

# Legal Governance of Local Tax Preferential Policies

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## ABSTRACT

Currently, preferential taxation policies have become an important administrative method for local governments in China to stimulate and promote economic development. Good and bad local tax preferential policies aim to promote GDP growth, often at the cost of deviating from the taxation rule of law. Against the background of comprehensive rule of law, in order to realize the economic and social transformation and development, the government should implement the existing local tax preferential policies in accordance with the principle of taxation law. The government can implement legal governance through the statutory scope of preferential policies, reconstruction of preferential tax reduction and exemption powers, and energy-based taxation, in order to achieve the justice of tax burden and gradually improve the environment of taxation rule of law in China

**Keywords:** Local tax preferential policies, Taxation rule of law, Justice of tax burden.

## 1. INTRODUCTION

For a long time, China's local tax preferential policies have been intermingled, which has seriously affected the fair competition order of the socialist market economy. Preferential taxation policies have become an important administrative method for local governments to stimulate and promote economic development. They are side by side with government subsidies, and the administrative role they assume surpasses government subsidies. Local governments, especially those in underdeveloped regions, are highly dependent on preferential tax policies. The uncoordinated and unbalanced development of regional economies promotes this dependence, which will cause the allocation and flow of resources to not entirely depend on the market. Tax arbitrage has become commonplace, and fiscal revenue has been lost to a certain extent. At present, local tax incentives are proliferating, and the tax incentives of the "simple model" are far more than the tax incentives of the "composite model". A large number of temporary preferential tax policies have been used for a long time, leading to the problems of excessive administrative intervention and insufficient taxation rule of law in local preferential tax policies. "For a long time, preferential tax policies have brought the economic

concept of 'growthism' into full play. Informal institutional frameworks with various preferential policies as the basic feature have been widely formed in the advancement of industrialization. The sustained rapid economic growth has witnessed the superiority of preferential tax policies." [1] It should be noted that local tax preferential policies that deviate from the taxation rule of law lay hidden dangers for the high-quality development of the Chinese economy, and may promote economic risks such as market failures and financial crises.

After the 2008 world financial crisis, China began to focus on the transformation of economic development, and its economic development gradually transitioned from a high-speed and low-quality type to a medium-low-speed and high-quality type. In this context, the governance of the existing local tax preferential policies will help implement a comprehensive strategy of governing the country according to law, and improve and perfect a socialist market economy that meets the requirements of taxation rule of law. In recent years, more and more scholars have participated in the research of local tax preferential policies. The existing theoretical results are mainly concentrated on economic system reform, taxation policy optimization, fiscal and taxation transformation, etc., and there is insufficient research on legal governance. Taking the taxation rule of law as the

goal, this article tries to propose legal governance ideas for local tax preferential policies from three aspects: the scope of tax preferential policies, the reconstruction of tax preferential reduction and exemption rights, and the scientific analysis of energy taxation, aiming to realize the transformation of local preferential tax policies from "temporary discretion" to "long-term stable planning".

## **2. LEGALIZATION OF THE SCOPE OF LOCAL TAX PREFERENTIAL POLICIES**

Local tax preferential policies refer to the implementation of abnormal tax changes such as tax reductions and exemptions, tax deferrals, and tax rate reductions on taxpayers by local governments in economic development affairs through administrative means on the basis of statutory standard taxation. "With the development and improvement of the tax law, the forms of tax incentives have become more and more abundant." [2] Regardless of whether the subsidy is first collected and then returned or the fiscal reward is collected first, the local government indirectly grants tax relief to taxpayers in order to circumvent the central unified tax reduction and exemption power, so as to achieve the purpose of attracting investment. As they do not have the right to reduce or exempt tax incentives authorized by the central government, local governments lack a clear legal basis in the process of tax incentives, and the scope of preferential tax policies is complex, vague, and confusing. In response to the changes in local tax preferential policies in the 40 years of reform and opening up, some scholars pointed out that "the scale is immeasurable, and the budget is difficult to monitor; the logic of multiple target policies is lacking; the policies are complicated and the effects are ambiguous." [3] For the legal governance of local preferential tax policies, the logical structure of relevant policies should be clarified through the legalization of the scope of preferential tax policies. In other words, the objects, content, and types of local tax preferential policies must meet the requirements of taxation rule of law.

