

JOURNAL OF CHINESE TAX & POLICY

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THE COMING OF AGE OF ENTERPRISE TAXATION IN CHINA
NATALIE STOIANOFF

CHARACTERISTICS OF THE CHINESE TAX SYSTEM AND ITS CULTURAL
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REAL ESTATE TAX OF THE PRC — AN ANALYSIS OF THE EFFECTIVENESS
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LUO YANG

税



THE UNIVERSITY OF
SYDNEY

JOURNAL OF CHINESE TAX & POLICY

ABOUT THE JOURNAL

The importance of China on the global economic stage cannot be ignored, and its unique legal and tax systems are of great interest to international scholars and business people alike. China's tax system is acquiring western features while remaining entrenched in its rich cultural and historical roots. This makes for interesting study, analysis and comparison as its laws are becoming more accessible.

The Journal of Chinese Tax & Policy focuses on the policy, administrative and compliance aspects of the Chinese tax system. It also welcomes comparative studies between China and other countries.

The Journal is an internationally peer-reviewed scholarly publication. For Australian authors, this publication satisfies the description as a refereed journal in the current Department of Education, Employment and Workplace Relations (DEEWR) categories.

Contributions are welcome and should be submitted in a Microsoft Word document to the editor. The Journal publishes both full Articles (between 3,000 to 12,000 words), as well as shorter Comments addressing current issues of Chinese tax and policy (usually about 2,000 words, and no longer than 4,000 words).

Articles are double-blind peer reviewed. Comments are reviewed by the editorial board. An abstract of no longer than 300 words must be included at the head of articles.

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FOREWORD

The Journal of Chinese Tax and Policy was born in an interesting era, where China is experiencing rapid changes which the west is able to understand. Taxes of a country give us an insight into the business and legal environments of the country. The journal will play an important role as the bridge to understand the taxes and related policies in China, adding to a scarce but growing literature for the benefits of both scholars and businesses. It will also open a window to China, once a land with many secrets, now our neighbour.

Dr Tyrone M Carlin
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《中国税收与政策》诞生在一个辨识的时代，这个时代的中国正在经历着西方可以理解的快速的改变。税引领我们探索一个国家的商业和法律环境。这个刊物将建立理解中国税及政策的桥梁；将补充现有稀缺而正在增长的研究。既有益于学者，也有益于商界。同时，它将打开一扇面对中国 - 一个曾经神秘的国土，现在我们的邻居-的窗户。

Dr Tyrone M Carlin
财经法规与财务报告讲座教授
悉尼大学商学院代理院长

《中国税收与政策》是在中国以外创办的第一本专门研究中国税收问题的杂志。中国经济总量越来越大、而且国际化程度日益提高，中国的税收问题必然受到国际社会的关注。有了这样一本杂志可以让全世界关注中国税收制度和政策的学者、税务官员、律师、企业管理人员、税务咨询和筹划工作者、以及大学的学生有一个了解、研究中国税收问题的集中平台。由于受文化、历史、政治和中国内部区域间经济发展巨大差异等因素的影响，中国的税收法律制度、政策和实行存在不少特点，具有鲜明的国家特征，存在一些只有在中国存在的特殊规律。只有系统地了解了这些特殊方面，才能全面把握中国税收制度和政策的内涵。我希望这本杂志成为中外税务专家交流合作的平台、成为海外税务专家及时了解中国税收发展变化的窗口、成为探索研究中国税收特殊规律成就高深学问的阵地。我衷心希望这本杂志创办成功！

--杨斌博士，闽江学院校长、厦门大学王亚南讲座教授

The Journal of Chinese Tax and Policy is the first journal published outside of China that focuses on Chinese taxation issues. Along with the rapid growth of China's economy, as well as its increasing degree of internationalisation, tax issues in China will consequentially attract worldwide attention. This journal can provide scholars, tax officials, lawyers, business managers, tax consultants and planning workers, as well as university students around the world who are interested in Chinese tax with an integrated platform to understand and study Chinese tax issues. Due to factors such as culture, history, politics and the significant disparity of economic development between different regions in China, China's taxation system, policy and their implementation have numerous features, with distinctive national characteristics, and special rules that solely exist in China. Only when these specific areas are systematically comprehended will the connotations of the Chinese taxation system and policy be fully appreciated. I hope this journal will become a platform for the exchange and collaboration between Chinese and foreign taxation experts, a window for overseas taxation experts to keep up with China's taxation development and changes, and a medium to explore and study the special tax rules in China and pursue meaningful discourse. I extend my best wishes to the journal.

Dr Yang Bin, Vice Chancellor, Minjiang University, WANG Yanan Professor of Xiamen University

China's shift from a communist to 'socialist market' economy has been accompanied by the evolution of taxation from a truly trivial distraction to the mainstay for Chinese public finance. The legacy of socialist views remains, however, as the country attempts to balance the views of those favouring a neutral tax system supporting a distortion-free market and those who see taxation as another tool for central command over market directions. The Journal of Chinese Tax and Policy is poised to play a valuable key role in the continuing debate over the role and design of taxation in China.

Professor Rick Krever

Director, Taxation Law and Policy Research Institute, Monash University

中国由共产主义经济到“社会主义市场经济”的转变伴随了税作为实际操作中的皮毛干扰到财政学的主要重心的进化。社会主义观点的遗产保留着。但这个国家尝试着去平衡：--赞成中性税收系统用以支撑一个无扭曲的市场之观点；---赞成将税作为中央调控市场方向的手段之观点。《中国税收与政策》准备好了在这场中国税设计与职能的持续辩论中扮演有价值的角色。

Rick Krever

教授

莫纳什大学税法与政策研究所所长

Congratulations on the great birth of the Journal of Chinese Tax and Policy! This is the first academic journal specifically concentrating on Chinese tax policy and law outside of Chinese territory. The merger of VAT and business tax has started the process of being trialed, the reform of real estate tax has caused considerable controversy, preferential tax treatments for foreign investors face new adjustments, etc. Herein, tax legislators will need wisdom and taxpayers will express their concerns. We often say in China, 'the onlookers see most clearly', so more academic support is greatly needed in China. This is the best time not only for China's tax scholars, but also for any world tax scholars studying Chinese tax. Consequently, in the second half of 2012, as a sponsor, my university will host the First International Conference of Chinese Tax and Policy jointly with the University of Sydney.

Dr Xiaoqiang Yang,

Professor of Tax Law, Sun Yat-sen University School of Law

祝贺《中国税收与政策》的诞生！这是中国境外第一本专注中国税政策的学术刊物。增值税与营业税的合并开始了新实验的过程；房产税的改革引发了众说纷纭的论争；海外投资者的税优惠也面临新的变化……因此，立法人需要智慧，税人将提出要求。古人云，旁观者清，中国急需众多的学术支持。当前状况不单只对中国税学者而言是好时机，同时也是国际税学者研究这个国家的最佳时机。在2012年的下半年，作为承办者与合作者之一，我们的大学将与悉尼大学共同举办首届中国税收与政策国际研讨会。期盼着与本刊的作者读者们会面。

杨小强博士，中山大学法学院税法教授

China's transformation since Deng Xiao Peng re-engaged China with the international community in 1978 has been as impressive as it has been rapid. The massive economic and legal reforms which have been put in place over the last three decades, and the fundamental social changes which have resulted from the reform process, have of course had a massive influence on China's 1.3 billion population but are also of increasing significance to the international community. China recently overtook Japan to become the world's second largest economy, and the laws and policies which drive its relentless development are of increasing significance to its trading partners. Taxation is, in the new China, a key ingredient of its economic infrastructure, a better understanding of which is the mission of the Journal of Chinese Tax and Policy.

Andrew Terry

Professor of Business Regulation and

Chair of Discipline, Business Law, The University of Sydney Business School

中国于1978年邓小平的领导下与世界重新接轨，期间的转变迅速且令人赞叹。过去三十年巨大的经济、法律改革，和其过程中的根本社会变化，必然会对中国的十三亿人口造成深远影响，对国际社会的重要性更日益增长。中国最近超越日本成为世界第二大经济体的地位，它的法律及政策都促使其不断发展，并对它的贸易伙伴影响渐增。税是中国经济架构中的一重要成份，对其进一步理解是《中国税收与政策》的目标。

Andrew Terry

商业法规讲座教授，

悉尼大学商学院商业法系主任

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EDITORIAL

Welcome to the inaugural issue of the **Journal of Chinese Tax and Policy**. The Journal aims to provide a forum in the English language that focuses on taxation in China. It publishes scholarly works on the policy, administrative and compliance aspects of the Chinese tax system and also comparative studies between China and other countries.

The theme of this issue is Tax Policy in China within its Unique Cultural and Economic Environment. The first paper by Stoianoff explores the theme from an economic perspective. It traces the historical development of the enterprise taxation system in China since the Open Door Policy to the unified regime for both domestic and foreign-owned enterprises that commenced operation on 1 January 2008. The paper argues that the development of the enterprise taxation regime and the introduction of a uniform and modern enterprise taxation regime reflect the maturity of China's economy, and the increasingly important role of domestic enterprises in the world economy which dictates the need to ensure fair competition between domestic and foreign-owned enterprises.

In the next paper, Bin and Huang explore the theme further, providing an overview of the Chinese tax system from a cultural perspective. The paper analyses the main characteristics of the Chinese tax system with a focus on the cultural differences with western-developed countries, aiming to facilitate a better understanding of the Chinese tax system.

The paper by Yang examines a more specific issue: the trial implementation of the Real Estate Tax in Shanghai. It analyses the effects of the tax on the demand for housing and housing prices. It also identifies a few reform options for the government to implement the tax as a policy tool to control housing prices.

We would also like to thank the following experts for their interest in the journal and their helpful suggestions to bring it to fruition:

Mr Xiuwen Liu, Director General, The General Office, The Budgetary Affairs Commission, The Standing Committee of The National People's Congress, People's Republic of China

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EVA HUANG AND ANTONY TING

The Coming of Age of Enterprise Taxation in China

NATALIE P STOIANOFF

This article commences with a brief historical overview of the taxation system in China and provides a context for the key elements relevant to foreign enterprises since the Open Door Policy. The unified taxation of domestic and foreign-owned business enterprises recognises the maturity of China's economy and the greater role that domestic enterprises are playing in the world economy and, consequently, the need to ensure competition is on a level footing. However, the primary concern of this article is to provide an analysis of the 'principles based' unified enterprise income tax regime that commenced operation on 1 January 2008 together with its implementing regulations. This analysis reinforces China's integration of western tax concepts albeit in a much simplified manner than most economically-developed regimes. However, the unified regime does pave the way for China to utilise the benefits of that unification to enable development of better wealth distribution throughout the nation and thereby enhance economic development.

This article also demonstrates that domestic businesses were at a disadvantage before this unification and that disadvantage led to behaviour that sought to circumvent the disadvantage by utilising the loopholes available between the Domestic and Foreign Enterprise tax rules. The article concludes that this reform is as much an attempt at ensuring competition is equal between domestic and foreign sectors of the Chinese economy as it is about dealing with tax avoidance. The introduction of specific and general anti-avoidance measures is evidence of this dual purpose. It is perhaps too early to judge the performance of this new regime, but once the grandfathering arrangements come to an end, the true impact of the unified Enterprise Income Tax Law will become apparent.

INTRODUCTION

The first decade of the century has seen some significant progress in establishing the People's Republic of China (China) as an economic power of global proportion. Key to that progress has been China's push toward membership of the World Trade Organisation (WTO), achieved in late 2001, and the ongoing structural and legal reforms that followed. Part of that progress is illustrated by China's use of the taxation regime as a tool of social and economic change. In the early days of the Republic, namely the Maoist era, the emphasis was on moving the means of production out of private hands and into the hands of the State. Then with the leadership of Deng Xiaoping came the 'Open Door Policy' enabling China to engage with the world and encourage foreign investment in order to develop a socialist market economy. Toward the end of the last decade, the focus has been upon bringing balance into the system. The decision to unify the domestic and foreign corporate/enterprise income tax systems is recognition that domestic business has come of age and the need to artificially encourage foreign investment is no longer a priority. Further, it is in keeping with China's responsibilities under the WTO Protocol on the Accession of the People's Republic of China¹ requiring conformity with GATT 1994, namely moving toward a neutral tax regime.

This article commences with a brief historical overview of the taxation system in China and provides a context for the key elements relevant to foreign enterprises since the Open Door Policy. The unified taxation of domestic and foreign owned business enterprises recognises the maturity of China's economy and the greater role that domestic enterprises are playing in the world economy and, consequently, the need to ensure competition is on a level footing.² However, the primary concern of this article is to provide an analysis of the 'principles-based' unified enterprise income tax regime that commenced operation on 1 January 2008 together with its implementing regulations. This analysis reinforces China's integration of western tax concepts albeit in a much-simplified manner than most economically-developed regimes. However, the unified regime does pave the way for China to utilise the benefits of that unification to enable development of better wealth distribution throughout the nation and thereby enhance economic development.

HISTORICAL OVERVIEW OF THE TAXATION SYSTEM IN CHINA

In the early stages of the planned economy of the Peoples' Republic of China, the taxation system was utilised as a mechanism to shift ownership of business and industry out of private hands and into State-owned Enterprises (SOEs).³ This 'socialist transformation of ownership' resulted in the elimination of the private ownership of the means of production by applying the highest taxes against such private enterprises and taxing the State-owned enterprises the least.⁴

First, the Principal Rules for Implementation of the National Tax Administration were promulgated in January of 1950 and established a unified system of taxation with 14 categories of taxation in addition to the existing agricultural tax.⁵ These taxes were a combination of property taxes, income taxes, consumption and sales taxes. Specifically they were the industrial and commercial business tax, the commodity or product tax, the deposit interest income tax, the salt tax and cotton tax, stamp duty, the transaction tax, real estate tax, land tax, slaughter tax, special consumption behaviour tax, vehicle and vessel licence tax, and two further taxes that were not implemented, namely, the employment income tax and the inheritance tax.⁶

Then in 1953, the tax system was simplified as the economy represented by SOEs grew resulting in further reform in 1958 with the number of taxes being rationalised to 11.⁷ The Consolidated Industrial and Commercial Tax was the most significant and consolidated all turnover taxes. Meanwhile, the Industrial and Commercial Income Tax was also established, taxing collectively and individually-owned enterprises, marking the introduction of the first enterprise income tax.⁹ SOEs continued to provide their profits to the State moving from the enterprise bonus system to the profit-contracting system enabling such enterprises to retain a proportion of their profits.¹⁰ The bonus system was reintroduced during the Cultural Revolution as such retention of profits was considered to resemble capitalism too closely.¹¹

The tax system was further simplified after the Cultural Revolution resulting in eight different taxes after the reforms of 1973.¹² Not only were the taxes consolidated and simplified but the collection mechanism was also simplified.¹³ SOEs were only liable to pay the Industrial and Commercial Tax while collective enterprises were liable for both the Industrial and Commercial Tax and the Industrial and Commercial Income Tax.¹⁴ Even so, the vast proportion of State revenue came from the SOEs prior to the economic reform of 1979.¹⁵

The beginning of the Open Door Policy in late 1978 represented the establishment of China's new socialist market economy. One part of that policy was focused on the opening up of China to the rest of the world while the other part sought to reform the economic system from within.¹⁶ A major element of this process was the encouragement of foreign investment. The implications for the tax system were two-fold. First, if foreign investors are to carry on business in China they ought to be paying taxes on their profits in China.¹⁷ Second, the foreign investment enterprises were to be managed autonomously and not form part of the centrally-planned economy; accordingly, a separate tax regime was necessary for such foreign investment.¹⁸

The period 1979 to 1993 saw significant change in the fiscal system in China. The economy was restructured to include privately-owned enterprises and collectively-owned enterprises in addition to the state-owned enterprises.¹⁹ The state-owned enterprises progressively moved away from having to surrender their profits to the state to paying income taxes instead and retaining the balance of their profits for expansion and to better reward employees.²⁰ The surge in Chinese-foreign jointly owned enterprises required the adoption of taxation laws applicable to foreign entities and individuals and by 1993, there were 32 different taxes on commerce and industry. Ho divides these taxes into five groups: taxes applicable to foreign entities and individuals, turnover and resource taxes, domestic enterprises income taxes and domestic individual income taxes, and the 'catch-all' wealth and behaviour taxes.²¹ Those taxes applicable to foreign investment enterprises initially corresponded with the different forms of enterprise. From 1980, the Chinese-Foreign Joint Venture Income Tax Law taxed the income of Chinese-Foreign Equity Joint Ventures, while from 1981, the Foreign Enterprises Income Tax Law taxed the income of Chinese-Foreign Co-operative Joint Ventures and Wholly Foreign-owned Enterprises.²² These tax regimes provided the necessary preferential tax treatment to compensate for the poor investment infrastructure available to foreign investors during the early stages of the Open Door policy.²³ In addition, further preferential tax treatment was available to foreign investors according to their location, such as being in specially designated Special Economic Zones (SEZs), or the nature of industrial projects in which they were engaged.²⁴

Foreign individuals earning income in China during this time were also subject to tax. The Individual Income Tax Law of 1980 dealt with foreign individuals working in China while the Individual Income Regulatory Tax Law applied to local Chinese from 1986. Meanwhile, turnover taxes still applied during this period. The Industrial and Commercial Tax remained in force until 1984 when it was split into two separate regimes. One regime was applicable to foreign investment enterprises and called the Consolidated Industrial and Commercial Tax while the other regime comprised a new suite of four separate taxes applicable to domestic enterprises. These new turnover taxes were the Value Added Tax, Product Tax, Business Tax and Resource Tax.

