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Taxation Reform in China's Public Finance

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TAXATION REFORM IN CHINA'S PUBLIC FINANCE

By Penelope B. Prime *

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SUMMARY

Tax reform is an important component of China's overall economic reform because taxation raises government revenue and influences enterprise decisions, without subjugating enterprises to direct government control. This paper presents an overview of China's tax reform since 1983. The main feature of this tax reform was that state enterprises began paying industrial and commercial taxes instead of remitting profits, referred to as *li gai shui* (changing profit to tax). In principle, this tax reform contained many desirable characteristics, but problems with other aspects of economic

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reform have diluted the positive incentive effects implicit within the new tax system.

I. INTRODUCTION

Taxation is a key determinant of economic behavior and resource allocation. The more decentralized an economy is, the more important the tax structure becomes in enhancing, or hindering, the effectiveness of the public sector. As part of its ambitious economic reform program beginning in 1978, China has paid increasing attention to how taxation affects decentralized decision-making. Although experiments with new taxes have been ongoing, comprehensive changes in the tax system began in 1983. Tax reform is important in China because of its potential effect on government revenue and on the central government's ability to guide enterprises, and local governments, without stifling initiative.

During the period of economic reform, and especially in the second half of the 1980s, China has also experienced persistent budgetary deficits. While these deficits have not been large by international standards, the fiscally conservative Chinese leadership considers deficits a major problem. The deficit problem has caused Chinese policy-makers to be concerned with increasing tax revenue to cover budgetary expenditure.

This paper presents an overview of China's tax reform and recent trends in government revenue collection. The first section discusses the new role China envisions for tax policy. Trends in the state budget, and in growth and sources of government revenue, are presented in the second and third sections. The final two sections look at enterprise reforms and performance, and the potential effect of these on government revenue.

While tax policy would be expected to affect government revenue, a causal relation is difficult to establish in this case because of the many other reforms China has implemented along with tax reform. The purpose here is simply to look at what has been happening on the revenue side of the budget in light of China's new tax policies. The theme that emerges is that while China's tax reform is well intended, the ability of the government to establish a sound but flexible, tax-based public finance system is both essential to, and dependent on, the success of the other economic reforms.

II. A NEW ROLE FOR TAX POLICY

The National Tax Bureau of the Ministry of Finance summarized the purpose of China's tax reform in the following six general goals:¹

1. Increase the number of tax categories and tax rates.
2. Vary tax rates by product and sector in order to influence the direction of economic development, and to encourage exports while protecting domestic production.

¹ Guojia shuiwu ju [National Tax Bureau], *Shuifa daquan (SFDQ)* [Complete Guide to Tax Law] (Beijing: Zhongguo caizheng jingji chubanshe, 1989), p.9.

These two goals contrast with policy in the late 1960s and early 1970s when China's goal was to simplify the tax system as much as possible. Within industry and commerce, for example, the number of taxable items fell from 108 to 44. The number of tax rates also fell, with reportedly only 16 in use. Most enterprises paid only one tax.² Simplification was consistent with direct government control over enterprises through the planning process, but to encourage enterprise initiative while maintaining some influence over the direction of the economy requires sophistication in tax instruments and adjustable tax rates.

3. Improve management and increase the economic responsibility of state enterprises by changing to a profits tax with retention of after-tax profits, rather than having enterprises remit all of their profits directly to the state budget.

Before economic reforms began in 1978, enterprise remittance of profits made up a larger share of government revenue than did taxes. The goal of replacing enterprise profit remittance with industrial and commercial taxes establishes taxation as an indirect "lever" to influence managers' decisions. This reform separates state enterprises from the government budget. Previously state enterprise accounts were part of China's public finance budget, and were made compatible with plan targets. Enterprises contributed nearly all of their profits to government revenue, but profits themselves were only an accounting phenomenon. Likewise, wage payments and reinvestment decisions had little to do with whether the enterprise was profitable or not, and managers had little control over incentives or production.

Taxation of state enterprise profits would reduce the difference between state and collective enterprises. Unlike state enterprises, collectives have always paid profit taxes and have been responsible for losses if they occurred. The budget has subsidized collectives to some extent, but the operation of collectives has not been part of the budget's function. Therefore one significance of separating state enterprises from the budget would be to put state enterprises in competition with collectives for inputs and customers. Furthermore, profits would become the most important objective for state enterprises, since funds for bonuses and reinvestment would no longer be provided through the budget.

This goal has been implemented via the *li gai shui* tax reform, which is discussed later in this section.

4. Use taxes to adjust enterprise profits that are excessively high or low due solely to the artificial nature of the planned price system.

The purpose of this goal is to reward enterprises by allowing them to keep after-tax profits that are earned as a result of better management rather than as a result of the price system. This goal is necessary because China has gone forward with tax reform before price reform.

This goal has also been implemented as part of the *li gai shui* reform in the form of an "adjustment tax" on enterprise profits.

² SFDQ, p.7.

5. Guarantee that the government will have sufficient revenue while creating incentives for enterprises, localities, and government bureaus to increase their profits by devising ways to share increments in profits.

This goal addresses China's desire to develop a tax policy that will give incentives to enterprises to increase their profits, and to governments to improve their tax collection and supervision functions. It is an extension of goals 3 and 4 in that it addresses increments in profits earned or revenue collected, and would allow higher retention rates for these increments.

To encourage enterprises to increase profits, this goal has been implemented as part of measures designed to make enterprises more "responsible" for their performance. This is discussed in section V of this essay in connection with the enterprise contract system. To encourage local governments to increase revenue collection, the Ministry of Finance has tried various forms of central-local government revenue-sharing. This is discussed in section IV.

6. Divide each tax into central and local (and shared) portions to ensure both levels have taxation authority and sources of revenue.

In the past, local governments have not had the authority to tax for local needs. They have relied on resources that were approved by, and usually shared with, central authorities. At the same time, the majority of government revenue is collected by local governments for the central government. The purpose of this goal, in combination with goal 5, is to establish a less arbitrary division of revenue sources and expenditure responsibility. The division of each tax into local, central, or shared proportions was established in 1985.

