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ABOUT THE JOURNAL

The importance of China on the global economic stage cannot be ignored, and its unique legal and tax systems are of great interest to international scholars and business people alike. China's tax system is acquiring western features while remaining entrenched in its rich cultural and historical roots. This makes for interesting study, analysis and comparison as its laws are becoming more accessible.

The Journal of Chinese Tax & Policy focuses on the policy, administrative and compliance aspects of the Chinese tax system. It also welcomes comparative studies between China and other countries.

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EDITORIAL

In the February 2012 issue of the Journal of Chinese Tax and Policy, we are proud to introduce a special feature — *Comments by Researchers in Chinese Government Think-Tanks*. The papers in this journal focus thematically on the most recent tax reforms of VAT and income tax in China.

As China's economy continues to grow and evolve, reform to the tax system is of increasing importance to maintain its efficiency and relevance as a social regulator, a revenue source for public services, and the primary method of macroeconomic control. As economic reform leads China's economic structure away from its historically socialist planned economy towards the internationally embraced market economy, so too, must its tax system follow in incorporating culturally relevant international trends in tax reform to optimise the social benefits of economic transformation and growth.

The paper 'Individual Income Tax Reform Still Has a Long Way to Go' is the first contribution to our special feature. Dr Jin Dongsheng of the Fiscal Sciences Research Centre of the PRC State Administration of Taxation explores the international origins of the Individual Income Tax, and its evolution since implementation in China. He discusses the characteristics of this tax type, its basic features, method of calculation, tax return procedure, and international trends in reform. Particularly, the author examines the process of transformation from a global to a schedular tax system, and assesses the desirable and undesirable features of each system. Jin comments on areas of possible reform, in relation to the deduction system, applicable tax rates and promotion of self-assessment.

Second, Lin & Sun's article, 'The Relationship Between VAT Base-Expansion and Intergovernmental Fiscal Relations' traces the historical development of the VAT in China, and the implications of VAT reform on local governments' fiscal capacity. The paper analyses these issues from the perspective of the dual process of Industrialisation and Urbanisation, discussing the necessity and feasibility of VAT base-expansion, empirically simulating the reform effects on the different levels of government.

Finally, Yang's article , 'Extending the VAT to Services in China: Special Difficulties and Choices' explores the necessity and potential difficulties of VAT base-expansion. Yang explores VAT reform from a different perspective to Lin & Sun, examining the sales tax's effects on specialisation, services and the export of services and drawing conclusions on whether the expansion of VAT scope may alleviate these issues. Consideration is given to the relevance of international VAT practices in China's vastly different cultural and economic structure, the issue of breaking the input credit chain, and problems arising from levying a VAT on the transport, construction and real estate industries in China. Similarly to Lin & Sun, tax policy reform regarding the financial services sector is considered, and a feasibility analysis is undertaken, although Yang's perspective on the cost vs benefit of base expansion differs from that of Lin & Sun.

What is highlighted in these articles is the gradual development of tax policy in China's economic growth. For this, a more integrated approach is necessary, to avoid tax types that have overlapping jurisdictions, and unfavourable effects on particular industries. The idea that tax reform must be undertaken with the intention of not only improving, or expanding one tax type, but rather integrating the entire tax administration system has been communicated by Sun Gang in 'Expanding Scope of VAT: A Reform that Kills Three Birds with One Stone', presented in the 2011 International Conference on China VAT Reform.

EVA HUANG
SYDNEY, FEBRUARY 2012

ARTICLES

Extending the VAT to Services in China
Special Difficulties and Choices [1]

BIN YANG

The reason for extending the Value Added Tax (VAT) to the services sector in China is not sufficiently powerful. Just looking at the services sector, substituting the sales tax with a VAT gives rise to many difficulties in terms of system design and implementation, and the possible problems may be greater in number than remaining with the status quo. If the neutrality principle where the tax burden remains unchanged is to continue, then broadening the tax scope is less advantageous than not doing so. If the neutrality principle can be deviated from, then there are fewer obstacles to extend the VAT to the transport, construction and real estate industries, but financial services should remain at the status quo, i.e. levying the sales tax.

