

POLICY BRIEF SERIES

China's 'Stir Fry' of Environmentally Related Taxes and Charges: Too Many Cooks at Work

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Introduction

The rapid degradation of China's environment and ecological system, accompanied by the speedy economic development of the country over the recent decades, has made China's central government determined to advance toward a low carbon economy and a resource-efficient and environmentally friendly society for achieving sustainable development and addressing both short- and long-term environmental problems of the country. A number of policies and measures have been announced in pursuit of these aims since 1994.

While command and control instruments that have mainly taken the form of regulatory directives have long been in a primary position in China in the area of environmental protection and management, market-based instruments, such as taxes and charges, have been playing an increasing role in recent years. Compared with developed countries, China thus far has not had an environmentally targeted taxation system and is still at the early stages of establishing market-based instruments for promoting environmental protection and energy conservation. Nevertheless, certain environmentally related taxes and a nationwide

pollution charge system have been in place for some years. There are also other types of environmentally related charges collected and administered by a variety of government departments. "Taxes" and "charges" are certainly different. A tax is imposed on the community as a whole, irrespective of who captures the benefits of the public goods and services funded thereby. Tax revenues go into the general budget. A charge is applied to specific beneficiaries in proportion to the services they personally receive. The revenues collected from charges are used for defined purposes.

Imposition of these taxes and charges has contributed to the government revenues. However, the effects of the taxation and charge system in preventing environmentally harmful activities and helping achieve public environmental targets remain limited. Apart from various problems arising from the design features of the current system such as lack of effective rates and energy pricing controls, regulatory problems are not minimal and cannot be underestimated.

The primary problem with implementation is that environmentally related taxes are subject

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to government discretion at different levels and environmental charges are administered by multiple governmental agencies. There is a lack of effective coordination and cooperation for multiple-level implementations of laws and policies across sectors and levels of government. There are also conflicts of laws and regulations, which cannot be easily resolved by adjudication due to a number of reasons, not least, the absence of a judicial review system in China. This primary problem of a lack of effective coordination has arguably been a contributor to China's failure or a negative factor affecting China to achieve the environmental targets set in its five-year plans. The problem, if it continues, may adversely affect the government in attaining other environmental protection aims in the future.

The lack of an effective regulatory framework for cross-sectoral and inter-governmental coordination has aggravated the negative effects of the existing environmentally related tax and charge system in China. This article, on the basis of examining the existing system, its related legal system and its major problems, argues that China's future efforts on environmental taxation reforms should focus on the improvement of the regulatory framework for environmental taxes and charges. This will help maximize positive effects of the system for the development of a low carbon economy and building of a resource-efficient and environmentally sustainable society.

Tax-Sharing of Environmentally Related Taxes

The tax system in force today was established by a significant tax reform in 1994. The reform not only revised a number of important taxes, but also introduced a tax-sharing system in which taxes were assigned into central and local exclusive taxes and shared taxed between the central and provincial governments.

The legal power to enact taxes, whether central, local or shared, lies with the central government. However, in practice, the executive branch of the (central) state power, the State Council and its affiliated departments, mainly the Ministry of Finance (MOF) and State Administration of Taxation (SAT), have exercised the de facto power to enact taxes. Consequently, a large amount of the dominant policy and related measures concerning taxation, including environmental tax policies, take the form of administrative regulations, rules or decisions and orders. The tax-sharing system strengthened the central government's legislative power, increased the flow of revenue resources to the center and gave the center more flexibility to use tax policies to achieve macroeconomic and social aims. But on the other hand, this system has limited local government's fiscal autonomy and posed difficulties to local governments, especially those in under-developed regions, in obtaining sufficient revenues for local development needs including environmental protection projects due, in large part, to the fact that major revenue sources are assigned to the central government. The system has also led to local protectionism of polluting companies and little, if any, compliance with environmental related laws and policies.

As noted earlier, China has yet had an environmental taxation system comparable to that in other jurisdictions. Nonetheless, certain taxes under the current taxation system have relationship with environmental protection. These taxes include resource tax, vehicle taxes (vehicle acquisition tax and vehicle and vessel tax for usage), consumption tax (equivalent to excise tax), urban construction and maintenance tax, and land use taxes (city and township land use tax and farmland occupation tax). There are also environmentally related tax policies that mainly apply to VAT and enterprise income tax. The table of "environmentally



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related taxes in China” below summarizes the application of these taxes in China.

