Issues & Studies© 45, no. 2 (June 2009): 159-183.

Informal Tax Competition among Local Governments in China since the 1994 Tax Reforms*

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This paper shows that tax competition among local governments in China takes place through informal means. One common form of informal tax competition in China is the tax refund: local governments compete for investment by offering to return a portion of tax receipts to firms. Through tax refunds, a considerable portion of reported local tax revenue has been returned to taxpayers' pockets. The prevalence of tax refunds suggests that the amount of tax revenue that local governments can use for public expenditure is much smaller than local tax collection data suggests. This study argues that the career interests of local political leaders are an important factor in determining the degree of tax competition. In China, the career advancement of local political leaders depends on their achievements in the cadre evaluation system. As the cadre evaluation system prioritizes the attraction of investment, local officials have strong career incentives to offer tax incentives in order to attract investment.

KEYWORDS: **tax competition; China; local government; tax reform; informality.**

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*The author is grateful for the financial support for this research from Ajou University. She would also like to thank Professors Lynn White III, Eric Thun, and Evan S. Lieberman for their comments.

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論 Fiscal decentralization is a fervently debated issue. While advocates argue that it is beneficial for economic prosperity because it constrains tax collection,[1] critics claim that it undermines the capacity of the government to deliver public goods.[2] Both sides agree that fiscal decentralization unleashes tax competition among local governments. The logic is simple. Under a fiscally decentralized system in which taxes paid by firms flow into local coffers, local governments have an incentive to offer lower tax rates in order to attract investment. Furthermore, if one region adopts a lower tax rate, other regions are motivated to follow suit so as not to lose out in the competition for investment. Therefore, it is expected that fiscal decentralization will lead to lower tax rates across regions.

Fiscal decentralization, however, does not necessarily lead to tax competition. Empirical studies suggest that two factors lessen the effects of fiscal decentralization on tax competition. First, the revenue needs of local governments could deter them from lowering tax rates on capital.[3] Hallerberg found that in Wilhelmine Germany (1890-1914) the tax rates of regional governments on capital increased after tax decentralization. Hallerberg attributes this to the increased revenue needs of regional governments due to the national government's demand for more tax con-

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[1]See Geoffrey Brennan and James M. Buchanan, *The Power to Tax: Analytical Foundations of a Fiscal Constitution* (Cambridge: Cambridge University Press, 1980); Barry R. Weingast, Yingyi Qian, and Gabriella Montinola, "Federalism, Chinese Style: The Political Basis for Economic Success," *World Politics* 48, no. 1 (October 1995): 50-81; and Barry R. Weingast, "The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Growth," *Journal of Law, Economics, and Organization* 11 (Spring 1995): 1-31.

[2]Richard A. Musgrave, "Devolution, Grants, and Fiscal Competition," *The Journal of Economic Perspectives* 11, no. 4 (Autumn 1997): 65-72; Wallace E. Oates, *The Political Economy of Fiscal Federalism* (Toronto: Lexington Books, 1977); and Rémy Prud'homme, "The Dangers of Decentralization," *The World Bank Research Observer* 10, no. 2 (1995): 201-21.

[3]In the context of international tax competition, Swank and Steinmo point out similar dynamics. They argue that mounting revenue needs of states prevent them from engaging in tax competition. See Duane Swank and Sven Steinmo, "The New Political Economy of Taxation in Advanced Capitalist Democracies," *American Journal of Political Science* 46, no. 3 (July 2002): 642-55.

tributions from the regions.[4] Second, regional disparity could dampen tax competition. In the context of international tax competition, studies show that wealthy countries can afford not to offer preferential tax treatment because they can offer first-class infrastructure, high-quality human resources, and large markets to attract investment.[5]

From the perspective of these studies, the Chinese case since 1994 is an anomaly. Despite the presence of two factors expected to dampen tax competition, local tax competition is intense in China. First, the 1994 tax reform in China increased the revenue needs of local governments. The share of total national revenues received by local governments decreased from above 70 percent in the years before the reform to below 50 percent afterward, without any reduction in expenditure responsibilities.[6] Although the central government returns a portion of centrally collected revenues to local governments through fiscal transfer, local governments complain that the 1994 tax reforms undermined local fiscal conditions. With less tax revenue available to meet heavy expenditure obligations, local governments were expected to increase tax generation efforts. Second, China has a huge regional disparity in local government revenues. Contrary to expectation, wealthy regions are the most active in tax competition. This paper seeks to discover why this is the case.

This study argues that the career interests of local political leaders constitute an important factor determining the degree of tax competition.

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[4]Mark Hallerberg, "Tax Competition in Wilhelmine Germany and Its Implications for the European Union," *World Politics* 48, no. 3 (April 1996): 324-57.

[5]Desai and Mutti emphasize the critical role played by affluent countries in dampening tax competition across countries. Major capital-exporting countries, such as the United States, Japan, and the United Kingdom, impose corporate income tax on worldwide income while at the same time offering foreign tax credits. Accordingly, multinational firms are not discouraged from paying taxes to host countries as long as host countries' tax rates are lower than those of the home countries. See Mihir A. Desai, "Are We Racing to the Bottom? Evidence on the Dynamics of International Tax Competition" (Paper presented at the Proceedings of the 91st Annual Conference on Taxation, Washington, D.C., 1999); and John H. Mutti, *Foreign Direct Investment and Tax Competition* (Washington, D.C.: Institute for International Economics, 2003).

