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## CENTRAL-PROVINCIAL-LOCAL FISCAL RELATIONS: THE REVENUE SIDE

Roy Bahl

From: *Taxation in Modern China*. Edited by Donald J.S. Brean. New York: Routledge, Inc., 1998.

### **Introduction**

One cannot address the subject of intergovernmental fiscal relations in China without also addressing the subjects of tax policy and tax administration. The three are inextricably linked (Bahl 1994). China's intergovernmental fiscal system is based on sharing rather than assignment, and is characterized by the following:

- All tax rates and bases are centrally determined.
- Each local government is given a designated share of revenue collections within its boundaries,
- Tax administration is a shared responsibility between central and local governments.<sup>1</sup>
- Grants are distributed among local governments on an ad hoc basis.

A major fiscal reform in 1994 affected all of these dimensions of the inter-governmental system. The tax structure was altered, changing the size of the total revenue pie to be allocated; tax administration responsibilities were changed to remove some of the ability of local governments to use "back door" approaches to revenue mobilization; the ability of local governments to

negotiate tax incentives with local enterprises was sharply curtailed; and the formula by which revenues are divided between the central and local governments was changed.

The subject of this paper is the revenue dimension of fiscal decentralization in China. Three issues are covered: a description and analysis of the revenue system and a review of its recent performance; an assessment of how the 1994 fiscal reform affected the intergovernmental system; and a view of the next steps in the Chinese reform. The revenue sharing and expenditure assessment dimensions of the system are discussed elsewhere (Bahl 1996).

### **Revenue Performance**

The 1994 reform of the fiscal system was prompted by declining central government revenues. There were three contributing factors: a long-term decline in tax revenue collections as a share of gross national product (GNP), an increasing share of revenues used for extrabudgetary purposes, and a reduced share of total revenue going to the central government.

#### *The Declining Tax Ratio*

The revenue trend over the past decade is described in table 6.1. The tax ratio (collections as a share of GNP) has fallen to less than half of its level of about 23 percent at the time the enterprise income tax

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<sup>1</sup> Throughout this paper, the term "local governments" will be used to refer to all subnational governments.

was introduced.<sup>2</sup> By 1996, government revenue mobilization was about 10 percent of GNP, a low share by international standards.<sup>3</sup> A declining government share of GNP is not a problem per se because it reflects the narrowing of the scope of government responsibility in China.<sup>4</sup> However, this decline has been greater than was planned, and fiscal deficits have arisen.<sup>5</sup> Between 1985 and 1996, the revenue income elasticity of the Chinese tax was only 0.60, i.e., the rate of revenue growth was a little more than

**Table 6.1**  
**Tax Revenue Performance 1985-1995**

Year	Total Tax Revenue (¥ Billions)	Total Tax Revenue (% of GNP)	Enterprise Income Tax Revenues (% of GNP)
1985	218.8	24.3	7.8
1986	224.8	22.0	6.8
1987	232.1	19.4	5.6
1988	257.6	17.3	4.6
1989	301.7	17.8	4.1
1990	313.8	16.9	4.0
1991	331.7	15.3	3.4
1992	345.7	13.0	2.7
1993	447.5	12.9	2.0
1994	524.0	11.3	1.5
1995	605.6	10.6	1.5
1996	691.6	10.3	1.4

*Source: IMF and World Bank*

half the rate of growth in GNP.<sup>6</sup> Such a slow growth in revenue will almost certainly create budgetary balance problems and restrain expenditure growth. Government policy is to increase the income elasticity of the revenue system and reduce the size of the deficit (Zhongli 1996).

The decline in the revenue share of GNP is largely due to the declining budgetary contributions of the enterprise income tax. On the one hand, this decline is neither unexpected nor undesirable. The

<sup>2</sup> The decline in the revenue share is exaggerated somewhat by the Chinese definition of revenues and expenditures, notably the treatment of debt issued as a revenue, debt repaid as an expenditure, subsidies to cover enterprise losses as a negative revenue, and the exclusion of government "departmental" revenues from the budgetary accounts. When adjustments are made to conform these data to standard international classifications, the results show that the Chinese revenue share of GNP still declined substantially, but less than is reported in table 6.1.

<sup>3</sup> Various analysts estimate the tax ratio to be higher by 1 to 2 percent of GNP, depending on the data source used and the definition of revenues (Xu Shanda 1995; World Bank 1994; IMF 1994). Data from the Statistical Yearbook of China, used in this paper, give consistently lower estimates. All analyses, however, show much the same trend of decline.

<sup>4</sup> Neither is a comparatively low tax ratio an indicator of "bad" fiscal performance. Many of China's social services, for example, are provided as tax expenditures rather than through tax financing.

<sup>5</sup> The consolidated fiscal deficit in China is not large by international standards (about 6 percent of GDP) but it has grown significantly since the late 1980s (World Bank 1994).

<sup>6</sup> Estimated from a linear regression of tax revenues on GNP with both variables expressed in logarithms. Technically, this is a buoyancy rather than an elasticity coefficient because no adjustments have been made for discretionary changes.

enterprise reform in China was meant to reduce payments to the government and to give enterprises more control over their resources (World Bank 1994). On the other hand, this industrial policy alone would not seem to have dictated so great a reduction in enterprise tax payments. There are several explanations for the large reduction: the offloading of some enterprises from the government sector, the granting of tax incentives, and enterprise losses. Another reason for the weak revenue performance of the enterprise income tax is the failure to expand the tax base to adequately include the private and collective enterprise sector. In the early 1990s, about 60 percent of GNP was accounted for by the nonstate sector, but almost 80 percent of tax revenues were derived from the state-owned enterprises (SOEs) (IMF 1994, 28). Whatever the reason, at a 1.5 percent share of GNP, the enterprise income tax has become much less a force in economic policy than it was at over 8 percent of GNP in its early years (see table 6.1). With the enterprise income tax in decline and the individual income tax very narrowly based, China has moved to heavy reliance on sales taxes. By 1996, indirect taxes accounted for about 74 percent of total collections.

