Proceedings of the 2023 International Conference on Management Research and Economic Development
DOI: 10.54254/2754-1169/19/20230113

The Significance of Regional Tax Incentives in Creating Economic Profit Zones: A Case Study of Khorgos, Xinjiang, China

Jiali Tang[1,a,*]

[1]Nanjing Audit University Jinshen College, Nanjing, 210033, China
a. anastasiaans@icloud.com
**corresponding author*

Abstract: The government may use tax incentives to attract companies to register in an economically unbalanced region to boost the local economy and create an economic profit zone. Regional tax incentives can reduce costs and increase profitability, thus creating an economic profit zone. This paper examines the significance of regional tax incentives in creating economic profit zones by using Khorgos of Xinjiang, China as an example. The study concludes that the significance of regional tax incentives in creating economic profit zones lies in balancing and regulating the regional imbalance of development from within the country itself.

Keywords: regional tax incentives, profit zone, Khorgos, Xinjiang Province, preferential policies, enterprise

1. Introduction

Taxation is a standardized form of financial revenue that the state obtains compulsorily and without compensation in accordance with the law in order to fulfill its functions as well as providing public goods, meeting the common needs of society, and participating in the distribution of social goods by virtue of its political power. At the same time, taxation is an essential policy instrument, the economic lifeline of the country, and the foundation of the regime. It is of great significance to play the role of macroeconomic regulation of taxation, improve China's socialist market economic system, and promote the overall and healthy development of the economy. According to the law, taxation is a form of distribution and redistribution of national income, and the compulsory and uncompensated collection of financial income is a form of distribution. At the same time, a certain tax policy and regulation is a major decision to balance the economic development of all parts of the country. Most developed and developing countries have unbalanced economic development. The main reasons for this are not only the imbalance among developed countries, but also the fact that the consumer markets of developing countries are occupied by developed countries. The natural resources of developing countries are plundered by developed countries. Developing countries are economically controlled and politically intervened by developed countries. In other words, developing countries are not really independent economically and politically and are not very stable internally. People in developing countries are generally less educated than those in developed countries and they are relatively backward in terms of the scientific and technological level [1]. Tax

DOI: 10.54254/2754-1169/19/20230113

policy regulation plays a major role in this, as regional tax incentives are generally found in economically underdeveloped regions of a country, where tax incentives are used to balance regional economic development and create an economic profit zone to boost the economic development of lagging regions [2]. This is precisely what the state does to balance regional economic development while creating an economic profit zone that enhances the economic development of backward regions. This paper examines the significance of regional tax incentives in creating economic profit zones by studying Khorgos of Xinjiang, China, thereby helping address the unevenness of the country's regional development in this day and age.

2. Background Information

2.1. Regional Tax Incentives

regional tax incentives refers to the treatment of enterprises registered in the tax administration jurisdiction of a specific region through regional tax incentives, simplified tax collection and management methods, and tax land or rebates. It is a reasonable and legitimate tax incentive policy. At the same time, tax depots have many advantages: (1) they can enjoy regional tax incentives; (2) they can realize tax savings by using simplified tax collection and administration methods, which is to use the tax administration method of "approved levy" to establish a sole proprietorship or individual business in a tax park, that is, to use a fixed amount of approved enterprise income tax or a tax return; (3) tax savings can be achieved by using tax rebates from local tax retention, which is set aside by local governments in order to attract enterprises to move in and promote local economic development. In order to attract enterprises and promote their economic development, the local treasury of the region with tax incentives will set aside the retained tax fund for tax rebates to enterprises; (4) there are many different ways to enjoy tax incentives, for instance, applying for a branch office and enjoying the policy in the form of business diversion or setting up a new company and subcontracting the business to the tax haven after the original company receives it. In addition, it is also a good way to enjoy the approved taxation for a sole proprietorship, individual business, and partnership.

2.2. Economic Profit Zone

Economic profit, in general terms, is the difference between the item's revenue and its cost, the latter including the revenue that can be obtained from the most profitable use of another item's resources. The difference between the net assets at the end of the period and the net assets at the beginning of the period, excluding the factors of the owner's investment and distribution to the owner, is professionally speaking. Under the economic profit concept, profit is calculated by valuing an enterprise's closing net assets and comparing them to their opening value, but transactions with owners must be excluded from the calculation. In formula terms, economic profit = (return on capital invested - weighted average cost of capital) * amount of capital invested, which can be expressed as the return on capital invested minus the cost of capital, multiplied by the amount of capital. The economic profit zone is the area of economic activity that, in the case of a company, brings a high level of profit to the company. This profit is not an average profit, a profit that changes periodically, or a profit that is short-term; in the profit zone, a sustained and high level of profit will bring great value to the company [3].

