

# ATI Working Paper

## Land-Based Finance and Property Tax in China

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## **ABSTRACT**

This paper describes how the municipal finance system and land-based finance work in China, and discusses the municipal finance challenges resulted from the decline of land concession revenues. In this context, the paper discusses the current hurdles for the introduction of a property tax on the ownership of private residential properties, and offers a few policy recommendations that aim to pave way for the property tax implementation.

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## **1 Introduction**

China is one of the few countries around the world that do not have a property tax on the ownership of private residential properties. As China is rapidly urbanizing and a majority of urban households own one or more residential properties, a local property tax could become a sustainable source of municipal revenues. In fact, the central government is currently developing a property tax law as a necessary step to introduce a local property tax nationwide. But the effort is met with significant public resistance and heated policy debates. This paper provides an overview of China's municipal finance challenges and makes an argument for the introduction of property tax to be a catalyst for reform in urban governance and finance.

## **2. Structure of Government**

The structure of government in China is unique. There are five levels of government: central, provincial, prefecture, district/county, and village/township. The term of "local government" refers broadly to any government under the central level, but it also refers specifically to the provincial-level government. The central-local relationship in the central government documents often refers to the relationship between the central and provincial governments. Any government body at each level except the level of village/township is a fiscal unit with its revenue and expenditure assignments, as well as a budget. The village/township governments have their own budgets, but their revenues come from the transfers from the higher level government.

Another aspect of the uniqueness is that there are no such governments that are created specifically for the urbanized areas. Cities are a geographical concept, not an administrative one. Currently, China has a total of 661 municipalities, of which four are at the provincial level (i.e. Beijing, Shanghai, Tianjin, and Chongqing), 283 at the prefecture level, and 374 at the county level. A municipality in China is usually a jurisdictional territory containing a central city built-up area and the surrounding rural districts or rural counties. A large municipality may contain several urban districts, one or two county-level cities, and several rural counties. This jurisdiction arrangement allows sufficient geographical space for municipalities to expand their urbanized areas. In addition to the municipalities, there are 1,636 county towns that serve as the administrative seat of a county, and about 20,000 administratively designated townships, mostly market towns serving the rural areas. Some of the county towns and townships are large, with population over 100,000.

The third aspect of the uniqueness is that all governments at each level are all-purpose governments. They are responsible not only for all public functions, but also for economic development and urbanization within their jurisdictions. There are no specialized governments in China that provide a single or specialized public service, such as the school districts or metropolitan service districts in the United States. If a metropolitan area or a megacity region grows across jurisdictions, the management and coordination of cross-jurisdiction matters will be taken up by the higher level government, such as the provincial government.

The political system for municipalities is highly centralized. The top leaders of a municipal government are the communist party secretary and the mayor. The party secretary is directly appointed by the higher level party committee. For example, the central party committee appoints the provincial party secretary, the provincial party committee appoints the prefecture party secretary, and so on. The mayor is selected and appointed by the municipal people's congress, but the higher level government often exercises a strong influence on the selection. This centralized political system is designed to ensure that the central policy and directives get implemented by the lower level governments. To some extent, it is compatible with the tax sharing system in which the central government maintains almost all tax powers, and the local governments are given little tax powers.

### **3. Land-based Finance in China's Urban Development**

China's urbanization has been rapid since 1978, the year when the economic reform spearheaded by Deng Xiaoping started. Between 1978 and 2017, the total population grew from 963 million to 1.38 billion, and the share of urban population grew from 18 percent to 57 percent. Today, over 780 million of China's citizens live in cities. The number is expected to reach over 1.13 billion (or 75% of total) by 2050. The physical expansion and development of cities has visibly been dramatic over the last two decades. Most cities, large and small, have expanded in population and land area by several times. A number of large cities, megacities and urban regions have emerged, and serve as the major centers of the nation's economic activities.

The rapid urban development is primarily driven by the rapid economic growth. But it is also made possible by the municipal governments' ability to mobilize and capitalize land resources. This ability has evolved from China's economic growth strategy adopted since 1978. In the early years of economic reform, the central government initiated an open-door policy to take

advantages of the investment opportunities from globalization and of the abundant domestic supply of low-cost labor and cheap land (or more precisely, land without a market, which was a legacy of the planned economy). The special economic zones (SEZ) were set up in several selected coastal cities to attract business and manufacturing firms from outside of mainland China. The local governments of these coastal cities allowed parcels of rural land to be leased for industrial plants. They also improved physical infrastructure, and converted rural land into serviced industrial parks. The government-led development approach succeeded greatly in attracting foreign direct investment and was later copied by many other cities across the country in the 1990s and 2000s.