This period of over a decade from the time of opening up China's economy saw immense growth.²⁵ By 1993, the Chinese economy increased ten times, a rate not to be matched even in the significant wealth-producing period that followed.²⁶ Foreign direct investment steadily increased during the first decade but then exploded during the 1990s and into the current century.²⁷ It is at the beginning of the 1990s that the two tax regimes dealing with foreign enterprises were streamlined into a uniform system, the Income Tax Law of the People's Republic

of China for Enterprises with Foreign Investment and Foreign Enterprises 1991. This unified regime provided better certainty and stability to investors.

Then in 1994, a new taxation regime designed to implement 'new macroeconomic controls' came into effect. While the Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises of 1991 remained in force, the regime affecting domestic enterprises was streamlined into the Provisional Rules of People's Republic of China on Enterprise Income Tax and resulted in a lowering of the tax rate to equal that applied to foreign investment enterprises, namely 33 per cent comprising 30 per cent national tax and a 3 per cent local tax.²⁹ While this exemplified the need of the central government to take greater control of tax revenues in order to deal with the increasing disparity in wealth, infrastructure and services between the eastern provinces and the western provinces, the reality was that a revenue sharing formula was put into place effectively splitting the revenue raised 50:50 between the provincial and central governments.³⁰

However, during this period, arguably the most significant reform was the restructuring of the turnover taxes into a regime applicable to both domestic and foreign enterprises alike.³¹ These included a Value Added Tax, Business Tax and Consumption Tax with the 1984 Consolidated Industrial and Commercial Tax applicable to foreign entities and individuals being repealed. Simultaneously, the regime dealing with income tax levied on individuals was reformed covering domestic and foreign individuals and introducing a residency element to the criteria for determining individual tax liability.

Both the Ministry of Finance³² and the State Administration of Taxation³³ (SAT) play their respective roles in developing taxation policy and administration in China. The SAT particularly has the role of drafting taxation laws and regulations and, in addition, is the primary 'operational unit for the administration and implementation of tax laws' in China.³⁴ Both organisations are empowered to interpret the laws and regulations including by issuing circulars, rulings and notices, however, this role tends to fall within the primary responsibility of SAT.³⁵ Sub-bureaus of SAT are found in the provinces, regions and cities and, together with the local tax bureaus, administer the tax laws including processing the tax returns and collecting taxes.³⁶ The SAT has a Commissioner and four Deputy Commissioners, a Chief Accountant and Chief Economist.³⁷ In addition, a Chief Supervisor is assigned by the CPC Central Committee for Discipline Inspection.³⁸ Such a structure is not unusual but rather illustrates the transplant of taxation regimes from China's western counterparts. Where the difference with China's western counterparts does lie is in the way the local offices operate and interact which, in the early days of the new socialist market economy, led to China's wealth concentrating in the eastern provinces that attracted

greater foreign direct investment and leaving the western, more remote, provinces starved of infrastructure, services and capital.³⁹

More than a decade later, China finally addressed the inequity of the divided enterprise income tax system by unifying the treatment of domestic and foreign owned enterprises under a residency and source-based income tax regime. This came after a relatively long consultation process and with the backdrop of the removal of the agricultural tax as part of ‘China’s drive to “build a new socialist countryside”’.⁴⁰ Part IV of this chapter provides an analysis of this unified system after Part III outlines the prior, and in most cases continuing, taxation regime applicable to foreign-owned enterprises in China.

TAXATION OF FOREIGN ENTERPRISES POST THE OPEN DOOR POLICY

With the opening up of the market in China in the late 1970s and the encouragement of foreign investment in that market, the taxation regime in China initially split in two: one levied in relation to foreign investment enterprises and foreign individuals and the other levied against domestic enterprises and Chinese individuals. By the mid-1990s a certain degree of rationalisation took place and established a regime that, for the most part, continues today. Much of the reform of the mid-1990s would have satisfied the requirements of transparency, equity and fair treatment, elements that were essential for any country hoping to accede to the World Trade Organisation. However, there remained a distinction between the income tax treatment of foreign investment enterprises and domestic enterprises. The following provides an outline of the taxes relevant to foreign investment enterprises.

As mentioned above, the reforms of 1994 saw the consolidation of individual income taxes, levied against the income of both Chinese citizens and foreigners, into one regime. Individuals domiciled or resident in China for at least one year have taxes levied against their salary and wages, business and other income from worldwide sources. Where the residency is less than one year only, income sourced in China is taxed.⁴¹ Foreigners working in China for more than one year up to a maximum of five years can apply to SAT to have only their Chinese sourced income taxed in China.⁴²

The Income Tax Law of the People’s Republic of China for Enterprises with Foreign Investment and Foreign Enterprises of 1991 applied to equity joint ventures, cooperative joint ventures and wholly foreign-owned enterprises, foreign companies with establishments in China and foreign companies without establishments in China but deriving income from sources in China: Art 3. While the tax rate comprised a 30 per cent national tax component and a three per cent local tax component (Art 10), a series of tax incentives in the form of tax holidays and reduced income tax rates (often 15 per cent) were available: Arts 7, 8 and 9. These incentives were either

provided because the enterprise was located in a city or region targeted for development or the enterprise was engaged in an industry targeted for development. However, it was also common for such enterprises to be incurring losses in the early stages of operation. Accordingly, Art 11 permitted losses to be carried forward for a maximum of five years. New arms-length transfer pricing rules were also introduced by this regime: Art 13. Investigations, disputes and penalties are dealt with under the Administrative Law on Levying & Collection of Taxes of the People’s Republic of China.

Significant incidents of tax evasion will invoke the operation of the criminal law and may result in prison sentences as well as large fines.

The turnover taxes during this period were the key revenue raisers. They were streamlined to apply to all businesses, foreign and domestic alike, and comprised the Value Added Tax (VAT), the Business Tax (BT) and the Consumption Tax (CT). VAT is levied on taxpayers engaged in the sale of goods, the provision of processing or repair and replacement services, or the importation of goods.⁴³ There are varying rates of tax depending on the nature of the goods or services. This system operates by crediting input taxes against output taxes. An input tax is paid by the taxpayer who receives taxable services or purchases goods. An output tax is the VAT payable by the taxpayer selling goods or taxable services.⁴⁴

Business Tax is aimed at covering those activities not subject to VAT. It is imposed on business gross turnover of taxpayers engaged in the provision of taxable labour services, the sale of immovable properties and the assignment of intangible assets.⁴⁵ This is not a creditable tax and accordingly input taxes cannot be recovered.⁴⁶ The various tax rates applicable are levied on the full selling price of the items subject to this tax.⁴⁷ Consumption Tax, on the other hand, is levied on the manufacturers and importers of specific luxury or non-essential goods.⁴⁸ This is akin to excise taxes and is levied on 14 classes of taxable items and applies 18 different tax rates.⁴⁹ Ultimately, the tax payable by the manufacturer or importer of these goods is passed onto the consumer in the form of higher prices. It is calculated on the sales value or the sales volume of those goods. In addition to these turnover taxes, there are a number of other taxes applicable to foreign-owned enterprises including the land appreciation tax, stamp duties and customs duties, however, they will not be covered in this article.

These turnover taxes would have played a significant role in the taxing of foreign enterprises as the income taxes levied were often quite low due to the preferential treatments available as described above and the fact that these foreign enterprises were often operating at a loss. It must be remembered that the rationale for such preferential treatment was to encourage foreign direct investment and this was clearly achieved. However, the turnover taxes were

less than ideal causing distortions in the economy, having a cascading effect and prejudicing service-based businesses and certain types of manufacturing businesses.⁵⁰ In addition, to take advantage of the preferential income tax treatment available to foreign enterprises, local business owners would engage in structuring their investments through offshore companies to invoke the application of the foreign enterprise tax regime.⁵¹ Li and Krever point out that the impact of the combination of the inefficiencies of the turnover taxes and the discriminatory enterprise income taxes on the distribution of revenue in China exacerbated the disparity in wealth between the provinces.⁵² This article will not be analysing the subsequent developments in the turnover taxes, rather, it will consider the reforms regarding enterprise income tax. The need for unification is made quite clear as the next section of the article explains. What is significant is the fact that the legislature has played a major role in the lead-up to the unification. Previously, as mentioned above, tax law was predominantly in the hands of the executive. The unification process engaged the legislature in a manner most western economies would recognise and resulted in tax legislation that exemplifies the national treatment expectations of all WTO members.

UNIFICATION OF THE CORPORATE OR ENTERPRISE TAXATION SYSTEMS

It was the Third Plenary Session of the Sixteenth Central Committee of the Communist Party of China that called for the unification of the income tax regime for all categories of enterprise.⁵³ Improving the socialist market economy was a key focus. This then led to the joint efforts of the Ministry of Finance, The State Administration of Taxation and the State Council Legislative Affairs Office in drafting the new Enterprise Income Tax Law which, in 2004, was provided to all levels of government for comment, and in relation to which roundtable discussions were had with relevant ministries, enterprises and experts.⁵⁴ Further comments were obtained from agencies and departments of the Central Government in 2006 before another draft was prepared and submitted to the Standing Committee of the National People's Congress on 28 September 2006.⁵⁵ After further deliberations and consultations, the final draft was delivered by the Minister of Finance at the Fifth Session of the Tenth National People's Congress on 8 March 2007. The Enterprise Income Tax Law of the People's Republic of China was promulgated on 16 May 2007 and became effective on 1 January 2008 (Enterprise Income Tax law).

In his delivery of the explanation of the final draft of the Enterprise Income Tax Law, the Minister of Finance noted the guidelines for the tax reform:

to establish a scientific and standardized enterprise income tax system uniformly applicable to various types of enterprises and create an environment for fair competition among all enterprises in accordance with the overall requirements of the Scientific Outlook on

Development and for improving the socialist market economy by basing the tax reform on the principle of simplifying tax regimes, broadening tax base, lowering tax rates and strictly enforcing administration of tax collection, and by drawing on international experience in this regard.⁵⁶

This has certainly been achieved with the Enterprise Income Tax Law as will become evident from the following analysis. Further the Minister points out six principles followed in the drafting of the new regime. The first deals with removing the differentiated tax burden between domestic and foreign-funded enterprises while the second is aimed at achieving sustainable development of the national economy.⁵⁷ The third recognises the utility of taxation as a regulatory instrument to encourage industrial development (for example through targeted preferential treatment), while the fourth recognises the importance of drawing upon international experience.⁵⁸ The fifth principle relates to rationalising distribution relations to effectively collect fiscal revenues (an issue identified above regarding the disparity of funding between the provinces) and the final principle deals with compliance and simplicity so that 'tax payment [is made] easier and costs to both the administrators and tax payers are reduced.'⁵⁹

Accordingly, the Chinese corporate taxation system came of age removing the differential tax treatment between foreign-owned and domestic enterprises from 1 January 2008. While individually-owned enterprises and partnership enterprises are specifically excluded from the operation of the new regime,⁶⁰ the Enterprise Income Tax Law does apply to 'enterprises and other organisations' ('Enterprises'): Art 1. This unification effectively removes the perceived 'unfair advantages for foreign enterprises over domestic enterprises'⁶¹ by providing a more equitable and efficient system. In addition, it represents China's acknowledgement that in order to encourage foreign investment through foreign-owned enterprises special treatment over domestic enterprises is no longer required. This demonstrates recognition of the sophistication of the Chinese economy. However, the Enterprise Income Tax Law is a 'principles-based' law comprising only 60 articles requiring further detail for its implementation. Accordingly, the Implementation Rules of the Enterprise Income Tax Law of the People's Republic of China (the Implementing Regulations) was promulgated by the State Council on 6 December 2007 effective, also, on 1 January 2008. Following is an analysis of the principles of the Enterprise Income Tax Law.

A Jurisdiction to Tax

1 *The taxpayer*

Like most other income tax laws a distinction is made between resident and non-resident enterprises. A resident Enterprise is one that is either established under the laws of China or, if established under the laws of a foreign

country, has its effective management located in China: Art 2. A non-resident Enterprise is one established under the laws of a foreign country and its management organisation is outside China but either has an establishment or place in China or, if it does not have such a place or establishment in China, derives income sourced from China: Art 2. The term ‘management organisation’ is akin to the taxation concept of effective management and control and is defined in Art 4 of the Implementing Regulations as organisations ‘implementing substantive and comprehensive management and control over the production and business operations, staff, accounts and property etc of an enterprise’.

2 *Residency and source*

Article 3 of the Enterprise Income Tax Law identifies the type of income upon which tax will be levied. Resident Enterprises must pay tax on income derived from sources both inside and outside China. There is no surprise here. Non-resident Enterprises with an establishment or place in China must pay tax on income derived by that establishment from sources in China and on income sourced outside of China that is effectively connected with the establishment in China. The tax rate applicable to such Non-resident Enterprises and Resident Enterprises is 25 per cent: Art 4. In the case of Non-resident Enterprises with an establishment or place in China, but whose income is not effectively connected with such an establishment, only income derived from sources in China will attract tax and the rate of such tax will be 20 per cent: see Arts 3 and 4. Similarly, a Non-resident Enterprise with no establishment or place in China will pay tax at the rate of 20 per cent on income derived from sources in China: see Arts 3 and 4.

3 *Analysis*

While at first glance these provisions appear to be quite regular, it is important to note that the dual regime identified and taxed enterprises according to where they were established. Those established in China were taxed on their worldwide income while those established elsewhere were only taxed on their Chinese-sourced income. Earlier, the point was made that under the dual regime, a Chinese company could interpose a foreign company in its structure in order to fall within the Foreign Enterprise regime thereby attracting a different tax rate on its Chinese sourced income. Equally it could avoid tax altogether on its foreign-sourced income through the foreign interposed enterprise. Such arrangements were not unusual in the establishment of joint ventures offshore from where the worldwide distribution of products or the licensing of new technologies would occur at market prices after obtaining the same from the Chinese source at cost. In some way, the reclassification of residency to include foreign enterprises with effective management in China, together with the unified law’s requirement that non-resident enterprises pay tax on income sourced outside of China that is effectively connected with the establishment

in China might go some way to addressing the type of arrangements that the dual regime left untaxed. Clearly, this would require significant restructuring of corporate structures and contractual arrangements. However, the transfer pricing rules together with the introduction of controlled foreign corporation rules make further headway into addressing tax avoidance.

Arts 41 to 48 in Chapter 6 of the Enterprise Income Tax Law provide for new anti-avoidance measures including the basic operation of a transfer pricing regime (Arts 41–44). Article 41 stipulates the basic operation of the transfer pricing rules and these are further clarified in Arts 109–112 of the Implementing Regulations where the basic terms of ‘interested party’, ‘independent transaction principle’, and ‘reasonable methods’ are defined. An enterprise can propose transfer pricing principles and determination methodology for transactions with related bodies and enter an advanced pricing arrangement or agreement with the tax authorities: Art 42, Enterprise Income Tax Law. However, the enterprise must provide information regarding these transactions as an appendix to its annual income tax return (Art 43, Enterprise Income Tax Law) and failing that the relevant tax authority will have the power to deem the enterprise’s taxable income in accordance with the laws and regulations: Art 44, Enterprise Income Tax Law. When the tax authority carries out an investigation pursuant to Art 43 of the Enterprise Income Tax Law, the Implementing Regulations at Art 114 describe the nature of the ‘relevant information’ that must be provided by the enterprise and its related enterprises. The extent of that information certainly doesn’t leave much room for disguising the types of arrangements that might have avoided attracting Chinese income tax in the past.

Article 45 of the Enterprise Income Tax Law comprises the equivalent to a controlled foreign corporation (CFC) rule. This is truly evidence of China’s increased sophistication in its taxation regime, albeit a rather rudimentary CFC regime. Further, it only targets controlled foreign enterprises in countries or regions with tax rates significantly/evidently lower than the tax rates in Art 4 of the Enterprise Income Tax Law. In essence, where the foreign enterprise is controlled by Chinese resident enterprises and/or individual Chinese residents, the profits of that foreign enterprise will be included in the taxable income of the resident controllers even if the profits are not distributed or are under-distributed. This regime also goes some way to addressing the opportunities for avoidance under the dual tax regime.

B Income and Deductions

1 Taxable Income

Taxable income is defined in Art 5 of the Enterprise Income Tax Law to comprise the gross income in a tax year less the non-taxable income, tax exempt income, deductions and allowable prior-year losses. In the case of foreign-owned enterprises, one needs to be able to distinguish between Chinese sourced and non-Chinese sourced income. Article 6 lists the types of monetary and non-monetary income that comprises the gross income, namely: income from the sales of goods, provision of services and transfer of property; dividends, bonuses and other equity investment income; interest; rent; royalties; donations and other income. Non-taxable income is defined in Art 7 of the *Enterprise Income Tax Law* to include government allocations, governmental administration charges and funds levied according to law and collected and managed as treasury management of the State (akin to businesses charging Goods and Services Tax and collecting that tax on behalf of government), and other non-taxable income specified by the State Council.

