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Journal of Comparative Economics 32 (2004) 128–147

Journal of
COMPARATIVE
ECONOMICS

www.elsevier.com/locate/jce

China's capital tax reforms in an open economy

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Received 30 September 2002; revised 1 September 2003

Lin, Shuanglin—China's capital tax reforms in an open economy

This paper analyzes the effects of China's upcoming capital tax reform of switching from a dual tax system to a unified system. A decrease in the tax rate on domestic capital has no effect on the domestic interest rate, capital–labor ratio, or output–labor ratio; however, it leads to an increase in domestic capital, a decrease in foreign capital, and an increase in the trade surplus. An increase in the tax rate on foreign capital increases the domestic interest rate and decreases the capital–labor ratio, the output–labor ratio, and domestic capital; it may also decrease foreign capital and the trade surplus. *Journal of Comparative Economics* 32 (1) (2004) 128–147. University of Nebraska at Omaha, Omaha, NE 68182, USA.

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JEL classification: P35; H25; F41

1. Introduction

China now has a dual tax system for corporate income, i.e., foreign investors are subject to a lower corporate income tax rate than Chinese domestic enterprises in specified areas. Recently, domestic industries and tax administrators have been demanding the abolition of tax concessions to foreign enterprises and to foreign-invested enterprises in favor of an equal tax burden on all enterprises. However, only limited analyses of the effects of the tax reform on the domestic, as well as on the interdependent economies, have been undertaken. This paper examines the effects of capital tax reforms that unify the corporate income tax rates faced by domestic and foreign investors on the capital–labor ratio, the output–labor ratio, foreign investment and the trade balance in China.¹

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¹ Since the opportunity cost of capital supplied by shareholders is not deductible from taxable income, the corporate income tax is a tax on capital as Rosen (2002) argues.

The effect of capital taxation is debated in the literature. In an overlapping generations (OLG) growth model, Diamond (1970) demonstrates that, with the tax revenue being rebated to individuals who pay the tax, an increase in the capital tax rate will decrease the real wage rate and lower the representative individual's utility if the after-tax interest rate is greater than the growth rate. Summers (1981) develops a life-cycle equilibrium model and demonstrates that a shift from capital taxation to consumption taxation would increase welfare substantially. With the tax revenue being refunded to tax payers in a lump sum manner, Chamely (1981, 1986) and Judd (1985) show that the welfare-maximizing capital income tax should be zero in the steady state. In addition, Lucas (1990) argues that capital should not be taxed at all.

The integration of the world economy has increased interest in the effect of capital taxation in an open economy. Two types of capital tax systems exist in an open economy, namely, a territorial tax system and a residential tax system. Under the territorial tax system, the capital income generated in the territory is taxed uniformly regardless of the residence of those who receive the capital income. In the residential tax system, all the capital income of all domestic residents is taxed regardless of where the income is earned.² In a model in which tax revenue is used to finance government consumption, Bovenberg (1989) shows that decreasing capital income taxation is particularly attractive to open economies. Gordon (1990), Gordon and Bovenberg (1996), Frenkel et al. (1991), and Mintz (1992) argue that, in theory, capital taxes might not be sustainable in an open economy with perfect capital mobility. Because capital is important for output growth, all countries have incentives to attract foreign capital and keep domestic capital. Since investors are motivated by after-tax returns to capital, higher capital income tax rates result in lower after-tax returns to capital and less capital. In theory, competition among countries to attract foreign capital drives the capital tax rate to zero.

However, foreign capital taxation is widespread in the real world. Developed countries, with free capital mobility, usually assess a unified capital tax rate on both domestic and foreign enterprises. On the other hand, many developing countries have a dual capital tax system in order to attract more foreign investment; they provide tax incentives to foreign investors, e.g., tax holidays, reduced tax rates, investment allowances, tax credits, and accelerated depreciation. Several reasons justify tax concessions for foreign investors. First, foreign direct investment (FDI) is a transfer of capital from the rich countries to the poor countries and capital is important to both economic growth and employment creation. Second, foreign enterprises and foreign-invested enterprises create positive externalities through transfers of technologies and skills. Third, foreign investors usually face disadvantages when investing in the host countries, e.g., high transaction costs, exchange-rate risk, asymmetric information, and political uncertainty. Tax incentives can be used to offset these disadvantages.

The effectiveness of tax incentives in attracting foreign capital and increasing domestic capital formation is still a controversial issue despite a long history of debate. Many economists argue that tax incentives played an insignificant role in attracting foreign

² The territorial tax system exists in Hong Kong and Macau, while the residential tax system exists in countries such as US, UK, Japan, and Singapore.

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