The Mainland Chinese government’s difficulty in collecting corporate taxes is created by its institutional environment, according to two recent studies published in leading accounting journals. The authors examine the effects on tax compliance of informal institutions such as the company’s political ties, and formal institutions such as the government’s fiscal policy and tax system. Results of both studies should be of interest to busy tax practitioners and policymakers.

Before the merger of the tax system, Mainland China had a two-tier tax administration of national and local tax bureaus. The former was responsible for collecting income taxes from centrally-controlled enterprises and the latter from locally-controlled enterprises. Although local tax bureaus were supervised by both central and local governments, directors’ appointments, cadre promotions, budgets, and pay scales were determined by local governments only. Local tax agencies were thus at risk of interference by local politicians. A majority of companies are also owned or controlled by the local governments, which are reluctant to enforce tax collection from them and other companies in their jurisdictions as they would have to share the revenue with the central government. The dual but opposing roles played by local governments, as both administrators of tax affairs and controlling shareholders of these companies, affect tax policy enforcement in Mainland China.

The importance of connections

Given this state of affairs, the first study, Do Political Connections Weaken Tax Enforcement Effectiveness? written by Lin, Mills, Zhang, and Li and published in the 2018 issue of Contemporary Accounting Research, explores whether companies with politically connected board members use their power to avoid paying corporate income tax in Mainland China. Since the level of tax enforcement varies considerably across regions, the authors use the provincial level probability of tax audits, the expertise of tax officers, and the consequences of underreporting tax liabilities to capture tax enforcement strength. The line of argument is that the high ex-ante threat of a tax audit, heavy penalties, and ex-post incidence of closer monitoring should deter companies from taking aggressive tax positions. They measure tax avoidance as the ratio of income tax expense to pre-tax book income, along with other alternative measures to produce robust findings, and capture the political connectedness of companies by the number of board members who serve or have served in a city-level government agency or are current or ex-members of the National People’s Congress or Chinese People’s Political Consultative Conference.

The authors opine that the process of enforcing tax laws in Mainland China is prone to political influence. For example, tax laws are interpreted and enforced differently from region to region because decentralized decision-making rights have reduced the “capability or willingness of Mainland China’s tax administration to detect and constrain sophisticated tax avoidance arrangements.” Uneven economic growth also means that some regions have greater resources for enforcement than others. Therefore, while government enforcement mitigates or inhibits companies’ capability to avoid taxes, ties to politicians by corporate boards of directors enhance it.

Using data on listed companies in Mainland China from 2003 to 2013, they find that tax enforcement is much less effective for companies with more politically connected board members. In terms of economic importance, connected boards reduce the sensitivity of tax to enforcement by as much as 85 percent.

To strengthen their results, the authors examine the effects of a change in a company’s political connections by taking into account the appointment of newly nominated connected directors. They find that enforcement becomes less effective when a politically connected person joins the board of a company with no previous political connection.

In contrast, enforcement effectiveness increased in 2012 following a nationwide crackdown on corrupt officials, which successfully reduced the number of companies with political connections. The authors suggest that tax enforcement became more effective because the crackdown “diminished the rent-seeking and favour-exchanging ability of both politicians and managers.”

But how did this occur? To shed light on the mechanism through which companies avoid taxes, the authors examine the most common method of tax avoidance in Mainland China: “the shifting of income between member companies in a business group.” They explain that Mainland China offers preferential tax rates to domestic companies in designated zones and industries, which creates sizable regional and industrial variations in tax rates. Large companies with subsidiaries and affiliates in different regions and industries can exploit these differences by reallocating taxable income within a group to reduce their overall tax burden.

Their findings suggest that tax...
avoidance through income shifting is hampered by tax enforcement “but unwound when companies are politically connected.” Specifically, the incentive to shift income for tax purposes varies, according to political connectedness and tax enforcement strength. The takeaway of the results is that government enforcement is less effective for companies with a politically connected board.

Local versus central

The difficulty in enforcing tax laws is echoed by the second study *Tax Collector or Tax Avoider? An Investigation of Intergovernmental Agency Conflicts* written by Tang, Mo, and Chan and published in *The Accounting Review* (March 2017), which examines the conflicting roles of local governments in Mainland China’s tax system. Local governments are responsible for maximizing tax revenue, which the career prospects of local officials hinge on. But often, these governments are the controlling shareholders of the companies they collect taxes from. In other words, they are expected to maximize tax revenue (for their region) and maximize after-tax profits (for their companies) at the same time.

Of course, that is not possible. If local governments were allowed to keep the taxes they collect, the problem might be less severe, but since 2002, they have had to share half with the central government. So local governments have a strong incentive to engage in tax avoidance to boost their companies’ after-tax returns.

The authors use the change in the corporate income tax sharing ratio in 2002 to investigate the “trade-off between local governments’ tax collection and tax avoidance incentives.” As in the first study, tax avoidance is measured by the effective tax rate and alternative methods. Their focus is on A-share companies listed on Mainland China’s stock market from 1996 to 2006 to determine whether tax avoidance patterns shifted following the 2002 policy change.

The policy change did indeed reduce tax enforcement and increase tax avoidance of local government-owned companies. These companies engaged in less tax avoidance than central government-controlled companies before 2002, but the situation reversed after the tax-sharing change. After the change, companies with less than 40 percent of local government ownership were less likely to avoid paying taxes than companies more than 40 percent owned by the local government.

The policy change seems to have encouraged local governments to “behave in a manner that is against the central government’s interests,” note the authors. One solution to the problem of tax collectors also being tax avoiders, they suggest, is to increase local share of total tax collections or reduce the local government ownership of companies. This can help constrain the opportunistic behaviour of local governments and motivating them to fulfil their commitments to national interests.

Conclusions

Although Mainland China is rapidly transitioning to a market-based economy, this situation is obviously challenging. In a relationship-based society where political ties are crucial to a company’s success, the dual supervision of tax administration and the wide variation in the enforcement of tax laws across the country mean that efforts to improve tax enforcement may deviate from what was intended.

Results from both studies indicate that reforms designed to increase government revenue focusing only on tax administra-

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