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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

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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The Relationship Between VAT Base Expansion and Intergovernmental Fiscal Relations

From the Perspective of the Dual Processes of Industrialisation and Urbanisation

LIN JIANG & SUN HUI

In this paper, the relationship between VAT base-expansion and intergovernmental financial relations is discussed from the perspective of the dual processes of industrialisation and urbanisation.

First, this article theoretically analyses the VAT base-expansion and its real world implications and then evaluates the intergovernmental fiscal relationship. Lastly, an empirical simulation of the effect of base-expansion on local fiscal revenue and expenditure in this dual process is performed. Based on this conclusions are drawn and relevant policy suggestions are put forward.

INTRODUCTION

The tax reform of 1994 has lead to the coexistence of Value Added Tax (VAT) and business tax in China. The VAT tax base is the value added in the secondary sector, and the wholesale and retail activities in the tertiary sector, while the tax base of the business tax is the turnover of the construction industry (which belongs to the secondary sector) and other fields besides wholesale and retail activities in the tertiary sector. The disunity of this tax policy on goods and services leads to double taxation caused by tax type differences[1], which hinders the development of the tertiary sector and its improvement as well as structural economic transformation. As the process of urbanisation and industrialisation has advanced in China, specialisation has increased, particularly in the service sector, and the boundary between goods and services has become unclear, which brings about many difficulties in the collection of VAT and business tax and also leads to administrative conflict between the national tax bureau and local tax bureaus.

The more prevalent international practice is to have a comprehensive goods and services tax that expands the tax base of VAT to that of the current business tax in China (VAT base-expansion). VAT base-expansion integrates goods and services tax policies completing the input credit chain consequently stimulating tertiary sector development and encouraging the dual process of industrialisation and urbanisation. Thus the introduction of a comprehensive goods and services tax in China is inevitable, however this may bring about some potential issues: As the business tax is the main tax type for local governments encouraged by the dual process, the tax base continues to expand, bringing extra revenue for local government. As a result, if its tax base is incorporated into the VAT, is this feasible? Will local governments be able to bear the potential fiscal revenue loss? And how can the fiscal relationship between central and local governments be readjusted? This paper examines these issues, analysing the reform of VAT and business tax in China from the perspective of the dual process of industrialisation and urbanisation. The purpose of this analysis is to determine how to find a breakthrough in the VAT base expansion reform to adequately deal with the fiscal relationship between the central and local governments.

1 The Necessity of VAT Base Expansion: Theory and Reality

a Brief History of the Implementation of VAT in China

In 1979, China started the first Pilot of a VAT, and in 1984, it became a formal tax type. Since then it has experienced multiple base expansion reforms in 1986, 1987, 1988, 1989 and 1994, [2] to the current tax base that included most goods and manufacturing-based services and imported goods. In particular, the reform of 1994 adapted to the needs of structural change, as it positioned the VAT within the scope of the turnover stage and processing, maintenance and repair activities, incorporating the majority of services into the scope of the business tax, beginning to address the conflict of double taxation and tax burden imbalance. This follows international precedent and suits the economic development levels and administrative capacity of China. However, the scope of the VAT is still too narrow overall, its advantages of neutrality and fairness are not evident and the issue of double taxation as well as tax burden imbalance are still not resolved.

b Literature Review

There is significant and long-standing international literature regarding the expansion of the VAT base. Representative perspectives include those of: Alan A Tait[3] who, based on the comparison of countries, suggested it is essential to expand the tax base from manufacturing to each link of the process from production to retail. This is because if the tax base only includes imports and manufacturing, the tax base will be too small and vertically-integrated enterprises will shift profit to its downstream entities to escape the VAT tax base. Tait further advises that when labour is used as an input, VAT should also be levied on it. The opposite point of view of VAT is that the VAT has high administrative costs and will lead to the loss of tax revenue, thus its implementation should be selective. This perspective is supported by Kay and King (1979)[4], who commented that the VAT is neutral and good; however, in practice, this has limitations as its administrative costs are high and it is relatively taxing on administrative and enforcement levels. Further, Due (1985)[5] suggests that the VAT is likely to cause tax fraud, and advised the Norwegian government to restore retail tax instead of the VAT that had been in place since 1970. Additionally, Fedeli Silvia (1999) concluded from income and value added tax empirical research that most tax evasion is likely to happen in the final links of the value-added chain.

Since the tax reform of 1994, there has been substantial discussion about the VAT base expansion in China. The majority of scholars thought that the VAT base should be expanded, including: Liu Hanbing and Chen Guofu (2001), Pan Mingxing (2002), Yang Jingzhong (2007), Yu Junlin (2008), Xia Jiechang (2006), Zhang Furong (2007), Cai Chang (2008, 2010), Liu Wei & Zhang Feng (2000). All of these scholars agree that the practice of VAT base-expansion will reduce double taxation and tax discrimination, however they do not consider the changes to the revenue-sharing structure of the central and local governments, or the costs of the reform. Scholars considering the administrative cost and fiscal conditions, including: Li Lingen (2001), Tong Jinzhi (2001), Xiong Rong (2003), Ma Guoqiang (2002), Han Shaochu (2009), Guo Tianyong (2009) as well as Liu ShangXi (2009), advise that the tax base of VAT should be gradually expanded, but there are areas of limitation. For example, Guo Tianyong (2009) calculated that if the business tax decreases by 1% it will lead to an increase in financial industry profits of 3%, concluding that the financial business tax rate should be decreased to around 2%–3% and that VAT on the financial industry should be postponed and the tax should be adjusted to be levied on net turnover. Further, Liu Shangxi (2009) suggested that the degree of VAT base expansion reform should be similar to that of the split tax system reform of 1994, the whole fiscal and tax system needs to be readjusted, thus requiring a gradual reform process. These theoretical and empirical explorations are helpful for subsequent research.