INTRODUCTION

Demanding that China extend its VAT to the services sector has become the mainstream voice in academia, that is, to establish a so-called modern VAT by levying a VAT instead of a sales tax on services, transfer of intangible assets and the sale of fixed assets (the services sector[2]). However, any extension of the tax base of VAT in China would be implemented within the interest distribution circumstances that are in existence, thereby involving the redistribution of tax burden. Also, some areas of the services sector, such as financial services, may, by their nature, find it difficult to adapt to a standard VAT. Therefore, implementing this reform will not only lead to issues met by other countries, but will also lead to a few other special issues. This paper first discusses the different points of view that push for this reform, then analyses the possible difficulties from levying a VAT on those service sector industries that make larger contributions to tax revenue, such as transportation, construction, real estate and the financial and insurance industries, before finally arriving at a standpoint of whether there should be reform, and how the reform should proceed.

1 Examination of the Different Points of View on the Necessity to Expand the VAT Base

The major reasons put forward by academia for expanding the tax base of VAT include the theory of heavy tax burden borne by the services sector; the theory of sales tax thwarting the development of the services sector; the theory of thwarting the export of services; the theory of difficulty in separating mixed transactions; the theory of not conforming to international convention; and the theory of breaking the chain of input-credits; they are discussed in the following summary:

1.1 The Theory of Heavy Tax Burden Borne by the Services Sector

Those who hold this point of view think that tax is levied on almost the full turnover amount on the services sector, there are no input-credits, and there is double taxation. This means the tax burden on the services sector is greater than on the industrial sector, thereby limiting the development of the services industry. Hence the services sector should also be taxed by the VAT. [3] Some scholars who hold this point of view performed comparisons of industry tax burden ratios. The so-called industry tax burden ratio is the percentage arising from the amount of VAT or sales tax paid by a particular industry divided by the tax base (turnover amount). Based on the average VAT burden table published by the State Administration of Taxation (SAT), their simple calculations show that the average tax burden of VAT is 4%, compared to the tax burden ratio of sales tax (based on a sales tax rate of 3% - 5%), the tax burden of sales tax is higher than that of VAT.[4] They also performed calculations to divide increase in value in an industry by VAT or Sales Tax, which is called the tax burden on increased industry value ratio (burden ratio). Scholars such as Ping Xinqiao listed the burden ratios of VAT on industrial taxpayers and the burden ratios of a few services sector industries. In an attempt to prove that the tax burden of the services sector is heavier than that of the industrial sector, take the 2006 data listed as an example, the VAT burden ratio of the industrial sector was 12.08%, the sales tax burden ratio of the leasing industry was 25.01%, that of real estate was 13.29%, and that of the financial services industry was 8.29%.[5] By using Shanghai as an example, some scholars have discovered that where the VAT burden ratio of the industrial sector was 16.2% and sales tax burden ratio was calculated based on industry — construction was 24.9%, real estate was 23.7%, while leasing and business services was 35.0% — a conclusion could be reached that the sales tax burden ratio for the services sector is much higher than the VAT burden ratio of industry.[6]

It is obvious there are issues with the above analysis. The industries listed in the average tax burden of VAT industries table published by the SAT are listed in Table 1.

TABLE 1: VAT INDUSTRY AVERAGE TAX BURDEN RATIO (Source: http://www.shui5.cn/article/0f/4184.html)

Industry	Average Tax Burden Ratio (%)
Food Processing	3.5
Food and Beverages	4.5
Textiles (Chemical fibres)	2.25
Construction Materials	4.98
Chemical Products	3.35
Pharmaceutical	8.5
Cigarette Manufacture	12.5
Plastic products	3.50
Metal products	2.20
Electronic Communications Equipment	2.65
Commercial Wholesale	0.90
Commercial Retail	2.50
Others	3.50

Table 1 illustrates that other than a relatively lower industry tax burden ratio for the wholesale industry, the industry VAT tax burden ratio is between 2.2% – 12.5%, the majority of industries have a VAT industry tax burden ratio above 3.5%, and when compared to the general sales tax rate of 3% – 5%, it is difficult to arrive at a conclusion that the tax burden of the services sector is heavier than that of the industrial and commercial sector. Even looking at what some scholars suggest to be a simple average of industrial and commercial tax burden ratio – 4%, in comparison with the general sales tax rate, does not lead to a conclusion that the sales tax burden is heavier.

In terms of tax principles, comparing tax burdens according to the above tax burden ratio or industry increase in value tax burden ratio lacks scientific basis. Since both the VAT and sales tax are turnover taxes, without considering burden shifting, the tax is added on top of prices, which means the tax is paid by the purchaser of goods and services, not borne by the taxpayer. No matter how high the tax burden ratio or burden ratio is, as long as the earnings after tax ratio is reasonable for an industry or an enterprise, the competitiveness of the industry will not be affected.

