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The Republic of China's Experience with the Introduction of Value Added Tax

Abstract

On 1 April 1986, a consumption-type value added tax was introduced in the Republic of China. The tax replaced the Gross Business Receipts Tax and some stamp duties and commodity taxes. The successful implementation of the value added tax, which was demonstrated by the negligible impact on price levels, smooth growth of tax revenues, and other favourable economic indicators since its inception, has made it highly regarded in both domestic and international societies. This article provides a general description of the introduction of the VAT, the principles and measures adopted and evaluates the introduction, with a view to providing some guidelines for those countries contemplating the introduction of a value added tax.

Keywords

consumption tax, China, value added tax

THE REPUBLIC OF CHINA'S EXPERIENCE WITH THE INTRODUCTION OF VALUE ADDED TAX



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On 1 April 1986, a consumption-type value added tax was introduced in the Republic of China. The tax replaced the Gross Business Receipts Tax and some stamp duties and commodity taxes. The successful implementation of the value added tax, which was demonstrated by the negligible impact on price levels, smooth growth of tax revenues, and other favourable economic indicators since its inception, has made it highly regarded in both domestic and international societies. This article provides a general description of the introduction of the VAT, the principles and measures adopted and evaluates the introduction, with a view to providing some guidelines for those countries contemplating the introduction of a value added tax.

Background to the introduction of the VAT

The old sales tax system of the Republic of China, other than customs duties imposed on imported goods, consisted of Gross Business Receipts Tax (GBRT), stamp tax and commodity tax. In 1952, the receipts from GBRT, stamp tax and commodity tax yielded 15% of total revenues (6%, 4.6% and 4.4% respectively). This ratio increased to 27.8% in 1984 (9.4%, 4.2% and 14.2% respectively). These figures reveal that these three taxes had become major sources of government revenue by the time China was considering the introduction of a value added tax.

Although the GBRT had undergone 13 amendments since its inception in 1931, the basic principle of levying tax on multi-stage turnovers remained unchanged. The Ministry of Finance noted that the GBRT was the typical cascading form of sales tax. The GBRT basically applied to each sale of a commodity or service as it passed through manufacture and distribution channels, without adjustment for tax paid on previous transactions.

The cascading effect of such a tax has several serious adverse consequences. First, it alters the choice of methods of production, as almost inevitably some methods of production and distribution are likely to be taxed more heavily than others. If purchased inputs are taxable, there is a strong

incentive for firms to produce inputs themselves rather than purchase them from other firms. Accordingly, cascading discriminates against smaller firms which are unable to produce their own inputs. The ratios of tax to final consumer spending on various goods will differ, since some will involve more transaction stages than others. Finally, tax elements will enter into export prices; there is no feasible way of excluding them. While exported goods can be exempt from the tax, the tax on inputs to produce the exported goods remains.

Commodity tax in the Republic of China (hereafter ROC) was, by its nature, a special kind of sales tax, to be levied only on high class or luxury consumer goods. Nonetheless, before the introduction of VAT, a substantial commodity tax burden was imposed on some important raw materials. This increased the management costs of industrial or commercial business enterprises. In addition, a major part of stamp tax levied on uniform invoices was essentially a surtax on the GBRT and generated the same problems as the GBRT. These problems demonstrate the need for reforming the sales tax system of China. Of all the measures considered, the introduction of VAT is the most important one.

In an agricultural society, which has relatively few goods and services transactions, multi-stage turnover tax does not generate serious cascading problems. However, when the domestic economy changes, so that transactions of goods and services become more frequent and more complicated and management style requires more divided professional co-operation, a multi-stage turnover tax can no longer satisfy economic development needs. In 1982, under the strong leadership of then Financial Minister, Li-Teh Hsu, the Ministry of Finance of ROC actively consulted with both academic circles and the industrial sector about reforming the sales tax system. The consultation strongly endorsed Minister Hsu's recognition that the economy of ROC had been transformed from a domestic consumption-oriented market into an export-oriented one and from an agricultural structure into an industrial one. Thus, Minister Hsu determined that a value added tax was the best vehicle to overhaul the sales tax system.¹

The principles and measures adopted

Principles adopted

To prevent radical opposition and conflicts from relevant sectors of the society, a step-by-step reform was undertaken. The major principles which were adopted are as follows:

(a) Setting steps to gradually achieve the goal of reform: Ideally, the stamp tax and most of the commodity tax should be integrated into VAT.

