

ADMINISTRATIVE DECENTRALIZATION AND TAX COMPLIANCE: A TRANSACTIONAL COST PERSPECTIVE

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A common phenomenon in tax administration in developing countries is that tax is collected not according to the rules of law but according to informal agreements between taxpayers and tax collectors. This article offers a novel explanation of this phenomenon in the Chinese context in terms of administrative decentralization. Administrative decentralization is defined as the concentration of government functions at the lowest ranks of a geographically-dispersed bureaucracy. Decentralization increases communication costs associated with the implementation of law, and changes the structure of taxpayers' costs in obtaining knowledge about the law. As a result, a "semi-compliant" type of behavior, involving many taxpayers who would have been compliant under a rule-based system, emerges where tax is remitted and collected despite both sides being under-informed about the law. The article argues that this dynamic has frustrated tax administration reform in China and, interestingly, explains the underdevelopment of the tax legal profession and of tax litigation.

Keywords: Decentralization, informal tax collection, rule of law, tax administration in developing countries, tax compliance

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INTRODUCTION

A central and persistent theme in economic scholarship on the role of taxation in economic development is that the capacity of tax administrations crucially determines the range of tax policy instruments available in developing countries.¹ For example, in a recent series of papers and a book,² Roger Gordon and others hypothesize that the state of development of the financial sector imposes important constraints on tax administration. How valuable the services are that the financial institutions of a country can provide to businesses—which is a matter essentially exogenous to the design of the country’s tax system—determines whether businesses will choose to use financial intermediation. When financial sectors are less developed, fewer businesses use financial services. But if tax collectors cannot rely on the paper trails generated by businesses’ financial records to audit taxable activities of most taxpayers, they would have to focus on taxing capital-intensive sectors that either unavoidably use financial services, or in any case operate in such ways that are easy for tax agencies to monitor. This, according to these authors, explains the paradoxical fact that many capital-starved developing countries nonetheless tax capital intensively.

Nonetheless, many economists admit that tax administration remains largely a black box for those who study tax policy and development. A leading expert in the field recently described tax administration as the “dull but critical job of moving beyond the moment of innovation to the hard work of implementation,”³ lamenting that even policy instruments such as the value added tax (VAT), which is supposed to be relatively easy to administer (compared to, say, the personal income tax), can under-perform

¹ See, e.g. Richard Bird, “Administrative Dimensions of Tax Reform” (2004) *Asia-Pacific Tax Bulletin* 10(3), 134-50 and the extensive literature cited therein.

² Roger Gordon and Wei Li, “Tax Structures in Developing Countries: Many Puzzles and a Possible Explanation” (2009) *Journal of Public Economics* 93(7-8), 855-866; Gordon and Li, “Puzzling Tax Structures in Developing Countries: A Comparison of Two Alternative Explanations” (2007) *Fiscal Policy And Management In East Asia*, NBER-EASE, vol. 16, 9-35; Roger Gordon, ed, *Taxation In Developing Countries: Six Case Studies And Policy Implications* (New York: Columbia University Press, 2010)(hereinafter “Six Case Studies”)

³ Michael Keen, “Taxation and Development – Again” (2012) IMF Working Papers 12/220, International Monetary Fund, p 14.

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because of limited administrative capacity.⁴ Another recent survey depicts the main challenges facing tax administration in developing countries as arising from the following factors: (i) the size of the agricultural and informal sectors; (ii) the (limited) use of financial services; (iii) the difficulty of restructuring government organization to suit the need of modern tax administration; (iv) the shortage of skilled human capital; and (v) the lack of political will to implement obvious improvement strategies.⁵ It can be observed that, of these five listed factors, most (i.e. (i), (ii), (iv), and (v)) are largely exogenous to the design of tax administration,⁶ while others ((iii) and possibly (v)) may tell us no more than that some developing countries failed to adopt the prescriptions of international organizations. Efforts to theorize about the organization of tax administration itself are relatively scant. Perhaps as a result, the recommendations for tax administration reform in developing countries that have been put forward by international organizations such as the World Bank and International Monetary Fund (IMF) tend to be remarkably vague. For example, adopting the VAT was hoped to “catalyze” administrative reform.⁷ Other casual proposals, such as imposing greater judicial oversight,⁸ may be no more than stabs in

⁴ Id. See also James Alm and Denvil Duncan, Estimating Tax Agency Efficiency (paper presented at the Columbia Law School Tax Policy Colloquium, November 7, 2013) (“there has been little systematic analysis of [the tax] administrative dimension, at least by economists”).

⁵ Richard M. Bird and Eric M. Zolt, “Technology and Taxation in Developing Countries: From Hand to Mouse” (2008) *National Tax Journal*, LXI(4), 791-821. See also Timothy Besley and Torsten Persson, “Why Do Developing Countries Tax So Little?” (2014) *Journal of Economic Perspectives* 28(4), 99–120 (discussing the consequence of informal economies and the need for “political will” in tax policy).

⁶ Some of the literature on tax and development, especially those generated under projects sponsored by international organizations, go into much prescriptive detail about human resource management. See, e.g. Richard Bird and Milka Casanegra De Jantscher, ed, *Improving Tax Administration in Developing Countries* (Washington DC: IMF, 1992). It is not surprising that some scholars find such studies “dull” (whether or not “critical”).

⁷ IMF Fiscal Affairs Department, *Revenue Mobilization in Developing Countries* March 8, 2011 (hereinafter “IMF 2011 Report”) p 10. This recent report repeatedly mentions administrative reform but does not offer (or cite) any specific analysis or recommendation.

⁸ See, e.g. IMF 2011 Report, p 9; Gordon, Introduction to Six Case Studies, *supra* note 2, p 7.

the dark.⁹

Indeed, a common response by economists to this lack of understanding is to take administrative weaknesses in developing countries as a given, and then to rely on the conceptual tools that public finance economists are familiar with—varying tax bases and tax rates, identifying substitute or complementary goods, measuring elasticities, and so on—to recommend policies that may significantly deviate from policies normally considered for developed countries. For example, if the informal sector undermines VAT implementation, one might switch back to tariffs and excise taxes.¹⁰ The implicit idea is to find ways of raising revenue despite administrative weaknesses that plague developing countries, and to return to the improvement of administration only when these countries are further along the development path.

In this article, I attempt to motivate a different research strategy, by showing how one may be able to unpack the black box of tax administration in developing countries through law and economics analysis. In particular, I consider a problematic approach to tax collection, under which revenue is raised not according to the rules of law but according to informal agreements between the taxpayer and the tax collector. Such practice, which one might call “non-rule-based” tax collection, has wide manifestations in many countries (both currently and in the past), and is almost uniformly disparaged by tax policymakers and administrators in developed countries.¹¹ Whether such disparagement is justified is a complex question,¹² but

⁹ As Part IV.B *infra* argues, administrative configurations can easily preclude the possibility of judicial oversight, even when judicial institutions are otherwise readily available.

¹⁰ See Joseph Stiglitz, “Development-Oriented Tax Policy”, Chapter 2 in Six Case Studies, *supra* note 2. For a critical response to such a proposal, see Michael Keen, “VAT, Tariffs, and Withholding: Border Taxes and Informality in Developing Countries” (2008) *Journal of Public Economics* 92(10-11), 1892-1906.

¹¹ See the Introduction to Six Case Studies 2010 (at 7): “How to improve tax administration is a difficult problem, and one the present volume only touches on. One approach mentioned is to improve the incentives faced by tax officials, so that their objectives will be to enforce the law rather than simply to collect revenue”.

¹² See further discussion in Part V *infra*. The main argument against such practice is that it is inconsistent with and undermines self-assessment, and precludes implementing modern tax policy in the way that the rule of law allows. The practice may also generate corruption, but that problem is regarded here as second-order, whereas the much more serious problem is that it perpetuates inefficient taxes and renders the implementation of more efficient modern tax policy instruments infeasible.

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my purpose is not to evaluate the practice but to explore some of its causes. I show that this administrative practice can persist even in a very active economy with a limited informal sector, where revenue is being successfully raised, and where tax collectors are well-educated and well-compensated. Moreover, the practice has persisted despite apparent evidence that the government views it as problematic and has mobilized political resources to reform it. In the particular context examined, therefore, this form of tax collection is not explained by the factors that are normally identified as standing in the way of improving tax administration.

The particular context in which this article examines the phenomenon of non-rule-based tax collection is contemporary China. I argue that in China, a crucial explanation of the phenomenon is a high degree of administrative decentralization. Moreover, the path of causation from decentralization to a specific mode of tax collection runs through behaviors that are of intrinsic importance to legal systems. Decentralized tax administration fundamentally increases the costs of communicating the content of law, and alters the transactions costs for taxpayers to interact with officials in such a way that a large body of taxpayers may be engaged in a form of “semi-compliant” behavior—heeding the preferences of local tax administrators, but in collective ignorance of the law.¹³ While the non-rule-based tax collection that results may have both advantages and disadvantages, my aim is to identify a cause of this practice in China in a fundamental institutional arrangement that is not normally thought to affect tax administration.

The causal connection between non-rule-based tax collection and decentralization argued for in this article is interesting for a number of reasons. First, because administrative decentralization has been the preferred mode of Chinese bureaucratic organization across regulatory areas, and has specific roots in Chinese history, it may be viewed as an externally given constraint on the design of tax administration.¹⁴ Its mechanisms also require investigation at the institutional level.¹⁵ Therefore, it is a type of “independent variable”

¹³ As discussed in Parts III.A, IV.A and V, *infra*, decentralization also prevents the adoption of some crucial administration techniques that are used in developed countries.

¹⁴ See Part VI *infra*.

¹⁵ Because tax administration in developing countries has been so impenetrable, commentators on the subject have not been unwilling to tell anecdotes of random mishaps to illustrate causes of failure of tax administration. See, e.g. Bird and Zolt, *supra* note 5, footnotes 12 (clerical staff in Indian tax

that social scientists would not want to miss. Second, at the same time, making tax administration less decentralized is also clearly conceivable, if the government is able to reflect on decentralization's relative costs and benefits and to mobilize reform. Decentralization is thus a kind of determinant of administrative practice that is more amenable to change than those (such as the informal economy and the state of development of the financial sector) that scholars of tax and development have traditionally alluded to. Third, although there is evidence that China is an international outlier in terms of its degree of administrative decentralization,¹⁶ the way decentralization leads to non-rule-based tax collection sheds light on the dimensions of this latter practice more generally. For example, I argue that such practice should be distinguished from presumptive taxation, and that it could create significant social costs even without generating a high level of corruption.¹⁷ I also argue that the prevalence of such practice is likely to result in low demand for tax professional services and low levels of tax litigation—which are themselves important phenomena of tax systems that have received little theoretical explanation.

The arguments of this article are also relevant to two areas of legal scholarship other than tax and development. One is the extensive literature on law and development. Social scientists have long posited that legal institutions are important for economic development.¹⁸ But how, and how much, legal institutions matter have been subject to much debate in recent research. Recent theoretical work, for example, has highlighted many weaknesses in the original claims, made by founders of the law and economics movement like Ronald Coase and Harold Demsetz, about the

agencies punching holes for name tags in diskettes that contained important taxpayer information) and 15 (employee unplugged and disabled tax agency IT system when trying to make tea).

¹⁶ See discussion in Part II.B *infra*. This article thus does not aim to establish an explanation of non-rule-based tax collection that has universal application.

¹⁷ See text accompanying note 113 *infra*. As argued there, presumptive taxation is a way of applying rules on the basis of limited information, whereas non-rule-based tax collection is a matter of failing to apply rules even when information would have been available to tax administrators.

¹⁸ See, e.g. Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny, "Law and Finance" (1998) *Journal of Political Economy* 106:6, 1113-55; Robert Cooter and Hans-Bernd Schäfer, *Solomon's Knot: How Law Can End The Poverty of Nations* (Princeton, New Jersey: Princeton University Press, 2013); Daron Acemoglu, Simon Johnson, James Robinson, "Institutions as the Fundamental Cause of Long-run Growth," in Philippe Aghion and Stephen Durlauf, ed, *Handbook Of Economic Growth* (North Holland, 2005).

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functions of property and contract regimes.¹⁹ Consistently with such theoretical critique, political economy research has found mixed empirical evidence for the significance of property and contract enforcement regimes for development.²⁰ Some political economists have thus explicitly proposed that legal institutions are of secondary importance to economic development.²¹ This debate, however, has largely neglected the administrative state in developing countries. As in developed countries, developing country governments need to rely on the rule of law to collect modern taxes, pursue environmental and other regulations, and implement a wide variety of social policies. Much of the importance of the rule of law in the 21st century is tied to the regulatory state,²² and the failure of rule of law within the spheres of routine government activities can seriously deter or distort economic development. Yet this has been little examined in law and development scholarship, which has equated legal mechanisms and institutions narrowly with the protection of property, contract, and minority shareholder rights and with judicial independence. This article, in examining determinants of the capacity of the government in a developing country to transmit legal information and secure compliance, begins to fill that gap.

¹⁹ See, e.g. David de Meza, "Coase Theorem", in Peter Newman, ed. *The New Palgrave Dictionary Of Economics and the Law*, 1:270–282 (1998) (the delineation of property rights does not always increase economic inefficiency); Steven Shavell, *Foundations Of Economic Analysis Of Law* (Cambridge, MA: Harvard University Press, 2004) (tax and regulatory regimes are often superior to legal systems that only assign and protect property rights); Lisa Bernstein, "Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry" (1992) *Journal of Legal Studies* 21:115–157 (informal practices are often adequate substitutes for formal legal institutions in securing contract performance).

²⁰ See, e.g. Timothy Besley, "Investment Incentives and Property Rights", Peter Newman, ed. *The New Palgrave Dictionary Of Economics and the Law*, 2:359–365 (1998) (surveying mixed evidence for the significance of property right regimes for economic development); Xiaozu Wang, Lixin Xu and Tian Zhu, "Foreign Direct Investment under Weak Rule of Law: Theory and Evidence from China" (2012) *Economics of Transition* 20 (3), 401–424 (finding that variations in contract protection had no effect on volume of FDI across Chinese cities).

²¹ See, e.g. Chenggang Xu, "The Fundamental Institutions of China's Reforms and Development" (2011) *Journal of Economic Literature* 49:4, 1076–1151; Hehui Jin, Yingyi Qian and Barry R. Weingast, "Regional Decentralization and Fiscal Incentives: Federalism, Chinese Style" (2005) *Journal of Public Economics*, 89, 1719–1742.

²² Eric Posner and Adrian Vermeule, *The Executive Unbound: After the Madisonian Republic* (New York: Oxford University Press, 2011).

Another research area to which this article contributes is the study of the Chinese legal system. There has been much controversy regarding how much progress China has made towards the rule of law,²³ though foreign scholars tend to be uniform in blaming China's authoritarian government for failures to meet rule of law norms. However, detailed examinations of the rule of law in China have generally focused narrowly on judicial institutions, despite the facts that China's civil law judiciary resembles other government bureaucracies in many ways,²⁴ and that the lack of political independence of the judiciary is by no means unique to China.²⁵ The arguments in this article show that conditions for the rule of law may often be violated in China *well before* disputes arise and reach courts, such that the presence or absence of an independent judiciary may be of secondary significance for important regulatory areas.²⁶ Moreover, excessive administrative decentralization may have held back the rule of law in ways that are contrary to the preference of China's authoritarian government itself.²⁷ Insofar as the phenomena studied in this article have relevance beyond tax administration,²⁸ it would seem that moral or ideological critiques of the lack of judicial independence in China, while correct in their own terms, reflect an under-appreciation of the fundamental importance of the rule of law for modern societies.

