China's Tax Reforms of 1994: Breakthrough or Compromise?

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1. Introduction

In late 1993, China announced a comprehensive economic reform program covering the fiscal and taxation system, central and commercial banking, foreign exchange, trade, investment and enterprise management. The initiative was an important step taken by the government in striving towards a more market-oriented economy with effective macroeconomic control. Top officials took pain to emphasize that 1994 would be "a year of reforms" for China. While the reforms were to be coordinated, they stressed the need to achieve breakthrough in some key areas.[i] Among the various aspects of the reform package, the ones that aimed at transforming the fiscal, monetary and foreign exchange control mechanisms clearly stood out. Attention has so far been focused on these macroeconomic changes.

Given the uneven developments of the Chinese economy since 1979, such an emphasis is understandable. Nevertheless, there is no guarantee that the intentions of the central government could be fully realized in the complicated process of elaboration and implementation, as the reforms may face resistance from powerful parties of vested interests. Other than political considerations, moreover, the reforms would run into problems that arise from the simple fact that the "socialist market economy" has yet to take concrete shape, as many aspects of the other reforms (e.g. enterprise reform, reform of the market for factors of production) are not showing much progress. Compromises may have to be made. Actually, judging from the course of discussion and negotiation in 1993, the subsequently announced blueprint and related regulations, and the process of actual implementation so far in 1994, one may say that the central government has already made a number of important concessions.

The objectives of the reform package were admittedly multi-faceted. A clue to them was revealed in the announcement of the Third Plenum of the Fourteenth Central Committee of the Chinese Communist Party in November 1993, which gave the official blessing to the program. With regard to the reforms of the fiscal and taxation system, the document of the Plenum, which was entitled Decision of the CCP Central Committee on Issues Concerning the Establishment of a Socialist Market Economic Structure (hereafter referred to as the Decision) listed a few major tasks to be achieved. In its paragraph 18, the Decision summarized the overall thinking. The paragraph pointed out as a first objective the need to change "the current fiscal contractual responsibility system of local authorities to a tax assignment system on the basis of a rational division of power between central and local authorities, and establishing separate central and local taxation systems".[ii] It went on to say that "we should gradually increase the percentage of fiscal income in the gross national product (GNP) and rationally determine the proportion between central and local fiscal income". As we will analyze in detail below, this is an attempt to rectify the worrying decline of the fiscal position of the central government in a period of rising regionalism.

As a second task, the Decision emphasized that "it is necessary to reform and improve the taxation system in line with the principles of unifying tax laws, fairness of tax burden, simplification of the tax system and rational division of power". The importance of an efficient indirect tax system based on value-added tax (VAT) was highlighted. As far as direct taxes (such as enterprise and personal income taxes) were concerned, the Decision stressed the need for uniformity and standardization. The third task that the Decision pointed out was the rationalization of China's budgetary system, with regard to central-local budgeting, as well as budgeting for state assets and social security. The need for controlling fiscal deficits was also referred to.

These summarized thoughts of the Decision were concretized to a certain extent through a series of regulations, legal amendments, as well as new laws enacted or announced through October--December 1993, many of which went into effect at the beginning of 1994. Nevertheless, even with that remarkable wave of macroeconomic law making, much detail apparently still needs to be worked out, particularly with regard to central-local fiscal sharing and a number of taxes such the land capital gains tax.

This paper situates the Chinese tax reforms of 1994 in the proper historical context, outlines their salient features, and discusses some of their major implications and problems. Our focus is on tax reforms, which are complicated enough, so related measures like the rationalization of the budgetary systems will not be analyzed. Some minor revisions such as the changes in individual income tax will also be left out. The paper is organized as follows. Section 2 looks at the political-economic factors that have motivated the leadership to attempt a relatively radical macroeconomic reform package. Ironically, some of the same factors also pose serious constraints on the full implementation of the package. Section 3 gives a general discussion of the problems of the old tax system in China before 1994. We then look at three major aspects of taxation in the ensuing sections

(Section 4 to 6), namely central-local fiscal arrangements, direct taxation on enterprises, and indirect taxes. Some initial assessments are presented in Section 7 while Section 8 contains a few concluding remarks.

2. The Political Economy of Chinese Macroeconomic Reforms

The changes in the taxation system were an important part of China's macroeconomic reform package of 1994. The reform of China's macroeconomic control mechanism has lagged behind other aspects of the country's economic development. Such an unbalanced development has given rise to serious tensions in a system undergoing rapid microeconomic changes, and there is no doubt an urgent need to rectify it. As we have analyzed elsewhere, Deng Xiaoping's pragmatism has been a key factor in ensuring short-term success and avoiding major blunders in China. However, that approach also runs the risk of making unintended long-term mistakes that are difficult to correct. With regard to macroeconomic control, the key concern has been the wrong sequence of various pieces of economic reforms.[iii] Wong has discussed it in relation to local finance and industrialization.[iv] The problem is in our view more pervasive.

In the context of China's economic reform, Wu and Reynolds have warned of the danger of failing to set up a framework of effective macroeconomic control before groups of vested interest become powerful.[v] In the old system, local authorities and enterprises were largely passive agents with little self-identity and self-interest. Therefore, in the early stages of the economic reform there should have been adequate time for the central government to modernize the macroeconomic control mechanism, without having to face much resistance. In discussing the economic transition many economists have emphasized the importance of changing the fiscal and monetary systems before launching the enterprise reform.[vi]

The Chinese government did not choose that sequence of reforms and has been facing the consequence. The reasons were complex, but a major one has had to do with the leaders' motivation and objectives. Tsang has pointed out that the key concern of the CCP in launching the economic reform in 1978-79 was to survive and revive after the turbulent years of the Cultural Revolution.[vii] Top leaders, particularly Deng Xiaoping, viewed the economic reform as a way to compensate the masses, who had suffered tremendously, and to regain some credibility for the CCP, which had been badly shaken. Hence they have emphasized the need for achieving quick, and observable results. Nothing would be more rewarding to the people, and the Party, when supplies were abundant in the market place and when urban and rural residents ate better and dressed better.

