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978-1-108-81215-3 — The Administrative Foundations of the Chinese Fiscal State
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Introduction

China's staggering economic growth in the past forty years is one of the most fascinating and important stories of social change in recent world history. Social scientists from around the globe have produced vast literatures to explore the story's countless dimensions. Invariably, the government's actions lie at the center of the narratives that emerge. The Chinese state nurtured the early growth of private entrepreneurship in township and village enterprises. It made dazzling investments in infrastructure projects and is responsible for a model of investment-led economic growth that dominates to the present day. It has tried, although with various degrees of success, to either build or revamp gigantic systems of public education and public health, of old age, medical, and unemployment insurance, and of poverty assistance. China has, of course, also expanded its military power and foreign operations. To do all these and many other things, the Chinese government has had to accumulate and deploy vast amounts of social resources. Certainly, it has done so partly by exercising control over the nation's banking sector, manipulating its capital markets, and owning large quantities of productive assets through state-owned enterprises. Yet these forms of state ownership and state control are dwarfed by the government's most important access to social resources: the power of taxation.

Taxation is not only an integral part of the story of China's breathtaking economic rise. It is also, in many ways, an astonishing story in itself. During the 1990s and early 2000s, China's ratio of tax revenue to gross domestic product (GDP) – which public finance specialists call the "gross tax ratio" – recovered from a low of 10 percent to over 20 percent (Figure 0.1). In terms of this ratio, China now easily surpasses many other countries (such as Taiwan, Malaysia, and Mexico) that have been classified as middle income for longer periods. Indeed, China's capacity for taxation is comparable to that of numerous high-income countries such as Chile and Ireland, and not far behind that of the United States. For all but a couple of years since 1997, tax revenue grew at annual rates even higher than the country's already-high

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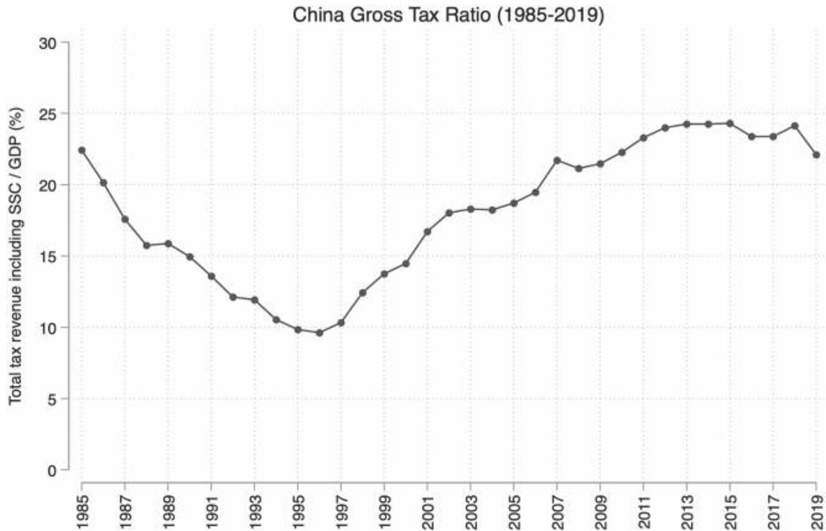

Figure 0.1 Evolution of tax-to-GDP ratio in China, 1985–2019

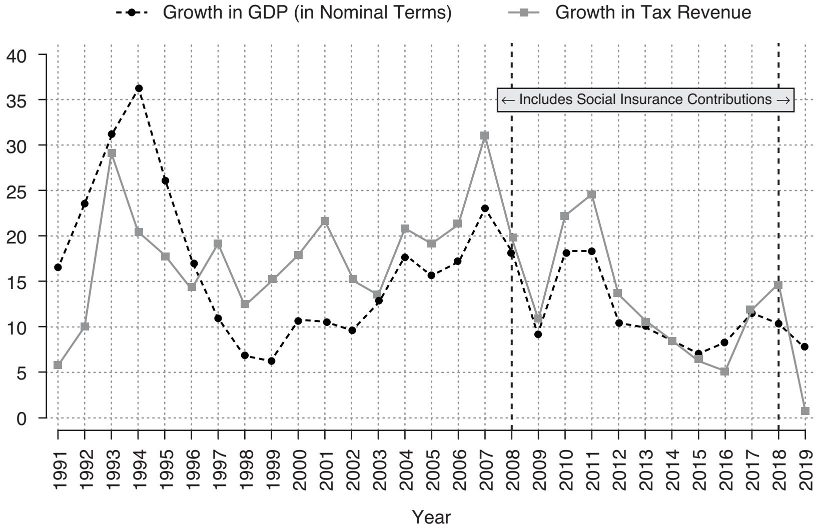

Figure 0.2 Growth of GDP and tax revenue in China, 1991–2019

rates of GDP growth (Figure 0.2). In recent years, this has allowed the Chinese government to adopt many tax cuts – even though prior to these cuts, China had neither adopted higher tax rates, nor imposed them on larger tax bases, nor used a larger variety of taxes, than is normal from

