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China's Business-Tax-To-Vat Reform: An Interim Assessment

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Abstract

The reform to replace the Business Tax (BT) with the Value Added Tax (VAT) is the largest tax reform initiative in China since 1994. This article assesses the first two years of the reform from a tax policy perspective. It shows that the Government has tried to pre-empt resistance to reform through highly unusual tax design and by allowing local governments to retain revenue from pilot sectors. The VAT for pilot sectors is characterised by two new reduced rates that apply to a wide range of business-to-business transactions as well as to consumer services (such as internet and mobile data services) not generally regarded in other VAT systems as requiring reduced rates. Moreover, a broad population of new VAT taxpayers is subject to "simplified collection"—a low-rate cascading levy. One possible overall characterisation is that a second VAT has emerged that perpetuates many of the BT's distortionary characteristics while also taking on the flaws of China's traditional VAT. This renders both the prospects and benefits of extending the reform to further sectors (most consumer services, real estate, and financial services) uncertain.

Introduction

China's effort to convert its Business Tax (*yingyeshui*, or "BT" for short) to the value added tax (*zengzhishui*, or VAT) through regional and sectoral "reform pilots" has already reached its third year. The reform has been hailed by many as the most significant tax reform in China since 1994, involving the reconfiguration of China's two most important taxes.[1] Viewed from afar, the reform may be perceived—and has been described—as replacing a crude, price-distorting cascading tax (the BT), which was understood to be unsatisfactory even upon its initial adoption, with an economically much more efficient tax (the VAT) that is the international norm.[2] The reform thus has the appearance of an enlightened policy initiative that has happily gathered political support at long last. When one closely examines the path that the reform has taken, however, a more alarming characterisation emerges: the political process of reform may be creating one of the most idiosyncratic VATs in the world, leading China away from, rather than closer to, international norms.

This article offers an interim assessment of the reform of replacing the BT with the VAT from a tax policy perspective, taking into account new policies that apply at the beginning of 2014. Chinese tax professionals have used the colloquial English label "B2V" for the

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[1] The VAT has been the largest source of overall government tax revenue, and the BT is generally the largest source of tax revenue for sub-national governments.

[2] See, e.g. B. Brys, S. Matthews, R. Herd, and X. Wang, "Tax Policy and Tax Reform in the People's Republic of China" [2013] *OECD Taxation Working Papers* No.18.

reform—corresponding to the Chinese term, "*yinggaizeng*"—an abbreviation which we will also adopt. The article will show that in the first two years of the B2V reform, the Chinese Government adopted substantial measures to reduce real or perceived opposition to the reform. The result, however, is the development of a "second VAT" applicable to pilot sectors, distinct from both the BT and the regular VAT. This second VAT is most importantly characterised by multiple rates applicable to business-to-business (B2B) transactions, and its integration with the regular VAT is postponed to the future. Moreover, the more challenging phases of reform lie ahead, involving extending the VAT to most consumer services, housing, and financial services. Given the problematic precedents set in the first two years of reform, there is a serious risk that the tax that replaces the BT will be a "VAT" in name only which retains many of the distortionary features of the BT. Finally, it will be argued that some fundamental features of the existing Chinese VAT, including the reliance on the Golden Tax System (*jinshui gongcheng*) to secure compliance, and significant limitations on claims of input tax credits, substantially reduce the benefits of replacing the BT with the VAT. Therefore, even the completion of the B2V reform will only be an intermediate stage to further necessary VAT reform. Until such further reform is undertaken, many of the advantages of the modern VAT will continue to elude the country.

While delivering the above narrative, the article highlights three aspects of the Chinese reform that are potentially instructive for those who study the VAT from a comparative perspective. First, the Chinese reform starts from a status quo that is relatively unique compared to the starting points of VAT reforms in other countries in the past (or at least those that are commonly discussed). For example, the introduction of the VAT in Europe, Canada, Australia, etc., each took as their starting points narrow-based turnover tax regimes, and replaced these regimes with relatively broad-based VATs that aim to avoid the taxation of business inputs. Many countries have also pursued VAT base-broadening because existing VAT exemptions still lead to the distortionary taxation of business inputs.[3] The Chinese B2V reform bears resemblances to both these well-known types of VAT reforms, but also differs from them, because the pre-reform indirect tax system contained, simultaneously: 1. a broad-based credit-invoice VAT; 2. a broad-based cascading tax; and 3. exemptions under both the VAT and the cascading tax. This raises certain distinctive policy issues as compared to reforms targeted at status quos that combine 3. with only either 1. or 2.[4]

Secondly, the B2V reform has adopted two interrelated reform tactics: choosing a particular sectoral sequence for the reform, and enacting multiple VAT rates for transactions that substantially occur among businesses. While there is much that is ad hoc about these two tactics, they are likely to shape the Chinese VAT for a number of years to come. In other VAT systems, the discussion of VAT "rate structure" typically applies to final consumption goods and services.[5] In China, as a result of the B2V reform, VAT rate differentiation applies to both intermediate

[3] See, generally, R. de la Feria (ed.), *VAT Exemptions: Consequences and Design Alternatives* (Kluwer Law International, 2013).
[4] See sections 1, 2 and 5.1–5.2 below.
[5] See R. de la Feria, "EU VAT Rate Structure: Towards Unilateral Convergence?" (2013) *Oxford University Centre for Business Tax*, WP 13/15; S. Cnossen, "What Rate Structure for a Value-Added Tax?" (1982) 35(2) *National Tax Journal* 205.

inputs and consumption items. This article will explore the extent to which this unusual feature of VAT design can be rationalised by reference to the complex dynamics of reform.[6]

Thirdly, the Chinese policy discourse surrounding the B2V reform is striking in that it tends to portray the VAT as a tax borne by businesses and not final consumers. It is not just popular debates that frame the reform as a matter of reducing the tax burden on businesses (and take as a measure of the burden on businesses the amount of tax remittance to tax agencies). Some of the core policy announcements, as well as scholarly analyses in respected academic journals,[7] also do so. Thus even though the presumed goal of the reform is to move China's indirect tax system towards a uniform, consumption-type VAT, the idea that the VAT minimises taxes on business inputs and is ultimately a tax on final consumption has gained little traction. While it may be tempting for VAT specialists from other countries to dismiss this as an instance of massive conceptual confusion, it is a confusion that has had real consequences[8]: it has not only affected the reform's political feasibility but it has also posed challenges for policymakers in gathering relevant information to steer the course of further reform.[9]

Section 1 briefly describes the pre-2012 Chinese indirect tax system and the timeline of the B2V reform during 2012 and 2013. Section 2 sketches a conceptual framework for understanding the economic implications of various aspects of a reform of converting a sales tax like the BT into a VAT. Section 3 uses the framework to analyse two aspects of the initial phase of the B2V reform: the choice of reform sectors, and the adoption of multiple VAT rates. Section 4 contrasts the analysis in section 3 with the prevalent understanding of the B2V reform in China as implementing tax reductions, and documents the unusual efforts to secure tax reductions following on from such understanding. Section 5 discusses the most important policy challenges facing the further phases of reform: expanding the VAT to the real estate, financial services, and consumer service sectors, and allocating indirect tax revenue among national and provincial governments. Section 6 explains those features of the existing Chinese VAT that limit the benefits of the conversion of the BT into the VAT. A brief Conclusion follows.

1. The background and timeline of B2V reform

From a comparative perspective, two features probably most distinguish the pre-2012 Chinese indirect tax system. First, this system comprised a VAT and a cascading tax (the BT) that have complementary tax bases: both are imposed on a nation-wide basis, and rarely is the same transaction subject to both the VAT and the BT. The VAT applied to the sale of all goods except for intangible and immovable property, as well as to the provision of processing, repair and replacement services.[10] The BT applied to the provision of other services, and transfers of

[6] See section 3.2 below.

[7] See, e.g. X. Ping, S. Liang, C. Hao, H. Zhang, and L. Mao, "A study of the welfare effects of the VAT and the business tax" [2009] (9) *Jingji yanjiu (Economic Research)* 66 (making comparisons between the amounts of BT and of VAT remitted by particular enterprises or whole industries, speaking of such remittances as "tax burdens" on businesses and industries). The very premise of B2V reform, however, is that BT and VAT payments have very different economic incidence in most circumstances, as discussed in section 2.1 below.

[8] Such confusion has also made the kind of analyses of the B2V reform offered in this article relatively rare to find.

[9] See section 4 below.

[10] The general VAT rate is 17%. A reduced rate of 13% applies to basic food and utilities; primary agricultural products and inputs to agricultural production; books, newspapers and magazines; and audio-visual products and electronic

intangibles and immovable properties. While it is not uncommon for the VAT to co-exist with cascading taxes in other countries,[11] it is uncommon for the same level of government to impose the VAT and a cascading tax simultaneously, and for the two taxes to have closely co-ordinated tax bases.