The article proceeds as follows. Part I demonstrates that, despite successful revenue mobilization in the last two decades, Chinese tax policymakers face many of the same challenges confronting their counterparts in other developing countries, and that serious constraints on further tax reform arise from problems in tax administration. Moreover, these problems have persisted despite eagerness on the part of the Chinese government to tackle them. Nor

²³ See, generally, Randall Peerenboom, *Judicial Independence in China: Lessons for Global Rule of Law Promotion* (New York: Cambridge University Press, 2011).

²⁴ Donald Clarke, "Empirical Research in Chinese Law", in Erik Jensen & Thomas Heller, ed, *Beyond Common Knowledge: Empirical Approaches to the Rule of Law* (Stanford, CA: Stanford University Press, 2003) 164-192.

²⁵ For a careful empirical analysis of the similar lack of independence of the Japanese judiciary, see J. Mark Ramseyer and Eric B. Rasmusen, *Measuring Judicial Independence: The Political Economy of Judging in Japan* (Chicago, IL: Chicago University Press, 2003)

²⁶ See Part IV.B *infra*.

²⁷ See notes 56, 62-66, *infra*, and accompanying text.

²⁸ This is quite likely, given the general feature of excessive administrative decentralization in China discussed in Part VI *infra*.

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are these problems easily attributable to features of the economic environment. Part II then explains, both qualitatively and using original quantitative data, how a fundamental facet of Chinese bureaucratic organization, administrative decentralization, has shaped tax administration: Chinese tax administration is concentrated in tax bureaus and “outposts” situated at county and lower administrative levels, and some core organizational features of such government units are determined by such decentralization. Part III, the core of this article, analyzes conceptually the impact of decentralization on transactional costs in the implementation of law. It defines the concepts of the *communication and advisory costs* of implementing law, and offers a theoretical analysis of how, by changing these costs, decentralization results in non-rule-based collection practices and a form of semi-compliant behavior.

Part IV then offers indirect evidence of the theory in Part III, by arguing that decentralization, and the non-rule-based collection practices it creates, also explain the under-development of the tax profession and the under-use of judicial monitoring in China. Part V considers certain alternative explanations, characterizations, and evaluations of non-rule-based collection practices. Part VI briefly examines the institutional and historical reasons why Chinese tax administration is so decentralized. A brief Conclusion follows.

I.

TAX ADMINISTRATION AS A BOTTLENECK ON TAX REFORM: THE CHINESE CASE

A recent OECD report on tax policy and reform in China states that “China’s tax regime has raised an increasing amount of tax revenues in relation to GDP over the past 20 years to...support development while at the same time maintaining sound public finances.”²⁹ This positive assessment is based on such facts as that, in each year after 1997, growth in tax revenue in China has outpaced even its recording-setting GDP growth—very often by a wide margin.³⁰ In one sense, therefore, the tax system in contemporary China seems to have already dealt with the grave challenge believed

²⁹ Bert Brys, et al, *Tax Policy and Tax Reform in the People's Republic of China*, OECD Taxation Working Papers No. 18 (September 2013), available at http://www.oecd-ilibrary.org/taxation/tax-policy-and-tax-reform-in-the-people-s-republic-of-china_5k40l4dlmnzw-en.

³⁰ Id, at 7 (Figure 2).

to confront many developing countries, which is to mobilize sufficient revenue to fund basic public expenditures.³¹

Nonetheless, as the OECD report goes on to discuss—and as other recent studies of contemporary Chinese public finance have also concluded³²—the Chinese tax system has much more in common with other large developing or transitional economies than with a typical OECD country. This can be seen first through the mixture of taxes. The Chinese corporate income tax raises more than three times the revenue that is yielded by the personal income tax.³³ This is a pattern widely observed in developing countries and stands in sharp contrast to the pattern in developed countries.³⁴ Indirect taxes—the value added tax (VAT), sales taxes, and various excises—in turn represent a far greater share of total revenue than all taxes on income, which is again a distinguishing feature of the tax structures in developing countries in comparison with developed countries.³⁵ When compared to the OECD countries, the percentages to overall revenue of social security contributions and property taxes are also low in China,³⁶ as is the overall ratio of tax revenue to GDP.³⁷ It is not clear, therefore, that China's success at revenue mobilization can be attributed to the adoption of any distinctive tax policy relative to other developing countries. Moreover, revenue collection falls well short of meeting the expenditure goals that the government has set for itself.³⁸

Beyond the tax mix, the Chinese tax system also has much in common with developing countries in terms of tax administration.

³¹ Clemens Fuest and George R. Zodrow, e.d. *Critical Issues in Taxation and Development* (Cambridge, MA: MIT Press, 2013), 3.

³² See, e.g. the essays collected in Jiwei Lou and Shuilin Wang, ed, *Public Finance in China* (Washington D.C.: World Bank, 2008).

³³ See Brys, et al, *supra* note 30, Section 1.3

³⁴ See Vito Tanzi and Howell Zee, "Tax Policy for Emerging Markets: Developing Countries" (2000) *National Tax Journal*, 53 (2), 299-328, at 307. The pattern also implies a much higher level of capital taxation than is regarded as optimal under conventional economic theory. *Id.* at 305.

³⁵ Richard Bird, "Tax Challenges facing Developing Countries: A Perspective from Outside the Policy Arena" (2011) Background paper prepared for the UK Department for International Development (available at <http://ssrn.com/abstract=1393991>), at 17. This typically implies more regressive tax structures than observed in developed countries.

³⁶ For low use of property taxation in developing countries, see Tanzi and Zee, *supra* note 35, at 300.

³⁷ Athar Hussain and Nicholas Stern, "Public Finances, the Role of the State, and Economic Transformation, 1978–2020," in Lou and Wang, *supra* note 33.

³⁸ *Id.*

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This in a way is predictable, if theorists of tax and development are generally right that tax administrative capacity is the most important determinant of tax structure in developing countries.³⁹ While it is not the intention of this article to provide a detailed description or evaluation of Chinese tax administrative practices, a few examples will be offered below to illustrate the point. Before going into the examples, however, it is worth noting that when features of tax policy design are determined by tax administrative capacity, important implications follow for evaluating the economic efficiency of these features. Generally, taxes that are inefficient and distortionary in one set of circumstances (e.g. an economic environment characterized by perfectly competitive markets and no externalities) may be efficient and optimal in another (e.g. an environment characterized by imperfect competition, externalities, and/or pre-existing distortions induced by tax and other regulatory policies).⁴⁰ Therefore it may not be possible, in the abstract, to say whether a tax mix (such as the one described of China above) is socially optimal or not. However, where tax policy options are limited by administrative constraints and where policies adopted mainly respond to such limitations, then it is less likely that a policy that looks sub-optimal is in fact optimal (i.e. as a matter of the second best, given other pre-existing distortions).⁴¹ Accordingly, the discussion below emphasizes how methods of Chinese tax administration have shaped the substance of Chinese tax law.

A first example is the administration of China's VAT, the largest source of revenue for the government.⁴² VAT administration is handled by a large and well-resourced bureaucracy, the State Tax Bureau (or STB) system.⁴³ There is, however, very little VAT audit capacity. Instead, VAT collection relies almost entirely on a unique "golden tax project" (GTP), where sales and purchases are monitored

³⁹ See literature cited in notes 1-2 *supra*.

⁴⁰ Richard G. Lipsey and Kelvin Lancaster, "The General Theory of Second Best" (1956) *The Review of Economic Studies* 24(1), 11-32.

⁴¹ See Part V *infra* for further discussion.

⁴² For an overview of the substantive rules of the Chinese VAT, see Wei Cui and Alan Wu, "China", Chapter 6 in T. Ecker, M. Lang and I. Lejeune (Eds.), *The Future of Indirect Taxation: Recent Trends in VAT and GST Systems around the World* (Kluwer, 2011), pp 159-89. For a discussion of the most important departures of the Chinese VAT from international VAT norms, see Alan Schenk, Victor Thuronyi, and Wei Cui, *Value Added Tax: A Comparative Perspective*, 2d ed (Cambridge University Press, 2015) Chapter 14.

⁴³ See note 61 *infra* and accompanying text for a discussion of the STB system.

and verified by tax agencies using an extensive system of encryption devices, specially printed invoices, and computerized cross-checking.⁴⁴ As “high-tech” as this may sound, in reality the GTP’s main function is to prevent criminal tax fraud (i.e. deductions and VAT refunds claimed when no purchases have been made), something that most other countries prevent by carrying out VAT audits.⁴⁵ Whether or not the GTP is successful in stopping criminal VAT fraud in China is controversial.⁴⁶ What is not controversial is that the GTP imposes heavy compliance burdens on *all* taxpayers, including generally compliant ones, through requirements to record and report sales and purchases that meet the government’s technological specifications.⁴⁷ It has been noted that the GTP goes against the general conception of the VAT as based on self-assessment.⁴⁸ At the same time, the GTP is for most intent and purposes the only way in which tax agencies monitor VAT compliance.⁴⁹ Because of the limits of tax administrators’ audit capacity, Chinese VAT rules are rife with restrictive conditions that seriously impede businesses’ capacity to claim VAT credits for purchases made.⁵⁰ This is so much the case that taxpayers, tax professionals, and even tax policymakers and academics in China

⁴⁴ See Jane Winn and Angela Zhang, “China’s Golden Tax Project: A Technological Strategy for Reducing VAT Fraud” (2013) 4 Peking University Journal of Legal Studies 1; Schenk et al, *supra* note 43, Chapter 14, Section V.

⁴⁵ Graham Harrison and Russell Krellove, “VAT Refunds: A Review of Country Experience” (2005) International Monetary Fund Working Paper WP/05/218; Liam Ebrill, et al, *The Modern VAT* (Washington, D.C.: IMF, 2001), Chapter 14.

⁴⁶ Signs that it is not include (i) an extensive and harsh legal regime dealing with the “sham issuances” of VAT invoices, which cannot be controlled by the GTP, (ii) continued government reports of a high level of criminal activity, despite the fact that features of the Chinese VAT regime (such as unavailability of VAT refunds for domestic supplies) already limit the payoff for such activity. See Schenk et al, *supra* note 43, Chapter 14, Section VI.

⁴⁷ See EY, A Look inside China’s VAT System: Understanding How the Regime Works to Effectively Manage VAT Risks and Opportunities (March 2013), available at [http://www.ey.com/Publication/vwLUAssets/China_VAT_system_en/\\$FILE/China_VAT_system_en.pdf](http://www.ey.com/Publication/vwLUAssets/China_VAT_system_en/$FILE/China_VAT_system_en.pdf) (highlighting the burdens and risks created by the Golden Tax Project).

⁴⁸ See Ebrill, et al, *supra* note 46, Chapter 13.

⁴⁹ A term widely used by Chinese tax agencies to characterize their own strategy of administration captures this fact concisely: “Using invoices to control tax compliance” (yipiao kongshui).

⁵⁰ See Schenk et al, *supra* note 43, Chapter 14, Sections VI.A, VI.C, and VII.B.

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widely believe that the burden of the VAT is borne by businesses, and not by final consumers,⁵¹ which is extraordinary given the typical international understanding of the VAT as a tax on final consumption. Much of this understanding, and the rules and practices that sustain it, can be traced to China's approach to VAT administration.

A second example is offered by the administration of the business tax (BT), a cascading tax that substitutes for the VAT in the service sector and in dealing with real property transactions. The Chinese BT is also collected with virtually no audit nor self-assessment. Most of the time, the only way in which that the government verifies that a transaction has occurred (for both the vendor and the customer) is that a special form of invoice is issued. No tax returns or accounting book entries are used. Quite often, BT invoices are obtained by enterprises from tax agencies—and the tax amount paid when such invoices are obtained—on the basis of estimated sales revenue, which can deviate significantly from actual revenue.⁵² Perhaps not surprisingly, therefore, two thirds of the nation's BT revenue is collected from financial services, real estate, and construction, sectors that are generally capital-intensive and easy to monitor by tax collectors. The effective tax rate on other services (especially consumer services) is likely quite low. This had made it politically and administratively difficult to integrate the VAT and the BT, even though the differential tax treatment of goods and services increasingly generate distortions.⁵³

Third, personal income tax revenue is collected largely through withholding, whereas the annual return-filing and self-declaration requirements imposed on high-income taxpayers since 2007 still generate no additional revenue. As a result, many tax policy options—such as deductions or credits for dependents, deductions for investment losses, etc.—are simply precluded by administrative limitations, whether or not they are desirable from a policy

⁵¹ For a discussion of the prevalent belief in China that the VAT is a tax on businesses and not on final consumption, see Wei Cui, "China's Business-Tax-to-VAT Reform: an Interim Assessment" (2014) *British Tax Review* 2014(5), 617-641.

⁵² This has fueled a large black market in which tax invoices are traded. See David Barboza, "Coin of Realm in China Graft: Phony Receipts", *New York Times*, August 3, 2013.

⁵³ See Cui, *supra* note 51. In comparison to the VAT, the BT imposes relatively low compliance costs. This aggravates the gap in treatment between supplies subject to the VAT and those subject to the BT.

perspective. The tax on business income earned by sole proprietors, the only source of tax on personal income that is not collected through withholding, is collected either through presumptive taxation methods or through flawed auditing that relies almost exclusively on invoices.⁵⁴

These patterns that one observes in the administration of some of China's largest taxes are, not surprisingly, also found in collection practices for the smaller taxes as well. Indeed, it is possible to make a generalization across tax types: Chinese tax administration at the moment generally relies very little on taxpayer self-assessments or on audits.⁵⁵ This implies that in routine tax compliance, taxpayers generally transmit relatively little information about their business activities that should determine their tax liabilities, and tax collectors also generally do little to enhance such information through investigations. Even when revenue is coming in for the tax authorities, information is not. Moreover, collection practices differ little for highly compliant taxpayers and those that are riskier. These features of tax administration impose serious constraints on the further development of tax policy. In the field of indirect taxes, they prevent more uniform (and less distortive) tax treatments of goods and services. In the field of direct taxes, they limit the size of the personal income tax base and preclude more progressive taxation both within the income tax itself and in the tax system overall.⁵⁶

⁵⁴ Generally, the use of indirect tax invoices has seriously undermined income tax compliance on the part of businesses (whether or not incorporated): instead of auditing taxpayer accounts and determining whether claimed expenses correspond to real business outlays, tax collectors grant or deny deductions for income tax purposes based entirely on whether invoices in the right proportions are presented. For most businesses, therefore, compliance under the income tax involves not maintaining truthful and accurate accounting entries, but assembling invoices (whether for genuine transactions or purchased through the black-market). Where tax agencies cannot be assured of compliance through controlling the use of invoices, arbitrary limitations on deductible expenses are adopted to prevent revenue loss.

