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China's Real Estate Tax Reform: The Intersection of Economic and Social Issues

Lyu Bingyang*

Department of Public Finance, Renmin University, Beijing, China

Review Article

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***For Correspondence:** Lyu Bingyang, Department of Public Finance, Renmin University, Beijing, China

E-mail: lby@ruc.edu.cn

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ABSTRACT

Real estate tax is a focal topic of societal concern in China, and the Chinese government has repeatedly emphasized the need for a real estate tax. Yet, after two decades of intense debate, China's real estate tax reform has not commenced. Society imposes certain expectations on the effect of real estate tax reform: Raising fiscal revenue, regulating high property prices, regulating property distribution, and promoting local governance. However, each expectation is controversial, which makes societal consensus on real estate tax reform difficult to achieve. This study argues that taxes, such as the real estate tax, where taxpayers bear the pain of tax burden and harbor high expectations for public services, must consider the overall societal psyche. Fiscal sociology, rather than pure economic theory, should be applied to consider real estate tax reform proposals, with tax obligations based on the acceptance of the majority. Taking into account social consensus and the level of tax collection and administration, this study proposes a progressive two-step reform plan for China's real estate tax reform: In the short- to medium-term, a Central tax design with selective taxation at a progressive tax rate for regulation purposes; in the long term, a local tax design with universal taxation at a proportional tax rate to promote local governance and raise revenue.

INTRODUCTION

Taxation is a means of apportioning the cost of public services. With time, this apportionment has evolved into three main categories: Taxes on goods and services, income taxes, and property taxes. Real estate tax belongs to the most important category of property tax and is commonly imposed in many countries worldwide [1]. Since 2000, with the rising prices of China's real estate market and accelerated urbanization, the value of real estate owned by residents has accounted for an increasing proportion of household asset allocation, resulting in greater calls from the public for the introduction of real estate tax. Over the past two decades, real estate tax reform has become a hot topic of discussion in Chinese society, and the Chinese government has repeatedly emphasized the need to introduce a real estate tax. However, thus far, China's real estate tax reform has stagnated at the level of academic discussion. This study argues that this is because of tax reform experts, who are mostly economists, adopting an economic perspective on the potential costs and benefits of real estate tax reform, as well as Chinese government officials, who consider the social costs and benefits when evaluating real estate tax reform proposals, being prudent and preferring to let real estate tax reform lag, rather than risk triggering potential social problems. The huge misalignment in perspectives between economists and government officials regarding the risks, costs, and benefits of reform has led to difficulty in reforming the real estate tax.

China currently has 18 taxes, one of which is the property tax-it had raised revenue of RMB 327.8 billion in 2021 that accounted for 1.89% of total tax revenues. However, this tax is targeted at the value of corporate property or rental income, not on the value of property owned by residents. In October 2003, the "Decision of the Central Committee of the Communist Party of China on some issues Concerning the Improvement of the Socialist Market Economy" was adopted at the Third Plenary Session of the Sixteenth Central Committee of the Communist Party of China (CPC Central Committee), proposing that a reform of urban construction taxes and fees will be implemented and a uniform property tax will be levied on real estate when conditions are met, with relevant fees being accordingly removed; the property tax refers to the real estate tax. Following which, the State Taxation Administration began executing simulations of property tax reform in Beijing, Shenzhen, Chongqing, and other regions, where each regional tax bureau designed a taxation scheme according to its local real estate situation, but did not levy taxes—it was, therefore, referred to as an idle property tax. In January 2011, Shanghai and Chongqing spearheaded the launch of a pilot property tax reform for residential properties. From both region's management of the property tax over 10 years, tax collection and administration involved an exorbitant cost, was limited to a small scale, and the reform had not achieved the expected effect of adjusting housing price and raising of local fiscal revenue. In November 2013, the Third Plenary Session of the Eighteenth CPC Central Committee proposed to accelerate legislation on real estate tax and promote the reform in due course. It was anticipated then that the real estate tax reform would be implemented soon. However, over time, the Central government has become increasingly cautious in its statements on real estate tax reform, repeatedly highlighting the need to steadily move forward with real estate tax legislation. On October 23rd, 2021, the 13th National People's Congress authorized the State Council to implement pilot real estate tax reform in a few areas. To date, no specific pilot reform plan has been witnessed and no local government is known to be conducting the pilot. To sum up, China has been discussing real estate tax reform for nearly two decades and it has become a hot topic of discussion in Chinese society, but it has not been properly implemented.