Environmentally Related Taxes in China

		Taxable Item	Tax-sharing
Resource Tax		Mineral resources (crude oil, natural gas, coal, other non-metal ores, ferrous metal ores and non-ferrous metal ores) Salt (solid salt and liquid salt)	Shared tax (central/ local tax sources)
Consumption Tax		Petrol, diesel, aviation kerosene, automobile tyres, motorcycles, cars, yachts, disposable wooden chopsticks, and tobacco, wine and liquor	Central tax
Vehicle Taxes	Vehicle acquisition Tax	Motor cars, motorcycles, trams, trailers and transportation vehicles for farmuse	Central tax
	Vehicle & vessel tax	Passenger vehicles, cargo vehicles, motor-tricycles and motorcycles	Local tax
Urban Construction and Maintenance Tax		Items that are subject to VAT, CT and/or business tax	Local tax (central share of certain revenue)
Land Use Taxes	City & township land use tax	Land owned by the State or land owned collectively in areas prescribed by the effective regulations	Local taxes
	Farmland use tax	Land for planting crops including grain and economic crops, land for vegetables, garden plots and newly cultivated wasteland, idle land, crop rotation land, and grass rotation plant land	

Since tax legislation power is centralized in the central government, local governments are not allowed to adjust the rules to local conditions in many areas. They only have the responsibility to implement taxation in accordance with central rules. This cannot effectively mobilize them to better implement the taxes when the collected

revenue flows into the center, especially if there is a lucrative connection between local fiscal revenue and environmentally harmful activities. In some other areas, such as the city and township land use tax, the method of implementing the taxes is largely left to the local governments to decide. While this may



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provide certain autonomy with the local government, it is detrimental to the uniformity of the tax regime and creates loopholes to harmful activities. Currently, many local governments still take economic development as their first priority and they may not implement taxation and tax policies intended for environmental protection purposes. Incentives for local development and higher fiscal returns, along with the incentives for personal career promotion, have impeded pollution reduction, particularly in certain industries that are both energy intensive and high in profits. One reason for the conflict of interest between central and local governments is the fiscal difficulties produced by the tax-sharing system. Local governments thus have to resort to other ways to raise revenues, among which the imposition of charges comes to the fore.

Regulatory Framework of Environmentally Related Charges

The currently effective pollution charge system at the national level was introduced in 1982 and reformed once in 2003. The charge applies to waste water, waste gas, solid waste and noise pollution based on the “polluter pays” principle. It is payable according to both concentration and volume of the pollutant discharged. Charge rates can be determined by central government departments as well as provincial governments provided there are no national rates applicable.

The charge system, despite being improved to certain degrees under the 2003 reform, is flawed in many aspects. The charge rates are too low to incentivize polluters to effectively abate pollution as paying charges (and even fines on delayed payments) makes more economic sense than investing in pollution reduction. Also, the coverage of the system is rather limited. For example, the charge applying to waste water and waste gas covers only fixed

emission sources. In addition, the amount payable is not calculated on the basis of certain formulae provided for by formal regulations but usually negotiated between polluters and relevant regulators. The reduction, deferral and exemption are made at the discretion of regulators at the local level, which might be needed in some cases but introduces considerable regional variation in implementation. Arbitrary discretion cannot be avoided, thus opening room for corruption. Furthermore, there are conflicts between the regulations on the pollution charge system and other related environmental protection laws. Environmental protection agencies particularly at the local level have no capacity in terms of both personnel and technologies to keep all polluters under their close control.

In addition to the nationwide pollution charge system, there are many other environmentally related charges in China, which are administered by multiple layers of governmental departments. The nature of the charges is hard to determine since most of them have mixed functions as user charges, ecological compensation charges or management fees, and some even have the characteristics of a tax. Compared with taxes, the charge types are more varied and they are collected by multiple governmental agencies. Some charge items are subject to more than one authority. Conflicts of interests among different sectors and levels of government are not easy to resolve through formal legal channels. For some cross-regional natural resources or environmental problems, local governments involved lack sufficient incentives and capacity to take measures within their own region and to cooperate with each other. They look to the central government to deal with these matters. Beijing is, however, not always able to resolve them efficiently, either.



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On one hand, multiple types of charges have been levied at both national and local levels. On the other hand, charge rates are normally low and the charge base is often narrow, which along with discretionary administration, limits the environmental effects of the imposition. Revenues from charges still cannot meet the necessary expenses of environmental protection activities. Even though the use of charges has been stipulated by regulations, rules and various documents, abuses are in practice not uncommon. Legal sanctions for these abuses are unfortunately often unclear or absent.