1.2 The Theory of Sales Tax Thwarting Development of the Services Sector

Those scholars who take this point of view think that since the sales tax is levied on the full turnover amount, and there are no input credits, double taxation is inevitable. This leads to internalisation of the production of services, which is disadvantageous to specialisation in the services sector and the development of services outsourcing.[7] Some academics attempt to prove the existence of this distortion through the proportion of the VAT or sales taxes a part of the increase in value in the industry. Based on the data from Shanghai on the proportion of tax as a part of the increase in value in industries (i.e. the burden ratio), they discovered that the burden ratio of construction was 24.9%, of real estate was 23.7%, leasing and business services was 35.0%, the sales tax burden of these industries are all higher than the industrial sector, and higher than other service sector industries, e.g. the sales tax burden ratio of the financial services industry is 7.4%, accommodation and beverages industry is 12%. The industries with relatively higher tax burden ratios are those industries which are more specialised; those industries with lower levels of outsourcing and less transaction points usually have relatively lower sales tax burden ratios, thereby illustrating that there is double taxation within the sales tax that affects specialisation.[8]

It should be admitted that the sales tax that exhibits the characteristics of a transaction tax, in reality, does have distortion effects on specialisation. It is disadvantageous to outsourcing, and it is advantageous to 'all-rounder' enterprises. This is the main reason when Western countries first implemented a VAT. The issue is: how large is the obstacle created by the sales tax on the development of specialisation? Could this obstacle be solved when the VAT is levied? If they can be solved, what is the improvement in welfare? What is the cost or welfare loss arising from a change from the sales tax to the VAT? Is the benefit greater than the cost? This requires further empirical analysis. Although the sales tax is currently an obvious obstacle to the construction industry, all-rounder large scale construction enterprises and real estate enterprises have not dramatically increased in number due to the sales tax. To the contrary, the management type and specialisation have become more prevalent. To some extent, enterprises have adapted to the current sales tax system, through accounting, tax planning and resource allocation, and their business activities have achieved the optimal benefit. Any change will lead to reallocation of resources and rearranging other affairs, thereby resulting in cost increases and welfare loss.

1.3 The Theory of Thwarting the Export of Services

Scholars who hold this point of view think zero rating for exports is international practice, but since a sales tax is levied on services in China, there are no tax refunds at the export stage, leading to tax inclusive exports. Compared to countries that levy a VAT on services, China's services exports are less competitive in the global market.[9]

This point of view also requires reconsideration. Firstly, services exports in China are increasing at a relatively fast rate. In 2009, total services export amounted to US$ 158.2 billion, which is 5.7 times the US$27.725 billion in 1997, and 2.2 times the US$71.602 billion in 2004. Secondly, the major issue with services exports in China is the structure of the types of exports. In 2009, transport was 29.5% of total exports, travel 27.6%, but financial services were only 0.4%, insurance services 7.1%, licensing and franchising fees 7.0%, computing and information services only 0.7%, construction also only 3.7%.[10] This means the proportion of high value adding services out of total services export is very low. The major reason for this situation is the less than optimal structure of China's services sector and its lack of strength. The export tax refund is not an important issue. Thirdly, the export tax refund for most other countries is mainly limited to goods, the export of services, especially intangible assets that do not go through the customs process as required for goods. Also the input-credit amount of services supply is difficult to determine, and hence, in reality, it is very difficult for tax refunds to apply. Therefore, even when a VAT is levied, for many services items, it would be difficult to implement export tax refunds.

1.4 The Theory of Difficulty In Separating Mixed Transactions

Scholars who take this point of view think the parallel existence of both the VAT system and sales tax system leads to some difficulties in tax administration practice, e.g. there are increasingly more sales activities that bind goods and services together, and their forms are increasingly complex. How best to separate the transaction to the goods and services components in order to apply the correct tax rates is becoming more difficult.[11] Only unifying the two will solve this issue.

In reality, the current tax law in China already has a systematic set of regulations that can solve the issue of selecting the tax type for mixed transactions relatively well. For those issues that still exist, they are localised rather than general. Tax system structure should not be changed simply based on this reason; it should only be changed when it leads to severe welfare losses.