In contrast, the reform of macroeconomic control mechanisms is of a very different nature. It is time-consuming and resource consuming, but results are mostly not observable, at least not directly. Few would realize the value of having a strong Finance Ministry or an effective central bank until the economy faces severe imbalances, i.e. these institutions obtain their worthy attention by default. Hence the relative neglect of that aspect of the economic reform by the Chinese authorities.

From the above perspective, it is logical to argue that the lagged development of the macroeconomic control mechanism requires a "forward leap" to rectify. A breakthrough is indeed needed. The initiatives taken by the central government on tax reforms in late 1993 were courageous moves, given the cumulative fiscal problems in China in the reform period. At the time of writing, major measures are still being tried out and controversies over some taxes and arrangements remain. While their success would undoubtedly represent a breakthrough in China's economic reform, it is foolhardy to assume that their thorough implementation would be plain sailing.

Serious constraints and obstacles remain in China's march towards a modern market economy with an effective macro-control mechanism. Because of China's peculiar mode of decentralization reforms in a fairly rigid political setting, the conflicts of interests among the central government, the local authorities, the enterprises, and the consumers have resulted in a complicated web of entangled but unstable relations, which is the focus of an endless process of bargaining. The problematic sequencing of the reforms, caused by historical-political as well as economic factors, means that the institution of a modernized macroeconomic authority will meet a great deal of resistance from various parties which over the years have developed a much strong sense of self-interest and are prepared to do everything to defend it. Factors such as historical legacy and regional diversity in a big country with long tradition also hinder sweeping rationalization based on idealistic formulas.

Experience in 1989-93 shows that the central government could still muster enough strength to overcome opposition and force through major price liberalization measures. Some economists would argue, however, that price reform would meet less resistance in implementation as it is more general in nature and hence intrudes less into specific interests.[viii] Since the late 1980s, the supply of most commodities has also significantly increased in China, making it even easier to push forward price liberalization. Reforms of the monetary and fiscal systems, particularly of central-local fiscal relations, are unlikely to be so smooth.

It appears that only a drawn-out give-and-take process that skillfully arbitrates the interests of various parties, vested or newly formed, stands a realistic chance of success in establishing a macroeconomic authority in China with sufficient legitimacy and adequate means in effectively managing an economy undergoing great transformation, while avoiding traditional crude methods which are showing diminishing marginal returns. In this context, the Chinese tax reforms of 1994 serves as a very interesting case for detailed study. On the one hand, the reforms were quite ambitious, at least in conception, reflecting the need for "catching up". On the other, the new reality of an economy characterized by a complicated web of powers and vested interests has also been quite revealing. Compromises, watering-down, and back-tracking have already occurred and further progress seems to be colored by a number of institutional and policy uncertainties.

3. China's Old Tax System

The tax system in China has undergone significant changes in the past few decades, particularly since 1979. The pre-1979 system was highly centralized and therefore provided little incentives to local governments and enterprises. However, the reform attempts in the 1980s were not very successful. Indeed, a good deal of backtracking occurred. The failure of the li gai shui (tax for profit) reform to establish an effective direct tax scheme for enterprises was particularly disappointing. The tax system remained arbitrary in nature, inequitable and inefficient in functioning, as the amounts payable were often subject to negotiations between the enterprises, local governments and the central government. Major problems included the lack of progress in enterprise reform and the limited scope of price reform, with the result that economic performance (e.g. profitability or turnover) was often more a function of policy than that of efficiency. Geographical, political, and sectoral diversity also meant that local authorities and enterprises were operating under a very uneven, non-competitive environment. The government was therefore forced to resort to all kinds of ad hoc measures and administrative arrangements to cater for these factors and constraints. In the extreme, it might degenerate into a situation of yihu yilui ("one tax rate for one enterprise").

Another serious problem has been that of "fiscal decline". The pre-reform taxation system was characterized by a heavy reliance on the revenue of the industrial sector, which was predominantly state-owned. Through deliberate pricing policies, the profit rate of the industrial sector was set at an artificially high level. The state could thus ensure sufficient revenue easily from industrial enterprises. Yet, with the flourishing of the non-state-owned enterprises in the reform period, the monopoly of state industries has weakened substantially. The state's tax base has thus been progressively eroded. Furthermore, even within the state sector, reforms have been carried out to decentralize financial resources to the enterprises. Presumably, that would raise productivity of the enterprises and in turn would increase the tax yield to the government. Unfortunately, this has not happened. Worse still, local authorities have been eager to provide preferential policies, mostly in the form of tax exemptions or tax holiday, to enterprises and investors to boost economic activities under its jurisdiction.

The result of all these was a drastic decline in the ratio of budgetary revenue to GNP, which went down from 31.6% in 1978 to 14.1% in 1993. (See Table 1) The capability of the government to regulate the economy through fiscal measures was significantly undermined.

Equally troubling has been the widening budget deficit. Since 1979, a deficit has been registered in every year. (See the column "adjusted balance" in Table 1). While financial resources have been continuously decentralized, the need to spend more to facilitate or smooth out the reform process has been increasing. The most important element was the huge amount of price subsidies which were mostly related to food items. While the prices of agricultural products have been adjusted upwards, as an incentive measure to the farmers, retail prices were kept stable until the early 1990s. In 1993, the budget deficit was as large as 12.7% of total revenue.

Moreover, the deficits have basically been incurred by the central government. According to recently released official statistics, as shown in Table 2, the cumulative deficit for the central government in 1979-1991 was 114.795 billion yuan, while a cumulative surplus of 6.521 billion yuan was recorded for local governments. Moreover, the share of the central government in total revenue has also been rather low, at least in the past few years (see Table 3 and discussions below). The central government has therefore found it difficult to cover all its spending with the decline of its revenue share in the total budget from around 60% to about 40% during the reform period.