Article 19 determines the taxable income for non-resident Enterprises with no establishment or place in China and for Non-resident Enterprises with an establishment or place in China, but whose income is not effectively connected with such an establishment. In relation to equity investment income such as dividends and bonuses, and income from interest, rent and royalties the calculation method shall be in accordance with Gross Income (Art 6) whereas income from the transfer of property shall be calculated by reducing the Gross Income by the net value of the property transferred (Art 16, see below). All other income comprising Taxable Income is to be calculated by reference to these two methods.

2 Deductions

When calculating Taxable Income, Art 8 provides that a reasonable amount of expenditures actually incurred in the derivation of that income will be deductible, including costs, fees, taxes, losses and other expenditure. This is an example of harmonisation between domestic and foreign-owned enterprises. Under the previous regime, only foreign investment enterprises were able to claim what was actually incurred in relation to salaries and wages whereas a cap was applied for domestic enterprises. There still remains a cap for claims relating to charitable donation expenditure with Art 9 requiring a cap of 12 per cent of total annual profit to be applied.

Further, Arts 10 to 18 stipulate further restrictions on what can be deducted from Gross Income in order to calculate Taxable Income. Article 10 specifically excludes the following from deductibility: payments of dividends, bonuses and other returns on investment; the amount paid in Corporate Income Tax; tax surcharges; penalties, fines and losses through the confiscation of property; donations other than those specified in Art 9; sponsorship expenditure; provisions that have not been

verified; all other expenditure that is not related to the generation of income. Depreciation of fixed assets is allowed as a deduction subject to various exclusions: Art 11. In relation to intangible assets, Art 12 allows amortisation to be deductible except in relation to the following intangible assets: expenditure related to self-developed intangible assets where such expenditure has already been deducted; self-developed goodwill; intangible assets not relevant to the operations of the Enterprise; and other intangible assets disallowed for amortisation and deduction. The amortisation of specific long-term deferred expenses is also allowed under Art 13, namely: reconstruction expenditures of fixed assets that have been fully depreciated and of leased-in fixed assets; expenditure incurred for the major repairs of fixed assets; and other expenditure to be amortized as long-term deferred expenses. The cost of investment assets are not deductible under Art 14 whereas the cost of inventory used or sold by the Enterprise is deductible under Art 15 according to specific rules, and the net book value of transferred assets may be deductible under Art 16. Losses incurred by the Enterprise in a tax year may be carried forward and offset against profits of following years for a maximum of five years: Art 18. However, in relation to consolidations, Art 17 provides that losses incurred by the overseas operating units of an Enterprise filing Corporate Income Tax will not be deductible against the profits of domestic operations.

The power to provide detailed rules relating to the scope and criteria of income and deductions and the tax treatment of assets rests with the Ministries of Finance and the State Administration of Taxation within the State Council: Art 20. Accordingly, the tax laws together with the administrative regulations of these authorities are to be followed when calculating Taxable Income where the corporate financial and accounting treatments differ from those tax laws and regulations: Art 21. What is important to note is that this new unified regime actually represents a unification and standardisation of deductions available to both domestic and foreign owned enterprises. Once again it brings both types of enterprises onto a level playing field as far as tax liability is concerned. But as for dealing with the potential to take advantage of the residence and source rules discussed above, namely refining the transfer pricing rules and introducing the controlled foreign corporation rule, the Enterprise Income Tax Law adds two more anti-avoidance provisions to its armoury.

3 Anti-avoidance Provisions

The anti-thin capitalisation rules together with a general anti-avoidance provision have been added to the suite of regimes designed to address previous losses of tax revenue.

Article 46 of the *Enterprise Income Tax Law* provides the anti-thin capitalisation rule. Where an interest expense is incurred by an enterprise due to related parties exceeding the specified debt to equity ratio for their investment in the enterprise, that enterprise will not be able to deduct the portion of the interest expense that corresponds to the exceeded ratio. Article 119 of the Implementation Regulations defines both direct and indirect ‘debt securities investments’ and ‘equity investments’ and empowers the finance and tax departments of the State Council to determine the specified debt to equity ratio. This attempt at an anti-thin capitalisation rule has been described as ‘a step forward but possibly not a large enough one’ by Dr Nolan Sharkey who points out that the regime does not take into account ‘overall excessive debt funding’ but rather is limited to a determination of related party debt, a mechanism abandoned by Australia, for instance, in 2001.⁶⁵ Nevertheless, this is an opportunity for China to learn the basic operation of such a regime before progressing to the more advanced one that engages with multi-national enterprise debt allocation.

A general anti-avoidance measure is provided at Art 47. Where an enterprise has entered into an arrangement that does not have a reasonable commercial purpose but results in a reduction of its gross income or taxable income, the tax authority will be able to make reasonable adjustments. Where adjustments to the taxable income of enterprises are made by the tax authorities in accordance with Chapter 6, interest will be applied against the additional tax payable as a result of that adjustment: Art 48. The interest rate is determined in accordance with Art 122 of the Implementation Rules of the *Enterprise Income Tax Law* of the People’s Republic of China. This is an interesting addition to the *Enterprise Income Tax Law* when one recognises firstly the necessity of detailed rules together with the importance of case law in making such a provision work. The Implementing Regulations do not provide the necessary details rules and, with China being a civil law jurisdiction, judges are expected to apply the law rather than develop it.

C Tax Payable and Preferential Tax Treatment

The tax payable by an enterprise is calculated by multiplying the Taxable Income by the relevant tax rate and then reducing that amount by any tax reductions, exemptions or credits provided under the *Enterprise Income Tax Law*: Art 22. Such preferential tax treatment is provided in Arts 25 to 36. Meanwhile, Arts 23 and 24 provide for the nature of credits to be granted in relation to foreign income tax already paid.

There are still quite a number of activities and industries that attract preferential tax treatment under the unified regime. Article 25 provides the general statement that those industries and projects specifically supported or encouraged by the State will be granted preferential tax

treatment. Specific investment income items are granted tax-exempt status under Art 26 as is the income derived by qualified not-for-profit organisations. In addition to the reductions/exemptions provided to non-tax resident enterprises, the Enterprise Income Tax may be reduced or exempted for enterprises earning income from agricultural, forestry, animal husbandry and fishery projects, from specified public infrastructure projects, from prescribed environmental protection, energy and water conservation projects and from prescribed transfer of technology: Art 27.

A reduced tax rate of 20 per cent is levied on small-scale enterprises that meet regulatory requirements while a reduced tax rate of 15 per cent applies to State-supported high technology or new technology enterprises: Art 28. Further, to the extent that the Enterprise Income Tax is allocated to local government, an autonomous government of an autonomous minority region may reduce or exempt such tax: Art 29.

Accelerated deductions, referred to as ‘super deductions’, are allowed under Art 30 for expenditure relating to research and development expenses and salaries paid to disabled and other staff whose employment is encouraged by the State. A specified percentage of investment in venture capital enterprises that have invested in State-encouraged industries can be deducted against Taxable Income: Art 31. A similar incentive is granted by Art 34 where an enterprise has invested in special equipment that either aids in environmental protection, water and energy conservation or enhances production safety. Meanwhile, shorter depreciation periods or accelerated depreciation may be applied against fixed asset investment where those assets pertain to technological advancements: Art 32. In addition, further deductions against Taxable Income may be available where the income of an enterprise is derived from the production of goods in respect of which State production policies have been followed including the comprehensive utilisation of resources: Art 33.

Article 35 provides the State Council with the power to formulate the detailed implementation rules in relation to the operation of these tax incentives. In Arts 82 to 102 of the Implementing Regulations, comprehensive details in relation to the operation of the tax incentives are provided. The State Council also has the power to develop tax incentive policies in accordance with economic and societal needs and must file those policies with the Standing Committee of the National People’s Congress: Art 36 of the *Enterprise Income Tax Law*.

D Administration, Assessment and Collection

1 Administration of Assessment and Collection

In addition to the provisions of the *Enterprise Income Tax Law*, the administration and collection of enterprise income tax will be in accordance with the rules in the Tax Collection and Administration Law of the People’s

Republic of China: Art 49. Resident Enterprises will be required to file their returns at the location of their registered address unless that address is located outside China in which case the return should be filed at the location of their actual management and control: Art 50. If there are a number of locations where the Resident Enterprise operates in China, in the form of business establishments without legal status, then income of each establishment will be combined and one return filed. Interestingly, enterprises are otherwise not permitted to consolidate for tax purposes.⁶⁶ The problem with this method, while trying to simplify the administrative burden of filing in each province of operation, is that the tax revenue collected will favour those local governments where the enterprise is registered. In section III of this article it was discussed that there is a sharing of revenue between the local government that collects the tax and the central government. This consolidation causes an imbalance in revenue distribution. However, with the local vs central sharing of revenue moving to 40:60, that does give the central government scope to distribute revenue to those provinces that lost out in the consolidation.

Article 51 deals with the filing of returns for Non-resident Enterprises. Non-resident Enterprises with an establishment in China that derives income from sources either in or out of China must file their tax returns at the location of their establishment. Non-resident Enterprises with an establishment or place in China, but whose income is not effectively connected with such an establishment, will pay tax at the location of their withholding agent. It is important to note that taxes must be paid in Renminbi and so if taxable income is earned in another currency it must first be converted to Renminbi and then taxed accordingly: Art 56.

The income tax year under this regime runs from 1 January to 31 December or part thereof where an enterprise starts or terminates operations or undergoes liquidation during the year: Art 53. Provisional tax payments are to be made on either a monthly or quarterly basis within 15 days of the end of each month or quarter: Art 54. The payments are to be accompanied by provisional tax returns with the final tax payment to be accompanied by the annual tax return to be lodged within five months after the end of the tax year. Where an enterprise terminates operations during an income year then it has 60 days from the date of that termination within which to settle its tax obligations: Art 55. Further, income from the enterprise's liquidation must first be paid accompanied by a further tax return prior to the cancellation of the enterprise's business registration.

2 Withholding at Source

Under Art 37, income derived by a Non-resident Enterprise from sources within China will be subject to withholding tax. The payer of the income will be acting as withholding agent and be required to withhold the required tax from

the payments made or due. The payer, of engineering contracts or labour services provided by non-resident enterprises, may be designated by the tax authorities as the withholding agent: Art 38. Where the withholding agent fails to withhold the necessary tax at source, the non-resident enterprise taxpayer must pay the tax at the place where the income was derived: Art 39. If the taxpayer also fails to pay the tax, then the tax authorities have the power to collect the outstanding tax from other income payable to the taxpayer that is sourced in China: Art 39. It would seem that Art 39 anticipates potentially poor compliance with the withholding tax system, particularly when Art 40 requires that withholding tax payments must be made to Treasury and corresponding withholding tax returns filed with the local tax authority within seven days of each incident of withholding.

E Supplementary Provisions

Article 57 grants a five-year grandfathering period to enterprises that were approved to be established before the promulgation of the *Enterprise Income Tax Law* and which were entitled to reduced income tax rates under the previous laws and regulations. The result is that the preferential tax rate will be gradually increased to the tax rate prescribed in the *Enterprise Income Tax Law* over a five-year period and in accordance with the rules stipulated by the State Council. Further, those enterprises that enjoyed preferential tax treatment in the form of tax holidays over a specified period will be able to continue to benefit from such tax treatment until the end of that period. Where an enterprise is entitled to such a tax holiday but has yet to benefit from such a preferential tax treatment due to not yet achieving profitability, the tax holiday period will commence from 1 January 2008, that is, the date of effectiveness of the *Enterprise Income Tax Law*. Article 57 provides that similar grandfathering arrangements for new or high technology enterprises encouraged by the State and located in special zones for the promotion of foreign trade, economic and technological cooperation and other State Administered special zones, will be determined by the State Council. In addition, other enterprises within an encouraged industry category will be able to benefit from income tax reductions and exemptions according to the regulations of the State Council.

The remaining provisions of the *Enterprise Income Tax Law* deal with the operation and application of the law. The State Council has the power under Art 59 to formulate the implementation rules which, as indicated above, it has promulgated on 6 December 2007 effective, on 1 January 2008. As for any conflict with the provisions of a tax treaty or agreement concluded by the government of China with a foreign government, Art 58 provides that the provisions of the treaty or agreement will prevail over those of the *Enterprise Income Tax Law*. Finally, Art 60 repeals the *Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises* as well as the *Provisional Rules of People's Republic of China*

on *Enterprise Income Tax* effective on 1 January 2008.

CONCLUSION

This article has considered the development of taxes in the People's Republic of China. It has demonstrated how taxation has been used as a tool for social and economic change during the different stages of the history of the People's Republic of China. The emphasis on foreign investment since the Open Door Policy has led to significant developments in the taxation regime. The most recent development considered in this article is the implementation of a new income tax regime for enterprises, domestic and foreign alike. A demonstration of compliance with World Trade Organisation principles, this new income tax regime is ultimately a corporate tax regime that is only now catching up with the unified individual tax regime implemented over a decade ago. However, it represents a recognition that China is at a stage in its economic development that can withstand a reform that brings both domestic businesses and foreign-funded businesses under a uniform regime that aims to provide a level playing field for all. Domestic businesses were at a disadvantage before this unification and that disadvantage led to behaviour that sought to circumvent the disadvantage by utilising the loopholes available between the Domestic and Foreign Enterprise tax rules. This reform is as much an attempt at ensuring competition is equal between domestic and foreign sectors of the Chinese economy as it is about dealing with tax avoidance. The introduction of specific and general anti-avoidance measures is evidence of this dual purpose. It is perhaps too early to judge the performance of this new regime, but once the grandfathering arrangements come to an end, the true impact of the unified *Enterprise Income Tax Law* will become apparent.

NOTES

¹ Accession of the People's Republic of China, Decision of 10 November 2001, WT/L/432.

² Finance Minister, Jin Renqing, Explanation on the Draft *Enterprise Income Tax Law* of the People's Republic of China, delivered at the Fifth Session of the Tenth National People's Congress on 8 March 2007 <http://www.npc.gov.cn/englishnpc/Speeches/2007-03/08/content_360344.htm> at 22 May 2011.

³ Daniel HK Ho, *Tax Law in Modern China: Evolution, Framework and Administration* (2001) 31 *Hong Kong Law Journal* 141, 147.

⁴ Ibid.

⁵ Jinyan Li, *China's Tax System: An Evaluation* (Spring 1989) 17 *Denver Journal of International Law & Policy* 527, 529.

⁶ Ho, above n 3, 145–6. See also Li, above n 5, 529.

⁷ Li, above n 5, 530.

⁸ Ho, above n 3, 148–9.

⁹ Ibid.

¹⁰ Ho, above n 3, 149.

¹¹ Ibid.

¹² Ho, above n 3, 150.

¹³ Ibid.

¹⁴ Li, above n 5, 530.

¹⁵ Kui Hua Wang, *Chinese Commercial Law* (Oxford University Press, 2000, Melbourne) 217.

¹⁶ Li, above n 5, 531.

¹⁷ Ibid.

¹⁸ Ibid.

¹⁹ Ibid.

²⁰ Ibid.

²¹ Ho, above n 3, 151.

²² Ibid 152.

²³ Li Qun, 'Tax Incentive Policies for Foreign-Invested Enterprises in China' (2008) 18(1) *Revenue Law Journal* 2–3.

²⁴ Ibid 3.

²⁵ Li Jin and Richard Krever, 'Globalisation and Modernisation as Drivers for Tax Reform in the Socialist Market Economy' (July 2010) 11 *Theoretical Inquiries Law* 687, 694.

²⁶ Ibid.

²⁷ National Bureau of Statistics of China, *China Statistical Yearbook* (2007) Table 18–14

<<http://www.stats.gov.cn/tjsj/ndsj/2007/html/R1814e.htm>>. It can be seen that during the 1980s, foreign direct investment annually was in the single digit billions of US dollars while in the 1990s the value of that investment annually was in ever-increasing double digit billions of US dollars.

²⁸ Passed by the 4th Session of the 7th National People's Congress on 9 April 1991.

²⁹ Jianfu Chen and Suiwa Ke (eds), *Structure of China's Tax System* (CCH Asia Pte Ltd, 2007) ¶50–207.

³⁰ Li & Krever, above n 25, 701.

³¹ Ho, above n 3, 154.

³² The US-China Business Council, 7. Ministry of Finance (MOF) at <http://www.uschina.org/public/china/govstructure/govstructure_part5/9.html>, Mandate of the Ministry of Finance <<http://www.mof.gov.cn/english/english.htm>>, no longer available.

³³ See the China Factfile, *State Administration of Taxation* (2006) <http://www.gov.cn/english/2005-10/09/content_75307.htm>.

³⁴ Ho, above n 3, 156.

³⁵ China Factfile, above n 33.

³⁶ China Factfile, above n 33; Ho, above n 3; CCH Asia Pte Ltd, *China Tax and Customs Law Guide Commentary — Tax Policy and Administration*, ¶3–000.

³⁷ China Factfile, above n 33.

³⁸ China Factfile, above n 33.

³⁹ Li & Krever, above n 25, 695.