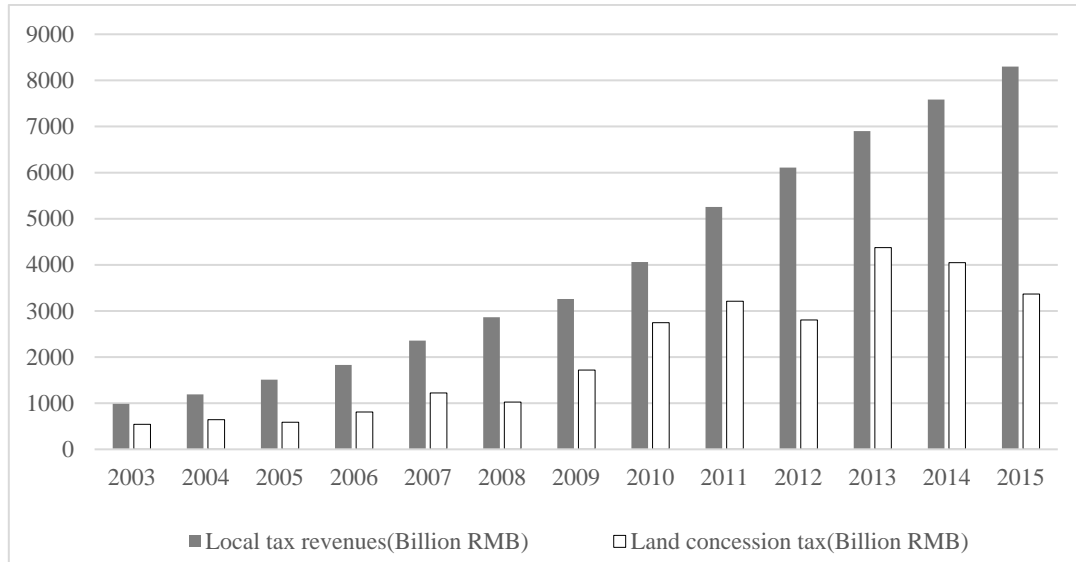
Under the economic growth strategy, local governments tend to give top priority to economic growth. For a long period of time, local governments have made a great effort, with whatever means possible within the legal and fiscal frameworks, to achieve or surpass the GDP growth target set by the central government. Much of the public investment has been made for infrastructure that aims at promoting local economic growth. However, the fiscal means available to municipal governments are limited. The current tax sharing system was established in 1994, under which the central government determines what to tax, the tax rates, and the shares of tax revenues between central and local governments. Local governments essentially possess no tax power and tax autonomy, and are not allowed by the Budget Law to borrow directly from the commercial banks or raise funds directly from the capital markets.<sup>2</sup> Facing these constraints, municipal governments have to raise additional funds through various ways, including most significantly sales of land use rights (also known as land concessions) for real estate development, and borrowing from commercial banks indirectly through municipal government-owned urban development investment corporations (UDICs), often using land as a collateral. As a result, a general pattern of fiscal revenues and expenditures under the tax sharing system for the last two decades is that municipal governments spend much more than the tax revenues they have (including inter-governmental transfers), with the fiscal gaps mainly covered by land concession revenues and commercial borrowing by the UDICs (which we call land-based finance in China). As the data in Figure 1 show, for most years between 2003 and 2015, the amount of land concession revenues was greater than 50 percent of the local tax revenues. Land concession revenues were mainly used by local governments to fund capital

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<sup>2</sup> An Amendment of the Budget Law in 2014 permits local governments to sell bonds directly to raise funds for public investment projects. In implementation, however, only a handful of provincial-level governments are allowed to sell bonds under the quotas set by the State Council.

investment projects. The large size of land concession revenues (as compared to the size of tax revenues), together with the UDIC borrowing, explains the unprecedentedly rapid urban expansion and modernization over the last two decades.