Secondly, the BT has a much broader base than most sales taxes or other turnover taxes found in other countries. It applies at the 3 per cent rate to the transportation, construction, postal and telecommunication, and cultural and sports industries, and generally at the 5 per cent rate for other services, including financial services,[12] the rental of real property, and the transfer (sale and resale) of real property.[13] The BT also applies generally to the cross-border flow of services.[14] In 2011 the tax yielded roughly US $215 billion of revenue,[15] which was about 15 per cent of the total tax revenue in China that year. About 40 per cent of the BT revenue was collected from the financial and real estate sectors. The conversion of the BT into a VAT is expected to apply to both financial services and real estate, two sectors that are often exempt under VAT systems in other countries.[16] Therefore it would be inaccurate to view the B2V reform as simply repeating the VAT introduction or base-broadening reforms that other countries have already gone through: while the mechanism of the BT as a cascading tax is presumably inefficient, its broad tax base distinguishes it from the cascading taxes that in other countries are regarded as inferior to, and that have been superseded by, the VAT.

Nonetheless, the rationales for converting the BT into a VAT are similar to VAT reforms in other countries: the BT results in tax burdens on business input and distort production decisions in competitive markets. We will discuss these rationales further in section 2 below. But given the size of BT revenue, government reliance on such revenue, and the effort that has been put into implementing the tax, it should be readily appreciated that attempts to reform the tax face considerable inertia. Proposals to comprehensively convert the BT into a VAT only began to be circulated among Chinese tax policymakers around 2009, and political interest in the proposals was weak. However, in 2010, politicians in the city of Shanghai began to take interest in such

publications. There is a large assortment of narrowly-defined exemptions. See W. Cui and A. Wu, "China" in T. Ecker, M. Lang and I. Lejeune (eds), *The Future of Indirect Taxation—Recent Trends in VAT and GST Systems Around the World*, EUCOTAX Series on European Taxation (The Hague: Wolters Kluwer, 2012), 159–190, at 176–180.

[11] For example, Canada and Germany impose federal VATs while their provincial or municipal governments may impose cascading sales taxes.

[12] Lending, dealing and brokerage, currency exchange, insurance and reinsurance services are all subject to the BT. In the case of lending, BT is applied to gross interest. In certain other cases such as the trading of foreign currency, marketable securities and futures, etc., the taxable turnover is the excess of the sales price over the purchase price. Cui and Wu, above fn.10, 180–181.

[13] Educational and health services are largely exempt from the BT, although services provided by public bodies are not necessarily exempt, above fn.12.

[14] See W. Cui, "Taxing Cross-Border Services in China: the (Partial) Switch to Destination-Based Taxation" in M. Lang, P. Melz and E. Kristoffersson, *Value Added Tax and Direct Taxation: Similarities and Differences* (IBFD, 2009), 323–338.

[15] This may make the BT itself the second largest indirect tax in the world in terms of revenue yield—falling behind only the Chinese VAT.

[16] See T. Edgar, "Exempt Treatment of Financial Services under Value-Added Tax: An Assessment of Alternatives" (2001) 49(5) *Canadian Tax Journal* 1133; S. Cnossen, "Proposal to Improve the VAT Treatment of Housing in the European Union" in R. de la Feria (ed.), *VAT Exemptions: Consequences and Design Alternatives* (Kluwer Law International, 2013).

proposals as a way of enhancing Shanghai's position as an economic and financial centre. Agreement was then reached between national policymakers and the Shanghai Government to pursue the B2V reform as a regional experiment.

The first round of B2V reform pilots was approved by the Chinese State Council on October 26, 2011. On November 17, 2011, the Ministry of Finance (MOF) and State Administration of Taxation (SAT) jointly issued two policy documents, one stating the general principles for B2V reform and the other laying out details for the reform's first phase in Shanghai.[17] In particular, the following business sectors (First Round B2V Sectors) were designated for conversion from BT to VAT: transportation by land (but excluding railroad transport), waterways, air, and pipeline; leasing (whether financial or operating) of tangible, movable properties; and certain "modern services," comprising research and development (R&D) and technology services (including technology transfers and licensing); information technology (IT) services; cultural innovation services (encompassing not only design, advertising, and intellectual property (IP)-related services but also the transfer of trademarks, copyright, and business goodwill); logistical services; and attest and consulting services, including accounting, tax, legal, management and certain other services. Shanghai, the lone pilot jurisdiction, began implementing these guidelines on January 1, 2012.

While the initial design of the B2V reform provided no specific timeline for expanding the reform beyond Shanghai, only seven months into the reform, on July 25, 2012, the State Council approved a second group of pilot jurisdictions, which all began reform implementation in 2012. These included Beijing (commencing September 1), Jiangsu and Anhui (October 1), Fujian and Guangdong (November 1), and Tianjin, Zhejiang, and Hubei (December 1). The State Council approved another expansion of the reform on April 10, 2013, proposing that, starting August 1, 2013, the B2V reform in the First Round Pilot Sectors would be implemented across the country. That is, the regionally-sequenced phase of the reform was over by August 2013.

The April 2013 State Council plan also proposed that the production, distribution and showing of radio, film and television products be brought under the VAT on a nationwide basis. It was announced that railroad transportation, postal services, and telecommunication would be covered by the VAT as early as during the first quarter of 2014, and that the complete conversion of the BT into the VAT would occur by the end of 2015. On December 4, 2013, a State Council executive meeting decided that railway transportation and postal services would be included within the scope of the VAT reform pilot programme starting on January 1, 2014. The bargaining to include telecommunications in VAT reform stalled, however, and the telecom sector was included in the reform from only May 2014.

While the initial choice to sequence the B2V reform regionally may be understood as a matter of political expediency, the sectoral sequence of the reform is more technical in nature and a proper part of tax policy design. The rest of this article will focus on this aspect of the B2V reform. By a rough calculation,[18] the First Round Pilot Sectors collectively generated more than 15 per cent of the total BT revenue between 2009 and 2011. The second-wave group of B2V

[17] MOF and SAT, *Circular on Printing and Distributing the Pilot Proposals for the Collection of Value-Added Tax in Lieu of Business Tax*, Caishui [2011] No.110 (Circular 110) and *Notice for the Introduction of the Pilot Scheme to Convert Business Tax to VAT*, Caishui [2011] No.111 (November 16, 2011) (Circular 111).
[18] Based on data from the Tax Yearbook of China 2010–12.

sectors announced—radio/film/television, railroad, postal services, and telecommunication—altogether accounted for another 4.3 per cent of total BT revenue during the same period. The three largest sectors in terms of BT revenue, construction and installation, financial services, and the sale and lease of real property, accounted for 67 per cent of BT revenue during these years. These sectors, along with residual categories consisting mostly of consumer services, are those for which the reform paths are the most difficult to foresee. The special challenges involved in applying the VAT to these sectors are discussed in section 4.

2. A conceptual framework for evaluating the B2V reform

The BT is imposed on service provision to both consumers and businesses, and as a result of its application to B2B transactions, distorts business' production decisions. This is usefully illustrated by a comparison with the operations of the VAT. In a B2B transaction that is subject to the VAT, the buyer of business input (whether of goods or services) is charged and pays the VAT by and to the seller, but can claim an input credit for such VAT paid against the VAT he collects on his subsequent sales to downstream customers: the tax paid on the input purchase and the tax credit subsequently claimed cancel each other out, and there is no net tax on the purchase.[19] By contrast, a business cannot claim an input credit for a purchase that is subject to the BT. The BT thus becomes a cost of B2B transactions that must be allocated among suppliers and customers or passed down through higher product prices. A supplier subject to the BT in China also generally cannot claim input credit for any VAT paid on business purchases. Previous VAT collected through the production process thus also becomes a genuine business cost, as opposed to merely the advance collection/withholding of a tax on consumer purchases. These tax costs may be reduced if the purchaser internalises the production of the required service or goods by producing it "in-house", or finds some substitute input that is somehow subject to less tax (but would not have been chosen otherwise). But these are tax-induced decisions that may reduce production efficiency. In addition, the BT on durable asset purchases and pre-payments for long term contracts imposes a tax burden on the return to business capital.

The removal of such production inefficiencies is the fundamental motivation for replacing the BT with the VAT. However, it is worth pausing to note here that within real world VAT systems, there are rules/mechanisms that similarly lead to inefficiencies in production. Internationally, the most common example is the VAT exemption: if a business is exempt from the VAT on its sales, it typically cannot claim a refund of the VAT it has paid on its input purchases, and therefore may make tax-induced, inefficient production decisions. For this reason, VAT exemptions are generally criticised.[20] China not only has many categories of VAT exemptions, but also other VAT mechanisms that are less commonly observed elsewhere, but which have distorting effects which are similar to the VAT exemption.[21] Thus arguments for the

[19] This describes "normal" VAT mechanisms. Section 6 below argues that China's VAT significantly deviates from this norm of not taxing business input.

[20] See, e.g. L. Ebrill, M. Keen, J. Bodin, and V. Summers, *The Modern VAT* (International Monetary Fund, 2001), Ch.8.

[21] These include a variety of "simplified collection" mechanisms further discussed in section 6 below, where the taxpayer pays a low-rate tax on its sales, but is denied any input credit for VAT paid on purchases used in production.

efficiency gains of converting the BT to the VAT must be tempered by realistic assessments of the efficiencies of the actual Chinese VAT. We will return to this in Section 6 below.