### **Extrabudgetary Revenues**

The second dimension of the problem was the rapid growth in revenue outside the budgetary accounts. Particularly, local governments had found a way to siphon revenues away from the normal budgetary accounts -- and the sharing pool -- to special purpose spending. The declining tax ratio shown in table 6.1 reflects this transfer of funds.

There are two types of extrabudgetary revenues. The first is the fiscal extrabudgetary funds (EBFs) of the government. These are earmarked for capital purposes and include a set of taxes and charges that are controlled by the local government finance departments. The most important are the public utility surcharge -- a 10 percent tax on the utility bills of consumers--and the urban construction and maintenance tax. There also are some minor taxes and charges in this category, including the surcharge on the agricultural tax, revenues received from public housing and public property, and institutional income that accrues to the various city enterprises. The latter includes fees and charges from hospitals, road maintenance charges, advertisement fees, and so on. Fiscal extrabudgetary revenues are relatively small compared with other sources. The World Bank (1994, 31) estimates that this type of extrabudgetary revenue has grown from 2.6 percent of gross domestic product (GDP) in 1978 to 4.2 percent in 1993 and now is equivalent to about one-fourth of total budgetary revenues.

The other type of extrabudgetary revenue is the retained earnings and depreciation funds of locally owned enterprises. EBFs of this type expanded very rapidly in the 1980s and in 1993 were equivalent in amount to about 12 percent of GDP. In principle, these funds should not be classified as part of the government budget because they are not resources over which the local governments have direct control. Nor is their rapid growth necessarily a cause for alarm. It could reflect increased profitability, increased enterprise savings, and government policy to allow enterprises more flexibility in managing their resources (World Bank 1993, 17-19). However, the flagging level of enterprise income tax collections suggests that there was not an increase in taxable profits in the enterprise sector. More likely, the increase in EBFs was a result of the contracting system between local governments and enterprises that led to a channeling of resources from the budgetary to the extrabudgetary side. These revenues

were used for social purposes and to support the economic development goals of the local government administration, and their growth was heavily influenced by local taxing and contracting practices.<sup>7</sup>

The responsiveness of extrabudgetary revenues to GNP would appear to be greater than the responsiveness of budgetary revenues -- there is a positive and significant relationship between the ratio of local government extrabudgetary revenues to total budgetary collection, and GNP, over the 1983-1992 period (Bahl 1994). Local government extrabudgetary revenues are about 1.5 times greater than central government extrabudgetary revenues, and this spread has remained approximately constant over the past decade.

### **Division of Revenues**

The revenue-expenditure balance between central and local governments changed markedly in the 1980s and early 1990s. At the time of the income tax reform in 1983, the local government sector was spending an amount equivalent to 74 percent of what it collected while turning 26 percent over to the central government for national purposes. By 1992, the local government sector was spending an amount equivalent to its collections and was receiving an additional subsidy from the center equivalent in amount to about 2 percent of expenditures (see table 6.2).

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<sup>7</sup> For a discussion of the long-term growth extrabudgetary revenues and the composition of this growth, see Wong, Heady, and Woo (1995, appendix I).

**Table 6.2**  
**Tax Collection and Expenditure of Central and Local Governments, 1980-1995**  
(in Billions of Yuan)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Central government revenue collections	28.4	31.1	34.7	49.0	66.5	77.0	77.8	73.6	77.5	82.3	99.2	98.8	98.0	95.8	290.7	325.7
Central government expenditures	66.7	62.6	65.2	76.0	89.3	79.5	83.6	84.6	84.5	88.9	100.4	109.1	117.0	131.2	175.4	199.5
Collections deficit/surplus	-38.2	-31.5	-30.5	-27.0	-22.8	-2.6	-5.8	-10.9	-7.0	-6.6	-1.2	-10.3	-193.1	-35.5	115.2	126.1
Local government collections <sup>a</sup>	87.5	86.5	86.5	87.7	97.7	123.5	134.4	146.3	158.2	184.2	194.5	221.1	250.4	339.1	231.2	298.6
Local government expenditures	56.2	51.3	57.8	65.0	80.8	120.9	136.9	141.7	164.6	193.5	207.9	229.6	257.2	333.0	403.8	482.8
Collections deficit/surplus	31.3	35.2	28.7	22.7	17.0	2.6	-2.5	4.7	-6.4	-9.3	-13.4	-8.5	-6.8	6.1	-172.7	-184.3

**Source:** Statistical Yearbook of China 1996.

**Note:** The difference between the local government's surplus and the central government's deficit is the central government's foreign borrowing and domestic budget deficit.

<sup>a</sup> Central and local government collections are before transfer from local governments to the central government and before earmarked grant distribution to the local governments.

The problem that arose was that the central government share of revenue was not sufficient to cover central government expenditures. Historically (through the mid-1980s) central fixed revenues were considerably less than central government expenditures, and the difference was made up by net transfers from the local government sector. For example, in 1984, the local governments ran a "collections surplus" of about 17 billion yuan while the central government ran a "collections deficit" of about 23 billion yuan (table 6.2). The net transfer was from local to center. However, by 1988, the situation was reversed; the central government was collecting more than it spent while the local government sector was running a collection deficit. In fact, in 1992, the net transfer from the center to the subnational sector (excluding any earmarked grants) was equivalent to about 19 percent of central collections. This change in the division of revenues, and the consequent growth in extrabudgetary revenues prompted the 1994 reform of the revenue-sharing system.

In anticipation of the 1994 reform, local governments increased revenues in 1993 to establish a larger base for the new revenue-sharing system. The result was a local government collection surplus in 1993. The new system was initiated in 1994, with the definition of the value-added tax

(VAT) as a central tax and income taxes as local revenues. In 1994 and 1995, the resulting central government surplus was not adequate to offset the local government deficit.

