.

This paper starts with reviewing various taxation evaluation criteria. It is ideal to have a tax system that is equitable, revenue adequate, easy to collect, and economically neutral. This is very difficult or impossible because of the trade off between several of the criteria—between equity and collectability, and between equity and economic neutrality. So the challenge for government officials in designing a tax system is to find a relatively appropriate balance. This is not an easy job for any government, including the Chinese government.

China's current tax system has been perfected in many ways over what it was before the 1994 reform. But it still has many problems and further reforms are needed. As mentioned earlier, China's tax system tends to be regressive and complex, and does not generate adequate revenue. To deal with these weaknesses, a few recommendations have emerged from the discussion. The first one is to simplify and expand the individual income tax among top-income individuals and expand that circle gradually. The second suggestion is to expand consumption tax. The third suggestion is to eliminate unnecessary preferential tax treatments in all taxes. A proposal to unify enterprises' income taxes is an important effort. The experiment to turn production-oriented VAT into consumption-oriented VAT is an effort to correct the negative impact on business capital investment.

While various tax reform proposals have been made and efforts are underway, the present overall tax structure will remain. In other words, in the near future, China will still rely on turnover taxes and enterprise income taxes as the main sources of revenue, even though efforts will be made to expand the use of individual income and consumption taxes.

Notes

[1] The word "scheduler" in this the context refers to the variable rates for each different category of income. Income is classified into different categories according to the nature of the income: wages and salaries, remuneration for personal services, rents, royalties, interest and dividend income, capital gains and incidental income, and other income. The rates for different categories are different and the tax liability is computed and taxed separately (Fulton, Li, and Xu, 1998).

[2] When turnover taxes, not individual income tax, are the source of major tax revenues, China's tax system is supposed to grow more slowly than GDP and have a tax elasticity of less than 1. But this has not been the case. China's tax elasticity was 1.98 in 1997, 2.40 in 1998, 3.33 in 1999, 1.99 in 2000. Wong (no date) did not give data for later years.

Author

Yuhua Qiao, Ph.D., is an associate professor in the Department of Political Science at Missouri State University. Her teaching and research interests are in public budgeting and financial management, interjurisdiction fiscal disparities, public procurement, public risk management, China's public administration reform, and China's tax policy reform.

References

Advisory Commission on Intergovernmental Relations (1977). *Significant features of fiscal federalism, 1976 – 1977, Vol. 2. Revenue and Debt.* Washington D.C.: GPO.

Brean, Donald (1998). “Financial perspectives on fiscal reform” in Fulton, Trish, Li, Jinyan, and Xu, Dianqing (editors) *China’s Tax Reform Options.* New Jersey: World Scientific, pp. 47 – 56.

“China says its experiment with VAT reform well underway.” Accessed May 27, 2006.
People’s Daily Online – http://english.people.com.cn.

“China to start reform of taxation system” People’s Daily Online – http:/ /english.peopledaily.com.cn.

“China to unify corporate income tax” (Jan. 2, 2005). http://www.china-embassy.org/eng/gyzg/t180603.htm.
“CIRD (2003). “Decisive Impacts of Building Up Public Service Oriented Government on China’s Reform Process.” *China Reform Forum*. http://www.chinareform.org/cgi-bin/ResearchPaper/ResearchPaper_main.asp?Ggwk_ID=44&Ggwk_Type=1.

Finance Department of China and State Taxation Administration (2002). Notification on taxation policy about the employment of the unemployed: Finance and Taxation [{2002] Number 208. http://www.chinatax.gov.cn/view.jsp?code=20030925164349915.

Fulton, Trish, Li, Jinyan, and Xu, Dianqing (1998). “Tax system and policy options in China.” in Fulton, Trish, Li, Jinyan, and Xu, Dianqing (editors) *China’s Tax Reform Options.* New Jersey: World Scientific, pp. 3-27.

Mikesell, John L. (2003). *Fiscal administration: Analysis and applications for the public sector.* Belmont, CA: Wadsworth/Thomson Learning.

Mikesell, John L. (2007). *Fiscal Administration: Analysis and Applications in the Public Sector* (7th ed). Belmont, CA: Thomson Wadsworth.

National Audit Office of the People’s Republic of China (2004). 2004 No. 4 Report (Serial No. 05): Audit & Investigation Findings on the Tax Collection and Management.
http://www.cnao.gov.cn/main/articleshow_ArtID_917.htm

“Our country made significant adjustment to consumption items and rates” (我国对消费税税目，税率及相关政策进行重大调整). Accessed April 25, 2006. http://www.chinatax.gov.cn/print.jsp?code=200603221637418609.

“Overview of China’s taxation” Beijing Local Taxation Bureau. http://english.tax861.gov.cn/index_english.asp.

Qian, Nancy (June 2004). “Income inequality and progressive income taxation in China and India, 1986-2010”

Smith, Adam (1937). *An inquiry into the nature and cause of the wealth of nations (Modern Library edition).* New York: Random House.

State Administration of Taxation, Department of Labor, and Department of Social Security (no date).
“Encouraging employment of unemployed tax policy and its detailed implementation notification.” http://job.sohu.com/article/2004/04/13/63/article219816352.shtml.

State Administration of Taxation. “Tax revenue statistics” (in Chinese). http://www.chinatax.gov.cn/data.jsp.

“State Propaganda Department and other departments held joint trend reporting press, Xie XuRen Giving a Report on China’s Tax growth and reform” (Feb. 27, 2006）
People’s Daily. http://www.chinatax.gov.cn/print.jsp?code=200602270810263357.

Tang, Fuchun (2005). “Road map of tax reform forecast.” China.org.cn.
http://www.china.org.cn/english/BAT/143989.htm.

Stiglitz, Joseph E. (1988). *Economics of the Public Sector* (2nd ed).New York: W.W. Norton & Company.

Vording, H (1997). “Chinese tax policy and the problem of fairness in taxation.” in Zhang, Yong and Fuke, Toshiro (eds.), *Changing Tax Law in East and Southeast Asian Towards the 21st Century. Netherlands:* Kluwer Law International, pp. 91-110.

Wang, Dashu (no date). “Tax Burden in China.” http://mams.rmit.edu.au/sd74hosgjd2s1.doc

Xinhua News Agency (March 6, 2006). “China Accelerates Pace of Unifying Corporate Income Tax” http://www.china.org.cn/english/20061h/160254.htm.

Xing, Qinjiao (2005). “Agricultural tax to be scrapped from 2006.” *China Daily*. http://www.chinadaily.com.cn/english/doc/2005-03/06/content_422126.htm

Xu, Dianqing (1998). “Income tax reform and its impact in China” in Fulton, Trish, Li, Jinyan, and Xu, Dianqing (editors) *China’s Tax Reform Options.* New Jersey: World Scientific, pp. 175 - 195.

Yin, Jason Zunsheng and An, Yuhua (1998). “Strategic Response to the Income Tax Reform for Enterprises in China” in Fulton, Trish, Li, Jinyan, and Xu, Dianqing (editors) *China’s Tax Reform Options.* New Jersey: World Scientific, pp. 196 – 210.