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China's Tax System: An Evaluation

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China's Tax System: An Evaluation

Keywords

Territorial Waters, State and Local Government Law, Investment, Taxation

China's Tax System: An Evaluation*

JINYAN LI**

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* It is important for the reader to know that most of the references and citations within the text's footnotes have been translated from Chinese by the author.

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Very little has been written in the West about the Chinese system of taxation as a whole, even though the appearance of numerous publications dealing with taxation of foreigners in China reflects the obvious interest of Western writers in this area. Taxation, however, is central to the current reform of China's entire economic system and, as such, merits greater attention. This article attempts to provide a concise overview and evaluation of the tax system, explaining its evolution, in the hope that this might stimulate comment and discussion among Western observers.

I. THE EVOLUTION OF THE CHINESE TAX SYSTEM¹

The tax system in China has developed with the evolution of the political and economic structure of the country. As the latter predetermines the fiscal structure, the fiscal systems of the various historical periods reflect the economic situation and the interests of the governing body. In the course of several thousands of years of feudal society, the feudal dynasties derived most of their revenue from compulsory levies, land taxes and various excise taxes on items like salt, tea, liquor and iron. Taxation of commercial activities was only commenced in the Song Dynasty (960-1279) when a class of merchants started to appear and commercial transactions became popular.² Direct taxes in the modern sense were first introduced by the Guomindang Government in 1936. By the end of the Guomindang Era (1912-1949), there existed about eighteen taxes, including land tax, contracts tax, income tax, profits tax, inheritance tax, business tax, stamp tax and excise taxes³.

The tax system of the Guomindang Government was abolished by the Communist Government with the promulgation of the "Principal Rules for Implementation of the National Tax Administration" in January 1950⁴. The Principal Rules instituted a new unified tax system and designated the different categories of taxation. Apart from the existing agriculture tax, fourteen taxes were introduced: the commodity tax, industrial and commercial tax, salt tax, custom duties, stamp tax, transaction tax, slaughter tax, house property tax, land tax⁵, special consumption tax, vehicle and vessel license plate tax, interest income tax, salary or remuneration tax and inheritance tax. The two last mentioned taxes, however, were never implemented.

From the beginning, the most important tax was the industrial and commercial tax which comprised a business income tax and a business turnover tax imposed on business entities temporary commercial enter-

1. For a more detailed discussion, see A.J. Easson and Li Jinyan, *The Evolution of the Tax System in the People's Republic of China*, 23 STAN. J. INT'L L. 399 (1987); WANG KUN, GUOJIA SHUIFA GAILUN (A GENERAL INTRODUCTION OF THE NATION'S TAX LAW) 57-82 (1985) (Chinese version); LIU LONGHENG, ZHONGGUO SHUIFA GAILUN (A GENERAL INTRODUCTION OF CHINA'S TAX LAW) 1-52 (1986) (Chinese version); and ZHAO WEIJIN & YIN ZHONGXIN, ZHONGGUO SHUIWU XUE (CHINESE TAXATION) 81-96 (1987) (Chinese version).

2. See generally Zhongguo Caizheng Jinrong Xueyuan Caizheng Jiaoyan Shi (The Teaching and Research Group of the Finance Department of China's Fiscal and Financing Institute), ZHONGGUO CAIZHENG JIANSHI (A BRIEF HISTORY OF CHINA'S FINANCE) 107 (1980) [hereinafter CAIZHENG SHI]; ZHOU BODI, ZHONGGUO CAIZHENG SHI (CHINA'S FINANCE HISTORY) (1981) (Chinese version); and R. HUANG, TAXATION AND GOVERNMENTAL FINANCE IN SIXTEENTH-CENTURY MING CHINA (1974).

3. CAIZHENG SHI, *supra* note 2, at 264.

4. Principal Rules for the Implementation of the National Tax Administration, adopted by the Government Administration Council on January 27, 1950 [hereinafter "Principal Rules"].

5. The house property tax and land tax were combined into an Urban Real Estate Tax, the regulations of which were promulgated in 1951.

prises and street-traders. A contract tax and a cotton-yarn monopoly sales tax were introduced soon afterwards. Despite the Korean War, economic recovery from the years of the anti-Japanese war and the civil war was quite rapid and tax revenue doubled in two years. The state sector of the economy had also commenced to grow and this facilitated the simplification of the tax system which occurred in 1953. The number of taxes was reduced to thirteen,⁶ with a number of the specific taxes either disappearing or being merged into a single commodity circulation tax. This reform was carried much further in 1958, when the number of taxes was reduced to eleven. The simplification, however, may have been more apparent than real, except from an administrative point of view, since the new Consolidated Industrial and Commercial Tax,⁷ which replaced four existing taxes, preserved many of the previous categories and grew in complexity and multiplicity of rates and schedules.