1.5 The Theory of Not Conforming to International Convention

Scholars who take this point of view think that internationally, of those countries that have a VAT, the majority of those tax both goods and services within the VAT. Extending the tax scope of the VAT to the majority, even all goods and services, and using the VAT to replace the sales tax conforms to international convention.

In reality, there is no unchanging international convention, even the rules and customs in Western developed countries differ greatly between each other, and this is the exact reason for the need for international treaties (such as the WTO, double tax agreements) or regional alliances (such as the EU, international free trade area), in order to incorporate the differences between countries. Conventions that conform to international law are often standardised, as they have not broken into the rules of each country and they cannot break into the rules of each country. Domestic laws and regulations are questions of sovereignty; they should be drafted based on the national circumstances of the country and on the public interest of the country, i.e. the highest benefit of the majority of citizens. When considering system design and methods of tax administration, it is only when international convention is not the focus (of course there are international common practices that could be effective when implemented in China), and more consideration is placed on China's national circumstances to create a tax system that is suitable for the social, economic and cultural development of China at the current stage; that reflect Chinese characteristics; that can be generally implemented with a low cost; and that is simple; will there be real conformance to international conventions.[12]

1.6 The Theory of Breaking the Chain of Input Credits

The VAT idealists all consider that a perfect VAT or the so-called modern VAT is an all-inclusive VAT, where the scope of the VAT covers all areas of the market economy. Whether agriculture, manufacture, commerce of services; whether supply of goods or provision of services, the VAT is levied in general, thereby stopping the complex situation arising from levying traditional indirect taxes, where multiple taxes are levied on goods and services. Under such a VAT, the input-credit link is not broken.[13] The relatively narrow scope is one of the fundamental reasons for breaking the input-credit link.[14] The breakage in the VAT link means there cannot be offsetting between all industries in order to achieve simplicity and equality.

These VAT idealisms have overly glorified the VAT. In reality, as long as exempt industries exist, the input-credit link will break. The EU is the region considered most successful in implementing the VAT, but due to exemptions for agriculture, financial services and small-scale tax payers, there are issues of breaking the input-credit chain. In the EU, this success of implementing the VAT is relative, and therefore, they are currently experiencing issues. Scholars from the EU itself also consider that "the VAT system, which is based on legislation adopted at European level and applied at national level, suffers from numerous shortcomings which do not make it fully efficient and compatible with the requirements of a true single market."[15] In China, the current VAT distinguishes between small-scale tax payers and normal taxpayers according to the turnover size and whether there is a fully-established financial accounting system. For small-scale tax payers, the VAT, in reality, is taxed as a full value turnover tax. There are no input-credits, which equate it to the sales tax, and hence its true nature is not a VAT — only the VAT on normal tax payers is a true VAT. Therefore, in China, the VAT itself is a composite tax system. Even if services are incorporated into the scope of the VAT, the VAT in China will still not be ideal, there will still be the breaking of the input-credit link.

Summarising the above, the only reason for expanding the scope of the VAT is that the sales tax may have some distortionary effects on specialisation, thereby disadvantaging outsourcing, and benefiting "all-rounder" enterprises. Therefore there are two issues we need to consider in terms of expanding the scope. One is, in which service sector industries does the sales tax thwart specialisation; and two, what are the possible issues that may arise from levying a VAT instead of the sales tax? How hard is it to solve these issues? The following analyses the possible issues arising from replacing the sales tax with the VAT according to the principle of focusing on the major conflict through using a few larger industries in the services sector as an example. It then goes on to provide advice in conclusion.

2 Issues from Levying a VAT on the Transport Industry in China

Currently the sales tax is levied on the transport industry, and a 7% claim rate is allowed for the purchaser of transport services to claim input-credits. There are two main issues. One is the fact that transportation is a main component in business activities. If it cannot be brought into the VAT input-credit link, for the purchaser of transport services, claims are all at 7%, either there is under-claim (where the VAT included in the transport service is more than 7%), or there is over-claim (where the VAT included in the transport service is less than 7%, but 7% is claimed). At the same time there is an issue from using transport general invoices to make up payments of transport input taxes to fraudulently claim tax refunds. In order to claim input-credits, some enterprises incorporate their transport departments into a separate company. Originally it provides transport services within the enterprise, which is internal transactions, where no invoices can be issued, any transport industry related input tax could not be claimed. After separation, input-credits are possible. In reality, this is a distortion to the normal operation of the enterprise. Another issue is that the transport service providers not only cannot claim input-credits, it would have to pay sales tax at 3%.