Furthermore, the fiscal system in the 1980s has given rise to regionalism. To increase financial revenues, local governments have encouraged the development of industries, especially those yielding large amounts of product taxes. As a result, duplications of investments have been immense and regional blockade of markets was frequently practiced as a means to protect local industrial production and tax revenue. This has hindered the development of a nation-wide and unified market whereby competition could foster productivity and drive out inefficient firms.

4. Central-local Fiscal Arrangements

Up to 1993, central-local revenue arrangements in China were dominated by the fiscal contract (baogan) system, which could be classified into two major subsystems:

(1) a fixed or adjusted quota arrangement applied to provinces such as Guangdong and Fujian, under which the local government remitted to (received from) the central government a fixed amount of revenue (subsidy) which could be adjusted upwards by a rate of acceleration; and

(2) a proportional sharing scheme under which the central and local governments shared revenue according to a pre-agreed ratio.

By mid-1980s, most local authorities had adopted the proportional sharing scheme. Yet a few of them, including Shanghai, shifted to the fixed or adjusted quota arrangement in the late 1980s after consistent protest of getting too little fiscal resources compared with Guangdong.[ix]

Such an arbitrary allocation system was out of tune with modern practice in most countries, where functions of the central and local authorities are first defined, and then tax sources are assigned to both. It has given rise to some perverse behavioral consequences on the part of local authorities as well as enterprises, including attempts to maximize short-term revenue by artificially boosting investments and enterprise activities, at the expense of longer-run developmental and social needs. Moreover, as we have shown above, the system resulted in a serious fiscal decline for the central government, as pre-set quotas and ratios worked against it in a high-growth, high-inflation environment.

Hence, in 1994, the government has launched a fen shui zhi (tax assignment system) whereby taxes are divided into three categories: central taxes, local taxes, and shared taxes between central and local governments (see Box 1). A manifest goal is to move from the central-local tax revenue ratio of about 40:60 in 1993 to that of 60:40, which is more in line with the pattern in most other countries.[x] However, no specific target date of fulfilling the goal has been given. A tax collection system for the central government will on the other hand be established at the local levels.[xi]

Nominally, a certain form of "tax assignment system" existed as early as 1980 for the majority of provinces and was revived in the reform of 1985. In reality, however, such a system was never strictly implemented and the "baogan" and the "proportional sharing" systems became the norm. The 1988 reform finally decided to formalize the contract system because the preconditions for the tax assignment system were not "mature". Three major reasons were often cited: (1) the price reform was not completed; (2) the tax reform needed deepening; and (3) the classification of administrative powers for different levels of authorities was not clear.

To give the tax assignment system a second go in the present era of zhuhou jingji ("economic warlordism") when local authorities are becoming increasingly powerful and vocal is a relatively bold attempt, although one could say that the increasing strains on the fiscal position of the central government has left it with little choice. Since the early 1990s, a number of top economists and officials have suggested that Beijing should reverse the trend of fiscal decline and increase the share of central tax revenue. For some, it is even more important to define clearly the financial rights and responsibilities of the central and local governments.[xii] In any case, most agree that the tax assignment system is the only way out. While the Fifth Plenum of the Central Committee of the 13th Party Congress in late 1989 decided to experiment with the system, the 14th Party Congress in 1992 included its establishment as one of the major tasks confronting the country. Actually, the Chinese government instructed nine regions to experiment with the tax assignment system in 1992.[xiii] By mid-1993, the government decided to apply the system nation-wide. However, it appears that in the process of actual bargaining on the detailed formula of the assignment and sharing of taxes, the government was forced to make compromises. Right after the Plenum in November 1993, the Finance Minister, Liu Zhongli, told reporters of the Xinhua News Agency that the "tax assignment system" would be implemented in a "slow-moving, step by step manner" (huanhuan er xing, fenbu tuijin). "Local interests" would be "guaranteed" under the proposed fiscal reform, while "the increase in the share of central fiscal revenue would only be gradually obtained from the growth in taxes from now on."[xiv]

Beijing has since decided to protect local interests by guaranteeing that their tax revenue under the new system would be no less than under the old one, through a complicated rebate scheme. Hence increased taxes for the central government come only from additional revenue. The basic motivation is to reduce local resistance.

The system is intended to work like this. 1993 is fixed as the "base year" for the rebate system. The imposition of the new assignment system implies that the taxes collected by local and central tax authorities will be re-accrued according to the agreed divisions of specified tax types and the central-local ratios of the shared taxes. It is most likely that a net transfer of revenue has to be made by the local authorities to the central government in the collection-accrual adjustment process. The amount of such a warranted transfer for the final accounts of 1993 is called the jishu (base amount). To safeguard vested interests, it was rebated to the local authority in total. In other words, as far as 1993 was concerned, the local authority fared the same under the new system, compared with old the baogan arrangements. From the opposite angle, the central government obtained no benefit at all in 1993 for the tax changes.[xv]

For 1994 and beyond, the sum of rebate would be adjusted by a coefficient of 1:0.3 on the basis of the national average growth rate of two taxes: consumption tax and value added tax. In other words, if the revenue arising from the two taxes goes up by a national average of 1%, the rebate will be increased by 0.3% on top of the jishu. Should the calculated net remittance to the central government in any year from 1994 onwards fall below the jishu of the preceding year, the rebate to the local authority will simply be the actual net amount so calculated.[xvi] In any case, the baogan system has been retained for the determination of inter-governmental transfers.

From the budget of fiscal year of 1994, we can see that the revenue share of the central government was to be increased substantially to 57%. Yet after deducting the total amount of rebates and subsidies to the local governments, the "disposable income" of the central government amounted only to 25% of the total revenue. The budgeted deficit of the central government also continued to climb. It seems that it would be a long way before the center could shift its fiscal burden to local governments.