The chief effect of the consolidation was to bring together a variety of commodity, excise, sales and turnover taxes, leaving the tax on business income as a separate item — the Industrial and Commercial Income Tax.⁸ Another achievement of the 1958 reform was that a new national Agriculture Tax was introduced.⁹ A further reform took place in 1973 when the Consolidated Industrial and Commercial Tax was merged with a few other taxes levied on state enterprises, such as the urban real estate tax, the vehicle and vessel license plate tax and the slaughter tax, and the name "Consolidated" was dropped. As a result of the simplification, state enterprises became liable only to the Industrial and Commercial Tax, whereas collective enterprises were liable to the Industrial and Commercial Income Tax as well as the Industrial and Commercial Tax.¹⁰

6. The taxes that were reduced were the commodity circulation tax, commodity tax, industrial and commercial taxes, stamp tax, salt tax, customs duties, livestock transaction tax, slaughter tax, urban real estate tax, entertainment tax, vehicle and vessel license plate tax, interest income tax and contracts tax; see LIU, *supra* note 1, at 11. For a further discussion of the tax system between 1950 and 1956 in China, see GE ZHIDA, GUODU SHIQI DE ZHONGGUO YUSUAN (CHINA'S BUDGET IN THE TRANSITION PERIOD) (1957).

7. Consolidated Industrial and Commercial Tax (Draft), *adopted* by the Standing Committee of the National People's Congress on Sept. 11, 1958, *promulgated* for trial implementation by the State Council on Sept. 13, 1958.

8. Until 1980, this was the only tax on business profits. Introduced in 1950 as one of four components of the industrial and commercial taxes, it was imposed upon the income of all industrial and commercial enterprises operated for profit. Since 1980, new legislation has been adopted to tax enterprises with foreign investment and various types of domestic enterprises.

9. Agriculture Tax Regulations of the People's Republic of China, *promulgated* by the 96th Session of the Standing Committee of the National People's Congress on June 3, 1958 [hereinafter Agriculture Tax Law].

10. In 1950, regulations were adopted which exempted most publicly-owned enterprises from income tax. See Ministry of Finance Notice on Payment of Industrial and Commercial Tax by Public Enterprises, *issued* Mar. 17, 1950; and article 5 of the Provisional Regulations on Industrial and Commercial Tax, *adopted* Jan. 27, 1950. See also H. Chao and Yang Xiaoping, *Private Enterprises in China: the Developing Law of Collective Enterprises*, 19 INT'L L. 1215, at 1236 (1985); and GE, *supra* note 6, at 67.

That, essentially, was how the Chinese tax system stood at the beginning of 1980. With the launching of the "Four Modernizations" programme in 1978, two years after the death of Chairman Mao Zedong and the end of the "Cultural Revolution", a new set of economic policies was adopted by the Chinese Government. The new policy was composed of two parts: the opening to the outside world and the reforming of the domestic economic system.

The "open to the world" policy called for more international cooperation, and foreign enterprises were invited to invest in China bringing with them capital, skills and technology. Fiscally, this had two major implications. First, if foreigners were to be encouraged to do business in or with China, they might also be expected to contribute to the Chinese economy by paying taxes on their profits. Second, if a tax regime for foreign investment was to be introduced, it was necessary that the system be differentiated from the domestic tax system. These differentiations were necessary as these investments would not form part of the central economic plan. The government promised the autonomous management of these foreign investment enterprises. As a consequence, the first major amendments to the Chinese tax laws since 1950 were those which concerned foreign business and investment in China.¹¹

On the domestic scene, the reform was initiated in rural areas in 1979 and expanded to urban areas soon afterwards. The introduction of the "household responsibility system" in the countryside, leading to the virtual dismantling of the People's Communes which had been set up in the 1950s, had enormous economic consequences but little impact on the agricultural tax system. As a deliberate policy, agricultural taxes have not increased in line with production and the main consequence of the rural economic reform has been an increase in the payment of taxes in cash rather than in kind.

Reform of domestic industry has been a different matter. The ownership structure of the industrial sector has been changed from the previous state-owned to a multiple structure of ownership whereby collectively-owned and privately-owned enterprises coexist with the state enterprises. State enterprises themselves have been given much more autonomy to operate as independent economic entities through experimentation with various responsibility systems. The orthodox central planning of the economy is being replaced with a state-guided market economy. The fiscal reforms have been equally significant. Whereas state enterprises were formally required to turn in all their profits to the state, experiments were begun as early as 1979 to allow those enterprises to keep part of their profits to expand production and to issue bonuses and awards to workers. This experiment proved generally successful, with the growth

11. The Individual Income Tax Law and the Joint Venture Income Tax Law, both of Dec. 14, 1980 and the Foreign Enterprise Income Tax Law of Dec. 13, 1981. These tax laws will be discussed further below.

rates of those enterprises chosen for the experiments averaging three to four times that of the average state enterprises. Based on the experience drawn from the experiments, a further reform took place in 1983 to make state enterprises subject to income taxes — a reform which is commonly referred to in Chinese as *li gai shui*.