In implementing these six general goals, the core program has been the introduction of a new set of industrial and commercial taxes that replaced profit remittance in state enterprises, called *li gai shui*. *Li gai shui* was implemented in two phases. In the first phase, begun in June 1983, enterprises paid a profit tax and remitted a portion of after-tax profits.³ Various calculation methods of tax and profit payments were used, but total payments for 1983 were set to be approximately the same as in 1982. In the second phase of *li gai shui* all profit remittance was replaced with taxation. This phase began in October 1984, and comprised the following five parts:

1. Divide the industrial-commercial tax into four taxes (product, value-added, turnover, and resource); make the product tax more detailed with adjustable rates.
2. Collect a natural resource tax from mining enterprises. (This tax is in addition to the salt tax, which has existed since 1950).
2. Reintroduce taxes on housing, land utilization, vehicle utilization, and urban maintenance and construction.

³ For details of this phase see Katharine Huang Hsiao, *The Government Budget and Fiscal Policy in Mainland China* (Taipei: Chung-Hua Institution for Economic Research, 1987), pp.162-64.

4. Levy a 55 percent profits tax on large and medium sized state enterprises, and one of eight rates on small state enterprises.
5. Levy an additional adjustment tax on profits (an excess profits tax), using 1983 profits as a base.

Most of these five parts have been implemented. The existing industrial and commercial tax categories as of 1989, and their starting dates are summarized in Figure 1. These changes have substantially increased the complexity and sophistication of China's tax system. If these changes work as intended, this increased sophistication can serve to make China's tax system more flexible and transparent, and therefore a potentially powerful "economic lever" for influencing the direction and performance of the economy.

III. THE GOVERNMENT BUDGET

Several recent trends in China's public finance, however, suggest that the transition from a centrally directed public finance system to one that is tax-based will not be easy. Budget deficits have been one problem that has been particularly sensitive for Chinese leaders. Table 1 reproduces annual official figures since 1978 for China's total (central and local) budgetary revenue and expenditures and the size of the surplus or deficit. These figures show that China's budget deficit problem was consistently worse during the seventh Five-Year Plan (1986-1990) compared with the previous Five-Year Plan period (1981-1985). The seventh Five-Year Plan period began with a deficit of 7.06 billion yuan in 1986. In 1989 the deficit reached 9.54 billion yuan, with a planned deficit in 1990 of 8.90 billion yuan. The average deficit for the five-year period was 8.11 billion yuan compared with an average of 2.42 billion in the previous five-year period.⁴

Furthermore, these official figures include revenue raised from issuing government bonds as budgetary revenue. The practice of counting bonds as revenue is common in socialist planned economies because of the ideological and political importance placed on a balanced budget in a socialist system. This goal has resulted in accounting practices that differ from Western methods, often with the purpose of decreasing or hiding deficits.⁵ In Table 2 the official figures are adjusted to exclude foreign and domestic bonds as revenue. With these adjusted figures the deficit situation looks substantially worse, reflecting the fact that reliance on raising revenue by issuing bonds has grown in recent years. The adjusted deficit in 1986 was 20.88 billion yuan. The deficit steadily increased throughout the period to reach 36.97 billion in 1989, with a planned deficit of 42.34 billion in 1990.

⁴ Part of the deficit increase is explained by a change in accounting practices. Before 1986 both price and enterprise subsidies were recorded as negative revenue. Beginning in 1986 price subsidies have been recorded as an expenditure item. It is unlikely, however, that the three-fold increase in the deficit between the two five-year periods can be explained in this way. See Caizheng bu zonghe jihua si [General Planning Department, Ministry of Finance], *Zhongguo caizheng tongji 1950-1988 (ZGCZTJ)* [China's Finance Statistics 1950-1988] (Beijing: Zhongguo caizheng jingji chubanshe, 1989), pp. 17, 197, and Guojia tongji ju [State Statistical Bureau], (*ZGTJNJ*, 1989).

⁵ See P. T. Wanless, *Taxation in Centrally Planned Economies* (New York: St. Martin's Press, 1985), pp. 66-7.

Figure 1. Industrial and Commercial Taxes: 1989

Circulation Taxes	Profit and Income Taxes	Resource Taxes	Special Purpose Taxes	Property & Behavior Taxes
1. Product (1984)	4. State enterprise profit (1984)	13. Salt (1950)	15. Construction (1983)	19. Housing (experimental)
2. Value added (1983)	5. State enterprise adjustment (1984)	14. Natural resource (1984)	16. Oil consumption (1982)	20. Vehicle use (1986)
3. Turnover (1984)	6. Collective enterprise profit (1986)		17. Bonus (1984)	21. Urban maintenance and construction (1984)
	7. Urban-rural individual industrial industrial-commercial profit (1986)		18. Wage adjustment (1985)	22. Slaughter (1950)
	8. Individual income (1980)			23. Animal transaction tax (1953)
	9. Individual adjustment (1987)			24. Market transfer (1962)
	10. Chinese-foreign joint-venture profit (1980)			25. Land use (experimental)
	11. Foreign enterprise profit (1982)			
	12. Private enterprise profit (proposed)			

Sources: Guojia shuiwu ju [National Tax Bureau], Shuifa daquan (SFDQ) [Complete Guide to Tax Law] (Beijing: Zhongguo caizheng jingji bu chubanshe, 1989), pp. 8-13; Caizheng bu zenghe jihua si [General Planning Department, Ministry of Finance], Zhongguo caizheng tongji, 1950-1988 (ZGCZTJ) [China's Finance Statistics, 1950-1988] (Beijing: Zhongguo caizheng jingji chubanshe, 1989), pp. 40-43.

Notes: 1. Dates in parentheses give approximate beginning of implementation.
 2. Some of the taxes have been reintroduced. For example, the 1986 vehicle use tax is a new form of the vehicle license tax begun in 1950.