### **Tax Structure Reform**

By the early 1990s, the Chinese tax structure was out of step with the goals of the system reform. Structural changes were needed, especially for the VAT and the enterprise income tax. Both taxes were characterized by rate and base structures that interfered with market-driven decisions and imposed an uneven distribution of tax burdens on enterprises; the determination of tax bases was subjective and less controlled by the tax law (regulations) than desirable. Both were complicated and difficult to administer. Moreover, the intergovernmental dimensions of the tax system was troublesome. Local governments used their considerable discretion to follow their own economic development and revenue mobilization policies, and these often compromised the ability of the central government to successfully implement its macroeconomic program.

The 1994 reform was designed to “recentralize” and to raise the long-run GDP elasticity of the revenue system. It was comprehensive in that it covered all taxes in the system and included changes in the tax administration and tax-sharing systems.

#### *The Enterprise Income Tax*

Before the 1994 reform, the income tax on enterprises was essentially a family of taxes. There was separate tax treatment of large SOEs, small state-owned companies, collectives, individual household enterprises, joint ventures, and foreign enterprises. The rate structures were different, there were differences in the definition of the tax bases, and a number of surtaxes were applied. Revenues were shared between the central and subnational governments on a derivation basis.<sup>8</sup>

Larger and medium-sized SOEs paid a flat rate of 55 percent on taxable profits, and smaller enterprises paid according to a graduated rate that rose from 10 percent to 55 percent. Taxable profit was defined as the difference between gross sales and allowable costs, with some notable departures from the conventional approach taken in most industrialized and developing countries:

- Repayment of loan principal was an allowable deduction.
- The depreciation deduction was an actual cash expense, paid into a depreciation fund.
- Wage bonus payments and some fringe benefits provided to workers were not allowable labor cost deductions.

A combination of this complicated tax structure, the uneven quality of recordkeeping by enterprises, and the manually operated collection, assessment, and audit system made this an especially difficult tax to administer. To complicate matters further, most SOEs did not pay according to the legal rate schedule but according to a contractual arrangement with the provincial government.<sup>9</sup> This “contract” agreed to by the local government administration and the enterprise (but not by the central government), usually required the enterprise to pay a quota amount of tax or to guarantee a quota level of taxable profit.

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<sup>8</sup> Revenues collected from centrally owned enterprises accrued directly to the central government. Revenues collected from enterprises owned by provincial and local governments are shared on a derivation basis, with the retention rate fixed by the central government and varying among provinces.

<sup>9</sup> For a description of the contract system, see World Bank (1990, annex 2).

Contracts typically had a three-year life. In effect, contracting merged the enterprise income tax with profit sharing. It was a step backward to the time when enterprise income was not taxed but profits were remitted to the government sector. By 1990, about 85 percent of all industrial SOEs were covered by contracts (International Monetary Fund 1994, 26).

In addition to the company income tax proper, SOEs paid an "income adjustment tax." This tax was intended to offset the advantages given to certain enterprises by the central government, for example, with respect to capital endowments or preferential prices for inputs and/or outputs. These advantages, it was supposed, led to an excess profit rate, and the government felt that part of this excess should be reclaimed. The amount of this tax was determined in an ad hoc manner and varied from enterprise to enterprise. A 15 percent energy and transportation tax (ET) and a 10 percent budgetary adjustment tax (SBAF) were levied on a base of after-tax earnings plus depreciation fund contributions. accrued primarily (70 percent and 50 percent, respectively) to the central government. These search taxes were imposed largely to claw back some revenues to the center.

After-tax earnings were also subject to a construction tax, a wage bonus tax, and a wage adjustment tax. Each of these three taxes was an attempt to regulate the economic decisions of enterprises. The construction tax was meant to discourage off-plan construction financed by EBF and to divert retained earnings to "more productive" investments. Wage bonus tax and the wage adjustment tax had a similar intent, to discourage excess distribution of profits to labor and to control interpersonal income disparities.

Income taxes on collective enterprises were levied under the same progressive rate schedule as applied to small SOEs. Deductible costs were approximately the same for SOEs, with a few exceptions. Individual household enterprises paid according to a progressive rate schedule with 10 rates ranging from 7 percent to 60 percent. A surtax was imposed for incomes exceeding a certain amount. The total rate on joint ventures was 33 percent, and generous tax holidays were provided for new companies. Tax rates in the special economic zones were (and remain) 15 percent. Foreign enterprises pay at progressive rates ranging from 20 percent to 40 percent. An additional local income tax surcharge may be added.

### **Problems with the Prereform System**

The Chinese government and numerous analysts have identified problems with this system and called for its reform.<sup>10</sup> First, as should be clear from the above description, the enterprise income tax was too complex to be properly administered by government or easily understood by taxpayers. There were five different tax rate schedules, depending on the ownership of the enterprise, and the tax base was defined differently for each form of ownership. In addition to the basic enterprise income tax, up to six different taxes were applied to various definitions of enterprise profits. Second, the contractual agreements with enterprises bypassed the income tax rules in favor of negotiated arrangements. This does not create a level playing field for all companies and is not consistent with the goal of the government to create a competitive environment that will lead to the best allocation of resources. The disparities in treatment were widely recognized by the government; some enterprises paid effective tax rates as high as 70

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<sup>10</sup> See, for example, World Bank (1990), Bahl (1994), State Tax Bureau (1992), State Tax Bureau (1993), and Xu Shanda et al. (1993).



percent while others paid as little as 5 percent. Collectives and private enterprise were not covered by contracts and faced a much higher effective tax rate. This provided a significant incentive for evasion. There also was the problem that local governments wrote the contracts in ways that led to more enterprise investment in social services and less payment of (shared) income taxes. The result was that the enterprise income tax accounted for only about 15 percent of GNP in 1995, in comparison with 8.2 percent in the first full year of the income tax reform (1985). With the expansion of the contracting system in 1986, the revenue contribution of the SOE sector fell by more than 4 percent of GNP (IMF 1994, 26).