⁴⁰ China's 11th Five Year Plan, delivered at the Fourth Session of the Tenth National People's Congress (NPC); Yang Lei (ed), *Facts and Figures: China's Drive to Build New Socialist Countryside* (2006) <http://www.gov.cn/english/2006-03/05/content_218725.htm>. This document notes that the Agricultural Tax has been collected in China for 2600 years.

⁴¹ *Individual Income Tax Law of the People's Republic of China 1993*, Art 1.

⁴² *Implementing Regulations for the Individual Income Tax Law of the People's Republic of China 1994*, Art 6. For further exemptions, see Art 7.

⁴³ *Value Added Tax Implementing Rules of the People's Republic of China*, Art 1.

⁴⁴ *Value Added Tax Provisional Rules of the People's Republic of China*, Art 2.

⁴⁵ *Provisional Rules for the People's Republic of China on Business Tax*, Art 1.

⁴⁶ *Asia Pacific Guide to Tax and Investment* (PricewaterhouseCoopers, 1998) 37.

⁴⁷ *Ibid.*

⁴⁸ *Provisional Rules for the People's Republic of China on Consumption Tax*, Art 1.

⁴⁹ *Provisional Rules for the People's Republic of China on Consumption Tax and Circular 33*.

⁵⁰ Li & Krever, above n 25, 706–7.

⁵¹ *Ibid.*

⁵² *Ibid* 712–3.

⁵³ Jin, above n 2.

⁵⁴ *Ibid.*

⁵⁵ *Ibid.*

⁵⁶ *Ibid.*

⁵⁷ *Ibid.*

⁵⁸ *Ibid.*

⁵⁹ *Ibid.*

⁶⁰ This was not the case under the *Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises 1991*, nor the *Provisional Regulations of the People's Republic of China on Enterprise Income Tax 1993*. Rather the practice of excluding such non-corporate enterprises was through administrative processes.

⁶¹ CCH Asia Pte Ltd, *China Tax and Customs Law Guide Commentary — Foreign Enterprise Income Tax*, ¶120-101.

⁶² Significantly/evidently lower tax rate is defined in Art 118 of the *Implementing Regulations* to be less than 12.5 per cent.

⁶³ Where control is defined in Article 117 of the *Implementing Regulations* as including:

'(1) where a resident enterprise or a Chinese resident directly or indirectly holds 10 per cent or more of voting shares solely in a foreign enterprise, and jointly holds 50 per cent or more of the shares in the foreign enterprise; and

(2) where the shareholding percentage of a resident enterprise or a resident enterprise and a Chinese resident has yet to attain the standard stipulated in item (1) but it/they has/have substantive control over the foreign enterprise in terms of shares, funds, operation and procurement and sale etc.'

⁶⁴ CCH Asia Pte Ltd, above n 61.

⁶⁵ Nolan Cormac Sharkey, 'China's New Enterprise Income Tax Law: Continuity and Change' (2007) 30(3) *University of New South Wales Law Journal* 833, a 39.

⁶⁶ Subject to any rules otherwise prescribed by the State

Council, *Enterprise Income Tax Law*, Art 52.

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Characteristics of the Chinese Tax System and its Cultural Underpinnings: A Comparison with the West

BIN YANG AND EVA HUANG

China's tax system is characterised by the co-existence of formal taxes, sundry levies and hidden taxes. In China, multiple authorities with tax law-making powers and tax administration powers exist. This leads to issues of tax jurisdiction and tax compliance such as differential treatment between local administrative areas and between taxpayers who have different status in the tax system. These unique characteristics of the Chinese tax system are rooted in China's special national circumstances. These national circumstances include issues of economic development, political system and issues that are culturally specific. Further, a 'human relationship system' arises from that culture, where the behaviour of politicians, grassroots administrators and the taxpayers cannot be viewed in isolation. Looking deeper, the reasons behind these characteristics relate to the status-conscious culture in China. This is exemplified in the saying 'Criminal punishment does not apply to senior officials and the etiquette does not apply to common people'¹, and the selfish culture of human sympathy², face relationships, and 'if it is not my business, hang it up'³.

INTRODUCTION

Taxation and the budget have always been amongst a nation's major concerns. The characteristics of a tax system often reflect a government's governing philosophy. Most people view China's tax and legal framework through its published laws and regulations, but this is far from enough. China is a country with thousands of years of culture and history, developing a human relationship system that is difficult for even its own citizens to comprehend. It can be explained neither verbally nor in writing; it can only be experienced — only those who are immersed in it and have analysed it can understand it. These cultural as well as economic developments and political system characteristics together form the characteristics of the Chinese tax system. This article discusses the main characteristics of the Chinese tax system, comparing it to prevailing systems in Western developed nations. It focuses on cultural attributes, providing a backdrop for understanding the full picture of the Chinese tax system.

MAIN CHARACTERISTICS OF THE CHINESE TAX SYSTEM

In order to clearly explain the characteristics of taxes in China, 'tax' needs to be defined. 'Taxation is a compulsory exaction of money by a government for public purposes, being neither a pecuniary penalty nor a fee for services rendered'⁴. This means 'tax' is the activity of a government in extorting amounts of money, goods or labour from those engaged in economic activities within its administration (including individuals, groups and enterprises). Further, it is a compulsory contribution by economic participants to the government to sustain public expenditure. Tax has a natural relationship with government. Only amounts contributed to governments by economic participants can be called a tax.

When viewing taxation in China, it has four characteristics: Compulsory, non-compensating, certainty and uniform. The compulsory nature of taxes is reflected in levying taxes according to the law. Taxes are based on political authorities (such as) the government, rather than debt or equity rights. The 'without repayment' nature of taxes is also called non-direct remittance. This means that governments do not give taxpayers goods or compensation of an equal value in return for the tax collected. Although governments do provide public goods from tax revenue, the amount of public goods received by individual taxpayers does not directly coincide with the amount of tax they have paid. The certainty nature of taxes means that tax cannot be randomly levied, there should be specified rules on whom to tax, what to tax, how much to tax, collection mechanism, collection time and location. In addition, the powers and responsibilities of collection authorities all need to be stipulated clearly by tax laws. The uniform nature of taxes means the same amount of tax will be collected from the same type of product, same activity, same type of tax object and taxpayers who have the same ability to pay. A tax that is not uniform will have internal conflicts between the public interest

and private interest of taxpayers, leading to fundamental issues of revenue collection⁵. Some government levies are not called taxes, but as these amounts are extorted without repayment, they are, in reality, taxes. For example, the provincial or local governments in China currently levy different 'funds', 'fees' or 'charges' on enterprises and individuals for specific purposes; although these are not formally called taxes, they behave like taxes. Restricting the definition of taxes as above gives rise to four characteristics of the Chinese tax system:

A. Other than Formal Taxes, There Are Many Sundry Levies and Hidden Taxes

1. The distinction between formal taxes, sundry levies and hidden taxes

In societies with a sound legal system, a tax cannot be levied without the consent of citizens. For a government to levy taxes, whether these are formally prescribed as taxes or otherwise, laws need to be enacted in parliament. However, in China, only a very limited number of tax laws have been passed in parliament (the National People's Congress (NPC) and its Standing Committee).

There are still major differences between Chinese law-making bodies and those of western constitutional democracies. Chinese law-making bodies provide transition positions for officials approaching retirement or facing a career change, they are also a propaganda platform for governments to provide working agenda information to the public. Therefore, whether China makes law through the NPC or through the State Council, there is no material difference. To a certain degree, laws made by top-level officials from the State Council are easier to administer. Therefore, this paper not only treats tax laws made by the NPC or its Standing Committee as formal law, it also treats regulations made by the State Council and its Ministry of Finance, the State Administration of Taxation and the General Administration of Customs as formal law. Currently, out of the levies imposed in the name of taxes, only Individual Income Tax and Enterprise Income Tax are legislated by the NPC. The other taxes have been legislated by the State Council, and its Ministry of Finance, the State Administration of Taxation, the General Administrations of Customers, the Ministry of Human Resources and Social Security, and the Ministry of Environmental Protection, through Regulations or circulars or decrees. These taxes, levied through the legislative process, are called formal taxes.

Other than formal taxes, China has a large volume of levies that exhibit tax characteristics. They are often called fees, funds, charges, etc, and are levied through specialists, regulations or departmental decrees or administrative regulations, rulings or circulars by the departments of central government, or even departments of different-level local governments. These include, for example, 'Education Law' levies, 'additional education fees', 'Forestry Law' levies, 'forestry industry fund', 'Land Law' levies, 'new vegetable patch development fund'. The 'rural power repayment

fund' are levied through Cai Qi [2001]#820, Cai Zong [2007]#3; the 'three gorges project development fund' is levied through Guo Fa Ban[1993] #34, Cai Qi [2002]#651, Cai Qi [2003]#155. From the early 1990s, China started going through a stock take of so-called government funds and administrative fees. They are reducing in number every year. However in 2009, there were still 34 types of government funds, 236 types of national administrative fees, and numerous local government levies. Some of these funds and fees are temporary, some permanent. There are various levying methods, and there are many more variants of taxation outside of formal taxes. Levies which possess tax characteristics, but which have not been through formal legislative processes, are called sundry levies. At some point in China's history, the government collected cash or goods from specific economic participants through price mechanisms. As an example, in a system where important agricultural goods such as grains are purchased and sold centrally, and farming equipment is allocated by plan, the government may deliberately raise the price of farming equipment and sell it to farmers above its value. At the same time the government would deliberately lower the price of agricultural goods such as grains. This creates what is termed a price 'scissors difference'. In reality this is an indirect tax on farmers, but the 'taxpayer' is unaware of it. Researchers call this taxing method 'hidden tax'. The 'hidden tax' system was in operation from 1953 to 1985, during which the Chinese government collected RMB 600 Billion⁶ from farmers. This is six times the amount of agricultural tax and equals the total industrial investment capital of the state-owned enterprises of the time. Some scholars are therefore of the view that China's initial industrial capital accumulation came mainly through depriving farmers. In order to achieve this deprivation, China has a strict population register system, dividing the population into two worlds — urban and rural.

In contemporary China, the land ownership system is prejudiced against farmers. Farmers can utilise the land but do not have ownership of the land. Land belongs to the collective or the government. The government can compulsorily acquire the land that farmers are using with compensation, but the land cannot be bought and sold. In the course of industrialisation and urbanisation, not only could farmers not receive profits from rising land prices, but due to inadequate compensation from the government, they lose wealth. In substance this deliberate legal arrangement is also a 'hidden tax' on farmers. Recent research reveals that in the decade between 1998 and 2007, the 'hidden tax' collected by the Chinese government through acquiring land from farmers is at least RMB 2007.984 Billion, which is five times the amount levied from the agricultural tax abolished in 2006. In 2008, this increased to RMB 494.071 Billion, which means that although the Chinese government abolished the agriculture tax borne by farmers, the 'hidden taxes' paid by farmers are much greater. From 1998 to 2007, these 'hidden taxes' plus the direct and indirect taxes farmers paid as consumers totalled RMB7869.519 Billion. At the same time, the public goods

provided by the government to farmers are valued at less than RMB 3521.898 Billion, which is only 44.75 per cent of the tax burden of farmers. Total net wealth taken from farmers was RMB 4347.711 Billion. The Chinese fiscal mechanism is therefore seen as strongly regressive, i.e. it does not take from the wealthy to assist the poor, but takes from the poor to assist the wealthy.⁷

2. Formal taxes

From the above characterisations, we treat tax laws made by the NPC and regulations made by the State Council as formal taxes. These include the 19 levies that are called taxes, social insurance charges and pollution discharge fees. In terms of tax objects, they can be characterised as:

- Indirect taxes (taxes on goods and services): value added tax (VAT), consumption tax, sales tax, customs duty, resource tax, city and rural area maintenance and development tax, tobacco tax, vehicle purchase tax.
- Income taxes: individual income tax, enterprise income tax, social insurance charge.
- Wealth and activity taxes: property tax, city real estate tax, deed tax, stamp duty, land capital gains tax, land usage tax, arable land occupancy tax, ship tonnage tax, vehicle and shipping tax, pollutant discharge fee.

In 2008, total collection of formal taxes minus export tax rebates was RMB 6638.103 Billion, which is 69.32 per cent of total 2008 government revenue of RMB 9575.902 Billion⁸, which in turn is 22.78 per cent of GDP of RMB 30067 Billion. If the social insurance charge and pollution discharge fee is disregarded, formal tax totals RMB 5422.379 Billion, which is 56.63 per cent of total government revenue, and 88.41 per cent of normal budgeted revenue of RMB 6133.035 Billion, and 18.34 per cent of GDP. This shows that the main source of revenue for normal budgeted revenue is formal taxes. Social insurance charge is a large proportion of formal taxes, but is not calculated in the normal budget. Below we will analyse the tax structure according to the data that includes social insurance charge and pollutant discharge fee.

Looking at the structure of the three types of taxes, of the total amount of formal tax of RMB 6638.103 Billion, indirect tax is 49.91 per cent, income tax (including social insurance charge) is 40.48 per cent, wealth and activity tax is only 9.61 per cent. This reflects that the Chinese tax system exhibits a mixed tax structure based on indirect taxes and income tax, as shown in Table 1 and Graph 1.

From the main tax types, the most revenue is gained through the VAT, at RMB 1933.167 Billion, which is 29.12 per cent of total tax revenue raised. Second place is social insurance charge, revenue is RMB 1197.2 Billion, which is 18.04 per cent of total tax revenue raised; third place is enterprise income tax, revenue of RMB 1117.563 Billion, which is 16.84 per cent of total tax revenue raised; fourth place is sales tax, revenue of RMB 762.639 Billion,

which is 11.49 per cent of total tax revenue raised; fifth place is individual income tax, revenue is RMB 372.231 Billion, which is 5.61 per cent of total tax revenue raised; sixth place is consumption tax, revenue is RMB 275.874 Billion, which is 4.16 per cent of total tax revenue raised; 7th place is customs duty, revenue is RMB 176.995 Billion,

which is 2.67 per cent of total tax revenue raised. Other small tax type total RMB 802.434 Billion, which is 12.09 per cent of total tax revenue raised. Please see Table 1 and Graph 2.

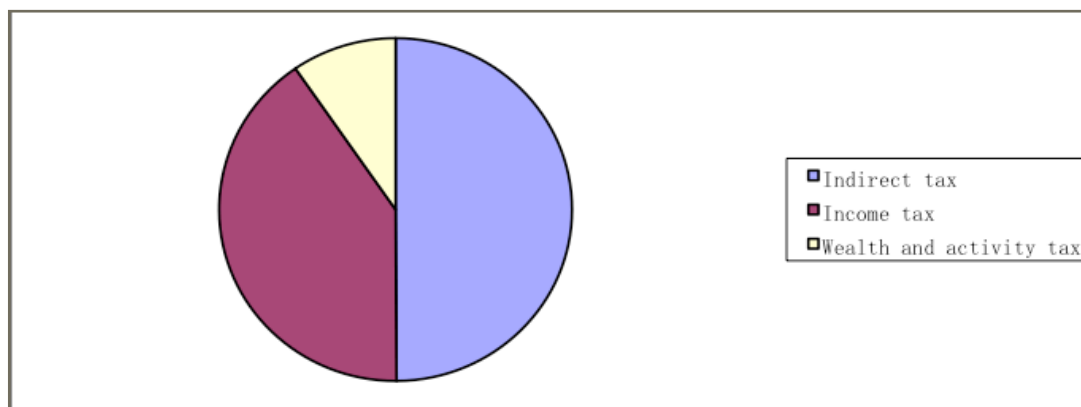
TABLE 1: 2008 FORMAL TAX STRUCTURE

CLASS	TAX TYPE	AMOUNT (RMB BILLION)	%
INDIRECT TAX	VAT	1933.167	29.12
	Consumption Tax	275.874	4.16
	Customs Duty	176.995	2.67
	Sales Tax	762.639	11.49
	City and Rural Area Maintenance Development Tax	134.409	2.02
	Resource Tax	30.176	0.45
	Total Indirect Tax	3313.260	49.91
INCOME TAX	Enterprise Income Tax	1117.563	16.84
	Individual Income Tax	372.231	5.61
	Social Insurance Charge ¹⁰	1197.200	18.04
	Total Income Tax	2686.994	40.48
WEALTH & ACTIVITY TAXES	Property Tax (including city real estate tax)	68.034	1.02
	Deed Tax	130.753	1.97
	Tobacco Tax	6.745	0.10

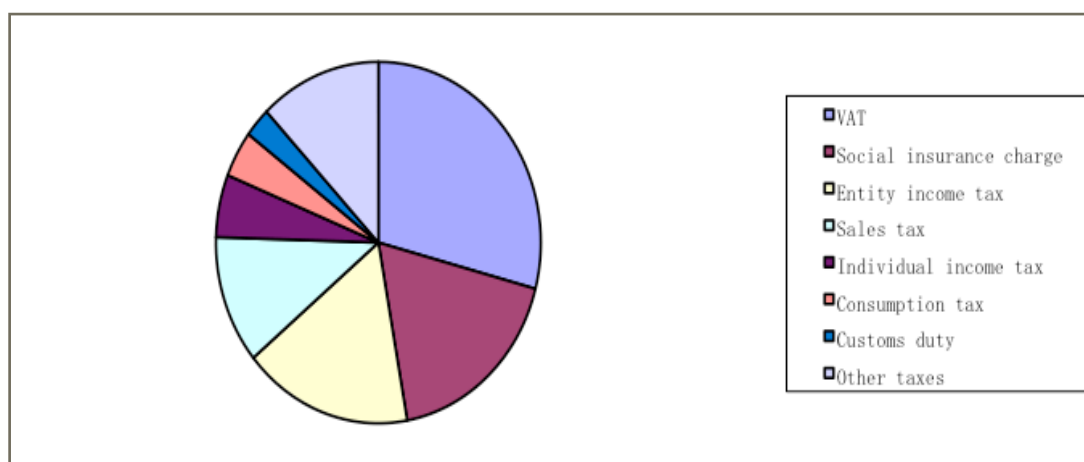
	TAX TYPE	AMOUNT (RMB BILLION)	%
	Arable Land Occupancy Tax	31.441	0.47
	Land Usage Tax	81.69	1.23
	Land Capital Gains Tax	53.743	0.81
	Ship Tonnage Tax	2.012	0.03
	Vehicle and Shipping Tax	14.421	0.22
	Vehicle Purchase Tax	98.989	1.49
	Stamp Duty	131.129	1.98
	Pollutant Discharge Fee ¹¹	18.524	0.28
	Other Tax Type ¹²	0.368	0.01
	Total Wealth and Activity Taxes	637.849	9.61
TOTAL FORMAL TAXES		6638.103	100.00

Data Source: Other than noted items, based on National Bureau of Statistics of China, China Statistics Yearbook 2009.