In addition, it is important to recognise from the outset that replacing a cascading tax by the VAT is not just about improving production efficiency: it has direct impacts on consumers as well. When the B2V conversion applies to transactions between businesses and final consumers ("B2C" transactions), the tax burden on such transactions may increase. This is because the common BT rates (3 per cent and 5 per cent) are significantly lower than the standard VAT rate (17 per cent).[22] While the lower BT rates are designed to take into account the BT's cascading nature, in sectors where the production chain is shorter (and therefore the extent of cascading is lower) than average, the conversion to the VAT (if levied at the standard rate) means a real tax increase—and likely increases in consumer prices for the relevant services. In some instances, such price increases may merely reflect the fact that the services were *under*-taxed relative to other consumer purchases, and that relative prices among consumer goods and services were distorted by taxation. Such distortions are very real and widely observable in China.[23] However, a tax increase to remove such tax-induced distortions in consumer choices immediately invites the question of whether consumers will be compensated through lower taxes elsewhere.[24]

To what extent the B2V reform would cause changes in consumer prices is a highly complex empirical question. But three preliminary conceptual comments can be made. First, it is widely recognised in the economic analysis of the VAT that whether a VAT rate increase (or decrease) would be passed onto consumers—what the economic incidence is of a rate change—depends on the market structure of the product on which the tax is imposed.[25] In a competitive market for a given good or service, who bears the economic burden of the VAT on the goods or service depends on the price sensitivities ("elasticities") of producers and consumers. The supply of a good in a competitive market with many entrants tends to be very elastic in the long term, which means that the burden of a tax on the good is likely to be "shifted forward" mostly to consumers.[26] In markets with imperfect competition and characterised by monopoly or oligopoly, on the other hand, the real burden of the VAT may be partially borne by producers.[27] The economic analysis of welfare gains from VAT reform has increasingly taken into account the significance of

[22] In other countries that convert a sales tax into a VAT, this problem arises often because the sales tax was not broad-based and effectively exempted many types of consumption purchases.

[23] A striking example is that take-outs from fast food restaurants are subject to the 17% VAT whereas the same food consumed on the restaurant premises is subject to the 5% BT rate. This large rate discrepancy has had less of an impact on consumer behaviour than one would expect because it has always been difficult to enforce the higher tax rate. Increased administrative costs are another negative consequence of different tax rates applied to consumption items.

[24] One response to this problem often adopted in other countries is to combine tax base broadening with a general reduction in tax rates. As discussed in section 3, the B2V reform has chosen instead to maintain differential tax rates for different goods and services, as the risk of maintaining distortions of consumption choices.

[25] See Copenhagen Economics, *Study on reduced VAT applied to goods and services in the Member States of the European Union* (June 21, 2007), Part B—App.I, for a review of the economic literature on this subject.

[26] See Copenhagen Economics, above fn.25, 20–22, for a summary of econometric studies of pass-through of changes in commodity taxes. See also especially C. Carbonnier, "Who pays sales taxes? Evidence from French VAT reforms, 1987–1999" (2007) 91(5–6) *Journal of Public Economics* 1219.

[27] See Copenhagen Economics, above fn.25.

imperfect competition.[28] Imperfect competition also characterises many of the sectors to which the Chinese B2V reform applies, for example, in aviation and rail transportation, telecommunications, and financial services, and therefore will likely be crucial for predicting the impact of reform.

Secondly, the uniquely broad tax base of the BT also has important implications for consumer prices. Converting the BT into the VAT for B2B transactions can potentially lead to significant reductions in the cost of production for all producers, including suppliers of both goods and services, since the VAT implies, in contrast to the BT, no tax burdens on B2B transactions (subject to imperfections in VAT mechanisms themselves). This effect would be especially pronounced when the BT is replaced by the VAT in the financial services and construction industries, which comprise mostly B2B services and in recent years generate over 40 per cent of BT revenue.[29] By contrast, in VAT base-broadening reforms in other countries, because prior to reform services are typically exempt from the VAT (but not positively taxed under a cascading tax), expanding the VAT to services may not have a large cost reduction effect for manufacturers of goods.[30] In other words, in the Chinese B2V reform as a whole, the cost reduction for the manufacturing sector and the resulting decrease in prices for the supply of goods may go some way to mitigate the effect of increases in the prices of services consequent upon higher VAT rates.

Thirdly, there is a collateral consequence of an increase in the prices of consumer services. Any increase in the tax rate applied to sales to consumers economically has the effect of a one-time, lump-sum tax on the business assets used to produce such sales. This effect can (if not anticipated) be efficient because it applies to an already-existing set of assets and therefore does not lead to tax-induced behavioural distortions.[31] However, the owners of the relevant business assets may oppose the tax increase, and political compromises may need to be made through transition policies that alleviate the tax on existing capital.

These general comments about the potential impact of the B2V reform on consumers are worth making because, as will be seen in the next few sections, the Chinese discourse surrounding the reform has focused almost exclusively on the beneficial reduction of producer costs (and the elimination of distortions of production decisions), and has been strikingly reticent about how the reform will affect consumer prices.[32] It is tempting to regard this as the result of a shrewd steering of public discussion by the Government toward only the positive, uncontroversial aspect

[28] For example, in B. Bye, B. Strom and T. Avitsland, "Welfare effects of VAT reforms: a general equilibrium analysis" (2012) 19 *International Tax and Public Finance* 368, the authors assume that the domestic market in Norway is characterised by monopoly behaviour, and that therefore VAT reform that has the effect of increasing domestic production leads to welfare gains.

[29] This is discussed further in section 5 below.

[30] For a recent detailed general equilibrium model of base-broadening in the Norwegian context, see Bye, Strom and Avitsland, above fn.28. For both of two reform scenarios (a partial and a complete VAT scope expansion) modelled, costs of production for manufacturing do not change significantly. Bye, Strom and Avitsland, above fn.28, 379 and 381.

[31] See L. Kaplow, "Capital Levies and Transition to a Consumption Tax" in A. Auerbach and D. Shaviro (eds), *Institutional Foundations of Public Finance: Economic and Legal Perspectives* (Cambridge, MA: Harvard University Press, 2009).

[32] As will be discussed in section 4 below, the limited public controversy that the reform has attracted tends to be narrowly about how to measure reductions in business costs (and is arguably misguided).

of the reform. However, it is also possible that real controversies—for example, concerns about increases in consumer prices and an effective capital levy on certain existing business assets, the reaction to tax increases by firms engaged in monopoly behaviour, etc.—have merely been disguised but have nonetheless created real resistance to the reform. It is also possible that some of the Government's unusual policy design for the reform constitutes disguised responses to these potential controversies. Thus while the preliminary discussion in this section is clearly no substitute for the real modelling and empirical investigations of the impact of the B2V reform, it may, by emphasising the impact of the reform on *both* producers and consumers, shed some novel light on the strategy and design of the reform.

3. The design of the VAT pilots

3.1 Choice of pilot sectors

The first aspect of reform design to consider is how industries are selected for the initial and subsequent rounds of BT-to-VAT conversion. The Government claims to have applied two main criteria.[33] The first is that the businesses should be intermediate suppliers to other producers instead of primarily serving final consumers (that is, they should supply "production-oriented services", *shengchanxing fuwu*). The second is that the businesses should belong to "modern" sectors whose development the state may want to encourage by removing distortionary taxes. The "modern" services included among the First Round B2V Sectors (for example, R&D, advertising, accounting) in fact appear to be mostly business services. *If* the Government were able to identify only or primarily B2B transactions for the B2V pilots, then the main effect of the reform should be the improvement of production efficiency, with little direct impact on consumer prices. The reform pilot should then have few opponents.[34]

However, even among the First Round B2V Sectors, there are services that clearly have significant B2C components, for example, passenger transport. The same is true for the second-wave group of B2V sectors, that is, telecommunications, railroad transport, the showing of radio, film and television products, and postal services. Indeed, a Government internal report estimates that at least 80 per cent of the value of telecom services provided in China represents individual consumption. Calling all these services "production-oriented" (or "modern", as though it is some type of industrial policy that is at stake) seems to be a public relations manoeuvre: it may help the Government to delay the discussion of how the reform would affect consumer services.[35] Yet the labelling also creates significant policy ambiguity. For example, the same reduced tax rate of 11 per cent is applied to transportation services, whether furnished to business or individual customers. Is the reduced rate intended primarily to limit the impact on consumer prices, or to limit the increase of producer costs?

[33] MOF and SAT, *Press Conference on Reform Pilots for Converting Business Tax Collection to the VAT*, November 17, 2011, Question No.2.
[34] One problem with this approach is that in reality only a subset of B2B transactions are included in the reform. This creates the need for much drawing of boundaries, which, within Chinese tax administration, has led to different analogies and conclusions made by different sub-national jurisdictions.
[35] MOF and SAT, above fn.17, claims that "everyday services" (*shenghuoxing fuwuye*) would be brought under the VAT later on, and would be subject to simplified VAT collection instead of the regular VAT. See further discussion in section 5.2 below.