While these features of the enterprise income tax are viewed as problems by the central government; they may be viewed as strengths by subnational governments, especially those in a stronger economic position. Since local governments cannot affect the structure of taxes, they have taken some autonomy by providing special treatments for "preferred" enterprises. This is very much the industrial competition model used by states in the United States. (Meyer and Oshiro 1996). Moreover, provincial governments have found ways to use tax policy to increase the rate of social infrastructure investment by enterprises. This arbitrage may have enhanced service delivery in the local area, but it compromised the central government's revenue take.

Third, the marginal rates of taxation were thought to be too high (Xu Shanda 1995, 1-25). A 55 percent basic rate, a 15 percent energy and transportation fund rate, and a 10 percent SBAF rate, coupled with a wage bonus tax and an adjustment tax, led to very high effective rates that may have dampened incentives for investment by enterprises. The World Bank (1990, annex 2) estimated a marginal effective tax rate of 87 percent for an investment in a fixed asset by a large SOE, financed with retained earnings, assuming a 20 percent inflation rate.

Fourth, loan principal and interest were deductible from the enterprise income tax, even though loan proceeds were not taxed as income. This is at odds with the international practice (which allows only interest cost as a deductible expense) and overstates the true costs of production of the enterprise.

Fifth, other production costs were understated in the Chinese system. In principle, all labor and capital costs that are incurred in producing taxable output should be treated as tax-deductible expenses. In China, there are two significant departures from this rule. Ordinary wages, which are counted as production costs for tax purposes, are only a fraction of total labor costs. Fringe benefits (housing, health care, schools, etc.) and a wage bonus, which the enterprise provides from its after-tax profits, are significant components of employee compensation. Because nonwage compensation is not a tax deductible cost, profits are overstated. The other area where true production costs are understated is depreciation. Chinese practice has allowed only very low depreciation rates, perhaps one-half to one-third of Western country rates for similar assets. No accelerated depreciation is permitted. The depreciation fund<sup>11</sup> was further reduced because the central government's energy and transportation tax and its adjustment tax both applied to the sum of after-tax income and contributors to the depreciation fund. The net result of this practice is to further overstate enterprise profit. High nominal rates exacerbate the problem.

In summary, the enterprise income tax was adjusted in piecemeal ways between 1983 and 1994 to accommodate a wide variety of needs, e.g., protecting central revenues, regulating wage payments and

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<sup>11</sup> In China, contributions to the depreciation fund are required.

investment, and compensating for unfair trading advantages. By the late 1980s, the statutory rate had reached very high levels. The provincial and local government owners of these SOEs used various types of tax incentives, administrative discretion, and the contract mechanism to both control the tax burden on SOEs and retain a greater amount of budgetary and extrabudgetary revenue for local use.

### **The Reform Program**

The central government established four general reform objectives for the enterprise income tax:

- The division of profits between the government and the enterprises is to be determined by the workings of the market and by an objective tax system that is uniformly applied to all enterprises. Other ways of transferring profits between enterprises and government (e.g., contracting) are to be eliminated.
- A more horizontally equitable system is to be created, where all firms are treated the same by the tax system, regardless of ownership. This is to enhance competition and lead to a better allocation of resources.
- Enterprises are to be taxed at rates that are high enough to raise adequate revenue but low enough to give incentives for new investment and more efficient operations.
- The overall rate of revenue mobilization must be increased.

The 1994 reform was more or less true to these objectives. Four major changes were introduced<sup>12</sup>

- The top bracket income tax was reduced from 55 percent to 33 percent. This new structure applies to all domestic enterprises regardless of ownership. At a later time, unification of the income tax for Chinese and foreign enterprises will be considered.
- Surtaxes were eliminated: the income adjustment tax, the energy and transportation contribution, the budget adjustment fund contribution, the extra budgetary construction tax, and the wage bonus taxes. Elimination of these taxes simplifies the administration of the tax system and makes the enterprise income tax more transparent.
- Tax contracting with enterprises was scrapped, except for insurance and banking. Existing contracts would be allowed to expire.
- The practice of allowing SOEs to deduct loan principal repayments from taxable income was eliminated. Only interest expense is now deductible.<sup>13</sup>

Tax reform moved in the direction of a full statement of labor costs in the definition of taxable profits. Enterprises would have preferred that all labor costs be made deductible. It would be to the advantage of profitable enterprises to shift expenditures from "below the line" outlays, such as worker welfare or investment, to deductible status since the "price" would be lower by the amount of the tax rate (33 percent). Because the individual income tax does not apply to most workers, there is no built-in

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<sup>12</sup> A detailed, English-language description of some of the enterprise reforms is in Curley and Fortunato (1995).

<sup>13</sup> The State Council issued a new set of accounting and financial regulations (effective in July of 1993) that govern the operations of enterprises but are not used to define taxable income. Deduction of all interest expense is allowed in the new accounting regulations, but the new tax law does not allow full deduction. The new law specifies two classes of interest expense. If the loan is from a financial institution (bank, insurance company, leasing company approved by the government), interest is fully deductible. If the loan is from a nonfinancial institution (e.g., another enterprise, a nonprofit government unit), interest is deductible up to the rate charged by financial institutions.

resistance to this. The government decided that it was more important to control enterprise decisions about outlays for labor and benefits than to correctly state labor costs, and therefore chose to depart from the more conventional practice by defining a cap on deductible labor costs. Wage and bonus payments (direct labor costs) became deductible, but only up to a limit. Each province is assigned a "standard" wage plus bonus amount, set by the provincial government and approved by the Ministry of Finance (MOF).

With respect to fringe benefits, partial deduction of expenditures for trade union expenditures, worker welfare, and training are allowed according to a centrally determined formula:

- Trade union costs are deductible on a per employee basis up to 2 percent of the "official" base salary. For example, if total base salaries in the enterprise add up to 10 million yuan, 200,000 yuan of total trade union expenses are deductible.
- Welfare costs, which include housing, clinics, etc., are deductible up to 14 percent of base salary.
- Worker training such as technical education will be deductible up to 14 percent of base salary.
- The deduction for charitable contributions is capped at 3 percent of taxable income. All charitable contributions by enterprises must be made through approved intermediaries.
- The new tax law makes an accelerated depreciation schedule available to all enterprises.

