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Taxation and Authoritarian Resilience

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ABSTRACT
Taxation provides important inferences about the nature of non-oil authoritarian regimes. This article looks at taxation to understand the ruling Chinese Communist Party's relationship to society. It finds that the party has maintained fiscal capacity through non-intrusive transactional taxes that allow it to deliver more services in wealthier areas where potential dissent is greatest. This model is reaching its limits because of its negative impacts on economic growth and social equity. Attempts to expand new taxation sources—such as property value taxes or progressive and comprehensive personal income taxes—are difficult because of the prior reliance on transactional taxes. As a result, the CCP will rationally continue to rely on inefficient and inequitable taxation because of the political costs of pursuing a modern taxation system. The China case is indicative of the fiscal dynamics of durable authoritarian regimes.

Introduction

The field of 'fiscal sociology' makes use of taxation data to understand the changing nature of state–society relations. Yet there is no general theory of fiscal sociology to guide an understanding of state–society relations in non-oil authoritarian regimes. This means that a key puzzle about authoritarian resilience in a country like China is how the one-party state is able to capture sufficient fiscal resources to govern. What does fiscal sociology tell us about the nature and prospects of authoritarian resilience in China?

This article uses the lens of taxation to understand the evolution of state–society relations, governance, and regime resilience in China. It argues that the Chinese Communist Party (CCP) has adopted a 'transactional' approach to taxation that relies mainly on indirect and corporate taxes. This system is less efficient, less equitable, and less sustainable than the 'modern' approach that depends more on direct taxes on personal income and property values. However, it remains politically optimal in the medium-term because it generates *sufficiently* good governance and requires *sufficiently* little consent to limit social opposition. Authoritarian resilience in China, from this perspective, is dependent on the party's ability to capture the gains of economic growth while remaining relatively unobtrusive in a marketized society.

The article begins with a discussion of fiscal sociology and its importance to understanding authoritarian regime resilience. This is followed by analysis of resource capture through taxation in contemporary China and its prospects. This introduces the debate on tax system reform and its limits. Implications for authoritarian resilience in China and elsewhere follow.

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The Thunder of World History

Writing in 1918, a year before he became finance minister of Austria, Schumpeter argued that fiscal history was nothing less than the history of a nation and its people, 'the thunder of world history' as he termed it.[1] His invention of the field of 'fiscal sociology' ushered in a view that the revenues and spending of a state are not just a cause but also a consequence of deeper social, economic, and political facts.

Schumpeter was particularly interested in taxes—the 'economic bleeding' on which states depend. Taxes are compulsory unrequited payments to general government by individuals or legal entities. Unlike fees, fines, or mandatory contributions to personal accounts, taxes are intended to support general government expenditures, to shape macro-economic conditions, and to encourage or discourage certain types of behavior. From an economic perspective, taxes are the resource transfers necessary for the provision of public goods. From a sociological (or Schumpeterian) perspective, taxes are also the financial manifestation of the patterns, struggles, and relationships within and between state and society. A 'new fiscal sociology' that revives the Schumpeterian approach pays particular attention to how informal institutions, historical junctures, and social context shape taxation choices.[2] In recent years, these approaches have been used to understand state capacity and state–society relations in developing countries where other forms of data may be less reliable.[3]

One consequence of the Schumpeterian view is that taxes have figured prominently in studies of political development.[4] These studies have shown that the dynamics of taxation and political change are highly variable. Low taxation may stabilize a regime because of the limited demands on citizens. However, it may also destabilize a regime because, as Goldstone argued in a qualitative study of revolutions, low taxation can weaken state capacity, creating vulnerability to rebellion.[5] By contrast, rising fiscal demands may stabilize a regime by generating capacity and control over society. On the other hand, rising fiscal demands might cause pressures for regime change. This may be in a more democratic direction as a new civic public seeks to capture the state, as occurred in Western Europe.[6] Or it may be in a non-democratic direction as anti-state movements undermine democratic prospects.[7]

In the case of authoritarian regimes, the assumption has been that since political access and consent-based legitimacy are limited, low taxation will be the norm and taxation will be mainly through indirect levies or direct control of economic sectors. Classic 'rentier state' theories argue that authoritarian regimes will minimize taxation because this in turn minimizes pressures for social control of the state.[8] While rentier states are not statistically less likely to democratize according to Herb,[9] they nonetheless remain a persistent feature of authoritarian regimes. Statistically, countries with lower

[1]Joseph A. Schumpeter, 'The crisis of the tax state', in Richard Swedberg, ed., *The Economics and Sociology of Capitalism* (Princeton, NJ: Princeton University Press, [1918] 1991), pp. 99–140, p. 101.

[2]Isaac William Martin, Ajay K. Mehrotra and Monica Prasad, 'The thunder of history: the origins and development of the new fiscal sociology', in I. W. Martin, A. K. Mehotra and M. Prasad, eds., *The New Fiscal Sociology: Taxation in Comparative and Historical Perspective* (Cambridge: Cambridge University Press, 2009), pp. 1–27.

[3]Evan Lieberman, 'Taxation data as indicators of state–society relations: possibilities and pitfalls in cross-national research studies', *Comparative International Development* 36, (2002), pp. 89–115; Melissa Ziegler Rogers and Nicholas Weller, 'Income taxation and the validity of state capacity indicators', *Journal of Public Policy* 34, (2014), pp. 183–206; Deborah Brautigam, Odd-Helge Fjeldstad and Mick Moore, *Taxation and State-Building in Developing Countries: Capacity and Consent* (Cambridge: Cambridge University Press, 2008).

[4]Reinhard Bendix, *Kings or People: Power and the Mandate to Rule* (Berkeley, CA: University of California Press, 1978); Sven Steinmo, *Taxation and Democracy: Swedish, British, and American Approaches to Financing the Modern State* (New Haven, CT: Yale University Press, 1993).

[5]Jack A. Goldstone, *Revolution and Rebellion in the Early Modern World* (Berkeley, CA: University of California Press, 1991), p.461.

[6]Toke Aidt and Peter Sandholt Jensen, 'Tax structure, size of government, and the extension of the voting franchise in Western Europe, 1860–1938', *International Tax and Public Finance* 16, (2007), pp. 362–394.

[7]Kevin M. Morrison, *Nontaxation and Representation: The Fiscal Foundations of Political Stability* (New York: Cambridge University Press, 2015).

[8]Gwenn Okruhlik, 'Rentier wealth, unruly law, and the rise of opposition: the political economy of oil states', *Comparative Politics* 31, (1999), pp. 295–315; John L. Campbell, 'The state and fiscal sociology', *Annual Review of Sociology* 19, (1993), pp. 163–185, p. 174.

[9]Michael Herb, 'No representation without taxation? Rents, development, and democracy', *Comparative Politics* 37, (2005), pp. 297–316.

levels of executive constraint collect less taxes in general and less direct taxes in particular, holding income per capita constant.[10] This means that non-oil authoritarian regimes that cannot supplement their taxation with rents are in theory doomed to long-term fiscal weakness, as Moore explores with respect to non-oil Middle East regimes.[11] In practice, however, a large number of such regimes are able to maintain fiscal systems that deliver sufficient state capacity and sufficient public services to survive.