Another distinction that is blurred in the choice of pilot sectors is whether the relevant service market is competitive. For example, much of the road transportation market in China is competitive and populated by multitudes of private businesses. By contrast, airlines are characterised by regional oligopolies, and railroad transportation operates under a monopoly.[36] The suggestion here is not that, under an ideal design for reform, these differences in market structure should be taken into account. The normal policy recommendation would be to apply the same VAT rates and mechanisms to all industries. Rather, what is notable is that, as discussed below, the Government chose unusual VAT mechanisms (for example, multiple reduced rates for business services and non-basic consumer services) for the B2V reform, but these choices do not reflect features of the relevant product markets in any obvious way.

Despite these ambiguities and inaccurate labels, it is possible to offer the following (speculative) rationalisation for the sequence of pilot sectors chosen, assuming that the ultimate policy aim is to implement a broad-based modern VAT. B2B services with competitive markets are chosen first since they reduce production distortions and should decrease producer costs (and tax revenue). Business and consumer services in sectors with imperfect competition and regulated prices (that is, aviation, film and radio, railroad, and telecom) are chosen next, with the possibility of limiting the impact of increased tax rates through price regulation, and of burden-shifting to monopolistic or oligopolistic firms (that are also wholly or partially state-owned). Finally, competitive and non-regulated consumer service sectors, such as residential real estate, hospitality, and everyday consumer services (for example, restaurants) are left for late phases of reform, given the political challenges associated with tax and consumer price increases. Also left to the last is the financial services sector, where both special VAT mechanisms and special revenue objectives are involved.[37]

3.2 Multiple rates

A second aspect of reform design, the adoption of multiple rates, is a novelty both in China and internationally. The initial VAT pilots deliberately introduced two new rates into the Chinese VAT: 11 per cent for transportation services; 6 per cent for services which qualified as modern services.[38] Only the lease of tangible movable properties is subject to VAT at the regular 17 per cent rate. This choice of multiple rates is curious especially for the First Round B2V Sectors. If, in this first round, B2V conversion were in fact applied largely to B2B transactions, it should not matter what the applicable VAT rate is: any VAT charged on the transaction to the purchaser will simply be credited by the purchaser against VAT on future outputs. This point can be appreciated through the fact that, internationally, the deployment of multiple rates within VAT systems is mostly driven by the desire to offer favourable treatment for certain types of consumer goods (for example, food and clothing), often on distributional grounds.[39] It is quite unusual for special VAT rates to be adopted specifically for B2B transactions.

[36] The major operators in these industries are also majority state-owned.
[37] See section 5.2 below.
[38] Both rates are lower than the previous preferential rate of 13% under the VAT. See fn.10, above.
[39] See Ebrill, et al., above fn.20, Ch7.

According to the official explanation of the choice of multiple rates,[40] the Government gathered information regarding the pre-reform input and output patterns of the pilot sectors, and asked the question: what VAT rates on their output would leave them with the same "effective indirect tax burden", that is, remitting the same amount of tax as the BT revenue they had previously remitted (taking into account VAT input credits that have now become available)?[41] This explanation is puzzling because the VAT remitted by a business is unlikely to be borne by it, either in terms of cash flow[42] or in terms of economic incidence. It is thus not meaningful to equate the pre- and after-reform amounts of indirect tax payments.[43]

One can attempt a number of explanations of the choice of multiple (reduced) rates in terms of more intelligible economic rationales, but none of these explanations is very convincing. One explanation is that, initially, the B2V pilots were run only in a small number of jurisdictions (first only Shanghai), and the timeline for a national roll-out was indefinite. The service providers in the pilot jurisdictions might have needed to participate in regional or national markets where prices were set by suppliers from non-pilot regions, whose services were subject to the BT. Pilot VAT suppliers from Shanghai, for example, might not be in a position to charge higher VAT-inclusive prices to customers (including final consumers), and therefore in order not to put them at a disadvantage, the VAT rate they charge must be modified to approximate the previously applicable BT. Therefore, the reduced rates are a function of the regionally-sequenced nature of the reform.[44] Yet this explanation no longer works because even after the national roll-out of the initial B2V pilots, reduced rates for transportation and "modern services" have been maintained, and reduced rates for new sectors (for example, telecom) have been adopted even though the new phase of VAT reform no longer involves local pilots.

A second explanation would describe the reduced rates as a function of the sectorally-sequenced character of the reform. The idea is that many customers purchasing the services within the scope of the B2V reform are businesses that are unable to claim (full) input credit for any VAT charged. Such customers may operate in sectors not included in the B2V reform (such as financial services, construction, and real estate). Or they may be VAT-paying businesses, but are constrained in their use of VAT input credits and therefore would prefer to purchase services which are subject to a lower-rate, though non-creditable, BT.[45] Applying the VAT rate to B2B services may thus increase production costs for the business purchasers (or reduce the profits of the suppliers). The reduced rates mitigate this problem for transactions with

[40] MOF and SAT, above fn.33, Question No.5.

[41] Thus for the transportation sectors (road, waterways and aviation), the same "burden" would be maintained if the rate applicable to output were between 11% and 15%. For the select modern services, that range was estimated to be between 6% and 10%. The Government purportedly chose the lower ends of these ranges. MOF and SAT, above fn.33.

[42] In terms of cash flow, VAT is typically collected by the supplier from the customer.

[43] Moreover, given that the BT is supposed to generate sufficiently large production distortions for reform to be warranted, it is not clear why pre-reform input and output patterns are relevant.

[44] As discussed in section 1, above, the regional pilot model for implementing reform may be understood as being politically required for the reform to proceed.

[45] As section 6 discusses, inefficiencies in China's existing VAT render the prevalence of this type of VAT-paying customer more plausible than one might otherwise expect.

such customers, while for customers who are able to claim input credits, it does not matter (other than administratively) what the applicable tax rate is.[46]

The logic of this second explanation is easy to recognise. The phenomenon of "exemption creep" is well known in other VAT systems[47]: suppliers to exempt producers tend to lobby for VAT exemption themselves, since the VAT charged on the supplies cannot be claimed as input credit by the exempt customers. Short of an exemption, such suppliers may prefer reduced over full VAT rates. A more interesting analogy can be found in a recent study of partial VAT base-broadening: it has been found in the Norwegian context that a partial VAT reform that extends the VAT to some but not all services may *reduce* social welfare compared to a narrower-based VAT, one reason being that the partial expansion increases the production costs of those services that are not yet covered by the VAT after the reform.[48] In other words, social welfare does not improve linearly as the VAT base expands.

Of course, to assume that most business customers would not be able to claim input VAT credits would imply that it is not possible to improve production efficiency through the B2V reform, which fundamentally weakens the case for the reform. It is understandable then that this second explanation for reduced rates has never been explicitly acknowledged or discussed in China. Moreover, there is a third possible explanation that is completely different in thrust: the reduced tax rates are meant to be effective ultimately not for B2B services, but for B2C services. The reduced rates may be a way of delaying the adoption of the 17 per cent standard VAT rate, given the likelihood that the latter could result in significant tax (and price) increases for a range of consumer services. These are thus transitional VAT rates on individual consumption. There is little support in official statements and Chinese public discussions for this speculative explanation (since public discourse rarely addressed the impact of reform on final consumers). Moreover, even to take this speculative account on its own terms, the Government has been unclear whether these two transitional rates would be options available to *all* services converting from paying the BT to paying the VAT in the future (and if so, which of the two rates), or whether they are merely fashioned for the First Round B2V Sectors, nor whether they are the only low-rate options. Moreover, no indication has been given as to how long the transition period would be.[49]

Therefore, the least speculative rationale of the adoption of reduced rates in the B2V reform is the one offered by the Government: these are the rates that, based on the Government's own projections, would ensure that indirect tax remittance to the Government from the pilot sectors does not go up. But this rationale is also nonsensical: it is highly unlikely that the amount of VAT (or BT) remittance by any business is even an approximate measure of its "tax burden". The next section examines how this conflation of remittance with incidence characterises public discourse about the B2V reform in general, and describes some of its political consequences as well as its relation to the ways in which the objectives of the reform are framed.

[46] Of course, reduced rates for B2B supplies do matter, as they increase administrative costs as well as the likelihood of excessive input credits that cannot be recovered in a timely manner.
[47] Ebrill, et al., above fn.20, 89.
[48] Bye, Strom and Avitsland, above fn.28, 379.
[49] The Business Tax itself, after all, was a compromise made in the 1994 tax reform and could have been regarded at the time as a "transition policy". A transition policy can hardly be viewed as such without a clearly defined termination.

4. Tax reduction, subsidies, and tax preferences

The unusual "pilot sector revenue neutrality" guideline used by the Government to set reduced rates—that the VAT remitted by pilot businesses should not be greater than the BT that would have been remitted by the same businesses—has had a number of political consequences. To begin with, it hamstrung the Government's publicity campaign, with the Government selling itself short on how much tax reduction is achieved by the reform. Consider the following: if most or even a significant portion of the VAT charged by pilot businesses to their customers can be used as input credits by those customers, and if none or little of the BT previously imposed on these businesses could be credited by their customers, then the amount of BT that would have been remitted by these businesses is itself the proper measure of the extent of tax reduction—not the difference between actual VAT remittance and the hypothetical BT remittance.