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a comparative perspective. If strong tax collection has not dampened China's spectacular economic progress in the past, the power of cutting taxes to stimulate future growth in China appears formidable.

Despite the unquestionable centrality of taxation to the modern Chinese state, and notwithstanding many of the unusual features and outcomes of China's tax institutions that deserve careful study, Chinese taxation has received very limited social scientific attention. The number of scholarly books and articles on Chinese taxation, even cumulated over thirty years, is small. Topics like China's state-owned enterprises, banking sector, and capital markets have received more extensive coverage in the social scientific literature. Notably, the lack of knowledge about Chinese taxation is not confined to the general public, news media, and public commentaries, but also characterizes the economics profession (in and outside of China), legal scholarship, and other social scientific disciplines.[1]

This book offers an account of certain foundational aspects of China's contemporary tax system. The book has two basic aims. The first is to answer the question: What aspects of Chinese taxation might be of general interest to policy makers and social scientists in other countries? In particular, I will explain what policy makers, administrators, and international organizations helping poor countries build their tax systems might learn from the Chinese experience. There are many lessons to be drawn, although they are quite different from what social scientists or international organizations providing technical assistance have previously emphasized. The book also seeks to provide new ideas to social scientists who do not study China in particular, but who are interested in identifying the determinants of fiscal capacity of modern states in both developing and developed countries.

[1] Indeed, an accurate and nuanced understanding of the Chinese tax system has been difficult to assemble even among tax specialists. International organizations such as the International Monetary Fund (IMF), the Organisation for Economic Cooperation and Development (OECD), the World Bank, and United National Development Program (UNDP), specialize in technical assistance in tax matters to developing countries. Their tax specialists usually have the capacity to see through countries' tax systems – often designing them themselves – and therefore characterize such systems in easily accessible terms. Yet although many of these organizations have been sending missions and training personnel to China for decades, they also offer inadequate information about China's tax system. For some such sources of information, see Lou and Wang 2008 (the most recent anthology on Chinese public finance published by the World Bank), Brys et al. 2013 (the most recent survey of Chinese tax policy by the OECD Center for Tax Policy and Administration), Brondolo and Zhang 2016 (a recent survey specifically dedicated to Chinese tax administration offered by the IMF Fiscal Affairs Department), and IMF 2018 (a report on a recent tax policy mission to China).

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Second, for readers who are more interested in China for its own sake, the book sketches out a framework for understanding the policies and politics of taxation in China. The framework is new, rather than a synthesis of existing narratives. I believe that given China's economic and political power, the understanding of Chinese taxation should no longer be left to the unfortunate combination of academic neglect, desultory media coverage, and Chinese government propaganda. Indeed, the book will seek to dispel many myths about Chinese taxation and highlight the inadequacy of much conventional wisdom.

Because of these two aims – to identify what might be generalizable about the Chinese experience and to delineate a new framework for both public policy debate and further academic research about Chinese taxation – the approach I take in this book is highly selective. I will focus on arguments and explanations, rather than descriptions of the endless facets of Chinese taxation. While I do lay out substantial and previously unknown details about the Chinese tax system, I will also omit many others.

In fact, it is critical to state, at the outset, a single choice that I made in writing this book that fundamentally shapes the scope of its discussion. I anchor my study of Chinese taxation in analyses of an often-neglected set of institutions: those that organize grassroots tax administration. I argue that ground-level tax administration is the key to understanding the entire edifice of China's tax system. Therefore, more than half of the book is about tax administration, while the remainder explores what light tax administration sheds on China's tax policymaking process, recent tax policy choices and debates, and the politics of taxation.