⁵⁵ As pessimistic as the above appraisal sounds, it is in fact not too different from the Chinese government's own assessments. See State Administration of Taxation (SAT), Notice Regarding Conducting Research on Crucial Issues in Deepening Tax Administrative Reform (Guoshuibanhuan [2012]127), May 17, 2012; SAT, Plan for Further Deepening Tax Administration Reform (Discussion Draft, November 2012, on file with author). The latter document acknowledges many of the weaknesses in tax administration just described.

⁵⁶ For the regressivity of the Chinese tax system, see Azizur Khan and Carl Riskin, "Growth and Distribution of Household Income in China between 1995 and 2002" (2007) in *Inequality and Public Policy in China*, eds. Gustafsson, Bjorn,

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These features, of course, also characterize tax administration in most developing countries.⁵⁷ Now, in many ways, these commonalities in tax administration between China and other developing countries should be surprising. China has one of the smallest shadow economies among all developing countries.⁵⁸ Its agricultural sector represents only 10% of GDP, and its financial sector is relatively developed.⁵⁹ The country also enjoys a relatively high literacy level. In addition to these well-known facts, it is also important to note that Chinese tax administration has experienced dramatic improvements in its human capital in the last decades. As recently as in 1997, the percentage of formal, permanent employees of Chinese tax agencies who had a post-secondary degree (junior college, college, or higher) was merely 40%. As of 2010, that percentage has climbed to 90%. Chart 1 illustrates this impressive trend for one of the two parts of Chinese tax administration, the state tax bureau (STB) system.⁶⁰ Chart 2, depicting changes in the age composition of STB employees, suggests that Chinese tax administrators have tended to stay in their jobs, accumulating years of experience and retiring later.⁶¹ In general, tax bureaus are also regarded as attractive employers and are among the top choices for young people entering the competitive civil service exam each

Li Shi, and Terry Sicular, 35–60 (Cambridge and New York: Cambridge University Press, 2007).

⁵⁷ See e.g. Bird, *supra* note 1, at 248; IMF 2011 Report, *supra* note 7, at 10; Bird, *supra* note 35, at 45–46.

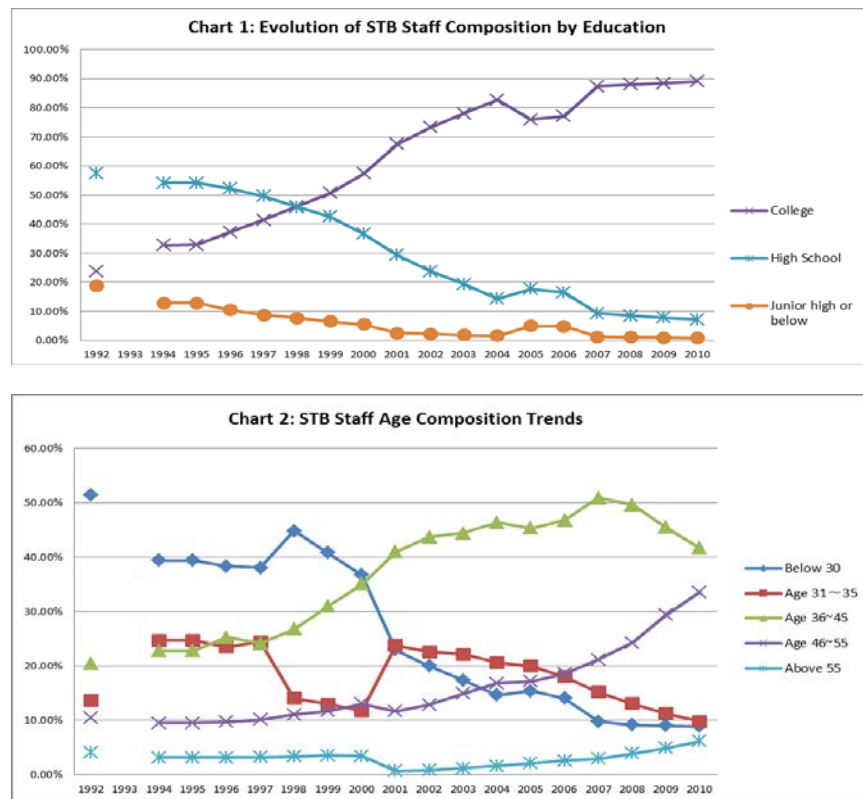
⁵⁸ See Friedrich Schneider, et al, “Shadow Economies All over the World: New Estimates for 162 Countries from 1999 to 2007” (2010) World Bank Policy Research Working Paper 5356, p 22 (finding that).

⁵⁹ For a recent, generally positive assessment of financial sector development in China, see World Bank/IMF, “China: Financial Sector Assessment” (2011) (available at <http://www.worldbank.org/content/dam/Worldbank/document/WB-Chinas-Financial-Sector-Assessment-Report.pdf>)

⁶⁰ The STB and LTB systems are primarily distinguished by the types of taxes they collect: STBs collect taxes the revenue of which went exclusively or in large part to the central government, whereas LTBs collected mostly taxes the revenue of which was primarily claimed by sub-national governments. As of 2010, the STB system is larger in terms of staff size by approximately 50,000 persons, and also collected more than twice the amount of tax revenue than the LTB system.

⁶¹ Similar patterns hold for the other part of Chinese tax administration, the local tax bureau (LTB) system, although they are not displayed here. The figures in Charts 1 and 2, as well as similar analyses for LTB personnel trends, are based on an original dataset on the composition of Chinese tax agency personnel from 1993 to 2010 compiled by the author.

year.⁶² All of these features of the Chinese economy and its tax administration workforce suggest that China should be further along the path of relying on self-assessment and audits than it is, and that the Chinese government should be gathering more information about its taxpayers than it actually does. Why is this not the case?



Adding to the puzzle is that fact that the combination of voluntary compliance with risk-based administration was actually the central goal of previous tax administration reforms.⁶³ Yet this goal has continuously eluded reformers. In the early and mid-1990s, the

⁶² For a recent discussion of the importance of pecuniary incentives in tax administration, see Adnan Q. Khan, Asim I. Khwaja, and Benjamin A. Olken, "Tax Farming Redux: Experimental Evidence on Performance Pay for Tax Collectors" (2014) NBER Working Paper No. 20627.

⁶³ See, e.g. The Implementation Plan for Reforming the Industrial and Commercial Tax System (adopted by the SAT on Dec. 11, 1993, and approved by the State Council on Dec. 25, 1993); Notice of the State Council Forwarding the State Administration of Taxation's Agenda for Deepening the Reform of Tax Administration (Guobanfa [1997]1, January 23, 1997)

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State Administration of Taxation (SAT, the national ministerial agency supervising most tax collection in China⁶⁴) several times obtained political endorsement from the highest levels for its vision of developing a tax system that is built on self-assessment, audits, taxpayer service, and the rule of law.⁶⁵ The Law on the Administration of Tax Collection, which remains to be one of the few national statutes governing tax matters in China today, was enacted in 1992 to empower tax administrators in a new market economy. It was then extensively amended in 2001 to give tax agencies greater capacity to gather taxpayer information and enforce tax law. A fundamental tax reform in 1994, as well as a well-known government-wide effort to improve administrative efficiency in 2000,⁶⁶ gave the tax bureaucracy opportunities to carry out major organizational and personnel changes.⁶⁷ Thus whatever has held back the development of modern tax administration in China, it is not for the lack of “political will” in any obvious sense of the term.

In summary, all of the usual suspects that purportedly obstruct sound tax administration in developing countries cannot explain China’s failure to implement a system based on self-assessment and risk-based management informed by taxpayer data. The aim of the

⁶⁴ Indirect taxes imposed on imports and exports of goods are collected by customs agencies. For more on the SAT, see note 86 *infra* and accompanying text.

⁶⁵ The Chinese government’s strategy for improving tax administration in the 1990s would probably meet the approval of most specialists in tax administration. The 1997 reform of tax administration, the implementation of which was completed in the early 2000s, included four components: (i) establishing a system of voluntary tax declaration and centralized tax payment, which replaced a prior system under which tax was assessed to and collected from specific taxpayers by individual tax administrators; (ii) investing in taxpayer services, including the publication of law, regulations and administrative guidance, and the setting up of taxpayer service centers, so as to facilitate self-compliance; (iii) developing computerized systems in which taxpayer information can be stored and analyzed, enabling tax agencies to monitor taxpayer compliance; and (iv) developing audit functions directed both at regular tax filing and compliance by taxpayers, and at specific industries and taxpayer types (based on risk), in addition to investigating serious non-compliance. In implementing all of these strategies, the rule of law was to be a guiding principle. See Guobanfa [1997]1, *supra* note 63.

⁶⁶ See Erik Brødsgaard Kjeld, “Institutional Reform and the Bianzhi System in China” (2002) 170 *The China Quarterly* 361-386.

⁶⁷ Throughout this process, the design of tax administration in China also received important support (both intellectual and financial) from the United Nations Development Program, the IMF, the World Bank and even the Japanese government. SAT, Outline of the Strategic Plan for China’s Tax Collection and Administration for 2002-2006, Guoshuihan [2003]267, March 10, 2003.

next three Parts of this article is to identify a culprit missing from the purview of received wisdom.

Before setting out in this investigation, two preliminary remarks are in order. First, because the Chinese government itself views taxpayer self-assessment and risk-based administration as the goal of administrative reforms, and because this is consistent with the mainstream views of international organizations such as the IMF and the OECD, I occasionally speak of “improving” or “modernizing” tax administration as though the superiority of self-assessment and risk-based administration is unquestioned.⁶⁸ This is strictly speaking unnecessary, since the main arguments of the article are about the causes of non-rule-based tax collection, however the latter is evaluated. For these arguments to be of interest, it is enough that non-rule-based tax collection arises not by design (i.e. not because it is deliberately adopted).

Second, what is the connection between modern tax administration—supposing that means self-assessment and risk-based administration—and rule-based administrative practices? The connection seems fundamental: the rule of law seems to be a necessary, even if not sufficient, condition for self-assessment and risk-based administration. For self-assessment to be possible, taxpayers need to be able to determine their tax liabilities based on published rules. In turn, risk-based administration means focusing administrative resources on detecting and punishing those who do not follow the rules.⁶⁹ It is difficult to conceive of a system of voluntary compliance where rules are either not known or not enforced. The suggestion here is not to blame unsuccessful tax administration on the weakness of the rule of law, as though the latter is an independently given trait of the social environment in which tax administrators operate.⁷⁰ Instead, Parts II-IV will highlight tax administrative techniques and organizational configurations that directly affect people’s attitudes towards the law and their compliance behavior, and it is such basic attitudes and behavior that give content to the concept of rule of law relevant here.

⁶⁸ Part V discusses a dissenting view.

⁶⁹ For further elaboration, see paragraph accompanying note 137 *infra*.

⁷⁰ Nor are all components of the multi-faceted concept of rule of law relevant. For example, as will be argued in Part IV.B, whatever weaknesses are suffered by the Chinese judiciary are unlikely to have contributed to the current problems of tax administration.

II. DECENTRALIZATION AND THE ORGANIZATION OF CHINESE TAX ADMINISTRATION

The culprit I am about to identify for the difficulties in improving Chinese tax administration is excessive decentralization. The term “decentralization”, however, means very different things to different people, and when these meanings are not adequately specified, some might find it surprising to hear that “decentralization” can be a bad thing, and that “centralization” is what I will propose for curing administrative maladies. The goal of this Part is to clarify the specific meaning of administrative “decentralization” in China, both in concrete organizational details and in systematic, quantitative terms. I begin by showing how a *county-level tax bureau* in China is organized. As discussed below, the majority of Chinese tax administrators—some 400,000 of them—work at these county-level tax agencies. Alongside another large set of tax administrators that staff below-county-level “outposts”, they constitute the frontline of the tax bureaucracy dealing with taxpayers on a daily basis. What county-level tax bureaus (and their subsidiary “outposts”) do—and don’t do—have a decisive influence on Chinese taxpayers’ compliance options.

A. County-Level Tax Bureaus, Outposts, and the Meaning of Decentralization

China has 2,856 county-level jurisdictions. County-level tax bureaus constitute, in Chinese bureaucratic parlance, the lowest level of “all-purpose” bureaus. That is, such bureaus play many roles, and the first among these roles is typically embodied physically in a *tax service center*, a building (often a big and bustling place) where businesses register for tax purposes, file monthly, quarterly or other periodic returns, make actual payments for taxes (and fines and penalties), apply for special tax treatments, and purchase or replenish their supplies of tax invoices. The central government pushed for establishing these tax service centers across China during the 1997 reform of tax administration, in order to ensure that payments of tax are centralized (to prevent corruption and embezzlement), and to make possible taxpayer voluntary compliance.⁷¹

⁷¹ See *supra* note 65. This aspect of the 1997 reform was arguably successful.

Yet the administrative heart of the county bureau is not the tax service center. It is instead an internal *division for taxpayer management*. This division fulfills an extremely broad set of functions,⁷² including: managing taxpayer registration, reviewing and verifying tax returns, carrying out routine inspections, making assessments, determining penalties, giving publicity to tax law, and providing taxpayer education, training, and other services. Moreover, taxpayer management divisions (at least in theory) are expected to conduct taxpayer research, gather information about the business activities and accounts of taxpayers in their jurisdictions, provide summaries of compliance by individual taxpayers and withholding agents, produce indicators concerning local economic performance and sectoral average tax burdens, and compare such indicators with information provided by superior units as well as other government agencies and sources of tax-related information.

This broad range of duties encompasses both relatively menial and rather advanced administrative tasks. Included among the latter are what internationally would be thought of as “desk audits”, as well as the selection of taxpayers for more intensive audits, and the conduct of some field audits.⁷³ However, given their quite comprehensive job description, taxpayer management divisions are remarkably internally undifferentiated. There is no general practice for setting up internal sub-divisions to deal with different types of taxes⁷⁴ or of taxpayers. Instead, the allocation of work within taxpayer management divisions usually follows the “taxpayer manager system”. That is, each individual staff member is designated to be the manager for a portfolio of specific taxpayers, with each portfolio comprising up to hundreds of businesses. With respect to the multitude of taxpayers in her portfolio, each manager assembles

⁷² SAT, Recommendations Regarding Further Standardizing the Internal Organization and Clearly Delineating the Duties and Divisions of Labor within the State Tax Bureau System (Guoshuifa [2004] 125, Sep. 3, 2004)

⁷³ China has designated a special kind of tax audit or inspection, *shuiwu jicha*, to be carried out by a separate system—the system of tax inspection bureaus—operating independently from all-purpose tax bureaus. Inspection bureaus at least historically have focused on tax frauds and outright tax evasion, and their audits/investigations are generally not ongoing with respect to most taxpayers. Therefore, whatever risk-based administrative practices may develop in China, they are likely to emerge primarily in the taxpayer management divisions.

⁷⁴ Although the bifurcation of tax administration into the state tax bureau and local tax bureau systems is based on tax types (see note 60 *supra*), each system administers quite a variety of different taxes.