[6]Organization for Economic Cooperation and Development (OECD), *Challenges for China's Public Spending: Toward Greater Effectiveness and Equity* (Paris: OECD, 2006); and the World Bank, *China. National Development and Sub-National Finance: A Review of Provincial Expenditure* (Washington, D.C.: The World Bank, 2002).

In China, the career advancement of local political leaders depends on their achievements in the cadre evaluation system. As this system prioritizes the attraction of investment, local officials have strong career incentives to offer tax incentives in order to attract investment.

Tax competition among local governments in China takes place through informal means. Local governments do not have the authority to set local tax rates, only the central government does. Furthermore, since the 1994 tax reforms, local governments no longer have the authority to grant tax breaks. Thus, in theory local tax competition, meaning the lowering of tax rates to attract investment, is not possible in China.[7] In reality, however, informal tax competition—through preferential tax treatment outside the realm of formal rules—is intense among local governments.

This study identifies four forms of preferential tax treatments: (1) tax refunds (先徵後返, *xian zheng hou fan*); (2) tax drawing (拉稅, *la shui*), which involves local governments inducing firms outside their districts to register with their tax bureau; (3) exploitation of preferential tax policies allowed by the central government; and (4) lax tax enforcement.

This study draws on field research I conducted in China and Hong Kong in 2003 and 2004. I interviewed eighteen officials working in local taxation and finance bureaus; thirty managers, owners, and accountants of firms; and nine local scholars in four coastal provinces (Zhejiang 浙江省, Shanghai 上海市, Jiangsu 江蘇省, and Guangdong 廣東省). I then conducted follow-up field research in 2008, interviewing a dozen local officials in Zhejiang. The interviews helped me understand the importance of informal tax practices. Newspapers and magazines published by the taxation and finance bureaus at the national and provincial levels were particularly valuable in helping me understand how tax organizations

[7]Tannenwald defines tax competition as "the design of tax policy to attract and to retain geographically mobile capital, labor, and consumption." See Robert Tannenwald, "Tax Competition," in *The Encyclopedia of Taxation and Tax Policy*, ed. Joseph J. Cordes (Washington, D.C.: The Urban Institute Press, 2005), 395. This conventional definition fails to capture informal tax practices that are employed to attract and retain mobile factors of production. This study makes the crucial distinction between formal and informal tax competition.

work. I also used a number of other sources, such as national and provincial newspapers.

Factors That Intensify Informal Tax Competition in China

Studies of tax competition assume that governments want to attract investment in order to facilitate economic growth. In China, local officials have career and economic motivations for attracting investment to their regions. This relates to the cadre responsibility system, which is composed of "a set of rules governing job assignment, performance appraisal, and remuneration, whose main purpose is to improve implementation."[8] Leading cadres at the county and township levels (the Party secretary and the government head) sign a performance contract with the central government. This contract contains various performance targets, covering such areas as tax revenues, economic growth, social stability, and implementation of the one-child policy. Performance targets are set numerically and ranked in importance. Certain critical targets have "veto power" because failure to meet them nullifies all other achievements. The failure to meet these performance targets is punished by salary reduction or dismissal; success in meeting the targets is rewarded with bonuses and promotions.[9]

Performance targets vary across region and time, reflecting the changing priorities of the central government as well as differing preferences of local governments.[10] One of the performance targets is based on how much investment local officials are able to attract to their regions. Increased investment also affects other criteria in the cadre responsibility

[8]Kevin J. O'Brien and Lianjiang Li, "Selective Policy Implementation in Rural China," *Comparative Politics* 31, no. 2 (January 1999): 172.

[9]Ibid.; Susan Whiting, *Power and Wealth in Rural China: The Political Economy of Institutional Change* (Cambridge: Cambridge University Press, 2001); and Yang Zhong, *Local Government and Politics in China: Challenges from Below* (Armonk, N.Y.: M.E. Sharpe, 2003).

[10]Maria Edin, "State Capacity and Local Agent Control in China: CCP Cadre Management from a Township Perspective," *The China Quarterly*, no. 173 (March 2003): 35-52.

Table 1
Priority Given to Investment Attraction in the Township Cadre Evaluation System across Regions

District/City/County/Province	Priority
Lin'an City, Zhejiang (浙江省臨安市)	Veto power
Xiucheng District, Jiaxing City, Zhejiang (浙江省嘉興市秀成區)	First
Changshan County, Zhejiang (浙江省常山縣)	First
Longhai City, Fujian (福建省龍海市)	First
Xinghua City, Jiangsu (江蘇省興化市)	Veto power
Qingyang County, Anhui (安徽省青陽縣)	First
Suning County, Hebei (河北省肅寧縣)	Not a priority
Anyang County, Henan (河南省安陽縣)	Not a priority
Yuanyang County, Henan (河南省原陽縣)	Second
Yantan District, Zigong City, Sichuan (四川省自貢市沿灘區)	Not a priority
Bin County, Shaanxi (陝西省彬縣)	Third
Linxia County, Gansu (甘肅省臨夏縣)	Not a priority

Notes:

1. Policy mandates are categorized into the following priority scale: veto, 1st, 2nd, 3rd, 4th, and 5th.
2. Counties are arranged in descending order of local farmers' net income.