### **Indirect Taxes**

Before the 1994 reform, there were three sales taxes in China: product tax, business tax, and value-added tax.<sup>14</sup> The basic structure of these taxes was designed at the time of the switch from a profit remittance system to an enterprise income tax. Since the government did not choose to reform prices at that time, it was decided to use sales tax rates to regulate profits and this became the distinguishing feature of the Chinese sales tax system. By the late 1980s, there were over 250 different tax rates in the indirect tax system. Revenues were shared with the provinces on a derivation basis, with central determination of the retention rate.

The product tax was levied on the total sales value of certain manufactured and imported goods. The base of the tax was the price paid by the buyer, which differs from international practice where the tax base is usually the producer's sale price. The rates varied from 3 percent to 60 percent. During the past decade, the VAT gradually grew in importance as the standard levy on manufactured and imported goods. No commodity was subject to more than one type of sales tax. The VAT rates varied by type of good and remained influenced by the regulation motive. The prereform VAT had 12 rates.

The base of the Chinese VAT was similar to international practice in some respects: exports were zero-rated, and exemptions included agriculture and most services. But it was different in other respects. Exemptions included the construction, transport, communications, wholesale, and retail sectors. Credit was not allowed for tax paid on capital inputs. The method of calculating the base was different from that used for value-added taxation in most countries. Taxes paid on raw materials and most tangible intermediate goods were credited, but credit amounts were established according to presumptive methods rather than invoices.

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<sup>14</sup> For a description of sales taxes in China, see World Bank (1990, 28-34).

The service sector was taxed through a turnover tax referred to as the "business tax." It was levied on gross receipts (gross markup in the case of wholesale). The rates of tax varied from 3 to 10 percent. The agricultural sector was exempt. Enterprises with monthly sales below a specified floor level (the floor level varies by sector) were exempt.

### **Problems with the Prereform System**

Chinese government officials and outside reviewers seemed to agree on the major problems with the prereform indirect tax system (Bahl 1994; Xu Shanda 1995; World Bank 1990; Wong, Heady, and Woo 1995). The first was that it acted as a substitute for the market process and was an impediment to competition and efficient resource allocation. Because tax rates varied so widely, enterprises faced widely different tax burdens and therefore were advantaged or disadvantaged relative to their competition. Such a system of differential rates was no longer necessary for "regulation" of prices. Prices have been decontrolled on most consumer goods; perhaps 70 to 80 percent of prices have been liberalized. Still, the practice of multiple VAT and product tax rates continued up to 1994, even though a simplified rate structure was possible for most goods.

Second, the prereform system introduced a bias against capital investment and against capital-intensive industries. This was because it did not allow a credit for tax paid on capital goods, and it did not allow full credit for taxes paid on the purchase of intermediate services and some raw materials. The former was by regulation and the latter was de facto: because some manufactured goods were subject to the product tax (which is a gross sales tax), because manufactured products subject to the VAT were given credit for taxes on eligible intermediate goods by a presumptive method, and because taxes paid on some intermediate goods were not allowable credits.

A third problem was that certain exporters were disadvantaged by the tax system. Those subject to the product tax were disadvantaged because of tax treatment of inputs, while those subject to the VAT did not always receive full credit for taxes paid on inputs and did not receive credit for taxes paid on capital inputs. This is different from the tax treatment of exporters in most competing nations. Fourth, because the indirect tax system was a mixture of a value-added tax and a turnover tax, it was subject to substantial cascading, which distorted prices and weakened the competitive position of exporters. The World Bank (1990, 186) estimated that the degree of distortion was quite large in some sectors, e.g., the statutory rates for the electricity and heavy chemicals sectors were 5 percent and 10 percent, respectively, but the full tax rates were 10 and 26 percent.

Finally, the system was unduly complicated because of the number of rates and the three separate sales taxes. This compromised administration, raised compliance costs, and made the system difficult to understand.

### **The Reform Program**

The Chinese government describe its objectives for reform of the sales tax system in a number of documents.<sup>15</sup>

- Move the sales tax system away from its role as a "regulating" instrument. This objective directly recognizes the proper role of the sales tax: to raise revenues of adequate amount, in an

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<sup>15</sup> See, for example, Xu Shanda et al. 1993; State Tax Bureau, 1992.

equitable manner, without compromising the government's goals for an economic environment where enterprises compete on a level playing field.

- Simplify the structure of the sales tax system and standardize the treatment of all enterprises (and most products). Departures from the standard treatment should be the exception rather than the norm.
- Structure the sales tax so that its responsiveness to growth in the economy yields the desired rate of revenue growth.

The 1994 reform program addresses these objectives by substantially restructuring the sales tax system.

- The VAT absorbs most sectors now covered under the product tax, and the latter will eventually be phased out. The wholesale and retail sectors are now taxed under the VAT rather than under the business tax. For a few industrial sectors, the product tax remains as an additional excise. These sectors include cigarettes, alcoholic beverages, jewelry, gasoline, and diesel. The justification for these excise taxes is the same as that used in many countries—to discourage luxury consumption and to penalize smoking and drinking.
- Adopt a two-rate system for the VAT. In addition to a standard rate of 17 percent, a low rate of 13 percent is applied to basic foodstuffs and the agricultural sector.
- Switch the base of the VAT to producer price. This will conform to the international practice and will improve the transparency of the tax.
- Eliminate presumptive crediting under the VAT in favor of an invoice method.
- Two standards were set with respect to coverage of small wholesale and retail enterprises under the VAT. They will be subject to the ordinary VAT if they have annual sales above a specified limit or if they can demonstrate competence to comply with VAT regulations. Otherwise, they will be subject to some presumptive levy, much like the present business tax.
- There was no proposal to permit a credit for taxes paid on capital goods. This is primarily because of the short-run revenue cost.