The first stage of *li gai shui* commenced in 1983 in accordance with the Provisional Regulations on Levying Income Tax on State Enterprises.¹² By the end of 1983, over 90 percent of profitable state enterprises were paying income tax.¹³ At this stage of *li gai shui*, state enterprises were still required to deliver their "extra" after-tax profits to the state. The purpose of the reform was to give enterprise managers greater independence and control over the allocation of funds and with regard to investment decisions and, by permitting a substantial part of the profit to be retained, to provide an incentive for greater efficiency and promote competition between enterprises. There was, however, a major obstacle to this. Due to the distortions caused by price controls and the unbalanced allocation of natural resources and capital investment, the level of after-tax profits among state enterprises does not necessarily reflect the level of management and productivity. Therefore the second stage of *li gai shui* was instituted in October 1984,¹⁴ requiring all taxable state enterprises only to pay income taxes and removing the obligation to deliver profits to the state. Enterprises were thus permitted to retain all their after-tax profits. The second stage of *li gai shui* also implemented a new turnover tax system which replaced the former Industrial and Commercial Tax with four new taxes — a product tax, a value-added tax, a business tax and a salt tax. Regulatory taxes on resources and state enterprise profits and other taxes were introduced to complete the substitution of tax payment for profit delivery for state enterprises so that, in the end, taxation became the primary means by which the state shares in the profits made by enterprises.¹⁵

The re-birth of collective and private enterprises also necessitated the introduction of new taxes on business profits generated in these enterprises.¹⁶

12. Provisional Regulations on Levying Income Tax on State Enterprises, *adopted by the Ministry of Finance on April 29, 1983.*

13. Yan Zhensheng, *Stage Two of the Substituting Taxation for Profit Delivery for State Enterprises*, Zhengfa Luntan (Political and Legal Forum), 1985, No. 3, 53 (Chinese version).

14. Pursuant to the Trial Measures concerning Stage Two of the Substitution of Taxation for Profit Delivery of State Enterprises, *adopted by the State Council on Sep. 18, 1984.*

15. Subsequently, however, there has been a move to adopt the "contract management responsibility system," under which a contract is made by the state with the management to require the latter to turn over a prescribed amount each year out of profits, thus reintroducing a form of profit delivery.

16. The Collective Enterprise Income Tax of Oct. 26, 1985, the Urban and Rural Individually-Owned Industrial and Commercial Households Income Tax of Jan. 7, 1986, and the Private Enterprise Income Tax Law of June 25, 1988.

Consequently, the current tax scene in China bears very little resemblance to that which existed at the beginning of 1980. There have been changes in the Agriculture Tax, especially in the method of payment. An entirely new system of taxation has been installed to deal with foreign enterprises and investment. An individual income tax has been introduced for the first time. Commodity and product taxes have been radically revised. State enterprises now pay tax on their profits instead of accounting for them to the state. Private and collective enterprises have been revived and are subject to wholly new taxes. Some new local taxes have been introduced. Not only has a complete new tax system been created but taxation has assumed a new importance: whereas in the period 1958-1978, tax revenue accounted for only 40 percent of state revenue, by 1985 this proportion had risen to approximately 95 percent.¹⁷

II. THE CHINESE TAX STRUCTURE

Currently in China, there are taxes levied on commodities and services, taxes imposed upon personal and business income, as well as taxes charged by local governments. Several "penalty" taxes are also levied by the government in order to implement certain state policies, such as the bonus taxes and construction tax. Each of the main taxes will be briefly described and commented on in the following section of this paper.

A. *Turnover Taxes*

Turnover taxes are those taxes levied on the basis of business revenue derived from the sales of products and the provision of services. Ever since the eighth century B.C., this type of tax has been an important and reliable source of government revenue in China.¹⁸ Before 1984, these taxes were levied under the Industrial and Commercial Tax Law, the greater part of which was collected from state enterprises which would eventually account to the state for their profits in any event. Thus the collection of the tax really represented little more than a bank transfer from the enterprise to the tax office at the time that sales receipts were realized.¹⁹ Nevertheless, turnover taxes were simple to administer and ensured a prompt and regular cash flow for the exchequer.²⁰ This liquidity advantage has become far more important with the change from profit delivery to profit taxation.

Additionally, turnover taxes operate as a form of "buffer" between the cost of production and the eventual price paid by the consumer. In

17. Cong Shuhai, *An Analysis of the Establishment of China's Tax System*, Caijing Yanjiu (Finance Study), 1986, No. 5, at 26 (Chinese version).

18. DING WEN, SHUISHOU YU CAIWU SHOUCE (TAXATION AND FINANCIAL AFFAIRS HANDBOOK) 30-1 (1987); and Wei Zuhou, *A Brief Introduction of Commodity Tax During the National Period*, Zhongguo Shuiwu, 1988, No. 5, 60 (Chinese versions).

19. G. ECKLUND, FINANCING THE CHINESE GOVERNMENT BUDGET 69 (1966).

20. Zhan Wu, Gong Qifang and Chen Deyan, *Several Questions on the Reform of the Taxation System*, Renmin Ribao (People's Daily), March 14, 1984, at 5 (Chinese versions).

most tax systems it is assumed that the burden of indirect tax will be shifted forward to the consumer in the form of higher prices. But in China the majority of prices, especially of goods produced and services supplied by state enterprises, are regulated by the state. Consequently, turnover taxes have a greater effect upon the level of profit of the enterprise; since, in most cases, the tax cannot be passed forward. It is shifted back to the supplier.²¹ Before *li gai shui*, when enterprise profits accrued to the state, the precise level of tax was relatively unimportant since the more tax the state collected on transactions, the less it received in the form of profit delivery. All this, of course, was changed once enterprises became responsible for their own profits or losses and private businesses were allowed to operate.