Table 1. Total National Budgetary Revenue, Expenditure, and Balance: 1978-1988 (billion yuan)

Year	Revenue	Expenditure	Surplus or deficit
1978	112.11	111.10	1.01
1979	110.33	127.39	-17.06
1980	108.52	121.27	-12.75
1981	108.96	111.50	-2.55
1982	112.40	115.33	-2.93
1983	124.90	129.25	-4.35
1984	150.19	154.64	-4.45
1985	186.64	184.48	2.16
1986	226.03	233.08	-7.06
1987	236.89	244.85	-7.95
1988	262.80	270.66	-7.86
1989	291.92	301.46	-9.54
1990	323.65	332.55	-8.90

Note: The figures for 1986 and later are not compatible with figures of revenue and expenditure from previous years. In 1986, due to the fact that some items previously deducted from revenue were reclassified as expenditure, there were nominal increase in both revenue and expenditure. Figures for 1990 are planned.

Sources: Guojia tongji ju [State Statistical Bureau], Zhongguo tongji nianjian, 1989 (ZGTJNJ, 1989) [China's Statistical Yearbook, 1989] (Beijing: Zhongguo tongji chubanshe, 1989), p. 657, for 1978-1987; ZGCZTJ, p. 12, for 1988; and Foreign Broadcast Information Service (FBIS) 12 April 1990, pp. 16-17, for 1989 and 1990.

IV. TRENDS IN REVENUE COLLECTION

The fact that budget deficits have worsened during the period in which tax reform was implemented raises the question of how government revenue has fared.

UNSTABLE GROWTH IN REVENUE

One salient characteristic, and problem, for China's public finance has been the variability of budgetary revenue. This is shown in Table 3, where bond revenue has been excluded. Revenue actually fell 4.9 percent in 1979, 2.4 percent in 1980, and 2.5 percent in 1981. Revenue increased annually after 1981, but at rates varying from a low of 2.3 percent in 1982 to a high of 22.1 percent in 1985.

Part of this instability was due to inflation, since revenue and expenditure data are reported in current prices. For comparison, Table 3 also gives China's officially reported, annual increases in

Table 2. Total National Budgetary Revenue, Expenditure, and Balance (Adjusted): 1978-1990 (billion yuan)

Year	Revenue	Expenditure	Surplus or deficit
1978	112.11	111.10	1.02
1979	106.80	127.39	-20.60
1980	104.22	121.27	-17.05
1981	101.64	111.50	-9.86
1982	104.01	115.33	-11.32
1983	116.96	129.25	-12.29
1984	142.45	154.64	-12.19
1985	177.66	184.48	-6.82
1986	212.20	233.08	-20.88
1987	219.94	244.85	-24.91
1988	235.72	270.66	-34.93
1989	264.49	301.46	-36.97
1990	290.21	332.55	-42.34

Note: The official revenue and expenditure data have been adjusted by excluding domestic and foreign bonds. The figures for 1990 are planned.

Sources: ZGCZTJ, pp. 11-12, 16-17, for 1978-1988; FBIS 12 April 1990, pp. 16, 19, for 1989 and 1990.

retail prices. Even considering inflation, however, there was still much variability in revenue growth, and between 1987 and 1989 revenue grew less than the rate of inflation.

Another way to evaluate revenue growth is to account for economic growth using a measure called revenue buoyancy.⁶ Revenue buoyancy is calculated in Table 3 as the percentage change in revenue divided by the percentage change in national income (*guomin shouru*). A buoyancy value of one or more would imply that the revenue-generating ability of the public finance system is keeping pace with economic growth. A value less than one would imply that the system is not capturing potential revenue sources as the economy grows. These interpretations are subject to the caveat that this measure does not distinguish between automatic increases in revenue due to growth and increases resulting from changes in the public finance system itself (e.g., new taxes).

Calculations of China's revenue buoyancy are given in the last column of Table 3. With this measure China's revenue collection also appears very unstable. China's revenue buoyancy was just over one between 1983 and 1986, but it was low (and negative)

⁶ Luc De Wulf, "International Experience in Budgetary Trends during Economic Development and Its Relevance for China," *World Bank Staff Working Papers*, no. 760 (Washington, D.C.: World Bank, 1986).

Table 3. Annual Percent Change in Revenue, National Income, and Retail Prices, and a Measure of Revenue Buoyancy: 1978-1989

Year	Revenue	National income	Retail prices	Revenue buoyancy
1978	24.8	13.0	0.7	1.9
1979	-4.9	10.7	2.0	-0.5
1980	-2.4	9.6	6.0	-0.3
1981	-2.5	6.6	2.4	-0.4
1982	2.3	7.7	1.9	0.3
1983	11.7	10.6	1.5	1.1
1984	19.7	17.7	2.8	1.1
1985	22.1	22.0	8.8	1.0
1986	17.8	11.5	6.0	1.5
1987	3.6	17.0	7.3	0.2
1988	6.9	22.9	18.5	0.3
1989	11.5	9.9	17.8	1.2

Note: The percentage changes in revenue and national income are based on figures given in current prices. Official revenue data have been adjusted to exclude domestic and foreign bonds.

Sources: Revenue (adjusted data), Table 2; national income, ZGTJNJ, 1989, p. 29, for 1978-1988, and Beijing Review 33.15 (9-15 April 1990): centerfold, p. 1, for 1989; retail prices, ZGCZTJ, p. 180, for 1978-1988, and Beijing Review 33.17 (22-29 April 1990): documents, p. IIV., for 1989.

before then, near zero in 1987 and 1988, and then back to more than one in 1989. There was a jump from 0.3 to 1.1 in the value of revenue buoyancy between 1982 and 1983, which coincides with the first phase of *li gai shui*, but this increase was not sustained. So a problem with variability, and therefore lack of predictability, in the size of government revenue has continued despite tax reform.

CHANGES IN THE SOURCES OF REVENUE

While tax reform seems to be a minor factor in annual fluctuations of government revenue, it has substantially altered the sources of budgetary revenue. As a result of *li gai shui*, there has been an increase in the importance of revenue collected from taxes and a concurrent decrease in direct transfers of enterprise revenues into the government treasury.

The changes in sources of budgetary revenue are summarized in Figure 2. The percentage of enterprise revenue in total budgetary revenue has decreased steadily from 51.0 percent in 1978 to only 1.9 percent in 1988. Concurrently, tax revenue has increased from

46.3 percent to 74.0 percent, respectively, over the same period. Fees generated 7.1 percent of revenue by 1988,⁷ and bonds generated 10.3 percent. Neither fees nor bonds were sources of revenue in 1978.