3. Tax Incentives in Khorgos, Xinjiang

Combined with the above explanation of what regional tax incentives and economic profit zones are, it is easy to see that regional tax incentives are favorable conditions for creating an economic

DOI: 10.54254/2754-1169/19/20230113

profit zone, which can save tax for a long time to reduce costs and create a new economic profit zone for an enterprise. With the rapid development of China's economy in recent years, there are more and more large conglomerates and some enterprises take advantage of preferential transactions to shift profits from the enterprises that are subject to 25% tax rate to the enterprises in the region with tax incentives [4]. In order to promote balanced regional economic development and create economic profits of greater value, the state has introduced many regional tax incentives, such as the "Notice on the Application of VAT Refund (Exemption) Policy for Goods Entering the China-Harbin Khorgos International Border Cooperation Center" issued in 2015, and the "Notice on Improving Preferential Corporate Income Tax Purposes for Key Encouraged Development Industries in Difficult Areas of Xinjiang" issued in 2016, and the "Notice on Preferential Corporate Income Tax Policies for Two Special Economic Development Zones in Kashgar Korgos, Xinjiang" issued in 2011. As can be seen, the most typical representative is the city of Khorgos in Xinjiang Uyghur Autonomous Region of China, where the Xinjiang government has introduced tax incentives mainly in the form of five exemptions and five halves reductions, i.e. the income tax of enterprises is exempted for the first five years and reduced by 50% for the next five years, and the income tax of enterprises in areas related to the development of capital cities is reduced by 15%. This paper uses the tax payable by Beijing Hongfu Grid Technology Co., Ltd. registered in Chaoyang District as an example.

(1). 3.75 million yuan in income tax paid in 5 months=50 million yuan*30%*25%

(2). 3 million yuan VAT paid in 5 months=50 million yuan*6%

(3). 5 months to pay additional tax of 360,000 RMB=3 million RMB*12%

The total tax paid is 375+300+36=7.11 million.

In order to benefit from the "Five Exemptions and Five Reductions" policy for enterprise income tax in Xinjiang Khorgos Economic Development Zone and reduce the operating costs, the company moved to Xinjiang Khorgos Economic Development Zone in May 2016, with business revenue of RMB 50 million in July, profit margin of 30%, income tax exemption, VAT rate of 6%, and additional taxes (VAT of 12%, including urban construction tax of 7%, education surtax of 3%, and local education surtax of 2%).

(1). 7 month corporate income tax exemption, which alone saves RMB 3.75 million in operating costs.

(2). 3,000,000 RMB = 5,000*6% and 1,500,000 RMB retained by the local government (50% of VAT) in July.

(3). 7 months to pay the additional tax 360,000=300*12% and the additional tax is fully retained by the enterprise to pay 3.36 million yuan, the local retained part is 1.86 million yuan.

(4). The financial incentive subsidy 279,000 yuan=186*15% of the actual enterprise tax 3.081 million yuan=336-27.9

7,110,000-3,081,000=4,092,000 RMB, which means that the company paid 4,092,000 RMB less taxes than Beijing by moving to Khorgos Economic Development Zone. From this case, there is no doubt that it is a favorable condition for enterprises to reduce costs for a long time and increase profits and for the local government to attract a large amount of investment and economic growth. It is also concluded that regional tax incentives and economic profit zones are complementary, and regional tax incentives are favorable conditions for creating economic profit zones.

4. The Significance of Tax Dpressions in Creating Economic Profit Zones

In summary, an economic profit zone created by regional tax incentives is significant, both for a company and for a region, and it is important to separate the two first.

DOI: 10.54254/2754-1169/19/20230113

4.1. The Significance of Economic Profit Zones

Economists argue that normal profits are the reward for entrepreneurial talent while excess profits exist in dynamic and non-perfectly competitive markets, where the innovation, risk, and monopoly factors that generate excess profits are constantly in flux, thereby driving social progress. First, the high or low level of normal profits reflects the entrepreneur's contribution to the firm, and the existence of profits promotes better management of the firm and greater economic efficiency. Second, because profits can be realized through innovation, they drive social progress by motivating firms to engage in various forms of innovation. Third, excess profits are derived from the benefits of risk-taking, which in turn encourages entrepreneurs to take on risky investments that benefit society. Fourth, the goal of business is to make excess profits, and the pursuit of profits by enterprises leads to a continuous reduction in production costs and the efficient use of resources. Fifth, profit is achieved through market exchange, and in order to make profits, enterprises must produce the products that society needs. In this way, social resources can be optimally allocated.