GRAPH 1: THE STRUCTURE OF THE THREE TYPES OF FORMAL TAXES 2008



GRAPH 2: MAIN FORMAL TAXES PROPORTION 2008



3. Sundry Levies

For a long time in China, central government and local governments at each level collected a substantial level of revenue by charging funds, fees and charges. This revenue is not listed in the budget for administrative purposes, thus treated as extra-budgetary funding, where some organisations even put them in the petty cash account for accounting purposes. These funds are away from the supervision of fiscal management and the People's Congress at each level, leading to serious issues of arbitrary levy and careless spending. Thus, not only does it create disorder in fiscal transfers and public income redistribution, it also increases the possibility of corruption.¹³ For this reason, central government and finance ministries began to manage the situation from 1993, cancelling a large amount of inappropriate, unlawful fees and funds, and gradually bringing government funds and administrative fees into the budgetary management process. Sundry levies mainly consist of the so-called government funds and administrative fees.

Almost all government funds have characteristics of taxes. These funds are not 'fees', not capital returns, not goods and services purchase. They therefore fit the four basic characteristics of taxes. People who pay the funds or fees (feepayers) cannot use without charge the facilities that are funded by the funds or fees, thus the payments by feepayers are without repayment; feepayers cannot choose how much to pay or when to pay, the payment is controlled by levying circulars, whenever the levying instance happens, the feepayer has to pay, otherwise they face penalties, the imperative nature is obvious; the amount or ratio of payment is set by the circular. This makes it certain as long as the feepayer is faced with the same situation. Thus, there is uniformity as the fee/fund type would be the same and amount the same. In the past few years, as the central government manages the situation, the number of government funds is decreasing, but until 2009, there are 34 types¹⁴ (details please see table 2), of revenue that are counted towards the budget, totalling RMB 422.802 Billion¹⁵.

NUMBER	FUND NAME	LEVY RIGHT	FUND MANAGEMENT
1	Rural Power Repayment fund	State Council agreed, Cai Qi [2001] #820, Cai Zong [2007] #3	Pay to Central and Local Coiffers
2	Three Gorges Project Development Fund	Guo Fa Ban [1993] #34, Cai Qi [2002] #651, Cai Qi [2003] #155.	Pay to Central Government Coiffers
3	New Wall Material Fund	Guo Fa [1992] #66, Cai Zong [2007] #3, Cai Zong [2007] #77.	Pay to Local Government Coiffers
4	Harbour Development Fund	Guo Fa [1985] #124, Jiao Cai Fa [1993] #456, Cai Zong [2007] #3	Pay to Central Government Coiffers
5	Civil Aviation Airport Management and Development Fund	Guo Yue [1991] #144, Guo Ban Fa [1995] #57, Cai Zong Zi [1999] #147, Cai Gui [2000] #28, Cai Zong [2004] #51, Cai Zong [2007] #3, Cai Zong [2007] #78	Pay to Central Government Coiffers
6	Civil Aviation Infrastructure Fund	Guo Fa [2002] #6, Cai Zong [2004] #38, Cai Kuai [2004] #8	Pay to Central Government Coiffers
7	Railway Construction Fund	Guo Fa [1992] #37, Cai Gong Zi [1996] #371, Cai Zong [2007] #3	Pay to Central Government Coiffers
8	Railroad Construction Additional Fee (Fujian Province)	Guo Fa [1998] #17, Cai Zong [2001] #26, Cai Zong [2007] #3	Pay to Local Provincial Government Coiffers
9	National Silk Development Venture Fund	Guo Yue [1996] #151, Guo Jian [1997] #11, Cai Zong [2004] #40, Cai Zong [2007] #3.	Pay to Central Government Coiffers
10	Bulk Cement Fund	Guo Han [1997] #8, Cai Zong [2002] #23, Cai Zong [2007] #3	Pay to Local Government Coiffers
11	Central International Trade Development Fund	Guo Han [1996] #17, Cai Zong [2007] #3.	Pay to Central Government Coiffers
12	Silviculture Fund	Forestry Law, Cai Shi Zi [1972] #250, Qing Zhong [1988] #122, Lin Cai Zi [1991] #74, (91) Cai Nong #333 (93) Cai Nong Zi #144	Pay to Central and Local Coiffers
12-1	Collective Silviculture and Variation Fund	Same as Si Chuan Province Lin Cai [1986] #20	Pay to Local Government Coiffers
12-2	National Silviculture and Variation Fund	Same as Si Chuan Province Lin Cai [1986] #20	Pay to Local Government Coiffers
12-3	Continual Simple Reproduction fee	(93) Cai Nong Zi #144	Pay to Local Government Coiffers
12-4	Forestry Continual Simple Reproduction fee	(93) Cai Nong Zi #144, Qian Fu Ban [1989] #39	Pay to Local Government Coiffers

NUMBER	FUND NAME	LEVY RIGHT	FUND MANAGEMENT
13	Forestry Fund (Shanxi Province)	Forestry Law, Cai Zong Han [2003] #1	Pay to Local Government Coffers
14	Forestry Vegetation Regrowth Fund	Forestry Law, Cai Zong [2002] #73	Pay to Central and Local Coffers
15	Water Conservancy Construction Fund	Guo Fa [1997] #7, Cai Zong Zi [1998] #117– #145	Pay to Central and Local Coffers
16	Large and Medium Dam Post Migration Assistance Fund	Guo Fa [2006] #17, Cai Zong [2006] #29, Jian Cha Bu Ren Shi Bu Cai Zhen Bu Ling #13	Pay to Central Government Coffers
17	Large and Medium Dam Fund (Qinghai, Guangdong, Chong- qing, Sichuan, Jilin, Shanxi, Hebei, Shanxi, Anhui, Hubei, Hunan, Guizhou, Hainan, Fu- jian, Guangxi, Liaoning, Yunnan Provinces)	Guo Fa [2006] #17, Cai Zong [2007] #26, Cai Zong [2008] #17, Cai Zong [2008] #29 、 #30、 #31、 #32、 #33、 #34 、 #35, Cai zong [2008] #64 、 #65、 #66、 #67、 #68, Cai Zong [2008] #85、 #86、 #87 、 #88、 #89、 #90	Pay to Central and Local Coffers
18	Three Gorges Dam Area Fund	CPG Ruling #299, Guo Fa [2006] #1, Cai Zong [2007] #69	Pay to Central Government Coffers
19	South Water to North Project Fund (Beijing, Tinjin, Hebei, Jiangsu, Shandong and Henan)	Guo Han [2002] #17, Guo Ban Fa [2004] #86	Pay to Central Government Coffers
20	New Vegetable Patch Development Fund	Land Law, National Construction Land Acquisition Regulation, [1985] Nong (Tu) Zi #11	Pay to Local Government Coffers
21	City Public Services Additional Fee	(64) Cai Yu Wang Zi #380, (78) Cai Yu #26, (78) Jian Fa Cheng #584, Cai Zong [2007] #3	Pay to Local Government Coffers
22	Cultural Development Fee	Guo Fa [1996] #37, Cai Shui Fa [1997] #95, Guo Fa Ban [2006] #43	Pay to Central and Local Coffers
23	National Film Industry	Guo Fa Ban [2006] #43, Cai Jiao [2006] #115	Pay to Central and Local Coffers

24	City Education Additional Fee	Education Law, State Council Ruling #60, Guo Fa [1986] #50, Guo Fa Ming Dian [1994] #2、#23 [1992] Cai Yu Zi #11	Pay to Central and Local Coffers
25	Local Education Additional Fee (Liaoning, Anhui, Fujian, Sichuan, Jiangsu, Guangxi, Ningxia, Guizhou, Qinghai, Hebei, Shandong, Zhejiang, Inner Mongolia, Yunnan, Heilongjiang, Hunan, Hubei)	Education Law, Cai Zong Han [2003] #2、#9、#10、#12、#13、#14、#15、#16、#18, Cai Zong [2001] #58, Cai Zong [2004] #73, Cai Zong Han [2005] #33, Cai Zong Han [2006] #9, Cai Zong Han [2006] #2、#61, Cai Zong Han [2007] #45, Cai Zong Han [2008] #7	Pay to Local Government Coffers
26	Local Education Fund (Beijing, Jiangsu)	Education Law, Cai Zong Han [2002] #31、Cai Zong Han [2003] #12	Pay to Local Government Coffers
27	Travel Development Fund	Guo Fa [1995] #57, Nu Fa Ban [1991] #124, Cai Wai Zi [1996] #396, Cai Hang [2001] #24, Cai zong	Pay to Central Government Coffers
28	Disabled Persons Employment Guarantee Fund	Disabled Person Guarantee Law, Cai Zong Zi [1995] #5、Cai Zong [2001] #16	Pay to Local Government Coffers
29	Coal Sustainable Development Fund (Shanxi)	Guo Han [2006] #52, Cai Zong Han [2007] #3, Fa Gai Ban Neng Yuan [2007] #1805, Jin Cai Mei [2007] #8	Pay to Local Government Coffers
30	Water Resource Compensation Fee (Shanxi)	State Council Agreement, Ji Ji Chu [2001] #349, Cai Zong [2001] #62, Cai Zong [2007] #3, Cai Ban Zong [2009] #5	Pay to Local Government Coffers
31	Electricity Base Construction Fund (Shanxi)	State Council Agreement, Ji Jia Guan [1997] #440, Zai Zong [2002] #33, Cai Zong [2007] #3	Pay to Local Government Coffers
32	Highway Vehicle Passage Additional Fee (Hainan)	Cai Zong [2008] #84	Pay to Local Government Coffers
33	City Infrastructure Associated Fee	Ji Jia Ge [2001] #58, Cai Zong Han [2002] #3	Pay to Local Government Coffers
34	Small Dam Post Migration Assistance Fund	Guo Fa [2006] #17	Pay to Local Government Coffers

Other than the above government funds, there are numerous numbers of administrative fees. These are fees that government or quasi-government departments receive from residents. There are three situations:

Firstly, whether the fees are levied on beneficiaries of specific services at cost, or they are fees for using specific national resources. These fees are of a pricing nature and are reasonable. They include: passport fees, notary fees, visa fees, normal high school fees, higher education fees, higher education accommodation fees, various examination fees, certificates fees, property ownership registration fees, waste water testing fee, maritime mediation fee, satellite transponder channel fee, radio channel occupancy fee, telecom numbering resource occupancy fee, farming watering water source and equipment occupancy compensation fee, Yangtze river sand and gravel resources fee, measuring instruments using fee, patent fee, etc. However, when some levying organisations continue to levy administrative fees after receiving fiscal funding, it becomes an extra sundry levy on residents. In addition, the amount above cost has the characteristics of tax where the fees levied to service beneficiaries for specific services are provided to residents above cost. Secondly, fees levied to beneficiaries of specific services at above cost, the amount above cost has the characteristics of tax.

Thirdly, government or its departments raise tax by authorising public institutions to issue licences, registrations, test and assessments to levy imperative contributions from residents. This includes an automobile safety test fee, foreign law firm annual review fee, ship and shipping equipment testing fee. These are taxes on the one hand because the operation funding of these institutions are already gained from fiscal funding and, on the other hand, these fee-paying activities are not based on services but on government administrative purposes. Therefore, they are not required by residents themselves and are accurately characterised as taxes.

The Fourth situation is fees levied by concocting various excuses — they are certainly sundry levies, for example, sole proprietor business management fee, pedlar's market management fee (these two were cancelled from 1 September 2008¹⁶), channel maintenance fee, road transport management fee, waterway transport management fee (these were cancelled from 1 September 2009¹⁷), education fee extras, mining registration fee, land acquisition management fee, land return to farming fee, land

idle fee, termite prevention and treatment fee, vehicle passage fee, port charge, river sand and gravel mining fee, water and soil erosion management fee, water wild animal resource protection fee, fishing resource reproduction protection fee, wild animal and plant export management fee, land wild animal resource protection fee, greening fee, plant new variety protection fee, hygiene management fee, hygiene quality testing fee, air defence basement relocation development fee, custom monitor filing fee, intellectual property customs protection filing fee, product quality monitor testing fee, manufacturing production authorisation certificate fee (including audit fee), pharmaceutical product administration protection fee, Chinese medicine variety protection fee, security marketing monitoring fee, futures market monitoring fee, insurance business monitoring fee, etc. All these fees, with the exception of the first, fall within the scope of 'sundry levies'. It is difficult to list and count the different sundry levies, take transportation and vehicles as an example, the items abolished by the State Council in 2000 is up to 238, which reduces the burden of cities of RMB 14.5 Billion per year¹⁸. After that, some items are abolished each year. In 2008 alone, the number of abolished national administrative fees items was 100.¹⁹ There are still 236 fee items that continue to be levied.²⁰ Currently, for administrative fees, some are included in normal budgetary management; others are included in extra-budgetary management.

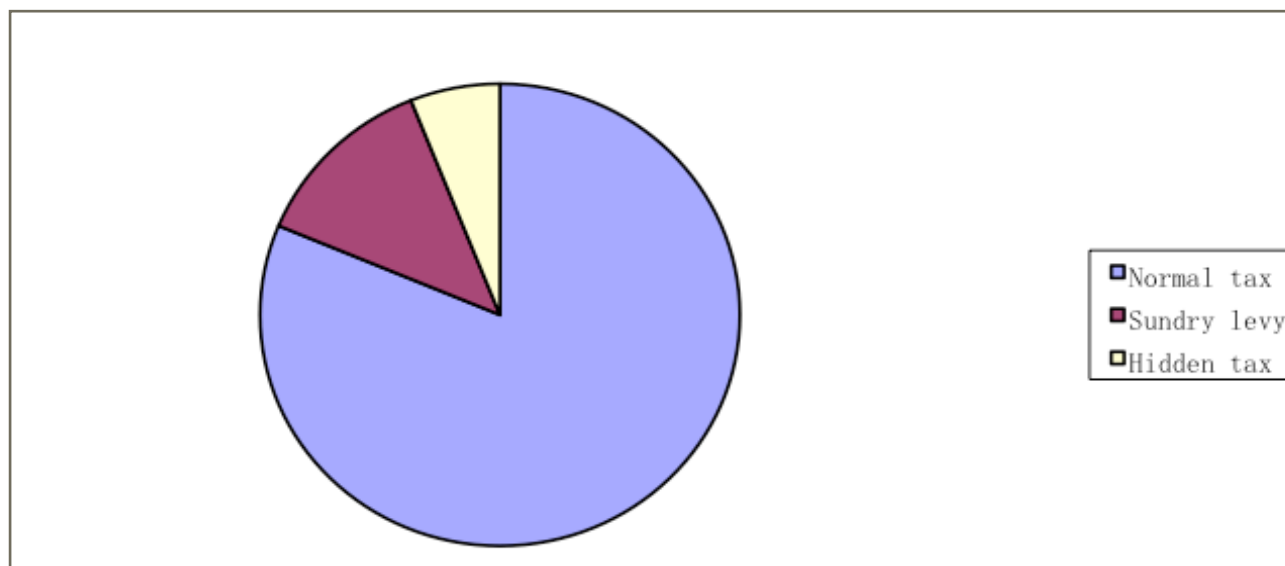
In 2008, the administrative fees included in normal budgetary management is RMB 213.486 Billion, extra-budgetary management amount is RMB 516.213 Billion, totalling RMB 681.591 Billion. Subtracting an amount around RMB 120 Billion is reasonable payment for the service supplied by the government such as normal high school fees, higher education fees, etc. The remaining sum is RMB 609.699 Billion, which is the sundry levy amount. Add to the fund budget sundry levy amounts of RMB 422.802 Billion, and the total sundry levy in 2008 is RMB 1032.501 Billion.