As will be discussed below, the relationship between taxation and pricing ensures that turnover taxes have a special role to play in regulating the economic activities of enterprises in China. Due to irrational pricing, enterprises producing high-priced goods or services will enjoy a greater after-tax income than those producing low-priced goods and services. This unbalanced "sweet and sour" situation became more obvious when enterprises were required to pay income taxes and were allowed, subject to certain restrictions, to dispose of their retained earnings. Although pricing policy is being reformed, this will inevitably be a lengthy process so that, in the meantime, the reform of the turnover tax system is necessary to regulate the effect upon profits of "irrational" pricing.²² The new rates of tax have been established by reference to the fixed price and to the average cost of production, leaving a reasonable margin of profit for the producing enterprise. Further, by regulating the profitability of particular types of goods and services, the new taxes may operate as economic levers to stimulate the production of those articles which are at present in short supply. Regulating profitability may also operate to reduce production of those articles where the supply is excessive due to high profit levels.²³

Under the current system, the following turnover taxes are imposed:

1. Product Tax (Chanpin Shui)

The product Tax is imposed on enterprises and individuals engaged

21. For a discussion of the shifting of tax burden in China, see Cao Erdong, *A Brief Discussion of Shifting of Tax Burden*, *Caijing Yanjiu* (Finance Study), 1985, No. 6, 24; and Xu Jianguo, *Whether Shifting of Tax Burden Exists in Socialist Tax System*, *Zhongguo Shuiwu* (Chinese Taxation), 1987, No. 6, 26 (Chinese versions).

22. The State Council made it clear that changes in turnover taxes were not to involve any price change, but must be absorbed by the paying enterprise. See State Council Circular on the Approval and Circulation of Finance Ministry Report on the Second Phase of Substitution of Tax Payment for Profit Delivery in State Enterprises: State Council Bulletin No. 23 of Oct. 10, 1984, at 796.

23. See Dai Yuanchen, *Substituting Tax Payments for Profit Delivery is a Decisive Step in the Economic System Reform*, *Jingji Yanjiu* (Economic Study), Sept. 20, 1984, at 17, (Chinese version).

in manufacturing taxable industrial products and purchasing taxable agricultural products, as well as on importers of foreign goods.²⁴ Under the Product Tax Law, there are 270 taxable items, of which 260 are industrial products and 10 agricultural, taxable at 26 different tax rates ranging from 3 percent to 66 percent. Necessities and industrial raw materials are taxed at lower rates, whereas luxury goods (such as top-grade cigarettes and electric appliances) are subject to high tax rates. The broad tax base and multiple rate structure make this tax a useful means for the state to control the price level of a product and the profit level of a producer by manipulating the tax rates.

The tax is payable by manufacturers on gross sales revenue when they sell taxable products to wholesalers or retailers. Products manufactured by an enterprise and used in its continuous production are not taxed, with the exception of products subject to high tax rates such as liquor, sugar, leather and silk.²⁵ Purchasers of agricultural products are liable for the Product Tax on the purchase price when the purchasers are state or collective enterprises. If such a purchaser is an individual or other type of entity, it is the seller who is liable to pay the tax.²⁶ A taxpayer importing taxable goods is subject to the tax, but the tax is normally paid to Customs upon importation together with import duties.²⁷

The Product Tax is levied only once on a taxable product, either on the manufacturer, purchaser or importer. However, the Business Tax may be levied again on the turnover of these products in the hands of wholesalers or retailers.

To encourage exports, goods are exempted from the tax if they are exported directly by manufacturers, or a rebate is given if they are exported through a foreign trading corporation. Gold and contraceptive products are also exempted whether they are exported or not. New products listed in the State Plan for trial production, and products which use waste residue, waste liquid or waste gas, may be granted a reduction of, or exemption from, the tax for a period of time. Certain products manufactured in minority nationality regions to meet the special needs of the minority people may also be exempted or receive a reduction of tax where there is difficulty paying the tax. Reduction or exemption can be granted in other special circumstances.²⁸

Since 1984, when the Product Tax was introduced, it has become one of the most important taxes in China. It provides about 40 percent of the total tax revenue of the country and 50 percent of the tax payment by

24. Regulations of the People's Republic of China on Product Tax (Draft), *promulgated* Sept. 18, 1984 by the State Council (hereafter Product Tax Law). The Implementing Rules for the Regulations of the People's Republic of China on Product Tax (Draft) were *promulgated* Sept. 28, 1984.

25. *Id.* at art. 3.

26. *Id.* at art. 4.

27. *Id.* at art. 5.

28. *Id.* at art. 7.

state enterprises to the state.²⁹ More importantly, because of its comprehensive tax base and numerous tax rates, this tax is considered to be an efficient economic regulator used in conjunction with pricing policy to adjust the supply and demand of the market.