### **Individual Income Tax**

The individual income tax is a relatively small levy in China, accounting for less than 1 percent of total tax revenue in 1992. Revenues are retained by the local government. Until the time of the 1994 reform, there were two separate individual income taxes. The first, a tax on the income of foreign residents in China, was levied according to a progressive rate schedule. The second, the personal income adjustment tax, was the tax on citizens. This tax was levied at a progressive rate, with an exemption level many times greater than the average Chinese wage. About two-thirds of the tax was collected through withholding. The coverage was very narrow; for example, the World Bank (1990, 179) estimated that less than 1 percent of all workers in Beijing were covered in the late 1980s.

The 1994 reform unified the tax on Chinese and foreign residents.<sup>16</sup> It maintained the high exemption of 800 yuan per month for individuals and actual expenses for individually owned businesses. The new law sets three rate schedules. The rates applicable to income from wages and salaries ranges from 5 percent to 45 percent, that on income earned by "individual industrialists and business people" ranges from 5

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<sup>16</sup> The features of the new law are described in "Personal Income Tax Law of the People's Republic of China." See also Curley and Fortunato (1995).

percent to 35 percent, and that on capital income is a flat 20 percent. The tax on wages and salaries is to be collected by withholding, and that on businesses by monthly payment directly to the local tax bureau.

The tax base is so narrow that one could say that for all practical purposes China does not have a personal tax. This provides some measure of justification for not allowing full deduction of labor costs under the enterprise income tax.

### **Tax Administration**

The 1994 reform established separate national and local tax administration services. This is a major national policy change with far-reaching implications. The responsibility of the State Tax Administration (STA) is to collect central and shared taxes. The STA has about 500,000 employees and operates down to the county level. Prior to the 1994 reform, about two-thirds of these employees operated at the lowest level of government, with relatively little central supervision. Consequently, they developed close ties with the local finance offices and with the locally owned enterprises (International Monetary Fund 1994). This led to a kind of collusion that was thought to weaken the position of the central government in revenue sharing (World Bank 1990). Under the reformed system, a separate local tax service operates in each province with responsibility for collection of "local taxes;" including the enterprise income tax on locally owned enterprises, collectives, and private businesses. The local tax service is now part of the local finance departments, and its operations are funded from local resources. The central tax service is responsible for collecting the VAT and all other central or shared taxes. The STA still operates on a regional basis but is independent of the local tax service.

This reform solves a longstanding problem of divided loyalties of the local officers in the STA. There no longer will be a question about the objectives of the tax administration office as regards the choice between full taxation under the law and maximization of retained local revenue. The STA now has every incentive to fully collect the indirect taxes due, since these are the mainstay of the central government revenue structure. The local tax service must decide how it will treat local enterprises under the income tax, but if it chooses to grant preferential treatment, it must absorb whatever revenue costs occur.

Once the direction of the tax reform was established, separate tax administrations became a necessity. The tax reform assigns the revenues from certain taxes to each level of government. Without a corresponding change in tax administration, the national tax service would collect taxes that the local government would fully retain (e.g., income taxes), as well as taxes from which the local government would receive a relatively smaller share (e.g., the VAT). This would compromise the objectives of the tax structure reform. It is not clear that tax assignment and a single national tax administration system could have functioned effectively in China.

This division of responsibility also offers some efficiencies. The indirect taxes in China are national, and they should be assessed and collected in the same manner throughout the country. There is a much greater chance of realizing uniform treatment under a true national tax service than under a decentralized service. A local tax service to collect enterprise income taxes also offers advantages. Local governments are familiar with local enterprises. This enhances their efficiency as assessors and collectors of the enterprise income tax.

There are some problems with this proposal. Some are drawbacks that must be accepted as costs of accomplishing bigger goals, and others are transition issues that must be faced:

- An effective STA requires a monitoring system. One of the great weaknesses of tax administration and tax policy in China is the absence of readily available data that can be used for monitoring. The government needs a management information system that provides data adequate for tracking assessment and collection efficiency, audit, registration, identification of problem areas, making revenue forecasts, and personnel issues.
- A weakness of separate tax administrations is that the audit function for enterprises is separated. At present there is little effective audit of enterprises, and separation of responsibility for enterprise sales and income taxes is not an improvement.
- Separate national and local tax administrations imply duplication of effort and higher cost than a single administration.
- Local administration of the enterprise income tax will not likely lead to a uniform application of the national law. In fact, there likely will be quite diverse treatment. Moreover, local administration of the enterprise income tax almost certainly means doing business in more than one province. This raises a need for some central government regulation.
- The new VAT will subsume the sales taxes paid by most retail and wholesale establishments (now under the business tax). Many would argue that the taxation of this sector is especially suited to the local government sector because of the local familiarity with such establishments and because their operations are generally restricted to the local area.

### **Tax Reform and Intergovernmental Fiscal Structure**

The 1994 tax reform must be judged a success in terms of the usual norms for evaluating a tax structure change. Clearly the horizontal equity of the system is improved with the equalization of enterprise tax burdens. This reform also simplifies the tax structure, thereby making the administrative tasks less difficult and the system more transparent to taxpayers; and it improves the ability of the central government to use taxation as an instrument of macroeconomic policy. The tax system moves toward the neutrality goal in this reform with the elimination of multiple sales tax rates that were designed to influence relative prices, and fairness is improved by eliminating the widespread practice of negotiating tax contracts with individual enterprises.

This set of policy changes should also be evaluated in terms of effects on the intergovernmental fiscal system, since most of the important features of the intergovernmental fiscal system are altered:

- It changed the tax rates and bases; therefore, it changed the local revenue bases.
- It changed the tax-sharing rates between the central and local governments.
- It changed the tax administration system.
- It eliminated the ability of local governments to strike tax "bargains" with their enterprises.