As research in this field progresses, the theoretical basis for introducing real estate taxation, and its use as a cornerstone of local finance, has been articulated by economists, and it has become an important aspect of the theory of fiscal decentralization. The study of real estate taxation generally began with model: A theoretical abstraction based on his observations of the operation of grassroots government in the United States. He argued that real estate taxation is intertwined with local public services and that if individuals are fully mobile, information about local public budgets is fully disclosed, and there are no externalities in local public goods, residents can migrate to better living environments by "voting with their feet." This addresses differences in demand for public goods from different results and allows for the most efficient resource allocation of public goods [2,3]. Illustrated that the tax that links grassroots government revenues and expenditures and enables them to operate efficiently in the United States is the real estate tax. Showed that the interaction of zoning restrictions and real estate taxes allows for the distribution of public service costs among households in a jurisdiction to meet minimum standards and increase the efficiency of resource allocation [4]. In reality, many Organisations for Economic Co-operation and Development (OECD) countries and a few developing countries have introduced real estate taxes, which have a better impact on the financial security of grassroots governments and public governance. This is largely consistent with the analysis of the Tiebout-Oates-Hamilton models. In Tax by Design-a systematic study published by a team led on how various taxes should be designed—the design of real estate tax reform is considered from a purely economic perspective, without including any social considerations [5].

Since the late 1990s, a growing number of researchers from economics, sociology, and psychology have focused on studying the psychological factors that influence tax morale, that is, data on attitudes associated with willingness to pay taxes. For traditional economists, taxpayers are rational and tax compliance is simply a matter of taxpayers' perceptions of the costs and benefits of paying taxes seminal research paper on tax compliance also used this rational taxpayer model for analysis. However, for sociologists, tax compliance is largely a matter of whether taxpayers perceive that tax justice is achieved. In a summary, argued that a considerable body of research suggests that three key psychological influences are important in the tax issue: Procedural justice, equity theory, and perceptions of fairness [6,7].

Tax issues are always at the intersection of economic and social issues, and the study of tax issues rests on the fiscal sociological theory. Since pioneered the theory of fiscal sociology, tax issues have been intertwined with social issues. In The Crisis of the Tax State, indicated the enormous social power contained within taxation—"the kind and level of taxes are determined by the social structure, but once taxes exist they become a handle, as it were, which social powers can grip in order to change this structure." Conversely, if tax reform is uncoupled from the social environment and fails to achieve widespread taxpayer support, it is prone to failure [8].

Where is the difficulty of China's real estate tax reform? Chinese scholars commonly believe that from an economic perspective, the speed of building China's tax information base has rapidly increased since 2000 through big data management and analysis. The four-phase Golden Tax Project epitomizes the tax management system that covers the entire economic network [9]. Therefore, from a technical perspective of tax administration, should the real estate tax be modeled after that of the United States, tax management would not be difficult. The problem, however, lies in the difficulty of bridging social differences and reaching social consensus on real estate tax reform. According to an important characteristic of a strong state is its ability to collect taxes based on social consensus, and a high degree of social consensus combined with the strong tax collection ability constitutes a "consensually strong state.” research on China’s tax reform over four decades suggests that tax reform is undergoing a transformation from economic to social embeddedness, but the social embeddedness of tax remains extremely low and real estate tax reform can only be implemented upon the foundation of broad social consensus. This study uses a fiscal sociological analysis to examine the difficulties of China's real estate tax reform and breakthroughs for reform [10].

LITERATURE REVIEW

The social controversy of China's real estate tax reform

The theoretical basis of a real estate tax lies in model, which suggested that by levying real estate tax to finance grassroots public services, grassroots governments could meet residents' demand for differentiated public services, and thus, improve the efficiency of resource allocation for public goods. Moreover, revenue from real estate taxes is relatively stable and predictable, and does not affect the budget of local governments. Therefore, in many countries, real estate tax is an important source of revenue for local governments, especially because the cost of taxation is not high and there is relatively little tax resistance. Based on the taxation theory and its implementation in different countries, many scholars-especially those new to research on real estate tax-may conclude that it is an ideal tax that reflects the benefit principle, and may recommend that China promptly introduce it. However, an in-depth examination of the discussions on real estate tax reform in Chinese society reveals that it is the tax with the greatest divergence in opinions and these views have proven to be the most difficult to unify. Why should China introduce a real estate tax? Based on discussions on real estate tax in Chinese society over the past decade, there are four main perspectives, each with significant opposition.