**Figure 1. Local Tax Revenues and Land Concession Revenues by Year**

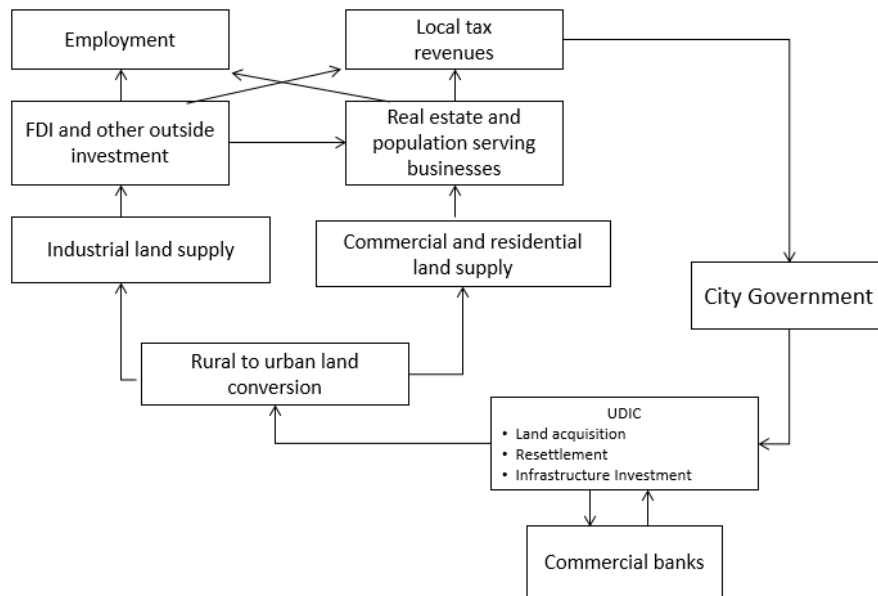


Source: China Statistical Yearbooks.

The sales of land use rights for real estate development are a part of the land operations by the municipalities. In competition for investment and employment opportunities, most municipalities offer sizable industrial land for use by manufacturing firms at very low prices or even free of charge. Municipal governments believe that the newly attracted manufacturing firms would bring in jobs, GDP and local tax revenues; that the new jobs would generate new demand for housing and other commercial services; and that the new supply of housing and services would generate further local GDP and tax revenues. The costs of subsidizing industrial land are covered by the revenues from sales of land use rights for commercial and residential development.<sup>3</sup> The prices of commercial and residential land—which are determined by competitive bidding by developers—are many times (ranging from 5 to 15) higher than the officially set prices for industrial land. Figure 2 illustrates the mechanism of land-based finance. It should be noted that the heavily subsidized industrial land has led to considerable inefficiencies in industrial land use across the country.

<sup>3</sup> Commercial development pertains to the real estate development for commercial purposes, such as business office buildings, shopping malls, and hotels. Residential development includes the development of commodity housing and affordable housing.

**Figure 2. The Mechanism of Land-Based Finance**



Source: Author.

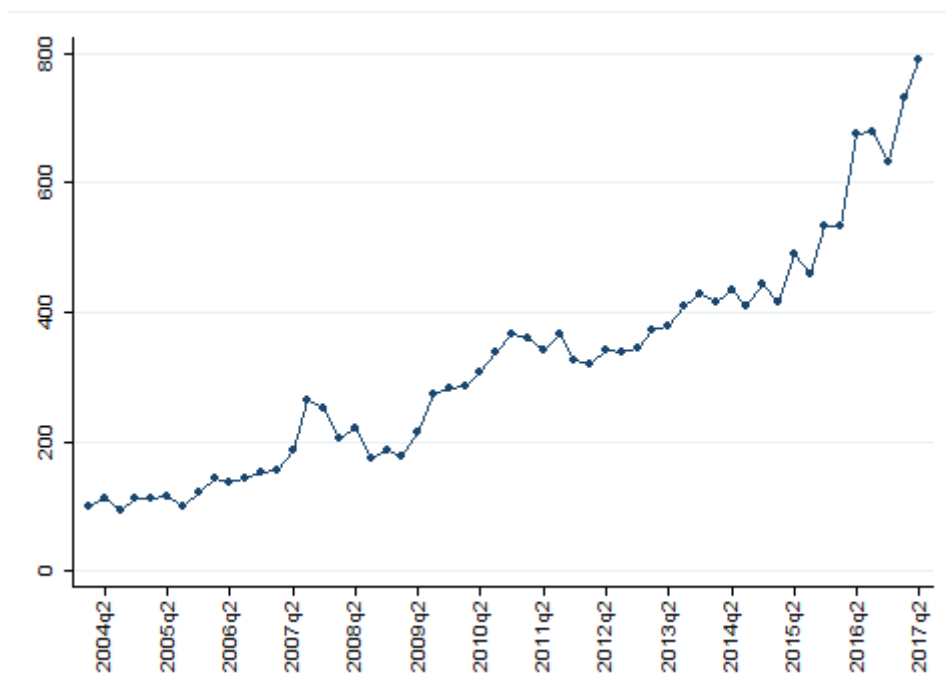
This mechanism is made possible by the legal arrangement that gives the local governments a monopoly power to provide land for urban development. By the Constitution, urban land is owned by the state, and rural land by the village collectives. By the Land Administration Law, the state possesses the power to control and regulate land use, and only the state—which is represented by the local governments—is given the legal power to convert rural land into urban land through land expropriation. The compensation to farmers for rural land taken by the government is not set at the market price of the land, but at the agricultural production value (or the value of land in its original use). The Land Administration Law allows municipal governments to sell the use rights of the serviced land to real estate developers for a certain period of time: 70 years for residential use, 50 years for commercial use, and 40 years for industrial use. This legal arrangement set a stage for the widespread practice of land concessions across China over the last 20 years.