2. Value Added Tax (Zengzhi Shui)

The Value Added Tax (VAT), a new tax in China,³⁰ was introduced on a trial basis in 1979 in some industrial cities including Shanghai, Liuzhou and Xian. From July 1, 1982, VAT was experimented with across the country.³¹ During this period, VAT applied only to five chosen items which had been cumulatively taxed under the existing Industrial and Commercial Tax. Regulations concerning VAT were formally adopted in 1984³² in the second phase of *li gai shui*, together with the Product Tax and Business Tax.

Pursuant to the 1984 VAT Law, the scope of VAT was restricted to two categories comprising twelve items of industrial products including machines, machinery and spare parts (covering mechanical equipment for general and specified use, motor vehicles, motorized ships, bearings and farm implements), steel products, billet, bicycles, sewing machines, electric fans, printed and dyed silks and western medicines. These products were taxed at six different rates ranging from 6 percent (on farm implements) to 16 percent (on electric fans). Two methods of calculating VAT liability were adopted: the *tax credit* method applying to "simply structured" goods, such as steel products, bicycles, electric fans, printed silk and western medicines; and the *sales subtractive* method applying to machines and machinery products.³³ Deductible items were limited to the cost of purchase and taxes paid on materials, fuels, power and packaging materials purchased from outside and used to manufacture the taxable products.³⁴

29. WANG, *supra* note 1, at 98 and DING, *supra* note 18, at 184.

30. For a discussion of VAT in China, see Li Jinyan, *People's Republic of China: Value Added Tax*, 42 BULL. INT'L FISCAL DOCUMENTATION 17 (1988).

31. This was conducted in accordance with the Provisional Measures on Value Added Tax, issued by the Ministry of Finance, *Cai Shui Zi*, No. 343. For further information, see GUO HONGDE, WANG WENDING AND HAN SHAOCHU, ZENGZHI SHUI GAISHUO (A GENERAL TALK ON VALUE ADDED TAX) (1984) (Chinese version).

32. Regulations of the People's Republic of China on Value Added Tax (Draft), promulgated on Sept. 18, 1984 by the State Council [hereinafter VAT Law]. The Implementing Rules to the Regulations of the People's Republic of China on Value Added Tax (Draft) issued on Sept. 28, 1984 by the State Council.

33. For further, see Li, *supra* note 30, at 19-20; Yan Zengzu, *A Talk on VAT Administration*, Zhongguo Shuiwu, 1986, No. 3, 33 (Chinese version).

34. Arts. 5 and 6 of VAT Law, *supra* note 32. Capital goods are not deductible because most capital investment is planned by the state and the government encourages labour-intensive investment. Moreover, the unbalanced existing capital structure of enterprises makes it difficult to set a uniform level of depreciation. The purpose of introducing VAT in China is to eliminate the unfair tax burden caused by cumulative taxation. Capital inputs are not considered a contributing factor.

As is well known, a VAT works ideally only if there is a single tax rate, or at most two rates, a comprehensive tax base, and the tax credit method is adopted. In China, VAT has been proved to be a superior tax to the Product Tax for the elimination of cumulative taxation of a product, and for the encouragement of enterprises to compete on a fair basis, whether they are comprehensive or specialized manufacturers. At present, VAT co-exists with Product Tax due to the particular political and economic situation in China. The role of government in direct regulation of the market through pricing policy and taxation, the traditional use of the product tax, and the unbalanced development level between regions, industrial sectors and enterprises make it impossible, for the moment, to completely substitute VAT for the Product Tax. Moreover, the government has used the Product Tax quite efficiently to control and regulate the supply and demand of the market by increasing or decreasing the tax rates applicable to specific products. Therefore, in maintaining the regulatory function of the Product Tax, efforts have been made to reduce the unfair tax burden on enterprises by increasing the scope of VAT while at the same time reducing that of the Product Tax.³⁵ By the end of 1987, there were 24 categories and some 120 items of industrial products subject to VAT and taxable at eleven tax rates and the tax credit method was adopted as the proper way of calculating VAT liabilities.³⁶ Consequently, although the categories of taxable products were increased by about ten times, the number of tax rates was merely doubled indicating the intention of the government to adopt a VAT system which not only accommodates the existing multi-rate structure of the turnover tax system but which is also easily administered and enforced. However, compared to the VAT system adopted in other countries, the Chinese VAT has too many tax rates and too restricted a scope of taxable products. To fully take advantage of the tax system, China's VAT needs to be further expanded in scope and simplified in rate structure.³⁷

3. Business Tax (Yingye Shui)

The Business Tax was one of the four components of the Industrial and Commercial Tax of 1950, and was incorporated into the Consolidated

35. The Ministry of Finance made it very clear that products which have been brought within the scope of VAT shall no longer be taxed under the Product Tax Law. *Cai Shui Zeng Zi*, No. 037 (July 13, 1987). See also *Cai Shui Zi*, No. 026 (Feb. 4, 1986); *Cai Shui Zi*, No. 009 (Jan. 27, 1987); *Cai Shui Zeng Zi*, No. 013 (March 26, 1987).

36. See Certain Regulations on Perfecting the Rules on Value Added Tax Administration, issued by the Ministry of Finance (March 20, 1987); *Cai Shui Zi*, No. 042. For an English translation of the taxable items and applicable rates, see Li, *supra* note 30 at 22. See also Ministry of Finance Notice, *Cai Shui Zi*, No. 242 (October 13, 1987).