Overall, the reform of central-local fiscal arrangements has turned out to be a compromise solution. The "double-track" arrangements involving rebates would ensure that the shift in central-local ratio is achieved through the growth in tax revenue, while the stock of revenue distribution is kept intact. It is unclear when the target ratio of 60:40 for central-local tax revenue would be realized and the rebate arrangement abolished under such a program. Top officials have so far refrained from giving any time table.

5. Income Taxation on Enterprises

As most enterprises were state-owned in China, the government was contented with a highly centralized system of profit remittance and loss covering before 1979. Such a system was of course an obstacle in motivating enterprises to behave rationally, assume profit-and-loss responsibilities, and take risks by making the right type of investment.

In 1983, China attempted a radical tax reform on enterprises by adopting the principle of li gai shui (tax for profit). Instead of remitting all their profits to the government or having their losses covered, state enterprises were asked to pay a fixed income (profit) tax rate of 55%. The reform was carried out in two stages, but by 1985-86 serious problems had emerged: the most important one being that enterprises' profits were not a reflection of their economic efficiency as prices were distorted and the reform of the whole economic system was far from complete. The fiscal deficit of 1986 also put pressure on the central government to get more revenue. As a result, the government had to impose different taxes and requirements (including different charges and contributions to funds) on different enterprises in order to reduce such distortion effects, thus making the system very complicated. Local governments and enterprises also complained loudly that the tax burden on them was becoming excessive.[xvii]

To compromise, the government shifted in 1987 to a management contract system (chengbao jingying zerenzhi), under which large and medium-sized state enterprises guaranteed to pay various taxes, including a profit adjustment tax (which was first introduced in the second stage of li gai shui in 1984) on top of the normal profit tax of 55% (intended to siphon off excessive "policy" profits not due to efficiency). Various baogan systems were imposed on different enterprises, but the most popular one, called "two-guarantee-and-one-link-up system" (liangbao yigua), obliged enterprises to fulfill various efficiency indicators. Loss-making enterprises continued to receive subsidies. Although nominally the management contract system was "built on the basis" of the li gui shui experiment, it represented a back-tracking to a regime under which the remittance from the enterprise to the government was more based on negotiation and ad hoc measures rather than manifest and uniform rules.[xviii]

Such a system led to a host of problems: enterprises had incentives to reduce the amount of profit subject to tax by substantially increasing the wages and benefits of workers, even to the point of reporting losses, since there was little threat of bankruptcy for unprofitable enterprises. The nexus between local authorities and enterprises under a process of fiscal decentralization also resulted in a number of anomalies.[xix] Without price reform, the tax-contract system in effect made most taxes negotiable, which also opened up venues for corruption and difficulties in making predictions on government revenue. A particularly worrying problem for the central government was that its share in revenue again fell drastically under the baogan system.[xx]

Another related development for enterprise taxation was the proliferation of various non-state and foreign-invested enterprises. As a result of different policy treatments, the tax system became rather complicated. Collective enterprises, like small state enterprises, were subject to a system of progressive profit taxes of eight brackets, at rates rising from 10% to 55%, while private enterprises were taxed at a rate of 35%. Foreign-invested enterprises (FIEs), on the other hand, were taxed at 33% in general, and at 15% in the special economic zones (SEZs). This differentiated tax system, plus various local exemptions and reductions, created an "unfair" environment for enterprises, particularly the large and medium-sized state enterprises.

Into the 1990s, a number of favorable conditions have emerged which would give macroeconomic reforms, including taxation reform, a better chance. They include, amongst others, (1) a firm commitment by the government to transform China into a "socialist market economy" in which the market would at least be responsible for microeconomic resource allocation; (2) remarkable progress in price reform, as far as prices of output is concerned; (3) significant expansion of the non-state sectors of the economy; and (4) convergence of opinions on what is to be done in taxation and other reforms.[xxi]

The tax reform of 1994 aims at taking advantage of these developments and rectifying the some of the problems of the management contract system and the unfair schemes of non-uniform taxation. It fixes the income (profit) tax at the uniform rate of 33% for all enterprises, state and non-state alike, with all progressive brackets and adjustment taxes abolished. Management contracts that obliged the state enterprises to pay lump-sum income taxes have been canceled, so have the income adjustment taxes. The preferential rate of 15% for FIEs in the SEZs has nevertheless not been changed. At the same time, the central government would curb the power of the local authorities to grant tax exemptions and reductions, with a view to ensure a level playing field for enterprises to compete with one another.[xxii]

Yet, the benefits to state-owned enterprises are not as significant as the reduction in the income tax rate would suggest. In 1985, the Chinese government abandoned the practice of allocating interest-free investment funds to state-owned enterprises directly from its budget. Instead, these enterprises had to apply for loans from banks for investment. In order to reduce their burden, they were allowed to "repay loans before taxation" (shui qian huan dai). This practice was widely criticized as instigating irrational investment behavior, as loan repayments were tax-deductible items. In fact, collective enterprises had since 1983 also enjoyed similar treatment, although only 60% of their loan repayments were deductible.[xxiii] The amount of budgetary concession in this kind of shui qian huan dai was as large as Rmb 20.1 billion in 1991.[xxiv] Under the new tax system of 1994, such tax deductibility has been discontinued. Instead, the practice of "repaying loans after taxation" (shui hou huan dai) is adopted. Hence, the taxable income of enterprises will be increased.[xxv]

6. Reforms of Indirect Taxes

From 1958 to 1983, indirect taxation in China was mainly implemented through the gongshang tongyi shui (consolidated industrial and commercial tax---CICT), which was essentially a turnover tax. In 1984, the CICT was replaced by the trio of the Product Tax (chan pin shui), the Value Added Tax---VAT (zeng zhi shui) and the Business Tax (ying ye shui). Among the three taxes, the Product Tax, which was imposed on the gross value of a good sold, was the dominant one, while the VAT---levied only on the net value of the good (gross sales minus input price)---gained importance over the years. Yet according to a World Bank report in 1990, its share was only about 26% of all indirect tax revenue.[xxvi] The Business Tax was applied to services rather than goods.