1 The author would like to take this opportunity to recognise and pay tribute to Minister Li-Teh Hsu for undertaking the most remarkable tax reform in the history of ROC.

However, the possibility of revenue imbalance and price inflation made the Ministry of Finance set out steps for reform. At the initial stage of implementing the VAT, the stamp tax collected from uniform invoices and the part of commodity tax related to the refund of exported goods or related to raw materials used in industrial business, were integrated first into the VAT, and those regulations which were not extremely important to this reformation were temporarily maintained to diminish an unnecessary impact on society. The remaining steps will be gradually implemented as taxpayers get used to it.

(b) Maintaining revenue level: In designing this VAT, tax reform has been considered more important than revenue increase. To generate the previous level of tax revenue, the Ministry of Finance proposed a cautiously set 5% rate of tax.

Measures adopted

Based on the understanding of other countries' experience with VAT, the Ministry of Finance of ROC was fully aware that it would encounter a large number of technical problems in adopting such a tax system. Therefore, the Ministry of Finance determined that many preliminary measures had to be taken before the implementation. These measures are described below. The later development of VAT in ROC is also included in order to provide a complete picture.

(a) Tax policy

(i) Adoption of single rate: The taxable range of the GBRT was classified into four categories and nine different tax rates applied. This created complexities for both tax administration and taxpayers. The Ministry of Finance noted the experience of other countries introducing VAT with multiple tax rates. This Ministry concluded that, while multiple rates could alleviate the regressivity of the VAT, it did not outweigh the penalties in administrative complexity, increased compliance costs and distortions in consumption decisions. Therefore, apart from exemption provisions, the ROC adopts only one rate which applies to all sales of goods and services and the importation of goods alike. The collection rate has remained at 5%.

(ii) Exclusion of small business entities from the scope of VAT: Looking at the complete elimination of cascading effect under the operation of value added tax, the Ministry of Finance of ROC regarded the VAT as the best form of sales taxation. However, value added taxation requires good bookkeeping ability. This might materially affect costs and the effectiveness of compliance. The effectiveness of administration at the lowest cost of compliance was calculated when designing the value added taxation.

In ROC, small entrepreneurs (nearly 60% of business entities) lack bookkeeping ability. To simplify the tax administration and make the tax reform smooth, the Ministry of Finance excludes them from VAT collection but adopts a special regime. The sales tax on small business is calculated on the gross sales, as calculated by the tax authority. This figure is then charged at the tax rate of 1%. This special regime relieves small businesses of the burden of filing VAT returns and has been generally regarded as a key to the smooth launching of VAT in the Republic of China.

(iii) *Change of tax computation method from tax-exclusive to tax-inclusive in the retail stage:* The tax-exclusive method makes it easier for business entities to compute their VAT liabilities and helps to promote the ultimate consumers' consciousness of bearing VAT.

The Ministry of Finance decided to adopt this method in introducing VAT in 1986. Nonetheless, consumers were reluctant to demand uniform invoices when the retailers advised them no VAT would be imposed. Therefore, the government amended the law in 1988 to adopt a tax-inclusive method in the retail stage and allowed VAT to be charged as part of the price. Experience has shown the correctness of making such a change.

(iv) *Change of the filing period from monthly to bimonthly:* In 1986, when the VAT was first implemented, business entities had to file their tax returns before the 15th day of every month. Tax officers had to stay within the service area to accept tax returns for 17 days per month and were unable to engage in spot-checking. To lessen the administrative and compliance costs of VAT, the Ministry of Finance, after comparing the practices of European countries, changed the filing period to bimonthly in 1988. However, exporters without any output tax could continue to file their returns monthly to enable them to claim a monthly refund of input taxes.

(v) *Simplification of the computation of partial tax credit:* In countries which implemented VAT, VAT business entities may credit their input tax, but business entities that sell both taxable and exempt goods at the same time may be eligible for partial credit of their taxable sales. Since only partial credit is allowed, the business entities may try to alleviate or prevent the sale of exempt goods and increase the sale of taxable goods within a specific filing period, so as to enlarge the creditable ratio. Most countries, to prevent possible evasion and distortion, require business entities to adjust the creditable ratio for a period of time. For example, this period in Korea is two years and five years in Belgium. Although the tax system would be fairer if the period could be longer, at the same time the tax administration would become much more complicated and troublesome for both taxpayers and tax authorities. Therefore, the Ministry of Finance of ROC only requires business entities to further adjust the creditable ratio at the end of every calendar year.