China is an important case of a non-oil authoritarian regime that has maintained fiscal capacity as well as regime stability. In addition to its sheer size (accounting for more than half of the world's population living under authoritarianism), China is important because it does not look or act like a classic rentier state. The ruling party has introduced a market economy, information technology, rapid urbanization, global opening, and limited elections (at the sub-national level), all without fiscal decline or regime threats. Can fiscal sociology explain authoritarian resilience in China?

Resource Capture and Being Shanghaied

A large part of the research on taxation in China concerns decentralization and transfers to local governments.[12] There is also a large amount of literature on rural taxation and the ruling party.[13] These two dominate the literature, accounting for 10 of 11 articles on taxation published in the *Journal of Contemporary China* since 1997. They reflect enduring concerns about two major fiscal relationships in China: central–local and party–rural. Yet from the standpoint of regime resilience, there is another important relationship: between the fiscal state and new economic groups among the country's 750 million urban residents. We might call this the 'central–urban' fiscal relationship.

The simplest way to interpret tax revenues for purposes of political analysis is to examine the share of social product captured by the state. During the first 15 years of economic reforms from 1978, China's state sector-based tax revenues fell as the non-state sector boomed (see Figure 1).[14] This represented a clear threat to the stability of the regime since, as Moore notes, a rule of thumb is that when the tax take falls below 20% of GDP, the state loses the capacity to minimally control and penetrate society.[15] As a result, major tax reforms were introduced in 1994 to rebuild state capacity, including a revised value-added tax. Taking a broad definition of revenues (that includes taxes but also social security contributions and other unrequited fees and fines as well as state sector dividend payments and land sale takings), China's state capacity has recovered strongly from the freefall of the early reform era. Of these revenues, about 65% come from taxes. Taxes alone were about 19% of GDP in 2014, bringing them back close to Moore's political risk cut-off point.[16]

This fiscal recovery had, by around 2002, brought China to a level of political extraction similar to that of other economies of similar development level and structure, and by 2011 it was about 20% above-average in this respect (see Figure 2).

This fiscal recovery has depended heavily on indirect taxes, especially the value-added tax, and on corporate taxes, much of it from state sector firms. Consumption, value-added, business, and corporate

[10]Timothy Besley and Torsten Persson, 'Taxation and development', in Alan Auerbach, Raj Chetty, Martin Feldtstein and Emmanuel Saez, eds., *Handbook of Public Economics*, (Amsterdam: Elsevier/North Holland, 2013), pp. 51–110.

[11]Pete W. Moore, 'Fiscal politics of enduring authoritarianism', *Project on Middle East Political Science Blog*, December 11, 2014. Available at: http://pomeps.org/2014/12/11/fiscal-politics-of-enduring-authoritarianism/. [accessed 23 June 2016].

[12]Shaoguang Wang and Angang Hu, *The Chinese Economy in Crisis: State Capacity and Tax Reform* (Armonk, NY: M.E. Sharpe, 2001); Jianli Tan, *Zhongyang Yu Difang Caiquan Shiquan Guanxi Yanjiu* [*On Central–Local Fiscal Power Relations*] (Beijing: Zhongguo caijing chubanshe, 2010); Eun Kyong Choi, 'The politics of central tax collection in China since 1994: local collusion and political control', *Journal of Contemporary China* 25 (97), (2016), pp. 146–159.

[13]Thomas P. Bernstein and Xiaobo Lü, *Taxation without Representation in Rural China* (Cambridge: Cambridge University Press, 2003); Hiroki Takeuchi, *Tax Reform in Rural China: Revenue, Resistance, and Authoritarian Rule* (New York: Cambridge University Press, 2014); Linda Chelan Li, *Rural Tax Reform in China: Policy Process and Institutional Change* (New York: Routledge, 2012).

[14]William Gamble, 'The middle kingdom runs dry', *Foreign Affairs* 79, (2000), pp. 16–21.

[15]Peter Moore, 'Fiscal politics of enduring authoritarianism'.

[16]John Brondolo and Zhiyong Zhang, 'Tax administration reform in China: achievements, challenges, and reform priorities', *IMF Working Papers* 116, (2016), p.7.

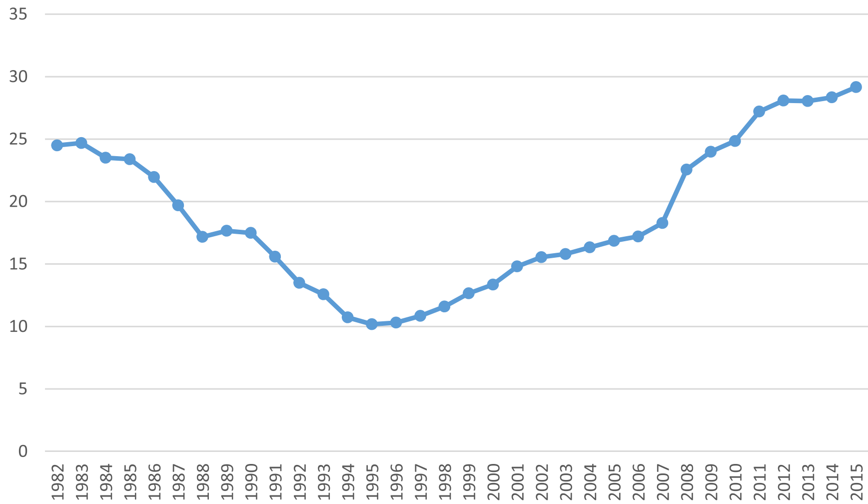

Figure 1. Government revenues as % GDP. Source: IMF World Economic Outlook Database; General Government includes central, provincial, and local governments, including social security and independent agencies, but not public corporations.

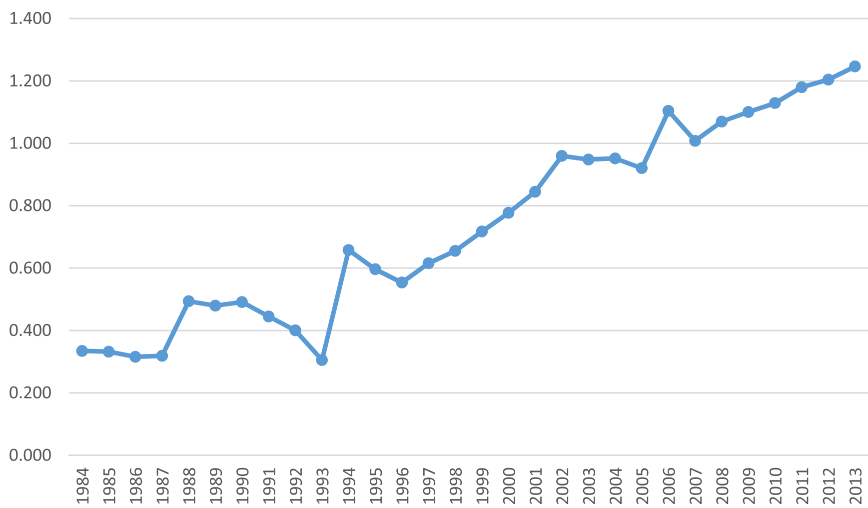

Figure 2. Relative political extraction. Source: Relative Political Extraction (Model 2) ('the ability of governments to appropriate portions of the national output to advance public goals' relative to countries with a similar economic structure and development level where 1.0 = predicted value'), Relative Political Performance Data Set Version 2.1(August 2013) and 2015 Update; TransResearch Consortium.