Economic profit is the value of the portion of the enterprise's return on invested capital in excess of the weighted average cost of capital, or the portion of the enterprise's future present metal flows that have a present value greater than zero when discounted at the weighted average cost of capital. The formula is as follows: Economic profit = (return on invested capital - WACC) * total invested capital. As early as 1890, the economist Alfred Marshall mentioned in his book Principles of Economics that "the remainder of the owner's or manager's profit, after deducting the interest on capital at the present rate, may be called operating profit or management profit". Marshall states that "the value created by a company in any period must take into account not only the expenses recorded in the accounting books, but also the opportunity cost of the capital employed in the business [5]." Traditional accounting profit precisely ignores the need for capital and the cost of capital. Economic profit eliminates the disadvantage of traditional accounting that depletes shareholders' capital costs without compensation by requiring the deduction of the cost of resources used, including the cost of owner's equity capital. As explained earlier, economic profit zones are enterprise-based. Once the economic profit mentioned above is raised, the cost of an enterprise is effectively reduced, and the entire enterprise's metallurgical operation is enhanced. Ultimately, profit is the basis for the sustainable development of a company, and how to obtain more profits with the least costs is essential for shareholders to continue to operate the company [6].

4.2. The Significance of Regional Tax Incentives

First of all, when an enterprise is located in a tax incentive park, it will enjoy local tax incentives and pay its taxable income to the park government, which will increase the local financial income and promote local economic development. Secondly, the increase in the number of enterprises in the park will also increase the number of local industries, which will facilitate the development of the local economy and promote the upgrading of the local industrial structure. Thirdly, the presence of enterprises in the area will lead to a rapid increase in the total number of local industries, which will enable the local economy to activate rapidly and accelerate the upgrading of the regional industrial structure. Fourthly, the presence of enterprises in the area can help solve the problems of the bankruptcy of entrepreneurs, reduction of jobs, and increase of unemployed people during the economic depression under the epidemic.

So far, most of the investment in China is done by enterprises. In general, the tax that directly affects the cost is the corporate income tax, so the analysis focuses on the impact of the corporate income tax on investment. The corporate income tax can influence the investment decisions of enterprises in two ways: first, by taxing the marginal income of investment, thereby lowering the marginal income of investment and discouraging investment; second, by allowing certain capital cost items to be deducted, resulting in "tax savings" and lowering the cost of investment and encouraging investment. Thus, all else being equal, any tax measure that raises the cost of investment will discourage investment, while any tax incentive that lowers the cost of capital will stimulate investment [7].

The impact of taxes on investment can be illustrated by using the standard theoretical model of investment costs in economics. In the case of a government-imposed corporate income tax, the determinant of a firm's investment costs is:

$$\mathrm{c} = \mathrm{q}(\mathrm{r} + \delta)(1 - \mathrm{uz} - \mathrm{uy})/(1 - \mathrm{u}) \tag{1}$$

where c represents the cost of investment, q represents the price of capital goods, r represents the market interest rate, δ represents the depreciation rate, u represents the corporate income tax rate, z represents the present value of future depreciation deductions for capital worth $1, and y represents the present value of interest deductions for capital worth $1. If (1-uz-uy)>(1-u), or (z+y)<1, then the corporate income tax is considered a disincentive to investment; if z+y > 1, the corporate income tax will have the effect of promoting investment; if z+y=1, i.e., the present value of the depreciation and interest deductions for $1 worth of capital is equal to $1. If the present value of the deduction is equal to $1, then the corporate income tax will be neutral [8].

The impact of the corporate income tax on investments also depends on two special measures allowed for tax purposes. (1) Direct write-off. If the investment is written off as an expense deduction without an interest deduction once it is created, then the corporate income tax will be neutral. This is because a direct write-off of the investment means that z=1 and no interest deduction means that y = 0, which satisfies the condition that x+y=1. (2) Actual depreciation and interest are fully deductible. If the tax system allowed corporations to depreciate the full value of their capital stock at actual depreciation and allow interest deductions, then the corporate income tax would also be neutral. If depreciation is allowed at the rate of δ in contrast, the present value of depreciation for $1 worth of capital is:

$$\mathrm{z} = \Sigma(1 + \mathrm{r})[-\mathrm{t}]\delta(1 + \delta)[-\mathrm{t}] = \delta/(\mathrm{r} + \delta) \tag{2}$$