Another aspect of this paper is about the fiscal relationship problems between the central and local government. Since the reform in 1994, the fiscal ability of local government compared to its administrative authority has been limited. There are two research perspectives. The first is that the local government doesn't have enough fiscal power as supported by Jia Kang & Bai Jing Ming (2002), Yang Zhiyong (2008), Tian Fa & Zhou Chenying (2009), Zhong Gaozheng & Zeng Kanghua (2009). The second is that the local government does have enough fiscal power as argued by Ping Xingqiao (2007)[6], Chen Zhiyong & Chen LiLi (2010), Li Baochun (2010), Li Shangpu & Luo Biliang (2010), Yang Zhiyong (2010), Wu Qun & Li YongLe (2010) as well as Shao Yuan (2010). In general the two types of literature both have flaws. The former either only considers local level income or neglects to consider that non-budgetary income makes up a large portion of local level income. This is not comprehensive and is impractical in the current economic environment. The latter adopts the concept of comprehensive budget management, such as Shao Yuan (2010) who suggests that the local government has the ability to receive income from land tax, the transfer of land usage rights, and land financing, which is sufficient for the local government to provide public services. It is noted that the sample is too small to support the latter argument, and doesn't reflect the current local government fiscal ability.

c A Brief Comment

A review of the course of VAT base-expansion shows that the VAT base has been gradually expanded with economic development especially the development of tertiary sector industry. In China, the changes in the value added tax and business tax revenue level directly relates to the industrialisation and urbanisation processes. Furthermore, the reform of the tax system is always closely related to intergovernmental relations. One very important premise is to make sure that the central government has sufficient fiscal resources to maintain macroeconomic control. During the dual process, the tertiary sector industry (mainly services industry) has been developed vigorously, and construction and real estate have been very prosperous and therefore it is essential to engage in VAT base-expansion. However, one major reform difficulty is how to deal with the fiscal capacity of central and local governments. Thus, the main topic of this paper is empirical analysis on the relationship between the VAT base expansion and the intergovernmental fiscal distribution from the perspective of the dual process.

d Necessity and Feasibility

As suggested previously, now there is a consensus on the disadvantages of the coexistence of VAT and business tax. In theory, VAT base-expansion is an objective requirement of China's current economic structure. It is also necessary to complete the link between production and circulation as the current VAT and business tax system has systematic defects and regulatory inadequacies. Internationally, emphasis has been placed on reform that promotes comprehensive, extensive as well as neutral tax policy. China, similarly, places focus on these characteristics, and the attainment of these characteristics is a requirement for completion of its VAT tax reform. Therefore, VAT base expansion reform is imperative and only when the scope includes primary and tertiary sectors will there be a comprehensive VAT where the turnover tax system forms a desirable situation of combining with VAT general adjustment and the consumption tax special regulation. As far as the entire tax system is concerned, in terms of expanding the scope, goals such as tax efficiency, fairness and revenue growth can be achieved.

At present, there is the capacity to expand the base of VAT. First, tax administrative means and tools provide the infrastructure, especially with significant developments in the software and hardware for tax collection and administration, such as, the widespread use of computers, tax business and banking information sharing, and the national implementation of a system of tax agents. Secondly, the gradual move towards a free market economy and the degree of monetisation are the 'soft' conditions for expanding the scope. This means that all transactions can be quantified and it will no longer be difficult to ascertain the tax burden for VAT tax payers. The characteristics of tax exclusive pricing and the possibility of it being shifted can now be addressed due to the shift towards a market economy. Finally, improvements in the legal system leading to increased voluntary compliance also support an expansion of the VAT tax base.

AN EMPIRICAL STUDY OF THE RELATIONSHIP BETWEEN VAT BASE-EXPANSION WITHIN THE DUAL PROCESSES OF INDUSTRIALISATION AND URBANISATION

From the international experience it is vital in the VAT reform process to adequately deal with the intergovernment fiscal relationship between central and local governments. Now, due to the special role of VAT and business tax in China's central and local fiscal relationship, the reform of VAT base-expansion is critical. The core issue is regarding the adjustment of the current tax revenue patterns in China's intergovernmental fiscal relationship. When reviewing the intergovernmental fiscal relationship in history, it has been a bargaining game with long term irregular and informal negotiations, leading to an unstable situation where the central government consistently takes most of the tax revenue and uses this revenue for the purpose of macroeconomic regulation.[7]

The Economic Indicators Under the Dual Process

International experience indicates that: the process of industrialisation and urbanisation will change a country's industrial structure, which affects tax base, tax structure, tax revenue as well as tax administration efficiency. When examining the actual situation in China, in 2009, there was an increase in business tax revenue, in the real estate and construction industries of 38.6% and 23.8% respectively. In 2008, as an example, 81.6% of VAT came from the secondary sector, of which 60% comes from manufacturing, 17.4% comes from wholesale and retail sales from the tertiary sector, and 1% comes from repairs and replacement services. As far as the business tax is concerned, 78.5% of all revenue comes from the tertiary sector industry, and 21.5% comes from the secondary sector. [8] Statistics show that the tax base of VAT has been larger than that of business tax, but the tax base of VAT has rarely been changed. Basically, it accounts for 48% to 51% of GDP, whereas the tax base of business tax has been growing steadily, increasing from 31.9% in 1994 to 38.4% in 2007. Therefore, the change of VAT and business tax reflects the dual process. In this process, the real estate and construction industries contribute substantially to local financial revenues. In 2008, as far as Guangdong is concerned, the contribution by these two sectors to increases in local government revenue is as high as 64.2%. Therefore, it is necessary to consider the dual process of industrialisation and urbanisation in order to study the relationship between VAT base-expansion and intergovernmental fiscal relations.

TABLE 1: DUAL PROCESS OF INDUSTRIALISATION AND URBANISATION, RELATED ECONOMIC DATA AND RANK

Region	The Rank of Per Capita GDP	Industrialisation Ranking	Urbanisation Ranking	Tax Revenue as a Percentage of Budgetary Income	VAT and Business Tax as a Percentage of Budgetary Income	Business Tax as a Percentage of Budgetary Income	VAT as a Percentage of Budgetary Income
Shanghai	1	1	1	94.3	46.6	32.4	14.2
Beijing	2	2	2	96.6	44.1	35.5	8.6
Regtianjingg	3	3	3	80.9	42.9	26.6	16.2
Zhejiang	4	5	4	92.7	47.8	29.7	18
Jiangsu	5	6	5	83.4	42	24.3	17.7
Guangdong	6	4	6	86.5	45.6	28.9	16.7
Shangong	8	10	9	78.4	37.3	20.2	17.1
Inner Mongolia	7	18	13	71.4	36.6	20.7	15.9
Liaoning	9	7	8	75	35.2	22.4	12.7
Fujian	10	8	7	84.5	42.1	27.2	14.9
Jilin	20	12	16	37.3	38.7	22.2	15
Hebei	11	17	10	79	43.7	22.9	20.8
Heilongjiang	13	9	12	72.7	39.7	17.3	22.4
Shanxi	21	11	11	75.7	43	17.3	26.3
Xinjiang	23	20	14	79.4	47.9	25.3	22.5
Hubei	12	13	17	75.6	38.9	23.9	15
Henan	14	25	22	73.6	36	20.8	15.3
Shanxi	19	14	21	77	43.6	25	18.6
Chongqi	22	16	18	62.4	35.1	25.1	10
Ningxia	24	15	27	81.8	51	31.7	19.3
Hunan	15	22	19	67.3	37.3	24.1	13.2
Qinghai	26	19	26	78.1	46.2	25.8	20.4
Hainan	25	27	15	83.2	45.5	36.1	9.4
Sichuan	16	24	23	70.3	37	25.8	11.2
Guangxi	18	28	25	66.8	36.2	23.5	12.7
Jiangxi	27	25	20	73.3	37.3	24.2	13.2
Anhui	17	23	24	72.9	37.9	24.5	13.4
Xizang	28	31	31	61	43	32	11
Yunnan	29	29	29	78.6	38.4	22.2	16.2
Gansu	30	26	28	61.4	34.4	20.1	14.3
Guizhou	31	30	30	75	38.9	23.1	15.9