Source: Adapted from Liu Mingxing and Tao Ran, "Local Governance, Policy Mandates, and Fiscal Reform in China," in *Paying for Progress in China: Public Finance, Human Welfare and Changing Patterns of Inequality*, ed. Vivienne Shue and Christine Wong (London: Routledge, 2007), 166-89.

system, such as GDP (gross domestic product) growth and unemployment rates. Liu and Tao's study, based on field research in 2003 and 2004, details the ranking of different policy mandates given to township leading cadres in twelve counties located in nine provinces. Investment attraction tends to be ranked high in many counties. Out of twelve counties, two set investment attraction as targets with veto power. Another four counties designate investment attraction as their first priority.[11] Interestingly, wealthy counties tend to put a high priority on investment attraction (see table 1). This may

[11]Liu Mingxing and Tao Ran, "Local Governance, Policy Mandates, and Fiscal Reform in China," in *Paying for Progress in China: Public Finance, Human Welfare and Changing Patterns of Inequality*, ed. Vivienne Shue and Christine Wong (London: Routledge, 2007), 166-89.

be because destitute and remote regions have difficulty attracting investment in the first place.

For some local governments, targets for investment attraction are allocated to each local bureau or even to each local official. Failure to accomplish these targets leads to a reduction of the official's wages or even dismissal.[12] According to one official in the Jiangsu finance department, if cities and counties fail to meet investment attraction targets two years in a row, top local officials are dismissed.[13] At the same time, local officials are frequently rewarded with bonuses for attracting investment. In some cases, the local tax bureau is assigned investment attraction targets.[14]

Under this pressure, local officials are eager to lure more investment to their region, even if this investment does not boost tax revenues. Local officials, who are evaluated both on their ability to attract investment and on their ability to increase tax revenues, must find a way to balance these conflicting goals. The informal nature of tax competition, however, reduces the need to sacrifice one goal for the other. For instance, tax refunds, a frequently-employed form of tax competition, do not reduce the amount of local tax revenues that local officials report to the upper levels of government.

In addition to the cadre evaluation system, the geographical proximity of affluent provinces intensifies tax competition in wealthy regions. Shanghai, Jiangsu, and Zhejiang are located close to each other, which facilitates the mobility of capital across their borders. When I asked why Shanghai needed to provide informal preferential tax treatment even though it is an attractive place for capital, one local scholar replied: "Competition between Shanghai and Jiangsu is very severe. Shanghai hopes to keep foreign-invested enterprises."[15] Another local scholar made a similar remark: "In Shanghai, investment costs are high. Suzhou [蘇州] and Wuxi [無錫]

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[12]*Zhongguo jingji shibao* (China Economic Times), June 17, 2005.

[13]*Ershiyi shiji jingji baodao* (21st Century Economic Herald), November 5, 2003.

[14]*Zhongguo shuiwu bao* (China Taxation News), June 30, 2003.

[15]Author interview, Shanghai Academy of Social Sciences, June 29, 2004.

[major cities in Jiangsu Province] have economic zones. To compete with them, Shanghai provides local preferential tax treatment."[16]

In addition to tax revenues, China's land use rights system gives local governments rights to lucrative land use revenues. The 1992 revised Land Law provided the legal basis for local governments to sell land use rights to private firms.[17] Under this system, local governments may lease land use rights to commercial businesses for up to forty years and to industrial businesses for up to fifty years. Fees for land use rights are collected at the time the lease is signed and flow directly into local coffers.[18] This means that local governments receive rents for up to fifty years all at once. Land revenues make up a large proportion of local government revenues. Chinese sources estimate that in 2002, land revenues made up 35 percent to 60 percent of city and county government revenues.[19] According to Pieke, "The sale or rent of land use rights now is the main way to share in the fruits of local development, making the allocation of as much land as possible for non-agricultural use a matter of sheer survival to local governments and cadres: their budgets and, even more directly, the payment of their own salaries now depend on their ability to raise revenue from the sale or rent of land use rights."[20]

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[16]Author interview, Shanghai University of Finance, Shanghai, July 12, 2004.

[17]F. Frederic Deng, "China's Urban Land Reform, Urban Productivity, and Local Government Behavior," *Eurasian Geography and Economics* 44, no. 3 (April-May 2003): 210-27.