Some real numbers from the VAT pilots illustrate this point.[50] According to a Shanghai Government report produced in August 2012, during the first half of 2012, pilot VAT payers in Shanghai remitted a total of 10.49 billion yuan of VAT.[51] "Regular" VAT payers—those who are entitled to claim VAT credits and who standardly issue creditable VAT invoices—were responsible for 9.59 billion yuan of this total. Supposedly, this was 0.63 billion yuan less than the BT that these taxpayers would have had to pay on their sales, had there been no B2V reform. The Government has led the media to view 0.63 billion yuan as the measure of tax reduction brought about in the first six months of the reform. Yet it was disclosed in the same report that Shanghai pilot VAT payers issued 9.6 billion yuan worth of invoices that may generate deductions for purchasers, which was 7.09 billion yuan more than the amount of creditable invoices they could have issued before the reform.[52] These figures imply that had there been no B2V reform (but had Shanghai pilot taxpayers engaged in the same transactions as they actually did in H1 2012), a total of 10.22 (= 9.59 + 0.63) billion yuan of BT would have been paid, but only 2.51 (= 9.6 – 7.09) billion of that amount would have been accompanied by creditable invoices issued to customers. The difference (10.22 – 2.51 = 7.71 billion yuan) would have been the cascading tax imposed on these transactions. B2V reform, by allowing the issuance of an additional 7.09 billion yuan of VAT invoices, largely removes this burden. The starting point for computing the true magnitude of tax reduction thus should be 7.09 billion yuan, which is more than *11 times greater* than the amount of diminishment in tax remittance that the Government in fact highlighted as the extent of tax reduction.

By adopting the variation in the amount of remittance as the measure of tax reduction, the Government thus made it much harder for itself to promote the reform. Interestingly, once the Government set the tone, both Chinese businesses and the media went along with it: much of the public discourse on the B2V reform portrayed the main benefit of the reform as being the ability of pilot businesses to claim input credit for VAT paid on their *own purchases*, not the

[50] The details of reform outcomes in Shanghai and Beijing reported in this article are based on internal government memoranda from 2012 and 2013, all on file with the author. Additional details are gathered through ongoing conversations and correspondence with members of the relevant policymaking units.
[51] This amounted to 11.3% of the VAT revenue generated by other (traditional) VAT payers in Shanghai during the same period.
[52] Transportation businesses previously issued VAT invoices to their customers at a nominal rate of 7%. Of the 7.09 billion yuan total value of additional invoices issued in Shanghai during the first half of 2012, 5.71 billion can be attributed to non-transportation services.

removal of a cascading tax on their sales to business customers. This quickly created problems. Since the "neutrality target" of tax remittance could only be set relative to sector averages, most businesses experienced reductions in tax remittance but some, as could have been expected, experienced increases. The increased remittance was used by taxpayers and the media to challenge the Government's claim that the B2V reform would lead to tax reductions. This debate, which is spurious from tax and business accounting perspectives, became one of the most salient surrounding VAT reform, and was perceived by policymakers to be an indication of political resistance. Remarkably, governments in Shanghai, Beijing and other pilot jurisdictions quickly offered subsidies to these businesses to "compensate" for their increased remittance.[53] A rather striking instance of this comes from Anhui province: the Government collected altogether 3.74 billion yuan of VAT from pilot taxpayers during the first year of reform, but offered back an aggregate of 1.09 billion yuan of subsidy to 1,818 taxpayers who claimed hardship.[54]

Because the conversion from the BT to the VAT is done through regional and sectoral pilots, it is difficult to measure the actual magnitude of tax reduction because revenue loss would be reflected in not only the pilot regions or sectors but also other regions and sectors. But the size of the tax reduction is likely to be significant. This reduction was achieved mainly through the combined effects of the elimination of the BT on B2B transactions and the reduced VAT rates on B2V sectors, and also through other measures. Two such measures deserve special mention because they represent, from a VAT design perspective, distortionary mechanisms that compromise the neutrality of the tax. The first is the "small-scale taxpayer" regime. VAT taxpayers in China that are classified as "small-scale taxpayers" (as opposed to "regular taxpayers") pay a 3 per cent turnover tax instead of the regular VAT.[55] Qualification for "small-scale taxpayer" status for the most part turns on the sales volume of a business, and the designers of B2V deliberately set the threshold of "regular taxpayers" much higher for pilot taxpayers.[56] As a result, most pilot businesses—79 per cent in Beijing, and 65.7 per cent in Shanghai—had turnovers that fell below this threshold and simply saw the turnover tax rate applicable to them drop from 5 per cent (under the BT) to 3 per cent (under the VAT). Because these small-scale taxpayers cannot rely on regular VAT mechanisms (for example, claiming input credits), their tax reduction is easier to measure: the amount was calculated to be 2.71 billion yuan in the first 16 months in Beijing, and 0.61 billion yuan in Shanghai in the first six months.

Secondly, just as the large population of small-scale taxpayers receives preferential treatment by being taken out of the VAT chain, many "regular taxpayers" may also opt out of VAT mechanisms through a "simplified collection" regime. Under this regime, VAT payable is

[53] Some officials admitted that it became hard to tell whether those businesses that complained vocally about increases in remittance complained really because they expected the increase to hurt their bottom lines, or whether the complaint was perceived to be effective in calling forth a government subsidy that offered a windfall (i.e. if the tax remitted was actually collected from customers, there was no real loss to compensate).

[54] China Finance and Economics News, *Outstanding results from Anhui's first year of B2V reform* (November 4, 2013).

[55] See A. Schenk, V. Thuronyi, and W. Cui, *Value Added Tax: A Comparative Approach*, 2nd edn (Cambridge University Press, forthcoming 2014), Ch.14, Section IV.

[56] Namely annual sales of Chinese yuan (CNY) 5 million, 10 times the sales volume that a business needs to demonstrate to qualify as a regular taxpayer in the traditional VAT sectors.

determined by applying a low, turnover tax rate on the value of specified categories of transactions, with no input credit claimed by the supplier and no credit claimable by the purchaser of the service.[57] In the latest round of guidance for B2V taxpayers issued in December 2013, "simplified collection" at the low 3 per cent rate is made applicable to a number of services at taxpayers' election, ranging from public transportation (including even taxis and long distance transport), services related to the production of animation, the storage, transportation and showing of film, and operating leases of equipment produced before the implementation of the VAT pilots. This low-tax option is probably granted primarily as a form of tax preference,[58] and not to allow businesses to reduce compliance costs.

Overall, what has emerged might be called a "no-losers" approach to reform: the Government seems to eschew any trade-off between a broader-based VAT and the efficiency gains it brings, on the one hand, and economic losses of any particular group of industries or consumers, on the other. Moreover, political appeasement of potential losers is accomplished by generously tinkering with the VAT mechanisms themselves, and not through broader political trade-offs using other tax or non-tax policy instruments. It is important to recognise that this outcome may not be accidental, and that it may instead be traced to the political origin of B2V reform. The Government's general framework for reform[59]—which was announced in 2011 and which has not received any substantial elaboration or supplementation since then—was silent on whether B2V reform as a whole would be revenue-neutral, and if it would not be and instead indirect tax revenue were to fall, how the tax reduction would be distributed. This was consistent with the fact that, as discussed in section 1, the political support for the reform in 2011 was unclear, resulting in it being experimented with on only a regional basis. It is likely that at that point, only tax reductions through the elimination of tax burdens on B2B transactions commanded (or was expected to command) political consensus, and the reformers only hoped to bargain their way through the rest of the reform. As a result, there was no conception of the revenue, price and distributional impact of the reform as a whole.

If this analysis is correct, it has strong implications for the remaining phases of the B2V reform. It means that the unusual VAT mechanisms that have been adopted in the first two years (especially differentiated rates and the retention of cascading tax mechanisms through the small taxpayer regime and "simplified collection") are likely to be applied to further sectors. Industries and the Government will bargain over such measures without taking into account the eventual adoption of a broad-based and more uniform VAT, or at least heavily discounting the probability (and time value) of such future policies. As a result, the VAT as applied to the new sectors will significantly differ from the VAT that applies to traditional VAT sectors, and China will effectively have two distinct VAT systems, instead of a VAT and the BT. In fact, extending the B2V reform to further sectors may further accentuate the distinction between the "two VATs" by making the BT-replacing VAT even more idiosyncratic. The next section elaborates on the

[57] For a discussion of "simplified collection" mechanisms as a form of VAT preference, see Schenk, Thuronyi and Cui, above fn.55, Ch.14, Section VII.B.
[58] The low-tax option for operating leases of pre-reform equipment is clearly a piece of transition policy. Special favourable rules were also offered for finance leases.
[59] MOF and SAT, above fn.17.

challenges facing the further phases of the B2V reform and the budgetary aspects of the "second VAT".

5. Challenges in extending the reform and the risk of a "second VAT"

5.1 Construction and real estate

Construction and installation services contributed on average 24.23 per cent of total BT revenue between 2009 and 2011. Interestingly, the Government originally announced in 2011 that an 11 per cent VAT rate would apply to the construction industry,[60] and considered including the latter in the earlier phases of reform, together with railroad, postal services, and telecommunication. This should have been surprising, because most construction services are probably supplied during the development of real estate, and before the real estate sector (sales and rentals) is converted to the VAT, the flow of the VAT to final consumers is bound to be blocked. Thus it would have made little sense to expand the VAT into the construction sector without doing so for real estate as well. In light of this, the postponed launch of the reform for construction, purportedly due to industry opposition,[61] should have been expected.