37. For further comments on the Chinese VAT, see Li Shengjun, *Our Country's VAT Needs to be Further Perfected*, *Zhongguo Shuiwu*, 1987, No. 2, 16; Wang Pingwu, *To Actively and Steadily Implement VAT*, *Zhongguo Shuiwu*, 1987, No. 4, 6; Yan, *supra* note 33 at 33; Chen Jijiang and Lou Jiwei, *An Inquiry on the Question of Fully Implementing VAT System*, *CAIMAO JINGJI* (FINANCE, TRADE AND ECONOMY), 1987, No. 11, 17 (Chinese versions).

Industrial and Commercial Tax in 1958, and subsequently the Industrial and Commercial Tax in 1972. It became a separate tax in 1984 and was imposed upon individuals and entities which were engaged in commerce, the supply and sale of commodities, transportation, construction and installation, financial and insurance services, post and communications, public utilities, publishing, entertaining, processing and other service industries.³⁸ Unlike the Product Tax and VAT, the tax rates of Business Tax are applied in accordance with the type of activity, and not with the type of product or service. Enterprises providing services closely related to people's everyday life, such as retailing, postal services, telecommunications, public transportation, publishing and entertaining are taxed at lower rates; whereas those activities which are normally highly profitable are subject to higher rates, the highest of which being petrol pipe transportation and railway cargo transportation.³⁹

The Business Tax is levied when a taxpayer receives business income and is payable on the gross amount of revenue. Wholesale businesses are taxed at 10 percent on the difference between purchase and sale prices.⁴⁰ Since industrial enterprises do not pay this tax, sales income realized by these enterprises is not taxable under the Business Tax Law, but sales revenue realized by wholesalers and retailers is taxable and service industries will be taxed on income derived from using these products. As a result, double or multiple taxation still exists in the system.

Exemptions are granted to entities selling grains and edible oil at state-planned prices. Incomes from export sales, agricultural insurance, medicare, and childcare, are also exempted.⁴¹

4. Salt Tax (Yan Shui)

Salt tax in China is almost as old as the country itself. References to the first salt tax in China are recorded during the Warring Period (710-221 BC).⁴² The salt tax was retained as one of the fourteen taxes introduced in 1950 and regulations on the tax were promulgated in 1984 during the second stage of *li gai shui*.⁴³ However, the revenue importance of

38. Art. 1 of the Regulations of the People's Republic of China on Business Tax (Draft), issued by the State Council on September 18, 1984 [hereinafter Business Tax Law]. The Implementing Rules for the Regulations of the People's Republic of China on Business Tax (Draft), promulgated by the Ministry of Finance on September 28, 1984.

39. Business Tax Law, *supra* note 38, art. 2; Schedule of Taxable Items and Tax Rates of the Business Tax annexed to the Business Tax Law.

40. Business Tax Law, *supra* note 38, art. 3(2). The purchase price includes Product Tax paid on the product.

41. Business Tax Law, *supra* note 38, art. 6.

42. WANG, *supra* note 1 at 138. See also SHAO-KWAN CHEN, THE SYSTEM OF TAXATION IN CHINA IN THE TSING DYNASTY, 1644-1911 (1914), reprinted in (1970).

43. Regulations of the People's Republic of China on Salt Tax (Draft), issued by State Council on Sept. 18, 1984 [hereinafter Salt Tax Law]; Implementing Rules for the Regulations of the People's Republic of China on Salt Tax (Draft), adopted by the Ministry of Finance on Sept. 28, 1984.

the tax has decreased from 5 percent of total tax revenue in 1950 to 1.2 percent in 1983.⁴⁴

The tax is levied upon salt producers, which are mainly state or collective enterprises, and upon salt importers and marketing agencies, on a per quantum basis.⁴⁵ The tax rates range from 40 yuan to 160.80 yuan per ton depending on the area of production and the quality of salt. It is exempted on salt for export and reduced for salt used for leather manufacturing, soap and animal feed industries, farming, fishing and animal husbandry.⁴⁶

5. Consolidated Industrial and Commercial Tax (Gongshang Tongyi Shui)⁴⁷

When the Consolidated Industrial and Commercial Tax (CICT) Law was promulgated in 1958, it was made to apply to all enterprises and individuals, Chinese and foreign alike, which were engaged in the production of industrial products, the purchasers of agricultural products, the importation of foreign goods, commercial retailing, communication and transportation, and all other service trades.⁴⁸ The 1972 tax reform consolidated the CICT and three local taxes into the Industrial and Commercial Tax. Since the Industrial and Commercial Tax was applicable only to domestic enterprises and individuals, foreign businesses in China continued to be subject to the CICT Law. The further reform which took place in 1984 likewise did not affect the application of CICT to foreigners.⁴⁹ This tax may, however, be repealed in the near future, so that foreign enterprises will be subject to the turnover taxes applicable to domestic businesses.⁵⁰

Altogether, CICT applies to over 100 categories of goods or transactions and prescribes some 42 different rates, ranging from 69 percent on top-quality cigarettes to 1.5 percent on certain basic necessities. Retail sales are taxed generally at 3 percent and the provision of services at

44. DING, *supra* note 18 at 70.

45. Salt Tax Law, *supra* note 43, art. 1.

46. Salt Tax Law, *supra* note 43, art. 6.

47. See A.J. Easson and Li Jinyan, *Taxation of Foreign Business and Investment in the People's Republic of China*, 7 NW. J. INT'L L. & BUS. 666, 668-9 (Fall-Winter, 1986); GONGSHANG TONGYI SHUI JIANGHUA (A TALK ON THE CONSOLIDATED INDUSTRIAL AND COMMERCIAL TAX) (First Department of the General Tax Bureau of the Ministry of Finance, ed., Beijing, 1964 Chinese version).