[18]In the early 1990s, the central government required local governments to submit 30 percent of land use revenues. However, this policy was not successfully implemented because local governments were able to hide these revenues. In the 1998 revised Land Law, the central government mandated that local governments could keep all land use revenues except those that were from newly acquired farmland. See ibid. Although in theory, land use revenues should be included under the budget item "funds and budget revenues" (基金預算收入, *jijin yusuan shouru*), in reality, most land use revenues are remitted as extra-budgetary revenues or even extra-extra-budgetary revenues. See Yongshun Cai, "Collective Ownership or Cadres' Ownership? The Non-Agricultural Use of Farmland in China," *The China Quarterly*, no. 175 (September 2003): 662-80; and Wang Jinxia, "Tudi churang ji zhengguan de wenti, yuanyin ji duice" (Problems, causes, and countermeasures of managing land use revenues), *Dangdai shenji* (Contemporary Auditing) 30, no. 6 (1997).

[19]Xin Hua, "Woguo tudi shouyi nian shi baiyi" (Our country lost 10 billion *yuan* in land use revenues each year), *Xibu kaifa* (West China Development), 2003, no. 8:51.

[20]Frank N. Pieke, "The Politics of Rural Land Use Planning," in *Developmental Dilemmas: Land Reform and Institutional Change in China*, ed. Peter Ho (London: Routledge, 2005), 104.

Land use revenues available to the local governments in China have two functions in tax competition and investment attraction. First, land use revenues encourage local tax competition because they give local governments the ability to grant preferential tax treatment. Furthermore, the possibility of obtaining lucrative land use revenues through attracting investment could lead local governments to be more willing to provide preferential tax treatment. Foreign investors and private enterprises are major buyers of land use rights for industrial and commercial land, since state-owned and collective enterprises obtain land almost for free through administrative allocation.[21] This provides an incentive for local governments to attract private capital,[22] which they frequently do by setting up development zones.[23] Second, some local governments even lower the price of land use to attract investment. Indeed, local governments in poor regions, where land is inexpensive, tend to rely on this approach to attract investment.

Forms of Informal Tax Competition and Tax Favoritism

In this section, I examine the different ways that local governments use informal tax practices to attract and retain investment. In some cases, local governments grant tax exemptions or reduce tax rates for investors, which is officially beyond the scope of their authority. However, since this can be easily detected by the central government, local governments utilize more "inventive" ways to reduce the tax bill for investors. Informal tax

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[21]Administrative allocation still accounts for a large proportion of urban land distribution. For instance, in 1998, 80 percent of urban land was distributed by administrative allocation. See Samuel P. S. Ho and George C. S. Lin, "Emerging Land Markets in Rural and Urban China: Policies and Practices," *The China Quarterly*, no. 175 (September 2003): 681-707.

[22]F. Frederic Deng, "Public Land Leasing and the Changing Roles of Local Government in Urban China," *The Annals of Regional Science* 39, no. 2 (June 2005): 353-73.

[23]Carolyn Cartier, "'Zone Fever', the Arable Land Debate, and Real Estate Speculation: China's Evolving Land Use Regime and Its Geographical Contradictions," *Journal of Contemporary China* 10, no. 28 (August 2001): 445-69.

practices cannot be communicated through official channels.[24] However, local governments inform their potential investors about them in other ways. In China, most local governments set up special offices that are responsible for attracting investment. These offices discreetly advertise the informal preferential tax practices of local governments to potential investors.

Tax refunds (先徵後返, *xian zheng hou fan*): One way in which local governments circumvent central government rules that deprive them of the authority to grant preferential tax treatment to investors is by collecting taxes from taxpayers and then returning a proportion of these payments, a phenomenon known as a tax refund. The local tax bureau is responsible for collecting taxes, and the finance bureau is responsible for tax refunds.

Local governments are able to refund only local tax revenues. The type of tax refunded and the refund rate vary case by case. It appears that the corporate income tax (CIT) is frequently used for tax refunds. From 1994 to 2001, local governments collected the CIT from all companies except state enterprises owned by the central government. In 2002, the central government changed the CIT into a shared tax and revenues were divided evenly between the central government and local governments. Since 2003, the central government has claimed 60 percent and local governments have claimed 40 percent of CIT revenues. Other types of local taxes can be also refunded. In some cases, local governments even refund the local share of the value-added tax (VAT) to firms, which is 25 percent of total VAT revenues.

How prevalent a practice is the tax refund? An article in China's taxation newspaper reported that the tax refund is practiced nationwide at all levels of local government, from provincial governments to townships. The amount of taxes refunded in the late 1990s was estimated to be 20 percent to 30 percent of local government revenues.[25] One study found

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[24]Helmke and Levisky have noted that informal rules are "created, communicated, and enforced outside of officially sanctioned channels." See Gretchen Helmke and Steven Levitsky, "Informal Institutions and Comparative Politics: A Research Agenda," *Perspectives on Politics* 2, no. 4 (December 2004): 725.