Land operations at the municipal level are heavily constrained by the national farmland preservation policy. Farmland is scarce in China. According to the 2015 data published by the World Bank, per capita arable land area in China is 0.09 hectare, as compared to the world average of 0.19 hectare. The national farmland preservation policy stipulates that a national total of 1.8 billion mu of basic farmland (or high-grade farmland) must be preserved, in order

to maintain sufficient food supply for a population of 1.38 billion.<sup>4</sup> In implementation, each province must maintain a fixed quantity of basic farmland. When x mu of basic farmland is taken for urban development in a province, the province must generate x mu of basic farmland of equivalent quality elsewhere within the province. This strict policy significantly limits the total amount of land supply for urban development, but it also drives up the prices of land concessions, and thus the revenues per unit of land supply.

Urban land supply for residential use is a small fraction of total urban land supply. Of the total amount of new land supply in a typical city, a significant portion (about 70% on average) would be allocated to industry, infrastructure, public administration and affordable housing—which generate little revenues to municipal governments. There is just a small fraction (often about 20-30%) of new land left for commercial and residential development that generates net revenues to the municipal government. As a result of limited supply, prices for the use rights of residential land have gone up quickly (see Figure 3).

**Figure 3: Chinese National Real Land Price Index, 35 Markets, Constant Quality Series (Quarterly: 2004q1 – 2017q2)**



Source: Wharton/NUS/Tsinghua Chinese Residential Land Price Indexes (CRLPI)

<sup>4</sup> “Mu” is a measure of farmland area in China. One mu is equivalent to 667 square meters, or 0.16 acre.



The land concessions generate a significant amount of revenues to the municipal governments, but also contributes to the high prices of housing. It is widely believed today that the cost of land accounts for about 30% or more of the final sales price.<sup>5</sup> The high housing prices and the expectation for price increases induce the sector to supply a large quantity of housing units every year, resulting in a high level of supply inventories (i.e. unsold units) in many localities across the country.<sup>6</sup>

Despite the high prices, housing demand has been strong, especially in the major cities. The main reason is that many Chinese households purchase housing units as the only viable means of household investment. China has experienced rapid growth in household income since 2000, which has been accompanied by strong consumption growth and increases in household saving rate. According to the OECD data, household saving rate has increased from 28% of household disposable income in 2000 to 38% in 2014.<sup>7</sup> But there are very few viable investment options for households to keep the value of their savings. The Chinese currency RMB is not yet internationalized, and investing savings overseas is not feasible for most households. Interest rates paid to the domestic savings accounts are low due to lack of competition in the commercial banking sector and strong government interventions to control interest rates. Domestic stock market is poorly regulated and not transparent, and its performance for many investors over the last 15 years has been money-losing despite continuing growth of the economy. Many high-income and middle-income households have purchased more than one housing properties, many of which are left vacant as the carrying costs are low in the absence of a property tax.

The UDIC borrowing with land as collateral has also caused a major problem in local government debts. There are no annual local debt data available. But a 2013 State Audit Report revealed a total of local outstanding debts in an amount of RMB 17 trillion, which accounted for 28.6% of the national GDP in 2013. Over the last few years, efforts were made to reduce

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<sup>5</sup> The share of land costs in housing sale prices varies substantially across the country. The share is highest in the first tier cities where market demand remains very strong, but it is much lower in smaller cities where demand is less strong. This could be inferred from the facts that housing prices vary significantly across the country, and the real cost of housing construction has remained similar over time and across regions. Liu and Wang (2014) found that the real cost index of housing construction in China fluctuated between 100 and 110 during 2005-2012.

<sup>6</sup> While housing demand remains very strong in the first-tier cities such as Beijing, Shanghai, and Shenzhen, excessive housing supply is visible in many lower level cities.

<sup>7</sup> OECD data, from: <https://data.oecd.org/hha/household-savings.htm#indicator-chart>, accessed on December 30, 2017.

the amount of local outstanding debts. The central government imposed a debt ceiling on local government borrowing, and pledged that there would be no bailouts. Moreover, the central government permitted a small number of local governments to issue bonds, in order to ease their repayment pressures. These measures appear to put the local debts under control. According to a recent National Audit Office report, the local government outstanding debts stood at RMB 15 trillion by the end of 2016.

Since 2014, China's economy has entered a new growth stage known as the "New Normal." National GDP growth no longer registers a rate close to the 10% a year as before. Instead, the rate drops to under 7% a year. Demand for land cools down accordingly for most cities except the most economically viable cities at the top of urban hierarchy. With a weakened land market, many municipal governments are seriously concerned with the sustainability of land-based finance in the near future. On the other hand, the compensation for rural land taking has also risen in recent years as farmers continue to press for higher compensation. This narrows the net revenues from land concessions. Municipal governments face a new challenge: when land concession revenues become unsustainable, what will be the alternative stable source of municipal revenues for urban development?