48. Art. 1, Regulations of the Consolidated Industrial and Commercial Tax of the People's Republic of China (Draft), *adopted in principle* Sept. 11, 1958 by the 101st Meeting of the Standing Committee of the National People's Congress [hereinafter CICT Law]. The Detailed Rules and Regulations for the CICT Law were adopted by the Ministry of Finance on Sept. 13, 1958 [hereinafter CICT Rules].

49. It was decided by the Chinese government that to avoid the de-stability of taxation applying to foreign investors and businesses, the current tax reform should only affect Chinese enterprises. See Decision of the Standing Committee of the National People's Congress Authorizing the State Council to Promulgate Tax Reform Regulations *issued on* Sept. 18, 1984.

50. Renmin Ribao (Haiwai Ban), July 7, 1988 at 3.

rates between 3 and 7 percent. It is this tax on services which is of primary interest and concern to foreign businesses.

Exemptions and reductions are specifically granted to enterprises with foreign investment on the exportation of taxable goods (with the exception of crude oil, petroleum products and products covered separately by state regulations) and on importation of raw materials, machinery and equipment used in the business.⁵¹ Further exemptions and reductions are available to those enterprises operating in the Special Economic Zones (SEZs), Hainan Province and the Economic and Technological Development Zones (EDTZs) established in the 14 Coastal Cities, where special policies are adopted to offer preferential treatment to foreign enterprises.⁵²

6. Urban Maintenance and Construction Tax (Chengshi Weihu Jianshe Shui)

The Urban Maintenance and Construction Tax is a new local tax levied on taxpayers of Product Tax, VAT and Business Tax for the purposes of urban maintenance and construction.⁵³ Though the tax is not strictly perceived as a turnover tax, the rate is expressed as a percentage of the amount of tax payable by enterprises under the Product Tax, VAT or Business Tax. This is normally 7 percent in cities, 5 percent in county towns and 1 percent in other areas. The tax is payable at the same time as the three turnover taxes are paid though revenue from the tax is required to be used specifically to maintain or construct urban utilities.

This tax has been criticized by some commentators as not equitable

51. See Regulations on the Supervision and Control of and Levying of or Exemption from Duties and Taxation on Goods Imported or Exported by Chinese-Foreign Equity Joint Ventures, jointly *promulgated* by the General Administration of Customs, the Ministry of Finance and the Ministry of Foreign Economic Relations and Trade on April 30, 1984; Regulations concerning the Levy and Exemption of Customs Duties and Consolidated Industrial and Commercial Tax on Imports and Exports of Goods for Chinese-foreign Cooperative Petroleum Exploitation of Offshore Petroleum, *promulgated* on April 1, 1982 by the General Administration of Customs and the Ministry of Finance; State Council Regulations Concerning Encouragement of Foreign Investment, *promulgated* on Oct. 11, 1986.

52. The four Special Economic Zones (SEZs) are Shenzhen, Zhuhai, Shantou (in Guangdong Province) and Xiamen (in Fujian Province); and the 14 coastal cities are Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhangjiang, and Beihai. The tax incentives in these areas are granted under the Provisional Regulations on Reduction and Exemption of Enterprise Income Tax and the Consolidated Industrial and Commercial Tax for the Special Economic Zones and the 14 Coastal Cities, *promulgated* by the State Council on Nov. 15, 1984; Regulations on Encouraging Investment and Development on Hainan Island, *adopted* by the State Council on May 4, 1988 [hereinafter Hainan Regs.]; Interim Provisions of the Ministry of Finance Concerning the Reduction of and Exemption from Enterprise Income Tax and Consolidated Industrial and Commercial Tax for the Encouragement of Foreign Investment in the Open Coastal Economic Zones, *issued* on June 15, 1988.