[25]*Zhongguo shuiwu bao*, January 27, 2000.

that 26 percent of local taxes was refunded to firms in Rongtang Township, a part of Fengcheng City in Jiangxi Province (江西省丰城市榮塘鎮) in 2004.[26]

Local competition for foreign direct investment in China is well known.[27] Less recognized but increasingly popular since the 1990s is local competition for investment by domestic private firms. Informal tax competition allows domestic companies to enjoy de facto preferential tax treatment. According to a study conducted by the Ministry of Finance on thirty-three large domestic private enterprises, these firms paid an average CIT rate of 10.5 percent as a result of local preferential tax treatment.[28] The CIT rate would have been 33 percent without the preferential tax treatment. One entrepreneur in Wenzhou (溫州), Zhejiang Province, who owns a medium-sized firm in the garment industry, said that he recently invested in Wuxi, Jiangsu Province, where he received preferential tax treatment. In Wuxi 50 percent of his tax payments were refunded to him. This preferential tax treatment, which was not made available to him in Wenzhou, was an important factor in his decision to invest in Wuxi.[29]

One official in the finance department in Hangzhou (杭州), Zhejiang Province, confirmed that her government does indeed refund taxes in order to attract investment. Her government returns 100 percent of the CIT and 20 percent of the VAT (the proportion of VAT proceeds that the Hangzhou government receives). Tax refunds are also given to local firms (本地企業, *bendi qiye*) regardless of ownership type. Money for tax refunds is drawn from local extra-budgetary revenues.[30]

One manager of a foreign firm in Shanghai revealed that the district government promised to refund CIT payments for four years if the firm

[26]Ibid., December 30, 2005.

[27]Mary Elizabeth Gallagher, "'Reform and Openness': Why China's Economic Reforms Have Delayed Democracy," *World Politics* 54, no. 3 (April 2002): 338-72.

[28]*Caijing bao* (Finance News), October 15, 2000. Out of thirty-two enterprises, twenty-nine produced profits and three were operating at a loss. The sum of their profits was 939 million *yuan*. They paid 99 million *yuan* in CIT.

[29]Author interview, November 20, 2003, Wenzhou, Zhejiang.

[30]Author interview, November 24, 2003, Hangzhou, Zhejiang.

agreed to invest there. Since this firm is located in a free trade zone, it pays a CIT rate of 15 percent. The district government promised to refund 93 percent of the firm's CIT payments in the first and second years of investment, 50 percent in the third year, and 33 percent in the fourth year. In the second year, however, the district government only refunded 50 percent of the firm's tax payments.[31] Because of the informal nature of tax refund agreements, their implementation cannot be fully guaranteed. Investors therefore need to be concerned about the credibility of local governments, which has created a market for consulting firms that advise investors about which local governments are most likely to keep their promises.[32] Since credibility is important in attracting investment, it appears that most local governments try to abide by their promises. In particular, local governments are likely to offer and implement tax refunds to large companies in the hope that they will bring additional investment to their region.

Privately-owned capital is not the only beneficiary of tax refunds. A considerable number of publicly-listed companies also receive tax refunds. In an effort to reform state-owned enterprises (SOEs), the Chinese government has offered shares of its companies on the stock market. In order to maintain state control, the Chinese government differentiates between state-owned and privately-owned shares; state-owned shares are non-tradable on the stock market. The state owned 42 percent of the total capital of publicly-listed Chinese companies in 2001.[33]

Table 2 provides information on tax refunds issued to listed companies in China. Out of a total 1,000 companies, 306 obtained tax refunds. Among them, 270 initially paid the 33 percent CIT rate and later were reimbursed 18 percent by local governments, which is more than half of

[31] Author interview, June 25, 2004, Shanghai. Since this firm engages in sales but not production, it was not entitled to get a "two years of exemption and three years of half reduction of the CIT."

[32] Author interview with a local scholar in Shanghai, June 29, 2004. According to him, local governments' credibility is related to the strength of their fiscal situation. Affluent local governments tend to implement preferential policies more regularly than poorer local governments.

[33] Nicolaas Groenewold et al., *The Chinese Stock Market: Efficiency, Predictability and Profitability* (Cheltenham: Edward Elgar, 2004), 24-25.

Table 2
Tax Refunds to Listed Companies

Tax rates charged (A)	Tax rates refunded (B)	Effective tax rates (A) – (B)	Number of firms
33%	Rates > 18%	Rates < 15%	2
	18%	15%	270
	4% < rates < 18%	15% < rates < 29%	3
24%	12%	12%	4
	9% < rates < 12%	12% < rates < 15%	5
15%	7.5%	7.5%	18
	Rates < 15%	7.5% < rates < 15%	4
			Total: 306

Source: Yao Jun, "'Xian zheng hou fan' yu shangshi gongsi shuifu yanjiu" (Tax refund and tax burden of publicly-listed firms), *Shuiwu yanjiu* (Taxation Research), 2003, no. 2:34-38.

their CIT payment. According to a study by Chen, Xiao, and Wang, after adjusting for tax refunds, the effective CIT rate for listed companies was 15.7 percent from 1996 to 1999, much lower than the statutory 33 percent.[34]

Drawing taxes (拉税, *la shui*): Drawing taxes involves local governments inducing firms outside their districts to register with their tax bureau. This practice violates Chinese tax law that stipulates firms should register with the tax bureau in the region where they do business. In order to draw taxes, local governments provide firms with preferential tax treatment.[35] For instance, in Beijing, suburb districts and counties draw taxes by offering a 20 percent business tax refund.[36]

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[34]Chen Xiao, Xiao Xing, and Wang Yongsheng, "Shuishou jingzheng ji qi zai woguo ziben shichang zhong de biaoxian" (Tax competition and its reflection in capital markets in China), *Shuiwu yanjiu* (Taxation Research), 2003, no. 6:18-23.