taxes accounted for 50% of government revenues and 60% of tax revenues in 2010.[17] Another growing source of revenues has been property sales taxes, which authoritarian regimes often use because they are easy to administer and enforce.[18]

In general, this fiscal recovery has helped the CCP to rebuild both the administrative and coercive capacity of the state.[19] Thus a simple lesson is that an authoritarian regime with a modernizing economy

[17]Bert Brys, Stephen Matthews, Richard Herd and Xiao Wang, 'Tax policy and tax reform in the People's Republic of China', *OECD Taxation Working Papers* 18, (2013), p. 11.

[18]Paola Profeta, Riccardo Puglisi and Simona Scabrosetti, 'Taxation and democracy in developing countries', in Clemens Fuest and Gearge R. Zodrow, eds., *Critical Issues in Taxation and Development* (Cambridge, MA: MIT Press, 2013), pp. 217–238.

[19]Dali L. Yang, *Remaking the Chinese Leviathan: Market Transition and the Politics of Governance in China* (Stanford, CA: Stanford University Press, 2004); David Andersen, Jørgen Møller, Lasse Lykke Rørbæk and Svend-Erik Skaaning, 'State capacity and political regime stability', *Democratization* 21, (2014), pp. 1305–1325.

can at first capture a large part of the growth in the form of relatively easy to administer indirect taxes as well as direct taxes on the state-controlled economy. These 'transactional' taxes have been the foundation of China's fiscal recovery.

Of equal importance to the overall level of tax revenues is the variations across China. China's central–provincial fiscal sharing does not incorporate an equalization mechanism, so the poorest provinces are also the fiscally weakest because the structure of their economies does not mesh well with China's urban and industrial-oriented tax system. The four 'river and lake' provinces—Hebei, Henan, Hubei, and Hunan—had tax revenues equivalent to only 7–8% of their GDPs in 2011, compared to 15–20% for the big municipalities—Beijing, Shanghai, Chongqing, and Tianjin.[20] To borrow White's term referring to the heavier taxation of richer areas, the CCP has 'Shanghaied' urban China as a whole in the reform era.[21]

From a political perspective, this variability of state capacity as reflected in taxation makes sense. The local governments with the greatest capacity are those that face the richest (and thus most empowered) societies. By contrast, governments in poor areas can deliver less yet they also face less resistance. Meng and Zhang show that village governments became less efficient after the central government abolished agricultural taxes in 2006 because they lost revenues.[22] Yet anti-tax resistance fell as well. Liu and colleagues show how village China has fallen into a low-level equilibrium of low taxes, low legitimacy, low resistance, and low services.[23] Ye calls this 'representation without taxation' because Beijing has replaced capacity-led bureaucratic rule with election-led popular rule in rural China.[24]

So the first insight about authoritarian resilience in China from fiscal analysis is that a growing economy and a resilient state sector can provide sufficient revenue from transactional indirect and business taxes to allow a regime to maintain in urban areas (i.e. most of the population) a 'high equilibrium' fiscal system of high capacity, high coercion, high services, and high expectations. In areas where this is not possible (mostly rural areas), the regime can adopt an alternative 'low equilibrium' strategy of low capacity, low coercion, low services, and low expectations. Urban China, which is today more representative of China as a whole, is more heavily taxed but governments there deliver more services and can more effectively manage contentious politics. The fiscal state is strongest where it is needed most. Over time, this may have the perverse effect of drawing more people into cities and magnifying the mechanisms whereby urbanization stirs collective action against authoritarianism, a general pattern shown by Wallace using cross-national city population, urban bias, and nondemocratic regime survival data in the post-WWII period.[25] But in the short term, the gains for the CCP are greater performance legitimacy and greater repressive capacity.

Between Transactional and Modern Taxation

In recent years, international institutions like the IMF,[26] OECD,[27] and the Asian Development Bank[28] have been unanimous in urging Beijing to change its approach to taxation and adopt what is often called a 'modern taxation system'. This involves raising more revenues to expand public services and

[20]Wang Xiao and Richard Herd, 'The system of revenue sharing and fiscal transfers in China', *OECD Economics Department Working Papers* 1030, (2013), p. 15.

[21]Lynn T. White, *Shanghai Shanghaied?: Uneven Taxes in Reform China* (Hong Kong: Centre of Asian Studies, University of Hong Kong, 1989).

[22]Xiangyi Meng and Li Zhang, 'Democratic Participation, Fiscal Reform and Local Governance', *China Economic Review* 22, (2011), pp. 88–97.

[23]Mingxing Liu, Zhigang Xu, Fubing Su and Ran Tao, 'Rural tax reform and the extractive capacity of local state in China', *China Economic Review* 23, (2012), pp. 190–203.

[24]Jing Ye, 'Representation without taxation: political changes in Chinese authoritarian regimes', *Journal of Contemporary China* 24(96), (2015), pp. 1–17.

[25]Jeremy Wallace, 'Cities, Redistribution, and Authoritarian Regime Survival', *Journal of Politics* 75, (2013), pp. 632–645.

[26]W. Raphael Lam and Philippe Wingender, 'China: how can revenue reforms contribute to inclusive and sustainable growth?', *IMF Working Papers* 15, (2015).

[27]Bert Brys et al., 'Tax policy and tax reform in the People's Republic of China'.

[28] Asian Development Bank, 'Reducing inequality in the People's Republic of China through fiscal reform', *ADB Observations and Suggestions* 3, (2013), pp. 1–34; Asian Development Bank, 'Fiscal decentralization in the P.R.C.', *ADB Observations and Suggestions* 1, (2015), pp. 1–18.

