



# The Top-level Institutional Design on the Perfection & Expansion of VAT Reform Pilot

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## Abstract

The VAT Pilot Reform has deepened the tax reform and adjustment, and also brought significant reform to the tax law system, tax institution and the whole economic, societal, and political institutions. In fact, a lot of unpredicted problems arose during the process of VAT Reform. For example, the doubt of legitimacy and constitutionality in this reform, the implementation of structural tax cuts in enterprises, the revenue allocation between central and local government, the principle of tax fairness and the reliance interests relationship between both sides as prime examples. Consequently, we must understand that only by improving tax legislation and specific institution design on structural tax cuts and enhancing the supporting measures of VAT Reform under the guidance of Constitution and Law can we really achieve the VAT Reform purposes.

**Key words:** VAT pilot reform; Structural tax cuts; Top-level institutional design

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## 1. THE VAT REFORM SHOULD BE STREAMLINED UNDER THE GUIDANCE OF THE CONSTITUTION AND LAWS

The 18th National Congress of Communist Party of China proposed to exert the important role of legislation in the social interest distribution. According to *Legislation Law*, in both taxational and financial fields, the legislation shall be made by the NPC and its Standing Committee, and authorization shall be strictly limited<sup>1</sup>. However, the current level of tax legislation is relatively low - only four tax laws were enacted by the NPC and its Standing, others are administrative regulations formulated by the State Council. Furthermore, the VAT Pilot Reform & Expansion is still based on the normative documents issued by the State Council, and the detailed implementation is governed by the local government. In other words, this major tax reform was hosted by the State Council, not the NPC and its Standing. Therefore, the State Council is both the legislature agency and law enforcement agency. This approach does not meet *Constitution and Legislation Law's* regulation about NPC & State Council's authority and the principle of legality in taxation<sup>2</sup>.

## 2. THE PURPOSE OF STRUCTURAL TAX CUTS SHOULD BE ACHIEVED ACTUALLY THROUGH THE VAT REFORM PILOT

At present, indirect tax is more than 70% of the country's total tax revenue, and taxes paid by enterprises is more than 90% of their profits, which results in a number of enterprises facing heavy tax burden. The tax burden will undoubtedly trickle down to commodity prices, which are passed on to consumers, causing CPI inflation and

<sup>1</sup> See Article 8, 9, 10 in *Legislation Law*.

<sup>2</sup> See Article 13, 62, 67, 85, 89 in *Constitution Law*.

reducing people's quality of life. To reduce the burden of enterprises, the State Council launched a VAT Pilot Reform, which was designed to reduce, if not at least alleviate, the burden on enterprises tax. It is noteworthy that according to official data, the first three quarters of VAT Reform Pilot in Shanghai, the corporate tax cuts amounted to 17 billion<sup>3</sup>. However, according to the survey made by China Federation of Logistics and Purchasing, 10.9% of the corporate tax burden was increased in the first batch of 135,000 enterprises by VAT Reform, especially in transportation, the tax rate was raised from 3% to 11%, and the actual tax burden rate rose from 1.3% to 4.2%. The main reason is that the current VAT system cannot offset the cost as input for many corporations<sup>4</sup>. Similarly, for various industries like architecture, industrial design and high-technology, whose main cost is human or intelligence, their input taxes are also non-deductible in existing VAT system. The VAT Reform would bring them a substantial tax increase<sup>5</sup>.

Meanwhile, considering the slow fiscal revenue growth in the first three quarters of 2013, the local government suffered a huge pressure on taxation, resulting in the State Administration of Taxation emphasizing the ban of "excessive taxes". On October 31, 2011, the Ministry of Finance announced to increase the threshold of VAT and BT. To this end, China has raised the threshold of VAT or BT to 20,000 Yuan a month, micro-enterprises or individual commercial households whose sales or turnover less than 20,000 Yuan are tax exempt. However, the micro-enterprises' sales or turnover are generally estimated by the tax authorities. Therefore, some tax authorities and administration staffs optionally convert sales to more than 20,000 Yuan, and make a monthly tax payment of 180 Yuan to 600 Yuan<sup>6</sup>. In addition, because the current implementation is not the consumption-type VAT, many local tax authorities distort the spirit of relevant documents, and thus the cost of the enterprise may be excluded from the deducted items as much as possible. The more "excessive taxes" exist, the higher tax

burden on enterprises, especially on micro-enterprises. This is not only an irony to structural tax cuts policy, but also undoubtedly worsening the trend of declining economic conditions.