Similarly, as long as capital is depreciated at a rate of δ in contrast to the rate of interest, and interest deductions are also allowed, the present value of interest deductions for $1 worth of capital is:

$$\mathrm{y} = \Sigma(1 + \mathrm{r})[-\mathrm{t}]\mathrm{r}(1 + \delta)[-\mathrm{t}] = \mathrm{r}/(\mathrm{r} + \delta) \tag{3}$$

Therefore, z+y=(δ+r)/(r+δ)=1 and the investment cost is reduced to q(r+δ). In simple terms, it can be said that profit after tax (i.e. net profit) is a very important economic indicator. For investors, net profit is a fundamental factor in obtaining a small return on investment, and for managers, it is the basis for management decisions. It is also a basic tool for evaluating the profitability, management performance and solvency of an enterprise, and a comprehensive indicator that reflects and analyzes the multi-sided situation of an enterprise. Net profit is the final result of an enterprise's operation. If the net profit is high, the operating efficiency of the enterprise is good; if the net profit is low, the operating efficiency of the enterprise is poor, and it is the main indicator to measure the operating efficiency of an enterprise. It is the main indicator of an enterprise's business efficiency. Regional tax incentives attract enterprises to register to drive local economic development. Once a company enters a region with tax incentives, there are many ways to enjoy the benefits. For example, it is possible to enjoy the policy in the form of business diversion from the branch to the tax; it is also possible to establish a new company and subcontract the business received by the original company to the company in the region with tax incentives to achieve tax savings; there are also forms such as the relocation of registered address, all of which are possible; in addition, it is also a good form for

DOI: 10.54254/2754-1169/19/20230113

a sole proprietorship, self-employed business, and partnership to enjoy the approved levy. Tax incentives are the reason why enterprises choose to register their businesses in these regions [9].

5. Conclusion

Combining the meaning of economic profit zones with that of regional tax incentives, companies can boost the economic growth of the regions with tax incentives. From a broader perspective, the study of the significance of regional tax incentives in creating economic profit zones is a favorable measure to solve the imbalance of a country's regional development, and from a smaller perspective. It is also a favorable springboard for the development of an enterprise, giving the most lenient tax incentives to an enterprise at the most difficult stage of its initial capital, so that the development costs of an enterprise are reduced and more funds are available to plan the development of the company, and the local government is able to attract foreign enterprises to invest and increase local tax revenues. It is also an effective policy for the local government to attract foreign enterprises to invest and increase the local tax revenue, regulate the income gap between the rich and the poor, promote employment equity, help optimize the industrial structure, stimulate the local supply-side structural reform, and increase the number of jobs. It is also a favorable measure for national unity between enterprises and local governments and the country and the regions to develop a mutually beneficial and win-win partnership. As an example, the tax incentives implemented by the local government in Xinjiang Khorgos, China, have attracted enterprises to register and invest in the region by issuing more favorable tax policies than other regions, which has not only boosted local economic growth but also supported most of the enterprises registered in the region, while creating economic profit zones that are conducive to the continuous development of local governments and enterprises.

References

[1] Riccardi, L., Ricardi, G.: China-Europe Tax Treaties Selected Tax Treaties and International Taxation, 49 (2022).

[2] Pisacane, G.: Corporate Governance in China The Structure and Management of Foreign-Invested Enterprises Under Chinese Law Part of the book series: China Law, Tax & Accounting (CLTA). General Manager, 75-78 (2017).

[3] Zhang, W. Q.: Economic analysis of the profit zone of a company. Jilin University (2005). https://kns.cnki.net/KCMS/detail/detail.aspx?dbname=CDFD9908&filename=2005107185.nh.

[4] Devonshire-Ellis, C., Scott, A., Woollard, S.: The China Tax Guide. Front Matter, China’s Business Taxes, 7-32 (2011).

[5] Marshall, A.: Principles of Economics. Palgrave Classics in Economics. Palgrave Macmillan London. 1-11 (2013). DOI: https://doi.org/10.1057/9781137375261.

[6] Slywotzky, A. J., Morrison, D. J., Andelman, B.: The Profit Zone: How Strategic Business Design Will Lead You to Tomorrow's Profits, Chapter 11 (2010).

[7] Schertler, A.: The Venture Capital Industry in Europe part of the Palgrave Macmillan Studies in Banking and Financial Institutions book series (SBFI), 42-75 (2006).

[8] Wu, Y. F., Liu, F. L., Wu, H. H.: Western Economics, 750 (2002).

[9] Damarackas, J., Šiaulys, J.: A note on the net profit condition for discrete and classical risk models. Lith Math J 55, 465-473 (2015). https://doi.org/10.1007/s10986-015-9292-x.