Whenever such sweeping changes in the intergovernmental system are made, a new balance in fiscal power is struck, and both levels of government cannot be winners. For example, this reform can give the central government increased flexibility to use taxation as an instrument of macroeconomic policy, but it can do this only at the expense of further limiting the fiscal autonomy of local governments; or the new system can be more or less equalizing, but this means that some provinces benefit at the expense of others. Normative evaluation of the intergovernmental impacts of the 1994 reform, therefore, depend on whose eyes one looks through.

There are three important ways in which the 1994 tax reform affects the intergovernmental fiscal system. First, it changes the total amount of revenue available for sharing. Second, it reduces the degree of local government autonomy. Third, it alters the equalization of the revenue-sharing system, i.e., the fiscal position of rich versus poor provinces.

### **Resources Available to Local Governments**

The government proceeded with tax reform in the hope that it would be revenue-neutral in the short run, i.e., there would be no revenue loss. Some specific negative revenue effects were expected, *ceteris paribus*, from lowering the top enterprise income tax rate from 55 percent to 33 percent, from eliminating the surtaxes, and from correcting part of the understatement of labor and capital costs in calculating enterprise profits. Another potential revenue loss stems from the switch to the credit invoice method under the VAT. This is a completely different approach to VAT administration and some transition costs would be incurred in the first years of operation.

Other elements of the reform increase revenue. The elimination of contracting increases revenue significantly. For example, if enterprise income tax revenues were to be restored to 1985 levels, relative to GNP, total government tax revenues would be higher by about 6 percent of GNP. Elimination of the loan repayment deduction also has a positive impact on enterprise income tax. The World Bank (1990) estimated the revenue cost of the loan repayment deduction to be equivalent to about 3 percent of total revenue in 1986.

The long-run revenue consequences of the reform are likely to be significant. The VAT is a more efficient revenue-raising instrument than the product tax, in that it reaches a much greater number of transactions and it has a self-policing component. If the administration of the Chinese sales tax was deficient, the shift to a credit invoice VAT could bring significantly greater long-run revenue growth than the present system. Wong, Heady, and Woo (1995, 52), however, point out that the buoyancy of the Chinese VAT in the prereform period was low relative to that in other countries. The elasticity of the income tax also could increase because the incentives for locals to offer preferential income tax relief have been removed. Moreover, the local governments have an intimate familiarity with local enterprises and can enhance the efficiency of local collections. Central and local governments both could benefit from increased revenue mobilization. Local governments could benefit in two ways. First, they retain all income tax revenues. Second, higher VAT revenues increase the pool available for tax sharing and for earmarked grants. Whether local governments actually would benefit from an increased revenue pool depends on the willingness of the central government to allocate more resources to the subnational level.

There are other aspects of this reform that may cause local governments revenues to be diminished. The more income-elastic VAT was assigned fully to the central government. Revenues from the VAT are now shared with local governments, but this seems to be a transition measure, and in the long run, derivation-based VAT sharing may be phased out. The reform assigns all income taxes to the local governments. If the long-run elasticity of the income taxes is less than that of the VAT, and surely it will be, then the relative growth potential of local government taxes will be less. Moreover, the enterprise income tax is less stable over the business cycle, hence local government revenue streams will become less certain.

### **Local Government Autonomy**



The 1994 reform did not give local governments increased autonomy in taxation. The power to set rates and define bases for all taxes remains with the central government. In the past, local governments exercised autonomy by using "back door" approaches such as providing preferential tax treatments in return for infrastructure investment or pursuing an industrial policy.

The 1994 reform eliminated the practice of enterprise tax contracts with local governments. There is no question but that this is good tax policy. Tax burdens had varied widely depending on whether an enterprise had a contract, the type of contract written, and the financial position of the local government that wrote the contract. The elimination of contracting substitutes a transparent tax system for a negotiated one and places all enterprises on a more equal footing.

However much this measure improves the functioning of the economy, it does reduce the fiscal discretion of local governments. Local governments in China had made the granting of tax incentives an integral part of their industrial policy. Moreover, they had used a combination of tax incentives and discretion in matters of tax administration to leverage more social overhead investment by enterprises. This was done largely at the expense of the central government because these actions reduced the level of revenues transferred to the central government. The elimination of these preferential, discretionary tax treatments was necessary for macroeconomic purposes, but they clearly strengthened the centralization of the fiscal system.

The changes in the tax administration system may also have a centralizing effect. Local governments now collect only income taxes and the smaller "local taxes" and no longer exert control over the assessment, collection, and audit of the VAT. An important component of local government discretion in tax administration is thus eliminated.

### **Equalization**

There are significant fiscal disparities among the Chinese provinces. The five highest-income provinces account for 10 percent of the population, 18 percent of the national income, and 19 percent of revenue collections. The net impact of tax sharing and earmarked grants is to exacerbate the fiscal disparities among provinces (Bahl 1994). There is also a significant urban-rural inequality that is widened significantly by government tax subsidy policy (Khan et al. 1993, 33-35).

An unintended effect of the fiscal reform of 1994 is the potential widening of the fiscal disparities among provinces. By giving the local government all revenues raised from income taxes, on a derivation basis, the central government has given an advantage to the higher-income provinces with more profitable enterprises. And by giving local governments responsibility for collecting these taxes, advantage has been given to the provinces that have the wherewithal to mount better administrative efforts. Again, these are likely to be the better-off provinces.

This does not mean that fiscal disparities will automatically increase, because the central government still may take discretionary action to equalize the revenue yield among provinces. For example, it may distribute earmarked grants on an equalizing basis or it may define a pool of funds from VAT collections for distribution on an equalizing basis. However, at the present time, there is no formula-based equalization grant system in China (Bahl and Wallich 1992).

### **Next Steps in the Reform**

Since 1983, tax structure reform in China has proceeded in increments, each change building on the last. The 1994 reform was more comprehensive, but there remains an unfinished agenda. Most of these future changes will have important implications for the intergovernmental fiscal system.