Note: Per capita GDP ranking is sourced from the National Bureau of Statistics of China (NBS), China Statistics Yearbook (2010) industrialisation rank sourced from Gui Ladan, Empirical Analysis of Regional Industrialisation Levels, Development Research (2007), Issue 4, and urbanisation rank sourced from Geng Haiqing, A Comprehensive Analysis of Urbanisation Levels on the Provincial Level Regions of China based on Social Compositions, Humanities and Geography (2009) Issue 5. Other data is sourced from China's finance statistics yearbook (2009).

The above table shows that per capita GDP of most provinces, level of industrialisation, level of urbanisation, percentage of business tax, percentage of VAT as well as that of percentage of business tax and VAT have high correlation.

During the process, as far as all provinces are concerned, the percentage of business tax is on the increase. It shows that as the urbanisation process has been accelerating the industrial structure has been upgraded, leading to tertiary sector development. Note the special provinces such as Shandong, Liaoning and Ningxia. For Shan Dong and Liao Ning, the rank of per capita GDP, industrialisation and urbanisation, and its contribution of taxes are asymmetric, which highlights its lack of development efficiency that has a direct relationship with the industrial structure. As for Ning Xia, the level of industrialisation and urbanisation is very low, but the tax contribution is very high. A possible explanation is that in the middle stage of industrialisation, the percentage that VAT revenue makes up in the total budgetary income for a province that is rich in resources is higher than others. Therefore, for those still in the primary stage of industrialisation and urbanisation, if using the 1994 reform model for the value added tax system of one size fits all, this will lead to poorer regions having to turn over some of their revenue to the central government. This will further complicate the reform process and effect the efficiency of China's fiscal system reform. In the process of VAT base-expansion, fiscal resources across the country are not equal, and regional differences are significant. Therefore it is a priority to determine how to guarantee the financial revenues of the less developed areas.

Effects of the Value Added Tax Reform

Effects of the Transition from Business Tax to VAT on the Revenue of Local Government

In order to simplify the problem, the provincial differences are ignored and taken as an aggregate number, as well as the effects on the city maintenance and construction tax and extra charges for education, only comparing the aggregate of VAT and sales tax belonging to local government before and after the reform. The current system allocated the business tax collection from railway departments, head offices of every bank as well as insurance corporations to the central government, and the rest to the local governments, with 75% of the value added tax distributed to the central government, and 25% distributed to the local governments. The specific method of this paper is to assume that the business tax paid by the railway department, bank head offices and insurance corporations now comply with the distribution ratio where 75% of VAT revenue is distributed to the central government, while 25% is distributed to the local governments. Thus we predict that the reform will have a significant impact on local government revenue.

TABLE 2: VALUE ADDED TAX AND BUSINESS TAX REVENUE BEFORE THE REFORM. UNIT: RMB MILLION

Year	Central Govt			Local Govt			Total
	Value-Added Tax	Business Tax	Total	Value-Added Tax	Business Tax	Total	
2008	1360451	23209.94	1383661	453483.4	739629.6	1193113	2576774
2007	1170753	20266.45	1191019	390250.8	639013.3	1028264	2219283
2006	967109.5	16054.04	983163.6	322369.6	496921.4	819290.9	1802455
2005	802383.6	12964.36	815348	267461.3	410187.5	677648.7	1492997
2004	669765.2	11098.78	680864	223255	347259.3	570514.3	1251378
2003	550603.9	10122.74	560726.6	183532.7	276764.1	460296.8	1021023
2002	470656.2	17130.05	487786.3	156883.9	229633.1	386517	874303.2
2001	408939.8	23372.1	432311.9	136312.8	185093.4	321406.2	753718.1
2000	350065.3	25741.58	375806.8	162828.4	162828.4	325656.7	701463.6

TABLE 3: VALUE ADDED TAX INCOME AND ITS CHANGE[9] AFTER REFORM. UNIT: RMB MILLION

Year	Central Government		Local Government	
	Value-Added Tax	Increase (%)	Value-Added Tax	Decrease (%)
2008	1932580	39.67	644193.4	46.01
2007	1664462	39.75	554820.8	46.04
2006	1351841	37.5	450613.6	45
2005	1119748	37.33	373249.2	44.92
2004	938533.7	37.84	312844.6	45.16
2003	765767.5	36.57	255255.8	44.55
2002	655727.4	34.43	218575.8	43.45
2001	565288.6	30.76	188429.5	41.37
2000	526097.7	39.99	175365.9	46.15

The above tables show that since VAT is collected by the central government, the sharing rate is 75%.

Business tax belongs to the local governments and as a result VAT base-expansion has great influence on the distribution pattern for all levels of governments. Furthermore, it is difficult to restore fiscal resources only through the share proportion. Therefore, all regions will quickly and inevitably be affected by the reform, and there is a period of time to cultivate a new principal tax. Therefore, the key measure after expansion is to increase the extent to which central government transfers revenue to local government.

It is worth mentioning that in recent years the off-budget activities of local governments has been frequent and substantial. Considering that local governments have neither financial income autonomy nor borrowing power, 'land financing' has been commonplace, and tax revenue has made up only a small part of local governments' discretionary resources. For example, according to the public data of Beijing in 2009, the land grant fee of RMB 92.8 billion accounts for 45.8% of local fiscal revenue (RMB202.68 billion). In some regions the land-sale ratio can even make up 60% of local government revenue.