Although revenue from taxes has increased, the makeup of tax revenue itself has not changed, as shown by Figure 3. Industrial and commercial taxes represented 86.9 percent of total taxes in 1978 compared with 88.4 percent in 1988. The rest of tax revenue was comprised of agricultural taxes, customs duties, and a small category of "other taxes." Direct agricultural taxes have always represented a small percentage of total tax revenue in China's public finance.⁸ Agricultural tax revenue represented 5.5 percent of total tax revenue in 1978, falling to 3.1 percent in 1988. Customs duties have also been a minor source of revenue. They represented 5.5 percent of tax revenue in 1978, increasing to 6.5 percent in 1988.

Within the category of industrial and commercial taxes, however, major changes have occurred with the introduction of *li gai shui*. These changes are illustrated in Figure 4. The industrial and commercial tax (sometimes referred to as the consolidated industrial and commercial tax), represented 87.5 percent of all industrial and commercial taxes in 1978. With *li gai shui* this tax was replaced with four new taxes: product tax, value added tax, turnover tax, and resource tax. By 1987 the revenue from these four taxes together represented 83.6 percent of all industrial and commercial taxes. The remaining 16.4 percent came from the industrial and commercial profit tax (7.9 percent), taxes on Chinese-foreign joint ventures and foreign firms (0.3 percent),⁹ and other, minor taxes (8.2 percent).

CENTRAL-LOCAL GOVERNMENT FISCAL RELATIONS

In connection with tax reform, there has been much discussion in China on the proper division of fiscal responsibility between the central government and the provinces, and between provinces and lower-level governments. A series of experiments in fiscal decentralization have been implemented over the last decade with the intention of finding the best mix of central-local revenue sharing and expenditure responsibility.¹⁰ The goal of these changes has been to introduce incentives for local government to care about the profitability of enterprises in their jurisdictions, and to improve revenue collection. Beginning in March 1985, the revenue collected from each tax has been designated to go to either central or local governments, or to be shared at a predetermined rate.

The division of revenue between the center and localities over the decade, given in Figure 5, shows that the center's share has in-

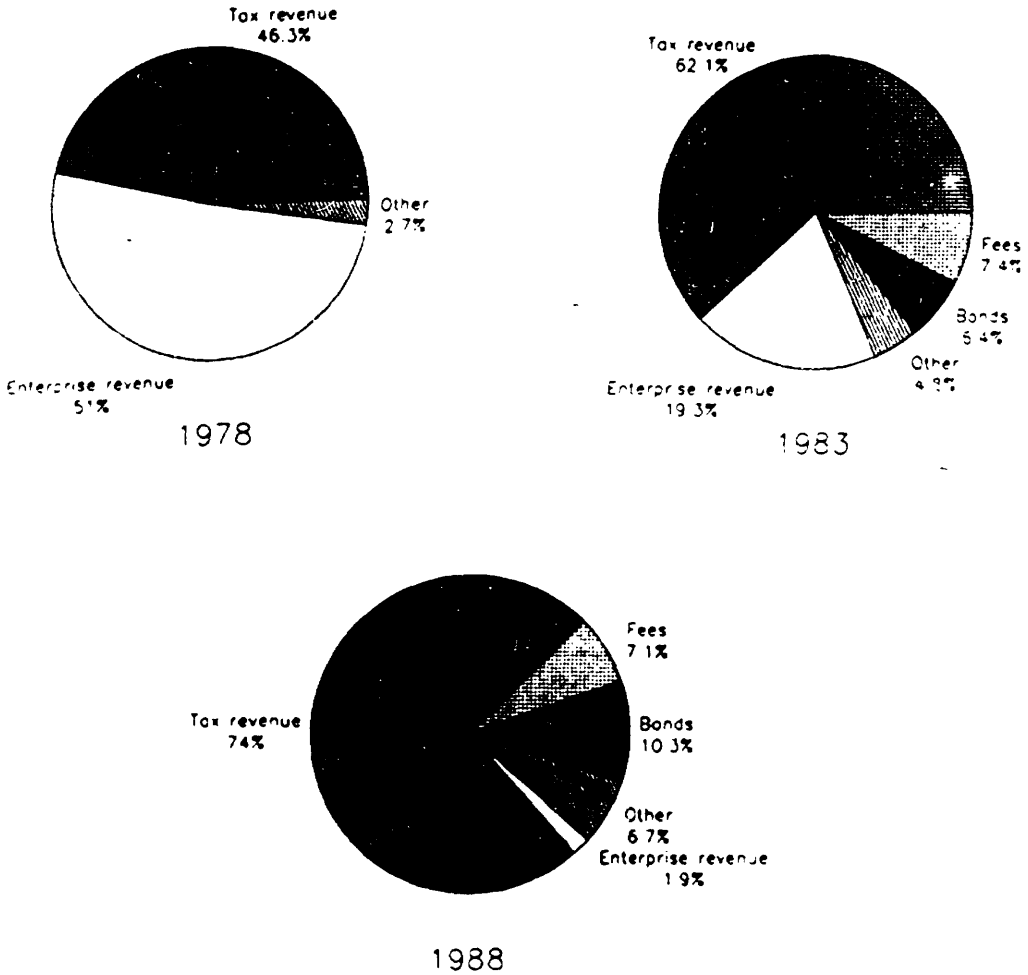
⁷ Examples of fees are usage fees paid by enterprises on fixed and working capital.

⁸ The actual contribution of agriculture to government revenues has been much higher than direct taxes indicate. Agriculture has also contributed to government revenue through pricing policies and collection of special fees (Hsiao, *The Government Budget*, p.109).

⁹ This figure is low because even though foreign business in China has increased rapidly in the last decade, its importance is still small compared with the size of China's economy. Also many foreign companies receive tax "breaks" in the form of low rates or uncollected taxes, although these are often countered with high prices for goods and services bought within China.

¹⁰ For a description of the numerous systems tried, see Hsiao, *The Government Budget*, pp.72-84.