### *The Assignment of Taxes*

China seems to be moving toward a revenue assignment system, but as is always the case with fiscal reform in China, the movement is gradual and partial, and with significant experimentation. The 1994 reform took two major steps in the direction of assignment: revenues from the income tax were fully assigned to local governments, and responsibility for administration of income taxes and the VAT was clearly assigned to the local and central governments, respectively. There is not yet a movement toward assigning responsibility for even partial rate-setting powers to the local governments.

In general, the Chinese reform introduced appropriate tax assignment. The VAT is properly a central government revenue source. This is an inappropriate tax for local government administration, and certainly it would be inappropriate to allow differential VAT rates and bases within China. It is also inappropriate to share the proceeds from this tax on a derivation basis, as is now done. If provincial and local governments retain a portion of what is collected within their boundaries, they have an incentive to adjust economic and tax policies to encourage local industry to "buy and produce locally." These protectionist-type industrial policies may take the form of lower rates of VAT provided through contracts, special tax preferences, or discretion in tax administration. There is evidence that the provincial government has aggressively used the VAT in this way in the past (International Monetary Fund 1994). During the transition period, the VAT is still shared with the provincial governments. By the use of a "hold-harmless" formula, a portion of the VAT collected in the province (about 25 percent) is retained. It is necessary that this sharing end with the VAT being fully allocated to central government purposes. If the VAT reverts fully to the center, some adjustment in the local revenue structure will be necessary. Among the options are a more revenue-productive individual income tax and allocation of a portion of the VAT to a revenue-sharing pool, with distribution on a formula basis.

Revenues from the individual income tax and administrative responsibility for this tax have been given to the local governments. This is in keeping with the best principles of taxation. The burden of the individual income tax is likely borne in the local area, approximately in correspondence with the expenditure benefits that its revenues finance. Moreover, the local government and its tax administration are familiar with the economic situation of the local enterprises that withhold the tax, and collection efficiency is likely to be enhanced by local administration.<sup>17</sup> There are, of course, income redistribution objectives for individual income taxation that are not a proper responsibility of local governments. This suggests that a proper assignment of individual income taxes in the future might take the form of a shared central- local base with local governments given the power to choose a tax rate within some limits. As the individual income tax begins to grow in importance in the next few years, the advantages of tax base sharing as a policy option will almost certainly be visited.

International opinion is more divided about the efficacy of local government income taxes on enterprises. Under the current system in China, this is the centerpiece of local government revenues. Each province is entitled to collections arising within its boundaries. But as the Chinese economy

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<sup>17</sup> The Russian federal system also assigns individual income tax revenues to the local governments. Individual income taxes in Russia account for about 10 percent of total national revenues. (Bahl and Wallace 1994).

develops and enterprises operate in many provinces-as comparative advantage tells us they should-the problem of allocating profits among the provinces will appear. The United States has learned well the great problems that come with trying to prorate the net income of national companies across state boundaries (McClure 1981; Fisher 1993). Other problems with a local government enterprise income tax are no less worrisome: the tax base (profits) is cyclically unstable, and local revenues can be significantly affected by changes in central government tax or industrial policy.

### *Tax Structure Changes*

Because all tax structure decisions rest with the central government, discretionary changes taken for reasons of macroeconomic policy may have significant effects on the revenue position of local governments. Under the revenue assignment arrangements of the new system, the central government is immune to any revenue consequences of income tax revisions. This disconnection between the power to enact structural changes and the responsibility for dealing with the revenue consequences of these changes is one of the major problems with the Chinese intergovernmental fiscal system.

There are two probable changes to the enterprise income tax structure that will have important implications for local government revenues. The central government may decide to further accelerate depreciation allowances for enterprises and to allow something more akin to a full labor cost deduction.<sup>18</sup>

These measures imply a revenue loss to the local governments. The central government might also decide to lower the deduction on the individual income tax and broaden the coverage of the tax. This would raise significant revenue for the local government sector and would be a reasonable approach to replacing the lost revenue from the VAT.

In the near future, the VAT will likely be reformed in important ways. The 1994 reform did not allow credit for taxes paid on capital goods, nor did it extend the VAT to most services. Both measures are on the reform agenda (Ministry of Finance 1996). Extending the credit to capital inputs implies a significant revenue loss, and bringing services into the base would increase revenues. The net impact on the local government revenue position depends on the specifics of the structural reform.

Although the VAT is a central government levy, changes would have important revenue implications for the local governments. First, if the total yield on the VAT increases or decreases, the amount available for overall revenue sharing likewise increases or decreases. Data available for VAT collections in the postreform era do not enable an estimate of change in the underlying elasticity of the system. Second, the local urban construction and maintenance tax is a fixed percentage of VAT liability, hence an increase in VAT revenues would directly increase the revenues of local governments. Third, the expansion of the VAT to services could reduce revenues from the local business tax, which is raised largely from services.

### *Equalization Grants*

As noted above, there are significant disparities in taxable capacity among the Chinese provinces. The prereform system of shared taxes and earmarked grants did not markedly reduce these disparities; neither will the reformed system. In fact, with the assignment of income tax revenues to local

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<sup>18</sup> These possibilities are mentioned in a recent discussion paper on next steps in Chinese tax reform (Ministry of Finance 1996).

governments, fiscal disparities will increase because of the relatively small income tax base of poor provinces. If the individual income tax is strengthened as a local government revenue source, these disparities could increase even further. The two remaining major sources of local government revenues- earmarked grants and the shared VAT-are not allocated on an equalizing basis. The VAT is shared on a derivation basis, hence is not equalizing, and Bahl (1994) has shown that the ad hoc earmarked grants similarly do not contribute to equalization. Only the hold-harmless provision under the transition revenue-sharing system is equalizing with a bias toward higher-income provinces.

A necessary and likely reform is the establishment of an equalizing grant system. The best approach is a revenue-sharing pool from VAT with proceeds allocated among provinces according to the inverse of provincial income.

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