In summary, the land, housing, and local debts issues highlighted above are caused by a number of distortions imbedded in the Chinese growth model, such as low cost of rural land taking from villages, the power of municipal governments as a monopoly of urban land supply, lack of investment alternatives for households, and the absence of a property tax on homeownership. All these have resulted in the over-exploitation of land for industrial development, and the waste of land and other resources in the form of housing vacancies and excessive housing supply.

#### **4. China's Tax Sharing System and Fiscal Policy Reform**

The current taxation system in China is known as the tax sharing system, which was adopted in 1994. All taxes are categorized into three groups: central taxes, local taxes, and shared taxes. The central taxes are those collected and fully retained by the central government. The local taxes are those collected and fully retained by the local (or more precisely provincial) governments. The shared taxes are collected by the central government and shared in a pre-determined proportion with the local government where the shared tax revenues are generated.

The most important feature of this system is that types and rates of all taxes are determined through a central government process. Practically, local governments do not have independent tax power, or tax autonomy. Appendix Table 1 lists the taxes under the three categories. Table 1 below shows the tax revenues by selected years from 1995-2015.

**Table 1: Tax Revenues by Year, 1995-2015**

	National GDP (billion RMB)	Total Tax Revenues (billion RMB)	Tax Revenues as % of GDP	Central Tax Revenues (billion RMB)	Local Tax Revenues (billion RMB)	Local Share of National Tax Revenues
1995	6,079.4	597.4	9.8%			
2000	9,921.5	1,258.2	12.8%			
2005	18,493.7	2,877.9	16.7%	1,605.2	1,272.7	44.2%
2010	40,151.3	7,321.1	19.3%	4,050.9	3,270.1	44.7%
2015	67,670.8	12,492.2	20.1%	6,226.0	6,266.2	49.8%

Source: Official website of the National Statistical Bureau ([www.data.stats.gov.cn](http://www.data.stats.gov.cn)).

#### 4.1. Taxes on Real Estate Properties

Five taxes are related to real estate properties: urban and township land use tax, arable land occupancy tax, land appreciation tax, real estate tax, and deed tax.<sup>8</sup> As the statistics shown in Table 2, the total revenues from these five taxes account for about 22% of the local tax revenues and 2% of the national GDP in recent years.

**Table 2: Revenues from Five Taxes on Real Estate Properties, 2013 - 2015**

	Year 2015	Year 2014	Year 2013
Urban and township land use tax	205.1	185.2	158.2
Arable land occupancy tax	214.2	199.3	171.8
Land appreciation tax	383.2	391.5	329.3
Real estate tax	209.7	205.9	182.8
Deed tax	389.9	400.1	384.4
Total of five taxes	<b>1,402.1</b>	<b>1,381.9</b>	<b>1,225.6</b>
As % of local tax revenues	<b>22.4%</b>	<b>23.4%</b>	<b>22.7%</b>
As % of GDP	<b>2.0%</b>	<b>2.1%</b>	<b>2.1%</b>

Source: Official website of the National Statistical Bureau ([www.data.stats.gov.cn](http://www.data.stats.gov.cn)).

<sup>8</sup> Xu and Wang (2004) provided an early discussion of China's land and property taxes.

The urban and township land use tax is imposed on urban land in use. An organization or individual using land in cities, county towns, administrative towns, and industrial and mining districts shall be a payer of urban land use tax. The annual tax rates on each square meter of land used are: (i) 1.5 to 30 yuan for big cities (with population over 1 million); (ii) 1.2 to 24 yuan for medium-sized cities (with population between 0.5-1 million); (iii) 0.9 to 18 yuan in small cities (with population under 0.5 million); and (iv) 0.6 to 12 yuan in county towns, administrative towns, and industrial and mining districts.

The arable land occupancy tax is imposed on entities and individuals who use arable land to build houses or for other non-agricultural construction purposes, on the basis of actually occupied area of arable land. Differentiated tax rates are adopted for different locations.

The land appreciation tax is levied on the incremental value received by the entities and individuals who transfer the right to use state-owned land, above-ground structures and their attached facilities and attain income from such transfer. There are four levels of progressive rates (30%, 40%, 50%, and 60%).

The real estate tax is imposed on owners of houses within cities, county towns, administrative towns, and industrial and mining districts. According to the tax regulation, the real estate tax for self-occupied houses is calculated with a tax rate of 1.2% on 70%-90% of the original value of the property. The real estate tax for rented houses is calculated on the basis of the rental income, and the applicable tax rate is 12%. Rental of personal-owned residential houses is taxed at 4% of rental income; rental of residential houses by enterprises and public institutions, social group and other entities is taxed at a preferential rate of 4%. So far, this tax is only imposed on houses for commercial use, not on private residential houses. The government plans to implement a tax on the ownership of private residential properties. This plan is a major topic in public debates.