Therefore, we should pay attention to the following points.

(1) Reduce the amount of annual VAT's goal for the next year. Experts estimate that every one percentage point decrease of VAT can get a tax cut of 200 billion Yuan. Moreover, with the Education Surtax, Urban Construction Tax and Local Education Fees attached to VAT cuts, the amount of tax cuts is expected to reach 250 billion Yuan.

(2) Reduce the VAT rate. It is better to adjust the tax rate than financial subsidies, because the financial subsidies are difficult to get. Such as the high-tech enterprises, the logistics industry, the telecommunications industry and so on, reduce from 17% or 11%, to 6% or 5% directly.

(3) Provide tax deduction standard and scope. In order to avoid "excessive taxes", State Administration of Taxation should change the "tax plan" or "tax task". By the principle of Taxed Based on Ability and the principle of Law Enforcement Practice, the structural tax cuts aren't "Flower in the Mirror", and all businesses can get benefits from structural tax cuts to enhance the competitiveness of enterprises and skills of technical upgrading.

### 3. THE DISTRIBUTION RELATIONSHIP BETWEEN CENTRAL AND LOCAL GOVERNMENT SHOULD BE RESOLVED PROPERLY

In the current tax structure, BT occupies the largest part of local taxes. The implementation of VAT Reform means half of the local government tax revenues need to be shared with the central. The rules about the ownership of tax revenues in VAT Reform were expedient, the revenue which used to be BT but change to VAT has now returned to the local government in Shanghai and other existing pilots, so that it will not affect the tax pattern and reduce local revenues. But once the VAT Reform is achieved nationwide, this expedient will not exist in practice.

Analyzing the tax origins of institutions, it means a chunk of tax revenue source from the local government would be dug up and placed under the control of the central government, thus breaking the balance of revenues and expenditure of local finance, making the local government face financial difficulties again. On one hand, it will lead the local government to explore new sources of income, such as sale land usage right to get a high land transfer fee<sup>7</sup>. On the other hand, in order to compensate

<sup>3</sup> HU Jian (2012, October 23). Shanghai pilot lightening 17 billion, expansion of VAT reform pilot will promote the separate tax reform. *HeXun Website, Tax, Text*, from <http://tax.hexun.com/2012-10-23/147085663.html>

<sup>4</sup> For example, the largest part of cost in a shipping company is the fuel and labor, each of them is 30% of total. According to the provisions, only fuel can be offset. And transport companies can't provide VAT invoices when refueling in foreign. In addition, compared with the BT, VAT is more complicated in calculation and collection, so there is a higher demand on the enterprise. Therefore companies have to re-purchase the specified device to print the VAT invoices, pay for the costs of accessing network, hire more professional staff, which is not a small cost.

<sup>5</sup> LI Yuanqing, LI Mingchun (2012, November 23). Guangdong VAT reform pilot runs, Guangdong and Shanghai pilot makes a difference. *From* <http://finance.qq.com/a/20120803/003697.html>

<sup>6</sup> ZHANG Jialong (2012, July 3). Why structural tax cuts changes to rise? *Tencent Website, Tencent Finance, Financial Watch No. 614*, from <http://finance.qq.com/zt2012/zengshui/index.html>.

<sup>7</sup> According to reports, all levels of government land transfer revenue reached 3.15 trillion in 2011, a third of 10.3 trillion revenue roughly. See May 10, 2012 "2011 China Land and Resources Community." announced by MLR (Ministry of Land Resources).

for the local finance vacancy through VAT Reform, the government may try to increase administrative fines<sup>8</sup>. These initiatives not only undermine the principle of legality in taxation directly but also pose a serious challenge of national taxation system. To this end, a clear specification of the following changes should be revised to the existing law and regulations:

(1) Reduce the current VAT and BT revenues accounted from 50% to 40%, for the aim of changing the dominant position of VAT. Meanwhile, it is also necessary to enlarge the proportion of Income Tax in total tax revenue, therefore to form a tax structure where Income Tax and Turnover Tax are equally important.

