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The Effect of a Fiscal Squeeze on Tax Enforcement: Evidence from a Natural Experiment in China

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Abstract

This paper investigates the impact of the abolition of the agricultural taxes in 2005 across China on county governments' incentives for tax enforcement. I show that the revenue loss of county governments was largely offset by tougher tax enforcement. The incentive for VAT enforcement can be weakened, however, if the county: (1) receives a lower share of total VAT revenues; (2) has a broader VAT tax base; or, (3) has more abundant sources of revenue from land sales. These findings suggest that incentives of local governments can be vital to tax enforcement and to the tax capacity of a country.

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