The problems concerning the Product Tax were well known in terms of multiple counting and distortions in resource allocation and enterprise behavior. Another feature with the triple indirect taxes was the highly differentiated rates that they employed. The major motivation was to offset the distortion effects of arbitrary prices that had yet to be equilibrated. So it is not surprising that the Chinese tax reform of 1994 has revamped the indirect tax system by displacing the Product Tax by the VAT and keeping the Business Tax, while simplifying the rate structures. A new tax, the Consumption Tax (xiao fei shui), is levied on luxury items.

The Value Added Tax (VAT) is the principal tax on the sales or import of goods. At a basic rate of 17% on net value, it is imposed on all domestic and foreign enterprises. For 19 items of agricultural and energy products, a preferential rate of 13% is applied, while exports are exempted from taxation. On the other hand, small businesses with an annual turnover of less than one million yuan face a rate of only 6% on their gross sales.[xxvii]

The Business Tax is the major indirect tax on the provision of services, but it also applies to the transfer of real estate and intangible assets. The tax rates are in the range of 3% to 5% in general, and 5% to 20% for entertainment. They are calculated as a percentage of turnover and no credit is given to purchases.[xxviii]

The design of the VAT, which is expected to grow substantially under the new system, also aims at alleviating the problem of excess investment and duplication in certain industries. By putting the VAT as a shared tax and with 75% going to the central budget (see Box 1), the new system supposedly would reduce the reliance of local budgetary revenues on specific industries and increase the revenue buoyancy of both the central and local budgets.

The Consumption Tax, a new tax type, is levied on the sale or import of a range of specified items. It is imposed before the levy of VAT on such goods, mostly luxury goods such as alcohol and jewelry, with rates ranging from 3% to 45%. In the past few years, the Chinese government applied the Special Consumption Taxes to the automobiles and color TV sets, so as to discourage their consumption. The introduction of Consumption Tax serves similar purpose, but it is levied on an enlarged range of products, including some of those that have been subjected to the old Product Tax. By assigning the Consumption Tax as a central tax, local government could supposedly be discouraged from the production of these goods.

Other reforms on indirect taxes cover the Land Capital Gains Tax (tudi zengzhi shui), the stock transactions gains tax (gupiao zhuanrang suode shui), and the Resources Tax. The Land Capital Gains Tax, a new tax, has been the most controversial of all and has since met rather strong opposition from the provincial governments and foreign businesses because of its very high progressive rates. It appears though that the central government is keeping its stance.[xxix] Because of the rather depressed atmosphere in the stock markets, however, the proposed stock transactions gains tax is to be delayed for two years.[xxx]

Overall, the new indirect taxation system of 1994 represents a rationalization over the old system. While new taxes have been introduced, the total number of tax types has been cut and the high degree of differentiation in rate structures is reduced. The replacement of the Product Tax by the VAT has been a particularly important step forward.

7. Some Initial Assessments

In our view, the basic objectives of the Chinese reforms of 1994 in rationalizing the tax system, which include the introduction of uniformity and consistency as well as the provision of a level playing field for various parties so as to enhance competition, deserve support. Furthermore, there is little doubt that the central government needs to revamp the system in order to raise sufficient revenue to cover its widening fiscal deficits and gain better control over the country's public finances. For a "socialist market economy" to function properly, all these are necessary ingredients. The Chinese government has indeed shown considerable courage and tact in launching the tax reforms of 1994.

Nevertheless, it appears that because of the cumulative pressure that has built up, the government has attempted a great deal of changes in a rather short time span. Some aspects of the tax reform were pushed forward in a relatively hasty manner, without paying sufficient attention to finer details and supplementary measures. As a result, uncertainties have remained in the implementation of some important taxes, e.g. the VAT and the Land Capital Gains Tax. Details have begun to emerge only months after launching. More specifically, whether the tax measures would be applied in a retrospective manner or not and how their impact should be distributed have also caused some controversy.[xxxi]

With regard to the tax assignment system, its major concern appears to have concentrated on shifting the central-local revenue shares, albeit in a manner generally agreeable to local interests. The long-term objective of rationalizing rights and responsibilities has unfortunately been side-tracked. The system has not been augmented by any measure in the clear demarcation of the responsibilities of the central and the local governments.[xxxii] Such an asymmetry between rights (tax assignments) and (expenditure) responsibilities could imply instability in the system, as different parties would contest about the tax assignments in the future, when problems and arguments arise on the expenditure side.

The accounting and rebating arrangements related to the assignment system also seem ad hoc and open to negotiation. For example, it is a question whether the rebate ratio of 1:0.3 would be raised or not in the future as a result of local pressure. When the rebate would end (so that the tax assignment system would come into full effect) is also unclear at the moment.

Furthermore, the central leadership appears to have committed a tactical mistake with regard to the pronouncement on the determination of tax rebates. The bargaining process apparently went on throughout the summer of 1993 and was finalized around September. When it turned out that the year 1993 would be used as the base year, local governments rushed in the remaining months to expand revenue to push up the jishu, with a view to fetch a larger amount of tax rebate in 1994 and beyond. A classic example was that of Guangdong. In January - July 1993, total budgetary revenue in the province increased by 31% over the same period in 1992. In the subsequent months, however, the growth rate rose rapidly to as high as 146% in December. As a result, Guangdong's budget revenue registered an increase of 56.4% for the year of 1993 as a whole.[xxxiii] Such strategic behavior on the part of the local authorities probably added to the inflationary pressure in the country, as enterprises and units with market power passed the higher costs to end-users. The artificial enlargement of rebates would also delay the rectification of central-local revenue shares.