Figure 2. Sources of Budgetary Revenue by Category: 1978, 1983, and 1988

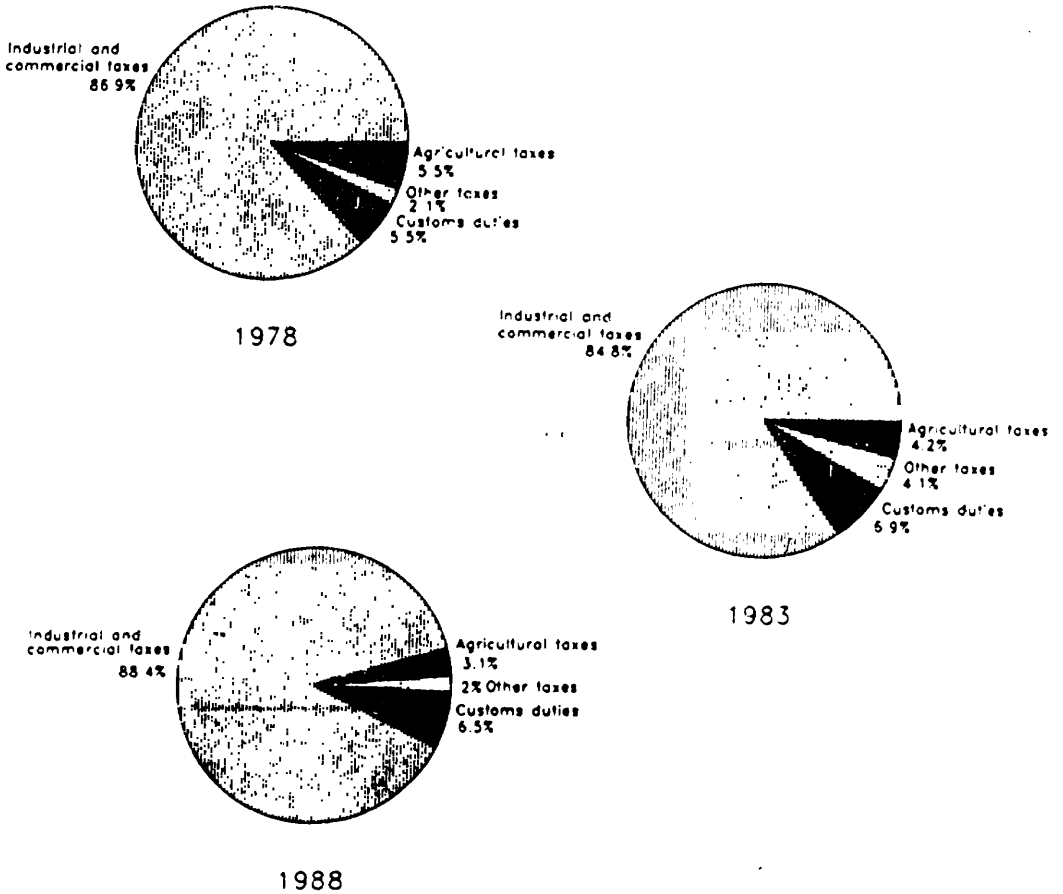


Source: ZGCZTJ, p. 17.

creased, despite the emphasis on decentralizing fiscal responsibility. The center's share in 1979 was 14.3 percent; by 1988 its share had increased to 36.4 percent.¹¹ Further, no major changes in the ratio of central to local revenue appear to have coincided with *li gai shui* in 1983 or 1984, or with the beginning of determining central and local revenue on the basis of each tax in 1985.

¹¹ These figures are based on domestic revenue only. The center's share would be higher if foreign revenue was included.

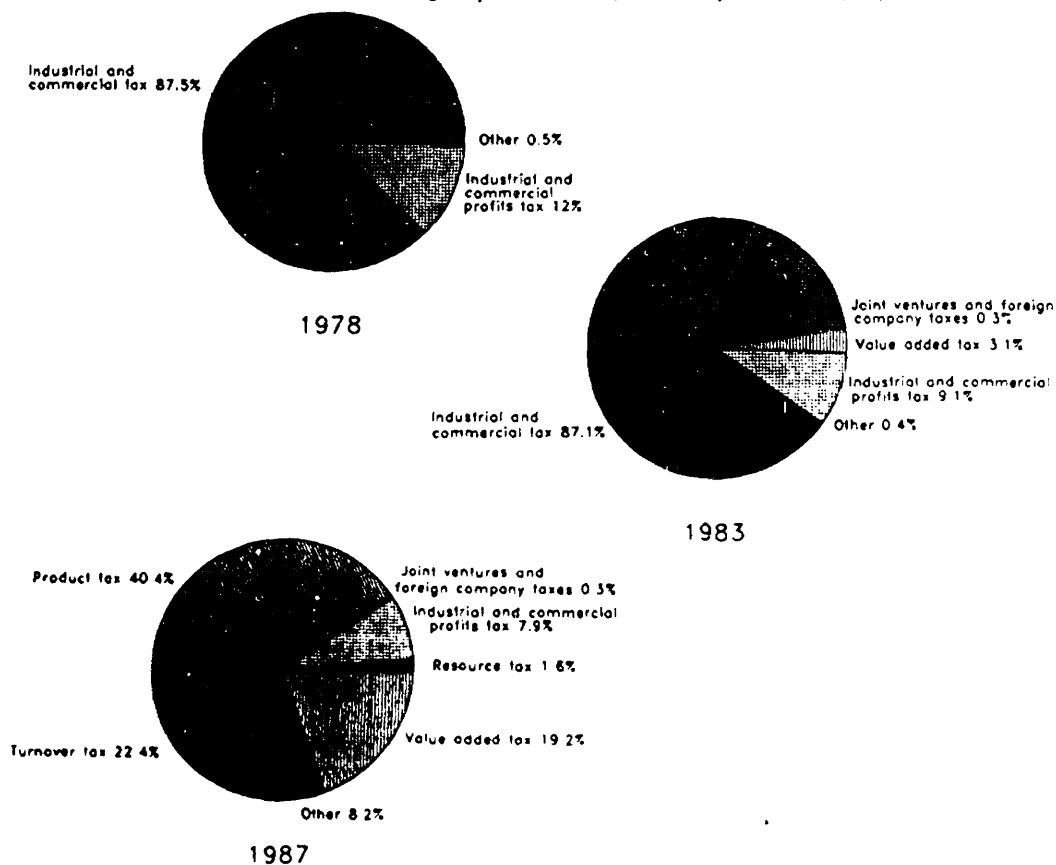
Figure 3. Sources of Tax Revenue by Category
as a Percentage to Total Tax Revenue:
1978, 1983, and 1988