[35]Liu Haijun, "Luan la shui zaocheng caizheng shouru liushi ying yinqi zhongshi" (Need to pay attention to tax loss caused by chaotic *la shui*), *Zhongzhou shenji* (Audit in Zhongzhou), no. 10 (1995); and Zhang Tao, "Jinfang 'la shui'" (Prohibiting "*la shui*"), *Liaoning caishui* (Finance and Taxation in Liaoning Province), 2003, no. 10:45.

[36]*Zhongguo shuiwu bao*, September 5, 2004.

Drawing taxes involves conflicting interests between the local government that draws taxes (local government A) and the local government in whose jurisdiction the firm is located (local government B). How this conflict of interest is resolved varies. In some cases, local governments A and B compromise by dividing the tax revenue. In other cases, local government A takes all the tax revenues from the firm that operates in another area.

Drawing taxes is possible because the upper levels of the government give tacit approval. An official of one town government told me that ten companies paid taxes to his government even though they were located in other towns across the county. According to him, this is possible because his town is poor and thus the county government gave tacit approval for this practice to be used.[37] Another example was a company located in Shanghai district A that registered for tax purposes in Shanghai district B. This was possible because the Shanghai government allowed it, the reason being that district B had a development zone and thus it was more appealing to the investor. Since city-level governments wield personnel control over local leaders at the district level, the local government of district A was in no position to oppose it.[38]

Local governments often assist firms in bypassing Chinese tax laws by creating fake addresses for firms in their district. For instance, the audit bureau found that in one district, ninety-two firms had identical addresses—the township government address.[39] Although the practice of drawing taxes violates tax laws, a township government in Hebei (河北) even gave specific tax drawing targets to each local official.[40]

Since China levies a lower CIT rate in special economic zones such as development zones (開發區, *kaifa qu*), free trade zones (保税區, *bao shui qu*), and technology development zones (新技術開發區, *xin jishu*

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[37]Author interview with a town official in Zhejiang, March 24, 2008.

[38]Author interviews with an accountant in Shanghai, July 12, 2004, and another accountant in Shanghai, July 16, 2004.

[39]*Caijing* (Finance and Economy), February 2004, 60-61.

[40]*Renmin ribao* (People's Daily), October 30, 2003.

Table 3
Tax Drawing in Tianjin, by Economic Zone

	Number of firms registered at local tax bureau (A)	Number of firms that do not engage in production or sales in the zone in which they are registered (B)	Proportion of (B) out of (A)	Total tax payments made to local tax bureaus (C)	Total tax payments made by (B) firms (D)	Proportion of (D) out of (C)
Units	Number		%	10,000 *yuan*		%
Development zones	8,393	2,991	36	71,744	2,915	4
Free tade zones	2,656	2,235	84	2,224	1,441	65
Technology development zones	2,788	480	17	8,575	1,696	20
Total	13,837	5,706	41	82,543	6,052	7

Source: Zhou Shiti et al., "Guanyu shuishou zhengguan moshi gaige de ruogan wenti yanjiu" (Research on problems related to tax administration reform), in *1999 nian quanguo shuishou lilun yantaohui wenji* (1999 national conference on taxation theories), ed. Zhongguo shuiwu xuehui (China Taxation Institute) (Beijing: Zhongguo shuiwu chubanshe, 2000), 505.

kaifa qu), enterprises have an incentive to register in these zones. CIT rates are between 15 percent and 24 percent in these zones, compared to 33 percent elsewhere in China. A manager of a foreign firm in Shanghai revealed that his firm is registered in a development zone, even though it does not do business there. According to him, many firms use this strategy.[41] A report by a tax official at the local tax bureau in Tianjin (天津) shows that 41 percent of firms registered in economic zones in Tianjin do not do business there (see table 3). In other words, these firms engage in production or

[41]Author interview, Shanghai, July 2004.

sales in other regions, but are registered in economic zones in order to enjoy preferential tax policies. A study on a technology development zone in Tianjin reveals how bargaining between local governments works. The technology development zone acquired land from neighboring regions and paid money for the land. In return, the technology development zone obtained the right to tax firms located on the land.[42]

Exploiting formal preferential policies: Local governments provide firms with preferential tax treatment by exploiting preferential tax policies of the central government. Local governments manipulate central tax regulations regarding high-tech firms, special development zones, and methods of CIT payment in order to attract investment.

To attract high-tech investment, the central government allows firms in high-tech industries to pay lower CIT rates than firms in other industries. Local governments exploit this policy by designating enterprises as high-tech firms. According to a private entrepreneur who owns a large firm in Wenzhou, Zhejiang Province, although China formally has a uniform tax system, "taxation [in reality] is different from region to region. Our firm also invested in Shanghai and three cities in Jiangsu: Wuxi, Suzhou, and Kunshan (昆山市). In Jiangsu, we receive a 'three years of exemption and two years of half reduction of the CIT' because we are designated as a firm in a high-tech industry. Here [in Wenzhou], our firm is not [classified as a high-tech company]." He added that preferential tax treatment was an important factor in his choosing to invest in Jiangsu.[43] Another private entrepreneur in Wenzhou conveyed a similar story. He recently set up a computer-assembly firm in Ningbo (寧波). This firm enjoys a "three years of exemption and two years of half reduction of the CIT" because it was categorized as a high-tech firm. He said that the lack of preferential tax policies in Wenzhou convinced him to invest in Ningbo.