(2) To achieve this goal, first of all the VAT rate should be changed from the existing five-levels to a two-level, that is, for the general taxpayers and small-scale taxpayers, to 6% and 3%. At the same time, the status of VAT should be clearly defined as shared between the central and local governments. However, while taking into account the principle of matching financial authority and affairs powers, the proportion of sharing between the two should be reduced to 60 % and 40 %, for the sake of ensuring that the local government has sufficient financial resources to fulfill its power.

(3) There are some overlaps between State Administration of Taxation and local taxation bureaus, which have been criticized widely because these have caused low efficiency and high costs. The VAT Reform Pilot will cut down the tax revenue of local government. The government shall promptly take in-depth reform of tax system, through the merger of State Administration of Taxation and local taxation bureaus. Subsequently, the tax collection power is attributed to the central government, but the power to implement specific administration affairs is delegated to local government, which improves the effectiveness of tax collection.

(4) Promote deep reform of taxes and fees in time. The government should clean the administrative fees carefully, control the fine revenues and land transfer fees, and decrease the proportion of taxes and fees from the current 1:1 to 1:0.1. As a result, the tax should be the main source of income, and taxpayers can no longer pay the additional costs besides according to the tax law.

#### 4. THE PRINCIPLE OF TAX FAIRNESS SHOULD BE PUT INTO EFFECT

The greatest difference between BT and VAT is that whether the cost can be deducted. From this sense, VAT can better reflect the principle of fairness. However, the VAT Reform Pilot was only promoted in some cities. Therefore, it may lead people to pay attention to the issue of fairness in VAT Reform process.

<sup>8</sup> ZHOU Tianyong (2011, November 23). China penalty fee equal to 1/3 of the tax revenue 2.1962 trillion. *New Express*, A30 version.

#### 4.1 Different Kinds of the Tax Cause Unfair Tax Burden of Enterprises in Different Regions

If the VAT Reform could bring the benefit to the pilot areas where the overall tax is reduced, which the non-pilot areas can't enjoy, it will lead to the unfair tax burden between pilot and non-pilot areas. Regional preferential policies will produce a depression effect, resulting in capital flow to these regions. Besides, the VAT Reform includes various chains such as production and operation. To the non-pilot regions, their industries would be influenced; the surrounding areas close to the pilot regions will especially be at a disadvantage. Actually, VAT is a neutral tax, its fundamental tenet is fairness<sup>9</sup>. Therefore, we believe that the duration of VAT Reform Pilot should not last too long. It is required to formulate legislation and appropriate rules to promote the VAT Reform nationwide and comprehensively, after gaining experience from Shanghai, Beijing and Guangdong. Even taking the progressive order into account, it should also be reformed firstly in accordance with industry, rather than region. Otherwise, no matter how heavy the tax burden is, it will still bring unfair tax burden between regions and lead to uneven regional development, especially for logistics which has been implemented nationwide by network management. The government should not differentiate between regional burdens, resulting in new regional division. Also, it may cause a shrink of the logistics industry in non-pilot areas.

#### 4.2 Different Tax Rates Cause Unfair Tax Burden to Different Companies in the Same Industry

BT sets different tax rates based on different industries. In addition to using this model, the VAT Reform Pilot also set a standard of 5,000,000 Yuan sales, so all the pilot taxpayers are divided into general taxpayers and small-scale taxpayers. It should be noted that compared with the Shanghai services, which are towards intensification trend, the main characteristics of Guangdong services are on a shoestring. If the small-scale taxpayers enjoy the low tax rate, it is not conducive to promote the modern service enterprises to be bigger and stronger. In the law profession, for example, if the firm is has less than 5 million annual revenue, it can apply the 3% tax rate. But for firms with income exceeding 5 million, it is taxed at a rate of 6%<sup>10</sup>.