To describe any country's tax system from the perspective of its tax administration is unusual. Consider the United States' Internal Revenue Service (IRS). For most Americans, and indeed for many people around the world, the IRS symbolizes the governmental power to tax. Yet I suspect that very few scholars would be inclined to present an overview of the US federal tax system by putting the IRS at the center. For one, the enactment of tax laws by the Presidents and Congresses of the United States seems far more important. Both the politics and the substance of these enactments occupy most of the attention of businesses, policy analysts, lawyers, economists, and political scientists. Further, understanding the economic and social consequences of US tax policies requires careful research. These seem intellectually far more significant than how the IRS administers tax policies on a routine basis and how taxpayers file returns and send checks to the IRS. What, then, can one

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expect from a book that describes Chinese taxation chiefly from the perspective of tax administration?

In the rest of this Introduction, I lay out the main arguments of the book by answering this last question.

China as an Alternative Paradigm in Revenue Mobilization

From a social scientific perspective, initially the most significant aspect of China's tax system is its success in raising revenue. In the past two decades, social scientists have offered extensive and compelling evidence that a government's capacity to provide law and order as well as other public goods – financed by taxation – is vital for economic development. Tax collection has come to be seen as a most fundamental aspect of modern "state capacity."[2] China's success at "revenue mobilization" reflects a strong and fundamental form of state capacity. For developing countries seeking to replicate China's economic success, it is necessary to understand how China built this capacity, as well as the potential costs and negative consequences of China's approach in building state capacity.

Specialists writing about taxation in developing countries have long emphasized the first-order importance of tax administration.[3] In poor countries, tax policy design plays second fiddle to tax administration: a strong tax administration can make any number of policy instruments roughly effective, while a weak tax administration severely limits the effectiveness of most policy instruments. More recently, political and developmental economists have tried to go beyond this pragmatic wisdom, rigorously analyzing the factors that determine the success of tax administration. As a result of this research agenda, economic research on tax administration has mushroomed into a thriving field. However, my own efforts at understanding Chinese tax administration have taught me that, collectively, we still have few useful hypotheses about tax administration in developing countries. Because of this, the claim that tax administration lies at the core of state capacity can appear, to a skeptic, either a vaguely defined truism or simply an article of faith among some researchers.

A few limitations in existing economic research on tax administration are especially relevant for this book.[4] Most notably, researchers have poured considerable analytical resources into a very small set of conjectures. For

[2] Burgess and Stern 1993; Besley and Persson 2013; Keen 2013; Bardhan 2016.
[3] Slemrod 1990; Gordon and Li 2009; Gordon 2010; Bird and Martinez-Vazquez 2014.
[4] I further elaborate on the following arguments in Chapter 8, where I discuss the general implications of the book's findings for developing countries.

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instance, one prominent idea in the literature surmises that because third-party information reporting will curtail tax evasion, developing countries should more widely adopt and strengthen such reporting mechanisms.[5] Another theory is that tax collectors need to be effectively incentivized.[6] But while the empirical evidence generated to support these conjectures is impressive, the conjectures themselves seem inadequate. For one, do we know that developing countries are particularly bad at implementing information reporting, or at incentivizing their civil servants? Suppose they worked hard to improve their tax administration along these dimensions, will their tax systems come to resemble those of the developed countries? There is actually abundant evidence that developing countries have generally adopted information reporting and civil servant incentives just as extensively as developed countries. If they put greater emphasis on these aspects of tax administration, they may or may not collect more tax revenue, but they will certainly become *more different* from developed countries. This is because developed countries do not rely on manipulating the incentives of their tax collectors for raising revenue. They also rely on information reporting to a much lesser extent than some researchers have claimed.

It is tempting to respond to this first criticism by saying that, of course, information reporting and incentivizing tax collectors are not the only things that developing countries need to do to strengthen tax administration. They must boost taxpayer morale,[7] enhance their audit capacity and therefore the credibility of audits as a form of deterrence,[8] and pursue other improvements as well. This type of response threatens to blur the vision of empirical inquiry, sending us back to the traditional advice given by international organizations to developing countries about "best practices" in tax administration.[9] In other words, the question of how to build state capacity remains unanswered; it is simply tautological to say that if developed countries become "more like us" by adopting all of the recommended best practices in developed countries, they will acquire the state capacity that typifies developed countries. How do they get to there from where they are now?

In writing this book, I learned that because there is a paucity of useful conjectures in existing scholarship, the process of carefully describing tax

[5] See, for example, Pomeranz 2015; Kleven et al. 2016; Naritomi 2019.
[6] Khan et al. 2016, 2019; Finan et al. 2017.
[7] OECD 2013; Luttmer and Singhal 2014.
[8] Carrillo et al. 2017; Brockmeyer et al. 2019.
[9] My point is not that such advice is not valuable, but instead that they cannot substitute for social scientific understanding.