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[42]Andrea Hampton, "Local Government and Investment Promotion in China" (Paper for the Research Program "Public Action and Private Investment" of the Centre for the Future State, hosted by the Institute of Development Studies, University of Sussex, Brighton, Sussex, England, December 2006). http://www2.ids.ac.uk/gdr/cfs/research/Phase2/prog1/projects/lgipChina.html.

[43]Author interview in Wenzhou, Zhejiang, November 21, 2003.

Another way for local governments to use central government-sanctioned preferential tax treatment is by establishing local development zones. By law, only development zones that are designated by the central government can provide preferential tax treatment. In practice, local governments grant preferential tax treatment to firms in their own "development zones" not designated by the central government. Local governments have established an astonishing 4,600 development zones.[44]

Yet another way that local governments exploit preferential tax regulations is by levying a fixed amount (定額, *ding'e*) CIT, rather than a CIT based on profits. The Chinese government allows fixed amount payments of CIT for small private firms with unreliable accounting records. This is a commonly used practice in other countries. What is unique about China is that local governments also allow larger private firms to pay their CIT in a fixed amount. By setting fixed amount CIT payments at a low level, local governments can attract private firms to their districts. According to a tax official in a Shanghai suburb, his county government allows private firms to make fixed amount CIT payments. Because private firms prefer this method, a number of firms located in other regions chose to register in his county.[45] One government official in Wenzhou, Zhejiang Province, said that his local government provides a "favorable" tax environment for private firms by allowing fixed amount payments of CIT. He claimed that if the local government collected CIT based on taxable profits, CIT revenues in their locality would increase at least 50 percent.[46] Similarly, a local tax official in Taizhou (台州), Zhejiang Province, said that his local government supports private-sector development by setting a low rate for fixed amount CIT payments.[47]

Whiting argues that local governments' use of simple procedures to streamline tax collection actually increases total tax revenues. She further

[44]*Zhongguo jingying bao* (China Business News), March 31, 2004. http://www.people.com.cn/GB/jingji/1037/2421154.html.

[45]Author interview in Shanghai, July 1, 2004.

[46]Author interview in Wenzhou, Zhejiang, November 10, 2003.

[47]Author interview in Taizhou, Zhejiang, November 14, 2003.

argues that successful tax collection from private enterprises fosters state development, claiming that "state building went hand-in-hand with the development of market institutions such as private enterprise."[48] By examining the effects of informal local tax competition, this study reaches a different conclusion. In fact, local governments frequently use simple procedures to reduce, rather than increase, tax revenues.

Lax tax enforcement: Strengthening tax enforcement, particularly through tax auditing, is a useful way of preventing tax evasion.[49] Lax tax enforcement is usually attributed to weak state capacity. In China, however, lax tax enforcement is a strategy used by local governments to provide firms with a "favorable" tax environment. In China, local governments appear to be *intentionally* slack in enforcing tax compliance, since strict tax collection would discourage investment. According to a local tax official in Wenzhou, "In China, almost all firms evade taxes, no matter if they are large firms or small firms. However, the local tax bureau rarely conducts tax audits. Even in the case that we do tax audits, we do them very superficially. This is because local governments emphasize the need for a 'good' tax environment."[50]

Interestingly, entrepreneurs appear to understand that local governments are not highly motivated to enforce tax compliance. A private entrepreneur in Shenzhen (深圳), Guangdong Province, said, "The local tax bureau does not do tax audits. The goal of the local tax bureau is totally different from that of the national tax bureau. The local government is interested in other matters such as firms' use of land and employment. Therefore, officials in the local tax bureau assist firms. They instruct us how to avoid getting audits by the national tax bureau."[51]

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[48]Whiting, *Power and Wealth in Rural China*, 177.

[49]Arindam Das-Gupta and Dilip Mookherjee, *Incentives and Institutional Reform in Tax Enforcement: An Analysis of Developing Country Experience* (Delhi: Oxford University Press, 1998), 18-50.

[50]Author interview in Wenzhou, Zhejiang, December 8, 2003.

[51]Author interview in Shenzhen, Guangdong, July 29, 2004.

Implications of Informal Tax Competition

The central government has attempted to eliminate the local practice of tax refunds. In 2000, the State Council issued the "Circular on Correcting Tax Refund Policies of the Local Governments" (關于糾正地方自行制定稅收先徵后返政策的通知) which said that the tax refunds were contrary to the unified taxation policy and weakened the health of the public finance system. The circular prohibited local governments from employing tax refunds to attract investment and stipulated that any tax refund promises made by local governments should be rescinded.[52] The local practice of tax refunds appears to be an enduring concern for the central government. In budget planning for 2005, the central government emphasized the prohibition of tax refunds.[53] My interviews in 2004 revealed that local governments often ignored the central government's ban on tax refunds. To my question about tax refund practices, a few local government officials responded that the central government prohibits tax refunds. However, if I asked further whether local governments still provide tax refunds, they answered that they did not use the term "tax refunds" but instead called them "tax encouragements" (稅收獎勵).