### **2.1 Objects of Preferential Tax Policies**

As a kind of abnormal tax policy, tax incentives have a few specific objects. This particularity should be clearly stipulated by the law, and it is based on the following three reasons. First of all, taxation is the main source of national fiscal

revenue and is related to the national economy and people's livelihood. In order to facilitate the taxation departments to collect taxes and verify taxes, and to make it easier for the public to clarify the tax obligations stipulated in the constitution, the objects of tax collection and tax incentives should be clear and specific. Secondly, China is committed to the modernization of a country under the rule of law, and the taxation rule of law is an indispensable link in construction. Clarifying the objects of tax incentives can better implement the principles of the taxation rule of law in the specific tax collection process. Finally, clarifying the objects of tax preference can effectively supervise and restrict the preferential tax policies of local governments, reducing and avoiding administrative intervention that deviates from the taxation rule of law and the requirements of the market economy. At present, different tax preferential policies have duplicated tax incentives on the same tax fact. The tax preferential standards are heavily dependent on the government, and tax preferential targets cannot be updated in time with economic development. Practical problems are frequent, such as tax incentive arbitrage, multiple tax incentives, and the loss of fiscal revenue. Therefore, although China's existing laws and regulations have established corresponding tax incentives, they still urgently need to be revised and improved. This article believes that the core of the establishment of tax preferential policy objects lies in the statutory standards that are coordinated with economic and social development. The statutory standards should have three logical levels: the first is limited to the actual needs of the economy and society and cannot be expanded for short-term GDP growth; the second is to optimize the tax structure through tax preferential policies with the goal of taxation rule of law; the third is that the central government adopts unified legislation to expressly stipulate that the application of tax incentives cannot exceed legal limits.

### **2.2 Contents of Preferential Tax Policies**

"Consistent with the situation of most fiscal policies, tax incentives, with their unique function of assisting economic development, appear in China's institutional practice as a means of macro-control, and their independent legal character is relatively weakened." [4] The content of local tax preferential policies is relatively simple, the regional administrative color is strong, and the scope of application has strong limitations. On the one hand, some local tax preferential policies are

merely "temporary discretionary decisions" of the government, and are intended to complete the supporting system of the government's economic development plan. On the other hand, the content of some local tax preferential policies is outdated, it is difficult to adapt to the economic and social transformation and development, and the content overlaps. In addition, some local tax preferential policies show strong local protectionism and economic supremacy, and their function has evolved from promoting economic and social development to simply realizing GDP growth. As it known to all, the original intention of preferential taxation policies is to coordinate adjustments between regional economic development and social development, and GDP growth is only a possible result of coordinated adjustments. Therefore, the content of preferential tax policies should be transitioned from "single mode as the mainstay and compound mode as a supplement" to the form of "complex mode as the mainstay and simple mode as the auxiliary". The "simple mode" emphasizes one matter, one discussion, which is convenient and quick but excessively random; the "complex mode" is not flexible but has unified rules. In comparison, the dominance of the "composite model" helps optimize the content of tax incentives, dilute the regional administrative color, and enhance the coordinated adjustment function.

### 2.3 Types of Preferential Tax Policies

For a long time, due to the unbalanced regional economic development and the central government's unified application of tax incentives, in order to attract investment and promote economic growth, local governments have formulated different types of tax incentives. On the one hand, in order to achieve rapid economic growth, some local governments use their administrative power to establish a wide range of tax incentives and link tax incentives with local economic development plans. On the other hand, in order to circumvent the central government's unified application of tax incentives, some local governments have established a large number of tax incentives to indirectly exercise their tax incentives. Therefore, in order to limit the improper use of local preferential tax policies, it is necessary to statutory types of preferential tax policies. Specifically, first, the taxation rule of law should be the principle of statutory types of preferential tax policies; second, the types of preferential tax policies should be based on China's current tax preferential reduction and exemption rights system;

third, the types of tax preferential policies should be based on the needs of economic development, that is, the types of tax preferential policies between the central and local governments should be coordinated according to the current economic development of various regions and their differences.