The Government also indicated the intention in 2011 to apply regular VAT mechanisms to the real estate sector, with no mention of special rates. In reality, though, substantial difficulties pertain to reforming the indirect taxation of real property. These difficulties can be appreciated by examining some crucial numbers. The BT imposed on the transfer of real property has in recent years consistently generated almost 26 per cent of total BT revenue, more than even construction and installation.[62] Moreover, the national effective BT rate on the transfer of real property—total BT revenue from such transfers divided by the independently-reported aggregate value of real estate sales—has stayed close to the legally stipulated rate of 5 per cent. Finally, the real property sales market is dominated by residential property: of the total value of all property sales in 2007, 85 per cent consisted of the sale of residential property, and that percentage has been typical of recent years.[63] This means that subjecting the real estate sector to the VAT mostly means collecting VAT on the sale of housing to final consumers. Therefore, the applicable tax rate is crucial. A 17 per cent rate would mean multiplying the current tax rate (both nominal and effective) by 3.4 times: it is highly unlikely that input VAT credits into real estate development would be able to offset a rate hike of this magnitude. Absent a reduced VAT rate, therefore, applying the VAT to real property sales means higher tax-inclusive property prices. But there is no sign that the Government is prepared to accommodate such a broad tax-induced price

[60] MOF and SAT, above fn.17. Construction services are currently subject to the BT at a 3% rate and usually the value of subcontracted work is deducted from the value of main contractor's taxable service.
[61] L. Wu, "B2V Reform Delayed for Construction, Tax Burden Increase Post-Reform Higher Than Initially Projected", *Huaxia Shibao* (*China Times*), May 25, 2013. By contrast, whereas the application of the VAT to telecom services is also delayed (also purportedly due to business opposition), the underlying policy issue is quite different, since telecom services are provided predominantly to final consumers.
[62] The transfer of land use rights and real property rental (which tend to be transactions entered into among businesses), by contrast, account for a much smaller 1.5% of total BT revenue. The computation in this paragraph is based on data from the *China Tax Yearbook* (2009–2011).
[63] National Bureau of Statistics, *China Real Estate Statistics Yearbook 2008* (Beijing: China Statistical Press, 2008). That percentage increased to near 87% in 2009.

increase in housing, given the housing bubble that it has been combatting for almost a decade now.

Thus real estate may be a current blind spot in the design for further B2V reform. In fact, real estate is a complex area for VAT policy in most countries, and other countries (for example, Australia and Canada) that have introduced broad-based VATs to the housing sector have tended to adopt substantial transition measures.[64] The policy for subjecting housing to the VAT is even more complex in China for at least two other reasons. The first is that the Deed Tax, which largely overlaps with the BT in taxing transfers of immovable property, may not be justifiable once a (high-rate) VAT is applied to housing. The Deed Tax, however, is a non-negligible source of revenue for sub-national governments. Secondly, in recent years there has been much discussion of broadening the Chinese property tax to cover residential property. However, from a tax policy perspective, the VAT on the sale of new residential property is equivalent to pre-collecting a tax on housing consumption. It therefore partially overlaps with the base of a property tax.[65] The simultaneous imposition of a substantial property tax and a major consumption tax on housing is uncommon internationally, though not altogether unprecedented.[66]

5.2 Financial and consumer services

The implementation of a properly designed VAT with respect to financial services is still being experimented with even in countries with mature VAT systems. One part of best practice is to collect VAT on any service with an explicit charge. What is more elaborate is to identify the implicit prices of financial intermediation services provided to customers (for example, depositors and borrowers) when no service fee is explicitly charged.[67] Although the best mechanisms that have been designed to keep track of such implicit prices of various types of financial transactions have yet to be adopted, two general goals of any proper VAT treatment of financial services are clear. The first is to ensure that financial institutions are least influenced by tax considerations in their input purchases, by allowing them to claim input credit for all VAT paid on such purchases.[68] The second is to ensure that net tax revenue is raised only from services provided to final consumers but not those to businesses. The latter can be achieved either by charging

[64] See S. Poddar, "Taxation of Housing Under a VAT" (2010) 63 *Tax Law Review* 443; W. Cui, "Objections to taxing resale of residential property under a VAT" (2012) 137 *Tax Notes* 777; and R. Millar, "VAT and Immovable Property: Full Taxation Models and the Treatment of Capital Gains on Owner-Occupied Residences" in R. de la Feria (ed.), *VAT Exemptions: Consequences and Design Alternatives* (Kluwer Law International, 2013). Real estate contributes a large portion of VAT revenue in countries with "modern VATs" (e.g. 27% in Australia), whereas residential property tends to be exempted or zero-rated under European VATs.

[65] The economic incidence of a property tax is a complex matter, but through a number of mechanisms it should fall at least partially on housing consumption. See G. Zodrow, "The Property Tax Incidence Debate and the Mix of State and Local Finance of Local Public Expenditures" (2007) 53(4) *CESifo Economic Studies, CESifo* 495.

[66] Australia and Canada both combine robust property taxes with a VAT on housing, though the latter at much lower rates than 17%.

[67] See S. Poddar and M. English, "Taxation of financial services under a value-added tax: applying the cash-flow approach" (1997) 50 *National Tax Journal* 89; A. Schenk and H.H. Zee, "Financial Services and the Value-Added Tax" in H.H. Zee (ed.), *Taxing the Financial Sector—Concepts, Issues, and Practices* (IMF, 2004).

[68] Current VAT systems in Europe generally fail to achieve this goal, as they exempt financial services from taxation, thus also denying input tax credits for purchases related to such services.

VAT on financial services provided to businesses but allowing business customers to claim input credit for such VAT charged, or by not charging VAT on such services through zero-rating.[69]

Whether China will adopt any of these methods is not just a technical matter. Under the BT, financial institutions are unable to claim any input credit for VAT paid on purchases. They are charged a 5 per cent rate on the interest on all of their lending, as well as margins earned on dealing and trading and other fee-based services. (There is, however, no BT on non-fee-based services provided to depositors.) Financial and insurance services contributed on average 15.59 per cent of total BT revenue between 2009 and 2011. The major portion of this comes from the BT on gross interest. Although consumer finance is a fast growing segment of financial services in China, as of the first half of 2013 consumer loans still represented only 17 per cent of the total balance of outstanding loans made by financial institutions,[70] and the percentage of earnings of such services is probably lower. Therefore the consumer portion of banks' value added is likely to be relatively small. If only this portion is subject to the VAT, and if input credit claims in connection with non-consumer services are granted, then B2V reform for financial services could mean a significant net tax reduction.

Banks (and their business customers) will welcome such a tax reduction,[71] but local governments may hold the view that financial institutions have (at least traditionally) profited greatly from government regulation and that therefore they should not see their tax reduced. They may thus propose that the B2V reform for financial services be "revenue neutral". One way to reconcile this revenue objective and tax reform would be to implement a true VAT for financial services, but levy an extra tax on the profits of financial institutions either nominally as a part of the VAT, or completely separately.

The negotiation between the Government and the multitude of financial institutions regarding such a solution may seem complex, but it may in fact be less politically challenging than extending the B2V reform to ordinary consumer services. The breakdown at the end of 2013 of the negotiation to extend the B2C reform to telecommunications may be a harbinger of more general difficulties to come for bringing consumer services under the VAT. Telecom services were until 2014 subject to BT at a low 3 per cent rate, and the Government had proposed to apply an 11 per cent rate upon conversion to the VAT. The major telecom operators objected that this would significantly increase their "tax burden", and that a 6 per cent rate was more appropriate. Neither side publicly presented studies concerning the prospect of increasing the tax-inclusive service prices to final consumers—presumably, both were interested in avoiding such a public discussion. In May 2014, a compromise was struck resulting in the telecom industry itself now being subject to two different rates: "basic" telecom services (including voice services and the sale or grant of bandwidth usage rights) are subject to the 11 per cent rate, whereas "value added" services (including all messaging, image, data and information services, internet connections, and satellite roaming) are subject to the 6 per cent rate. Although the three major state-owned telecom operators

[69] This is the approach currently adopted by New Zealand. Unlike an exemption from VAT, zero-rating allows the financial institutions to claim input credits for business purchases.

[70] Computed from People's Bank of China, *Statistical Report on Uses of Loans by Financial Institutions*, H1 2013.

[71] Household deposits in China may remain generally inelastic with respect to interest rates before any significant loosening of capital control. A higher explicit tax on financial services furnished to depositors may simply replace the previous implicit tax in regulated and suppressed interest rates, but would bring revenue to governments instead of profits to banks.

forecasted immediate reduced profits as a result of this change, it is unclear yet whether such forecasts were based purely on accounting artifacts,[72] or what the long-term forecast will be.

With respect to consumer services provided in more competitive markets, any government-business negotiation would have to be more indirect. At the outset of the B2V reform, the Government had already indicated an intention to apply "simplified collection" to "everyday" services.[73] Given that, as explained in section 6 above, "simplified collection" under the Chinese VAT is no different from the BT—except that the former may be set at an even lower (turnover tax) rate than the latter—this could be interpreted as an announcement that there would be no reform for such services. This implies maintaining the BT/VAT dichotomy with respect to a wide range of consumption goods and services. In this respect, a broad-based uniform VAT is clearly not the aim of the B2V reform.