As to enterprise taxation, the unification of the income tax rates at 33% may be regarded as a move to achieve breakthrough as the management contract system implemented since 1987 has been abolished as well. A major constraint is however the very difficult position that the state enterprises have found themselves trapped into in the past two years. The financial health of the state-owned sector has been deteriorating. In the first quarter of 1994, 49.6% of state-owned industrial enterprises recorded losses, which added up to a total of 15.7 billion yuan.[xxxiv] This was probably a major reason why Beijing decided to abandon the chengbao system, because the state enterprises could hardly be counted as a buoyant source of revenue, not to say be squeezed further. Indeed, as a "transitional measure", the government has allowed two preferential income tax rates, at 27% and 18%, for state enterprises with low profitability.[xxxv] Whether these ad hoc concessions would become a focus of bargaining and result in a compromising of the reforms (in terms of uniformity and consistency) in the future, one can only wait and see, bearing in mind the failure of the li gui shui reform in the 1980s.

8. Concluding Remarks

All these imply that while a relatively bold and promising start has been made, the thorough implementation of the tax reforms in China might not be plain sailing. Even the blue-print itself has left some important problems unattended, by design or by default. Concessions have been made, and more may become necessary in due course.

Undoubtedly, if the reforms are successfully pushed through, a more stable relationship will exist between the central and local authorities in public finance and tax-sharing, paving the way for a more rational inter-governmental structure in China. It will also provide a fairer and more competitive environment among domestic and foreign enterprises and thus create a more favorable atmosphere for economic growth. In any case, it appears that China still has quite a lot to do before it could establish an effective macroeconomic control mechanism that embodies an efficient taxation system, and ensure that it becomes entrenched in the rapidly evolving economy.

Notes

i. See, for example, the speech of He Guanhui, the Deputy Director of the State Commission for Economic System Reform, in the National Work Conference for Economic System Reform, which was reported in *Remin ribao* [People's Daily], 6 December 1993, p.1. For theoretical justifications of this strategy, see Research Team on Situations [Institute of Economics, Chinese Academy of Social Sciences], "Zhengti peitao, zhongdian tupo" [Comprehensive Reforms and Major Breakthroughs], *Jingji yanjiu* [Economic Research Journal], no.1 (January 1994), pp.3-11.

ii. The quotations concerning the fiscal and taxation reforms as discussed in paragraph 18 of the *Decision* are taken directly from the English version provided by *China Daily* on 17 November 1994.

iii. For discussions of the reasons behind such a phenomenon and the problems that it has caused, see Tsang Shu-ki, "Towards a System of Modernized Macroeconomic Control in China", paper presented in the 34th ICANAS (International Congress of Asian and North African Studies) Meeting, Hong Kong, 22-28 August 1993; and Tsang Shu-ki "Financial Disorder and Macroeconomic Reforms in China", *Hong Kong Economic Papers*, 1994, forthcoming.

iv. Christine P. Wong, "Fiscal Reform and Local Industrialization: The Problematic Sequencing of Reform in Post-Mao China", *Modern China*, Vol.18, no.2 (April 1992), pp.197-227.

v. Wu, Jinglian and Bruce Reynolds, "Choosing a Strategy for China's Economic Reform", *American Economic Review*, Papers and Proceedings, May 1988.

vi. See Fei, John and Bruce Reynolds, "A Tentative Plan for the Rational Sequencing of Overall Reform in China's Economic system", *Journal of Comparative Economics*, Vol.11, no.3 (1987); and McKinnon, Ronald I., *The Order of Economic Liberalization* (Baltimore and London: Johns Hopkins University Press, 1991).

vii. Tsang Shu-ki, "Wenge mengyan yu jingji gaige de jingyan" [The Nightmare of the

Cultural Revolution and the Experience of the Chinese Economic Reform], in C. H. Ng et al. (eds), *Kunjing yu chulu: zhongguo minzhuhua tansuo* [Blockade and Exit: Exploration of Democracy in China] (Hong Kong: Meeting Point Ltd., January 1991), pp.123-138.

viii. See Lal, Deepak, "The Fable of the Three Envelopes: The Analytics and Political Economy of Reform of Chinese State Owned Enterprises", *European Economic Review*, Vol.34 (September 1990).

ix. See Ping Xinqiao, *Caizheng yuanli yu bijiao caizheng zhidu* [Principles of Public Finance and Comparative Fiscal Systems] (Shanghai: Shanghai Joint Publishers, 1992), chapter 13. These two subsystems were called "the Guangdong model" and "the Jiangsu model". There were two other minor versions applied to a number of provinces and special regions in the interior and along the western border. See also The World Bank, *China: Resource Mobilization and Tax Policy* (Washington, D.C.: The World Bank, 1990), Section III.

x. See "Finance Vice Minister on Central-Local Tax Assignment", *China Economic News*, Beijing, Vol.XV, no.1 (3 January 1994), pp.7-8.

xi. See *Wen Wei Po* (Hong Kong), 28 February 1994, p.A3, for another interview with Vice Finance Minister Xiang Huaicheng, in which he said that the crux of the assignment system was to "separate power, separate taxes, separate organizations" between the central and local authorities. China's tax administration system was characterized by a mixture of over-centralization in the legal framework and over-decentralization in implementation, which gave rise to serious problems. See The World Bank, *China: Resource Mobilization and Tax Policy*, Section III.

xii. See, for instance, Li Peng's report submitted to the People's Congress in March 1991, collected in *Zhongguo jingji nianjian* [Almanac of China's Economy], 1991, pp.I-6-28; and Li Junsheng, "Bijiao yu qishi: caizheng jizhonghua qushi ji qi neihan" [Comparison and Lessons: the Trend of Fiscal Centralization and its Substance], *Zhongyang caizheng jinrong xueyuan yuebao* [Journal of the Central Academy of Fiscal and Financial Studies] (Beijing), no.5 (1990), pp.56-60.

xiii. See the budget report of the Chinese government in 1992, in *Zhongguo jingji nianjian* [Almanac of China's Economy], 1992, pp.31-37.

xiv. See *Wen Wei Po* (Hong Kong), 18 November 1993, p.3.