(vi) *Amendment of the regulation on lottery for uniform invoices:* If an ultimate consumer asks for uniform invoices, the retailer will, with a view to acquiring creditable documents and calculating its costs, request upstream

business entities to issue him a uniform invoice. This is the so-called "built-in cross-checking function". Therefore, the ROC government, for the purposes of preventing tax evasion, getting hold of a revenue source and encouraging the issuing of uniform invoices, amended the Regulation on Lottery for Uniform Invoices to increase the amount and ratio of prizes.

(b) Tax administration

(i) *Establishment of a computer operations system:* A successful VAT administration depends significantly on an efficient information system. The development of a strong computer system was an integral part of the preparation for VAT. The Data Processing Centre of the Ministry of Finance actively participated in the preparation of VAT. The Centre established a special working group to design the computer system and to purchase the necessary hardware. A *Computer Operations Manual* for VAT was prepared in 1984 and training programs on computer operations were implemented. This enabled tax officials to develop a comprehensive perspective on the procedures in VAT administration. Before April 1986, the use of off-line and on-line data entry facilities had been simulated and tested. Also, before the computerisation of VAT, the records of VAT taxpayers in all regional tax offices were checked and updated.

After the introduction of VAT, the Data Processing Centre has developed some indicators and information which have proved helpful in tax audit and assessment, such as a value added ratio to total sales of the firms and a ratio of inventory to sales.

(ii) *Training of tax functionaries:* The training of tax functionaries was emphasised in the preparation for VAT implementation. Education was intensive and comprehensive.

The training programs for senior officers were handled by the Public Finance Training Institute of the Ministry of Finance. The courses were varied and designed according to the needs of the trainees. Initially, the trainees were composed of senior staff members of the Ministry of Finance, Customs, Data Processing Centre, regional tax offices, and government-owned corporations. The training programs were then localised by training tax officers, who became instructors themselves in the different regional offices and local governments. This process enabled almost all the tax officials, including those not directly involved in VAT implementation, to become familiar with the tax reform.

(iii) *Publicity campaign:* To ensure a smooth launching of VAT, it was necessary to inform people about the new tax system. For this reason, the Ministry of Finance actively consulted with the members of the Finance Committee of the Legislative Yuan (Congress) and eminent professors in public finance and economics, before initiating the legislative process. Immediately after the enactment of VAT Law, the Ministry of Finance sent its staff to conduct lectures for industrial and commercial associations,

public or privately operated business entities, and all levels of schools. To cope with the publicity efforts of the Ministry of Finance, the regional tax offices provided VAT introductory lectures to regional groups and business entities within their own jurisdiction. About 200,000 people received this instruction.

From 6 January 1986, regional tax offices constantly gave free lessons and practical demonstrations to make accountants and treasurers of business entities understand the major amendments and VAT return operations.

From 6 January to 28 February 1986, the Ministry of Finance invited representatives of every industrial and commercial association at the national level to participate in seminars to explain the amendment of VAT, to clarify problems and to request them to adjust their sale prices reasonably.

The mass media is popular in the Republic of China. The Ministry of Finance was very successful in seeking support from various newspaper companies and television stations. For the purpose of publicising VAT, the author was invited to explain VAT on all television channels.

The government also printed and distributed free, thousands of simple and attractive brochures on VAT. The *Price Guide* deserves special mention.

Because the introduction of VAT would affect the tax burden, prices inevitably fluctuated. In an attempt to prevent undue fluctuation resulting from unfair business practices at the beginning of the introduction of VAT, the Ministry of Finance prepared carefully and distributed the *Price Guide* widely. It instructed business entities to reset their sale prices and inform the general public about possible price fluctuations in certain consumer goods. The Ministry of Finance, after consulting with the other related government agencies and renowned specialists and scholars, chose 151 sample commodities, including food, clothing, housing, transportation and communication, medicine and medical care, education and entertainment, and miscellaneous categories. The *Price Guide* listed the ratios of untaxed price to price under GBRT and price under VAT to that under GBRT by percentage, to show price increases or decreases. This publication was the key to clarifying doubts on the inflationary effects of the introduction of VAT.