Do We Need a “Chief Chef”?

Major Regulatory Problems

The environmentally related taxes and charges system in China is limited in its effects on reducing pollution, conserving energy and protecting natural resources. One of major factors contributing to this is the inadequate regulatory framework for market-based instruments and the lack of effective coordination and cooperation across sectors and regions.

There are overlaps between charges and taxes or between different charges in some areas such as in water recourse, but little or no taxes or charges in other areas such as consumption of coal. There also exist conflicts between central goals and local practice. The central government, in viewing the worsening natural environmental and frequently-occurring environmental accidents in recent years, has put more emphasis on the environment and employed various means to address environmental challenges. Nevertheless, it has not been successful in efficiently enforcing these measures, particularly taxes and charges at the local level. Many local governments face difficulties in financing administration and

development needs through the assigned tax sources under the current tax-sharing system. Their need to extract more revenues and to protect local economic development inevitably results in conflicts of their practice with the central goals in environmental protection.

The center lacks sound information systems to monitor compliance. For cross-regional environmental issues, very often there lacks an effective central agency to facilitate coordination and implementation. At the central level, there is a lack of effective cross-agency coordination. In the area of environmentally related taxes, the effects of taxes applying to resources depend on tax rates, which largely relies on pricing of the resources. The pricing of resources, typically electricity and oil products, is controlled by another government department, the National Development and Reform Commission (NDRC). In regulating some consumption behavior such as vehicular emission, there are other central departments involved in addition to the tax administration agency. However, the demarcation of responsibilities among them is not clear and no one is really accountable in law for policy performance. As to environmental charges, the Ministry of Environmental Protection (MEP), despite having acquired more functions in formulating and implementing policies, matters such as natural resources pricing and imposition of pollution charges are beyond its mandate. With respect to pollution control and ecological protection, other central departments including the Ministry of Land and Resources, Ministry of Water Resources, Ministry of Agriculture, Ministry of Housing and Urban Rural Development and State Forestry Administration are each responsible for the management of their respective resource sector, which includes the enforcement of relevant environmental charges. The NDRC, MOF and SAT also involves in matters



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concerning the environment and natural resources.

The Way Forward

The current institutional framework for environmentally related taxes and charges create too many cooks in the kitchen, with no one having the authority to resolve conflicts among them.

With the increasing complexity of environmental issues and the need for effective long-term development, strong and efficient cross-departmental and regional coordination is vital for China. In January 2010, the State Council established the National Energy Commission (NEC), which was headed by the then-Premier Wen Jiabao. The NEC was mandated to coordinate domestic energy development and international energy cooperation, among other matters. Membership of the NEC includes heads of those critical and powerful ministries or units, such as the NDRC, MEP, Ministry of Public Security, Ministry of Land and Resources, MOF and the People's Bank of China. This was seen as an attempt to build an authoritative central body to deal with the different powers and interests that have been distributed among different ministries. Presumably, the NEC may play a stronger role in helping coordinate other issues, such as implementing environmentally related taxes and charges.

It is worth considering whether the creation of a "super" agency, such as the NEC, will be able to address all the problems with the current regulatory framework for environmentally related taxes and charges. The institutional conflicts in China arise because there are a number of government agencies involving in tax and charge policies concerning environmental protection, while each of them is responsible for enforcing different types of taxes or charges

and using methods that are often not uniform. Differing values exist within the same level of government when different departments are involved in the process. It is also true that different levels of government use different philosophies to implement taxes and charges and related policies. Another type of conflict is the conflict between the policymaking body and an implementing agency. These conflicts, resulting from the division of responsibility, have historical foundations: taxes and charges were introduced piecemeal and their legal design, including how to administer them, could not fully address the problems on which they were focused due to institutional constraints and other factors. Moreover, the changing environment has meant that they have needed to be adjusted from time to time.

These types of institutional conflicts are not unique to China, however. The division of administrative responsibility is necessary, but should not be chaotic or in disorder. The current major regulatory problem in China is that the division of functions and responsibilities is ambiguous and adjusted in a random, ad hoc and inconsistent manner. The State Council, as both the executive branch of the state power and a de facto legislation body, has failed to divide administrative responsibilities among its departments and across levels clearly and specifically. If it were to adopt a clear policy to make the demarcation of administrative responsibilities among involved departments and regional governments far less ambiguous and to explicitly spell out the role and powers of the super agency at the same time, the current regulatory framework could be steadily improved.