Controversy 1: Can a real estate tax raise local revenue? Presently, the main sources of tax revenue of local governments in China are value-added tax and corporate income tax, with little contribution from local taxes. Fiscal principles state that local taxation of a mobile tax-base tends to stimulate competition among local governments, which is destructive to a unified market. Moreover, with the slowdown of China's economic growth and growth of fiscal expenditure needs, local governments in China are generally under tremendous fiscal pressure. The introduction of a real estate tax can supplement local fiscal revenues. However, opponents argue that even if a real estate tax is introduced, its revenue potential will be extremely limited because of its low tax rate. Among OECD countries, real estate tax accounts for a slightly higher proportion of tax revenue in the United Kingdom, the United States, and France, but only between 2.6% and 3%. The average of other countries is 1.1%, of which a significant part comes from taxing non-residential properties. In developing countries, the financing role of property taxes is even more insignificant. China's local governments have many roles and large expenditure needs, and the introduction of a real estate tax will have an extremely limited effect on supplementing the financial resources of local governments.

Controversy 2: Can a real estate tax regulate housing prices? Since the twentieth century, a few central cities in China have experienced a rapid rise in housing prices, and the introduction of a real estate tax may curb this trend. However, opponents argue that in the era of globalization, many countries in the world have experienced similar rapid growth in housing prices in central cities. Fluctuations in house prices are the product of land, population, and currency factors, rather than a real estate tax. Countries such as Japan and South Korea have introduced real estate taxes, yet the increase in housing prices has not been suppressed. As a local tax, the real estate tax must be designed with a low rate, and therefore, it cannot be expected to produce a dampening effect on housing prices, just as property fees in upscale communities have failed to control high housing prices.

Controversy 3: Can a real estate tax regulate property distribution? The current reality experienced by the Chinese public is that affluent individuals own multiple houses whereas the lower- and middle-class of society face significant financial pressure when it comes to buying a house. This stark contrast creates the illusion that introducing a real estate tax will make the rich pay more taxes and encourage them to sell their vacant houses, thereby improving the distribution of housing. However, opponents argue that as long as housing prices rise, or if rents are higher than taxes, home ownership is profitable and the effect on a tax on improving distribution is unlikely to be achieved. In fact, China's current tax law does not tax residents' rental income at a low rate. For example, Beijing stipulates that houses rented for less than 100,000 yuan a month be taxed on rent, with a total rate of 2.5%. Such a high tax rate has not played a role in regulating distribution, let alone a real estate tax. Conversely, as real estate tax is linked to public services, residents who are willing to enjoy better citizen services will choose to live in the same community. A high real estate tax rate may aggravate social stratification-an outcome to be avoided. The property tax in the United States has had this effect to some extent, with a clear distinction in public services provided between upscale and downscale residential areas.

Controversy 4: Can a real estate tax promote local governance? Proponents of a real estate tax argue that, according to Tiebout's model, a real estate tax can induce local governments to respond positively to taxpayers' public service demands and drive up the level of governance of China's grassroots governments [2]. However, opponents argue that after the introduction of the real estate tax, taxpayers, who experience a stronger pain of tax burden and have higher public service expectations, will harbor greater demands, such as the transparency of government budget, protection of taxpayers' rights, and quicker response to residents' demand for public services. If these demands are not met, residents may resort to tax evasion, tax resistance, or putting pressure on the government. While this is beneficial in forcing local governments to improve the quality of public governance, it is a potential flashpoint for social risks that must be carefully considered.

Owing to the significant controversy surrounding the goals and potential outcomes of real estate tax reform in Chinese society, it has been difficult to promote for nearly two decades and remains at the level of academic discussion.

The difficulty of reform: Conflict between social consensus and tax collection

In China, a vast majority of government officials and scholars believe that the future real estate tax should be a local tax. In countries around the world, it is common for real estate taxes to raise revenue for local governments and be linked to public services. However, the inherent requirement of the benefit principle of tax is that the value of real estate is closely related to its surrounding public services, and as no real estate can be separated from public services, all real estate should be taxed for public services-in other words, real estate tax should be a universal tax. However, in terms of societal acceptance in China, China's per capita GDP only recently surpassed 10,000 $USD, while the national per capita disposable income in 2020 was 32,188.80 yuan, reflecting the income insufficiency of many families. Furthermore, payment of the real estate tax is independent of the cash flow availability, which generates considerable tax burden. In current Chinese society, it is impossible to obtain taxpayers' consent without granting them certain tax deductions. The general social mindset is that if a real estate tax were to be introduced, it should be deducted according to the number of properties owned by residents or their area per capita; this mentality was reflected in the real estate tax pilot in Chongqing and Shanghai in 2011. Chongqing's property tax was mainly levied on high-end residential properties-that is, individually owned single-family commercial houses or newly purchased high-end houses-with three tiers of tax rates at 0.5%, 1%, and 1.2%. Shanghai's property tax pilot adopted two tax rates of 0.4% and 0.6% on local resident families who owned two or more properties, and the first house purchased by foreign resident families, with an exemption area of 60 square meters per person. However, these unique properties of real estate tax and their tax deductions for taxpayers will create significant distortions; so, many countries abstain from adopting such tax deduction measures.