xv. See the interview with Vice Finance Minister Xiang Huaicheng on *Wen Wei Po* (Hong

Kong), 28 February 1994, p.A3. Xiang told the reporter that for 1993, "central finance gained no improvement at all."

xvi. See Jiang Yonghua and Zhao Huaitan (eds.), *Caizheng shuishou xinzhidu xiangjie* [Detailed Explanations of the New Fiscal and Taxation Systems], Qiye Guanli Chubanshe [Enterprise Management Publishing House], 1994, section 1, chapter 3.

xvii. See Joseph C.H. Chai, "Incentive and Profit Sharing in Chinese Industry", *Hong Kong Economic Papers*, No.21, 1991.

xviii.*ibid.*

xix. See Christine P. Wong, "Fiscal Reform and Local Industrialization", pp.197-227.

xx. According to Jiang Yonghua and Zhao Huaitan (eds.), *Caizheng shuishou xinzhidu xiangjie*, p.61, the government took 45% of the enterprises' total profit in 1986. After the implementation of the management contract system, the share fell to 27% in 1988.

xxi. For a more detailed discussion, see Guo Shuqing, *Jingji tizhi zhuangui yu hongguan tiaokong* [Transformation of Economic System and Macroeconomic Control] (Tianjin: Tianjin People's Press, 1992), pp.207-209; and Tsang Shu-ki, "Towards a System of Modernized Macroeconomic Control in China."

xxii. For the detailed measures, see *Xin shuzhi zhidao* [Guide Book on the New Tax System] (Beijing: Economic Management Publishing House, 1994), chapter 3.

xxiii. Wang Shouyao and Zhang Yi, *Xinjiu shuizhi bijiao* [Comparisons of the New and the Old Tax System] (Beijing: Reform Press, 1993), pp.217-218 and 232-233.

xxiv. *Zhongguo caizheng nianjian* (Finance Yearbook of China), 1992, p.937.

xxv. See Jiang Yonghua and Zhao Huaitan (eds.), *Caizheng shuishou xinzhidu xiangjie*, pp.58-60.

xxvi. The World Bank, *China: Resource Mobilization and Tax Policy*, p.29.

xxvii. See Sun Shangqing (ed.) *Xin shuiwu zhidu shouce* [Manual of the New Taxation System], Xinhua Chubanshe [New China Publishing House], 1994, pp.17-22.

xxviii. See *Xin shuzhi zhidao*, p.66; and Sun Shangqing (ed.), *Xin shuiwu zhidu shouce*, pp.326-329.

xxix."Pleas fail to change property gains tax", *South China Morning Post*, Hong Kong, 9 April 1994.

xxx. "Market fears force delay in securities gains taxation", *South China Morning Post*, 13 April 1994.

xxxi. See Joseph Fu, "New detail lifts the fog hanging over tax reform", China Business Review, *South China Morning Post*, 5 May 1994, p.2. Even for the VAT, there were uncertainties after four months about its exact due date, the scope of its application (e.g. whether it applied to the purchase of plant and machinery), and the refund procedures on input VAT paid etc.

xxxii. A critical comment on this aspect of the reform is raised in Jiang Yonghua and Zhao Huaitan (eds.), *Caizheng shuishou xinzhidu xiangjie*, p.35. Since "no action has been taken", the demarcation of expenditure responsibilities is regarded as one of the "outstanding issues" of the tax assignment system.

xxxiii. See CERD Consultants limited, *Guangdong Economic Analysis - Monthly Reports* (Hong Kong), issues from August 1993 to January 1994.

xxxiv. See the statement made by Ye Zhen, a spokesman of the State Statistical Bureau, as reported by *Ta Kung Pao*, Hong Kong, 19 April, 1994, p.2.

xxxv. *Guowuyuan guanyu shishi fenshuizhi caiwu guanli tizhi di jueding* [State Council Resolution on the Fiscal Management System of the Tax Assignment System], *Caizheng* [Public Finance}, No.2, 1994, p.20.

Table 1 China's Fiscal Deficits under Two Different Accounting Systems

(Rmb 100 million)

Year	Fiscal revenue	Fiscal expenditure	Official balance	Adjusted revenue (AR)	Adjusted expenditure	Adjusted balance	AR/GNP (%)
1978	1121.1	1111.0	10.1	1132.2	1122.1	10.1	31.6
1979	1103.3	1273.9 1212.7	-170.6	1147.2	1353.1	-205.9	28.7
1980	1085.2		-127.5	1159.9	1301.8	-141.9	25.9
1981	1089.6	1115.0	-25.5	1175.9	1211.5	-35.6	24.6
1982	1124.0	1153.3	-29.3	1212.4	1270.0	-57.6	23.3
1983	1249.0	1292.5	-43.5	1367.0	1447.4	-80.4	23.5
1984	1501.9	1546.4	-44.5	1642.9	1735.8	-92.9	23.6
1985	1866.4	1844.8	21.6	2038.3	2067.0	-28.7	23.8
1986	2260.3	2330.8	-70.5	2122.1	2280.6	-158.6	21.9
1987	2368.9	2448.5	-79.6	2199.4	2368.7	-169.3	19.5
1988	2628.0	2706.6	-78.6	2357.2	2629.9	-272.6	16.8
1989	2947.9	3040.2	-92.3	2664.9	2967.8	-302.9	16.7
1990	3312.6	3452.2	-139.6	2937.2	3261.8	-324.6	16.6
1991	3610.9	3813.6	-202.7	3149.5	3566.8	-417.3	15.6
1992	4153.1	4389.7	-236.6	3483.4	3951.1	-467.7	14.5
1993	5114.8	5319.8	-205.0	4421.0	4982.5	-561.5	14.1
1994	4760.0	5429.1	-669.2	4760.0	5429.1	-669.2	n.a.

Notes:

1.The figures for 1993 are preliminary and those for 1994 are budgeted amounts.

