

To Replace the Business Tax with a Value-added Tax: A Key Point in Establishing the Modern Value-added Tax System with Chinese Characteristics

Wang Dehua

In accordance with the State Council direction deployment, the Ministry of Finance and the State Administration of Taxation jointly issued Circular [2016] No.36 on finance and taxation, which has clearly established that from May 1st, 2016, industrial sectors of real estate, construction, financial services, and life services will be included within the system of replacing the business tax with a value-added tax. Therefore, the pilot launched in Shanghai in 2012 has entered the crucial ending stage and the business tax will formally withdraw from the arena of history. It also indicates that the modern value-added tax system geared to international standards and with Chinese characteristics has gradually come to the joint definition phase.

I. What is the so-called modern value-added tax system?

Unlike other tax types, value-added tax is an item which is designed based on theories, its base is not that intuitive. Traced back to the very past, we have a long history of levying tax on commodities and its trading. Since the industrial era, the simple indirect tax on commodities has led to double taxation in socialized mass production, and thus hindered the division of labour. Therefore in 1917, Adams, the economist of Yale University, first brought about the concept of taxing on added value. In 1919, German Seimens suggested that replace multi-phase trade tax with value-added tax obtained by tax base subtracting. This has become the main idea of modern value-added tax. In 1948, France adopted a tax system similar to the modern value-added tax, which meant to levy taxes in the phase of producing and allow a range of deduction. From 1954, the ranges of phases and deduction have been further expanded. It's a wide recognition that the value-added tax system of France in 1954 is the first value-added tax in the world. Since then, the European countries have generally accepted the value-added tax, and it then became one of the requirements to join the European Union. Besides, the World Bank and International Monetary Fund also strongly recommended value-added tax to the vast developing countries. Therefore, it soon became popular around the world. Until now, about 160 countries and regions, except for the United States, a few island countries and petroleum exporting countries, have adopted value-added tax, which has involved more 90% of population and has collected over 20% of taxation.

Unlike some Chinese scholars holding a doubting attitude towards value-added tax, in the international society, it is known as a marvelous creation. No fiscal tool has expanded as fast as value-added tax in the world. However, there's a lot of diversity in its implementation in international society. According to some scholars, value-added tax is not a simplex taxation type. In fact, it's a series of taxes. Its diversity mainly displays in three aspects:

First, differentiated range of deduction has led to different disparity in tax bases. Without thinking about government policies and foreign trades, according to the national income accounting approach: $GDP=C+I=W+P+D$. It means that the national income of a country equals the sum of wages (W), profits (P) and deduction (D), and also equals the sum of Consumption (C) and Investment (I). The main trend in the international society is the consumption-oriented value-added tax, which means to levy tax on consumption in GDP. The way of implementation is that input credit on fixed capital assets can counteract the tax. Its tax base can be described as: $C=W+P+D-I$. The second one is production-oriented value-added tax, which does not allow deduction of fixed capital assets investment. Its tax base can be described as: $C+I=W+P+D$. The third one is income-oriented value-added tax, which only allows fixed assets depreciation deduction. Its tax base can be described as: $C+I+D=W+P$.

Second is the method of taxation. The first method is invoice deduction, which using the invoice of input VAT for deduction to avoid double taxation. It's now the most common way; the second method is factor income summation, which is adopted by Israel and Argentina in levy tax on financial industries; the third method is reduction, which means to calculate the tax base of a company on the base of its financial account. Comparatively speaking, the first method—invoice deduction, realizes the interaction of taxpayers, has great advantages in strengthening taxation management, and therefore is commonly adopted in the world.

Third, there are differences in the industries it covers. Viewed from the point of keeping the tax neutral and avoiding repeated tax, the value-added tax should involve all the industries with a fixed tax rate. However, affected by facts like social equality, the range of industries involved in value-added tax of different countries are not always the same.

Diversity in practice has caused difficulties in defining modern value-added tax system. At present, the most widely recognized conclusion is the one made by the World Monetary Fund: Value-added tax is a tax type that "collected in the phase of producing and selling of commodities, with a broad tax base, and the main point of this tax system is that the input tax can deduct the output tax." According to this description, the essential

characteristics of modern value-added tax can be summed up in three points: first is that it adopts deduction in its taxation management process to avoid repeated tax; second is that it has a broad tax base, which means it covers as much industries as possible; third is that it's an indirect tax that levies tax on the producing and selling of commodities.