First, is the first house for a family tax-exempt? The mainstream perception is that the first house owned will be tax-exempt; however, if the real estate tax is treated as a local tax, the operation of tax collection will be extremely difficult. For example, if a family owns properties in different cities, which house is considered the first property? If it is determined based on the time of registration of the property deed, the taxpayer can exploit property transactions to make the most expensive house the first house and, hence, tax-free. Moreover, if the real estate tax is a local tax, the location of the first home determines local tax sources, and local governments will compete for tax revenue from the first home.

Second, should the tax be deducted per capita area? It has been argued that real estate taxes should consider the basic housing needs of residents and be deducted on a per capita basis (e.g., 60 sq. m) such an approach is also highly impractical. Not only is it difficult to solve the problem of families having multiple houses in different areas as mentioned above, it will also lead to the distortion of the real estate market. A realistic loophole for taxpayers is to sell houses with large areas at low prices and buy houses with small areas at high prices. Furthermore, such a tax deduction also triggers new inequalities. For instance, as property prices in rich areas are higher than in poor areas, tax deduction based on area per capita is actually a tax cut for the rich.

A few scholars believe that real estate tax can be deducted per capita income, for instance, by deducting a certain amount from the real estate tax from local wages. Yet, this still does not solve the problem of off-site property holdings, and because wages do not represent total household income, deducting on a per capita income basis would be inequitable. Therefore, if the real estate tax is treated as a local tax and given a larger tax deduction, it will be difficult to operate in terms of tax collection, and it will not be effective if implemented.

The crux of the above discussion understands how to promote property tax reform based on social consensus. It is timely to reflect on Schumpeter's statement that, "At first the concession of taxes by no means implied a general tax duty", and "Tax liability on the basis of a majority decision, even more so general tax liability and a legally controlled distribution of the tax burden among lords and vassals all this came about but very slowly" [8]. China's real estate tax reform program needs to consider the acceptance of all segments of Chinese society and implement reforms progressively.

DISCUSSION

China’s real estate tax reform proposal to reduce social costs

Considering the social costs and level of tax collection and administration, I propose a two-step reform plan: In the short- to medium-term, a central tax design with selective taxation at progressive rates for regulation purposes; in the long term, a local tax design with universal taxation at proportional rates to promote local governance and raise fiscal revenue.

The core of the controversy about real estate tax focuses on the positioning of real estate tax, whether to regulate or raise revenue. Objectively, both functions cannot be achieved simultaneously and there needs to be a trade-off. According to the analysis above, the financing potential of real estate tax over time is quite discouraging, and the positioning of real estate tax reform should be for regulation. Since the regulation is on a national scale, in the short- and medium-term, the real estate tax is bound to be a centralized tax. However, the benefits of the real estate tax in promoting local governance and raising local revenue is undeniable, such that in the long run, it should be a local tax. First step of the reform design of property tax as a centralized tax. As a centralized tax, the design of a property tax is based on a narrow tax base and progressive tax rates. The approach is as follows:

First, a narrow tax base. The scope of taxation is 36 key cities across the country, and according to data from the national real estate network, the tax department can determine the property ownership status of each family and offer a certain tax deduction. For instance, a family may be able to deduct taxes for two or three properties, and only be taxed for per capita area exceeding a certain threshold (e.g., 60–100 sq m).

Second, progressive tax rates. The tax department, based on to the assessed value of the properties amenable to taxes and the time of registration of the property, can use progressive rates starting from 0.5%, with every 1% increment in tax rate representing a tier: 0.5%, 1.5%, 2.5%, and so on. As households hold an increasing number of properties, they pay increasingly more taxes. Their willingness to own excess property rapidly declines as the costs of holding a house exceed the benefits of holding it.