5.3 Allocation of VAT revenue among national and provincial governments

The most obvious way in which the BT is being replaced not by "the" VAT, but by a second VAT, consists not in the detailed differences between the VAT rules that apply to B2V pilot businesses and the VAT rules that existed prior to the B2V reform and which continue to apply to industries previously covered by the VAT, but in the formal legal and budgetary features of the reform. Legally, the MOF and SAT have developed a set of regulatory guidance intended to be the law governing the B2V reform, which has legal effect independent of existing VAT rules. Budget-wise, practitioners have come to call the traditional VAT the "shared-revenue" VAT, and the tax that replaces the BT the "local revenue" VAT.

An important perceived obstacle to launching the B2V reform was the fact that BT revenue accrues almost entirely to sub-national governments whereas 75 per cent of VAT revenue was traditionally allocated to the national government. It is widely believed that for the BT to be replaced by the VAT, either the provincial sharing percentage of the VAT has to be increased, or greater shares of other taxes must be allocated to sub-national governments, or both. For the initial phases of the B2V reform, it was decided that although state tax bureaus would collect VAT from pilot businesses in the pilot sectors and regions, whereas local tax bureaus would continue to collect BT, all of the VAT revenue paid in connection with services newly subject to the VAT would be assigned to the sub-national jurisdiction in which the pilot businesses are located. By contrast, VAT payable in connection with goods and services previously subject to VAT is still shared 75 per cent and 25 per cent between national and provincial governments.

The implementation of these two budgetary regimes for the pre-existing and the new VATs implicates taxpayers extensively and can be far from intuitive. The two types of taxable transactions (always VAT-able versus newly VAT-able) appear in two separate lines on a tax return: entering a certain amount in the wrong line, if uncorrected, would result in the associated revenue going to the wrong level of government.[74] If a taxpayer was previously engaged in a

[72] Under Chinese accounting, the business tax is included in the value of sales revenue whereas the VAT is not. Thus the conversion to the VAT immediately reduces gross revenue.
[73] MOF and SAT, above fn.17.
[74] For example, the lease or sale of equipment is subject to the same VAT rate, but whether it is a lease or sale determines whether the revenue goes 100% to a provincial government or only 25%.

VAT-payable business and has unused, carryover input credit,[75] such input credit cannot be used against any new VAT payable as a result of transactions to which the B2V reform applies. This rule is needed to prevent VAT payable to the pilot jurisdiction governments from being diluted due to the higher central government share of traditional VAT revenue. Moreover, the VAT payable by businesses engaged in both traditional and newly VAT-able supplies is allocated in proportion to the amount of the two types of taxable sales.[76]

Special rules were also designed to allocate new VAT revenue arising from the different operating branches of a single company and different members of a single corporate group. All branches or subsidiaries pre-pay VAT at a given percentage of the value of their sales to the jurisdictions in which they are located. All VAT pre-paid would be deducted when computing tax payable at headquarters or the group parent company. Because this is likely to reduce revenue at the headquarter jurisdictions,[77] a new rule was adopted in October 2013 that allocated the overall VAT liability of a company (or corporate group) to its various branches (or subsidiaries) according to their respective volumes of newly VAT-able services, and to suspend pre-payments by branches or subsidiaries as long as prior payments exceeded allocated liability. However, this scheme of consolidation and allocation applies only to newly VAT-able services, whereas the same taxpayers must pay VAT with respect to any traditionally VAT-able supplies on the basis of some very different prior VAT rules.

6. General inefficiencies in China's VAT

It may now be abundantly clear to the reader that, in many not-so-subtle ways, the purported reform in China to replace the BT with the VAT falls short of applying VAT norms and rules that are familiar internationally. The liberal use of multiple rates and cascading mechanisms is not a marginal phenomenon in the reform but arguably forms its political and economic core. A unified VAT that eliminates the tax burden on the input factors to the production of goods and services is not the goal of the reform. Of course, there are also more banal ways in which the reform has fallen short. Take, for example, the treatment of postal services announced in December 2013: although postal services are nominally brought under the VAT as of 2014, most of the services provided by China Post and its corporate group members, which were exempt under the BT, will remain exempt under the VAT. These businesses will thus not be able to claim input

[75] The rule for carrying over (but not refunding) input credit for domestic supplies is discussed in section 5 below.
[76] The non-intuitive results of these rules can be shown in a simple example. If a business has 100 of carryover input credit, 20 of new input credit, 50 of new taxable supplies, and 50 of previously taxable supplies, then it would be able to claim 70 of input credit (20 of the new input credit and only 50 of the carried-over credit), and the VAT payable of 30 would be allocated half and half between central and provincial governments according to the volume of the two types of taxable supplies.
[77] It was estimated that five airline companies headquartered in Beijing paid 131 million yuan of VAT in Beijing during the first 10 months of 2013, but had made 814 million yuan of prepayment in their various branches.

credit on their purchases any more than they were able to previously.[78] The "reform" was in name only.[79]

But there is yet another fundamental consideration that may further modify one's evaluation of the reform. When Chinese policymakers, academics, and others identify the flaws and inefficiencies of the BT in order to advocate its replacement by the VAT, there is an implicit premise that the Chinese VAT itself is efficient (or at least more efficient than the BT). In reality, many Chinese VAT rules and the ways in which they are implemented raise the possibility that in its real operation, the Chinese VAT can be quite inefficient. At least, the efficiency of the Chinese VAT, as an empirical matter, is still largely unknown. Perhaps the most troubling sign of the potentially high inefficiency of China's VAT (as it stood before the B2V reform) is the apparently widespread and steadfast belief of the Chinese public that it is businesses that bear the VAT, and that this burden is measured by the amount of remittance. The idea that the VAT on input purchases creates no burden on businesses (at least as a general matter) is often dismissed in China as bookish naiveté.

While the inefficiencies of many real world VAT systems in other countries (for example, relating to the use of VAT exemptions) arise because of substantive policy choices,[80] a significant portion of the quirks of China's VAT, as applied to both the traditional and the new pilot sectors, can be attributed to problems in tax administration. Consider, first, the large variety of ways in which the Chinese VAT refuses to remove tax burdens on business purchases. China is quite unique in that, aside from VAT refunds due to zero-rating for exports, excess input VAT credits in any period must be carried forward to offset VAT collected on future sales, but can never be refunded, not even when a business liquidates.[81] This can impose a significant cash flow (and sometimes permanent) cost on business input purchases. It was reported that on the eve of the B2V pilot in Beijing in August 2012, there was over 59 billion yuan of unused input VAT credit among Beijing taxpayers; this was equivalent to over 60 per cent of the total amount of domestic VAT (that is, not counting VAT collected on imports) collected in Beijing during 2011.[82]

In addition, China has adopted "simplified collection" mechanisms for the 84 per cent of the VAT taxpayer population that are "small-scale taxpayers", as well as for a wide variety of supplies even if made by relatively large businesses that are regular taxpayers.[83] There is almost no

[78] For a discussion of the failure to eliminate exemption treatment for postal services in the EU, see R. de la Feria, "The EU VAT Treatment of Public Sector Bodies: Slowly Moving in the Wrong Direction" (2009) 37(3) *Intertax* 148, 163. The optimal tax treatment under the VAT of many publicly-provided private goods such as postal services, education and healthcare is an important issue in tax policy design, and the traditional, exemption treatment has been much criticised. See Ebrill, et al., above fn.20, Ch.8, and Oskar Henkow, *The VAT Treatment of Public Bodies* (Kluwer 2013). There has been little discussion of this important area of policy so far in the B2V reform.

[79] This should be familiar to those who have studied the introduction of the VAT to replace cascading taxes in Europe. V. Lenoir, "April 1954–April 2004—VAT Exemptions: The Original Misunderstanding" (2004) 10 *European Taxation* 456.

[80] See, generally, I. Crawford, M. Keen, and S. Smith, "Value Added Taxes and Excises" in Institute for Fiscal Studies, *Dimensions of Tax Design—The Mirrlees Review* (Oxford: OUP, 2010), Ch.3.

[81] See Schenk, Thuronyi and Cui, above fn.55, Ch.14, Section VI.A.

[82] Calculation based on *China Tax Yearbook* (2012).

[83] The line between "small-scale taxpayers" and "regular taxpayers" basically corresponds to the VAT threshold in other jurisdictions. The "simplified collection" mechanism as applied to "small-scale taxpayers" is potentially analogous to the special scheme for small undertakings permitted under Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax (the European VAT Directive). See J. Kajus and B. Terra, *A Guide to the*

difference between the BT and "simplified collection" under the Chinese VAT[84]: for a transaction subject to either, the customer cannot take an input credit for the tax charged, and the supplier cannot reduce remittance to the Government by the VAT paid on input purchases. Both distort production decisions. The rationale typically offered for introducing such cascading mechanisms back into the VAT is that, often, the input purchases of the taxpayer are not properly documented, and therefore VAT input credits cannot safely be granted. It would then be easier for both the taxpayer and tax administrators to forego VAT mechanisms and opt for a low-rate turnover tax instead. This rationale reveals both the significant compliance costs potentially borne by taxpayers and the limited audit capacity of tax agencies. The requirement under the normal VAT to refund excess input credit is indeed an important potential vulnerability of the tax.[85] In order to protect itself from this vulnerability, Chinese tax agencies seem to prefer to abandon the VAT altogether instead of enforcing the VAT. The same motive to limit the risk of revenue loss that may result from both legitimate and illegal taxpayer behaviour seems to underlie the more general restriction on the use of input credits for all taxpayers.