The evaluation of the introduction

During the research and planning stage, the Ministry of Finance believed that the implementation of VAT would give the following advantages to the Republic of China:

(a) Prevent undesirable disturbance to business management so as to promote economic efficiency: Because the GBRT was levied on the gross receipts at every transaction stage, the tax burden on consumer goods varied according to the frequency of the turnovers. The GBRT preferred fully

integrated business enterprises. In a highly industrialised and commercialised society, divisions between specialist areas are much more delicate and the relationship between manufacturer and distributor is much more intricate than it used to be. A well designed tax system should be neutral in its effect on management style in business enterprises. The VAT is by nature a neutral tax. If the total amount of value added from the manufacturer to the retailer is the same, no matter how many transaction stages take place, the sales tax burden on this consumption good is the same. Therefore, the replacement of GBRT by VAT will not involve undesirable disturbances. Nor will it decrease the efficiency of management of business enterprises or dampen economic growth.

(b) Strengthen competitive ability of exports so as to speed economic development: As indicated above, the economy of ROC relies heavily on exports. Thus, the greater the volume of exports, the greater the benefit to the domestic economy. Since the VAT treats exports as zero rating, it may fully refund all the sales tax collected from prior stages, thereby easing the refunding procedure. Furthermore, it may directly reduce manufacturing costs, lowering sale prices and indirectly making exports more competitive in international markets.

(c) Raise investment incentives so as to help promote capital formation: The degree of economic development of a country is determined partly by investment incentives. Every country in the world usually takes some sort of measures to encourage its people to invest. In GBRT, because the capital goods were taxed, the cost of investment was increased, the rate of return on investment was decreased, and the investment incentive was incidentally discouraged. After the implementation of VAT, the sales tax paid for acquiring machinery and equipment can be used as credit against output tax so as to completely exempt capital goods from sales tax. Therefore, the cost of investment is substantially reduced, the rate of return on investment is relatively increased, and the incentive on investment is raised to promote capital formation.

(d) Reduce management costs of industrial and commercial business enterprises so as to mobilise business transactions: According to VAT, the input tax, which is paid either for acquiring capital goods, such as machines and equipment, or for business expenditure, such as raw material, water, electricity, gas and stationery, may be used as credit against output tax. In other words, the input of business entities will no longer contain sales tax. The management cost is thus reduced. Besides, the part of the commodity tax which was levied at a high tax rate on the raw material of industrial business and the part of the stamp tax which was a surtax on the GBRT will be gradually integrated into VAT. Thus, the management cost of

industrial and commercial sectors will be considerably reduced, due to the adoption of VAT.

Few people enjoy paying taxes. The VAT in the Republic of China has functioned better than its supporters anticipated, nonetheless. As a whole, the attitude of businesses toward the VAT was favourable, especially the exporting firms, which could not enjoy full refund of input tax under the GBRT. Consumer resistance was negligible, because the VAT replaced the GBRT and had no perceptible impact on prices. Tax collection has been smooth, in large part because the basic administrative scheme was already in place to administer the replaced GBRT. The following paragraphs, which analyse the effects of the implementation of VAT on price level, tax revenues and collection costs, and macro-economics, endorse the belief of the Ministry of Finance.

1 Impact on price level

VAT was to replace the earlier GBRT. The principle of revenue neutrality guided the design of VAT. In theory, therefore, the introduction of VAT causes price adjustments only once and will not cause constant price inflation. The comparison of the price level before and after the implementation of VAT proved the accuracy of this theory.

According to the statistics, the consumer price index in the Taiwan area in April 1986, the month of introducing VAT, was slightly higher than that in March by 0.58%. From April to May it fell to 0.36% and further decreased to 0.25% in June. It showed clear decreases month by month. In July the index started to go down. Moreover, the wholesale price, after a slight raise in April, started to fall. In May, June and July, the wholesale price fell 0.29%, 0.09% and 0.98% respectively.

2 Impact on tax revenues and collection costs

(a) Impact on tax revenues: Due to good advertising and sufficient preparatory measures, after the implementation of VAT, business entities generally filed their tax returns properly and paid their tax. After the implementation of VAT, the tax revenues did not decrease but increased slightly. Statistics showed that the revenue from GBRT was NT\$30 billion, 9.7% of total revenues in the fiscal year 1985. After the introduction of VAT on 1 April 1986, revenues from GBRT and VAT altogether increased to NT\$39 billion, 11.4% in that fiscal year. Later, revenues from VAT grew sharply to NT\$62 billion and NT\$73 billion, 13.5% and 13.2% for fiscal year 1987 and 1988 respectively. All these figures indicate that the successful implementation of VAT brought an increase in revenue for ROC.