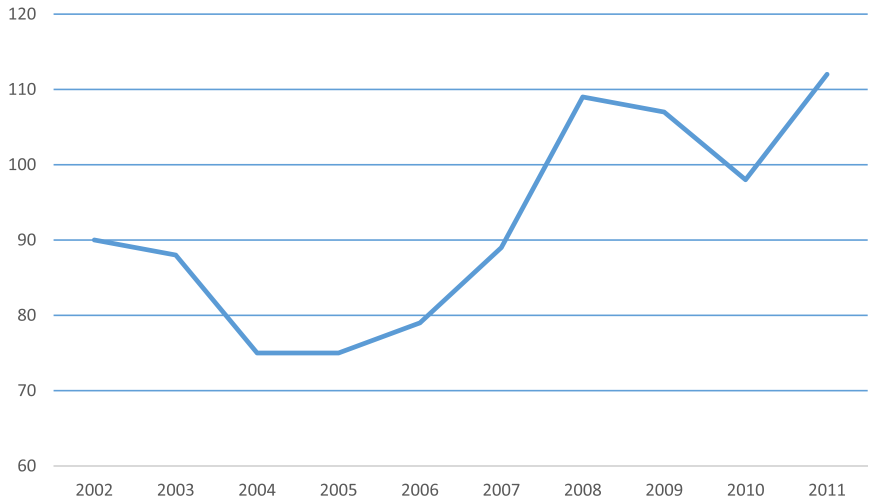

Figure 3. Corporate income tax effort (Actual as % of ideal). Source: Yang Deqian, 'Woguo qiye suodeshui shouru nengli ji shuishou nuli guji: 2002–2011 ['An estimate of income tax earning capacity and tax efforts of China's enterprises: 2002–2011'], *Dangdai Caijing* [*Contemporary Finance & Economics*] 9(358), (2014), pp. 36–44. Table 2, p. 39. Tax effort is taxes actually collected as a % of taxes that should be collected given ideal administrative capacity and behavior, current tax regulations, and current economic conditions.

raising them in ways that are more efficient (in order to maintain growth) and less regressive (in order to reduce inequality).

The IMF, for instance, argues that the state could boost revenues by up to 6.5% of GDP—or about a quarter above present levels—with new environmental (1%), property value (1.5%), and personal income (3%) taxes, as well as a merging of various business turnover taxes into the value-added tax (1%), the latter of which was begun in 2016. These proposals are based on technical calculations that show how the current approach will give rise to declining revenues and worsening inequalities as a result of the reliance on investment-sapping corporate taxes and regressive consumption taxes. For instance, Yang finds that corporate taxes (which account for about 20% of tax revenues nationally) have exceeded 100% of growth-maximizing levels since 2008 (see Figure 3). At the 2015 meetings of the National People's Congress, the chairman of the privately held Wahaha Group, Zong Qinghou, complained that the company pays 40–50% of its profits to taxes and other government fees and as a result 'in the last two years it has been difficult for us to expand'.[29] Local governments, faced with fiscal deficits, increasingly organize their state enterprises into multi-layered holding companies to reduce their tax obligations to the central state (boosting profits paid to the local government).[30] Those local state enterprises in turn fiddle their accounts to reduce their profits payable to local governments.[31] Exporting firms, meanwhile, sell their goods to state-owned trading companies to evade value-added taxes, which in 2005 reduced general government revenues by 0.3–2.1% according to Liu and colleagues.[32] Moreover, corporate tax reforms introduced in 2016 substantially cut taxes for service firms and for research at industrial firms. All in all, corporate taxation is an eroding source of state capacity.

[29]Esther Fung, 'China needs to reduce business taxes, cut red tape – Wahaha Chief,' *Dow Jones News Service,* March 7, 2015, Factiva News Database, accessed March 12, 2016.

[30]Min Zhang, Lijun Ma, Bo Zhang and Zhihong Yi, 'Pyramidal structure, political intervention and firms' tax burden: evidence from China's local state enterprises', *Journal of Corporate Finance* 36, (2016), pp. 15–25.

[31]Lixing Li and Guangrong Ma, 'Government size and tax evasion: evidence from China', *Pacific Economic Review* 20, (2015), pp. 346–364.

[32]Xuepeng Liu, Huimin Shi and Michael Ferrantino, 'Tax evasion through trade intermediation: evidence from Chinese exporters', *International Review of Economics & Finance* 42, (2016), pp. 518–535.

Numerous party and state declarations have paid lip service to the need for tax system reform. A 2014 politburo strategy on 'deepening reform of the tax revenue system', for instance, included calls for 'speeding up the legislation on a property value tax'.[33] Yet progress has been limited. Fiscal sociology helps to explain why.

China's current property taxes come from transactions not values. This has caused perverse economic effects, such as limiting secondary transactions and encouraging rash new developments by local governments. Since 2011, under a central mandate, Shanghai and Chongqing have been experimenting with property values taxes of 0.5% to 1.2% on high-end or second properties. As pilot programs, these experiments have probably cost more to administer than they have generated in revenues.[34] But they have yielded rich insights into the political obstacles to such taxes.

For one, middle-class property owners who paid large transaction taxes when they purchased their properties would be hit with a second tax if valuation taxes were introduced, making the implementation of the tax more difficult as time goes by (a negative reinforcing effect). More importantly, a property valuation tax requires a detailed registry of properties and their owners, which is likely to expose significant official corruption and fraud relating to property acquisition. For instance, in 2015 researchers from the southern city of Guangzhou reported results of an analysis of that city's new property registry. It showed that so-called 'hidden income' is on average 1.8 times officially reported income for property owners. The largest ratios (often 3.0 or higher) were for government officials and managers in state-owned enterprises. 'This finding provides direct evidence that helps explain the fervor among Chinese youth to take the national civil-servant test to become government officials', they noted wryly.[35]

In the Shanghai and Chongqing cases, the Asian Development Bank estimated that the pilot property taxes *should* have generated 40 to 97 and 15 to 36 billion yuan of revenues in 2012 respectively if there was full collection and no evasion.[36] The actual figures were 9 billion and 140 million respectively, implying that 80–99% of taxes were not collected. Creating a national property registry will take years, according to Moody's Investor Services, meaning that significant property tax revenues are at least a decade away.[37] As a vice minister of finance told reporters in 2015 about the property tax roll-out: 'This process is very cautious and must make ample consideration of public opinion'.[38]

Environmental taxes, meanwhile, also have limited potential because they threaten growth, as noted by Guo et al.[39] They might also unleash intra-state conflicts, especially relating to coal.[40] There is no general consensus in China about whether they should be earmarked for environmental uses or used for general spending. Finally, they would be regressive, especially in the absence of personal income tax reforms (of which more below).[41] This likely makes them politically infeasible and explains why there has been no movement in this direction despite more than ten years of discussions.

[33]Jie Han, Li Gao and Yuxin Han, 'Yi chang guanxi guojia zhili xiandaihuade shenke gaige: caizhengbu buzhang Lou Jiwei yangjie shenhua caishui tizhi gaige zongti fangan [A profound reform relating to governance modernization: minister of finance Lou Jiwei details program to deepen fiscal and tax reform]', *Xinhua News Agency*, July 3, 2014. Available at: http://news.xinhuanet.com/politics/2014-07/03/c_1111449207.htm. [accessed 12 May 2015].

[34]Bert Brys et al., 'Tax policy and tax reform in the People's Republic of China', p. 56.

[35]Qin Gao, Qianwei Ying and Danglun Luo, 'Hidden income and occupational background: evidence from Guangzhou', *Journal of Contemporary China* 24(94), (2015), pp. 721–741, p. 739.

[36]Ziying Fan and Guanghua Wan, 'The fiscal risk of local government revenue in the People's Republic of China', *ADBI Working Papers* 567, (2016), pp. 1–57.