However, there are issues for levying a VAT on the transport industry. The characteristics of the transport industry are that in its cost structure, a large percentage are fixed assets, whereas labour costs and raw material costs amount to a relatively smaller proportion. Currently the sales tax rate for transport is 3%. According to the research of Shao Ruiqing et el, if allowing input-credits for newly-acquired fixed assets, then when applying the 17% general VAT rate, the average real tax burden of transport industry enterprises that are surveyed, including road transport, internal river transport, seaside transport and loading at dock are still as high as 6.86%; when applying the 13% beneficial rate, the average tax burden is 3.83%; when applying the low tax rate of 10%, the real tax burden is 1.42%. If the beneficial rate of 13% is implemented, the real tax burden of road transport enterprises is 4.39%, internal river transport enterprises is 4.18%, seaside transport enterprises is 3.11%, dockside loading enterprises at 4.33%; the actual tax burden for enterprises are all higher than the current tax burden level, the percentage increase of the whole industry is 32.07%, and the average rate of increase between the type of transport is relatively balanced. The turnover tax as part of turnover ratio for road transport enterprises has increased by 28.73%, internal river transport by 37.05%, seaside transport by 37.61%, and dockside loading by 24.43%.[16]

In order to be neutral i.e. maintaining the tax burden of the transport industry after the change to a VAT at the current level, a low tax rate of 12% needs to be selected. This will lead to multiple rates for the VAT where the effects of the VAT are difficult to measure, and hence, it will give rise to tax administration difficulties. For example, in the year where the fixed asset is purchased, the input tax would exceed output tax, therefore tax refund is required (inputs are taxed at 17%, turnover at 12%). Furthermore, at the beginning of the reform, if input-credits are allowed for existing fixed assets, the public finance reform costs would be relatively large. On the other hand, if input-credits are not allowed, it will be hard for new and old enterprises to compete equally, as new enterprises are in a beneficial position, leading to a series of social problems.

3 Issues from Levying a VAT on the Construction and Real Estate Industries

If a VAT is levied on the construction and real estate industries, the major issues are:

Firstly, the distinction between commercial and residential real estate. Real estate can be differentiated as commercial (as through put), or residential (as consumption). There can be input-credits for the former. As the latter is a final consumption, it should bear all the tax, but when residential real estate is for investment purposes, input-credits should be allowed. Therefore, levying a VAT on the construction and real estate industries will face the above issue first, and the differentiation is not a simple matter.

Secondly, there are layers of sub-contracting in construction. In order to not break the input-credit chain in the construction industry, where the tax burden is balanced, all sub-contractors at all levels would have to be normal VAT tax payers. In China, there are a large number of small scale construction teams, giving rise to VAT tax payers. In China, there are a large number of small scale construction teams, giving rise to VAT administration issues. Many small-scale sub-contractors often disappear before they pay any VAT. Self construction for the purpose of lease or sale would not receive input-credits as the constructor could not be characterised as a normal tax payer. Further, the construction industry is an important area for the government to apply other economic policies, such as the difference between normal buildings and social security housing. Should social security housing be exempt or taxed? If tax is applied equally, the price of this housing would increase. However, if not taxed, then the same constructor would be required to differentiate between the inputs for taxable and exempt construction, and such a differentiation is also not a simple task.

Thirdly, similar issues facing the transport industry would also occur. For example, if the 17% standard rate is levied, the tax burden for the construction and real estate industry will dramatically increase. The research of Guo Xinnan et al based on the Qinghai Province looked at the VAT tax burden situation on different types of construction industries, please see table 2. Table 2 illustrates that if following the continuing neutrality principle of not changing the tax burden utilised through China's tax reforms, then the 17% standard tax rate is not suitable. A low tax rate would be required, and the optimal is to implement multiple low tax rates. This will destroy the simplicity of the VAT, leading to complexity in tax administration from differentiating tax items for different tax rates and input-credit rates. Also, small scale constructors still face taxes in the manner of a sales tax — tax on full turnover value.