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information and makes general assessments of their level of compliance, as well as provide taxpayer services upon request.⁷⁵

The taxpayer manager system thus establishes, for each business taxpayer, access to a tax administrator. And each such administrator is responsible for supervising the compliance of a sizeable population of taxpayers, often with respect to multiple types of taxes. This unusual arrangement raises the question: Why is the taxpayer manager system adopted? Why is it that everyone in the taxpayer management division generally does the same thing, just covering different specific taxpayers? What, for example, prevents a taxpayer management division from establishing various sub-divisions, so as to enable greater specialization among staff members?

These questions can be answered only by attending to the fundamental phenomenon of *administrative decentralization*. A county-level tax bureau is already at such a low rank within the Chinese state that an internal division of it, such as a taxpayer management unit, almost could not have a separate official rank.⁷⁶ Therefore, subdivisions of a taxpayer management division would not be hierarchical.⁷⁷ It is also not possible, to circumvent this problem of not being able to create hierarchies below a division that are required by specialization, simply to have more divisions within a county-level tax bureau. Again because a county-level bureau sits at such a low level of the bureaucratic scale, there are general

⁷⁵ To prevent corruption, tax managers are rotated every two years among different portfolios of taxpayers. They also generally do not collect tax payments, nor issue penalties, nor negotiate tax reductions or settlements. Instead, they may conduct field inspections and issue reports on taxpayers on the basis of such inspections.

⁷⁶ A name for such a division, “gu”, had to be invented in administrative practice so as to give some recognition to the leader of the division. The rank of a “gu” is not formally recognized in the Civil Servant Law. Essentially, a “gu” is the lowest tier of bureaucratic organization at which a leader may be designated; no differentiation of rank in civil service, and only minute differences in pay scale, are possible below a “gu”.

⁷⁷ It might be argued that a non-hierarchical division of labor is conceivable, and therefore the infeasibility of hierarchy does not explain the lack of division of labor. That is, it is conceivable for a group of civil servants (say 30 people) all at the lowest bureaucratic ranks to divide up specialization within themselves, so that some are responsible for taxpayer registration, some for providing information for each type of taxes, some for audits, and others for revenue and taxpayer data analysis, and so on. (Such internally specialized cells would also have to be systematically replicated across the country). While conceivable, it is difficult to think of real-world embodiments of such organizational structures within bureaucracies anywhere.

limitations—imposed not on tax administration alone but on all government agencies—as to how many internal divisions it can have. As all-purpose bureaus are generally expected to have numerous other divisions,⁷⁸ further division of labor within taxpayer management is bureaucratically not feasible.

Now, Chinese counties can be quite large, in terms of both population and the size of their economies. Thus even though there are close to 3000 county-level jurisdictions in the country, for much of the Chinese population and many Chinese businesses, the county government is not “low down”, but “high up”. This reality is certainly reflected in tax administration: for many Chinese taxpayers, the real face of the tax system is not the county-level tax bureau, but a large network of branch tax bureaus and tax offices/stations, each covering three to five township-level jurisdictions.⁷⁹ These are called “outposts”,⁸⁰ and their broad functions essentially match those carried out by the taxpayer management divisions of county-level bureaus.⁸¹ Like taxpayer management divisions of county-level bureaus, outposts also follow the taxpayer manager system, with individual administrators comprehensively covering portfolios of taxpayers. Similarly, at most one person in each outpost has a title (at the lowest possible rank) of a “leader”, while the rest of the employees are, to put it bluntly, bureaucratic nobodies.⁸²

By contrast to both outposts and county-level bureaus, tax bureaus at higher levels—including prefectural/municipal

⁷⁸ These typically include a legal and policy division (staffed by a few individuals who provide legal advice to taxpayer managers and handle formal appeals when they arise); a planning and accounting division; a central clerical office; and one or two other divisions that handle internal administrative matters, including personnel and anti-corruption supervision.

⁷⁹ There are 40,906 township-level jurisdictions in China as of 2010.

⁸⁰ Outposts are not “all-purpose”: while some outposts in remote areas also process actual tax payments, no outposts contain legal, planning, personnel, and clerical functions.

⁸¹ These range from field inspections of taxpayer business activities and accounts, assembling and analyzing compliance data, comparing such data with data provided by superior agencies or other government agencies to detect tax evasion, and liaising with the legal and revenue planning divisions of county-level bureaus to address commonly observed issues in tax collection.

⁸² Outposts and taxpayer management divisions within the same jurisdiction would normally not duplicate taxpayer portfolios. They are thus substitutes, and collectively carry out “taxpayer management”. One difference between the two, especially in the Local Tax Bureau system, is that outposts may be partially funded by lower-than-county-level government, and may need to attend to the revenue targets and needs of these lower-level governments.

jurisdictions and, above them, provincial-level jurisdictions⁸³—generally do not directly face taxpayers. Instead, they perform a large range of policy, political, and superior administrative functions, such as determining the internal organization of lower-level agencies, budgeting, and appointment. These bureaus are permitted to have a greater number of internal divisions due to these additional functions, and their internal divisions also enjoy higher bureaucratic ranks. They have even been permitted to have specialized divisions handling international tax matters, but a proposal in 2002 to set up large-taxpayer units at these higher-level bureaus was never implemented.⁸⁴

The foregoing outline of the allocation of administrative functions along the hierarchy of subnational tax administration allows us to define the phenomenon of “administrative decentralization”, which, the rest of the article will argue, substantially accounts for the difficulties China has encountered in modernizing tax administration in recent years. The meaning of decentralization can be broken into two components. First, there is a single bureaucratic hierarchy, and decentralization means that government functions viz-a-viz citizens are performed at the lower levels of the hierarchy. By contrast, higher levels of the bureaucracy do not exercise government power with respect to citizens directly, but instead issue commands to bureaucratic subordinates. Second, the lower the bureaucratic rank, the more geographically dispersed are units within that rank, and the smaller is their geographical jurisdictional reach. Decentralization thus implies that the scope of functions of a particular, citizen-facing government unit is usually delineated by reference to the finer geographic divisions of government. What is unusual about China is first, how deep (i.e. multilayered) the bureaucratic hierarchy is, and second, how resolutely the tasks of tax administration are placed at the bottom ranks of the hierarchy.⁸⁵

⁸³ As of 2013, China has 31 provincial-level jurisdictions and 333 prefecture-level (including large municipal) jurisdictions. In the following, the terms “prefecture” and “municipal” are used interchangeably to denote a level of government (where they exist) intermediate between the county and the provincial levels.

⁸⁴ Even the existing international tax divisions at these higher-level bureaus play mere advisory roles (similar to legal and policy departments), instead of taking over tax administration entirely from county- or lower-level agencies.

⁸⁵ As discussed in Part VI *infra*, decentralization is a general characteristic of the Chinese administrative state in the performance of most government functions.

Table 1 lays out certain quantitative information about the organization of Chinese sub-national tax administration in 2010. The italicized rows in the table correspond to tax administration units at the county level or below. It is apparent that most all-purpose tax bureaus lie at the county level, two levels down from provincial tax agencies. Moreover, by far the largest category of tax agencies consists in outposts.

Table 1: Tax Bureaus at Different Levels of Government, 2010

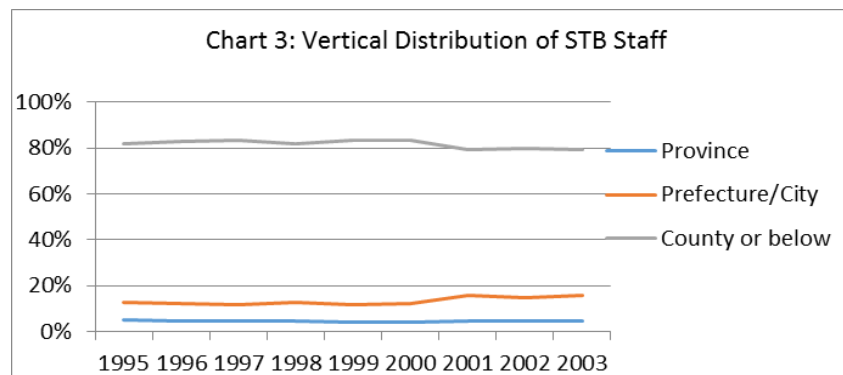
| | STB System | LTB System |
|---|--------------|--------------|
| Provincial bureaus and bureaus for cities with quasi-provincial status | 46 | 45 |
| Prefecture bureaus | 336 | 317 |
| <i>Bureaus in districts of directly-controlled municipalities, of cities with quasi-provincial status, and of prefectures</i> | <i>1073</i> | <i>748</i> |
| <i>County bureaus</i> | <i>2054</i> | <i>1949</i> |
| <i>Branches, offices, and other outposts</i> | <i>10507</i> | <i>18178</i> |

B. The Extent of Decentralization

So far, I have said very little about tax administration at the national level. This is because the SAT, with a staff of only 850, constitutes a tiny portion (just over 0.1%) of total workforce of Chinese tax administration. As can be expected, the SAT undertakes very little direct administrative responsibility viz-a-viz taxpayers. According to a recent OECD study,⁸⁶ which covered 35 OECD countries and 17 non-OECD countries/regions and which specifically examined “office networks for revenue bodies,” in 2011, China had the smallest percentage of tax administration staff working at headquarters (i.e. national) offices among the 52 countries surveyed. Further, if provincial tax bureaus are counted as a form of regional offices, China’s percentage of tax administrators working at either national or regional offices is still the lowest among all countries surveyed. Therefore, China is an extreme when compared to other countries in how “light” its tax administration is at the top.

⁸⁶ OECD, *Tax Administration 2013: Comparative Information on OECD and Other Advanced and Emerging Economies* (Paris: OECD Publishing 2013), p 83.

The OECD does not further break down tiers of administration among local/branch offices for China or any other country.⁸⁷ However, data compiled by the SAT (for the years from 1995 to 2003) allow us to obtain a more fine-grained view of the “bottom-heaviness” of Chinese administration. Chart 3 graphically presents this information by dividing subnational employees of tax agencies into three tiers: the provincial level, the prefectural level, and the county level.⁸⁸ The chart reveals that despite the dramatic changes in staff composition (in terms of education levels and age) in the tax bureaucracy during the 1990s and 2000s (as shown in Charts 1 and 2), the vertical distribution of tax administrators hardly changed during the years in question, and remained very bottom-heavy. For example, in 2003, provincial-level employees accounted for only 5% of the staff in the STB system; prefectural level employees accounted for 16%, and those at the county level or below represented an overwhelming 79.5%. Because the most important internal reorganizations of tax agencies were completed before 2003, it is likely that the distribution of staff up and down the hierarchy is similar today.



If one were to visualize Chinese tax administration in a pyramidal figure, divided into 5 tiers (corresponding to the national, provincial, prefectural, county, and township-level jurisdictions), then the proportions of areas of the tiers from the top to the bottom

⁸⁷ In many countries, for example those in Europe, such a further breakdown would not make sense: a local (as opposed to a regional or national) office is already at a municipal level that is much smaller in both geographical and population size than a Chinese county.

⁸⁸ The chart presents data for the STB system. Patterns for LTBs are similar.

would have the ratio of 0.1:4.9:15:40:40.⁸⁹ The top tier, the national-level SAT, would almost be invisible.

Having established the character and extent of decentralization in Chinese tax administration, I now turn to the analysis of how decentralization may have contributed to the failures of tax administrative reform in China since 1997. It is fairly straightforward to demonstrate the incompatibility of decentralization with certain important administrative techniques: I have already alluded to the difficulty of setting up specialized subdivisions within low-level administrative units, and I will discuss similar difficulties created by decentralization for techniques such as large taxpayer management and the use of advance rulings.⁹⁰ But the focus in the next Part is the more fundamental impact of decentralization on taxpayer compliance options, particularly on how non-rule-based collection practices may emerge. This analysis is more fundamental for two reasons. First, unlike traditional discussions of tax administration techniques, which assume the rule of law or at least the awareness of rules by tax collectors or taxpayers (whether they enforce or follow such rules or not), I precisely do not take rule-awareness for granted. Second and relatedly, tax administration is not a unilateral activity on the part of the government. The interactions between taxpayers and tax administrators determine both behavior and the perception of behavior, and such perception may have a major impact on how people interpret the needs of administration. For example, as discussed below, within non-rule-based collection practices, the line between compliance and non-compliance could be blurred, which would make it difficult to define what “risk-based” administration is.⁹¹ This is why I give greater emphasis to the basic incentives underlying compliance decisions.

⁸⁹ The figure takes into account the fact that as many as 40% of STB employees that would be categorized as working at the county level or below in Chart 3 in fact work below the county level. And in the LTB system, employment at outpost units represented a dominant 40% of total LTB employment. This means that well over half of the LTB staff engaged in routine tax administration is employed at a level below the county. Putting the STB and LTB systems together, then, approximately half of the employees that are counted as county-level staff work in outposts below the county level.

⁹⁰ See Part III.A. *infra* on large taxpayer management; and text accompanying notes 123-6 *infra* on advanced rulings.

⁹¹ Thus without changing the organizational pattern responsible for the emergence of such dynamics, there is no “technical” way of implementing risk-based administration.

III.

DECENTRALIZATION AND TRANSACTIONAL COSTS IN IMPLEMENTING
THE LAW

This Part argues that administrative decentralization has likely led to the persistence of non-rule-based tax collection practices in China. The arguments draw on a strand of scholarship in the economic analysis of law that identifies various transaction costs involved in the adoption and implementation of law.⁹² Louis Kaplow,⁹³ for example, has described the costs of specifying the content of law to be applied in the future (promulgation costs), the costs for regulated subjects to inform themselves of the likely application of law to particular cases (labeled “advisory costs” below), and the costs for determining the correct application of law to a particular case in an enforcement action or legal dispute (enforcement costs).⁹⁴ The analysis in this Part is inspired by this approach, but introduces certain important refinements to it, so as to shed light on the consequences of administrative decentralization. Specifically, the following analysis improves the classification of transactional costs by defining the concept of the *communication costs* of law, and advances existing discussions of the structure of advisory costs by introducing the possibility for regulated subjects to consult government officials about the content of law, as an alternative to learning about the law either by themselves or engaging legal advisors. Moreover, I will show that communication costs and advisory costs may affect compliance both independently and in interaction with each other.

A. Decentralization Increases Costs of Communicating Law

I define the “communication costs” in the implementation of law as the costs of making relevant parties aware of the content of law as it may apply to a general class (or classes) of circumstances. For example, the communication costs associated with a newly adopted tax regulation include the cost of publicizing the regulation so that

⁹² See Louis Kaplow, “General Characteristics of Rules” in Boudewijn Bouckaert and Gerrit De Geest, ed, *Encyclopedia of Law and Economics* (Cheltenham, UK: Edward Elgar, 2000), Volume V and the literature cited therein.

⁹³ Louis Kaplow, “Rules versus Standards: An Economic Analysis” (1992) 42 Duke Law Journal 557.