The deed tax is imposed on the transferee (entities and individuals) of land and houses within China for the market price for the transferred right to use the land or the right of ownership of the house, or the price margin resulting from the exchange of land use right and house ownership. The tax rates are 3%-5% of the purchase price of house. Purchase of a housing unit under 90 square meters by individuals, which is the only housing unit of the household, is taxed at a preferential rate of 1%. Purchase of a housing unit by individuals, which is the only housing

unit of the household, is taxed at half of the applicable tax rate.

#### 4.2. Indirect Taxes and Direct Taxes

China's taxation system is characterized by the dominance of indirect taxes. By definition, an indirect tax is a tax that is paid to the government by a firm or entity in the supply chain, but it is passed on to the consumer as part of the price of a good or service. A direct tax is a tax paid directly by a person or a firm. In China's taxation system, the direct taxes include corporate income tax, individual income tax, vehicle purchase tax, vessel tax, deed tax, and real estate tax. According to the data published by the Ministry of Finance, direct tax revenues accounted for 32% of total tax revenues in 2016. In comparison, direct tax revenues usually account for over 50% of total tax revenues in OECD countries.

As there is no property tax on the ownership of private residential properties yet, the share of tax revenues from individuals (instead of firms) is small in China. As the data in Table 3 show, the individual income tax revenues accounted for 9.7% in 2015. In comparison, 45% of the total tax revenues come from individual taxpayers in the OECD countries on average (Gao, 2017).

**Table 3. Individual tax revenues: 2013, 2014, and 2015 (in billion RMB)**

	Year 2015	Year 2014	Year 2013
Individual income tax revenues	1,206	1,033	914
Total tax revenues	12,492	11,918	11,053
% of total	9.7%	8.7%	8.3%

Source: Official website of the National Statistical Bureau ([www.data.stats.gov.cn](http://www.data.stats.gov.cn)).

The dominance of indirect taxes in the tax sharing system is partly a legacy of the planned economy where the government collected “profits” from the state-owned enterprises as the main source of fiscal revenues. When the tax sharing system was established in 1994, China was still a low-income country. By design, the system only taxed personal incomes from foreigners and the Chinese individuals with very high incomes, and excluded the majority of the people as a source for taxation. In 2011, the central government raised the threshold of individual income tax from RMB 2,000 per month to RMB 3,500 per month. The decision was highly popular, but it substantially limits the number of individual income tax payers to less than 50 million people, or less than 4% of the total population. Today, there are still strong

public calls to the central government to further raise the threshold. Under the taxation system dominated by indirect taxes, most Chinese citizens are not used to paying direct taxes. This explains a strong social tendency to resist the introduction of the broadly-based direct taxes, such as the property tax on the ownership of private residential properties.

### **4.3. Fiscal Policy Reform**

The current round of fiscal policy reform started after the Third Plenary Session of the 18th National Congress of the Communist Party of China, which was held in November, 2013. The key objective of the reform is to optimize the tax structure while maintaining the level of overall tax burden on the economy. It is also considered a key measure under the government's "supply-side" reform initiative that aims to cut the high tax and non-tax burdens on the real economy. It requires an increase in direct tax revenues and a reduction in indirect tax revenues. Over the last four years, the reduction of indirect tax revenues has been achieved through the conversion of business tax to value-added tax, both of which are indirect taxes. The reduced amount of indirect tax revenues amounted to about RMB 1 trillion a year (Gao, 2017).

This revenue reduction to be made up from other taxes if the level of public expenditures is maintained. China recently introduced a resource tax and will soon roll out a new environmental tax. But the amount of revenues from these two new taxes will be far from adequate to close the revenue gap. On the side of direct taxes, there is no room for higher corporate income tax as the policy is to reduce the tax burden of enterprises. Therefore, the hope is on personal income tax and private residential property tax. Otherwise, the government will have to rely on borrowing, which will increase the fiscal risks, especially at the local level where the burden of local public debts has been heavy.