TABLE 2: TAX BURDEN RATIO AFTER LEVYING VAT ON THE CONSTRUCTION INDUSTRY (QIANGHAI PROVINCE AS EXAMPLE)

VAT RATE / ENTERPRISE TYPE	17%	13%	11%	10%
AVERAGE	7.32	4.29	2.70	1.88
BUILDING CONSTRUCTION	8.27	5.52	3.65	2.83
INSTALMENT	7.15	4.12	2.53	1.71
ROADS & BRIDGES	7.83	4.80	3.21	2.39
PLUMBING & ELECTRICITY	6.20	3.17	1.58	0.76
DECORATING	10.30	7.28	5.68	4.86

Fourthly, there are no VAT invoices for the purchase of base materials, therefore no input-credits. Construction enterprises not only require the three principle materials of steel, concrete and timber, they also require a large amount of base materials, which are sand, gravel and brick. These base materials are often supplied by local small scale enterprises. Because the construction and installing industries cannot receive VAT invoices, they are therefore not able to claim the input-tax paid on base materials under a specified VAT rate (assuming it will not change the tax burden). Hence, the tax burden of enterprises may still increase.[18]

Furthermore, if also incorporating real estate into the VAT, there is also the question of whether the land capital gains tax should continue to exist. Currently, the land capital gains tax base in China is the realised capital gain of real estate, which is levied on a four-bracket progressive scale between 30% – 69%. Due to the buoyant nature of the Chinese real estate market in recent years, land value increased significantly, the policy behind land capital gains tax is to balance the return from land and promote the development of land. If a VAT is levied on real estate, then two taxes on the increase in value would exist at the same time, which have almost identical tax bases. If the two taxes are combined, the land capital gains tax will lose its function in balancing returns from land, significantly increasing the profits of land developers, leading to dissatisfaction in the community.

4 Exemption Mechanisms and Replacement Methods for the Financial Services Sector

The financial services and insurance industries account for a large proportion of the services sector, but how to levy a VAT on the financial services sector is a challenge around the world. Theoretically, the financial services and insurance industries should pay VAT and claim input-credits like other industries, issue VAT invoices to service receivers, thus the financial services and insurance industries like other industries are just withholders of VAT. Those taxpayers who receive financial services or insurance services could claim input-credits for the VAT they paid on the financial service or insurance service, and the tax is finally borne by the consumer. Only then is such a tax system equitable. However, in reality, the turnover tax base and input tax base of the financial services and insurance industries have their special features, which are difficult to identify by using the general rules suitable for production type enterprises.

Firstly, the financial services sector not only includes the income from real resources, there is a risk premium from bearing risk; in general, turnover taxes can only be levied on income from real resources, it should not be levied on the risk premium, [19] because the risk premium may have to be paid out when the risk realises in the future. In reality these two types of income cannot be distinguished. As Alan Tait said: "because the price paid by the user of the services (interest rate, policy premium and so on) embodies both the price of the services and other considerations, it cannot be used as a basis for a VAT".[20]

Secondly, it is not possible to ascertain the input tax and output tax at a point in time (e.g. transfer of title, receiving of fund) like goods transactions. For example, a loan that calculates interest based on annual interest rate may have different incidences for interest depending on the length of the loan, the method of payment may also vary, thus it is difficult to generalise a taxing point. It is impossible to collect tax from financial services receivers through an invoice in the same way as normal goods transactions. If this has to be done, the law or regulation would be overly complex and the tax administration cost would be very high. Therefore, the standardised calculation methods for input and output tax are not suitable for the financial services and insurance industries. Theoretically and practically, each country has engaged in research in an attempt at implementing a VAT on the financial services and insurance services. For example, Israel uses a "summation" method, to add up the value add amounts of the financial services and insurance industries such as wages and salary, profit, etc, then multiplied by the tax rate to calculate VAT. This method is based on realisation, not an accrual of rights. It extends fair treatment to the financial services and insurance industries, but it still is an individual tax type, not incorporated into the standard VAT system, and thus the aim to achieve an ideal VAT without breaking the input-credit chain is still not achieved. France chooses to use a method of tax base approximation based on ascertained time, where the banking industry has a choice to pay a 0.21% tax on interest differential or a 0.14% VAT (where there is input-credit). However, since the tax base is based on a particular date in the year, a distortion arises as banks artificially arrange seasons.