⁹⁴ Kaplow evaluates, in terms of these costs, the relative efficiency of adopting rules as opposed to standards in various circumstances.

knowledge of it may be acquired by taxpayers, tax advisors, and tax administrators. It also includes the costs these groups of individuals incur in actually acquiring such knowledge, through various kinds of training, so that they may be aware of the types of circumstances to which the regulation may apply. To a large extent, communication costs are incurred by or for the benefit of legal professionals, whether they are in the government, in law or other professional service firms, or non-legal businesses. These professionals have an interest in acquiring knowledge about what the law says independently of specific transactions: possessing such knowledge is what makes them professionals, and the cost of acquiring such knowledge is a type of fixed cost for being in the profession. By contrast, many regulated subjects have no incentive to acquire general knowledge about the law independently of the specific transactions they enter into. For instance, most taxpayers have no reason to learn about the tax law beyond the few rules that affect their ordinary activities.

Communication costs as defined above differ from the cost of legislation (or “promulgation costs”) as modeled by Kaplow: they are incurred *after* either a legal rule or a standard is adopted. They can also be distinguished from the advisory costs incurred by various parties—government officials, advisors, and regulated subjects—in informing themselves of the law applicable to a particular proposed transaction. One can think of this latter type of cost as a form of marginal, as opposed to fixed, cost. For example, taxpayers may need to incur such marginal costs for a transaction under consideration by consulting a tax advisor. In contrast, for the tax advisor, besides the cost of learning about taxpayer’s circumstances, it may be that no marginal cost need to be incurred for knowing the applicable law—the advisor may already have acquired the knowledge, as a matter of fixed professional investment.⁹⁵ Finally, it should be clear that communications costs is distinct from enforcement costs, which, like advisory costs, are triggered by particular transactions.

To see the connection between decentralization and communication costs, start by noting the importance of specialization among individuals entrusted with applying law. Specialization facilitates learning. A specialized tax administrator, for example, will

⁹⁵ Of course, what each person knows always comprises to a greater or lesser extent what one has specifically dealt with in the past. But for professionals, we typically expect that their expertise is partially based on making ongoing fixed-cost investments in acquiring knowledge about the law.

more easily learn new rules in his area than someone who does not specialize. When tax agencies are internally specialized, the cost of communicating any new law to a particular agency (so that it will begin to enforce such law) should be lower than agencies that are not internally specialized. Effective training, for example, may be harder and more costly for the latter. If decentralization impedes specialization, then, *ceteris paribus*, it increases communication cost.

One reason why decentralization impedes specialization is that it reduces the volume of a given class of transactions that falls within the jurisdiction of any agency. As a result, most agencies may not be justified to assign staff to specialize in the law that applies to such transactions. For example, for most localities in China, it is difficult to envision international tax specialists operating at a county-level tax bureau, let alone a sub-county-level outpost. There simply wouldn't be sufficient amounts of international transactions arising in these jurisdictions. Accordingly, most local tax administrators would have very low incentives to learn about international taxation. The natural course to take in response to this would be to centralize international tax administration to higher-level agencies, with possible exceptions for local jurisdictions where cross-border transactions are frequent (e.g. counties where foreign direct investments are concentrated). As we saw in the last Part, the structure of Chinese tax agencies currently preclude this possibility.

Examples analogous to international tax rules also include those rules that are particularly relevant to large businesses, corporate headquarters, and transactions among businesses across domestic jurisdictions. It is obvious that most local tax administrators would have insufficient incentives to specialize in these rules, since the relevant taxpayers and transactions tend to be geographically concentrated. However, if this were the only way in which decentralized administration increases communication costs, the significance of decentralization for compliance would be secondary. This is because international or large businesses are reasonably likely to adequately inform themselves of the content of law and to display a reasonable degree of basic compliance (even while pursuing a wide variety of legal, tax, and regulatory maneuvers and arbitrage). If taxpayers tend to be compliant in sectors that require administrative specialization, the lack of such specialization may generate problems for taxpayer service, but possibly not for the level of compliance itself.

It is thus important to recognize other ways in which decentralization may increase the cost of communicating law to law

enforcers. One is the effect on career incentives. Decentralization of the Chinese variety implies a very steep administrative hierarchy. Most government employees starting at the bottom of the hierarchy, in the townships and counties, cannot expect to rise very high. Thus neither monetary compensation nor career prospects encourage low-level government employees to invest a great deal in professional development.⁹⁶ Another is the cost of transmitting information through a chain that has too many links. For example, until fairly recently, the SAT, like many other national agencies, issued informal guidance on law and policy—which comprises much of the substance of what is known as Chinese tax law⁹⁷—that are transmitted layer-by-layer, from provincial to prefecture to county tax bureaus, and eventually to the branch bureaus and tax offices. According to government officials, not infrequently, a rule would fail to be enforced in some jurisdictions simply because some intermediate office did not pass it on to subsidiary agencies. A 2010 SAT initiative aimed at promoting transparency in rulemaking, requiring that all guidance intended to be binding on taxpayers and other regulated subjects be published, has mitigated this problem.⁹⁸ But it is already remarkable that it took a government transparency project to solve this internal bureaucratic problem. Moreover, this pattern of layered transmission of information still characterizes other aspects of the communication of the law, for example the training of tax officials.⁹⁹

Overall, then, decentralizing government regulatory functions to the bottom of a steep administrative hierarchy increases the cost for government officials to learn the law. This effect applies to both higher- and lower-level officials: because the former are not directly engaged with regulatory activities, they may not have sufficient first-hand experience or incentive to learn the law in detail (or reinforce what was once learned). Note that this is not a problem of principals

⁹⁶ Despite low turnover in tax agencies (see Chart 2 *supra*), Chinese commentaries on tax administration mention low incentives and lack of interest on the part of employees with some frequency.

⁹⁷ Wei Cui, “What Is the ‘Law’ in Chinese Tax Administration?” (2011) *Asia Pacific Law Review* 19(1), pp 75-94

⁹⁸ *Id.*

⁹⁹ For example, the SAT would sponsor training sessions targeted at provincial tax administrators; provinces would convene training for lower-level agencies, and such lower agencies for their subsidiary agencies. The reliability of the content of much low-level training therefore very much depends on the level of knowledge and incentives of the trainees of the higher-level training sessions.

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properly monitoring agents, of making sure that lower-level officials implement the law. It is a problem of communication. In itself, the problem may be significant only in certain policy areas where regulatory complexity favors centralization (e.g. tax rules relating to large or international businesses). However, in interaction with other effects of decentralization, high communication costs can undermine compliance for a larger population of regulated subjects.

B. Decentralization and the Structure of Advisory Costs

Let us now examine how decentralization within a regulatory bureaucracy may affect the costs for regulated subjects to inform themselves of the content of law, and thereby their decisions regarding whether to seek such information. To do this, consider a simple framework for thinking about taxpayer choice.¹⁰⁰ Suppose that a taxpayer, when contemplating entering into a particular transaction, is uncertain about the content of tax law applicable to the proposed transaction. He has three choices about how to determine the relevant content of law:

- (A) He may engage in self-study (e.g. by consulting government publications), acquire professional tax advice, or inquire with taxpayer service units within the tax administration if taxpayer inquiries are routinely answered by such units;
- (B) Alternatively, he may make a mere guess about the content of law, including the likelihood of detection of non-compliance and applicable penalties;
- (C) Finally, he may be able to consult with the tax collector/administrator whom he deals with during routine (e.g. weekly or monthly) tax compliance, regarding the tax collector's view about how the transaction should be treated.

In many countries, (A) and (B) are the only choices that a taxpayer has available. Only a small set of taxpayers, e.g. large corporations where audit teams from the tax agency are routinely stationed, have tax administration staff specifically assigned to them

¹⁰⁰ The framework set out here may be compared with related models in Kaplow, *supra* note 93, and in Yehonatan Givati, "Resolving Legal Uncertainty: The Unfulfilled Promise of Advance Tax Rulings" (2009) 29 Virginia Tax Review 137. See note 112 *infra* for a brief comparison with Kaplow's model; and notes 121-2 *infra* and accompanying text for some discussion of Givati's model.

and deal with them on a routine basis. Taxpayers may have access to good taxpayer services, including having simple inquiries answered, but the government staff answering the inquiries are not the ones that will engage in audits and make tax assessments for the inquiring taxpayers. However, in a decentralized tax administration, where most tax officials are at the lowest level and their primary task is to monitor a specific set of taxpayers, (C) becomes an option for taxpayers.

One may conjecture that choices (A), (B) and (C) are associated with different outcomes in terms of compliance with tax law. This is for two distinct reasons. First, different pre-dispositions for compliance may be associated with the three choices. A taxpayer who chooses option (A) is more likely to comply with the law than one that chooses option (B). This is more likely to be true when the content of law is more uncertain, and the amount of potential tax liability (and of penalties for non-compliance) is greater: it is hard to imagine a taxpayer who faces high risks of significant negative consequences without trying to find out more about such consequences, unless he believes that he can get away without suffering such negative consequences. The intrinsic compliance potential of a taxpayer who chooses (only)¹⁰¹ option (C) is more interesting. On the one hand, he is not someone who simply disregards the law, failing to inform himself of the content of law even when there is uncertainty. On the other hand, if he regards the views of specific low-level tax officials as the only information about law that is relevant, his compliance decisions may be more narrowly based on judgments about the capacity of these particular officials to detect and penalize non-compliance. This suggests that, all other things equal, the taxpayer is likely to be more non-compliant than a taxpayer who chooses option (A).

The second reason why choices (A), (B) and (C) may produce different compliance outcomes has to do with the nature of the advice the taxpayer receives. Under option (B), the taxpayer receives no advice and merely makes an uninformed guess. Under option (A), the taxpayer receives advice, which we will assume is generally accurate. Both independently and in combination with the pre-disposition to comply on the part of taxpayers who choose (A), this means that a taxpayer is much more likely to act in a compliant manner when choosing (A) rather than (B). The choice of (C) is

¹⁰¹ Later on, we discuss the case where a taxpayer's chooses to pursue both options (A) and (C).

again interesting. It was argued earlier that where decentralization significantly increases the communication costs of law, the likelihood that a tax collector does not know the law increases. Specifically, there is a distinct possibility that many tax collectors know less tax law than independent providers of tax advice.¹⁰² Thus a taxpayer may receive different advice under choices (A) and (C), not only because paid tax advisors (and taxpayers themselves) may be inclined to interpret the law differently from government official, but also because, interpretive tendencies aside, third-party advisors and enforcement officials may possess different levels of knowledge about the law.¹⁰³ Because of this, a taxpayer who makes inquiries only with low-level tax officials (choosing option (C)) may ironically be less likely to be in compliance with tax law in the end than one who independently acquires knowledge about the law.

In summary, it may be hypothesized that the even though the choice of (C) produces more compliance than the choice of (B), the choice of (A) produces more compliance than both the choices for (B) and for (C).

How, though, does the taxpayer choose among options (A), (B) and (C)? We may suppose that all taxpayers aim to minimize the sum of the following costs: (i) the expected tax payments associated with a specific proposed transaction,¹⁰⁴ (ii) the expected cost of penalties associated with under-payment of tax for the transaction, and (iii) the advisory costs incurred. Costs of type (i) and (ii) may be relevant under all three options. Costs of type (iii), however, will be incurred only under options (A) and (C). Thus if the expected costs of types (i) and (ii) are sufficiently low, no advice of any type may be sought (resulting in the choice of (B)).

Turning to the choice between (A) and (C), the cost (“C_o”) of consulting a local, low-level tax official “in charge” of the taxpayer under option (C) may either be higher or lower than the cost (“C_a”)

¹⁰² As discussed in Part IV.A *infra*, there is an endogenous relationship between the taxpayer’s choice among (A), (B) and (C) and the availability of advice under option (A).

¹⁰³ Even in well-functioning tax administrative systems, government officials may be more prone to errors at least relative to some tax advisors (if not in comparison to the average tax advisor). For example, tax agencies may be understaffed, and civil servants may be insufficiently paid, or insufficiently informed about the nature of market transactions compared to tax advisors. But the discrepancy may be small and tolerable.

¹⁰⁴ The taxpayer may learn, under either option (A) or (C), that the expected tax payment is so high that it would not make sense to pursue the transaction.

of consulting a knowledgeable third-party advisor under option (A). In many countries, for most taxpayers and transactions, consulting a tax administrator in advance about the tax treatment of a transaction may be difficult, whereas a market for tax advisors readily exists. In such situations, $C_o > C_a$.¹⁰⁵ In a decentralized system where tax administrators are assigned to supervise specific taxpayers, however, C_o may be lower, sometimes significantly, than engaging a third-party advisor.¹⁰⁶ In such a case, the taxpayer would choose option (A) only if the advice it receives can lower the sum of costs of type (i) and (ii) sufficiently to cover the cost differential between C_o and C_a .¹⁰⁷

Conversely, it also follows that a taxpayer is unlikely to choose option (A) and independently acquire knowledge about the tax law if, on average, choosing option (C) and inquiring with the “in charge” tax authority does not generally result in greater aggregate costs of types (i) and (ii).¹⁰⁸ This condition may be satisfied because of numerous features of a decentralized tax administration that in themselves do not have to do with transactions costs. For example, when there are many decentralized tax collection agents, internal bureaucratic monitoring of their performance in terms of adherence to legal rules may be difficult. Instead, revenue collection targets may be adopted. If these targets are set either roughly at or below the level of revenue that would be collected if the law were faithfully applied, then, again, the decisions of tax collectors about how specific transactions are to be treated are likely to be advantageous, or at least not disadvantageous, to taxpayers who follow these decisions instead of law.¹⁰⁹ Moreover, where tax administration is

¹⁰⁵ While advance rulings are well known in developed countries, the range of issues for which they are available tends to be limited. Advance rulings are also not systematically available in many other countries.

¹⁰⁶ For example, the only professional tax advisors available may be those serving high-compliance clients and who charge high fees.

¹⁰⁷ A knowledgeable tax advisor may recommend legal means for lowering taxes. The expected cost of penalties can also depend on whether one receives professional advice.

¹⁰⁸ In other words, it must be the case that one does not always get “unfavorable” answers by talking to tax administrators. If tax officials tend to arrive at the same conclusions about applicable tax law as independent tax advisors, then taxpayers should choose (C) over (A), if $C_o < C_a$.

¹⁰⁹ If these targets are set too much above the level of revenue that the law dictates, on the other hand, appealing to the law may be of no use: the tax collector may still insist on extracting payments from taxpayers regardless of whether there

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perceived to be weak, statutory tax rules may be written—with higher tax rates, broader tax bases, and more types of taxes on identical transactions—so as to reflect significant “expected slack” in enforcement. Again in such situations, it may not be advantageous for the taxpayer to follow the rules of law.¹¹⁰

Whether decentralized tax administration, the adoption of revenue targets as primary measures of tax agency performance, and the design of statutory rules specifically to take into account enforcement “slack” are mutually correlated is an important question deserving separate investigation. Each of the latter two may have adverse effects on the rule of law and the implementation of tax policy, but for the purpose of the analysis here, the crucial point is that relying on the views of a tax collector as opposed to an independent tax advisor may not be associated with greater expected aggregate tax payment and penalties.