Therefore, during VAT base-expanding reform, the original distribution pattern and conventional fiscal rebates should be taken into consideration. Also the observation of local governments' financial resources has to be undertaken, consequently, based on these three conditions, the way in which expanding the VAT base may influence the financial relationship between central and local government can be determined. Therefore, a reasonable revenue allocation ratio between the central and local governments can be determined limiting reform resistance and efficiency loss.

The Feasibility of the VAT Base-Expansion Reform

The VAT reform relies on the ability of local government to bear revenue loss. In order to judge the feasibility of the VAT base-expansion, all levels of local government financial resources must be calculated and post-reform financial changes must be calculated.

In terms of local government fiscal capacity[10], adopting the concepts of *M1*, *M2* and *M3*, in finance, this paper divides fiscal capacity into three levels: first, narrow diameter financial resources (*R1*) which comprises only local corresponding fiscal revenue, determined by the current tax revenue distribution framework. This is the local fiscal capacity after the primary financial distribution between central and local governments. Second, general diameter financial resources (*R2*) *R2* = local corresponding fiscal revenue + central government tax rebates and subsidies — local government liabilities to central government.[11] This reflects the local government fiscal capacity in the current system's framework, such as through fiscal redistribution means such as transfer payments from central government to local governments; broad diameter financial resources (which *R3*).[12] *R3* is equal to *R2* plus the land grant fee income and non-budgetary income, which is the actual financial resources under the control of the local governments. Through calculations the following three tables reveal the three levels of local government fiscal capacity.

TABLE 4: LOCAL FINANCIAL SITUATION FROM YEAR 2004 TO YEAR 2009. UNIT: RMB ONE BILLION

Year	R1 (Local)	B1 (Expenditure of Local Government)	Ratio of Financial Capacity of Local Government (= R1/B1)
2004	1189.337	2059.281	57.75
2005	1510.076	2515.431	25.9
2006	1830.358	3043.133	24.7
2007	2357.262	3839.929	23
2008	2864.979	4942.849	21.3
2009	3260.259	6104.414	20

TABLE 5: LOCAL FINANCIAL SITUATION FROM YEAR 2004 TO YEAR 2009. UNIT: RMB ONE BILLION

Year	R_2	B_2 (Local Corresponding Expenditure)	Ratio (R_2/B_2)
2004	2169.416	2059.281	105.35
2005	2587.282	2515.431	102.86
2006	3101.776	3043.133	101.93
2007	4084.772	3833.929	106.54
2008	5069.418	4942.849	102.94
2009	6028.487	6104.414	98.76

TABLE 6: THE CENTRAL AND LOCAL FINANCIAL SITUATION FROM YEAR 2004 TO YEAR 2009. UNIT: RMB ONE BILLION

Year	A_1 (Maximum)	C_1 (Contribution)	R_2	R_3	R_3 (Central)	C_2 (Central)	C_3 (Local)
2004	4540.3	516.6	4023.7	3245.483	778.217	1.934	8.066
2005	5253.1	632.4	4620.7	3689.822	930.878	2.015	7.985
2006	6419.3	767.2	5652.1	4503.617	1148.483	2.032	7.968
2007	8378.7	953.7	7425	5935.439	1489.561	2.006	7.994
2008	9598.6	1225.9	8372.7	6719.434	1653.266	1.975	8.025
2009	10802.4	1447	9355.4	8035.806	1319.594	1.411	8.589

Source: The R3 data comes from Zhang Bin & Wang Dehua (2010)[13]. R2 = A1 – C1, because the social security payment properties is special, and hard to be divided between the central and local ownership part. R3 (central) = R2 – R3, the 7th and 8th of the common denominator are R2. Local financial ratios= R3 / (Local corresponding fiscal income + non-budgetary expenditures-government fund spending).

This analysis indicates that: in the narrow diameter financial resources of the local government are clearly insufficient. In the general diameter, the financial resources of the local government are sufficient and in the broad diameter, financial resources are borderline sufficient. It can be seen that local government fiscal capacity is not small and local financial resources are sufficient. From the perspective of the expenditure structure, the proportion of local government spending for non-budgetary items in urban infrastructure construction is higher, indicating that the local government investment impulse is relatively intense. Therefore, the essence of the problem is due to the existence of non-budgetary fiscal resources, and the behaviour of local governments cannot be constrained by the basic fiscal status. Unnecessarily large, uncontrolled and poorly targeted government expenditure deteriorates the local government budget situation leaving local finances in a poor state. Therefore the distribution framework for financial resources should be regulated by the central government so that irresponsible expenditure by local government is prevented.

Valuable International Experience

Thus far more than 60 countries have adopted the VAT, of which France was the first. When initially implemented, the scope was confined to production stage, then expanded to the commercial wholesale industry in 1954, and finally included commercial retail, agriculture, the self-employed and services in 1968. A similar process is observable in Sweden and the Netherlands which, in 1969, began to implement the VAT in the original business tax base, and gradually expanded its scope to production and circulation, services, and other fields. These experiences indicate that after implementation, the tax base will be gradually widened.

It is established in academic circles that an efficient VAT should have a national scope, be uniformly formulated, and executed in a unified way by central government. After the central government collects VAT they should redistribute revenue to the local government. The reasons behind this include: tax fairness, efficiency of tax collection, administrative convenience, macroeconomic regulation theory and cross-border transactions.[14] In light of the complexity of the tax system reform, the current tax system couldn't change fundamentally, and the reform has the potential to be operational with lower administrative and compliance costs. This would allow the economic efficiency of the VAT to be fully realised, improve allocative efficiency, and support the formation of the unified market. There are many international experiences regarding how to redistribute VAT revenue between different levels of government. For example, Canada put forward 'a virtual import and export rebate system' between regions, in order to solve the issue of revenue redistribution. Germany has redistributed revenue between three levels of government as well as with the European Union. In this case, the sharing ratio between federal and state is not fixed, but through consultation by both parties. Vertical local fiscal capacity is compensated through raising the VAT rate, and through engaging in horizontal transfer payments according to population size, population density as well as per capita tax revenue.[15] Australia distributes the entire revenue from the goods and services tax to state governments who in return abolished a series of local taxes, and agreed not to reintroduce those taxes. The federal government reduced the state transfer payment, and the state increased the local governments' transfer payment. The information gained from these countries experiences is that: the VAT in theory is regarded as an ideal tax, but it hasn't been globally implemented, and a unified model does not exist. Regional development imbalances can be addressed by adopting the VAT in a flexible way through transfer payments to aid financial resources for underdeveloped regions.