Other scholars propose different methods[21], but the feasibility is relatively low. From 2005, New Zealand no longer exempts financial services but has a different method. Supplies of financial services to private customers continue to be exempt; zero-rating is applied to business-to-business supplies of financial services if certain criteria are met, allowing the financial services providers to claim input tax credits. Those criteria include financial services supplies made to GST-registered customers where the customer makes taxable supplies equal to or exceeding 75% of their total supplies in a 12-month period.[22] This means the financial institution needs to check each transaction to see whether it meets the criteria for zero rating. It also needs to separate its input tax between transactions that meet the criteria, and transactions that do not meet the criteria. The administrative complexity can be imagined. Furthermore, New Zealand is a small country, its financial sector is concentrated, there are only 18 banks, and the 5 large banks have a combined market share of 87%. The practice in New Zealand is difficult to adopt. Therefore, exemptions for financial services are the dominant practice amongst countries that implement a VAT. [23]

There are problems with exemption. One, in the eyes of the general public, exempting the financial services and insurance industries does not meet the requirements of equity. Two, to the economist, exemption does not meet the requirements of efficiency and equity, because economically, only when taxes are levied on those goods and services that are substitutes to leisure, will it not lead to the situation where leisure is preferred above the consumption of labour or goods, thus avoiding welfare loss. Therefore exemptions can only be applied to necessities, for the reason of equity. Neither the financial services nor the insurance industry fulfil the economic conditions of exemption. Three, to the tax administrator, exemption will lead to reducing revenue, and the loss of administrative information. Four, to the tax specialist, exempting the financial services and insurance industries means that they cannot claim input-credits; which increases its tax burden, leading to a decreased competitiveness.

According to Alan Tait, for the financial services sector, "there is not a satisfied way to impose the VAT on the sector and allow a credit for users of financial services. An exact calculation of value added in the sector, even on an annual basis, is extremely difficult. In view of these problems, little seems to be lost and much gained in terms of simplicity if the sector is exempted from VAT and a separate tax is imposed that produces a yield approximately equal to that which would be produced by application of the VAT." [24] The author agrees wholeheartedly with Tait. In 2010, the total sales tax paid by the financial services and insurance industries was RMB 168.804 billion, of which banks account for RMB 122.617 billion, insurance RMB 24.182 billion, securities RMB 9.83 billion. The sales tax paid by the financial services sector account for 15.13% of total sales tax of RMB 1,116.014 billion. The amount collected by local tax administrations is RMB1,098.050 billion, which goes to the revenue of local governments. The SAT collects RMB17.966 billion, of which 14.524 billion is collected by the SAT at the central level. If the financial services and insurance industries are exempt, fiscal revenue, especially that of the local government, will be significantly decreased, and it is not possible to replace through other means. It is impossible to discard such a large revenue source. If incorporating the financial services sector into the VAT, not only will the above issues be encountered, a special question of tax rate design will arise. Pure financial services mainly give rise to income from services (reflected in the savings and loan differential, brokerage commissions, services fees, etc). The input amount is low. If the standard 17% rate is used, the turnover tax burden of the financial services sector would be significantly increased, inevitably increasing prices of financial services, especially interest rates would be changed. If this is done, different aspects of the macro-economy would be affected. If a lower rate is designed for the financial services sector, the issue of multiple VAT rates would arise again. Therefore, after comparison, it is better for the financial services sector to remain at the status quo, where the sales tax is levied. In reality, the current sales tax on the financial services sector in China is already levied on the value added, sales tax of banks based on loan interest, and loan interest is a value added amount in the national accounts. The tax base of the buying or selling of financial instruments (including share, debt, foreign exchange etc) by banks or non-bank financial institutions is the residual of sales price less purchase price. Therefore the sales tax does not discriminate specialisation in the financial services sector.

In summary, simply considering the major services industries, the multiple difficulties in system design and implementation, from replacing the sales tax by the VAT may give rise to more issues than remaining at the status quo. If the reform principle of achieving neutrality i.e. no change in tax burden is to be continued, then expanding the scope is worse than not expanding. If the principle can be changed, then there are fewer obstacles to extend to the transport industry, the construction and the real estate industries. It is best for the financial services sector to continue at the status quo, i.e. levy sales tax. Tax reform for the sale of equity sometimes will give rise to greater inequality, because the taxpayer can adapt to any tax system design through rearranging their resources, as long as there is satisfactory competition and information symmetry. When the tax system is unchanged, competition will lead to equivalent post-tax profits, naturally there will be horizontal equity, in contrast, changing the tax system will lead to inequality. Although the original tax system has flaws, maintaining neutrality i.e. the stability of the tax system is still the optimal choice.