The upshot of the foregoing analysis is that, where (C) is an available option for taxpayers,¹¹¹ there is a significant likelihood for taxpayers to pursue the option *instead of* option (A), in order to minimize advisory costs. The taxpayer and the tax collector may agree to a tax treatment—the former anticipating the treatment and latter endorsing such an anticipation—both in ignorance of (or a state of uncertainty about) the actual content of the law. Because of this, there is a greater likelihood that the subsequent conduct (e.g. tax payment after the implementation of the transaction) is not in accord with the actual requirement of law.¹¹² Taxpayers may also use the

is ground for doing so in the law. Or, if the taxpayer resists, the tax agency may seek other means to make up for the revenue shortfall.

¹¹⁰ In such circumstances, some taxpayers may choose not to acquire knowledge about such rules, i.e. option (B) is superior to option (A).

¹¹¹ That is, C_o is lowered to a level below C_a . Institutional arrangements (b)-(d) also imply that option (C) may be superior to option (A) even if $C_o > C_a$.

¹¹² Kaplow, *supra* note 93, analyzes the choice of an individual about whether to acquire information about the liability law applicable to a potentially harm-causing activity that the individual might pursue. The individual will decide to acquire information only if advisory cost is outweighed by savings in expected liability costs (net of the cost of care). The advisory cost may depend on whether the applicable law assumes the form of a rule or a standard. Because advisory costs are cheaper when a rule is available, some individuals might acquire information when a rule is available but not when only a standard is available. For these individuals, whether a rule or standard was adopted may lead to different behavior that is in greater or lesser conformity with the underlying norms of law, depending on the form of the law.

Taxpayer choices within our framework can be analogized to the choices of Kaplow's individuals, i.e. those who choose (B) are analogous to those in

combination of (A) and (C) to achieve a superior outcome than the choice of (A) alone permits. In this case, ignorance about the law is one-sided, but the result is again non-compliance with the law.

This framework reveals several interesting features that may characterize non-rule-based tax collection. First, even when a taxpayer has acted differently from what the law requires (e.g. made an underpayment of tax), the taxpayer is in one sense not non-compliant. It may instead be said to be “semi-compliant”, insofar as its actions are blessed by the tax administrator’s (non-binding) advice. Second, although taxpayers predisposed to non-compliance are more likely to choose option (C) over option (A), compliant taxpayers may also choose option (C) in balancing the expected costs and benefits of obtaining knowledge about the law. That is, semi-compliant behavior blurs the distinction between more and less compliant taxpayers.

Third, the resulting tax collection is non-rule-based in the sense that the tax liability is determined under incomplete information about the law. This is distinguishable from presumptive taxation, a practice that has received more attention in the existing literature.¹¹³ Presumptive taxation is a matter of determining tax liability when there is incomplete information about the true tax base relating to a taxpayer’s businesses and transactions. It can be, and is generally recommended to be, rule-based: the factors that determine presumptive tax liabilities—even though they differ from normal rules for determining tax liabilities—are supposed to be set out in rules. By contrast, in the type of taxpayer-official interaction described here, even if the taxpayer is capable of keeping relevant records and willing to disclose relevant information, such records and information may not be assembled and transmitted to tax

Kaplow’s model who do not acquire information about the law regardless of whether a rule or a standard is adopted; those who choose (A) to those in Kaplow’s model who acquire information regardless of the form of the law. However, in our framework, the choice that leads to less compliance ((C)) may be the cheaper one from an advisory cost perspective. More importantly, under Kaplow’s model, the existence of individuals who acquire information only when there is a rule but not when there is a standard is merely a logical possibility. Under our framework, by contrast, information can be introduced to predict how often taxpayers will choose to consult “in charge” tax officials instead of independently acquiring information about the law. Under a wide range of scenarios, such behavior may be quite likely.

¹¹³ See Victor Thuronyi, “Presumptive Taxation,” Chapter 12 in Thuronyi, ed., *Tax Law Design and Drafting 1* (Washington, D.C.: IMF, 1996).

agencies—due to ignorance about the applicable law. As a result, information is simply forfeited.

Fourth, although mutual understandings in deviation from the law may be reached regarding tax liabilities, there may be no corruption or any seriously unscrupulous dealing involved. From a tax administrator's perspective, reasons for agreeing to enter into the type of interaction under option (C) might include (i) the desire to gather factual information and ensure revenue collection, (ii) possibly to enhance one's turf/power and (iii) to create opportunities for rent-seeking. To be weighed against these are the fact that such informal interactions (iv) increase the tax administrator's workload, and (v) reduce the deterrence effect of penalties. The corrupt motive ((iii)) need not be dominant. Often, both the tax administrator and the taxpayer may be accused at most of benign negligence.

In fact, because the type of non-rule-based tax collection depicted above is essentially continuous with rule-based tax collection and compliant behavior, and because the motives involved in the taxpayer-official interactions are benign, one can imagine such behavior and practices to happen *on a massive scale*. But where they are prevalent, the law ceases to be relevant beyond the boundaries of specific tax administrator's knowledge about the law. Compliance ceases to be rule-governed, and tax policy—or at least the finer points of it—cease to be implemented.

Because such phenomenon is conceptually continuous with compliant behavior and rule-based tax collection, its prevalence is hard to measure.¹¹⁴ Fortunately, the phenomenon implies a number of observable and distinct outcomes.¹¹⁵ The next Part discusses two of such outcomes, namely the under-development of a tax advisory profession and the low level of observed legal disputes between taxpayers and tax agencies. These two phenomena are of course important in themselves for the operation of tax administration. But if they can be further traced to administrative decentralization—which, in the absence of the framework developed here, would not

¹¹⁴ While the description of the phenomenon may strike those familiar with daily tax compliance in China as accurate, one might be wary of mere anecdotal evidence. Even such anecdotal evidence tells us something, however, assuming that the phenomenon depicted is unfamiliar to taxpayer and tax administrators in developed countries with mature tax systems.

¹¹⁵ The framework developed in this part can be verified, for example, by sociological surveys of what taxpayers and tax administrators actually do. Such investigation, to the author's knowledge, has not been attempted by anyone.

be obvious at all—the explanatory power of the framework would be quite significant.

IV.

INDIRECT EVIDENCE OF NON-RULE-BASED TAX COLLECTION

In the early 1990s, when Chinese national policymakers drew the blueprints for a brand-new system of tax administration, their vision identified, with what seems to be remarkable learnedness, two interesting components of administrative reform. One was the promotion of taxpayer representation, with accountants, lawyers, and other “social intermediary organizations” assisting taxpayers in their voluntary compliance. The development of a tax profession was perceived to be the international norm and even said to be an indispensable link in tax administration.¹¹⁶ The thinking behind this view presumably was that given that China would be promulgating many new tax law and regulations, if a large workforce in a large economy was going to be induced to engage in voluntary tax compliance, and if government resources were going to be limited, the assistance of professionals would be needed. The other component was formal dispute resolution between taxpayers and tax agencies, through both an administrative appeal system and judicial processes.¹¹⁷ Both these two components, however, have failed to achieve the significance predicted of them.

A. Under-Development of the Tax Profession

As to taxpayer representation, 20 years later, the Chinese tax profession is widely regarded as under-developed. Law firms in China—whether domestic or international, and from the high to the low ends of the market—generally do not practice tax law, whether

¹¹⁶ The Implementation Plan for Reforming the Industrial and Commercial Tax System, *supra* note 63, Section 6.2. The importance of tax service providers continued to be emphasized by the government throughout different phases of tax administration reform. See Guobanfa [1997] 1, *supra* note 63, Section 2(2)(ii); Plan for Further Deepening Tax Administration Reform, *supra* note 56, Section 2(2)(iv).

¹¹⁷ The Implementation Plan for Reforming the Industrial and Commercial Tax System, *supra* note 63 (reform expected to bring about a “new configuration in tax administration where lawmaking, tax collection, tax inspection, and administrative review and litigation form four equally important, coordinated but mutually constraining functions”).

in transactional or litigation practices (the latter is not surprising, given the low volume of tax litigation discussed below). While the accounting profession is more active in providing tax services, and while certification as a registered accountant requires examinations that include tax as one of the subjects, the market for tax compliance and advisory services provided by accountants is highly segmented. Major international accounting firms serve almost exclusively multinational clients, and the high fees they charge reinforce market segregation—few domestic clients are willing to pay. Domestic accounting firms have generally remained small and localized. The tax services offered by such firms appear to be limited: tax compliance is usually done in-house, and then usually within an accounting department rather than a separate tax department. Even in commercial centers like Beijing and Shanghai, tax sections in bar and accounting associations are inactive.¹¹⁸

There is actually a third profession providing tax services in China. The profession of certified tax agents (CTAs) was specifically created and supported by the Chinese government and is supervised by the SAT. Given their government backing, and given the low market shares of lawyers and accountants in domestic tax services, one might expect CTAs to have prospered. In reality, although there are CTA firms all over China (many of which absorbed retirees from local tax agencies), they barely make money and struggle to justify their own existence. Throughout the past decade, CTAs continuously lobbied the SAT to mandate certain tax services and grant them monopolies in providing such services. To its credit, the government has so far declined to do so. The desperation of CTAs testifies to the low domestic demand for professional tax services.

Yet this is precisely what the analysis of semi-compliant behavior and non-rule-based tax collection offered in Part III would predict. The wide availability of the option of consulting tax officials directly about the appropriate treatment of proposed transactions reduces the population of taxpayers choosing consultation with third-party advisors, and thereby reduces the size of the market for tax advice. The only remaining tax advisors are those who serve clients

¹¹⁸ The main manifestation of professional activity in the tax area is now online: as both commercial transactions and Chinese tax law and regulations become more complex, the internet has seen a growing number of active forums for the discussion of tax law. However, professionals tend to participate in such forums as individuals without advertising their businesses (if they had any). They also generally do not gather in person.

who choose the costlier ways of learn about the law (option (A)). Such advisors are likely to have invested in training in tax law to a much greater extent than most enforcement officials. This in turn increases the likelihood of different advice come from the two different types of sources of legal information.

Indeed, decentralization producing inadequately informed enforcement officials may also be perceived by some taxpayers to decrease the utility of third-party tax advice: tax advisors can only tell them what the appropriate tax treatment *should* be; they cannot reliably predict what the tax treatment will actually end up being: *that* result is generally determined by the low-level officials in the “taxpayer management” system described in Part II.A. As a result, the practice of informal consultation with government officials reduces the demand for professional services even from potential clients who are able to pay for such services. In recent years, even the most powerful and lucrative international accounting firms have struggled with the question: What does it mean to provide Chinese tax advice? Is it to interpret the law, or is it instead to find out government officials’ interpretation of law? And if the answer is the latter, *which* government officials’ views are relevant? The uncomfortable truth is that when the law is not what provides guidance, individual outcomes are determined by the views of individual government employees populating the bottom of the bureaucratic hierarchy. It is difficult even for very large professional firms to gather information about the views and attitudes of most individuals in this large population.

The predicament of Chinese tax advisors can be illustrated by one administrative practice. To tax specialists in mature tax systems, option (C) discussed in Section III.B may bring to mind the practice of obtaining advance rulings, in which tax advisors in developed countries play important roles.¹¹⁹ But significant differences exist between taxpayers consulting low-level tax officials informally about proposed transactions and advance ruling “systems” as commonly conceived. As has been argued in connection with the application for private letter rulings (PLRs) in the U.S.,¹²⁰ the key benefits of advance rulings include reducing legal uncertainty and the prevention of high penalties if taxpayer’s position turns out to be

¹¹⁹ Rulings are favored by many tax advisors because they not only earn fees from preparing for a ruling application, but also reduce their own risk by substituting rulings for professional opinions issued to clients.

¹²⁰ Givati, *supra* note 100.

wrong. Certainty and mitigation of potential penalties are also possible incentives for taxpayers to initiate the type of interaction with tax administrators captured under option (C) in our analysis. However, any certainty obtained tends to have nothing to do with the law.¹²¹ If any certainty is created by such interactions, it is only because the same officials expressing their views now may be in charge of examining (if any examination happens) the transaction in question in the future. That is, the official's view now may be a relevant predictor of his view in the future. Nonetheless, this type of "cheap ruling" has some reliance value: although the taxpayer has no legal ground for relying on the official's pronouncement, the official may still feel bound to a large extent by his own pronouncements. Moreover, the likelihood of severe penalties is also reduced.¹²²

Obviously, it is difficult for professional advisors to insert themselves into this kind of taxpayer-government interaction and charge fees for services. Conversely, the type of ruling system for which advisors can charge fees for is difficult to set up in a decentralized system. Reflecting the fact of decentralization, China's Law on the Administration of Tax Collection generally gives tax agencies at different levels concurrent jurisdiction over matters relating to particular taxpayers.¹²³ This means that a private ruling issued by the SAT (or by a provincial or any other superior tax bureaus) may not be legally binding on a lower-level bureau. Even though the national or provincial tax agency is bureaucratically superior, if a lower-level agency disagrees with the legal

¹²¹ The low-level tax administrators contacted are unlikely to be authorized to issue binding decisions in any way. Their bureaucratic superiors, colleagues who subsequently take over their positions, or even they themselves are all free legally to adopt different views about the relevant tax treatment in the future. Indeed they may be at greater liberty to change their views than independent tax advisors.

¹²² It is worth noting that taxpayers in our framework do not face some of the considerations that, according to Givati (id.), discourage U.S. taxpayers from seeking PLRs. For example, Givati suggests that the application for a ruling may significantly increase the probability of inspection and of detection of a controversial issue. In contrast, if sufficiently many taxpayers make inquiries about the basic content of law without having independently informed themselves of the law, each inquiry may not significantly raise the probability of audit or detection for the transaction that the inquiry relates to.

¹²³ Law on the Administration of Tax Collection (promulgated by the Standing Comm. Nat'l People's Cong., Sept. 4, 1992, effective Jan. 1, 1993) Article 14 (all references to "tax agencies" in the statute are to tax bureaus and branches at different levels).

interpretation adopted in the superior-agency ruling, it is legally entitled to disregard the ruling.¹²⁴ The SAT has indirectly acknowledged this phenomenon: its guidance on the procedures for the issuance of private rulings stipulates that the request for a ruling should normally be submitted to the (local) tax agency in charge of the taxpayer, even if only a higher office has the power to resolve the legal issue raised.¹²⁵ The ruling request would then be forwarded up the bureaucratic ranks for resolution. In cases where the applicant sidesteps the local tax agency, the ruling request must be brought back to the local tax agency for investigation, regarding which the local agency may suggest the appropriate treatment. The guidance thus rather explicitly discourages taxpayers from seeking shortcuts in the administrative hierarchy, in order to reduce potential internal discord with lower-level agencies. This, however, significantly raises the cost of the ruling process, and dilutes the value of the tax advisors' access to government officials at the SAT level.