After the reform of the VAT base-expansion, we can maintain the way of redistributing revenue between central and local government and then once VAT is collected by central government, it should redistribute it to local governments based on the actual consumption of local residents. This is a more desirable distribution method. Furthermore transfer payments can be used to distribute VAT revenue, based not only on the amount of tax collected locally but also considering the population scale, consumption ability, basic needs of public services, economic development conditions as well as fiscal revenue capacity of local government and so on. The redistribution of VAT revenue and transfer payments will form a steady and normal source of revenue for local governments.

Conclusions and Policy Implications

Based on the research of the dual process of industrialisation and urbanisation, the VAT reform and intergovernmental financial relationship is examined. Based on a theoretical and real world data analysis of VAT base-expansion, a review of intergovernmental fiscal relationship was conducted, empirically simulating the influence of possible reform of VAT on the fiscal capacity in the dual industrialisation and urbanisation process. Based on this, it is concluded that in the dual process of industrialisation and urbanisation the fiscal capacity of local government is sufficient. The behaviour of local government is not constrained by the fiscal situation due to the existence of non-budgetary financial resources. Unreasonable, uncontrolled expenditure will lead to a deterioration in the local government fiscal position and lead to tough financial conditions.

Therefore, the following is concluded:

(1) The practice of VAT base-expansion is imperative and theoretically there is no 'forbidden zone'. In pursuit of fairness and efficiency, all business tax should be removed and its scope incorporated into the VAT tax base. Consequently irresponsible expenditure by local government must be restricted in order to achieve the goal of transformation of public service oriented government.

(2) Under the assumption of future macroeconomic control and encouragement of local government fiscal management by central government, in order to increase the share of VAT revenue by local government within the current income distribution framework the government must: enhance the fiscal transfer system between central and local governments; utilise the fiscal mechanism to adjust the income distribution between central and local government; carefully consider the spillover effect on the sources of local tax revenue arising from the reform

to expand the tax base of VAT and search for an interest balancing mechanism and cooperation between the central and local government.

(3) Expanding local tax sources, such as collecting the property tax, social security tax as well as environment tax and so on will increase the revenue of local government, making up for the possible loss due to the VAT base-expansion reform. Considering the international experience, we can resort to the real estate tax as well as resources tax collected in the western underdeveloped areas. In short, the ability of VAT to absorb the loss in revenue from removal of business tax must be considered to avoid deteriorating the local government fiscal revenue position.

In summary, it is necessary to consider the feasibility of reform in relation to the revenue structure of the business tax and choose an approach that is not only able to address the main points of the business tax reform, but also avoid the impact on local government revenue that could be caused by a sudden onset of reform.

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NOTES

[1] This refers to when the VAT tax payer and Business tax payer engage in a transaction, as the Business tax payer cannot issue a VAT invoice, the VAT tax payer cannot realise the input credit thus leading to double taxation.

[2] 1986: Pilot VAT on textiles, home electronics, white goods, porcelain enamel, and thermal flasks. 1987: Implement VAT on five types of goods including: clothing, some types of light industrial products, synthetic fibre, premixed Chinese medicine, and veterinary medicine. 1988: 7 types of goods are introduced into VAT scope including: non-ferrous metal, mining extracts, non-metal mining extracts, other non-metal mining extracts, construction material, and non-ferrous metal wires and cables. 1989: VAT instead of business tax levied on raw materials purchased by industrial enterprises for the purpose of industrial processing, industrial maintenance

and repairs who already pay the VAT.

[3] Alan A Tait, *The Value-Added Tax: International Practice and Problems*, International Monetary Fund, Washington, 1988.

[4] John Kay and Mervyn King, 'The British Tax System' (1979) *Journal of Economic Literature* 9.

[5] John F Due, 'Trends in State Sales Tax Audit Selection Since 1960' (1985) *National Tax Journal* 6.

[6] Ping Xingqiao suggests taking local government non-budgetary income and land sales income into consideration. Local government disposable fiscal capacity in 2004 is as high as RMB 3 trillion which amounts to 19 per cent of GDP.

[7] During the process of urbanization and industrialization, urbanization is restrained, and the urbanization level has been below the industrialization level. The tertiary sector has not developed properly. Due to the lag in economic development, China's GDP mainly came from the industrial sector making VAT the principal tax for central fiscal revenue. Due to the urbanization process in recent years, the development of tertiary industry broadens the business tax base. As the tax system cannot be fundamentally changed in order not to affect the base of the system set in 1994, and maintain central financial stability and the effectiveness of macroeconomic regulation, VAT base expansion reform is inevitable.

[8] The data comes from Yang Quanshe, 'The Trends in the Volume of VAT and Business Tax Revenue and A Direction for Reform' in (2010) 6 *International Taxation*. The authors of this paper world like to thank Yang for the inspiration from his paper.

[9] With the different share proportion, conclusion and such.

[10] Financial resources, this paper of local government was originally wanted to raise the local government controlled financial resources, but there was no formal formulation so this paper used the most common formulation.

[11] The index from Jia Kang (2004), Roch C. TianFa ZhouChen shadow (2009).

[12] Ideas from Flat New Joe (2010) and the practice of the caliber of budget management thoughts.

[13] This is internal data from the author, if you have any questions, please do not hesitate to contact the author.

[14] That is, in terms of administration, as the VAT tax base is flexible if the local government collects the VAT then both the administrative and compliance costs will be high. Considering maintaining central government macroeconomic regulation, this large revenue source should stay with the central government. From the processing of cross-border trade, in theory it should be collected at the locality of consumption, however the current method of taxing at different stages and input credits is difficult to perform, a second best policy of taxing at source is chosen, thus collecting at the point of sale. However since the administrative method for the VAT is an input credit method, this leads to tax shifting between regions, leading to the possibility of local protectionism, through the design of artificial barriers to limit the sales of goods from other areas in the local area. The final result becomes regionalization affecting the building of a unified market in the country.

[15] Specifically those states which have per capita tax revenue below 92 per cent of the national average are allowed to receive a quarter of VAT revenue, when the VAT revenue is balanced the few states that have a higher than national average fiscal capacity will again perform horizontal fiscal transfer to other states.

