

Chapter 2

Transition of Local Revenue Systems

It is clear that China is tentatively transitioning or attempting to transition from an old local revenue system that relied exclusively on land transfer fees (LTF) from selling land use right to a new system that changes the one-time fee into a regular tax alongside a different use for the revenue. In this chapter, we provide a more detailed analysis of the transition process.

2.1 The Old System: Land Transfer Fees

By Chinese laws, all land is the property of the sovereign state, i.e., the central government. This has never been changed, even after the Property Right Law was promulgated in 2007. The exercise of the property right over state-owned land, however, has almost always been by local governments instead of the central government. From 1949 to 1980, transference of the right of land use had been between governmental entities or organizations affiliated with government. Deviation from that old practice started in the early 1980s as a means to attract foreign investment; it was part of the country's overall opening and reform program. A 1981 Guangdong Provincial People's Congress interim rule over land use granted the use of state-owned land for investors to build factories and run businesses for which the investor would pay a "land use fee".¹ In December 1987, the first public auction for the use of land (8588 m² for a lease term of 50 years) was conducted in Shengzhen city, the first case of land use right as an asset listed on the market for exchange. In the next April, the National People's Congress amended the Constitution with a clause on "legal transfer of the land use right within the provisions of the law."

Revenue from the transfer of the land use rights was split initially between the central and local government and was all earmarked for exclusive use on infrastructure. In 1993, part of the central-local compromise for adoption of the tax-sharing system was to grant localities exclusive control over land transfer revenue (to compensate for their loss of revenue from the new tax system). That compromise

¹ 1981年广东省人民代表大会常务委员会公告第六号公告:《深圳经济特区土地管理暂行规定》。

Table 2.1 Local revenue from sale of land use right (land transfer fees) and its ratio against total local outlays 2008–2011 (in millions of RMB Yuan). (Source: Chinese Ministry of Finance, “Report on central and subnational governments’ budget implementation of past fiscal year and budget of current fiscal year,” <http://www.mof.gov.cn/>.)

| | 2008 | 2009 | 2010 | 2011 |
|--|--------|--------|--------|--------|
| Subnational general budget expenditure | 49,993 | 63,202 | 74,959 | 94,334 |
| Subnational fund budget expenditure | 12,928 | 14,292 | 30,299 | 37,486 |
| Subnational land transfer fees | 10,375 | 13,965 | 29,110 | 33,166 |
| Ratio(%) | 16 | 18 | 28 | 25 |

Chinese governments use a multiple budget system that includes General Budget, Fund Budget, and State-owned Enterprise Budget

The ratio equals subnational LTF over the sum of subnational general budget expenditure and subnational fund budget expenditure

triggered an increasing transfer of land use right by local governments and over time “cultivated” local dependence on LTF. In fact, the central government at the time of the compromise did not realize that a temporary measure would develop into such rampant use or that the total transfer revenue could reach such amounts.

By objective observation, the overdependence by local governments on LTF is rooted in a loophole in the country’s financial system that embeds a mismatch between revenue sources and service provision responsibilities among central, provincial, and local governments. In simple terms, the new separate tax regime assigned major taxes and designated the largest share of the shared taxes to the central government, leaving localities with minor taxes and the smallest share of the major taxes. However, localities were assigned most of the responsibilities of basic services provision; thus, their own-source revenue is always short of the tasks on their shoulders.

Meanwhile, top local officials all target high growth rates of the local economy for their own legacies with local residents and for their career prospects at higher positions, with the latter possible mainly from grand achievements on the former. Thus, it only became rational for local officials to maximize the discretionary assets within their control, LTF, which is a very brief version of the complicated “(government) land coffer” story. Table 2.1 offers data from public sources, for the years 2008–2011, on the size of the land coffer and its contribution ratio to total local outlay. The ratio was 16% in 2008 and peaked at 28% in 2010.

Needless to say, the huge amounts of LTF played a very positive role in raising the urgently needed financing for urban infrastructure, which paved the way for fast economic growth, as has been observed everywhere in the country in the past two decades. But problems also arose. One example is that most of the raised funds were used on urban construction so that the gap in facilities and services has been enlarging between urban and rural areas. Another example is that some local governments

did not adequately compensate relocated residents or resort to simplistic measures in relocation, which has caused numerous tragic incidents even social unrests. The biggest problem is that the stock of land is limited; thus, this route for fund raising is unsustainable for long-term growth.

There has been some research in this regard. Anderson (2011) examines the effect of LTF in China (the fees paid at the time of development) on development timing and structural density. He argues that charging the LTF may delay development and the impact of LTF on structural density depends on the situation of a municipality (growing or declining). As an extra cost on land, LTF increases the structural density in a growing municipality and decreases the structural density in a declining municipality. Thus, removal of the LTF may speed up development.