Setting up a new central body, or a revamped version of the NEC, which has more extensive and supervisory powers, could go a long way in facilitating future environmental tax reform in China. It would be particularly desirable to



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increase the role of market-based instruments in the policy instrument mix as a way of enhancing their role in environmental protection and pollution reduction. Direct regulation has failed, or had little real effect in China, due, inter alia, to corruption, which has led to the need to find other means, in particular taxes and charges, to help protect the environment, modify individual behavior and regulate production and consumption. The use of the market-based instruments can be effective even within a political system with corruption: by taxing consumers and letting the market work. It should be remembered that China's market has been proved successful in terms of GDP growth and foreign investment. Despite the fact that corruption has also compromised the implementation of taxes (and/or charges) to a degree, tax collections and administration still have achieved successes in China in recent decades. There have been improvements in both technology and legal design of Chinese tax and charge systems, which can benefit the imposition of future taxes including environmental taxes.

Future environmental tax reform in China should proceed towards an independent environmentally targeted tax system. In the process, the current regime of co-existing complicated taxes and charges should be streamlined. Prevailing charges that have the characteristics of a tax, such as the pollution charge on waste water, waste gas and sulphur dioxide emissions, should be explicitly converted into taxes, so as to make the implementation more efficient. However, not all existing charges necessarily need to be transformed into taxes or eliminated. First, it is impossible for government to completely change these charges into taxes due to high transitional costs and operational costs. Also, many current environmental charges are implemented on a relatively small-scale, with incomplete scope and a low rate which may be

far lower than the average marginal disposal cost. This provides space for certain overlapping charges and taxes to co-exist (at least in the medium term) in order to increase the incentive for pollution reduction, and to help exchange information between tax agencies and environmental protection agencies. Such exchange of information could reduce implementation costs and increase efficiency. Certain charges which are targeted on specific resources or pollutants, like the Yangtze River sand-gravel resource fee, should be continued alongside further reforms in their design and more importantly, in their administration. In particular, a government department needs to be in charge of their imposition, especially where, in the past, the targeted resource or pollutants have been subject to regulation and/or taxation by more than one agency. To determine which charges should be transformed and which charges should be retained or phased out requires comprehensive, case-by-case research is needed to reach sound conclusions, which is beyond the scope of this article.

Another way to improve the regulatory framework would be to establish a specialist judicial or administrative tribunal to mediate disputes arising in the implementation of environmental taxes and charges. This may also serve as a way to increase public participation and supervision. With respect to the inter-governmental fiscal relationship involving in the environmentally related tax and charge system, a long-term solution is needed to assist under-developed regions to develop faster and more efficiently with minimum environment damage. Greater government revenue transfers are needed to help balance the widening regional wealth gap and to provide funds for poor regions to address environmental issues. These transfers, however, must proceed in a transparent and just way.



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Conclusion

China has, so far, had limited success in implementing a comprehensive environmental tax regime, even though there have been some environmentally related taxes and charges “on the paper” for some time. While a number of governmental agencies have been involved in the implementation of these taxes and charges, the process has been ineffective as this has been at the discretion of various enforcing bodies. The lack of horizontal and vertical coordination and cooperation across agencies and levels of government has led to compliance and other related problems. For the purpose of enhancing the environmental effects of the tax and charge system, further improvement in the regulatory framework is much needed.

Achieving such an important aim is no easy task, however. One of the most difficult things among the myriad of issues in the existing system is to identify the most serious problems and then to find solutions for these. A policy document designed along the lines of the national FYP, with a particular agenda for the reform in the regulatory framework of environmentally related taxes and charges, may be needed. This could go a long way toward removing, systematically and consistently, some of the institutional problems arising from the regulation and implementation of the current complex mix of taxes and charges. A specialized central authority should be established for the purpose of fostering efficient coordination and cooperation across regions and sectors of government.

Attaining the foregoing presents formidable challenges, but the light at the end of the tunnel is evidenced by the fact that the political will for environmental protection and for building a low carbon economy and a resource-efficient and environmentally friendly society has become much clearer in China. If the political will can be

combined with efficient decision-making and mobilization, it is not unrealistic to expect that over time, the many ‘cooks’ may be encouraged to become more efficient in coordinating and cooperating with each other.