Source: ZGCCTJ, p. 37

Even so, there has been much concern in Beijing that central revenues are inadequate, and that local governments have gained financially at the expense of the center. This apprehension over the size of central funds originates in the distinction between budgetary and extrabudgetary funds. While the center's share in budgetary revenues has increased, budgetary revenue itself has fallen dramatically compared with national income. As Figure 6 illustrates, in 1978 budgetary revenue represented 37.2 percent of national income; in 1988 it represented only 20.0 percent. In contrast,

Figure 4. Industrial and Commercial Taxes by Category: 1978, 1983, and 1987



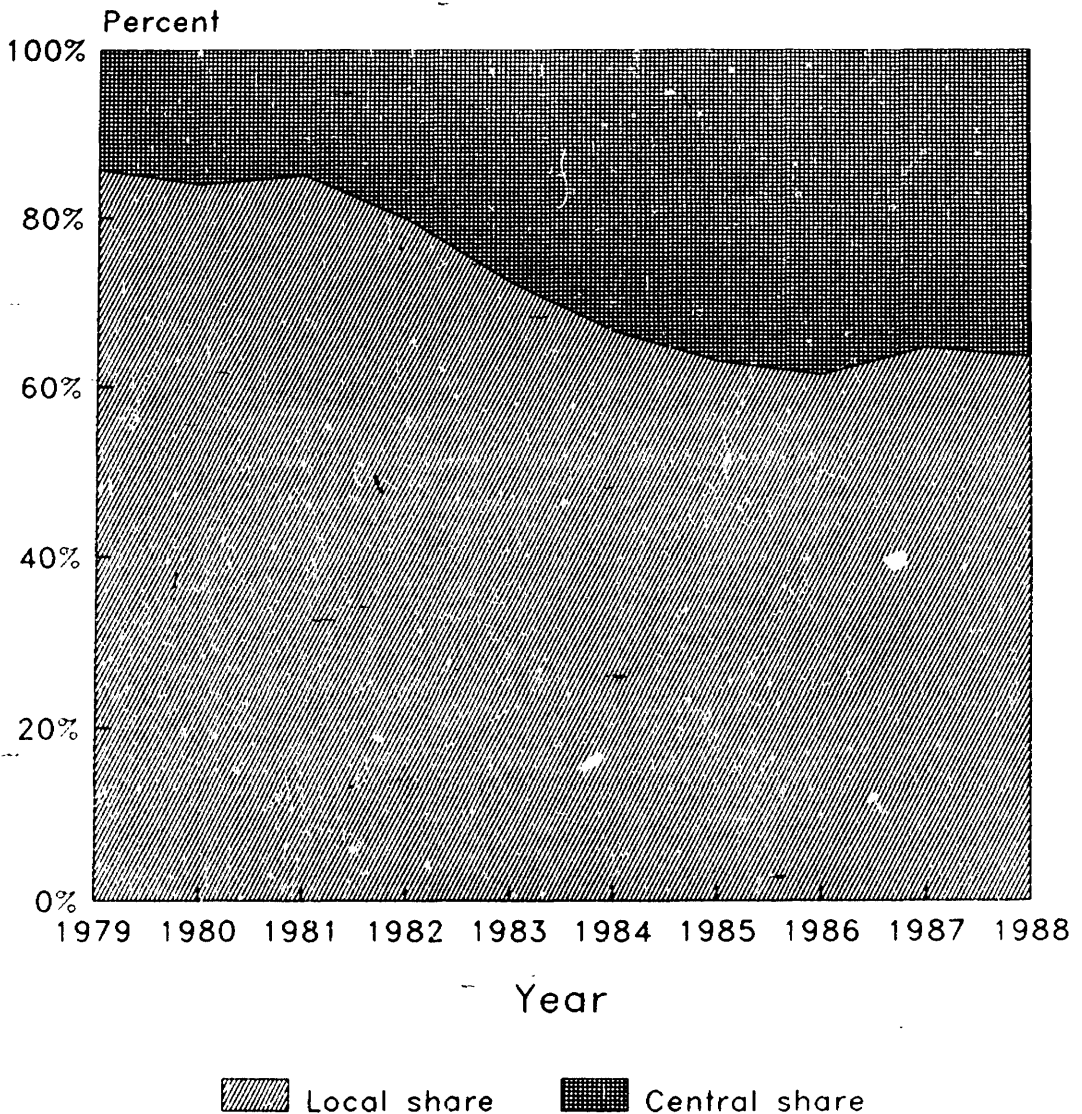
Source: ZGCZTJ, p. 40-43

Note: Data for 1987 are used here, rather than for 1988 as in Figures 2 and 3, because comparable data for 1988 are incomplete

extrabudgetary revenue increased from 11.5 percent of national income in 1978 to 19.3 percent in 1988. Since extrabudgetary revenue is controlled primarily at local levels, these trends would explain the central government's concern over its control of revenue.

Figure 6 also suggests that a halt in the rise of extrabudgetary revenue coincided with tax reform. An inverse relationship between budgetary and extrabudgetary revenue, as a percent of national income, existed until 1982; that is, as budgetary revenue fell, extrabudgetary revenue rose. Beginning in 1983, their relationship

Figure 5. Central-Local Revenue Sharing:
1979-1988



Source: ZGCZTJ, p. 59.

Note: Based on data for domestic revenue including domestic bond revenue.

has stabilized with their proportions in national income generally moving together (except for a jump in budgetary revenue in 1986). More research is needed to understand how China's tax system affects extrabudgetary revenue.

V. THE "ENTERPRISE RESPONSIBILITY" FACTOR

Complicating the tax reform picture are various forms of enterprise reform, or "enterprise management responsibility," begun by the Ministry of Finance in 1987.¹² With these reforms, contracts for fixed periods of time are set up between enterprises and the Ministry. The contracts specify quotas for payment of profit taxes and adjustment taxes. Methods for deciding on the quotas are numerous and complex, but basically the enterprise agrees to pay a set percentage of profits based on previous performance, and then profits earned above this are taxed at lower rates. Since profit tax rates fall as the amount of profits increase, these contracts are supposed to create incentives for enterprises to increase profits.