(b) Impact on collection costs: When the government first introduced VAT into the ROC to replace GBRT in 1986, stamp tax collected from uniform invoices and the commodity tax collected from plastics, paper, round bars and other steel products, furs and leather were integrated into the VAT. Most final products of the above-mentioned commodity tax items were exported, so refunds on exported goods or related raw material complicated the collection process and posed a heavy collection cost burden. The integration undoubtedly reduced its collection costs. For example, in the fiscal year from July 1985 to June 1986, the share of commodity tax expenses to tax revenue was 1.7%. However, this figure fell to 1.3% in fiscal year 1987 and 1.2% in 1988.

The stamp tax on uniform invoices contributed about 80% of total stamp tax revenue. Its integration into VAT moved the cost ratio up from 1.4% in 1986 to 3.7% in 1987. Revenues from stamp tax were rather trivial in terms of total government revenue and the stamp tax on uniform invoices had the same weaknesses as GBRT, ie, a tax on tax. The government's decision to merge this part of stamp tax into VAT attracted wide support from the general public and helped VAT implementation.

The ratio of the collection expense of GBRT/VAT to its total revenue was 2.9%, 2.7% and 2.3% for the fiscal years 1985, 1986 and 1987 respectively. If we put the above-mentioned information together, on the whole, the implementation of VAT sharply reduced the costs of collection.

3 *Impact on macro-economics*

Before the introduction of the value added tax in the Republic of China, it was generally accepted that the implementation of VAT could solve the problems of double taxation and tax on tax which result from GBRT. Moreover, VAT might upgrade the sophistication of industries, expand exports, and encourage investment incentives.

Major changes in economic development after the implementation of VAT are discussed below. Even the precise evaluation of the sales tax reform is quite difficult. The introduction of VAT should be one of the contributory factors.

(a) Capital investment: In 1986, capital investment was NT\$500.8 billion, while it was NT\$449.1 billion in 1985. The growth rate of capital investment was 11.5% in 1986. In the first quarter of 1986, the quarter immediately preceding the implementation of the VAT system, the growth rate of capital formation was only 0.81%, while the growth rates of the last three quarters of 1986 and the first quarter of 1987 were 3.35%, 16.56%, 23.99% and 22.60% respectively.

(b) Export and import: Under the VAT system, an exporter enjoys zero tax rate on his exports and receives a refund for all VAT paid on his inputs. This has strengthened the competitiveness of exports and promoted foreign trade. In 1986, total exports and imports were US\$39.79 billion and US\$24.16 billion. A trade surplus of US\$15.63 billion was achieved. The aggregate amount of exports from 1 April 1986 to the end of 1986 increased 29% over the same period for the previous year.

(c) Economic growth: The economy has grown steadily since the implementation of the VAT system. The economic growth rates of the four quarters of 1986 were 9.31%, 9.87%, 11.77% and 15.40% respectively, and the annual growth rate in 1986 was 11.64%. The gross national product (GNP) per capita was US\$3,784 in 1986. The economic growth rates of the first two quarters of 1987 were 11.80% and 11.91% respectively.

The encouragement of export and capital formation can be proved by a study of tax refunds. During the first 10 months after the implementation of the VAT system, total tax refunds on export and capital investment amounted to NT\$34.8 billion and the average was NT\$3.5 billion per month. The monthly average tax refund on GBRT, stamp tax on sale invoices and commodity tax was NT\$1.7 billion prior to the implementation of the VAT system. The growth rate of tax refunds after the implementation of the VAT system exceeded 100%.

Conclusion

Experience is the name everyone gives to their mistakes. The government of the Republic of China learned from experience that the GBRT system had some serious weaknesses, both from taxation and non-taxation perspectives. To improve that situation, the Ministry of Finance undertook thorough research of the experiences from some foreign countries before introducing its VAT. After determining to implement VAT as a means of reforming the sales tax system, the Ministry of Finance took great trouble to ensure an efficient and effective introduction of the tax. The launching of VAT in the Republic of China has proved to be an example of successful tax management.