[37]Moody's Investors Service, 'Regional and local governments – China: stabilization benefit of property taxes will take time to materialize', June 16, 2016. Available at: https://www.moodys.com/research/Moodys-Stabilization-benefit-of-property-taxes-will-take-time-to--PR_350653 [accessed 12 August 2016][.

[38]Chun Han Wang, 'China property tax needs public support, Vice Finance Minister says', *Dow Jones News Service*, 3 March 2015. Factiva News Database [accessed 12 March 2016].

[39]Zhengquan Guo, Xingping Zhang, Yuhua Zheng and Rao Rao, 'Exploring the impacts of a carbon tax on the Chinese economy using a CGE model with a detailed disaggregation of energy sectors', *Energy Economics* 45, (2014), pp. 455–462.

[40]Dong Wang, 'Analysis on conflicts of China's coal tax reform', *International Journal of Energy Economics and Policy* 4, (2014), pp. 108–116.

[41]Zhujun Jiang and Shuai Shao, 'Distributional effects of a carbon tax on Chinese households: a case of Shanghai', *Energy Policy* 73, (2014), pp. 269–277.

So the second insight about authoritarian resilience in China from fiscal sociology is somewhat in tension with the first. While easy resource capture and the Shanghai strategy have allowed the regime to sustain itself in urban areas since the early 1990s, this strategy has limits. It becomes a drag on growth and worsens inequalities. It also creates path dependencies that make the adoption of tax reform more difficult. The party is caught in a dilemma between the falling utility of transactional taxation and the rising barriers to modern taxation.

Modern Taxation and Class Conflict

The political obstacles to modern taxation are most visible in the debate on personal income taxes. China arguably invented the idea of the fiscal state.[42] Yet in part because of that, taxes were historically closely connected with regime survival. When it came to power in 1949, the CCP abolished personal income taxes on the grounds that they reflected a capitalist exploitation of workers (the so-called 'no tax theory' or *feishuilun*). The theory also reflected a more conservative calculation based on historical memories of tax revolts that overthrew political regimes in imperial China.[43] Indeed, the CCP's own rise was in part due to opposition to Republican China's regressive salt tax.[44]

Having learned those lessons, the CCP sold large amounts of heroin and opium in order to finance its revolution.[45] It then relied on gradual expansion of state control of the economy from the late 1950s. Yet the 'no tax theory' became unsustainable once de-Stalinization of the economy began in the 1980s. The personal income tax was relaunched in 1994 as part of wider tax reforms. It is shared 60/40 between central and provincial governments. Provincial governments keep about 35% of their share while the rest goes to sub-provincial governments.

Despite more than 20 years of implementation, the share of tax revenues from personal income taxes remains vanishingly small, indeed it peaked in 2005 and plunged in 2015 (see Figure 4). In OECD countries on average, about 25% of tax revenues (or the equivalent of 8–9% of GDP) come from personal income taxes. In China, by contrast, personal income taxes accounted for only 2.5% of tax revenues and less than 1% of GDP in 2015.

Personal income taxes are the most information-rich contributors to fiscal sociology. This is because they penetrate deeply into the personal lives of citizens and require highly-developed administrative systems. Personal income taxes require a high degree of honesty and compliance from citizens which in turn typically derives from social empowerment to monitor and control the state. As Morrison argues, in developing countries with weak democratic institutions, the direct taxation of personal income is usually destabilizing and thus governments do better by generating non-tax sources of revenue.[46] Much work has confirmed that regimes which afford their citizens less civil and political rights levy significantly lower personal income taxes.[47] From this perspective, China's low level of personal income taxes reflects two facts: it is an authoritarian regime; and it lacks an active, consent-based form of legitimacy among its population, whatever their attitudinal support.

[42]William Guanglin Liu, 'The making of a fiscal state in Song China, 960–1279', *Economic History Review* 68, (2015), pp. 48–78.
[43]James Tong, *Disorder under Heaven: Collective Violence in the Ming Dynasty* (Stanford, CA: Stanford University Press, 1991); Jin Xu and Dingxin Zhao, 'Zhengfu Nengli He Wanli Nianjiande Minbian Fazhan ['State Capacity and the Dynamics of Tax Riots During Late Ming Dynasty'], *Shehuixue Yanjiu* [*Sociological Studies*] 22, (2007), pp. 1–23.
[44]Ralph Thaxton, *Salt of the Earth: The Political Origins of Peasant Protest and Communist Revolution in China* (Berkeley, CA: University of California Press, 1997); Sherman Xiaogang Lai, *A Springboard to Victory: Shandong Province and Chinese Communist Military and Financial Strength, 1937–1945* (Leiden: Brill, 2011); Felix Boecking, 'Unmaking the Chinese nationalist state: administrative reform among fiscal collapse, 1937–1945', *Modern Asian Studies* 45, (2011), pp. 277–301; Arthur N. Young, *China's Nation-Building Effort, 1927–1937: The Financial and Economic Record* (Stanford, CA: Hoover Institution Press, 1971).
[45]Yung-fa Chen, 'Blooming poppy under the red sun: the yan'an way and the opium trade', in Tony Saich and Hans van den Ven, eds., *New Perspectives on the Chinese Communist Revolution* (Armonk, NY: M.E. Sharpe, 1995), pp. 263–298; Richard L. G. Deverall, *Mao Tze-Tung: Stop This Dirty Opium Business! How Red China is Selling Opium and Heroin to Produce Revenue for China's War Machine* (Tokyo: Toyoh Printing and Book Binding, 1954); Guodao Zhang, *Wode Huiyi* [*Memoirs*] (Hong Kong: Mirror Publishing, 1971).
[46]Mevin Morrison, *Nontaxation and Representation: The Fiscal Foundations of Political Stability*.
[47]Paola Profeta and Simona Scabrosetti, *The Political Economy of Taxation: Lessons from Developing Countries* (Cheltenham: Edward Elgar, 2010).

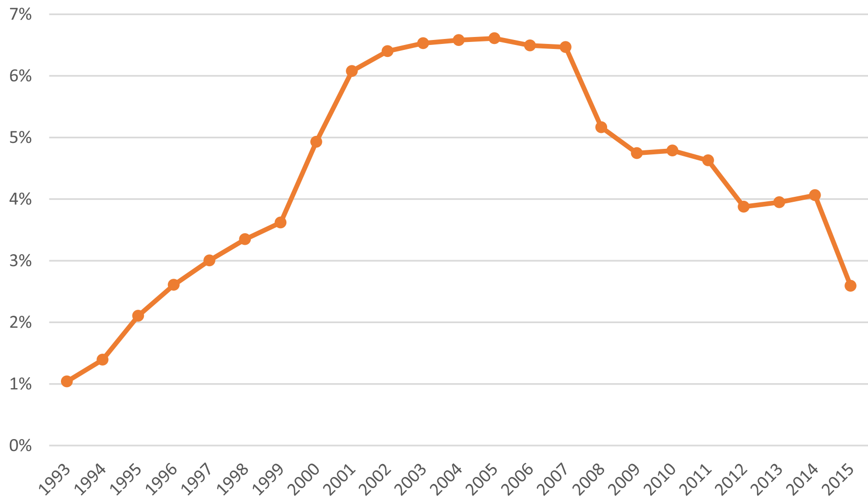

Figure 4. Personal income taxes as % general government revenues. Source: Media reports. IMF General Government Revenues. PRC Ministry of Finance.