2.Since the fiscal accounting system of China was revamped in 1994, figures for 1993 and before have to be adjusted in order to cater for the changes and facilitate comparison. There are various ways to adjust the Chinese budget to bring it in line with international practice, given the country's institutional peculiarities. Following common standards, here we deduct borrowings from the expenditure side and repayments from the revenue side. Such an adjustment is not needed for the 1994 budget as it was already made. On the other hand, since price subsidies were deducted from revenue instead of being entered as an expenditure item before 1986, the amount is here added back to both the revenue and the expenditure sides. On top of these adjustments, the World Bank suggests that cash from sale of state assets should be deducted form the revenue side, extra-budgetary capital constructions be added to the expenditure side, and the subsidies for operating losses of state-owned enterprises be added to both sides. See World Bank, *China: Resource Mobilization and Tax Policy* (Washington, D.C.: World Bank, 1990) p.10. Since complete and reliable series of data for these items are not available, we have not implemented these adjustments here.

Sources: *Zhongguo tongji nianjian* [China's Statistical Yearbook], 1993, pp.215, 227, 231; and *Jingji ribao* [Economic Daily], 25 March 1994, pp.2-3.

Table 2 Fiscal Balances of Central and Local Governments 1979-91

(Rmb 100 million)

Year	Whole country	Central budget	Local budgets
1979	-170.67	-133.33	-37.34
1980	-127.50	-145.50	+18.00
1981	-25.51	-11.87	-13.64
1982	-29.34	-46.28	+16.94
1983	-43.46	-83.96	+40.50
1984	-44.54	-30.00	-14.54
1985	+21.62	+0.83	+20.79
1986	-70.55	-94.18	+23.63
1987	-79.59	-96.78	+17.19
1988	-78.55	-106.51	+27.96
1989	-92.33	-109.86	+17.53
1990	-139.65	-107.97	-31.68
1991	-202.67	-182.54	-20.13

Note: A figure prefixed by a "+" sign represents a budgetary surplus, while that by a "-" shows a deficit.

Source: *Zhongguo Caizheng Tongji 1950-1991* [China's Fiscal Statistics 1950-1991], p.321.

Table 3 Central and Local Budgets since 1989

(Rmb 100 million)

Items		1989	1991	1993	1994
Central total revenue	(CTR)	1557.20	1889.95	2382.68	3329.10
Central revenue	(CR)	1105.49	1399.65	1808.41	2720.56
Local remittance to center	(LC)	452.01	490.30	574.27	608.54
Central total expenditure	(CTE)	1667.36	2072.49	2587.68	3998.29
Central expenditure	(CE)	1105.19	1517.74	2004.68	1862.89
Central transfers to local	(CL)	562.17	554.75	583.35	2135.40
Central balance	CB= CTR-CTE	-109.86	-182.54	-205.00	-669.19
Local total revenue	(LTR)	2404.55	2765.98	3297.31	4174.79
Local revenue	(LR)	1842.38	2211.23	2713.96	2039.39
Central transfer to local	(CL)	562.17	554.75	583.35	2135.40
Local total expenditure	(LTE)	2387.02	2786.11	3297.31	4174.79
Local expenditure	(LE)	1935.01	2295.81	2723.04	3566.25
Local remittance to center	(LC)	452.01	490.30	574.27	608.54
Local Balance	LB=LTR-LTE	17.53	-20.13	0.00	0.00
Central disposable income	CDI=CTR-CL	995.03	1335.20	1799.33	1193.70
Local disposable income	LDI=LTR-LC	1952.54	2275.68	2723.04	3566.25
Central share in disposable income (%)	CS=CDI/(CDI+LDI)	33.76	36.98	39.79	25.08
Central share in total revenue (%)	CRS=CR/(CR+LR)	37.50	38.76	39.99	57.16
Adjusted central share in total revenue (%)		30.86	29.79	29.11	57.16
Adjusted central share in disposable income(%)		26.73	27.74	28.88	25.88
Adjusted central balance		-320.46	-397.14	-561.40	-669.19

Note: Official figures for 1994 are not comparable with those of the previous years due to changes in the fiscal accounting system (see notes in Table 1). The last three lines in the table show the adjusted figures, which follow the new system of 1994. In the computation, borrowings are deducted from central revenue and repayments of loans from central expenditure. It is assumed that all borrowings and repayments of loans in the state budget are accrued to the central budget. It should be a reasonable assumption to make, in lieu of more detailed information, as all domestic debts have been used for financing central deficits and most of foreign debts are borrowed by the central government.

Sources: Figures for 1989-1991 are taken from the finalized budgetary accounts of China, published in the August issue every year in *Caizheng* [Public Finance] (Beijing). Figures for 1993 are preliminary and those for 1994 are budgeted amounts, which are taken from *Jingji ribao* [Economic Daily], 25 March 1994, pp.2-3.

Box 1 The New Tax Assignment System

Central Taxes

- Tariffs
- Income tax of central enterprises
- Tax on revenues turned in by railways, banks and insurance companies
- Income tax from financial enterprises which have obtained business licenses from the People's Bank of China
- Consumption tax
- Offshore oil resource taxes

Local Taxes

- Business tax (exclude that turned in by banks, railways and insurance companies)
- Income tax from local enterprises
- Personal income tax
- Capital gain tax on land and property sales
- Estate duty
- Stamp duty

Shared Taxes

- Value-added tax : central government (75%) and local government (25%)
- Stock transactions gains tax : central government (50%) and local government (50%)
- Resource tax other than offshore oil resource tax: mostly to local government

Sources: "Finance Vice Minister on Central-Local Tax Assignment", *China Economic News*, Beijing, Vol.XV, No.1, 3 January 1994, pp.7-8; and Jiang Yonghua and Zhao Huaitan (eds.), *Caizheng shuishou xinzhidu xiangjie* [Detailed Explanations of the New Fiscal and Tax Systems], Qiye Guanli Chubanshe [Enterprise Management Publishing House], 1994, section 1, chapter 3.