<sup>9</sup> LI Bin. (2012, November 28). VAT Reform Pilot expanding encountered practical problem, *the CPPCC(Chinese People's Political Consultative Conference) Network, Economic and Social, Financial Information*, from [http://www.rmzxb.com.cn/jjsh/cjzx/t20120328\\_444216.htm](http://www.rmzxb.com.cn/jjsh/cjzx/t20120328_444216.htm)

<sup>10</sup> For example, a law firm in Guangzhou, annual income of 10 million Yuan, before the "VAT Reform Pilot", business tax payable  $1000 \times 5\% = 50$  (10 thousand), after the "VAT Reform Pilot", the VAT denominated revenues  $1000 \div (1 + 6\%) = 943.39$  (ten thousand Yuan), VAT  $943.39 \times 6\% = 56.61$  (10 thousand), the actual rate of  $56.61 \div 1000 = 5.66\%$ , nominal tax rate of 6% -5% difference = 1%, the effective tax rate deviation of  $5.66\% - 5\% = 0.66\%$ , the rate is less than nominal tax rate differential. Assuming that the firm operating income has no change before and after the "VAT replaced

Since the latter cannot take advantage of deduction of costs, many firms prefer small-scale operations. This runs opposite to the goal of the Department of Justice to upgrade the law profession to be bigger, stronger and more influential. Therefore, it should narrow the tax rate gap between general taxpayer and small-scale taxpayers. At the same time, it is supposed to clear the deduction scope in related industries, make the practical tax measures to encourage enterprises to compete in a healthy background, transform and upgrade economic structure, and thus promote the market economy develop healthy.

## 5. THE RELIANCE INTERESTS RELATIONSHIP BETWEEN BOTH SIDES SHOULD BE RATIONALIZED

Tax is related to property rights and property distribution. In this sense, all tax reforms should be taken beyond the trust and negotiation between the country and taxpayers. The VAT Reform is designed to satisfy structural tax cuts and reduce the burden for taxpayers. It is a national step for taxpayers' interests. However, in promoting the reform process, what has been ignored is the taxpayers' trust and consultation mechanism. To a certain extent, the absence of taxpayers' agreement would damage the taxpayers' trust of government and damage the trust between both sides.

Firstly, this reform is hosted by the State Council as tax authorities. Without Law Amendment hearings or listening to the taxpayers, it is clearly an abuse of integrity between the country and taxpayers. Secondly, the principle of VAT Reform is reducing or at least not increasing the taxpayers' burden. But the truth is that a lot of taxpayers' burden has been increased, although there are financial subsidies<sup>11</sup>, which are not easily granted. According to reports, many companies give up the tax subsidies due to fear of auditing<sup>12</sup>. This expansion spread to 12 provinces

and cities, actually still basically on the Shanghai Mode without adopting more perfect and practical measures. This also further damage taxpayers' trust.

Therefore, we propose the following solutions:

(1) The State Council and relevant departments should consider the taxpayers as major trust subjects and participants in VAT Reform. At the same time, hearings should be held regularly to update new situation and sum up problems in the reform process, and then take effective measures to solve.

(2) The principle that reducing or at least not increasing the tax burden should be insisted in VAT Reform process. To the enterprises whose burden increased unpredictably, the State Council and relevant departments should reduce taxes rate directly, so that the taxpayers' actual tax burden can be cut down effectively.

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BT", no other factors exist, the annual growth of tax revenue 66,100 Yuan .In addition to the normal VAT and BT, The enterprises need to take this as the base, calculated and paid urban construction tax, education surtax and other taxes and surcharges, as the change in tax reform, turnover tax and additional changes will be presented in the same direction, for example, before the "VAT replaced BT", Construction Tax payable  $50 \times 7\% = 3.50$  (10 thousand) , Education Surcharge Payable  $50 \times 3\% = 1.50$  (10 thousand); after the "VAT replaced BT", Construction Tax payable  $56.61 \times 7\% = 3.96$  (10 thousand), payable Education Surtax  $56.61 \times 3\% = 1.70$  (10 thousand). Before tax reform, Business Tax is  $(3.50 + 1.50) = 5$  (10 thousand), after tax reform, VAT payments is  $(3.96 + 1.70) = 5.66$  (10 thousand), after the tax reform, tax increase  $5.66 - 5 = 0.66$  (ten thousand Yuan); plus turnover tax, the overall tax burden increased by  $6.61 + 0.66 = 7.27$  (10 thousand).

<sup>11</sup> Zeng Zhiqian in Guangdong Provincial Finance Minister said that Guangdong has developed a pilot transitional financial support policies, and will set up special funds to finance the pilot in the future, to be supported the enterprises increase tax burden due to pilot, the overall support policies and programs is under study .

<sup>12</sup>VAT Reform Pilot caused tax inspection storm in Guangdong, some corporate tax increase slight. *China Business News, October 14, 2012*.