B. Low Volume of Formal Dispute Resolution

Scholars studying Chinese tax law or administrative law¹²⁶ have puzzled over the low volume of litigation against tax agencies in recent years. All across China, only about 400 lawsuits per year are brought against tax agencies each year, and tax litigation currently comprises less than 0.3% of all administrative law suits brought against government agencies. Despite the fact that tax agencies employ more than 10% of China's civil servant, and despite the presumed importance of taxation in the lives of citizens and the businesses they operate, tax had remained one of the less litigious areas of government. This suggests that whatever general institutional factors have suppressed citizens' willingness to

¹²⁴ See, e.g. *Shenzhen Energy Group Ltd. v Inspection Bureau of the Qinzhou Local Tax Bureau* (Guixingzhongzi (2002) 30, Higher People's Court of the Guangxi Zhuang Autonomous Region, date of decision in 2002 unclear) (describing local tax agency's non-compliance with an SAT ruling)

¹²⁵ SAT, (Trial) Work Protocols for Replies Regarding Specific Tax Matters (Guoshuifa [2012] 14, February 10, 2012), Art. 8.

¹²⁶ He Haibo, "The Wearied State of Administrative Litigation" (2012) *Journal of the Eastern University of Political Science and Law*, 2012:2; Ji Li, "Dare You Sue the Tax Collectors? An Empirical Study of Tax-Related Administrative Lawsuits in China" (2014) 23 *Pac. Rim L. & Pol'y J.* 57.

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challenge government actions in Chinese courts,¹²⁷ factors special to tax administration may be at play.

Existing studies have been rather quick in endorsing some obviously unreflective explanations of the low volume of tax litigation. The general lack of independence of the Chinese judiciary is often offered as the first culprit,¹²⁸ and purported low win rates for plaintiffs are sometimes cited as evidence of this familiar proposition. This explanation, however, ignores arguments and evidence that Chinese courts have generally displayed growing independence, especially in areas that are not regarded as politically sensitive,¹²⁹ as well as evidence that the “government gorilla” tends to “come out ahead”¹³⁰ even in judicial systems that are generally regarded as independent. Another unreflective explanation of the low level of tax litigation is that taxpayers fear retaliation.¹³¹ From a comparative perspective, this explanation is certainly unusual: probably no one, including those in government, likes being sued, but why should we assume that Chinese tax agencies are aggravated by lawsuits to a worse degree, and are likely to be more vindictive, than other Chinese government agencies or than tax agencies in other countries?¹³²

¹²⁷ Jinhua Cheng, “Institutional Options for the Settlement of Administrative Disputes in China: From the Perspective of Public Demand” (2010) *Social Sciences in China* 31(3) 5-26

¹²⁸ Li, *supra* note 127. For a general discussion of existing explanations of the low level of tax litigation in China, see Wei Cui, “Understanding Tax Litigation in China: A Systematic Content Analysis of Published Case Law” (2014) paper presented at the Annual Meeting of the Canadian Law and Economics Association, Toronto, September 20, 2014.

¹²⁹ Yulin Fu and Randall Peerenboom, “A New Analytical Framework for Understanding and Promoting Judicial Independence in China”, in Randall Peerenboom ed, *Judicial Independence In China: Lessons For Global Rule Of Law Promotion* (New York: Cambridge University Press, 2010)

¹³⁰ Herbert Kritzer, “The Government Gorilla”, in H. Kritzer and S. Silbey ed, *In Litigation: Do The “Haves” Still Come Out Ahead?* (Stanford, CA: Stanford University Press, 2003), 342-371.

¹³¹ Li, *supra* note 127.

¹³² Retaliatory actions, if themselves in deviation from the law, presumably may also be challenged in court. The fear-of-retaliation explanation of the low volume of tax litigation thus implies an unexplained sphere within which tax administrators have unchecked discretion, and in which they can easily impose unwanted costs on “disobedient” taxpayers. Since the rule of law is supposed precisely to limit or eliminate such spheres of government discretion, the fear-of-retaliation explanation postulates an unexplained sphere in which the rule of law fails, in order to explain the much more limited phenomenon of most taxpayers choosing not to litigate.

If, however, most Chinese taxpayers and tax administrators are engaged in the type of semi-compliant behavior and non-rule-based collection practice depicted in Part III, then the low volume of tax litigation in China has a much more natural explanation. If, in the compliance game played most of the time, tax liabilities are determined jointly by taxpayers and tax administrators in a state of collective ignorance (and under-informedness) about the law, then a taxpayer deciding to hold tax authorities to the letters of the law is in an obvious sense reneging on the bargain. Thus it is not necessary that Chinese tax administrators are more vengeful than others against citizens who want to uphold their rights under the law; it is sufficient that the normal equilibrium in tax administration—one which taxpayers not only are complicit in but even derive advantage from—is attained in significant deviation from the requirements of law. Part III explained why such an equilibrium might obtain, as a result of administrative decentralization.

This alternative explanation of the low volume of tax litigation in China has two important implications. First, even if the Chinese judiciary were much more independent than it actually is today, taxpayers still might not bring lawsuits, if normal tax compliance continued not to be shaped by the rule of law. In other words, the rule of law has foundered at a much earlier and fundamental stage than adjudication, as a result of the level and structure of transactional costs in the communication and learning of law. Litigation patterns may be determined more by this more fundamental failure in the legal system than anything relating to adjudication mechanisms themselves. Second, since judicial monitoring of the actions of tax administrators is generally possible only if taxpayers are willing to challenge tax agencies in court, the non-rule-based tax collection practice engendered by administrative decentralization indirectly renders judicial monitoring unlikely. sThis casts serious doubt on the intuition of some policy advisors that judicial monitoring is what is needed to make tax administrators collect tax on the basis of law.¹³³

V.

EVALUATING AND EXPLAINING NON-RULE-BASED TAX COLLECTION

Part IV described indirect evidence for the type of non-rule-based tax collection practice conceptualized in Part III.B. The

¹³³ See notes 9-10 *supra*.

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discussion does not presuppose that active tax professions and active tax litigation are intrinsically good things. Instead, they are only proxies for how often *legal rules* are resorted to in tax administration and compliance.

Knowledge of and compliance with rules is important for taxation for many reasons. In some areas of law, informal mechanisms can often serve as adequate substitutes for legal institutions. For example, community norms may regulate behavior with respect to property rights without the intervention of property law;¹³⁴ and the desire to maintain one's reputation may be sufficient to ensure performance of contractual obligations.¹³⁵ In these areas, the choice of private parties not to learn about the law does not necessarily result in undesirable social outcomes. But in many areas of modern government activity, especially the implementation of modern tax and regulatory policies, social norms are very unlikely to be adequate substitutes for the law itself. Such policy tends to be made based on its expected impact on the behavior of large populations of private subjects (engaged in increasingly specialized activities), as well as on the distribution of resources among them.¹³⁶ It is essential for the implementation of such policies that private parties learn what the law is. Taxes and regulations thus depend on the rule of law in a much broader and more basic sense than the availability of independent judiciaries, constraints on government actors, etc.

Moreover, many techniques of government administration (in tax as well as elsewhere) use concepts and categories that implicitly depend on the law. An example is risk-based tax administration. Are the semi-compliant taxpayers discussed in Part III.B high- or low-risk? Insofar as tax agencies may possess little relevant information about such taxpayers (because the parties do not know what information the application of appropriate rules requires), and insofar the taxpayers themselves do not know the relevant law, they cannot be said to be low-risk. However, this means that the population of

¹³⁴ See, e.g. Robert Ellickson, "Of Coase and Cattle: Dispute Resolution among Neighbors in Shasta County" (1986) 38 Stan. L. Rev. 623; Eric Rasmusen and Richard McAdams, "Norms in Law and Economics", in A. Mitchell Polinsky & Steven Shavell ed. *Handbook of Law and Economics* (North Holland, 2007), Volume 2.

¹³⁵ Shavell, *supra* note 20, Section 10.2, Chapter 13.

¹³⁶ For example, while particular taxpayers (and tax administrators) may care about only the amount of tax paid, tax policy cares about whether taxes cause distortions, are sufficiently progressive, etc.

risky taxpayers will be relatively large, whereas the rationale for risk-based tax administration is to conserve tax agency resources and make administration more targeted. In fact, as discussed above, even taxpayers who are capable of investing in compliance (e.g. independently investigating the content of law) and therefore should have been low-risk may either be forced to follow the opinions of low-level tax administrators (in order to avoid friction) or strategically choose to consult their opinions. Thus, non-rule-based tax collection can make compliant taxpayers less compliant, and render risk-based administration infeasible.¹³⁷

It is important to consider now some alternative explanations of the phenomena described in Parts III and IV.¹³⁸ A first alternative that may be proposed to the analysis in Part III is that the felt need for making inquiries with local tax officials arises from the fact that written Chinese tax law is full of holes and ambiguities. This fact itself implies a great deal of variation in practice among different regions. Naturally, taxpayers will need to find out what the relevant local practice is. In other words, if there are no rules to rely on, tax collection by definition will have to be non-rule-based.¹³⁹ Could this explain such practices in China, without resorting to the fact of decentralization?

The answer is that, while one might reasonably hold that there is a short supply of legal rules in China, the impact of decentralization is distinct. Suppose that tax administrators are not easily accessible, as they are under decentralized administration. Then the absence of clear legal rules may be expected to increase demand for tax advice—tax advisors would be asked to divine what the applicable legal rule might be. Gaps and ambiguities in the law may also be expected to increase the quantity of disputes, and some of that increased quantity should end up in courts. In other words, the dearth of rules alone should arguably produce a number of consequences that are in fact not observed. Conversely, as Part III showed, in the presence of decentralization, even if there are unambiguously applicable rules, informal practices that neglect such

¹³⁷ Another example of an essential regulatory device that depends on rule-awareness is self-reporting. See Louis Kaplow and Steven Shavell, "Optimal Law Enforcement with Self-Reporting of Behavior" (1994) 102 J Polit Econ 583, 601–03.

¹³⁸ Some of these explanations are also likely accompanied by more positive evaluations of non-rule-based tax collection than has been so far implied.

¹³⁹ Put in terms of the analytical framework in Part III.B, option (A) may not be available.

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rules may still (and do) emerge. Therefore, the state of Chinese tax law cannot by itself explain non-rule-based collection practices, although it might be shaped by such practices and by decentralization itself.¹⁴⁰

An alternative explanation may also be offered for the phenomena described in Part IV. It might be suggested that the core of the story told in Part III is that taxpayers have access to tax collectors in a cheap and informal manner. Once such access is possible, a variety of things can happen, and Part III depicted only one possible scenario: namely that, when neither the tax collector nor the taxpayer bothers to find out about the law (because the cost of doing so is relatively high), the tax liability they agree to will deviate randomly from the law (within certain bounds).¹⁴¹ But a different imaginable scenario is that both the tax collector and the taxpayer do know what the relevant legal standard is. However, the legally required tax liability serves only as a reference point for the two sides to bargain for a different outcome, which will always be lower than the legally required tax liability. That is, one can imagine tax collectors always being willing to offer “discounts” from the tax liability legally imposed (which is merely the “sticker price”), if the taxpayer makes a sufficient effort to bargain for it.¹⁴² If such bargaining is prevalent, then it will also follow as a consequence that

¹⁴⁰ For example, the authors of legislation and regulations may be too high up the administrative hierarchy, and too far away from the reality of tax administration, to provide timely legal guidance for issues in tax administration.

¹⁴¹ The analysis in Part III.B argued that this option would be rational for the taxpayer to choose if the resulting tax burden is, on average, not higher than what would have been required by actual legal standards. It was necessary to make this condition explicit, if one assumes that tax collectors are interested in maximizing revenue collection, and that legal standards often serve as a meaningful constraint on the tax collector’s effort to maximize revenue. In other words, I assumed that neglecting legal standards could mean foregoing this form of constraint on tax collectors.

¹⁴² It may be further suggested that this type of systematic discounting of stated (and well-known) legal obligations happens in more rule-based settings as well, as evidenced, for example, by many developed countries’ persistent tolerance for tax avoidance activities. Different explanations for such discounting may be offered. For example, some argue that legal loopholes (including tax shelter opportunities) exist because of the inherent nature of legal rules as the results of multi-criterial choices. See Leo Katz, “A Theory of Loopholes” (2010) *The Journal of Legal Studies* 39(1), 1-31. Others argue that tax authorities engage in some form of price discrimination. See Benjamin Alarie, “Price Discrimination in Income Taxation” (2012), manuscript available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1796284.

there is little tax litigation.¹⁴³ The role for tax advisors will also be limited, except to the extent that advisors know what the going rate of discount is. In other words, the phenomena of low litigation volume and low demand for tax advice can be explained by a different type of informal collection practice than is emphasized in Part III.¹⁴⁴

The deliberate “discounting” of legally imposed obligations, through generally condoned informal (i.e. unregulated) bargaining between taxpayers and tax administrators (or between regulated subjects and regulators generally), is certainly distinct from the type of deviation from actual legal standards analyzed in Part III. The former implies obvious trade-offs of costs against benefits: for example, it might reduce outright tax evasion (by offering discounted tax payments), but it might also encourage collusion between taxpayers and tax collectors. Unless the benefits clearly outweigh the costs, such a policy is unlikely to be adopted.¹⁴⁵ By contrast, in Part III, non-rule-based tax collection is portrayed as an inadvertent consequence of decentralization:¹⁴⁶ it can be the outcome even if its social costs outweigh its social benefits. This logic arguably gives greater credibility to the account given in Part III than the possibility that tax collectors deliberately negotiate tax payments below what is known to be legally required levels.

Similarly, as already suggested in Part III.B, it is possible to imagine informal dealings between taxpayers and tax collectors to be rife with corruption, which would also result in low demand for tax services and low tax litigation. However, unless one assumes that there is a high tolerance for corruption, it is not clear that corruption is the main way in which non-rule-based tax collection is engendered. The point of Part III is to show that it is not necessary to make such an assumption. Of course, ultimately, which of these possibilities—deliberately ignoring legal standards as a result of either price discrimination or corruption, or inadvertent but systematic ignorance of applicable legal standards—more accurately characterize non-

¹⁴³ An analogy would be that few people would dispute a speeding ticket if no speeding is punished unless it is significantly above the speed limit, and if moreover penalties are always negotiable.

¹⁴⁴ I am grateful to an anonymous referee for raising this point.

¹⁴⁵ It is not clear that a case has been made that “price discrimination” in tax collection is an attractive policy option.

¹⁴⁶ It was crucial for the analysis there that decentralization implies not just cheap access to civil servants, but also, simultaneously, civil servants’ partial ignorance of the law.

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rule-based collection practices in China or other developing countries, is something that can be ascertained only through closer empirical investigation in particular contexts.¹⁴⁷ This article does not resolve this issue, but mainly identifies a plausible scenario that has not previously been articulated.

It is also worth noting here that easy informal access to tax collectors is not something that should be taken for granted for developing countries. As a general empirical pattern, developed countries tend to have a much higher number of tax administrators relative to population than developing countries. Even in China, the number of tax administrators relative to the size of the country's general workforce is much lower than the OECD average.¹⁴⁸ It is the fact that these relatively few tax administrators are geographically dispersed and heavily concentrated at the lowest bureaucratic rank that allows taxpayers frequent access to them.