4. Total Tax Amount Relative to Total Government Revenue and GDP

According to the above calculation, we know that total tax revenue in 2008 was RMB 8164.675 Billion, comprising formal tax of RMB 6638.103 Billion or 81.30 per cent; sundry levy of RMB 1032.501 Billion, which is 12.65 per cent; hidden tax totalling RMB 494.071 Billion²¹, which is 6.05 per cent (Refer to graph 3). Total tax revenue is 85.26 per cent of total government revenue, or 27.15 per cent of GDP.

The graph reveals that tax revenue is not a small part of GDP. When considering the tax burden in China, sundry levies and hidden taxes have to be considered; merely considering formal tax will largely underestimate the tax burden of Chinese residents.

GRAPH 3: FORMAL TAX, SUNDRY LEVY AND HIDDEN PROPORTION 2008



a) Type	b) Amount (Billion)	c) Percentage of government revenue	Percentage of GDP
Formal tax revenue	6638.103	69.32%	22.08%
Sundry levy revenue	1032.501	10.78%	3.43%
Hidden taxes	494.071	5.16%	1.64%
Total tax revenue	8164.675	85.26%	27.15%
Government revenue	9575.902	100.00%	31.85%
GDP	30067		100.00%

B. Plurality in Law Making and Administration of Tax Law in China

Section 3 of the Tax Collection and Administration Law in China stipulates: 'The levying and stopping to levy of a tax and tax cuts, exemptions, rebates and payment of unpaid tax would be executed according to the law; those that are authorised by the law to be regulated by the State Council, will be prosecuted following the administrative laws and regulations issued by the State Council. Any departments, organisations and individuals cannot disobey laws, administrative laws and regulations to unilaterally make decisions relating to the levying and stopping to levy of a tax and tax cuts, exemptions, rebates and payment of unpaid tax and any related activities that are against tax laws, administrative laws and regulations'. However, an important characteristic of Chinese culture is that name is above reality.²² This law only administers taxes which are formally termed as 'tax', and levies which are in reality taxes, but not called a 'tax' (for example, the government funds and administrative fees which have tax characteristics, i.e. sundry levies) are not included within its scope. Taxation in China exhibits plurality in law-making, execution and administration. The following discussion details the distinction between formal tax and sundry tax.

1. The legal system and administration characteristics of formal tax

Formal taxes are those which are levied as a tax, according to the Tax Collection and Administration Law mentioned above and other laws and regulations. In principle, the National People's Congress (NPC) and its Standing Committee are the law-making bodies; Courts of all levels are the judiciary, State Council, different levels of governments and their finance departments are the law enforcement bodies. However, in reality, this is not the full picture. The following helps reveal the entire picture:

i. Coexistence of law making and delegated law making

Tax law in China is enacted through legislation passed by the legislature as well as through delegated legislation. This means that tax law can be made by the NPC or its Standing Committee, or even by a State Council authorised by the abovementioned law-making bodies. Legislature legislation²³ are commonly called 'XX laws', delegated legislation are called 'XX tax regulation'. Currently, only Individual Income Tax Law and Enterprise Income Tax Law are legislature legislation, the rest are regulations made by the State Council. Before a tax law or tax regulation is issued,

there is a consideration process. Normally the finance and tax departments will draft legislation according to research and consultation, pass the review from the legal system office of the State Council, then the State Council will meet to discuss and pass the legislation. Draft legislation that needs to be passed by the NPC will be sent for review by the appropriate offices of the NPC; the NPC or its Standing Committee will convene to pass the legislation. Finally the President of China will announce the law. During the process, if there are issues relating to tax law principles involving significant systemic or policy changes before the final legislative process or before going to the NPC, the draft legislation has to be sent to the Political Bureau of the CPC Central Committee or its standing committee. The principle following their decision-making process will be the accepted legislative basis. This reflects the uniformity of the principle that governs post-1949 China 'where country is lead by the party, the people own the country, and the country is government by laws'.

ii. The multi-layered nature of the source of tax law

The formal laws made by the NPC are usually principle-based, the State Council would need to issue related enforcement regulations to explain the laws. When enforcement regulations are not detailed enough, the Ministry of Finance, the State Administration of Tax, and General Administration of Customs will explain the regulations in more detail through circulars. The regulations made by the State Council are normally also principle-based. The State Council issues related implementation rulings to explain further. Some tax types such as property tax, arable land occupancy tax, city and rural land usage tax, deed tax, social insurance charge etc. will be administered by measures of implementation issued by provincial local governments, the standard to levy pollutant discharge fee is jointly set by the State Council's pricing departments, finance departments, environmental protection administration departments and economic commercial departments. These laws, regulations, enforcement regulations, implementation rulings and department circulars (or department rulings) combine to form the source of law for tax law, they are the legal basis taxpayers and tax administrators follow, they are also the legal basis for the judiciary to follow. However, in western countries, only tax laws made by the legislature and the cases decided by courts with authority (in common law countries such as the US and the UK) are the source of law. These are the only things binding upon the judiciary. The legislature can disregard any decisions made by government departments. In China, as has been

explained above, the situation is rather different.

iii. Separation of tax law explanation, policy making and tax administration

The Ministry of Finance has specialised tax policy departments (i.e. the tax policy group and customs group), who are responsible for tax law explanation and tax policy making. The circulars are often issued in the name of the Ministry of Finance, or Ministry of Finance, and State Administration of Tax or Ministry of Finance and General Administration of Customs. For issues of pollutant discharge fee and social insurance charge, circulars are normally issued by the Ministry of Environmental Protection, Ministry of Human Resources and Social Security respectively. When the policy affects special industries and departments, circulars will be issued in the names of the Ministry of Finance and the other department. Local governments have the right to decide on detailed taxing standards, tax rates and taxes that require policy adjustments. Further, detailed policies are made by local finance departments. Tax administration is separately enforced by administrations or departments of tax, customs, environmental protection and human resources and social security at all levels of government. Among the taxes, customs duty, ship tonnage tax, import/export VAT and consumption tax are administered by customs departments; administrations of tax at all levels are responsible for administering all other formal taxes. In addition, the pollutant discharge fee is administered by environmental protection departments. However, in more and more provinces, the administration is done by local tax administrators. Social insurance charges on the other hand are administered by departments of human resources and social security. However, even the administration of this is shifting to local administrators in a growing number of provinces.

iv. In the process of tax administration, the two sets of administrations of tax and administration of customs operate both separately and overlaps

Currently the State Administration of Tax in China has two tax administration systems for levels of governments at or below provincial levels — one national tax administration system and one local tax administration system. In principle, national tax bureaus are responsible for central taxes and shared taxes, while local tax bureaus are responsible for local taxes, but in reality this separation of powers is unclear. For example, it is originally stipulated that for enterprise income tax, according to subordination relationships, central state-owned enterprises' enterprise income tax would be levied by national tax

bureaus, local enterprises' enterprise income tax would be levied by local tax bureaus. For new enterprises that are registered after 2002, no matter of their subordination relationships, their enterprise income taxes would be administered by national tax bureaus. At the same time, individual income tax becomes a shared tax, but would continue to be administered by local tax bureaus. VAT and consumption tax would be administered by national administration of tax, but import/export VAT and consumption are administered by customs.

2. Plurality in law making and administration of sundry levies in China

From the early 1990s, central government started to manage the 'three arbitrary' situation of urban and rural areas — 'arbitrary levy, arbitrary fines and arbitrary requisition of donations'. It has carried on rural area tax reforms and reforms of management of extra-budgetary funds. Up to now, the disastrous situation of large volumes of sundry levies have been relatively controlled, most sundry levies are included in budgetary management and are relatively controlled and monitored. However comparing with standard situations in societies with a rule of law, the issue, levy and usage of sundry levies still exhibit the following:

i) The levying of tax did not go through legislature legislation or a delegated legislation process

An obvious sign of a nation with a rule of law is no taxes without representation, where the people agreed to the new tax through elected members of parliament. So called agreement of the people is the passing of legislation through the legislature or having delegated legislation. However, most sundry levies are revenues collected by central government or its departments, or local governments or its departments for specific reasons or projects. They are levied on enterprises, organisations or individuals. Some sundry levies are based on a single piece of legislation, for example, education addition levy is based on Education Law. Many sundry levies are levied because funding of specific reasons or projects cannot be passed in the normal budgetary management process, so as temporary levying 'policy'. The result is in a particular historical moment, these sundry levies became a disaster. To regain control, central government has to manage the situation, abandon some items and agree to keep others.

ii) The laws the levies are based on are not systematic

The legal basis for sundry levies is normally government circulars, i.e. a document, although it fits the imperative, without repayment and unambiguous

nature of taxes, its regulations are not as systematic and clear as formal taxes. For example, the levy of Continual Simple Reforestation fee (Continual Simple Reforestation fee is the combination of the original publicly-owned forest felling area road extension fee and collectively-owned forest renewal redevelopment fund), is based on the Ministry of Finance 'Circular re issues on forestry production business implementing new financial standards' ([93] Cai Nong #144). The ratio, quantity of sundry levies are changeable, the changes also do not require consideration through a legislative process. For example, the railway construction fund's levying standard started at RMB 0.002 per ton per kilometre and has risen to RMB 0.033 per ton per kilometre through five adjustments in seven years, becoming a higher proportion of rail transportation price. This measure was wholly decided by the administering department, without any public discussion, consultation or debate process.

iii) Revenue not included in normal budget

Before the State Council started managing the situation, establishing the separation of revenue collection and expenditure, sundry levies are levied and spent by the same administering department. Currently sundry levies are still not included in normal budget, the Ministry of Finance established the 'fund budget' to manage this revenue, and some sundry levies in the name of government funds are still managed extra-budgetary.

iv) Administering organisation is the same as spending organisation

Most sundry levies are administered by the government department spending the levy or the authorised organisation; they are not managed by tax administrators. For example, the railway construction fund is collected by railway transportation enterprises when they are collecting transportation fees authorised by the Ministry of Railways, to be spent on national planned large or medium-sized railway construction projects²⁴. The civil aviation basic infrastructure fund is levied by civil aviation administrators on civil passenger and goods transport aviation businesses who are registered in China and who utilise national air way resources, to be spent on the development of civil aviation safety, air traffic control, airports, scientific education and information management.²⁵

C Difference between the Letters of Law and Real Operation of Law of Chinese Tax Law

In China, there isn't a tradition to strictly follow the letter of the law to solve problems. It is the same regarding tax. There is a further layer of complication

in the laws of China. When the letters of the law are applied, depending on the situation, they may still need to be discounted to greater extends.

1. Geographical development disparities

Economic development in China is very unbalanced. Throughout the country, there is a large difference between the East and the West, and between urban and rural areas, the extent of polarity is evidence. On the one end of the scale is the development of large cities and a number of townships in developed areas of the East, they are close to the levels of developed nations; on the other end the mountain areas of the middle and west and the townships that mainly have an agricultural economy are relatively poor. Even in developed provinces, the differences between localities are still large. Not only are there large differences in economic development, there are large cultural differences.

The uniform national tax system is often based on urban areas, and most formal taxes are modelled on western developed nations. In developed areas, businesses are relatively larger, there is sound financial management and appropriate information exchange channels, and tax laws can thus be enforced relatively smoothly. In less developed areas, businesses are relatively smaller, tax sources are scattered, administration is often inappropriate and the basic conditions for operating modern tax systems are lacking. Within such a pluralistic, diverse economic scenario, the tax law is often administered as a set of basic principles, allowing local tax authorities a relatively wide ambit for enforcement. As tax administrators often have wide discretionary powers, the end result is that the same laws and policies are executed differently in different places, and the difference can often be substantial.

Within the tax administration itself, China currently uses an administrative method of 'planned collection tasks' instead of collection according to the tax law. In the system of 'planned collection tasks', the central government decides on the required annual revenue amount, according to fiscal need and economic development, and then issues the tasks to each of the lower level tax administrators by its higher level administrator. Each tax administrator has to complete the task, which forms their main working agenda. How these tasks are set is by mechanism to add or take away from the collection level of the previous year, normally only add, not subtract; even when there is an economic downturn, the tax authority still has a task to increase collection volume. Each local tax

bureaus, in order to fulfil their tasks, needs to adjust tax amounts between years within the legal limits. In years when the economy performs well and when there is a large tax source, there is under collection according to the law, collection stops when the task is finished or slightly over collected, thus hide the tax in businesses. When collection the task increases in the following years, that task becomes easier, this is called slowing down the collection of taxes. The basic method is to negotiate with businesses, in order to not pay taxes on time, especially in the fourth quarter of each year, or to administer relatively loosely during normal times, to allow avoidance by businesses, to allow for years of economic downturn, when there is inadequate tax source, to increase auditing pressure to collect overdue taxes. The existence of this mechanism leads to the difference between the letters of tax law and the execution of tax law. Furthermore, it leads to different tax treatments of taxpayers in areas of different levels of development. In more developed areas where the economy grows faster, the tax source is larger, and it is easier for the tax administrator to finish its task, thus tax audits are less frequent, and leading to a lower ratio of discovery for tax avoidance, resulting in a lowered tax burden. In less developed areas, where the economy grows slower, the tax source is small, the tax administrators normally need to audit a lot harder to finish their tasks, in years of economic downturn, it is even possible for over-collection of tax above the legal requirement to occur.

In a fiscal system where there is separation of taxing powers, local level governments will pay close attention to tax revenue that it could be spent by, and thus will award tax administrations who can better finish their tasks, the bonuses from the awards will become employee benefits, local tax administrators even of the national tax administrations will have vested material interests. Under these circumstances, some administrative practices will be compromised, leading to different tax law enforcement practices in different areas. For example, the new enterprise income tax law that began operation in 2008 is based on a legal person taxpayer system, with a collection mechanism of cross-locality, consolidation between head office and subsidiary for tax purposes. In the past, the taxpayer is an 'independent economic unit', subsidiaries pay tax to its local government, the result of the new tax affects local fiscal interest. To look after vested interests, the State Administration of Tax implemented a collection method of 'uniform calculation, separate level management, local withholding, consolidate for settlement, fiscal transfer' to share the tax revenue.²⁶ The tax administration headquarters needs to provide 'distribution forms'

to the tax administrations at subsidiary levels. This leads to a situation where the tax bureaus at the location of the head office and at the location of the subsidiaries are constantly in a gaming position, everybody tries to compromise the administrative practices. In areas where subsidiaries are located, tax is originally collected from the independent economic entities, now they have to withhold by proportion, the source of tax revenue is significantly smaller, directly affecting the collection task and local government revenue, some tax administrations even ignore the 'distribution forms', and directly collect tax from subsidiaries through deeming.

2. Status

Other than locality differences, there are differences in tax treatment due to the status of the taxpayer. With regard to business enterprises, the same tax laws have different administrative practices for transnational companies, state-owned enterprises, public companies, small to medium enterprises and sole proprietor businesses. For sole proprietor businesses and small to medium enterprises, tax is normally levied by deeming on a fixed rate or fixed volume; for the other enterprises, taxes are levied according to accounts.

For enterprises that are levied by assessment, depending on the information transparency, the effective collection rates are different. For more transparent enterprises, the collection ratio is higher, tax laws are more enforceable. At the same time, these enterprises often have larger tax planning space, and they can use legal means to lower their tax burden. For other enterprises, this route is usually not as simple as negotiating with or bribing tax officials. For individuals, it is difficult to apply uniform treatments on officials, salary earners, celebrities, workers, farmers and underground figures. When tax avoidance is discovered, ordinary citizens without social connections or citizens of low social standing often receive treatment and penalties according to the law, while citizens of differential social standing and with connections to people in power often find that law enforcement authorities and the judiciary can be quite accommodating, sometimes even cancelling the penalties.

CULTURAL UNDERPINNINGS OF THE CHARACTERISTICS OF THE CHINESE TAX SYSTEM

Tax systemic characteristics c highlighted above include: the coexistence of formal taxes, sundry levies and hidden taxes; legislation without a

democratic mandate; law-making and administration by numerous authorities and a multiplicity of tax jurisdictions; the difficulty in implementing issued tax laws uniformly, with execution often dependent on locality and taxpayer status.

These unique characteristics of the Chinese tax system are drawn from China's specific national circumstances. These include economic development, political system and cultural specific issues, as well as the 'human relationship rules' arising from them. The imbalance within China's economy and political structure are certainly important influences on its tax systems, but cultural issues are undoubtedly the more fundamental reason. These cultural reasons explain why the political system is hard to change — when change is attempted, it often manifests more in structural form than real substance. Cultural circumstances also affect the final result of economic development. High levels of trust and abundant social capital are necessarily connected with continual economic prosperity.²⁷ The following pays attention to the effects China's culture has on its tax system.