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administration is not a matter of mechanically sorting through obscure facts. Instead, new concepts need to be invented; intellectual discoveries may emerge. I believe the discoveries from studying Chinese tax administration can substantially enrich the range of social scientific hypotheses that can be fruitfully tested in studying tax and development generally.

I would summarize these discoveries in terms of three related *trade-offs* faced by tax administrators in many parts of the developing world. The notion of trade-offs is critical. The compliance environment in poor and even middle-income countries like China is quite different from the compliance environment in rich countries like the United States and Canada. In the former, there are many more small or micro firms and many workers laboring in informal jobs, for whom complying with tax and other regulations is often not the best choice. In such an environment, tax administrators cannot follow the same approach to administration as their counterparts in richer countries; instead, they must make some difficult choices. The distinctiveness of Chinese tax administration can be defined in terms of choices regarding the following three trade-offs.

The first is how much government and society value the norm of truthful reporting. Because tax administration is such a multifaceted exercise, enforcing the norm of truthful reporting is not necessarily the most effective way of raising revenue in many circumstances. One can adopt other administrative tactics that advance the objective of revenue raising at least as effectively. This means that there can be a trade-off *between raising revenue and enforcing the norm of truthful reporting*. On closer scrutiny, Chinese tax collectors put much less value on truthful reporting than on ensuring taxpayer registration and tax payments. To put it bluntly, taxpayers who lie on their tax returns mostly go unpunished. However, Chinese practice also highlights the surprising sustainability of approaches that de-emphasize truthful reporting.

Describing this form of administrative practice turns out to be challenging. In the professional vocabularies of public economics, accounting, and tax law that have international currency, as well as in the policy advice routinely dispensed to developing countries by organizations, certain basic elements in the experiences of taxation in developed countries are taken for granted. The norm of truthful reporting is a central example. Not only do we value compliance with that norm, the very language we use for discussing tax administration also assumes that norm. The notion of a tax audit, for example, is widely taken to be universally applicable. That notion, however, makes sense only when describing the enforcement of the norm of truthful reporting. When applied to contexts where such norm is secondary, it

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quickly loses accuracy. Studying the Chinese case reveals basic assumptions in the very vocabulary we use to discuss tax administration. Once a more reflective vocabulary is developed, the contrast between tax collection practices that rely on the norm of truthful reporting and those that do not becomes very stark.

Because of the de-emphasis on norms of truthful reporting, Chinese tax administrators engage in a second trade-off. They devote much of their time to taxpayer registration. This sharply reduces what might be called "firm informality" in the Chinese economy, as most business firms now show up on the government's radar. At the same time, many practices typical of the informal economies elsewhere in the world remain: informal work arrangements, under-reporting of sales and profits, and dodging of regulatory requirements. The economist Gabriel Ulyssea calls this latter form of informality "labor informality." Chinese tax administration thus illustrates a trade-off between reducing firm and labor informality, or between enforcement along the extensive and along the intensive margins of formality. The Chinese choice is to enforce the extensive margin of formality. This choice goes a long way in explaining the character of Chinese tax collection.

Third and finally, Chinese tax administration has heavily invested in incentivizing civil servants – including grassroots tax collectors, senior managers at tax bureaus, and local politicians – in tax collection. Indeed, in tax administration and elsewhere, China offers a paradigm for providing incentives to civil servants. Interestingly, the intense incentives structures faced by Chinese tax administrators both engender and reinforce practices that de-emphasize the norm of truthful reporting. This is because compliance with the norm of truthful reporting lies largely beyond the control of tax administrators, and depends on many other social institutions that either reward or create indifference to compliance with the law. To effectively incentivize civil servants, one must forego emphasizing goals that lie beyond their control. This, I will argue, has led to a trade-off between incentivizing civil servants in tax collection and incentivizing taxpayers (especially business firms) in self-assessment.

These three trade-offs have rarely been recognized in mainstream scholarship and policy discourse on tax administration in developing countries.[10] Insofar as China's choices with respect to these trade-offs

[10] The first trade-off, between raising revenue and enforcing the norm of truthful reporting, is recognized in the analysis of auditor incentives offered by Di Porto et al. 2013. While

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differ from choices familiar in developed countries, it represents an alternative archetype in revenue collection. To illustrate how these trade-offs shed light on building tax capacity in the developing world, consider a few seemingly unrelated examples, from recent economic research.