This represents a large obstacle to modern taxation however because personal income taxes need to rise in order to improve economic efficiency, fiscal capacity, and social equity. Under the IMF's suggestions, the proportion of earners paying personal income tax would quadruple from the current 19% to 75%, while middle-class tax rates would leap from 3–5% to 25-35%.[48] The Ministry of Finance warned in 2009 that without an increase in personal income taxes, social spending will decline for the poor 'who will therefore be the most impacted'.[49] Similarly, the Asian Development Bank argues for more progressive personal income taxes 'to shift the tax burden from low-income to high-income households"'.[50]

But while the policy debate concerns how to *increase* the tax, the political debate concerns how to *decrease* it. Each time the government solicits public comment on how to raise personal income taxes, it is besieged by demands to lower it. In response, the government raised the exemption threshold for the personal income tax to 3,500 yuan per month from 2,000 yuan in 2011 (after earlier rises in 2006, 2006, and 2008). This exempted 56 million people from the tax (equivalent to the entire adult population of Germany). Even so, arguments that 'the tax threshold is too low' continue to dominate discussions. During discussions on the 2011 threshold change, the national legislature received 230,000 comments, more than for any other change it has considered, most of them calling for a threshold of 4000 or 5000 yuan.[51] Li Daokui, an adviser at the People's Bank of China and professor at Tsinghua University, told a forum in 2011 that personal income tax 'has the highest political cost in China' since it 'bears most of the public's criticism'.[52]

The main problem is that the wealthy can game the system. Wages and salaries accounted for 61% of personal income tax revenues in 2012, while individual business income, contract income, property

[48]Raphael Lam and Philippe Wingender, 'China: how can revenue reforms contribute to inclusive and sustainable growth?', p. 17.

[49]PRC Ministry of Finance Tax Policy Division, 'Woguo Rensuodeshui Jiben Qingkuang' ['Basic facts about China's personal income tax']. October 1, 2009. Available at: http://www.mof.gov.cn/zhuantihuigu/zhongguocaizhengjibenqingkuang/gerensuodeshuizi/200906/t20090619_169579.html [accessed 12 September 2015]; PRC Ministry of Finance Guangdong Inspectorate, 'Long Jiang: Fenshuizhi Bianxi' ['Long Jiang: an analysis of the tax-sharing system]'. May 1, 2014. Available at: http://gd.mof.gov.cn/lanmudaohang/dcyj/201405/t20140528_1085021.html [accessed 3 March 2016].

[50]Asian Development Bank, 'Reducing inequality in the People's Republic of China through fiscal reform', p. 7.

[51]Xinhua News Agency English, 'Proposed tax threshold changes generate record amount of feedback', May 31, 2011. Available at: http://news.xinhuanet.com/english2010/business/2011-05/31/c_13903179.htm [accessed 4 March 2015.

[52]Xing Wang, 'Economists, too, possess concerns with tax law drafting', *China Daily*, 9 June 2011. Factiva News Database [accessed 21 July 2015].

income, royalties, interest and dividends accounted for only 39%.[53] Most estimates suggest that those proportions would be roughly reversed if all income were properly reported. Indeed, when compulsory social security contributions are included, 'households in the lowest income quartile face a much higher effective tax rate than those in higher income groups' while the entire tax system is 'regressive at the range of employment income below 70 percent of average wage income'.[54] While income taxes across the OECD countries reduce the pre-tax Gini coefficient of inequality by an average of 0.1 points on the 0 to 1 scale, the personal income tax in China has no impact on its Gini coefficient (which is variously estimated at between 0.45 and 0.50 in 2012).[55] Weng argues that the working class is now the main source of the personal income tax, which 'goes against the whole aim' of its reintroduction in 1994.[56]

Under reforms to be introduced in 2017, individuals will report gross income from all sources, a measure intended to prevent the wealthy from avoiding taxes by shifting income into obscure sources such as trust funds and online sales. At the same time, expenses on mortgages, childcare and elder care will be deductible. Yet even with these reforms, China's personal income tax will retain a strong anti-poor bias without a significant expansion of deductions for medical, housing, and pension costs.[57]

Moreover, while these reforms may capture some legally hidden income, they will not capture illegally hidden income. A 2015 study found that 34% of Chinese earners simply do not comply with personal income tax laws.[58] Hidden income, both legal and illegal, is between 1.3 and 1.7 times official data, with ratios much higher for higher decile income groups (as shown by the Guangzhou study).[59] Wang notes that it is not just the private rich but also 'high wealth work units and administrative agencies' that actively evade personal incomes taxes on behalf of their staffs.[60]

In 2006, a system of mandatory income reporting for those with incomes over R10,000 per month was initiated. In the first three years, only 3 million people came forward, less than half the estimated number. One popular business commentator argued in 2015 that the figure of only 28 million people paying personal income tax is 'not credible' given the millions of small businesses in the country whose proprietors are likely avoiding taxes. The income tax, he argued, 'has become a wage and salaries tax rather than an income tax'.[61] The Asian Development Bank estimates that illegally hidden individual investment income (dividends and capital gains) is the biggest driver of worsening income inequalities.[62]

A sense of the scale of hidden and unreported income can be seen from local figures. In early 2015, for example, the government of the Xi'an high-technology zone reported that 11,236 people with incomes over the R10,000 threshold had filed reports for 2014.[63] In 2012, the zone reported a population

[53]Jiachen Weng, 'Geren Suodeshui Zhineng Youxiao Fahuide Duice Sikao ['Countermeasures to ensure personal income tax effectiveness']', *Shandong Nongye Gongcheng Xueyuan Xuebao* [*Journal of Shandong Agriculture and Engineering University*] 32, (2015), pp. 71–80.

[54]Raphael Lam and Philippe Wingender, 'China: How Can Revenue Reforms Contribute to Inclusive and Sustainable Growth?', p. 11.

[55]Ibid.; Ping Wang, 'Geren Suodeshui Shuizhi Moshi Bijiao Ji Woguo Shuizhi Xuanze' ['A comparison of personal income tax system models and China's taxation choices'], *Jianghan Xueshu* [*Jianghan Academia*] 35, (2016), pp. 123–128.

[56]Jiachen Weng, 'Geren Suodeshui Zhineng Youxiao Fahuide Duice Sikao ['Countermeasures to ensure personal income tax effectiveness'], p. 79.