COMMENTS

Comments by Researchers from Chinese Government Think-Tanks

The Reforms of the Individual Income Tax Still Have A Long Way to Go

DONGSHENG JIN

The Chinese Premier Wen Jiabao hosted the State Council conference on the 1st March (2011), discussing and passing the Draft Individual Income Tax Law Amendment ('Amendment'). The 'Amendment' outlines changes that should be made as a part of the individual income tax reform suggesting that based on wage and salary income, the tax brackets should be adjusted and the exemption level increased. The 11th NPC was passed.

HOW TO RECOGNISE THE INDIVIDUAL INCOME TAX

Individual income tax is a widely-levied tax type globally, and is called a 'social stabiliser' as it increases tax revenue and adjusts the income distribution. There is an old saying in western countries that 'the only two certainties in life are death and taxes'.

Individual income tax is levied on an individual's various types of net income and has five characteristics: First, the individual is the taxpayer, where residents and natural persons are the taxpaying units. Therefore, resident or non-resident individuals who earn income may be liable to pay individual income tax. From this perspective, individual income tax is a citizen tax and all individuals are legally obliged to pay tax. Second, the tax object is an individual's various net taxable incomes. An individual's income can be non-assessable or assessable and only the legally assessable income can be the tax object of individual income tax. Further, when paying the individual income tax, the tax payer can deduct various costs and expenses incurred during the process of deriving income. Therefore, net assessable income is the base for individual income tax calculation. Third, a progressive tax rate system is adopted whereby the government imposes a higher tax rate on high income earners and a lower tax rate on low income earners. Fourth, tax burden shifting is difficult as the tax is levied directly on the individual's net assessable income, therefore the taxpayer bears the final tax burden. Fifth, the method of expense deduction is used when calculating individual taxable income whereby basic necessities and costs incurred in the process of deriving income are tax exempt, therefore compensating low income earning individuals.

These five characteristics enable individual income tax to fulfil its two fundamental roles: The first role is to collect tax revenue for the government, and as there are many taxpayers and the scope of individual income tax is broad, the individual tax type can be the main source of revenue for the government. The second role is to manage the social income distribution, this is done by collecting a greater proportion of income from high income earning individuals and then redistributing that income through government transfer payments to low income earning individuals. From an economic perspective, the progressive tax rate system of individual income tax compensates low income earning individuals, increasing their level of consumption, stimulating higher aggregate demand and economic growth, and from a social welfare perspective, the individual income tax can improve the uneven distribution of income caused by the substantial wealth gap, relieving social tension between high and low income earning individuals.

INTRODUCTION AND DEVELOPMENT OF THE INDIVIDUAL INCOME TAX

Individual income tax was first introduced by Great Britain in 1799. At that time, the British-French war left the British Treasury short of funds and so in order to finance the war, the British government levied a temporary income tax on wealthy individuals. With the rapid development of the industrial revolution, in 1874, British individual income tax became a permanent tax type through parliamentary legislation. Since then, Germany, France, Japan, the US and other countries followed suit, and after more than 200 years of development, individual income tax, because of its unique advantages, gradually became an essential tax type in various countries around the world.

China's individual income tax was introduced relatively late, with the Qing government drafting the 'Income Tax Statute' in 1909. It was, however, not implemented as the Qing government was overthrown because of the Xinhai revolution. Following the revolution there was political instability and years of war, so the income tax could not be trialled, and was essentially stalled.

After the establishment of Peoples Republic of China (PRC), in 1950, the 'State Tax Administration Regulation' was published, providing the first regulations on individual income tax. This document permitted the levying of the 'Wages and Salaries Income Tax' and the 'Interest Income Tax', however due to the widespread use of the low wage policy and other reasons, the requirements and conditions necessary to implement the individual income tax were not satisfied. After the 11th Communist Party Meeting 3rd sub-meeting in 1978, a new trend of reform and the open door policy was adopted, and following that, in September 1980, the 5th NPC 3rd sub-meeting passed the 'PRC Individual Income Tax Law', formally levying the individual income tax for the first time. Initially, individual income tax was levied on both foreigners and Chinese citizens, however in 1986, Chinese citizens were no longer taxed under the 'PRC Individual Income Tax Law', as several special tax types were sporadically levied on Chinese citizens under the 'Provisional Regulation on the Urban and Rural Industrial and Commercial Individual Income Tax' and the 'Provisional Regulation on the Individual Income Adjustment'. Consequently, the individual income tax then only applied to foreigners and contemporaneously, there were three overlapping laws and regulations regarding individual income tax. In 1993 the 8th NPC 4th sub-meeting amended and passed the new 'PRC Individual Income Tax Law', and simultaneously discontinued the 'Provisional Regulation on the Urban and Rural Industrial and Commercial Individual Income Tax' and the 'Provisional Regulations on the Individual Income Adjustment', unifying the individual income tax law. On 28 January 1994, the State Council issued the 'Implementation Regulations of PRC Individual Income Tax Law' and on the 31st March issued the 'Regulations on the Issues of Individual Income Tax Administration', after which, the NPC made some minor amendments to the 'PRC individual income tax law'. For example, on 1 November 1999, individual income tax was levied on interest yield from savings, but was temporarily exempted on 9 October 2008. From 1 January 2000, sole proprietorship, partnership enterprises outsourcing, contracting and subleasing activities of enterprises and government agencies, were exempted from paying enterprise income tax, however, like a sole trader, individual income tax was levied on their income from business operations. Then, from 1 January 2006, an individual's taxable income was the net assessable income of monthly wages and salaries subtracting RMB 1600 to account for basic necessities. Previously only RMB 800 was subtracted for basic necessities, and this amount increased further to RMB 2000 on the 1st March 2008. Nevertheless, the current individual income tax policy in China is still based on the 'PRC Individual Income Tax Law' issued during the 1994 tax reform.

In recent years, individual income tax revenue in China has gradually increased, and its average proportion of total tax revenue is approximately 7%. In the years before 2006, the average proportion of total tax revenue made up by Individual Income Tax increased gradually, however then decreased slightly. The main reason behind this was the two increases in the subtractions for basic necessities to net assessable income for individual income tax. (see Table 1).