2.2 The New System: Local Property Tax

It is high time that China switched into a new system—the local property tax (LPT), as the means to overcome the problems caused by the rampant sale of land use rights and over-reliance on LTF. As we have argued in a few other places in this monograph, the change from land rent to property tax is to place finance on a regular and contractual basis that facilitates financial planning and supervision. Anderson (2011) also argues that switching to the property tax (if it is designed as a unified ad valorem tax on both land and improvements) will be more favorable to development timing. Another recent study (Hong and Brubaker 2011) examines issues in integrating the property tax into the current local public finance system in China. With empirical results, they are optimistic about switching from land-leasing to the property tax—as long as local governments devote revenue from the property tax to public services in their jurisdiction, the land value will not see a drastic decline.

Starting from the 1994 “separate taxes system”, Chinese local governments have been relying on central transfers for about half their annual outlays. Under the *Initial Equilibrium*, the **revenue equation** for local governments is:

$$R_{t,j,i} = F_{land} + G_{(dis+spe)} + T_{(b+vat+fees)} \quad (2.1)$$

The term “local government” refers to that in an urban district or a rural county, respectively. R is total revenue of local government i of province j in year t . Total revenue includes own-source revenues and fiscal transfers. F is “land transfer fee” that a local government attains by selling land use rights. G is fiscal transfer from the central government and provincial government. Transfers can be classified as discretionary transfers (*dis*) and special transfers (*spe*). The former can be used for any purpose without strings attached; the latter can be used only for designated purposes. $T_{(b+vat+fees)}$ are other own-source revenues from the business tax (T_b), value-added tax (T_{vat}), and other fees (T_{fees}).

On the expenditure side, the initial **expenditure equation** is:

$$E_{t,j,i} = C_{ecn} + S_{(edu+hth)} + A_{(psn+ope)} \quad (2.2)$$

E is total local expenditure from own sources and fiscal transfers. C_{ecn} is outlay on infrastructure for economic development. $S_{(edu+hth)}$ is outlay on key public services education and public health. $A_{(psn+ope)}$ is outlay on government administration, which consists of personnel expenses (psn) and operational expenses (ope). It is important to separate personnel expenses from operational expenses because in the Chinese context, the government payroll is large and usually rigid; operational expenses are more flexible in comparison and can be subject to cuts more easily than personnel expenses.

There exist corresponding relations between terms in the revenue equation and the expenditure equation. Land transfer fees (F_{land}) are typically used for infrastructure (C_{ecn}) to facilitate economic development and attract business investment. Special purpose fiscal transfers (G_{spe}) are typically designated for education and health services ($S_{edu+hth}$); discretionary fiscal transfers (G_{dis}) are mostly for personnel and operations.

The “land transfer fee” is the price paid by developers to a local government for the right to use a land parcel for up to 70 years. Given this long window of the use right at a one-shot fee, we take it as infinite in terms of government budgeting. This price for land use per unit is a function of the local economy (developed, under- or undeveloped; urban, suburban, or rural) and the specific location (downtown, mid-, or up-town). The final price is determined through open bidding. The **land transfer fee equation** is:

$$F_{j,i} = \gamma\mu\rho L \quad (2.3)$$

The equation does not carry the year marker (t) because revenue from LTF is irregular and unstable. It is not a guaranteed recurring income, and the amount fluctuates from year to year. γ is the ratio of the total fee that is allowed to be kept at the local level as own-source revenue; the rest is to be remitted to the central and provincial governments. μ is a binary of 1 and 0, 1 being urban and 0 rural. ρ is the location index, $0 < \rho < 1$. 1 indicates prime location like downtown; 0 is farmland that is prohibited from development. L is the stock of land in a jurisdiction.

The **fiscal transfer equation** is:

$$G_{t,j,i} = Zr\mu_{(dis+spe)} + P\mu(1-w)_{(dis+spe)} \quad (2.4)$$

Z stands for central government transfer programs; P for provincial transfers. r is the region designation of 1, 2, and 3. It is linked to economic development of the province: 1 for the eastern or developed provinces; 2 for interior or underdeveloped provinces; and 3 for western or undeveloped provinces. Using this designation as a multiplier, central transfer programs distinguish the provinces by their extent of

development, for equity between provinces. μ is the urban marker since property tax is levied only in urban areas (including the county seat or metro townships in rural counties). w is the indicator of within-province, local economy or tax base, $0 < w < 1$; it is used by the provincial government in distributing provincial transfers, for equity between local jurisdictions.

After three decades of high-speed industrialization, in particular residential housing development in the past 15 years, urban land for construction is facing severe restrictions; additionally, land supply is limited and land transfer fees are very unstable. China started in early 2011 to introduce the LPT. We can assume that if the introduction is smooth, then overtime LPT will be an effective tool for sustainable local revenue (Dye and England 2010), particularly for Chinese local governments that now rely heavily on LTF.