Local officials often ignore the central government's ban on tax refunds because the cadre responsibility system puts emphasis on investment attraction. This finding concurs with the observations of Edin and O'Brien and Li that the cadre responsibility system allows the central government to selectively achieve certain policy goals at the expense of others.[54] Then, what accounts for the failure to implement the ban on tax refunds? First, the central government is not likely to place a priority on enforcing its tax refund ban since tax refunds diminish local, but not central, tax revenues.

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[52]http://dangan.jianghai.gov.cn/Article_Show.asp? ArticleID=9687 (accessed December 2008).

[53]"Guanyu 2004 nian zhongyang he difang yusuan zhixing qingkuang ji 2005 nian zhongyang he difang yusuan cao'an de baogao" (Budgetary implementation in 2004 and budgetary plan for 2005 for central and local governments). http://www.people.com.cn/GB/paper464/14307/1272795.html.

[54]Edin, "State Capacity and Local Agent Control in China," 51; and O'Brien and Li, "Selective Policy Implementation in Rural China," 173.

Second, it is difficult to monitor this practice since money for refunding taxes often comes from extra-budgetary revenues, which are not normally scrutinized by the central government.[55]

The prevalence of informal tax competition dilutes the impact of formal preferential tax treatment. The central government employs preferential tax treatment to achieve certain goals, such as attracting foreign investment. As Huang points out, the Chinese tax laws prior to 2008 treated foreign capital more favorably than domestic capital.[56] Informal tax competition, however, extends preferential tax treatment to domestic firms. Considering the prevalence of informal taxation, real differences in taxing foreign and domestic capital prior to 2008 were much smaller than formal rules suggested.[57]

In China, local governments at various levels (i.e., provincial, prefectural, county, and township governments) compete for investment. Tax competition among lower levels of local government suggests that preferential tax treatment is also available to smaller firms. The higher levels of government tend to compete for investment from larger firms, while lower levels of local government, which lack the resources to compete for larger firms, are interested in attracting smaller firms.

The prevalence of tax refunds suggests that the amount of tax revenue that local governments can use for public expenditure is much smaller than local tax collection data suggests. Although it is impossible to know the exact amount of tax revenue refunded to firms, fragmentary information suggests that tax refunds represent 20 percent to 30 percent of local tax revenues. Further research needs to be done to assess the impact of this revenue leakage on the provision of public goods. Insofar as local governments have sufficient extra-budgetary revenues, this shortage of tax revenue may have a limited effect on the provision of public goods. However, this will not be the case if extra-budgetary revenues of local govern-

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[55]See note 30 above. Also see *Zhongguo jingying bao*, July 7, 2003.

[56]Yasheng Huang, "One Country, Two Systems: Foreign-Invested Enterprises and Domestic Firms in China," *China Economic Review* 14, no. 4 (2003): 404-16.

[57]In 2008, the corporate income tax for domestic and foreign firms was unified.

ments are dwindling.

Informal tax competition puts poor regions at a disadvantage. While wealthy regions are able to provide preferential tax treatment to capital, poor regions must either follow suit or lose their attractiveness to capital. Because of the weak fiscal capacity of poor regions, the provision of preferential tax treatment is a heavier burden for them than it is for their wealthier counterparts. According to a local official in one city in Zhejiang Province, firms are moving out of their city to Shanghai. One of the reasons for leaving is that Shanghai provides preferential tax treatment. Asked why his government did not provide such treatment, he answered, "Our local government does not have enough fiscal capacity to provide it."[58]

In sum, informal tax competition has both positive and negative effects, depending on the issue. However, informal tax competition is not an optimal option. If China wants to maximize the positive effects of local tax competition, the central government should provide local governments with autonomy in setting the types and rates of local taxes. This is a better option because informal tax competition tends to increase uncertainty among investors with regard to whether local governments will abide by their promises. On the other hand, if China wishes to minimize the negative effects of local tax competition, it should find ways to limit informal tax competition. Local tax refund practices suggest that the "German solution" to tax competition would have only a limited effect in China. In Wilhelmine Germany, the problem of local tax competition was solved when the national government took over responsibility for collecting CIT and then returned it to the states.[59] In China, this system would do little to prevent the local practice of tax refunds. In order to abolish tax refunds, China would have to overhaul its fiscal management system in such a way as to make local extra-budgetary revenues more transparent.[60]

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[58]Interview, Zhejiang, 2003.

[59]See note 4 above.

[60]A common criterion for evaluating the effectiveness of treasury management systems is whether they regulate extra-budgetary revenues. See Ali Hashim and Allister J. Moon, *Treasury Diagnostic Toolkit* (Washington, D.C.: The World Bank, 2003).

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