## 3. RESTRUCTURING OF THE RIGHT TO TAX INCENTIVES AND BREAKS

At present, the right to tax incentives and breaks is exercised uniformly by the central government. For a long period of time since the reform and opening up, China's local economic development models have converged, and the differences in economic development have not been highlighted. It is reasonable for the central government to exercise tax incentives and exemptions in a unified manner. However, with economic and social changes, China's local economy has shown a diversified state in the process of transformation and development, and it is impossible for the economic management systems of all regions to be completely consistent. Based on this, as an important administrative tool for local governments to stimulate and promote economic development, preferential tax policies should be authorized by the central government, and this authorization should be reconstructed in a proportional manner. From a long-term perspective, it is necessary to appropriately grant more tax incentives to local governments; at the same time, for different regions, the distribution of tax incentives should be different.

### 3.1 The Distribution System of Right to Tax Incentives and Breaks

The taxation rule of law is a systematic structure that requires not only horizontal logical coupling, but also vertical logical coupling. Specifically, there are two distribution systems for the distribution of tax incentives and breaks, that is, the central government decentralizes power to local governments and the central government delegates power to local governments. In view of the long-term cumulative negative effects of local tax incentives, if the central government decentralizes the distribution system to the local governments, it may lead to abuse of tax incentives and breaks by local governments, and correspondingly weaken the central government's tax control over local governments. In this regard, the central government should first implement the distribution system that

delegates the right to tax incentives and breaks to local governments, and then gradually implement the central government's decentralization of the right to tax incentives and breaks to local governments when conditions are ripe. This distribution system model is suitable for China's economic and social status quo, and is conducive to the realization of the central government's legal governance of local tax preferential policies. First of all, there are essential differences between the two distribution systems. Under the authorized distribution system, the central government still has complete and unified legislative powers, which can effectively control the exercise of local right to tax incentives and breaks. Second, the distribution system authorized by the central government to local governments is conducive to solving the problem of statutory scope of preferential tax policies, that is, the central government can clarify the object, content and types of preferential tax policies through legislation. Finally, the authorization of the central government to local governments should be dynamic, and the content and duration of the authorization should be adjusted with the development of local economy and society in order to better give play to the government's macro-control role.

### **3.2 *Reconstruction of the Distribution Ratio of the Right to Tax Incentives and Breaks Between the Central and Local Governments***

Reconstructing the distribution ratio of the central and local right to tax incentives and breaks will help fundamentally solve the abuse of local tax incentives. Based on the differences in the level of economic development, different regions have different levels of demand for preferential tax policies. For example, in developed coastal areas, due to their own good corporate resources, their demand for preferential taxation policies to attract foreign investment is not high. Conversely, there is a higher demand for foreign investment through preferential taxation policies in the underdeveloped areas of central China. "The two major functions of tax incentives are macro-control and ensuring people's livelihood. On the one hand, the realization of these two functions depends on the central government's formulation of unified policy guidance, and on the other hand, it must also rely on local governments to make appropriate adjustments and implementations based on the guidance of the central government and local conditions." [5] Therefore, the central authority's

authorization of local right to tax incentives and breaks should be limited to local actual needs. So, this kind of authorization should be delegated proportionally in different regions to prevent vicious competition between different regions using preferential tax policies. Among them, proportional authorization includes the percentage of authorized types and the percentage of authorized content.