[57]Chen Zhi, 'Jiyu Shengcunquan Baozhangde Geren Suodeshuifa Gaige Ji Wanshan' ['On the reform and improvement of the right to life guarantees of the personal income tax law'], *Wuhan Daxue Xuebao, Zhexue Shehui Kexue Ban* [*Wuhan University Journal, Philosophy and Social Science Edition*] 69, (2016), pp. 122–129; Zhiwei Wang, 'Qianxi Geren Suodeshui Feiyong Kouchu Cunzaide Wenti Ji Wanshan Jianyi' ['Brief analysis of problems and suggestions for personal income tax deductions'], *Zhongguo Shanglun* [*Economic Review*] Z, (2016), pp. 182–184.

[58]Jiachen Weng, 'Geren Suodeshui Zhineng Youxiao Fahuide Duice Sikao' ['Countermeasures to ensure personal income tax effectiveness'], p. 76.

[59]Xiaolu Wang and Wing Thye Woo, 'The size and distribution of hidden household income in China', *Social Science Research Network*. Available at: http://ssrn.com/abstract=1695231 [accessed 12 June 2015].

[60]Jiachen Wang, 'Geren Suodeshui Shuizhi Moshi Bijiao Ji Woguo Shuizhi Xuanze' ['A comparison of personal income tax system models and China's taxation choices'], p. 127.

[61]Fenghui Yu, 'Di Menkan Shanghai Geren Suodeshui' ['A low threshold harms the personal income tax'], *Shangjie Pinglun* [*Business Review*] 4, (2015), pp. 27.

[62]Guanghua Wan and Chen Wang, 'Income polarization in the People's Republic of China: trends and changes', *ADBI Working Papers* 538, (2015), pp. 1–22.

[63]People's Daily English Online, 'More than 10,000 people report over 120,000 yuan of annual income for tax declaration in Xi'an high-tech zone', May 6, 2015. Available at: http://en.people.cn/n/2015/0506/c209361-8888114.html [accessed 21 July 2015].

of 273,000. Assuming the national average of 60% economically active population employment, this implies that about 7% of the workforce in the zone qualified as high income earners. While admittedly a wealthier area, if extrapolated to the urban workforce alone (359 million in 2011), this would imply there are 25 million high earners in China who *should* be paying personal income tax. Yet the total number of *all* people paying income tax was just 26 million in 2012. Jiangxi province reported that only 65,576 people had reported incomes above the threshold for 2014, a mere 0.5% of the employed urban population of the province.[64] Similarly, in Tianjin only 162,000 people reported high incomes for 2014, which would be only 4% of the employed permanent urban population of that wealthy coastal city.

The result of this unfairness is that low and middle income people in China increasingly demand lower taxes (or achieve them through non-compliance) alongside higher services, even as growth slows. Yet the rich feel just as overtaxed as the poor. In a survey of 336 taxpayers in 2015, Zheng found that consistently around 75% of people feel their tax burden is too high and thus 'latent conflicts with taxpayers exist at all occupation and income levels'.[65] The party, mindful of the political implications, does not move forward on efficient taxation but also does not scale back rising public service expectations. 'One or two voting members of the Standing Committee of Politburo would be removed from office if wide-spread instability broke out in a region or if public services totally collapsed', wrote three scholars from the Central University of Finance and Economics in Beijing. 'Thus the General Secretary and the Premier would require provincial officials to cap taxes *and* to expand essential public goods in case of any disturbances'.[66]

So the third insight about authoritarian resilience in China from fiscal sociology is that marketization unleashes latent class conflicts that can be defused only by adhering to a radically non-intrusive tax system and maintaining public service provision in urban areas. The CCP has been wise to the political tradeoffs of higher personal income taxes and, for the most part, has opted against reliance on this feature of a modern taxation system. The result however is less fiscal capacity, less economic efficiency, and less social equity.

Modern Taxation and Party–People Conflict

It is easy to get distracted by the class dynamics of the personal income tax and forget the more important state–society dynamics. Even with administrative reforms to reduce tax evasion and increase tax progressivity, the CCP would still be stuck with a more fundamental challenge: China's citizens do not trust it with their money irrespective of whether others are paying their fair share.

In official explanations, tax evasion is attributed to 'historical' and 'cultural' factors. People feel 'suspicious' and 'exploited' by personal income tax claims because the CCP long told citizens that such taxes were a form of theft by rulers.[67] Another expert believes that the more the CCP tries to catch and punish offenders, the more tax evasion becomes a 'national game'. 'Many people think that not getting caught is a form of good luck and so are willing to try again even if they get caught and have to pay a fine,' he wrote. The idea that evading taxes is despicable behavior has still not been internalized (*guominhua*)'.[68] Beijing reinforces the idea that taxation is for the unlucky or the bad by using personal income tax evasion charges to silence political dissidents. The artist Ai Weiwei was fined $2.4 million for tax evasion in

[64] Peihong Huang, 'Jiangxi Nian Suode 12 Wan Yuan Yishang Shenbao Geshui Chao 6 Wan Ren' ['Number of people with incomes over 120,000 yuan per year reporting exceeds 60,000 in Jiangxi'], *Zhongguo Jiangxi Wang Xinxi Ribao* [*Jiangxi Online Daily*] 9 April 2015. Available at: http://jx.ifeng.com/news/jd/detail_2015_04/09/3761127_0.shtml?_from_ralated [accessed 21 July 2015].

[65] Jianghui Zheng, 'Geren Suodeshui Guanli Chongtu Zai Butong Nashuirenqun Yixiang Jieguode Tongjixue Fenxi' ['The breakthrough in the management of personal income taxes will be in the statistical analysis of the results of surveys of different taxpaying groups'], *Dongnan Xueshu* [*Dongnan Academia*] 54, (2016), pp. 132–138, p.135 and 137.

[66] Chunli Shen, Jing Jin and Hengfu Zou, 'Fiscal decentralization in China: history, impact, challenges and next steps', *Annals of Economics and Finance* 13, (2012), pp. 1–51, p. 37.

[67] Lei Fei, 'Woguo Geren Suodeshui Loutaoshui Wenti Shentao' ['Discussion of China's personal income tax evasion problem'], *Caihui Yuekan* [*Financial Meetings Monthly*] 23, (2011), pp. 37–38.

[68] Lihua Ma, 'Woguo Geren Suodeshui Zixing Nashui Shenbaode Yanjiu' ['On voluntary tax payment in China's personal income taxes'], *Shang* [*Business*] 5, (2013), pp. 12.

2011. Tax authorities have reinforced the message that taxes are about social control rather than social contract by adopting the personal identification numbers issued by the Ministry of Public Security.