Introducing the property tax brings in a *New Equilibrium*, under which the **revenue equation** changes to:

$$R_{t,j,i} = F_{land} + P_{t,j,i} + G_{(dis+spe)} + T_{(b+vat+fees)} \quad (2.5)$$

The land fee is maintained because it will stay for a long time as a local revenue source and exert downward pressure on expansionary land use, though revenue from this source remains unstable and irregular. The new addition is the property tax as extra revenue, P , that is regular, recurring each year; more importantly, this new revenue is stable because market values of existing property parcels tend to be stable. The **property tax equation** is:

$$P_{t,j,i} = \tau v n \quad (2.6)$$

τ is the rate set for the LPT. Different from other existing taxes whose rates are set by the central and/or provincial governments, this LPT rate is (will be) set by local governments. v is the benchmark value of residential property as an eligibility test for the LPT. n is the ratio of total property stock subject to the tax. In the pilot property taxes in Chongqing and Shanghai, the benchmark value, v , has been set at a very high level (only targeting luxury housing, for now) in order to mitigate the shock of the tax to the middle class or other house owners. In the long run, this benchmark will decrease to broaden the tax base; ultimately, all (urban) residential property will be subject to the tax.

Once property tax revenue streams in, the **expenditure equation** adjusts also:

$$E_{t,j,i} = C_{ecn} + S_{(ph+edu+hth)} + A_{(psn+ope)} \quad (2.7)$$

Specifically, property tax revenue is now designated for a new service, public housing (ph), as has been planned for in Shanghai and Chongqing. In the future, it is expected to provide extra resources for education and public health also.

2.3 Local Discretion and Decentralized Service Choice

It has long been established in the public finance literature that public service provision by local governments maximizes economic efficiency from their proximity to service recipients and thereby better, real-time information about citizen demands and preferences for public services (Tiebout 1956). More recent studies provide further evidence that despite its over-strict assumptions, the Tiebout model remains valid when local preferences are similar in localities where most “residents can benefit from those goods” (Gruber 2007, p. 281). China-specific studies reveal that regional decentralization and fiscal incentives have played a significant role in the process of China’s economic development from 1970 to 1999 (Jin et al. 2005).

As evidenced in the literature, local governments “dependent on grants have little autonomy” (Fisher 1996, p. 211). Fiscal independence to some extent determines the level of political autonomy; China’s economic development process has also showcased this tendency. The institutionalization of the LPT is a major step in this direction. We can represent the degree of fiscal independence with B , the ratio of own-source revenue against total revenue, $(Ros/Rtot)^{-r}$; the superscript is to take into account the gap in economic development between the three regions (eastern, interior, and western).

With increasing revenue from the LPT, local governments will be able to afford more own-source outlay on services thereafter, in particular outlay on education and public health, which will capitalize into the local tax base, v , so that the relationship between local public service outlays and local own-source revenue is increasingly clear and tight. This closer link of own-source revenue to service provision will help bring about democratic governance by holding local government accountable for service provision and the quality of services, which in turn will capitalize into the property value in a jurisdiction. This loop will form a favorable cycle.

We can represent this loop with D , the ratio of LPT revenue against total own-source revenue, $(P/Ros)^{-w}$; the superscript takes into account the within-province differences in economic development (w). Earmarking property tax revenue for specific uses establishes the tax-service link. Making transparent the LPT levy and collection and basing the use of the LPT revenue on formulae will help institutionalize the link, which enforces democratic governance via public oversight of tax administration and the local government budget (use of LPT revenue). The above equations will be substituted or combined to formulate workable and testable propositions.

Based on the aforementioned theoretical framework, we formulate the following hypotheses:

- H1: Levying the LPT will provide a stable revenue source for local governments.
- H2: Increased own-source revenue to be designated for local public services will closely link the local revenue to service provision, more truthfully reflecting resident preferences and demands.
- H3: Increased own-source revenue will reshape intergovernmental fiscal relations, granting local governments more autonomy.

With that said, the immediate next argument is to make the property tax a local tax as a means to increase local autonomy in making taxing and spending decisions. Thus, decisions for the type, quantity, and quality of services to provide will be local issues through mechanisms of collective decision-making, like public budgeting and voting. These are among the best ways to bind local governments to local residents and tax payers, increase transparency, hold officials accountable for results, and ultimately improve the trust between the citizenry and government. These are topics we refer to again and again in this monograph.

The Property Tax in China

History, Pilots, and Prospects

Hou, Y.; Ren, Q.; Zhang, P.

2015, XVII, 186 p. 39 illus. in color., Hardcover

ISBN: 978-3-319-10048-7