NOTES

1 This paper was first presented in the 2011 International Conference on China VAT Reform. A Chinese version of this article has been accepted by Taxation Research 《税务研究》。

2 Strictly speaking, the services sector does not include construction, it includes all industries except agriculture, industry and construction, i.e. what is internationally categorised as the tertiary sector, which can be further categorised into four sectors: first is circulation, including transport, post and telecommunication, commercial food and beverages, material supply and marketing and warehousing; second is services provided for the requirement of production and living, including financial services, insurance, public facilities, residence services, travel, consulting and information services and technical support services, etc; third is services that improve the level of sciences and culture and the quality of life, including education, culture, TV and radio, research, welfare, etc; fourth is services for social public needs, including government departments, social groups, the military and police etc. In China's current tax laws, the third and fourth sectors above are not taxed. Therefore in this paper, the services sector refers to the industries where the sales tax is levied, including transport, construction and real estate, financial services and insurance, post and telecommunication, culture and sports, entertainment, restaurants and hotels, agency, travelling, warehousing, leasing, advertising, other services (bathing, hairdressing, colouring, photography, visual arts, paper mounting, copying, typing, carving, calculating, testing, pathology, sound and video recording, photocopying, blueprinting, designing, drawing, surveying, prospecting, packaging, consulting, etc), transfer of intangible assets, sales of fixed assets.

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《中国税收与政策》创刊暨第一次学术年会
征稿通知

中国是世界上最大的转型经济国家，其在全球经济舞台中的重要性不断凸显。中国独特的法律和税收制度近年来得到国际学者和企业界人士的广泛关注。中国的税收制度在其原有丰富的文化和历史根基之上借鉴了西方发达国家税收和税法的优点。并且，随着其法律和学术论著的翻译推介，西方学者能够更多地参与研究。鉴于此，悉尼大学商学院创办《中国税收与政策》（英文名为《Journal of Chinese Tax and Policy》），本刊是第一本专门研究中国税收与政策的英文学术刊物，按照国际学术刊物模式运作。

《中国税收与政策》鼓励采用国际规范的研究方法，研究与中国税收的政策、法规、征管和执行等方面的研究，同时，也希望从比较研究中参考它国的税收经验。能够被《中国税收与政策》接受的稿件，必须要在帮助人们理解中国税收政策和法规的制定的制度背景及其执行等问题上有独到的见解和贡献。

《中国税收与政策》立足中国，面向世界。期刊暂定一年发行两期。本刊按国际研究类刊物惯例，文章采用双盲审。文章建议长度为英文3000到12000单词，如果确有必要，也可适当放宽。

《中国税收与政策》第一次学术年会将于2012年11月24~25在广州中山大学举行。我们已经邀请到杨斌教授，加拿大约克大学法学院李金艳教授， 悉尼大学商学院商业法系 Andrew Terry教授，亚利桑那州立大学的Adam Chodorow教授, 悉尼科技大学 Natalie Stoianoff 教授，悉尼大学法学院副教授 Vivienne Bath,等几位著名教授做主题演讲。

现面向海内外公开征稿。论文截止日期为2012年6月30日。所提交的论文除首页外不得披露有关作者的信息，以便匿名评审。论文要求采用小四号宋体、2倍行距打印。论文提交地址：eva.huang@sydney.edu.au或者shuran1212@gmail.com。我们会在2012年8月15日发出会议通知。凡是入选的论文作者，大会将提供相应的财务资助，并邀请海内外同领域知名学者进行点评。接受会议资助的论文本期刊有优先录用权，不愿受此条款约束的作者请在投稿时明确说明。

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《中国税收与政策》编辑部

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The International Conference of Chinese Tax and Policy is the annual conference of the Journal of Chinese Tax and Policy. The Inaugural Conference will be held at Sun Yat-Sen University over 24-25 November 2012. It will be co-hosted by The University of Sydney Business School http://sydney.edu.au/business, the Journal of Chinese Tax and Policy http://sydney.edu.au/business/research/journals/jctp, the Taxation Law and Policy Research Institute of Monash University http://www.buseco.monash.edu.au , the School of Law of Sun Yat-Sen University http://law.sysu.edu.cn/, Lingnan (University) College, Sun Yat-Sen University http://www.lingnan.net/, and the Department of Public Economics Xiamen University http://czx.xmu.edu.cn/user/index.asp.

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The Conference Organizers welcome any paper dealing with the Conference theme and/or its implications. Papers by new academics are welcome.
All papers accepted for the conference may be selected for publication in the Journal of Chinese Tax and Policy.

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October 30, 2012
Final date for registration.

November 15, 2012
Final date for submission of power point presentations for conference speakers. Please submit presentations to Eva Huang .

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