A. Defining Culture

Broadly speaking, culture is the material and spiritual result of human activity. However, this paper uses a narrow definition of culture, it is a moral tradition formed by the value norms, which are behavioural rules that exist in society at the time. Cultural characteristics can only be shown in comparison. Here we compare Chinese cultural attributes against Western cultural norms. The different ethnic groups and different countries of the West have different cultures. For the purposes of our discussion, Western culture is defined as the moral tradition including value norms and behavioural rules that arose and developed from England and Germany, especially the standards of human relationships.²⁸

China is a nation with multiple cultures, a large geographical area and different ethnic groups. The same ethnic group residing in different locations may have internal cultural differences. In this paper, Chinese culture is the culture shared by the Han ethnic group, which finds its origins in two main sources. One is the moral standards and values of Confucianism — in summary, the 'three cardinal guides and five constant virtues'. The three cardinal guides are: ruler guides subject, father guides son and husband guides wife; the five constant virtues are: benevolence, righteousness, propriety, wisdom and fidelity, its core is propriety. Propriety is the class system based on the three cardinal guides of the rights

of the ruler, the rights of the father and the rights of the husband. In this system, the courtier serving the ruler, the son serving the father and the wife serving the husband are natural rights. Society is divided into classes, and every person needs to consider of their position and keep to their station in life. Thus the notion of 'criminal law not applying to senior officials and the etiquette not applying to common people' is in operation. The benevolence of Confucius thought is not universal love, but rather benevolent love that follows propriety, i.e. love depends on classes; it is charity of a higher class person bestowed on a lower class person, not love based on equality. Righteousness (do right, appropriate moral behaviour or reason) is the same — there is no righteousness between people of different classes. Wisdom too has its own unique meaning — the maintenance of proper class differences and the general status quo, balancing relationships and keeping the peace are considered the highest virtues of wisdom, not creativity and criticism. The same principle applies to fidelity, trust is differentiated in relation to classes, integrity means loyalty, it is only applicable when considering the behaviour of the lower classes to higher classes.

This gave rise to a series of moral codes such as loyalty, chastity and filial piety. In the Chinese context, loyalty required that even if one's ruler was cruel, the courtier could not resist, he could only persuade; chastity required a woman to obey her husband regardless of his status, when he dies, she shall not remarry but keep herself; filial piety require a child to obey his parents wholly, and without hesitation rebellion was forbidden even if the parents were unreasonable. This Confucian ethical code, based on strict class-consciousness which favours the interests of the upper class minority, possesses certain similarities with Western religious codes.

There have been sweeping changes in China in recent years. Some traditional practices including filial piety, the favouring of male children, loyalty and complete chastity no longer exist; however, thousands of years of Confucianism still remains embedded in the cultural subconsciousness. In particular, especially that of autocracy, class-consciousness, formalism, exploiting the weak, the suppression of basic freedoms and benevolent love in the Confucius tradition are still the source of many social problems, including compliance to tax laws.

Another influence was custom, i.e. tradition. Although Confucianism affected the historical development and cultural traditions of China, that influence remained

largely academic and political? The general rules and value norms that governed day-to-day behaviour and accepted ways of doing things — whether consciously or unconsciously — were derived mainly from custom. Basic concepts included ‘saving face’, human sympathy and Guanxi (relationships) ; some academics have termed these unwritten cultural rules as ‘covert rules’.

Cultural differences are differences arising from situations where although people are similar because human nature is similar, but people deal with each other differently, and this interaction does not reflect on the quality of the people. Whether in China or the West, when a culture is seen as the norm of social life, and it becomes the moral tradition for the people living in it, without judging the culture, or whether people realise it exists, it becomes an invisible net that covers everybody’s social life. As Weber said, culture is a factually unalterable case in which a person must live²⁹. E.g. in western culture, when a social participant he sets out on a series of market relations, the capitalist economic structure will compel him to follow rules of capitalism. A manufacturer that disregards these rules faces commercial failure; workers who cannot or will not adapt to these rules face unemployment. In Chinese society, ‘saving face’ and ‘human relationship are important social norms beyond the law and market economy and a person ignores these norms to his own detriment. Thus when living in a specific culture, people will consciously or unconsciously adjust themselves to suit the culture, otherwise they will face difficulties in their lives.

B. Cultural Underpinnings of Tax System Characteristics: In Comparison with the West

Any system would have a cultural basis for its existence and evolution, when the system matches with its cultural basis, the system thrives and evolves; when the system does not match its cultural basis, the system would be dissected by the culture, or will create an opposing system.

In Western developed nations such as the UK, US and Germany, culture exhibits the following characteristics:

Firstly, religious belief is prevalent, deep-rooted and less varied; even in contemporary technologically-advanced society, the religious nature of society has not decreased³⁰. This religious nature leads to different observations to morality. For example, advancing economic interest is a common motivation for most people, the acquisition of wealth is seen as an end itself, this end happens to meet consumption needs. This is

consistent with Weber’s analysis of modern Western society — ‘Here, people are oriented to acquisition as the purpose of life; acquisition is no longer viewed as a means to the end [in] satisfying the substantive needs of life’. As long as it is carried out in a legal manner, the acquisition of money in the modern economic order is the result and manifestation of competence and proficiency in a vocational calling’.³¹ It is tantamount to treating the acquisition of wealth as a God-imposed responsibility; a person lives to work, not works to live. Weber believes this abnormal spirituality is the core of capitalism, and endows humans with the motivation to create wealth and gain profit.

Secondly, value can be realised from within the self not dependent on societal perceptions of status. While networks of influence and social connections are still important, the benefits derived are not above the law. The overt flaunting of wealth and strict adherence to formal rules of propriety are also less prevalent in Western culture.

Thirdly, the wealth creation mechanisms are based on strict calculations, thus rational. In both manners of lifestyle and behaviour there are characteristics of precision leading to emphasising on efficiency, i.e. the productivity rationale. The prevalence of rational calculations make people in the west sensitive to price signals, they are often more fussy, which gives rise to an economic operation mechanism that is conscious of quality.

Fourthly, trust that extends beyond blood ties is common. Personal relationships in the West are concerned more with mutual interests and long-term development. This is the reason why in developed societies organisations such as churches, specialist organisations, unions, clubs, welfare organisations, private schools and other volunteer organisations are common historically, especially the modern business enterprises that are established based on non-blood relations. In these social organisations, people from the west cooperate with each other well and are very social.³² In western culture, not only is this competition based on promotion of economic interest, but there is cooperation based on trust, it is a selfish culture, but it also is a trust and cooperating culture based on links through social organisations. If a market only has competition, without trust and communication, the market economy will not be able to exert its basic function of resource reallocation.

The abovementioned culture brought about some important social management characteristics:

perfectionism allows for long-term planning and high quality, where information is relatively symmetric, although there are often events of fraud, but they are not viewed with distain; credit rating is high as there is a high cost for untrustworthiness; high credit rating leads to low social cost, which allows businesses to exist on a large scale for a long time; business people have individual social status, they have enough powers to resist dictators, this is the basis for constitutional democracy. When making laws, details can be considered, individual situations could be clarified, making the enforceability of laws relatively high; people knows the power of laws when doing things. Economic interest is of core importance, everyone protects their own interests, there is no human sympathy, leading to democratic consciousness, democratic activities and democratic systems — where law is the measurement. Law becomes the basic rules for human relationship, the separation of judicial, executive and enforcement powers stop illegal activities of officials effectively. Taxes can only be imposed by popular mandate through the mechanism of an elected government. In such a society, levying taxes without a legal mandate is stopped at source, and the concept of a 'sundry levy' is virtually non-existent. The system of property rights is also generally clear and transparent, with property transfers effected through legal transactions that curtail the imposition of hidden taxes. While industry monopolies will lead to excessive profits, these revenues do not enter government coffers, thus it is impossible for them to become hidden taxes. Tax administration and payment are governed by law, not 'human relationships'. Here the principle is equality in the eyes of the law. While there are stringent penalties for tax evasion and avoidance, the dynamic of social connections or networks of influence rarely have any mitigating effect in the West, unlike in China, creating a social psychology that accepts the high costs of tax non-compliance and a public perception of shame attached to non-compliant behaviour. While some instances of tax avoidance and evasion are unavoidable, this is usually limited to a minority and is far from common practice. In this cultural background, tax administration is equitable in the western taxing model. E.g. The Value added tax allows input tax credit to be offset through invoices (there is no need to print centrally with an anti-fraud symbol); individual income tax is based on self assessment; property tax adheres to the beneficiary principle³³, these are all achieved with relatively low cost and controllable loss of welfare in the economy.

In comparison with western countries, China's current

cultural characteristics are as follows:

Firstly, low religious involvement of the general populace, with the vast majority not holding specific religious beliefs. Some people pray to Buddha or the gods, but with little knowledge of religious philosophies. China is an atheist, pantheist and polytheist country, an extra-moral value scope does not exist and most people live completely secular lives. Few believe their chosen professions to be vocation, money is seen as a means to live and the acquisition of wealth perceived as the keys to a better life or a means to demonstrate social standing. nobody considers earning money itself as a way to relate to God in the way described by Weber.³⁴ The result is economic activities naturally lack longevity.

Secondly, the custom of 'saving face' leads to receiving a way to represent values from external means. In China, 'face' is a metaphor for reputation or regard; reputation is reflected in the individual's position in the social ladder. For those with status (reflected in wealth, power or social connections), society will give him 'face'. A large 'face' means you have more social resources. Personal dignity is derived from right conduct and the social approval it has secured. Personal worth is not considered innate within each human soul as it is in the West; it is extraneous and has to be acquired externally.³⁵ Since value is largely derived from external means, this means that the major motivation behind economic gain is not improvement or innovation, but self-interest. 'In the Chinese tradition, however, the economic man will do best not by increasing production but by increasing his own share of what has already been produced. He will rise by competing against his fellows directly rather than by creating new wealth through the conquest of nature, or the increased exploitation of her resources, or applications of improved technologies. The incentive for innovative enterprise, to win a market for new products, has been less than the incentive for monopoly, to control a market by paying for an official license to do so. The tradition in Chinese has been not to build a better mousetrap but to get the official mouse monopoly'.³⁶

Thirdly, the tradition where human sympathy is of the utmost importance and where relationships need to be taken into consideration, leads to difficulties in enforcing laws strictly. Human sympathy is the way to deal with people.³⁷ A person belongs to the society, thus each ethnic group has human sympathy issues, but in China's society, human sympathy is one of the basic moral rules to constrain people by a social exchange relationship based on mutual help. Sometimes its

power of constraint is higher than the law and material exchange relationships. In China, human sympathy differs according to relationship, for those who have special relationships (e.g. blood relations), mutual help is not considered as 'exchange', others there is equal exchange--social exchange. People use this social exchange to establish relationship networks (Guanxi). The grouping of Chinese people is based on the lowest common denominator, e.g. place of origin, extended family, work colleagues, classmates, sworn brothers and teacher and students, etc.³⁸ Therefore, these relationship networks differentiates by whether you belong or not, within the network, there is equal treatment and mutual trust and when dealing with strangers, there is selfishness 'when a person does not consider the self, the heavens and earth will kill him'. There is a mentality of 'it is not my business, hang it up' and 'I only have to clean the snow in front of my door, I don't worry about the ice on the neighbour's roof'.

Fourthly, the relationship network system that differentiates by belonging leads to trust being very uncommon. In the analects of Confucius, 'trust' came up 38 times, which is only less frequent than 'benevolence' and 'propriety'. It recorded, 'If a person is not trustworthy, how is it possible for him to live'. The idea that Confucianism promotes trust is a misunderstanding. The basis for Confucianism is propriety and class, hence only the gentlemen³⁹ / ruling class are seen as trustworthy, while 'small men' who are not respectable persons, strangers and women (who are perceived as similar to 'small men') are not considered trustworthy. Therefore 'trustworthiness' in Chinese culture is dependent on class. This is different from the West.

In the abovementioned cultural environment of human sympathy, saving face, relationship networks, 'it is not my business, hang it up', people who rebel against inequality are rare, the weaker in society can only keep quiet and allow themselves to be exploited. It is impossible to establish a system that prevents inappropriate levying, one can only hope for wise rulers and good courtiers. The uncommonality of trust means private businesses cannot escape the saying that 'wealth will not stay in one family for more than three generations', it is difficult to grow large and strong. Society still cannot have a civilian class with business people as the core, making constitutional democracy hard to develop. Laws do not need the approval of the people; taxes can be levied without representation, making the situation where there are many sundry levies and hidden taxes besides formal taxes hard to avoid.

In China, helping family and friends is a matter of course in human sympathy; one has a larger responsibility to help those who are closer related. This creates conflict, for people who human sympathy is more important, they have to look after their selfish interest over the public interest, they have more human sympathy, but less public responsibility. For those who are officials, as a public servant, they have to follow the law, the law demands 'do the public's business in a public manner', 'treat everyone equally' and 'do not consider self interest', 'if the prince disobeys the law, they will be guilty as the peasant'; but as a person belonging to the society, he has to be constraint by the moral rule of 'human sympathy', human sympathy as a rule is more basic and has better constraints. If he does not follow this rule, he would be considered as not knowing how to be a person, thus isolated. This thus gives rise to role conflicts, in the majority of situations, people will compromise the law for human sympathy, under certain circumstances, human sympathy is the moral rule accepted by the society⁴⁰. In China, the enforcement of administrative rulings and regulations that differs according to individuals is a matter of course, an attitude of equal treatment for all would be considered as ignorance of common customs⁴¹. The person with 'face' is normally the leader of the law enforcer, their colleague, teacher or otherwise related by family or friendship, if the law enforcer does not answer the favours asked, and coldly follow the law, they are not giving the pleader 'face'. The less serious consequence is they will lose the relationship, i.e. lose the opportunity to return the favour; seriously they will face jealousy and retaliation, thus the case may not continue in their hands. In a society full of these 'face', human sympathy relations, the wise law enforcer will have to consider rationally when dealing with cases, to find a way that meets both the law and the human sympathy. This leads to the social psychology of low expected cost for one being punished from disobeying a law. Therefore there is no tradition in China where laws have to be followed to the letter. When illegal activities are discovered, if the accused can find someone in the relationship network with 'face' to plead for them, a large issue will become small, and a small issue will go away. Thus the administration of laws is far from uniform.

In a situation where constitutional democracy cannot be created, in order to deal with the above problem, one has to design systems that 'face', human sympathy and relationship networks cannot operate, therefore anti face, human sympathy and relationship systems⁴².

CONCLUSION

In today's increasingly globalised economy, it is harder to view China and its tax system from either the point of view of an 'insider' or that of an 'outsider'. The 'insiders' may want to see China in its deep rooted culture of saving face, human sympathy and the system of 'guanxi' relationships, and design a tax system for those purposes. The 'outsiders' look from the west in, where these cultural underpinnings seem difficult to understand, but urge China to design a tax system following western ideals⁴³. This paper discussed the tax systems currently present in China and the relationship with their cultural underpinnings, providing evidence that China and its Ataxes can now be studied objectively, from a theoretical basis familiar to scholars and in a context understandable to stakeholders in its tax system. It also presented the cultural reality of China and advocates that when debating tax reforms in China, these cultural sensitivities need to be taken into consideration.

AUTHOR BIO

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NOTES

- ¹ Translation of '礼不下庶人，刑不上大夫' from Liji. Liji is an ancient Confucian Classic on the law and system of government written during the War Lords period.
- ² Human Sympathy operates parallel to the law in China's administrative system and governance structure.
- ³ Translation of '事不关己，高高挂起'.
- ⁴ Defined in Peter E Nygh and Peter Butt (eds), Butterworths Australian Legal Dictionary (Butterworths, 1997) 1150.
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- ⁸ 2009 Government Revenue included general budget revenue of RMB 6133.035 Billion, fund budget income is RMB 1563.635 Billion, social insurance charge revenue RMB 1197.2 Billion, extra-budgetary revenue of RMB 682.032 Billion (Data of 2007), these do not include income from national or international debt and extra-systemic government income that are collected and used by the same organization and which are not included in fund budget management. Detailed calculation method please see Yang Bin, ed, chapter 1 in Public Finance (《财政学》), North Eastern Finance University Press, 2007.
- ⁹ Includes import consumption tax withheld by customs, but excludes export deduction.
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- ¹¹ According to State Administration of Environmental Protection, 2008 National Environment Statistics Public Announcement.
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¹⁷ Ministry of Finance, National Development and Reform Committee, Ministry of Transport, Ministry of Monitoring and Ministry of auditing, Circular on abolishing fees relating to transportation and vehicles such as road maintenance fees, Cai Zong [2008]#84.

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¹⁹ Ministry of Finance, National Development and Reform Committee, Circular on abolishing 100 administrative fees, Cai Zong [2008]#78.

²⁰ Ministry of Finance, National Development and Reform Committee, Circular on printing the 2008 list of national departmental and administrative organization fees, Cai Zong (2009) #46.

²¹ Calculated according to the data provided by Minister of Finance, Xie XR, Report on the administering of central and local government budgets of 2008 and the central and local government budget drafts of 2009 (Second meeting of the 11th Conference of the National People's Congress on 5th March 2009), in 2008, government fund revenue is RMB1563.635 Billion, including land sales and new construction land compensation fee revenue of RMB 1037.528 Billion, subtracting land acquisition, compensation for force removal and compensation for land acquired from farmers equaling RMB 377.815 Billion, land development and arable land protection expenditure equaling RMB 128.622 Billion, rural area infrastructure, basic farm development and protection expenditure of RMB 36.988 Billion etc. which are compensation to farmers and other land owners, the remaining amount is RMB 494.103 Billion.

²² Authors' note, this is similar to form over substance that is familiar to western researchers, but the emphasis is placed on what the tax is called.

²³ A distinction is made between legislature legislation in China and laws made by parliaments of developed democratic countries. The legislature includes both the NPC and its standing committees.