The 19th National Congress of the Communist Party of China, held in October, 2017, continues to emphasize fiscal policy reform. Specifically, it continues to call for the deepening of taxation system reform, and the improvement of local tax system. A key task is to continue the current round of fiscal policy reform by increasing the share of direct taxes. For the first time, the government recently revealed three principles for the roll out of a property tax on the ownership of private residential properties. Firstly, a property tax law has to be passed by the National People's Congress before the roll out of the property tax. Secondly, the central government will give full authorization to local governments for the implementation of the property tax, which

implies local flexibility on tax rates and exemptions. Thirdly, the roll out should be taken step by step, implying that the ready cities may go ahead first. Furthermore, the residential property tax will be based on property value assessment, and the other taxes on the construction and transaction of properties will be lowered. By all indications, the government is determined to move ahead with the roll out of the property tax, even though there is no specific timetable yet for the property tax law to be presented to the National People's Congress for approval. Even if the law is passed by the National People's Congress in the near future, it will still take a few years for many municipalities to establish a working system of residential property assessment and administration. Therefore, it would be years away before residential property tax becomes one of the main sources of municipal revenues.

However, the introduction of property tax will be significant in shaping urban governance in the future. Residential property tax is a local tax, introduced on the justification that the revenues would be used by municipal governments to provide local public services which would constitute a portion of the property value. As such, tax payers are expected to demand for the rights to influence and participate in the municipal decision making and the performance monitoring process of municipal budget expenditures. This bottom-up pressure will fundamentally change the management style of municipal leaders, from responding mainly to the directives from the higher level, to responding to the needs of the urban residents.

## **5. Addressing the Implementation Issues of Property Tax on Private Homeownership**

### **5.1. A Hugely Missed Opportunity**

The political hurdles for the introduction of a property tax on the ownership of private residential properties are obvious and very strong. As natural, few households who have owned one or more housing units will be happy to pay the property tax. It would represent a considerable outlay for an average household. Suppose that the annual amount of new property tax revenues from urban areas accounts for 3% of the national GDP of RMB 74 trillion (the level of 2016), it would amount to RMB 2.2 trillion in total or RMB 2,846 per urban resident (assuming 780 million urban residents). Nonetheless, one would question why a property tax could be implemented in a large number of countries (including many with lower per capita income than China) for many years, but not in China.

In fact, the central government studied the feasibility of property tax around 2000, which led to the publications of Xie (2005) and Xie (2006). It is a huge missed opportunity that the property tax was not introduced around year 2003, just a few years after the housing policy reform to transform housing provision from welfare to market in 1998 and right before the start of the housing boom that had lasted till 2013. Today, over 90 percent of the urban households own one or more housing units. They form the strongest public resistance to the property tax. Many of them argue that the purchase price of their home included a share of land concession fee for the use of public land underneath their home for 70 years, and that the land concession fee was actually the property tax. While this argument is obviously incorrect, it is expected that the land concession fee would be lowered in the presence of a property tax. Many homeowners also argue that it is not fair to impose property tax after they made the decision to invest on the property without the prior knowledge about its introduction. Of course, this argument is also incorrect as it preclude any new taxes on assets, regardless their justifications.

The need for and impacts of a residential property tax in China has increasingly been a subject of academic and policy inquiries in recent years. For example, from the municipal finance perspective, Man (2012), Bahl et.al (2014) and Hou et. al (2014) argue for the need to introduce a property tax as a stable source of municipal revenues. Hong and Brubaker (2012) discusses how to integrate the property tax with the public leasehold system. Zhang and Hou (2016) uses the household income data to estimate the household ability to pay local property tax under alternative exemption scenarios. Dale-Johnson and Zhu (2017) uses a dynamic general equilibrium model to examine how different type and usage of property tax revenue and expenditure scenarios impact land price, house price, house rent, vacancy rate, and government revenue as well as land concession revenue. Hou et. al (2016) proposes a design of the property tax system for China. In short, knowledge has been building up for the design and implementation of the property tax in China. The remaining text under this section will discuss the possible solutions to a few practical issues facing the Chinese policy makers in the design and implementation of the property tax. These solutions aim to make the property tax more acceptable by homeowners, but they are also expected to reduce the impacts on housing and land prices of introducing the property tax.



## **5.2. Reforming the Price Structure of Public Land Leasing**

The current price structure for public land leasing consists of a one-time payment of land concession fee only. It is deficient and unsustainable. Without annual rental charge on public land leasing and a property tax for recouping part of the costs for public services, real estate developers would be able to bid a higher land concession fee up-front. While the municipal government of the current term (normally four years) gains substantial revenues for capital investment, the subsequent terms of the government will have less and less land concession revenues when the city expansion slows down.

Under the public land leasing system, the ideal price structure would be one consisting of three components: (i) a land concession fee up-front to determine the most efficient use of newly supplied land; (ii) an annual rental charge for the use of public land; and (iii) a property tax to finance the public infrastructure and services. The components (ii) and (iii) could be bundled together since both are imposed annually on the basis of the same property assessment value. This is essentially the same structure adopted in Hong Kong. China should reform the land price structure by introducing the property tax and public land rental charge. This structure would also give municipalities some degree of flexibility to use public land rental charge as a policy tool to stabilize land costs.