TABLE 1: THE PROPORTION OF CHINA'S INDIVIDUAL INCOME TAX AS THE TOTAL TAX REVENUE

Years	Total Tax Revenue	Individual Income Tax	Proportion of Individual Income Tax Over The Total Tax Revenue (%)
2001	1530.138	99.526	6.5
2002	1763.645	121.178	6.87
2003	2001.731	141.803	7.08
2004	2416.568	173.606	7.18
2005	2877.854	209.491	7.28
2006	3480.435	245.371	7.05
2007	4562.197	318.558	6.98
2008	5422.379	372.231	6.86
2009	5952.159	394.935	6.64

Data source: Chinese Statistical Yearbook 2010, Chinese Statistics Press, 2010

BASIC FEATURES OF INDIVIDUAL INCOME TAX

Individual income tax law states that an individual who has residency in China or an abode in Chinese territory, or who does not have abode but has lived in China for more than one year, is considered a resident for tax purposes and therefore is legally liable to pay individual income tax on income derived in China or overseas. Alternatively, an individual who does not have abode and does not live in China, or has lived in China for less than 1 year, is considered a non-resident for tax purposes and is liable to pay individual income tax on income sourced in China. As is evident, in mainland China, the 'resident' and 'source' tax liability method is applied as the basic principal for collecting tax. This distinguishes between resident and non-resident taxpayers, whereby the worldwide income of residents is taxable but only income sourced in China is taxable for the non-resident. This means the resident taxpayer and non-resident taxpayer bear unlimited and limited tax liabilities, respectively.

The Tax Rate and Calculation of Taxable Income

In China's individual income tax, types of income are categorised differently and attract different rates of tax according to the nature of the income, and tax is withheld and paid by the employer. According to the type of income, there are five types of tax rate:

1. Wage and salary income is taxed progressively with the tax rate ranging from 5% to 45% (see table 2);

2. Income from sole traders, sole proprietorships, partnerships, outsourcing, contracting and subleasing activities of enterprises and government agencies are taxed progressively at tax rates ranging from 5% to 35% (see table 3);

3. Income from authorship is taxed at a flat rate of 20%, with a 30% discount applicable to the taxable income;

4. Income from personal services attracts a flat tax rate of 20%. For exceptionally high one-off payments, a further amount may be levied. Taxable amounts between RMB 20,000 and RMB 50,000 attract a further tax rate of 50%, and for taxable amounts above RMB50,000, there is a further 100% tax rate.

5. Income from royalties, interest, dividend, bonus, rent, property disposal, extraordinary income and other income, is taxed at a flat rate of 20%.

In conclusion, with respect to the above tax rates, taxable income on mainland China can be divided into two categories: first, taxable income that a progressive tax rate is applied to, including income from: wage and salaries, sole traders, sole proprietorships, partnerships, outsourcing, contracting and subleasing activities of enterprises and government agencies. Second taxable income that a flat tax rate is applied to, including income from: authorship and personal services, royalties, interest, dividends, bonuses, rent, property disposal, extraordinary income and other activities. The difference between the application of tax to income from authorship and personal services is that a reduced rate of tax is levied on taxable income from authorship and if service income is exceptionally high then a further amount of tax is levied.

TABLE 2: INDIVIDUAL INCOME TAX RATE TABLE (APPLICABLE FOR WAGE, SALARY INCOME)

Level	Monthly Taxable Income (RMB)	Tax Rate (%)
1	less than 500	5
2	between 500 and 2000	10
3	between 2000 and 5000	15
4	between 5000 and 20000	20
5	between 2000 and 40000	25
6	between 40000 and 60000	30
7	between 60000 and 80000	35
8	between 80000 and 100000	40
9	more than 100000	45

Data Source: PRC Individual Income Tax Law, PRC President Decree 2007 No.85

Note: In this table, the 'monthly taxable income' defined in Article 6 of Individual Income Tax Law, refers to the residual balance of the monthly income subtracting 2000 or deduction fees.

TABLE 3: INDIVIDUALINCOMETAXRATE TABLE(APPLICABLE FOR INCOME FROM SOLE TRADERS, SOLE PROPRIETORSHIPS, PARTNERSHIPS, OUTSOURCING, CONTRACTING AND SUBLEASING ACTIVITIES OF ENTERPRISES AND GOVERNMENT AGENCIES)

Level	Annual Taxable Income (RMB)	Taxable Income (%)
1	less than 5000	5
2	between 5000 and 10000	10
3	between 10000 and 30000	20
4	between 30000 and 50000	30
5	over 50000	35

Data Source: PRC Individual Income Tax Law, PRC President Decree 2007 No.85

Note: In this table, the annually taxable income which is defined in Article 6 of 'Individual Income Tax Law' refers to the residual balance of the annual total income subtracting costs, fees and losses.

Deduction Items

When calculating the individual income tax payable, the individual taxable income contains various deduction items, mainly necessities deduction, cost deduction and special deduction.

The various deductions applicable to wage and salary income are as follows: for an individual living within Chinese territory, the taxable income is the net assessable income subtracting RMB 2000 to account for basic necessities; alternatively, for an individual who does not have abode (foreigner) but who, however, derives income in China or who has abode in China but derives income overseas, after subtracting RMB 2000, a further RMB 3200 is subtracted. In addition, the basic pension insurance, medical insurance, unemployment insurance paid individually, the housing reserve fund, business purpose vehicle use and communication subsidies which are paid by businesses and individuals are deductible.

For an income less than RMB 4000, acquired from authorship, personal services, royalties, and rent, RMB 800 is deductible. For an income of more than 4000 derived from the above activities, a flat rate deduction of 20% is applied. The taxable income from selling property and personal assets is the transaction proceeds subtracting the original purchase cost and reasonable expenses.

With income derived from interest yield, dividends, bonuses, extraordinary and other income, no deductions are applicable, therefore the entire income derived is the net assessable income. In addition, educational and public welfare donations by individuals are tax deductible.

Preferential Tax Policy

There are tax-exempt items in China's individual income tax including:

1. Bonuses from government 'danweis' above provincial people's government, state council ministries and People's Legislative Assemblies; bonuses in the areas of science, education, technology, culture, health, sports and environment from foreign and international organisations;

2. Interest on State bonds and financial bonds issued by the state;

3. Subsidies and allowances granted according to the national standard;

4. Welfare, compensation payments and social security payments;

5. Insurance premiums;

6. Soldiers redundancy package;

7. The relocation allowances, retirement payments and retirement salaries issued to cadres and workers according to the national standard;

8. Foreign ambassadors, consulates of diplomatic representatives, consular officers and other personnel's income in accordance with China's relevant laws and regulations should be exempt from tax;

9. Those in accordance with the Chinese government's participation in international conventions and agreements;

10. State Council approved financial sector tax-free income.

The tax-reduction items in China's individual income tax law:

1. Income of disabled, single elderly persons, and martyrs;
2. Significant loss due to severe natural disasters;
3. Other tax reductions approved by the state council financial department.