There are four benefits to having a property tax as a centralized tax

First, it will help reduce resistance to tax reform. A significant reason for the delay in launching the real estate tax is that it involves most households. A tax on the third or fourth house of a family will exclude the vast majority of families from the scope of the tax and concentrate the tax on a small number of families in the country. Families not subject to the tax will approve of it while it will be difficult for families subject to the tax to raise objections. Therefore, there will be much less resistance to reform at once.

Second, it is useful in rapidly calibrating housing allocation and avoiding property speculation. In general, when the tax rate exceeds 5%, families will feel that it is not worthwhile to hold on to their houses and will sell their extra houses, thus quickly adjusting allocation and curbing prices and lowering the cost of home ownership for young people. In particular, given China's declining fertility rate and aging population, the significance of reducing the cost of home ownership for young people in mitigating the decline in population growth cannot be underestimated.

Third, it is effective in boosting the real estate market as an economic driver. There are concerns that the introduction of a real estate tax will lead to a decline in housing prices, which, in turn, will lead to a contraction in demand in the real estate market. This downward pressure on the economy is not conducive for economic growth. However, there is no necessary relationship between falling house prices and shrinking demand for real estate, which comprises both speculative demand and residential demand. Implementing the real estate tax will suppress speculative demand while increasing residential demand, thereby boosting the real estate market. To make the reform easy to implement, the Central government can collect taxes and distribute the revenue to localities according to the tax source. Therefore, the tax is “local” only in name it actually functions as a tax rebate and can be referred to as local tax or transfer payment.

Second step of the reform: Designing the real estate tax as local taxes

A centralized property tax is the optimal choice in the current economic and social contexts, but it does not have to be immutable. Over time, when grassroots governments become more competent and public acceptance of real estate taxes increases, it may be timely to convert the real estate tax into a local tax and implement a universal levy. However, as a local tax, it is crucial to understand two characteristics: The significant tax burden and high expectations for public services. For example, residents will demand transparency in government budgets, protection of taxpayers' rights, and quicker response to their demands for public services. If these demands are not met, they may resort to tax evasion, tax resistance, or may put pressure on the government. On the bright side, it forces local governments to improve their public governance. On the other side, it is a potential flashpoint for social risks that must not be ignored. Therefore, it is still necessary to design reform proposals from both economic and social perspectives when converting to local taxes. I believe that the following two aspects have to be achieved.

First, building social consensus. The introduction of a real estate tax requires a broad national discussion through extensive grassroots discussions so that people can understand the real estate tax, their rights, and obligations; learn to compromise and make concessions; and become capable of collectively expressing their concerns through local assemblies. Concerns may include tying the property tax to a particular public good at the county level (education, healthcare, etc.) and to make the budget public, while making the tax affordable for most people without too heavy a burden. There could be an exemption policy for a few communities, like low-income individuals and the elderly.

Second, risk reduction. The issue to consider with any tax is the situation of taxpayers not paying taxes. Property tax involves millions of families, and some collection and payment conflicts will inevitably arise at the beginning of the tax collection. The Central government can set several basic standards, such as the tax base and tax-rate range, and leave other details to the city and county councils for discussion, allowing grassroots councils to decide a reasonable range of levy. Consequently, should there be tax resistance from taxpayers, they will engage with local groups, rather than the government. The two-step approach to real estate tax reform is an application of China's success in progressive reform in many other areas, as well as a more prudent tax design to mitigate social risks and reduce reform costs.

CONCLUSION

The introduction of a real estate tax for residents is a hotly debated and socially divisive topic in Chinese society. Ever since the Chinese government proposed the introduction of a real estate tax nearly two decades ago, its implementation has dragged on. There are four positions on the function of a real estate tax: Raising revenue, regulating high property prices, regulating property distribution, and promoting local governance. However, each position is fraught with controversy, and no social consensus on real estate tax reform can be formed. This study argues that the root of the problem lies in the fact that researchers generally design real estate tax reform proposals based on the fiscal decentralization theory and real estate tax practices around the world, without fully considering the social psyche of Chinese residents and the potential social costs and risks. Therefore, a fiscal sociology, rather than a purely economics approach, should be applied to real estate tax reform proposals, considering social consensus and the level of tax collection and management. This study proposes a progressive two-step reform plan for China's real estate tax reform: In the short- and medium-term, a centralized tax design with selective taxation at a progressive rate for regulation purposes; in the long term, a local tax design with universal taxation at a proportional rate to promote local governance and raise fiscal revenue. This reform proposal is optimal in being aligned with the actual situation of Chinese society and is likely to garner the support of most people.

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