Unofficial discussions, however, center on the lack of accountability mechanisms over state spending. If the CCP raises direct taxes on personal income (and capital gains) it must improve accountability mechanisms and consent-based legitimacy, both of which invariably require participation and social control over the state. The journalist Deng Jiwen was among the earliest to point out the relationship between the two in a lengthy article of 2002: 'If after paying taxes, citizens have no say over how those revenues are spent, and even worse that they are misused or embezzled by corrupt officials, and taxpayers have no avenues of recourse, then even the government's legitimacy in levying taxes from the people, not to mention the hopes of raising people's taxpayer awareness, will be in doubt,' she wrote.[69]

The debate came into sharper focus in 2011 when the central government introduced a so-called 'mooncake tax' regulation that sought to ensure that in-kind gifts were included in personal income reporting. The regulation elicited a storm of criticism because of a fundamental mistrust of how public funds are spent, according to Southeast University (Nanjing) economics professor Hua Sheng. 'While it is easy to dismiss as irrational the sensitive and extreme reactions that most people have about tax issues, we cannot ignore the fact that people are extremely dissatisfied with the corruption of public power and the squandering of public funds,' Hua wrote in a popular business magazine. 'It reflects the lack of transparency and public participation in matters of public spending. If government departments do not resolve to get control of public spending and rampant bribery, then no matter how loudly they proclaim the need to "serve the people" and other empty, lying clichés, then they will never get the social stability they seek'.[70]

A more probing critique was lodged by Zhang Xiaojun of Southwest University's School of International Law in his 2010 book *The Legitimacy of National Taxation Power*. Since the CCP envisions taxes as a national obligation rather than as a constitutionally regulated contract between citizens and government, he argued, it can never establish a modern tax system based on direct taxation. 'Our constitution is excessively focused on the responsibilities of citizens to pay taxes and lacks any mention of the requirements of legal organs and tax collectors to respect the rights of citizens,' he wrote. 'The basic theory of taxation in China has long been one that does not rest on notions of constitutionalism but on an authoritarian nationalist ideology. As a result, it cannot embrace the modern meaning of taxation and threatens the legitimacy of taxation itself. This is the deeper cause of all the legal and practical problems of taxation in China'.[71]

This state–society dynamic requires accountability reforms, according to these and other observers in China.[72] In 2001, the editor-in-chief of the government's *China Taxation* magazine, Zhang Musheng, argued that the CCP could not tax its way to resilience unless it created a new relationship with citizens that allowed for transparency, accountability, and open debate on spending priorities.[73] He called for 'fiscal democracy' (*caizheng minzhu*) measures such as 'democratic budgeting' (*minzhu licai*) under legislative, judicial, and popular control. This, he argued, would ensure 'public confidence in the government' (*zhengfude gongxindu*)

To some extent, the CCP has embraced these goals. The revised 2014 budget law was hailed by the official news agency as an 'economic constitution' for China because it includes measures to ensure transparency

[69]Jinwen Deng, 'Taoshuide Minjian Jichu' ['The social basis of tax evasion'], *Zhongguo Jingji Shibao* [*China Economic Times*] 8 August 2002.

[70]Sheng Hua, 'Furen He Jide Liyizhe Loushuitaoshui Jiaju Pinfu Fenhua' ['Tax evasion by the rich and vested interests worsens the rich–poor divide'], *Jingji Cankaobao* [*Economic Reference News*], 9 September 2011. Available at: http://finance.sina.com.cn/review/mspl/20110909/072810458290.shtml [accessed 21 July 2015].

[71]Xiaojun Zhang, *Guojia Shuiquande Hefaxing Wenti Yanjiu* [*A Study of the Legitimacy of National Taxation Power*] (Beijing: Renmin Chubanshe, 2010), p. 258 and 276.

[72]Jinxiu Wang, 'Chuangxin Difang Caizheng Nengli Jianshede Siwei Yu Shixian' ['Innovative thinking and practice of local fiscal capacity building'], *Guojia Zhili* [*National Governance Weekly*] 15, (2015), pp. 38–42.

[73]Musheng Zhang, 'Ni Gei Wo Helide Shuizhi, Wo Gei Ni Lianjia You Lianzhengde Zhengfu – Cong Shuifu Kan Jingji Zhidu Chuangxin' ['Show me a reasonable tax system and I will show you an honest and efficient government: economic reform from the perspective of taxation'], *Zhongguo Shuiwu* [*China Taxation*] 33, (2001), pp. 4–11.

and supervision.[74] But there are no provisions to force local or national governments to implement these reforms within the 750,000-employee tax bureaucracy. Zhang Musheng subsequently commented publicly on the need for an independent judiciary, effective legislative oversight, party and government anti-corruption bodies, participatory budgeting processes, and more general use of netizen activism to patrol government spending.[75] Likewise, law scholar Zhang Xiaojun argued in his 2010 book that constitutional amendments protecting property, establishing tax fairness, and delimiting rights and responsibilities would require broader shifts towards constitutional rule. 'To a large extent, the success of any constitutional provisions concerning taxation in China depends on the overall progress of constitutional change'.[76]

So the fourth insight about authoritarian resilience in China from fiscal sociology is that the apparent economic and class conflicts that make a non-transactional tax system difficult to implement reflect deeper state–society conflicts. The ruling party's self-identity limits its willingness to countenance constitutional evolution that would make possible accountability measures that would defuse these conflicts—such as budget transparency and fiscal oversight by properly elected legislators. Yet it may be that the fiscal incentives to modify that identity are not yet sufficiently strong. On this view, a 'people's government' will emerge in China only when costs and risks of political reform are less than the costs and risks of the current fiscal system.

Conclusion

To recap, fiscal sociology provides novel insights into authoritarian resilience in China. It shows how the regime has maintained control over a rapidly modernizing country by adopting different fiscal strategies for different social groups and by limiting its intrusion into market society. Under rapid economic growth, the inefficiencies and inequities of this system can be managed because it delivers 'good enough' governance. The CCP will continue to rely on inefficient and inequitable taxation because of the political costs of pursuing a modern taxation system.

Two general conclusions about taxation under authoritarian regimes can be made. First, the revenue-raising options available to modern authoritarian regimes are not well-captured by the ideas of 'rentier' states or 'resource control'. Various forms of taxation can be introduced in an authoritarian market economy that raise significant revenues without the need for political accountability. Yesterday's theories of authoritarian resource capture are ill-suited to the sorts of market-oriented authoritarian regimes remaining today such as China, Russia, Malaysia, Vietnam, Ethiopia, Egypt, and Uganda.

Secondly, and related, a focus on strong institutions can lead to an underestimation of the political benefits of less intrusive relationships between states and societies. In certain contexts, it may make sense for an authoritarian regime to live with inefficient taxation even if this limits institutional capacity (and worsen inequalities). The thunder of world history in China is a far off rumble that keeps the ruling party at a safe distance from its citizens.

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[74]Zhiming Xin, 'Revised budget law to have far-reaching effect', *China Daily*, 1 September 2014. Factiva News Database, accessed June 23, 2015.
[75]Musheng Zhang, 'Yinianlai Zhenggai Shixian Yu Fanfu Lujing Jiexi' ['The past year's road to political reform and corruption control'], *Ifeng News*, 17 October 2014. Available at: http://news.ifeng.com/a/20141017/42232693_0.shtml [accessed 21 July 2015].
[76]Xiaojun Zhang, *Guojia Shuiquande Hefaxing Wenti Yanjiu* [*A Study of the Legitimacy of National Taxation Power*], p. 271.