Tax Return

Currently, China's individual income tax system is similar to a schedular systemas — they use a tax administration method of withholding at source (employer), supplemented by self-assessment. The 'Notice of 'Self-declaration Method of Individual Income Tax' issued by the State Administration of Taxation' (Guo Shui Fa [2006] #162), commences discussion regarding self-declaration of individual income tax in China. The notice states that for an individual who earns more than 120,000 RMB annually, they must declare their income to the local tax authorities. This declaration is a good start for the individual income tax reform.

THE DEVELOPMENT TREND OF INDIVIDUAL INCOME TAX

The decisions in the Chinese Communist Party 16th meeting 3rd sub-meeting in October 2003 mark the beginning of a new round of tax reform in China. The meeting emphasises individual income tax reform, implementing both comprehensiveness and classifications into individual income tax policy. The '11th Five Year Plan' issued in 2005 further restates the content of the individual income tax reform decisions of the 16th meeting 3rd sub-meeting, emphasising the implementation of comprehensiveness and classifications into individual income tax policy. On 18 October 2010, the Chinese Communist Party Central Committee 5th meeting passed The Suggestion for the 12th Five-Year National Economy and Social Development Scheme issued by CPC', pointing out 'Gradually Establishing and Improving Comprehensiveness and Classifications into Individual Income Tax'.

The Combination of Global and Schedular System

There are currently three fundamental models of individual income tax. The first is the schedular income tax system. Its main advantage is that it is easy to administrate, however its disadvantage is the inherent lack of tax fairness. The second is the global income tax system. Its main advantage is its tax fairness, however, its disadvantage is that it is difficult to administrate and compliance costs for taxpayers are substantial. The third is the combination of the schedular and global tax system.

In order to optimise the fairness and feasibility of utilising an individual income tax, China currently employs a combination of schedular and global systems. This is a transitional measure, until there are appropriate conditions to fully implement a global tax system.

The features of the combination of the schedular and global system are as follows: on one hand, income from wages and salaries, sole traders, sole proprietorships, partnerships, outsourcing, contracting and sub-leasing activities of enterprises and government agencies are administered under the global method. When income is derived, tax is prepaid, and taxable income is calculated at the year-end using a progressive tax rate. On the other hand, tax payable on income from personal services, authorship, dividends, interests, bonus, capital, property disposal and extraordinary income is withheld at the source under a schedular tax administration system. This maintains the feasibility of the tax administration and also ensures that the global system enhances the fairness of the individual income tax.

Improve the Deduction System, Relieve the Labor Burden

Under the current individual income tax policy, the deductions are determined by either a fixed amount or as a percentage, of which the features are fairly simple. It does not reflect the cost incurred by the taxpayer to derive the assessable income, nor the taxpayer's actual ability to pay. International practice suggests that individual income tax deduction items can be designed as a basic deduction, necessity deduction and special deduction.

Basic Deduction

The basic deduction mainly refers to costs incurred in deriving the income as well as tax reduction and exemption items. The tax exemption items are taxable income, however, allowed to be exempt due to preferential tax policy. They are determined based on the consideration of economic efficiency, social equality, political stability and various industries' strategic development.

Necessity Deduction

The necessity deduction exists to allow subsidisation of living expenses. The purpose of the necessity deduction is to achieve a reduced tax burden on employees, exclusion of low income earners from individual tax return scope and higher levying of tax on high income earners. For the same level of income earners because of their different family structures and different quality of life, when applying the deduction the income of the spouse, dependent children and dependent elderly persons must be considered.

Special Deduction

The special deduction mainly refers to the living expenses that reduce the tax burden of the taxpayer in situations other than those listed above. These expenses are not incurred by all taxpayers, and neither the deduction items nor the amounts are the same, therefore it is necessary to deduct expenses before tax. The special deduction can be divided into three categories. (1) Medical expense deduction. (2) Education expense deduction. (3) Mortgage interest or rent expense deduction.

Improve the Tax Rate System, Adjust the Income Gap

In order to improve the income adjustment function of China's individual income tax, it requires a progressive tax rate to achieve the vertical equity; it needs to combine with the current schedular and global combination income tax model. Compared to the schedular income tax model, under the combined income tax model, the horizontal and vertical equity will be easier to achieve.

The changes in the individual income tax rate structure of OECD countries are as follows: (1) the average maximum marginal tax rate of these countries decreased from 55% to 38%; (2) average minimum marginal tax rate decreased from 19% to 14%; (3) the number of tax brackets dropped from 8 to 4; (4) maximum marginal tax rate over the standard enterprise income tax decreased from 15% to 8%. In other words, in the past 15 years, the individual income tax rate is becoming increasingly flat, lower and simpler; it has become the reform and development trend of the individual income tax in each country. China will follow the trend of the international tax reform, lowering the tax rate and brackets as well as broadening the tax base.

Promotion of Individual Income Tax Self-Assessment

Implementing the schedular and global combined individual income tax policy needs the support of self-lodgement. The common point of the individual income tax policies in each country is that the majority of countries adopt the self-assessment of individual income tax. The US and Germany allows couples to submit a joint assessment, France adopts a more unique and complex 'head of household' assessment method. China has achieved the self-assessment of individuals who earn more than RMB 120,000 annually, gaining experience and laying the foundation for widespread use of self-assessment.

AUTHOR BIO

The author is the deputy chair and researcher of the Fiscal Science Research Centre of the State Administration of Taxation of the People's Republic of China.

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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.

The theme of the conference will be 'Tax Policy in China: A Multilateral Dialogue – Modernizing China's Tax Laws for a Diverse Economy'. There are researchers studying the tax policies from the disciplines of law and public finance; there are tax practitioners who are lawyers or accountants; and taxes affect both the public and private sector. This conference is a multilateral dialogue between economists and lawyers; between researchers in government think tanks and academics; and between practitioners and researchers.

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.

Submission Guidelines
- Please submit an abstract in English of 300 words.
- Please provide the final paper in both English and Chinese.
- Please indicate that you cannot organize translation when submitting the abstract.
- Please send all submissions to business.jctp@sydney.edu.au.

KEY DATES

April 25, 2012
Final date for submission of Abstracts. Acceptance will be notified by the middle of June, 2012.

August 15, 2012
Final date for submission of written conference papers if you cannot organize translation.

September 10, 2012
Final date for submission of written conference papers if you would like assistance with the translated document.

October 30, 2012
Final date for submission of written conference paper for inclusion in full conference papers made available to conference attendees.

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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