II. To Replace the Business Tax with a Value-added Tax is key Point in Establishing the Modern Value-added Tax System with Chinese Characteristics

The tax reform in 1994 has established the value-added tax as one of the main taxes in China. In the designing of tax system, China has learned a lot from international experiences, such as adopting invoice deduction system, setting up 17% as the main tax rate, etc. However, it also has many differences with the international mainstream. The two major differences are: input credit on fixed capital assets is cannot be deducted, which means China adopts the less common production-oriented value-added tax; China's value-added tax has only involved the industry of manufacturing and retailing and wholesaling, while most of the service industry sectors still adopt business tax. Therefore, to complete its' tax system, China's value-added tax should transferred form the production-oriented type to the consumption-oriented one, and its coverage should be expanded to the service industry. These are the so-called two missions of "transition" and "expansion".

Thereinto, the fact that the service industry and the manufacturing industry respectively adopt business and value-added tax has distorted economic growth should not be ignored. On the one hand, business tax is to levy tax on total output, so the problem of repeated taxation cannot be avoided and will accordingly hinder the decision-making of service industry. On the other hand, since the business tax of service industries cannot be deducted in the chain of value-added tax, therefore under the same condition, the industry sectors should rather have inside services than purchase from outside. This kind of tax system would suppress the externalization of services and will lead to the result that while China's economy is going through servitization in general, its manufacturing industries reduce invest on external services.

After a lot of pilot launched in the year of 2004, China has started its reform on value-added tax in 2009. It has allowed input credit on fixed capital assets like machinery equipment to be involved in deduction. However, at that time the industry of construction adopted business tax, so the 2009 "transition" was still halfway, and the value-added tax at that time can only be referred to as half-consumption-oriented value-added tax.

While the reform launched on May 1st, 2016 is promoting at the same time the two major tasks of “expansion” and “transition”. It marked that China’s value-added tax system has geared to the international standards, which is the key process in establishing modern tax system. On the one hand, all the service industries have business tax with value-added tax, the task of “expansion” has been completed and therefore repeated taxation can be avoided. On the other hand, with the construction industries adopting value-added tax, input credit on fixed capital assets like plants and other buildings been involved in deduction, the value-added tax system was finally established.

This time, the reform has also set up the principle that tax bearing of all the industries will only keep decrease, which will realize a tax reduction of 500 billion yuan of that year. It shows that the proactive fiscal policy has been more powerful. However, tax reduction is only part of the reform dividends, and the more important dividends are reducing the distortion of economic operation and enhance economic efficiency. Researches based on the pilot spot have founded that with the implementation of replacing business tax with valued-added tax, the division of labour among enterprises will be deepened, and the industrial linkage will become closer. For establishing modern value-added tax system, this kind of reform dividends will have more profound influence.

III. Value-added tax reform should be further promoted

Comprehensively promoting the reform of replacing business tax with value-added tax indicates that China’s modern value-added tax system has come to the stage of definition. In this process, we are still facing with lots of challenges, and the effect remains to be seen. After the framework of modern value-added tax is established, there are still a lot of reforms to achieve.

First is how to degenerate multi-range tax rate. This time the reform has set up two separate tax rate of 11% and 6% for service industry, which results in the current situation of multi-range tax rate. Viewed from the international trend of development, only one of the major tax rates can be considered as the direction of reform, which is the indication of neutral tax. If the reform become much too often, it will distort the economic operation. How to seize advantageous opportunities to balance profits among different industries and generate tax rate at one go will become a great challenge.

Second is how to complete the value-added tax system in certain industries. Under the presumption that value-added tax covers all the industries, how to design tax system for financial industry and public service industry has become an advanced question in the international

society. Especially for the financial industry, the reform of replacing business tax with tax-value-added tax has only simply translated the former business tax base. While from the international point of view, the mode of value-added tax of financial service industries will gradually transferred to the “EU mode”, “Canadian mode”, and “Australia-New Zealand mode”, It include different way of choosing tax base and collecting tax. In the future, how to choose appropriate mode of value-added tax for these industries will be the most challenging area.

Third is whether the function of value-added tax can be extended. Since some enterprises that choose compensation as its tax base has many problems inefficiency and equity, many countries have started reform of using value-added tax to raise money for all kinds of social insurances, which is normally referred to as “social insurance value-added tax”. It’s an important extension of the function of value-added tax, and also a new direction for development. Viewed from China’s current situation, we can know that its social insurance expends rate is so high that causes negative effects on the burden of enterprises and employment situation. Whether China can take example by international experience to launch the “social insurance value-added tax” to replace part of expends of social insurance? That’s what deserves discussion.

Translator/ Dong Xin