This brings us to a second, unique feature of the Chinese VAT, namely its implementation through the "Golden Tax System" (GTS).[86] As a result of the Chinese Government's heavy investment in and promotion of the GTS, many academic non-specialists perceive it as an important strategy that explains the relative success of Chinese tax administration in the last two decades. From the perspective of taxpayers themselves, however, the GTS is a regulatory albatross.[87] Under the GTS, sales and purchases are monitored and verified by tax agencies using an extensive system of encryption devices, specially printed invoices, and computerised cross-checking. As "high-tech" as this may sound, in reality its main function is to prevent criminal tax fraud—something that most other countries prevent by carrying out VAT audits.[88] Even if one is willing to credit the Government with success in terms of this effort,[89] the cost is that the GTS subjects *all* taxpayers, including generally compliant ones, to the requirement of recording and reporting sales and purchases in ways that meet the GTS' technological specifications. Even highly compliant businesses have to devote substantial staff time to

European VAT Directives, Introduction to European VAT 2013 (Amsterdam: IBFD, 2013), Vol.1, Ch.19, Section 19.2. However, such practices are much more prevalent in developing countries. See Schenk, Thuronyi and Cui, above fn.55, Ch.14, Section IV. "Simplified collection" mechanisms as applied to specific transactions of regular VAT taxpayers seem rare, from a comparative perspective.

[84] One difference arguably makes the BT superior: in certain BT-able sectors of the Chinese economy, such as transportation and construction, where subcontracting is common and therefore "links" in the supply chain dense, the BT is levied only on the margin of the producer, and thus crudely approximates to a value added tax and mitigates the effect of cascading. There is no analogous "margin scheme" for the VAT charged under "simplified collection".

[85] See M. Keen and S. Smith, "VAT fraud and evasion: what do we know, and what can be done?" (2006) 59 *National Tax Journal* 861.

[86] See J. Winn and A. Zhang, "China's Golden Tax Project: A Technological Strategy for Reducing VAT Fraud" (2013) 4 *Peking University Journal of Legal Studies* 1; Schenk, Thuronyi and Cui, above fn.55, Ch.14, Section V.

[87] See EY, *A look inside China's VAT system: understanding how the regime works to effectively manage vat risks and opportunities* (China: Ernst & Young, 2012), available at: *http://www.ey.com/SG/en/Issues/Impact_2013Feb* [Accessed October 27, 2014].

[88] G. Harrison and R. Krelove, *VAT Refunds: A Review of Country Experience*, International Monetary Fund Working Paper WP/05/218 (2005); Ebrill, et al., above fn.20, Ch.14.

[89] The severity of VAT fraud in China has diminished relative to the 1990s, as reflected in the abolition of the death penalty for such fraud in 2011. However, campaigns to crackdown on VAT fraud are frequently launched, and now such fraud is reported to have spread into the B2V pilot sectors.

co-ordinating the GTS and their own business accounting software and physically handling the "special" VAT invoices on which Chinese VAT administration depends. Taxpayers are often denied input VAT credits because of mishaps in the use of the GTS. This has led to a significant amount of VAT litigation.

It has been argued that the GTS risks locking China into obsolete technology by having the Government, not the market, designate business administration devices.[90] But the problem goes deeper. In promoting the GTS, the Government is engaged in an ongoing war of technology with criminals, while the entire taxpayer population suffers collateral damage. In fact it is not just taxpayers who are hurt. The GTS is, to most intents and purposes, the only way in which Chinese tax agencies monitor VAT compliance: there is almost no VAT audit capacity, and VAT returns filed by taxpayers contain little extra information than that which the GTS has already gathered. Hundreds of thousands of tax administrators have been trained to become specialists in handling VAT invoices, but have only rudimentary experience of examining business books and records. Thus there may be a vicious circle where the use of the GTS exerts a negative effect on the audit skills of tax agencies, which in turn results in excessive conservatism on the part of tax administrators and rules that limit taxpayer rights, which further increase compliance costs and fuel an illegal market in VAT invoices and fraudulent practices.

The GTS is perhaps the single issue that has generated the most disagreement between VAT specialists from other countries and Chinese VAT administrators. For the former, the GTS goes entirely contrary to the recommendation of implementing a VAT on the basis of self-assessment.[91] For the latter, the GTS has stemmed rampant tax fraud and will become less costly in the future as technology improves. One of the implications of the B2V reform is that this unresolved, high-stakes controversy is now carried over to sectors that used to be subject to the BT, which has low compliance and administrative costs. In this connection, it is interesting to note that the MOF and SAT made a remarkable decision in early 2012 to allow all B2V pilot taxpayers to deduct all costs of purchasing GTS equipment from their VAT liabilities. However, as the foregoing discussion suggests, the costs of VAT compliance go well beyond such one-time outlays.

Finally, it should be observed that China's VAT has a very large array of tax exemptions as purported tax preferences, which differs substantially from the list of exempt goods in other countries.[92] There are two explanations of why this is the case. The first is the logic of "exemption creep": suppliers to VAT-exempt businesses tend to lobby for VAT exemptions themselves, since the VAT they charge to their tax-exempt customers cannot be credited by the latter. But since all businesses subject to the BT in China are exempt from the VAT on their BT-able sales, in effect there has been a much larger population of VAT-exempt customers in China than elsewhere. The scope of exemption creep is correspondingly much greater. Secondly, Chinese VAT exemptions are typically granted by administrative instead of legislative means, and thus may be more responsive to special lobbying than otherwise would be the case. The exemptions are often narrowly defined and have opaque rationales which may have been valid only in limited

[90] Winn and Zhang, above fn.86.
[91] VAT specialists have repeatedly identified the GTS as an outlier in international VAT practice. See Ebrill, et al., above fn.20, 139 (and Ch.13 generally); Harrison and Krelove, above fn.88, 27.
[92] See Cui and Wu, above fn.10, 178–179.

circumstances and time periods. While broadening the scope of the VAT may have the effect of slowing the pace of exemption creep, it is not clear whether, and through what processes, past VAT exemptions would be eliminated.

The gains of the B2V reform should, of course, be evaluated not in terms of a hypothetical conversion of the BT into a normative VAT, but in terms of the conversion into the Chinese VAT as actually practiced. The problematic features of the Chinese VAT referred to above suggest such an evaluation is a complex matter. One might take the incorrigible habit on the part of Chinese policymakers, the media, and businesses to speak of the burden of the VAT as being borne by businesses (as opposed to ultimate consumers) as an indication of the extent to which the Chinese VAT in fact puts a burden on businesses. If this inference is not totally invalid, then the difference between the BT and the VAT *as actually practiced* may be smaller than reformers have claimed.

Conclusion

Replacing a low-rate cascading sales tax with a true consumption-type VAT reduces distortions in production decisions as well as the tax burden on business investments. It may, however, increase the tax borne by some previously undertaxed goods and services and therefore raise their prices. When such reform has been attempted in other countries, it has sometimes been characterised as involving shifting tax burdens from businesses to consumers.[93] In China today, such a characterisation would not in itself create political controversies. Moreover, because China already implements the VAT on the sale of goods, replacing the BT by the VAT may lower the prices of goods by reducing their production costs, which partially mitigates the effect of increased prices on consumer services. In addition, by broadening the VAT tax base, the Government may even have the option of lowering the general VAT rate. This, at least, is roughly how the analysis for the B2V reform would run within a standard tax policy framework.

This article has shown that this is not how the policy of B2V reform has been framed and pursued in China. In the first two years of the reform, the Government has both deferred reform measures that directly affect the price of consumer services and avoided discussion of the effect of current and future reforms on consumer prices. Nor has there been public discussion of reducing the general VAT rates. Instead, the Government has proceeded as though the reform is about reducing the tax burden on a sequence of sectors. Moreover, instead of relying on regular VAT mechanisms to achieve such a reduction, it has adopted many measures antithetical to normal VAT design, such as multiple low rates and simplified collection mechanisms. These measures have been taken as ad hoc compromises, or as a matter of transition policy with an indefinite prospect of termination. What has emerged from the reform pilots is a highly unusual, second VAT in the country. How the extension of the reform to further sectors would fit into (or alter) the mould of this second VAT is uncertain. If successful tax reforms involve trading improvements in efficiency (for example, base broadening) with tax reductions and necessary political

[93] See, e.g. M. Smart and R. Bird, "The Economic Incidence of Replacing a Retail Sales Tax with a Value-Added Tax: Evidence from Canadian Experience" (2009) 35(1) *Canadian Public Policy* 85.

compromises, the Chinese B2V reform has involved an ample dose of tax reductions and compromises which one would not have thought was necessary.

China; Consumers; Financial services; Indirect taxes; Real property; Tax administration; VAT

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