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²⁵ Ministry of Finance, Civil Aviation Infrastructure

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Real Estate Tax (RET) of People's Republic of China

LUO YANG¹

This paper examines the trial implementation of the Real Estate Tax in Shanghai through analysing its effects on housing price, its effects on the rigid demand of housing and on housing as an investment option. It also identifies a few reform options if the government chooses to implement the Real Estate Tax as a policy to control housing prices.

BACKGROUND

Although the 2008–2009 Stimulus Package² implemented by the PRC government successfully stimulated the national economy during the 2008 Global Financial Crisis, it had the effect of fuelling an already overheated residential real estate market³. The stimulus policy resulted in an increase in both demand for investment and consumption, GDP growth of 8.7% and a 40% increase in real estate sales. During this period, average house prices increased by more than 25% and sales revenue from property increased by more than 70%. This demand marked the highest point that the real estate market has experienced since the Open Door Policy.

In response to the rapid overheating of the real estate market³, utilising both monetary and fiscal policy, the government issued a series of new control and regulation policies during 2010. An analysis of the policy indicates that the government aimed to reduce demand in the real estate market by increasing the requisite down payments of investment property to 50% of purchase price⁴ and prohibiting insurance funds from purchasing new property with the exception of public housing. These regulation measures were also aimed at limiting speculative investment activity.

On 27 January 2011, the Shanghai Municipal Government issued 'Temporary Rules on Implementing the Real Estate Tax on Some Personal Housing in the Shanghai Pilot Project' (RET). The geographic scope for this pilot program was limited to the administrative region of Shanghai. This provisional tax is levied on all new home purchases affecting both new homeowners and existing homeowners who purchase additional property after the 27 January 2011. The tax liability is calculated on the market-based value of the property, however during the provisional period, it will be calculated on the transaction value. The tax rate is currently set at 0.6% of purchase price which is to be reduced to 0.4% of purchase price in the event that the purchase price per metre squared is less than double the average price of metre squared of new developments in the area from the previous year. Properties which are smaller than 60 square metres are exempt from this tax. Under these provisional implementation rules, tax concessions are available for highly skilled individuals who have migrated from outside of Shanghai.

HISTORY OF REAL ESTATE TAX (RET) IN CHINA

Real estate tax (RET) is levied on properties that are used as residential housing for individuals. The

tax calculation is based upon the residual value of the house or rental income received. The objectives of the RET are to enhance the management of the real estate industry and to raise the service efficiency of the housing market. RET is also used to control the growth of fixed assets investment and to readjust and optimise the investment structure. RET is an important tool in cooperating the adjustment of state real estate policy. RET also has the ability to reasonably adjust the wealth of properties' owners and operators.

After the founding of the People's Republic of China, the Government Administration Council in 1950 issued 'The Law of the People's Republic of China concerning the Administration of Tax Collection.' RET is one of the 14 taxes that was administered by this legislation. In August 1951, the Government Administration Council issued the 'Provisional Regulations of the PRC Urban Real Estate Tax'. As a result the real estate tax and other land taxes were merged into the Property Tax. To simplify the tax system, the Property Tax, which was levied on state-owned enterprises and collectively-owned enterprises, was merged with other commercial and industrial taxes under the 'Commerce and Industry Tax'. During the reforms to the taxation system, the government reinstated the Property Tax, and separated the Housing and Land Tax into Property Tax and urban land use Tax.

The present RET in China is levied after the second phase of replacement of profit by tax in china. In 1986, the state council officially published 'Provisional Regulations of the People's Republic Real Estate Tax' (Provisional Regulations) on the 15th September 1986. The regulations came into effect on the 1st October 1986 and were levied on domestic units and individuals.

CONSIDERATIONS FOR FURTHER DEVELOPMENT OF RET IN CHINA

1. The Collection Scope of the Tax is Limited

Currently, under the Provisional Regulations, the RET laws are only applicable to urban areas. This is an issue as although rural areas have also experienced rapid growth, which in some cases has eclipsed growth seen in urban areas, they are not burdened with the duty of RET. This limited scope is a departure from the fair and efficiency principles of the collection of tax revenue. Simultaneously, some companies have used this limited scope as a tax avoidance strategy. Tax revenue growth in this area has been limited due

to this policy.

2 .The Tax Relief Provisions Have Not Been Adjusted to Reflect the Growth of the Market Economy

All non-business use, personal properties are exempt from property taxes. However, due to the rapid development of the real estate market, it is necessary for the RET policy to change accordingly to deal with this unprecedented growth. As the market for fixed asset investment is growing rapidly, suitable adjustment to the scope of tax relief is needed. As the reform of the management of public institutions induce marketisation in those units they gradually acquire the characteristics of enterprise. Therefore, institutions should be included in the tax base.

3. Increasing Property Prices Have Led to Unaffordable Rental Prices

Investment in the property market for rental purposes has exploded in the wake of the tax relief provisions granted under the RET. As a direct result of the price rises in the property market, rental prices have made housing unaffordable. This has led to an exponential increase in the vacancy rate for investment properties. Figures from various media sources indicate that vacancy in the rental rate has reached 40% in April 2010; the international common practice is 10%. This phenomenon leads to unfairness in the allocation of social resources and a widening gap between the rich and the poor.

RESEARCH METHODOLOGY

This paper uses a quantitative analysis method with the new rules⁵ in Shanghai, to analyse fluctuations in housing prices after the introduction of the trial. The research will aim to establish the change in disposable income after the new tax is introduced and predict whether the new prices will still be affordable to the average income earner. The research will focus on the middle and lower income groups, as this is where the tax is targeted at. For example, assuming a family has an annual income between 100000 to 300000 RMB, since they are the mainstream purchase power in Shanghai, they will have a motivation to change their living conditions, this can be more specifically defined as rigid demand. The high-income group will hardly be affected by this new tax as the tax does not substantially reduce their income. However, the investment behavior of high income earners should be considered. A basic rate of 6.80% is chosen to represent the interest rate charged on property mortgages. Since the first property of a non-resident will become tax-free after three years of work in Shanghai, and the

fact that local residents are only taxed on their second property, for the purposes of this paper, we only need to consider those local residents who are purchasing their second property. The second home loan will apply 1.1 times of base rate and 60% down payment.

The aim of this paper is to discover the relationship between RET and house prices in Shanghai. Although the RET of investments before 27 Jan 2011 will not be imposed, we will run a hypothetical case as if the investment before 27 Jan 2011 would be taxed.

INTRODUCTION OF RET POLICY IN SHANGHAI

Collection Scope

From the collection and the scope of the object, 'all housing purchased after the first residential home, bought after the 27 Jan 2011, by residents of Shanghai in addition to first home purchases by non-residents, will be levied with this tax'.⁶ The date of application may lead to unfairness as those buying before that exact date will be able to avoid this tax. Any property brought one day before or one day after will have different tax liability. Nevertheless this tax is a truly efficient method to control the demand.

Basis of Tax Assessment

The assessment is 'with reference to the market price of taxable real estate, and the period reassessment is required. At the early stage, the tax is based on the 70% of the market trading price'⁷, this means the tax base will fluctuate with the real estate market, allowing this tax to be coordinated with current economic situations.

Duty Rate

Different fair value of the property will have different duty rates. The tax rate is 'temporarily set at 0.6%, if the average per square metre selling price is lower than twice the average per square metre selling price of the last year, the tax rate is reduced to 0.4%'.⁸ In terms of equity, people with different wealth will have a different tax burden. It will reduce the inequitable distribution of wealth, and narrow the gap between the rich and poor.

Tax Exemptions⁹

If the buyer can hold a residence permit for more than three years, the levied tax will be refunded. Consistent with the introduction of the relevant provisions of state and city high-level personnel, if there is shortage of key industry personnel and they are required to move into the taxable area urgently, and the house is their only property, the tax will also be refunded. These conditions can significantly reduce the speculative

conduct in the real estate market. The tax refund on the property that is used for personal purposes will aid in wealth redistribution. This is rooted in the fact that people who can afford additional property will be burdened with a higher tax liability.

Spending Direction of Tax Revenue¹⁰

The RET levied in Shanghai will be used to construct public housing. An increase in the supply of affordable housing will relieve the unevenness between supply and demand. This will lead to the price returning to the equilibrium point.

Quantitative Analysis

Assumptions:

1. The house area is around 120 sq, This area is the normal demand for a three-member family with 2-3 bedrooms.
2. The average housing price in Shanghai 2010 is around 20000/sqm¹¹.
3. Assume two income levels: low income families have an annual income 100000 RMB; middle income families with 300000 RMB. The family with the lower income level can still afford housing and have an incentive to improve their living conditions. The middle income group prefer living in a more central area to the central business district, as there are more facilities and services. We assume that their property is valued at 40000 RMB/sq.m, with the lower income family assumed to own housing in the suburbs with a price of 10000 RMB /sqm.
4. Public accumulation fund for housing construction (PAFFHC) is 7% of monthly income in Shanghai¹². We assume all the income is under the PAFFHC system, to simplify, each family has a deduction of monthly income multiplied by 14% in their house loan PMT payments.
5. The maximum maturity of housing loans is 30 years. It is assumed that most people will choose to take advantage of this maximum.
6. As the first home is tax exempted, or can be refunded after 3 years working in Shanghai , we will only consider people who are attempting to buy their second house; meanwhile, as the first house will not be

used for rent, no extra income needs to be considered.

7. Since the regulation states that the down payment of a second home loan needs to be greater than 50% of the total price , we assume that all the families will choose a 60% down payment. And the interest for the second house is 1.1 times of basic interest, the basic rate is now 6.8%, so the base rate for the second loan is 7.48%.

8. The house buyers are all rational, and choose to buy a house suitable for their needs and income.

THE EFFECT OF RET ON RIGID DEMAND

Scenario 1

Low income family with annual income lower than 100000. The monthly income is around 8333, since the Second home loan interest rates is 1.1 times of the base rate, so the rate rise to 7.48%; and the tax be calculated monthly. The price is 10000/sqm.

After the RET, the family Net Income reduced from 6150 to 5750, the tax seems to have little influence on the disposable income. It cannot stop people from investing in the second house.

Scenario 2

Middle income family with annual income lower than 300000. The monthly income is 25000, the second home loan interest rate is 7.48% and the tax is calculated monthly. As the middle income group prefers the centre of the city, the price will be higher, and the tax rate will rise to 0.6%.

After the RET, the family Net Income is reduced from 15100 to 12700, it seems that the tax only has a very limited effect on the disposable income for a middle income family.

From scenarios 1 and 2, under rational assumption, we find that the deduction of households will not have a notable effect on the net income of a family. So the RET may not be pressing on the rigid demand.

Base rate	Family monthly income	House area	Price/sq.m	Total
7.48%	¥8,333.33	120	¥10,000.00	¥1,200,000.00
Loan value	Maturity(Year)	PMT	PAFFHC	Net PMT
¥480,000.00	30	(¥3,349.66)	¥1,166.67	(¥2,182.99)
Tax rate	Tax/month	IBT	NI	
0.4%	(¥400.00)	¥6,150.34	¥5,750.34	

Scenario 3

If the low income family do not buy a house suitable for the income, they choose to buy a house at 15000/sq.m. All the condition same as the scenario 1, except the unit price increases from 10000 to 20000.

Base rate	Family income monthly	House area	Price/sq.m	Total
7.48%	¥8,333.33	120	¥20,000.00	¥2,400,000.00
Loan value	Maturity(Year)	PMT	PAFFHC	Net PMT
¥960,000.00	30	(¥6,699.32)	¥1,166.67	(¥5,532.65)
Tax rate	Tax/month	IBT	NI	
0.4%	(¥800.00)	¥2,800.68	¥2,000.68	

From the numbers above, if people choose to buy a house which is not consistent with the family income, the disposable income is hard to satisfy the consumption of a normal family, so a rational person will choose a house they can afford.

The Effect of RET on Investment

For the high income group, an investment in the property market house is primarily to make profit. However, the new regulation states that the RET will only be imposed on housing bought after 27 Jan 2011. Shanghai has prohibited people from buying a third property since 2010. So the RET will have no effect on the investment conduct which happened before. With the prohibition on additional properties already in place the RET will have no direct effect on the investment property market.

Scenario 4

From the historical data, there is about a 35% vacancy rate in the rental housing market in Shanghai. If RET can levy on this part of housing, the investor will pay RET. For example, we assume a normal investor will pay the RET.

All the properties grant a 50% loan from the bank, from the price control targets (March 2011) of more than 600 cities is limiting the growth rate under the growth rate of GDP. If the house prices increase at 9%, match the growth of GDP. The housing price for investment equal to the average price, reached 20000/sq.m. For a single investment property:

Base rate	House area	Price/sq.m	Total	Loan value
7.48%	120	¥20,000.00	¥2,400,000.00	¥1,200,000.00
Investment profit	Interest(about)	Tax	NI	
¥216,000.00	¥89,760.00	¥9,600.00	¥116,640.00	

We can see that if the control target is a 9% increase rate in the real estate market, the investor who invests a 120 area house with 20000 unit price, even include the interest and RET, the Net income before turnover tax is about 116640. As there are limited areas for investment in China, the real estate market remains a preferred choice for investors wishing to receive a positive return on investment.

CONCLUSION

RET that is imposed on middle or low-income families may adjust the structure of the property market, but it will not suppress rigid demand. In regards to effects on the investment property market; the RET is not an effective way to control house prices since the decrease on the profit of these investment properties is limited.

According to the details of ‘Temporary Rules on Implementing the Real Estate Tax on some Personal Housing in the Shanghai Pilot Project’, equity is considered as the primary element in this new tax.

At present, the gap between rich and poor is widening. As a result, there are calls for the fair distribution of wealth. This requires the tax system to reflect the equity principle. The defective tax system in real estate has a strong impact on the distribution of social resources. Reform to property tax is urgently needed. Generally speaking, action is needed to enhance the equity and efficiency of RET. In particular, there needs to be a formulation of a complete tax system, suitable duty rates, and an improvement of the legal system.

However, targeting the inconsideration of equity of Ramsey optimal commodities tax, Diamond and Mirrlees (1971), Feldstein (1972), Atkinson and Stiglitz (1976) state that ‘brought the issue of redistribution into the analytical framework, and indicate that the efficiency and equity goals of commodity tax are difficult to achieve at the same time, when designing real tax systems, a balance is required’. The principle of tax efficiency is the precondition of equity, the inefficiency of allocation of tax resources will have a strong effect on the health of the economy. Tax equity is an important prerequisite for ensuring efficiency. The injustice of wealth distribution will cause social instability, and finally be detrimental to efficiency.

In comparison to the turnover tax; the direct tax is normally levied on the phases of distribution and consumption. The effectiveness on distribution (allocation) of resources is inferior to that of the turnover tax. The direct tax is more likely a tool for achieving the equity.

Real estate tax is a direct tax. It should be primarily focused on the principle of equity. There are two categories of taxpayers: Enterprises and individuals. The new policy on RET in Shanghai is levied on individuals. Equity becomes the main point of dispute.

The real estate tax levied in Shanghai is based on a specific time point, area and purpose (characteristic) of the housing property. When taking into account situations such as different family configurations, the tax burden would be different; when using a floating interest rate will mean prices of housing would be different. These factors all contribute to the question of equity.

RECOMMENDATIONS FOR FUTURE REFORM TO THE RET POLICY

1. Establish A Non-Punitive Tax System and Introduce Multi-sector Cooperation

In the real estate tax area, a complete tax system should be established. A well-structured and exhaustive Real Estate Tax System is a good solution for the high price of housing. An increase to the tax duty of maintenance may be suitable for the nation’s circumstances. RET is not only a tax issue, it is also an issue dealing with the regulation of the real estate markets. Cooperation from different sectors is needed in order for the RET to be relevant to the whole economic environment.

2. Enlarge the Tax Base of the RET

As we know, real estate tax is a stable source of tax revenue. With the narrow tax base, states not only lose a considerable part of fiscal revenue but businesses and individuals may be tempted to avoid the tax by investing in rural areas. The issue of economic development imbalance in China is significant, fiscal revenue collected from a small village in the east can exceed that of a city. These discriminatory policies will create inequity. An enlargement of the tax base could also coincide with further economic development and better tax policy.

3. The Basis of Tax Assessment Should Be Reasonable

The trend in real estate assessment in China is to use the fair value rather than the original value. The advantage of fair value is the convenience in supervising in the real estate market. The fair value method also allows the tax to rapidly respond to any fluctuations in the market. The fair value can reflect the real capacity of the taxpayer. It is also helpful in equity.

4. Increase the Flexibility of the Tax Rate

The establishment of a tax rate should follow the principles of flexibility and elasticity. Areas with different capabilities should have different tax rates. This will adjust the imbalance in development in different areas. It will also be good for balancing

social wealth and the allocation of the economic resources, narrowing the gap between the rich and poor, ultimately stimulating people's happiness index.

5. The RET Should Be Administered by Tax Authorities

The Rule of Law is the basis of levying the RET. A property registration system is needed to prevent tax evasion. An increase in transparency with regards to sale of real estate is also needed. Each department should share information and create a mutual supervision system. The tax department should also increase their quality of service, simplify their processes and educate taxpayers to increase efficiency in tax collection.

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