In the past few years, the economist Jonathan Weigel has run a number of elaborately designed experiments on tax collection and political participation in the Democratic Republic of the Congo.[11] Weigel describes Congo as a country with very low capacity for tax collection. In one of his experiments, a property tax collection campaign was launched across neighborhoods in the city of Kananga in 2016. Prior to the collection campaign, the level of compliance with the tax in question was essentially zero. In the experiment, some randomly selected neighborhoods received a particular "treatment": tax collectors went door-to-door collecting taxes. The remaining neighborhoods, representing the "control group," stayed in the old system where citizens pay at the bank themselves.

What was the outcome of the campaign? It raised property tax compliance from 0.1 percent (observed in the control group) to 10.3 percent (observed in the treatment group). That surely is an increase. But it also means that even when showing up at the doors of taxpayers, Congolese tax collectors came away empty handed *90 percent of the time*. Weigel reports that certain groups of people (e.g. wealthy, male, educated, and employed) were more likely to pay tax to the collectors, but such greater likelihood seemed only statistically, but not economically, significant. According to Weigel, the program did not even appear to increase bribes to tax collectors. It is hard to imagine how this could be anything but a thoroughly demoralizing experience for the tax collectors.[12]

the distinction between the extensive and intensive margins of informality is introduced by Ulyssea 2018, he does not discuss choosing among these margins for enforcement. The contrast between incentivizing civil servants and incentivizing businesses, to my knowledge, has not previously been drawn.

[11] Weigel 2020. Weigel's experimental method – the randomized controlled trial or RCT – won three of its original proponents the Economics Nobel Prize in 2019.

[12] This was not the focus of Weigel's study. Instead, in the second stage of his experiment, Kananga citizens were given opportunities to attend town hall meetings in which taxation and public spending were discussed, and to submit anonymous evaluations of the government. Weigel found that citizens from the treated neighborhoods – those who had tax collectors knocking on their doors – were more likely to pursue either or both types of political engagement. Interestingly, those individuals who refused to pay any tax to the tax collectors were just as likely to show up at the town hall meetings as those who actually paid. Weigel's interpretation of these results is that the tax campaign sent a signal of state capacity that raised the expected benefits of participation.

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Like many other randomized control trials (RCTs) recently carried out in developing countries, Weigel's experiment has a clockwork-like quality: it has many components, each delivering precise formulations about what might have motivated real-world individuals to act. However, it is important to highlight some background features of Weigel's study that might otherwise escape notice. The first observation may seem obvious: the tax collection capacity of the world's rich countries today does not generally depend on knocking on taxpayer's doors. Business firms remit most of the tax revenue directly to the government – whether in the form of business taxes like the corporate income tax (CIT) or the value-added tax (VAT), or in the form of withholding on wage and financial payments to individuals. Because of this, we simply do not know what would happen if the IRS (or the Canadian Revenue Service) sent officers door-to-door to collect taxes from American (or Canadian) taxpayers.[13]

This shows that when researchers talk about "state capacity," they are often using a very abstract notion. In the Congo, it means door-to-door tax collection, while in developed countries, it means making sure – or doing whatever is compatible with the expectation – that most taxpayers will file tax returns and remit taxes without direct government prompting.[14]

Is there something wrong with this way of talking? Here, we can make the second observation regarding Weigel's study. State capacity can vary substantially in respect of specific mechanisms, and not just outcomes. It is possible for much stronger state capacity than is observed in the Congo to take the form of door-to-door tax collection. As we will see in this book, tax collection in China has a strong door-to-door flavor. Tax collectors routinely visit taxpayers, and tax bureau offices where payments can be made are always nearby. However, in contrast to the discouraging outcomes in the Congo, tax administrators across China have reported – for two decades now – rates of timely tax return filings of over 95 percent, and similarly high rates of timely tax payments.[15] Imagine dialing up the compliance rate in Kananga from 10 percent to

[13] Or actually, we could know, but only by learning about a thoroughly different and unfamiliar world of tax collection in nineteenth century America. See Hickman and Kerska 2017.

[14] Perhaps by "state capacity," scholars are merely talking about outcomes (i.e. how much tax is collected), not mechanisms (i.e. how tax is collected). But this would render the question, "How do we build state capacity to achieve the goal of raising more revenue?" tautological.

[15] These facts are detailed in Chapters 3 and 5.

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