Under any system that taxes profits there is an incentive to reduce the amount of profit subject to tax. In China this incentive has been strengthened by the tax-contract system, even to the point of reporting losses, because there is little threat of bankruptcy for unprofitable enterprises. In fact, subsidies to unprofitable enterprises may be guaranteed to enterprises within the contract system, although the Ministry of Finance's goal is to build into the contract that subsidies will be phased out over time. As a result, certain practices that reduce accounting profits are very popular, whether an enterprise is profitable or not. For example, wages and nonwage benefits, such as housing, have increased dramatically, as has borrowing for investment, because both worker benefits and repayments on these loans are deducted before the tax liability is assessed.

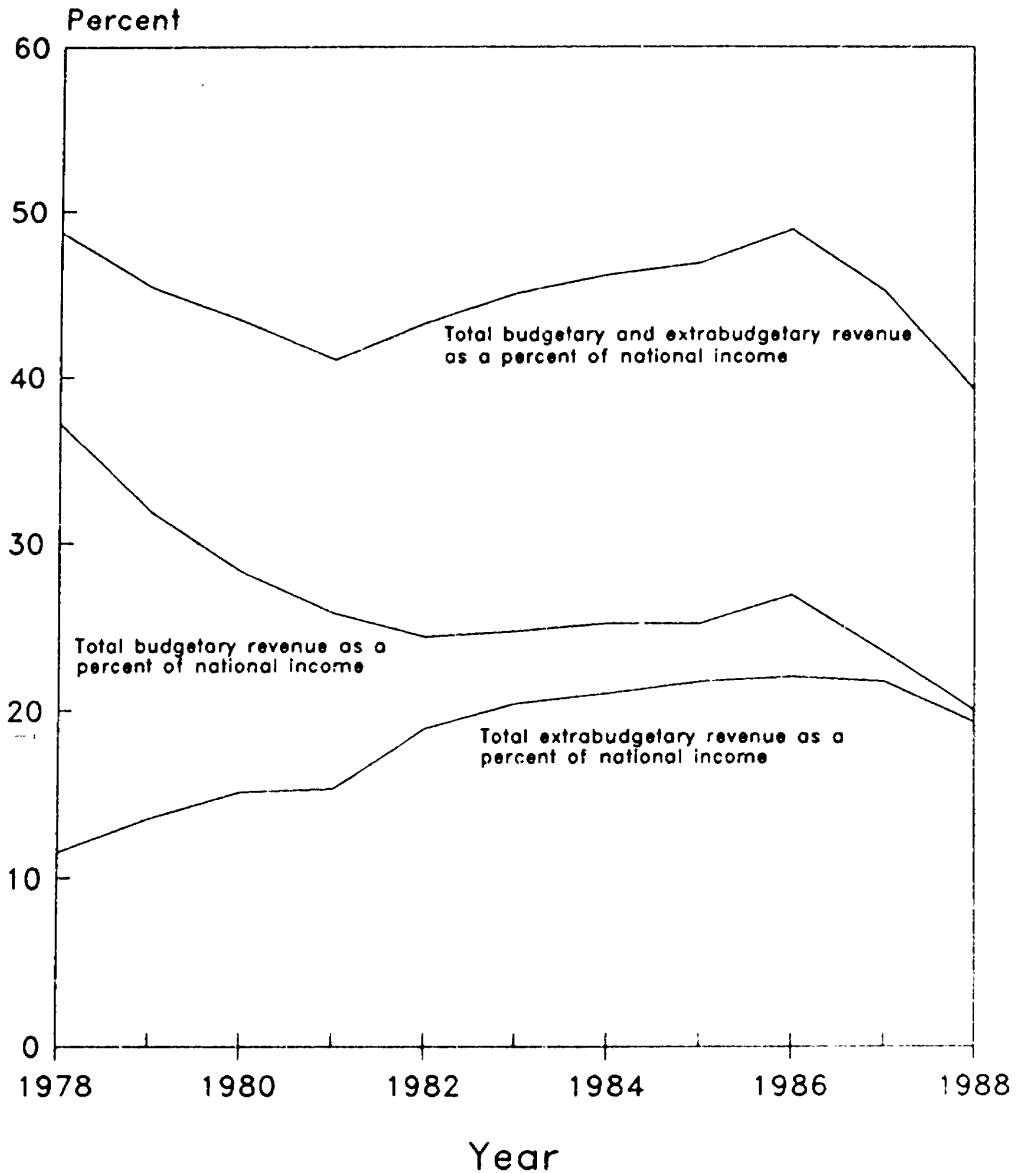
Another result of the contract system is that taxes on profit are in effect negotiable. According to the tax code, the tax rate on earnings of state firms is 55 percent for medium to large enterprises, and one of eight rates between 10 and 55 percent for small enterprises, plus the adjustment tax.¹³ In actuality, because the profit and adjustment taxes are negotiated according to the specific contract, the rates vary for each enterprise. Tax assessors have the authority to consider all sorts of special circumstances when the contracts are made.

Some of these special circumstances are beyond the control of an enterprise. One of these is price. Because some prices are market prices and others are fixed prices, profits may not correspond to the success of management or productivity of workers. Also profitability varies widely across industries. One reason for the new industrial and commercial taxes is to equalize profit rates so enterprises with low profits due to artificially high input prices or low

¹² Before 1987 other forms of enterprise responsibility existed, such as the "enterprise fund" and the "profit and loss" responsibility system. The main purpose of these earlier forms was to give enterprises financial resources with which to reward workers. In these forms the amount of funds an enterprise could retain was tied to variables other than profitability per se, such as the size of their wage bill (*Jingji xue wenti* [Problems of Economic Study] no. #1 (1988):15; *Jingji wenti tansuo* [Inquiry into Economic Problems] no. #12 (1988):49-56).