## **4. THE SCIENTIFIC APPLICATION OF THE ABILITY-TO-PAY OF TAXATION**

Ability to pay is a basic method of taxation rule of law. "On the one hand, the principle of ability to pay based on the amount of energy requires taxpayers to bear tax obligations, and on the other hand, it recognizes the right of taxpayers to demand fair tax payment. And fair taxation means the protection of taxpayers' rights and the restriction of the state's taxation rights." [6] In reality, the lack of synergy between some local tax preferential policies and economic and social development has made it impossible to achieve quantitative ability-to-pay of taxation and fair tax burden. Affected by the external environment and its own factors, the taxpaying ability of tax preferential policy objects is not static, but a large number of temporary local tax preferential policies have been applied for a long time, and they have not been revised and improved in time. Therefore, it is necessary for the local preferential taxation policies to re-examine the amount of ability-to-pay of taxation, and implement scientific preferential taxation policies for different objects on the basis of the rule of taxation rule of law.

### **4.1 *The Original Intention of Ability-to-pay of Taxation***

The original intention of ability-to-pay of taxation is that people in the same situation should pay the same tax, and at different stages should bear the tax corresponding to their own ability. At present, there are three main problems with local tax incentives and ability-to-pay of taxation: First, the tax incentives are not updated in a timely manner. Some objects that no longer meet the tax incentives still enjoy the tax incentives, while some objects that meet the tax incentives cannot enjoy the tax incentives in time, resulting in unfair tax burdens; second, the access conditions for tax incentives are relatively rigid, that is, once the access conditions for tax incentives are met, they can continue to enjoy tax incentives, and they do

not fully consider whether the tax burden of the object has changed; third, the differences between the objects that meet the same access conditions for tax incentives are not fully considered, and the same tax incentives cannot be achieved. The above-mentioned situations that violate the original intention of the amount of ability-to-pay of taxation must be effectively governed by law, and the amount of ability-to-pay of taxation can be dynamically adjusted to achieve justice of tax burden.

## 4.2 Scientific Analysis of Ability-to-pay of Taxation

The scientific analysis of ability-to-pay of taxation refers to the real-time dynamic matching of taxation capacity through big data technology and Internet of Things technology when implementing tax incentives according to different conditions of tax incentives, to ensure the scientific nature of tax incentives. The scientific nature of tax incentives should not only be reflected in the selection of tax incentives, but also in determining the proportion of specific targets. In order to make better use of the effect of ability-to-pay of taxation, it is necessary to make full use of big data technology and Internet of Things technology to conduct intelligent analysis of tax preferential objects in stages and categories. Specifically, the first is to establish dynamically adjusted access conditions for tax incentives; the second is to establish electronic files of tax incentives to update their tax burden capacity in a timely manner, and to match the scope of tax incentives; the third is to establish a tax incentives evaluation system, and optimize tax incentives in a timely manner through big data technology and Internet of Things technology, and ultimately achieve justice of tax burden. Then, "this kind of substantive tax fairness is connoted with ability-to-pay of taxation. It can be said that the process of implementing quantitative ability-to-pay of taxation in China's tax law is a process of better promoting and guaranteeing distribution justice in taxation." [7]

## 5. CONCLUSION

"Tax legalism, as the most important principle of the tax law, also has the rank of constitutional principles. It must be strictly adhered to in order to better solve many related issues such as the distribution and grant of legislative power, and the interpretation and application of laws." [8] In the context of comprehensively governing the country according to law, it is obviously not enough to

govern local preferential taxation policies solely relying on economic policy adjustments and industrial structure optimization. We should actively implement the taxation rule of law through legal governance. In the governance process, the law should clarify the scope of tax incentives. On this basis, the right to tax incentives and breaks should be exercised by the central government and gradually transitioned to partially authorized local governments. "By establishing a unified and allowing reasonable differentiation of local tax incentives systems, local governments are allowed to formulate tax incentives within their statutory powers, which can not only promote the establishment of a fair and unified tax system, but also reduce the differences in economic development between regions." [9] And through appropriate authorization, the local governments need to overcome the excessive dependence of local tax preferential policies on administrative power, and strengthen the authority of the rule of law.

## AUTHORS' CONTRIBUTIONS

Zhiyu Cao wrote the manuscript, Xin Cao contributed to revising and editing.

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