## **5.3. Starting with Low Rate and Wide Base**

Given the urgency of strengthening the municipal finance system when the traditional land-based finance is losing steam, it would be the most ideal if the property tax could be introduced right away. A possibility is to adopt a wide tax base and a very low rate to start with. The rate may be determined locally by the municipal governments depending on the affordability of their urban households. The acceptance of urban households is extremely important in changing the culture of not paying direct taxes. However, to do so would require tremendous political will and luck. Once a property tax with a low rate is accepted, municipal governments will have opportunities to gradually raise the property tax rate to the point that balances affordability and revenue needs for public services.

#### **5.4. Grandfathering**

If it is difficult to implement a broadly based property tax right away, an alternative would be to adopt a “grandfathering” approach. A property tax would be imposed on the new owners of housing units that are built on the new land under the new land price structure proposed above. It will also be imposed on the current owners of housing units built on land under the old price structure, when the current land leasing term expires and is extended to the next term. The tax may also be imposed on the new owners of the current housing units after the second-hand transaction. This alternative is transitional. As homeownership in urban China is a rather recent phenomenon starting after the 1998 housing reform, most homes still have 50 years or more in their land leasing term. Therefore, if this alternative is adopted, it will take many years before all residential properties are subjected to property taxation.

#### **5.5. Allowing Time for Adjustment before Effectiveness of the Property Tax Law**

Most of the current urban housing units were built and purchased after the housing reform of 1998. As discussed earlier, owning multiple housing units and keeping them vacant by many households is a phenomenon caused by various distortions, such as lack of household investment alternatives, weak social security coverage, and very low carrying costs in the absence of a property tax. For these households, the property tax burden would be very high if they do not sell the extra or vacant housing units or rent them out. Considering that they made the purchase of the properties at the time without a property tax, the government should allow them a certain period of time to economize their housing investment portfolio after the national property tax law is passed by the National People’s Congress. A simple way to do so is to make the law effective two to three years after its approval.

#### **5.6. Allowing Ready Municipalities to Implement Property Tax First**

China has 661 municipalities, 1,636 county towns, and about 20,000 administrative townships. Most of these municipalities and towns are not ready for the implementation of a residential property tax due to lack of institutional capacity for property value assessment and property tax administration. However, a number of large municipalities have been making significant effort to establish a city property database and develop property valuation methodologies.

Some are ready to implement the property tax. Therefore, it makes a great sense that the central government will allow the ready municipalities to go ahead with the property tax after effectiveness of the national property tax law. At the same time, the central government and provincial governments may consider funding a capacity development program to assist other municipalities to develop property assessment and administration system. A financial incentive program based on the inter-governmental transfer system may be considered by the central government to reward municipalities that make real effort to roll out the property tax.

## **6. Conclusion**

This paper describes how the municipal finance system (especially the land-based finance) works in China, and discusses the challenges facing the Chinese municipalities when the land concession revenues are declining. In this context, the paper discusses the current hurdles for the introduction of a property tax on the ownership of private residential properties, and highlights a few policy recommendations that aim to pave way for the property tax implementation.

China has missed an opportunity to implement a property tax at the time before the housing boom. Today, it is extremely difficult for the housing-owning public to accept the tax. If not implemented, the problem of finding a sustainable own-source of municipal finance will continue to challenge municipalities. In a broad sense, a property tax on the ownership of private residential properties is a significant missing piece in China's taxation reform strategy that aims to reach a better balance between indirect taxes and direct taxes.

Despite the political hurdles, there are ways to make the introduction of property tax less painful to the public. These include starting with low rate, grandfathering, allowing time for ownership adjustment, and allowing municipalities with readiness to go ahead with discretionary rates. Moreover, China could learn a lot from international experiences, such as deferred tax payment for the property owners with small cash income.

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**Appendix Table 1. Taxes by Category under the Tax Sharing System**

	Central	Local	Shared
<b>Turnover taxes</b>	✓ Excise tax	✓ Business tax	✓ Value-added tax (50:50)
<b>Income taxes</b>			✓ Corporate income tax (60:40) ✓ Individual income tax (60:40)
<b>Resource taxes</b>		✓ Resource tax ✓ Urban & township land use tax	
<b>Specific purpose taxes</b>	✓ Vehicle purchase tax	✓ Urban maintenance and construction tax ✓ Arable land occupancy tax ✓ Fixed asset investment orientation regulation tax ✓ Land appreciation tax	
<b>Property taxes</b>		✓ Real estate tax ✓ Inheritance tax (not yet levied)	
<b>Behavior taxes</b>		✓ Vehicle and vessel tax ✓ Stamp tax ✓ Deed tax ✓ Vessel tonnage	

		tax	
<b>Customs duty</b>	✓ Custom duty		