¹³ The distinction between "small" enterprises and others varies depending on whether the firm is involved in industry and transport, retail sales, or other services, and whether it is located in Beijing, Tianjin, and Shanghai or elsewhere. The definitions are based on a range of values of fixed assets, size of earnings, and number of people employed. The specifics can be found in Sun Shuming and Zheng Li, "Guoying chiye lirun fenpei de falu guiding" [Legal regulations of state enterprise profit distribution], *Jingji wenti tansuo* [Investigations of Economic Problems] no.12 (1988):51.

Figure 6. Total Budgetary and Extrabudgetary Revenue as a Percentage of National Income: 1978-1988



Source: ZGCZTJ, pp. 12, 103, and 173.

Note: Budgetary revenue data exclude bonds.

output prices will not be discouraged from improving efficiency.¹⁴ In this way economic reform can go forward without having to wait

¹⁴ For a discussion of how the product tax can be used to influence price while controlling profitability in Chinese enterprises, see Wang Chuanlun, "Some Notes on Tax Reform in China," *China Quarterly* no. #97 (March 1984):53-67.

for full-scale price reform. Prices will still influence consumption, but their effect on investment and production decisions can be adjusted.

Without price reform, however, the tax-contract system in effect makes all taxes negotiable, and therefore ad hoc. In addition, adjusting taxes for each enterprise is unwieldy, and is hindered by poor accounting, negotiation, and corruption. Therefore the overall, long-run effect of tax and enterprise reform on government revenue is difficult to predict. On the one hand provisions to allow enterprises to keep higher shares of incremental profits should encourage enterprises to increase sales and reduce costs; on the other hand, the combined effects of negotiation, incentives to reduce accounting profits, and administrative costs may overwhelm the increases in revenue due to incentives to increase profits.

VI. ECONOMIC PERFORMANCE AND REVENUE GROWTH

The *li gai shui* tax reform has been concerned with making state enterprises efficient and dynamic by subjecting them to the same taxation system as collectives. The achievement of these goals, however, has been undermined by other factors that have adversely affected the performance of state enterprises. For example, inflation in the late 1980s, also a result of economic reform, hurt state enterprises more than others because they are subject to fixed state prices and cannot pass on increased costs. This decreased profits in state enterprises and increased the amount of revenue used for subsidies.¹⁵ Also, attempts to control budgetary expenditure by cutting investment curtailed growth in the state sector, and industry in particular. Investment is a large expenditure, and is easier to cut in major central projects than in smaller, local projects.

Failure to make state enterprises more efficient and dynamic has affected government revenue, especially since industrial and commercial taxes are such a large revenue source. This can be seen in Table 4, which gives the share of revenue collected by ownership category. The figures in this table show that the state sector's share has fallen from 86.8 percent in 1978 to 74.1 percent in 1987. Table 5, which gives the share of revenue collected by economic sector, shows that concurrently industry's contribution to budgetary revenue has also fallen. Industry's share was 75.4 percent in 1978, and only 56.9 percent in 1987. While industry's share was falling, the category of "other" rose from 2.1 percent to 20.9 percent during the same period, as this is where bond revenue is counted. Contributions from the other economic sectors remained about the same. This implies that decreases in revenue from state industry have been largely made up by issuing bonds.

CONCLUSION

Implementation of the *li gai shui* system is the core of China's efforts to establish a legal, uniform tax system, which gives enterprises autonomy from government and incentives to care about

¹⁵ Enterprise subsidies were 44.6 billion yuan in 1988, up from 24.52 billion in 1985 (the first-year figures for these subsidies were made available). Price subsidies increased from 1.1 billion yuan in 1978 to 31.7 billion yuan in 1988 (ZGCZTJ, pp.17, 88, 197).

Table 4. Percentage of Revenue Collected by Ownership Category: 1978-1987

Year	State	Collective	Individual	Other
1978	86.8	12.7	0.5	0.0
1979	86.5	13.0	0.5	0.0
1980	85.4	14.0	0.6	0.0
1981	84.4	14.7	0.9	0.0
1982	81.6	15.1	3.3	0.0
1983	80.1	16.0	3.0	0.9
1984	78.9	17.2	2.8	1.1
1985	71.6	23.1	4.3	1.0
1986	77.1	16.9	4.1	1.9
1987	74.1	18.4	4.5	2.4

Source: ZGCZTJ, p. 25.

their economic performance. Budget deficits have increased since the introduction of reforms and the share of revenue contributed by state enterprises has fallen, but there is no evidence that tax reform is to blame for these developments. Meanwhile the new system has replaced enterprise remittances with tax revenue, and shares of budgetary and extrabudgetary revenue appear to have stabilized.

One unresolved issue is whether sufficient incentives have been introduced to increase profits and tax revenue. The success or failure of tax reform in this regard cannot be determined yet because the effects of the tax system cannot be separated from the results of other economic reforms being introduced at the same time. However, the intent of establishing a uniform, nonarbitrary tax code has been potentially undermined by the tax-contract system.

Another test of the success of tax reform will come when the new policy instruments are used to resolve problems that arise in the future. If tax policy is not adequate, will central leaders fall back on directives?

So far China's leaders have not passed this critical point. Economic austerity measures in the fall of 1988, and panic directives after economic disruption caused by the student demonstrations in June 1989, are cases in point. Nonetheless, economic reform is still on the agenda, and a new tax system is in place. That Chinese leaders have concerned themselves with these important aspects of the economy is reason for optimism.

Table 5. Percentage of Revenue Collected by Economic Sector: 1978-1987

Year	Industry	Agriculture	Commerce	Transport	Construction	Other
1978	75.4	2.8	12.2	7.3	0.2	2.1
1979	78.8	2.9	4.7	7.7	0.0	5.9
1980	82.7	3.0	1.5	6.5	0.1	6.2
1981	81.9	3.5	0.3	5.8	-0.1	8.6
1982	84.0	4.4	-3.7	4.6	0.1	10.6
1983	86.0	5.4	-7.9	5.7	0.9	9.9
1984	77.8	4.1	-0.8	8.3	0.4	10.2
1985	64.0	4.7	7.7	7.0	0.4	16.2
1986	56.1	3.6	14.7	5.4	1.0	19.2
1987	56.9	5.1	11.5	5.2	0.4	20.9

Source: ZGCZTJ, p. 33.