Finally, an overall question can be raised about the explanation of non-rule-based tax collection offered in this article. In Part I, I argued that Chinese tax collection currently relies too little on self-assessment and risk-based administration, and that this forms a bottleneck on tax policy reforms. Yet Part I also began by noting that the Chinese tax system has been relatively successful at revenue mobilization, which is generally regarded as the more fundamental challenge for the fiscal systems of developing countries. Could it be, then, that the analysis so far has given unwarranted emphasis to self-assessment, risk-based administration, and other "modern" tax collection techniques adopted in developed countries?¹⁴⁹ Even if such techniques indeed have to be rule-based, there may be room for debate as to whether they are in fact optimal in the context of developing countries like China. For example, the discussion in Part II.A suggests that in Chinese county-level tax bureaus, a large portion of staff resources is devoted to ensuring that businesses remain registered for tax purposes (and pay *some* taxes), even if this results in each tax collector covering a large portfolio of taxpayers and not being able to specialize in audits. But the importance of keeping businesses registered (and remain in the formal economy)

¹⁴⁷ See, e.g. Khan, Khwaja, and Olken, *supra* note 62 (finding evidence of corruption in property tax assessment in Punjab, Pakistan, but that collusion between taxpayers and tax collectors is far from uniform).

¹⁴⁸ See Appendix in Leslie Robinson and Joel Slemrod, "Understanding Multidimensional Tax Systems" (2012) *Int Tax Public Finance* (2012) 19:237–267

¹⁴⁹ I am grateful for two anonymous referees for both raising this important question.

has itself been stressed by IMF and other international organizations.¹⁵⁰ If there has been a conscious trade-off in favor of focusing on registration (at the expense of audit capacity), then one may ask whether non-rule-based tax collection is truly an unintended consequence of Chinese administrative decentralization.

This criticism indeed highlights certain unresolved paradoxes in the Chinese tax system, as well as possible weaknesses in the existing discourse on developing country tax administration in general. Why tax revenue has grown faster than GDP in China since 1997 is a puzzle that has already attracted a small body of economic research, although no definitive resolution has been found.¹⁵¹ Moreover, as discussed in Part I, China's tax structure is not dissimilar to tax structures of other developing countries, which many have argued are inefficient.¹⁵² Yet the alleged inefficiencies have at least so far not hampered China's economic growth. One's views about how such apparent paradoxes can be resolved will likely affect one's evaluation of the effectiveness of Chinese tax administration. Many believe in self-assessment and risk-based administration as the appropriate goals of all tax administrative reform; it is also the orthodox view endorsed by international organizations.¹⁵³ Yet the belief in the superiority of self-assessment and risk-based administration—and in rule-based tax collection practice generally—is generally based on experience. Like many other beliefs about tax administration, it has not been systematically empirically verified. Therefore, like the question of how to properly describe non-rule-based tax collection, the question of how to evaluate it also requires further empirical research.

V.

DECENTRALIZATION AS A SYSTEMATIC FEATURE OF THE CHINESE REGULATORY STATE

The previous Parts argued that excessive bureaucratic decentralization has frustrated China in its attempts at modernizing

¹⁵⁰ See e.g. IMF 2011 Report, *supra* note 8, at 22; Bird, *supra* note 36, at 37-8.

¹⁵¹ See, e.g. Li-An Zhou, Chong Liu, and Xing Li, "Tax Effort, Tax Bureaus, and the Puzzle of Abnormal Tax Growth" (2011) (in Chinese) China Economic Quarterly 11(1), 1-18

¹⁵² See notes 33-39 *supra* and accompanying text.

¹⁵³ This belief is shared by many senior tax officials in China. See notes 62-64, 66 *supra*.

tax administration in the last 15 years. Some readers may have wondered by this point: why is Chinese tax administration so decentralized? A full answer is beyond the scope of this article, but a preliminary answer is especially useful for understanding the character of explanation offered in this Article for the failure of tax administration (and the rule of law) in a developing country. Three points require emphasis. First, decentralization is a systematic phenomenon in the Chinese regulatory state. Second, it came about not as a result of routine policymaking in the stable development of the state apparatus but is likely attributable to specific historical processes and political forces beyond the control of ordinary bureaucrats. Thirdly, it nonetheless falls within a dimension of institutional design in which tax policymakers can at least carry out moderate reforms, and in which a wider group of political actors may decide to implement deeper reforms.

The type of decentralization that characterizes Chinese tax administration is in fact shared by a majority portion of the Chinese regulatory state. In most regulatory areas—be it business registration, public health and food safety, environmental protection, policing, education, labor and social security, land management, and cultural and media regulation—the Chinese state is decentralized, i.e. bottom-heavy in a geographically dispersed hierarchy. The few less decentralized spheres of regulation, e.g. banking and securities regulation, customs, etc. constitute exceptions to a general rule.¹⁵⁴

This general pattern has also been implicitly acknowledged by recent social scientific scholarship of China. Some of the most influential theories of Chinese political economy in recent years have emphasized the role of decentralization in Chinese economic development.¹⁵⁵ An important theme in this strand of the literature is that, at the start of the process in the late 1970s that eventually led to China's abandonment of the planned economy, regional governments in China, unlike their counterparts in the Soviet Union, were characterized by an "M-type" instead of "U-type" economic structures: divisions of labor in production and regulation occurred within regions instead of across regions under the supervision of the

¹⁵⁴ See, generally, Li-An Zhou, *Local Governments in Transition: Official Incentives and Governance* (in Chinese) (Shanghai: Anzhi Press, 2008).

¹⁵⁵ See, e.g. the theories of "market preserving federalism" in Jin et al, *supra* note 22, and of "regionally decentralized authoritarianism" in Xu, *supra* note 22.

central planner.¹⁵⁶ Consequently, Chinese regional governments were able to experiment individually with the transition away from the planned economy. Moreover, because each province faced similar problems of economic growth with some others, the performance of provincial political leaders can be compared. As a result, there effectively developed “yardstick competition” among provincial politicians in the promotion of economic growth during the terms of their office.¹⁵⁷ Thus decentralization in regulatory activities simultaneously made it possible and created strong incentives for Chinese politicians to foster the development of markets.

Underlying much of this theorizing is the assumption that at fairly low levels of the state, local politicians still command a wide range of regulatory tools. But this is basically the same as saying that in a wide range of regulatory areas, administrative decisions are made at very low-levels of the bureaucratic hierarchy—the phenomenon emphasized in this article. Nonetheless, this article has conceived administrative decentralization in a distinctive way relative to the social scientific literature. First, that literature is vague about the scope and meaning of decentralization. Some portray provincial decision-making as decentralized, while others emphasize that the logic of political competition reaches much further down.¹⁵⁸ From the perspective of this article, the phenomenon of decentralization can be appreciated only when one focuses on the county or even lower levels of government.¹⁵⁹ Second, the political economy literature, not surprisingly, focuses on politicians who have, through whatever faction or line of patronage that they joined, become “generalists” who are evaluated by the results of governing a particular territorial jurisdiction. Very little has been said about the behavior and incentives of bureaucrats in local regulatory agencies—within, so to speak, the more “Weberian” aspect of the Chinese state. Third and relatedly, theorists have tended to see a major distinction between whether a particular local government agency is “vertically” supervised by a superior agency within the same sphere of regulation

¹⁵⁶ Eric Maskin, Y. Qian, and C. Xu, “Incentives, Information, and Organizational Form” (2000) *Review of Economic Studies*, 67(2), 359-78.

¹⁵⁷ Hongbin Li and Li-an Zhou, “Political Turnover and Economic Performance: the Incentive Role of Personnel Control in China” (2005) *J. Public Economics* 89 (9-10), 1743-62..

¹⁵⁸ See, Zhou, *supra* note 153.

¹⁵⁹ See Part II *supra*.

or “horizontally” controlled by a local chief executive office.¹⁶⁰ The focus of this article, however, has been on consequences of decentralization that emerges regardless of whether an agency (e.g. tax bureau) is controlled vertically (as in the case of a country-level State Tax Bureau) or horizontally (as in the case of a country-level Local Tax Bureau or lower-level LTB post).

In any case, given that decentralization appears to be the preferred general structure of government in China, it can be viewed as exogenous to the design of Chinese tax administration: it is a structure that a single bureaucracy, even one that is as large as Chinese tax administration, may not be in a position easily to change.

The degree of administrative decentralization in taxation lies beyond the scope of normal decision-making of Chinese tax policymakers also in another sense: decentralization is likely the result of specific historical processes. While it is certainly beyond the scope of this Article to investigate the historical origins of administrative decentralization in China, a brief narrative that throws the institutional analysis given here in historical relief may help underscore the significance and plausibility of the analysis.

Before the 20th century, the administrative state in dynastic China was tiny: it had no more than a few thousand official posts, and delivered very limited government services.¹⁶¹ This may be viewed as the historical predecessor of the very lightly-staffed higher ranks of the contemporary Chinese bureaucratic state. What China did not have back then was the massive population of civil servants at the lower ranks of the state. Government functions in the lower tiers came into being during the 20th century, as the Nationalists and the Communists built government presences in rural China, to collect more taxes and, later under socialism, to carry out collectivization.¹⁶² A notable feature of this form of government expansion at grass-root levels was that government agencies did not grow organically but was spurred by totalitarian mobilization: political mobilization may have allowed the government to extend its reach in ways that would

¹⁶⁰ Zhou, *supra* note 153, at 139-45.

¹⁶¹ Ch'u Tung-Tsu, *Local Government in China under The Ch'ing* (Cambridge, MA: Harvard University Asia Center, 1962), 168-92; Bradley W. Reed, *Talons and Teeth: County Clerks and Runners in The Qing Dynasty* (Stanford, CA: Stanford University Press, 2000).

¹⁶² See, generally, Prasenjit Duara, *Culture, Power and The State: Rural North China, 1900-1942* (Stanford, CA: Stanford University Press, 1988); Philip Kuhn, *The Origins of The Modern Chinese State* (Stanford, CA: Stanford University Press, 2003).

not be efficient in periods of political stability and routine bureaucratic management. Tax administration, for example, was largely suspended during from the mid-1950s until the late 1970s, during the planned economy era. But when it had to be rebuilt in the 1980s, it was built very quickly:¹⁶³ hundreds of thousands of tax administrators were hired to be posted at local state-owned enterprises and markets to collect taxes where none had been collected before.¹⁶⁴ The management and use of such a veritable army of dispersed low-rank tax collectors, however, pose very different problems for the long term.

In other words, it is plausible to see decentralization in the Chinese administrative state as the product of two fundamental elements of the country's past: (i) a (very) long history of a small, centralized government apparatus that was incapable of performing the functions of a modern state; and (ii) a shorter history (i.e. since the 20th century) of a quickly expanding network of government offices low in the administrative hierarchy, designed to carry out the commands of totalitarian regimes and not to cater to the needs of a stable market economy. In its current pattern of decentralization, the Chinese administrative state still operates in the shadow of this past. Clearly, these historical processes are beyond the control (and perhaps even the reflection) of reformers within tax administration.

Explaining the failings of tax administration in terms of decentralization in the Chinese regulatory state is appealing because the latter is both a more fundamental phenomenon than the items being explained, and, at the same time, amenable to change. It is clearly conceivable for the government to decide to centralize tax administration to a greater extent, whether (depending on the particular administrative function concerned) to municipal, provincial, or national levels.¹⁶⁵ To pursue administrative centralization in the sense of staffing municipal and provincial tax bureaus sufficiently so that they can directly deal with taxpayers,

¹⁶³ The size of the tax administration workforce nearly quadrupled from 170,000 in 1978 to 600,000 in 1993.

¹⁶⁴ State revenue plunged despite this effort, as state-owned enterprises failed en masse after market liberalization. See Christine P. W. Wong, "Central-Local Relations in an Era of Fiscal Decline: the Paradox of Fiscal Decentralization in Post-Mao China" (1991) 128 *The China Quarterly* 691-715.

¹⁶⁵ Centralizing large taxpayer management, international taxation, and the building of central information systems has been under discussion in China recently. See Plan for Further Deepening Tax Administration Reform, *supra* note 56.

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however, will be bureaucratically and politically difficult, if it is done in isolation from broader bureaucratic reform. It would require the deployment of political resources that bureaucrats in the SAT either do not possess or are unwilling to expend. However, locating the source of difficulty for reforming tax administration in the broader configurations of the state should, in the long term, better focus the “political will” to pursue reform.¹⁶⁶

CONCLUSION

This article sought to demonstrate that contemporary Chinese tax administration displays many of the same flaws that characterize tax administration in other developing countries, particularly the low use of self-assessment and audits. I also showed that Chinese tax administration is extremely decentralized, in a manner that is determined by larger patterns in the organization of the Chinese state and arguably unique moments in Chinese history. I then postulate a causal connection between the two phenomena—between the challenges faced by administrative reform and decentralization. The causal hypothesis is motivated by the fact that many of the other factors that are normally appealed to for explaining the limitation of tax administration capacity in developing countries do not seem present in the Chinese context. According to my hypothesis, the causal mechanism from decentralization to the unattainability of self-assessment and audits runs through people’s ability and willingness to acquire knowledge of the law. When decentralization negatively affects people’s ability and incentives to inform themselves of the content of legal rules, non-rule-based practices emerge, making self-assessment and many other tax administrative techniques irrelevant.

The rule of law is an essential component of the causal story to which this article seeks to give plausibility. However, the way rule of law makes an appearance here is very different from how it has generally appeared in the tax and development literature. In the existing literature, the rule of law, while normally agreed to be a prerequisite for modern tax administration, is viewed as an exogenously given variable. Economists have been more willing to find some rule

¹⁶⁶ For a recent example of advocacy for the direct delivery of government services by higher level government entities, see Jiwei Lou, “Reconfiguring Central-Local Relations,” *Caijing Magazine*, April 1, 2012 (in Chinese)(editorial piece by China’s current Minister of Finance).

of law “indicator” as an independent variable in regression analyses than to inquire into how the rule of law may emerge within tax administration.¹⁶⁷ In this article, by contrast, whether the rule of law will prevail depends crucially in the mundane but fundamental decisions of taxpayers and tax administrators to find out what legal rules there are. I argue that it is these decisions that determine the larger aggregate outcomes observed at the institutional level, for example whether there is a market for a certain type of legal advice, and whether lawsuits will be brought to courts.¹⁶⁸ The “rule of law” variable in the analysis here is clearly endogenous.

The causal story advanced in this article is capable of empirical verification (and refutation). How much does decentralization affect the level of knowledge and specialization of tax administrators? How much do interactions between taxpayers and tax administrators increase as a result of decentralization? How high is the level of (perceived) corruption during such interactions? How much do taxpayers substitute between third-party advice and conversations with tax collectors? Are outcomes significantly different depending on which is chosen? What is the respective significance of knowing and unknowing deviations from the law? These are some of the questions that may be relevant to implementing an empirical test of the causal hypothesis in this article. The analysis given in this article is intended to show that these questions are worth asking, and that answering them may allow us to better understand the role of law in developing countries’ tax administration.

¹⁶⁷ See Robinson and Slemrod, *supra* note 146, at 252-3; Besley and Persson, *supra* note 5.

¹⁶⁸ For a recent theoretical discussion of the need (particularly for explaining the emergence of the rule of law) to distinguish between legal order and legal institutions, see Gillian K. Hadfield and Barry R. Weingast, “Microfoundations of the Rules of Law” (2014) *Annu. Rev. Polit. Sci.*, 17: 21–42.

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