53. Art. 1 of the Provisional Regulations of the People's Republic of China on Urban Maintenance and Construction Tax, *promulgated* on Feb. 8, 1985 by the State Council.

because enterprises which are exempted from the Product Tax, VAT or Business Tax benefit from urban public utilities without contributing to the fund and enterprises manufacturing heavily taxed products have to pay more tax than taxpayers paying lower rates of tax even if they do not benefit from the public utilities at all.⁵⁴

B. *Income Tax*

Historically, income taxes have played a relatively insignificant role in the public finances of China. At various times over the past fifty years attempts have been made to levy taxes on income, generally with little success.⁵⁵ In 1950, when the new tax system was established, income tax on business activities formed a part of the industrial and commercial taxes, although a wages and salaries income tax was also proposed. The only independent income tax was the Interest Income Tax,⁵⁶ chiefly payable by former capitalists whose businesses had been transferred to public ownership in return for bonds. This tax was paid until 1959 when it was discontinued and interest rates were correspondingly reduced.⁵⁷

The present income tax system dates from 1980, with the introduction of the Joint Venture Income Tax Law and the Individual Income Tax Law. In 1981, the promulgation of the Foreign Enterprise Income Tax Law completed the income tax system regarding foreign individuals and enterprises doing business in China. Between 1983 and June 1988, four more business income taxes were promulgated which applied to state enterprises, collective enterprises, individual households and private businesses. Another two personal income tax laws were passed in September 1986 and June 1988 which were applicable only to Chinese citizens. As a consequence, the revenue importance of income taxes has greatly increased and now constitutes about 40 percent of total tax revenue.

Before discussing the various income taxes, some initial comments should be made regarding income tax in China. First, the law distinguishes between the urban and rural sectors. Income from agriculture is not treated in the same way as income from other forms of business activ-

54. Guo Hongde, *Suggestions on Improving the Principles on Levying the Urban Maintenance and Construction Tax*, Zhongguo Shuiwu, 1986, No. 6, 15 (Chinese version).

55. Although a short-lived progressive personal income tax was imposed as early as 10 A.D., the first income tax in the modern sense was introduced, (without ever being enforced), in 1913. In 1936, an income tax law was formally promulgated by the Guomindang Government. This law was based on the British schedular system and divided income into three categories: business income, employment income and income from securities and deposits. In 1938 and 1943, the Government introduced "excessive income tax during the Anti-Japanese War Period" to collect revenue for waging the war. See Yang Zukun, *Wang Mang First Introduced Income Tax*, Zhongguo Shuiwu, 1988, No. 6, 64; WANG, *supra* note 1 at 184-5 (Chinese versions).

56. Interim Regulations on Interest Income Tax, issued on Dec. 29, 1950 by the Administrative Council.

57. See Xu Zenghong, *Major Developments of Our Country's Income Tax System*, Zhongguo Shuiwu, 1987, No. 3, 22 (Chinese version).

ity. Second, the tax system is essentially a schedular one. Although some of the taxes are progressive, most income is taxed at a flat rate. There is no general system of aggregation whereby the eventual tax burden of an individual is computed by reference to his or her total income. In particular, a basic distinction is drawn between income from business and income from other sources. Third, different types of business organizations are subject to different rules based on the ownership of the enterprises. Finally, an obvious feature of the system is that it is divided into two parts. Taxes on foreign individuals and businesses are distinct from taxes on citizens and domestic enterprises. Foreigners and foreign businesses are generally taxed more favorably when compared to Chinese nationals and enterprises.

1. Personal Income Taxes

When it was introduced in 1980, the Individual Income Tax Law⁵⁸ applied to both foreigners and Chinese citizens, although the main target was the growing community of foreigners working in China.⁵⁹ Another tax, the Individual Income Regulatory Tax⁶⁰ was introduced in 1986, and from the beginning of 1987 has applied to Chinese citizens resident in China. In June 1988 a separate regulatory tax on private investors' income from private enterprises⁶¹ was adopted to adjust the income level between these investors and ordinary wage earners.

(a) Individual Income Tax (Geren Suode Shui)

As a general rule, residents of China are taxed on world income while non-residents are taxed only on income from sources within China. There is no precise definition of "residence," but taxpayers are subject to different tax treatment based upon the period of time spent in China. Individuals who stay in China for more than five years are liable for Individual Income Tax ("IIT") on their world income with a foreign tax credit avail-

58. Individual Income Tax Law of the People's Republic of China, *adopted by the 3rd Session of the 5th National People's Congress on Sept. 10, 1980* [hereinafter IIT Law]; Detailed Rules and Regulations for the Implementation of the Individual Income Tax Law of the People's Republic of China, *approved by State Council on Dec. 10, 1980, promulgated by Ministry of Finance on Dec. 14, 1980* [hereinafter IIT Regs.].

59. It was estimated at the time that no more than 20 Chinese citizens would initially have to pay the tax. N.Y. Times, Sept. 3, 1980, at 1. By 1985, it was reported that there were 1,318 in Shanghai alone paying the tax. Wang Xiaochun, *Why the Shanghai Tax Bureau's 1985 Personal Income Tax Receipts Increased Rapidly*, Zhongguo Shuiwu, 1985, No. 6 at 15.

60. Provisional Regulations of the Individual Income Regulatory Tax of the People's Republic of China, *adopted by the State Council on Sept. 25, 1986* [hereinafter IIRT Law]; Detailed Rules and Regulations for Implementing the Provisional Regulations of the Individual Income Regulatory Tax of the People's Republic of China, *adopted by Ministry of Finance on Dec. 10, 1986* [hereinafter IIRT Regs.].

61. The State Council Regulations Concerning the Levy of Individual Income Regulatory Tax on Private Investors' Income from Private Enterprises, *adopted by State Council on June 3, 1988, promulgated on June 25, 1988* [hereinafter Private Investors IIRT Law].

able for taxes paid in other countries. Individuals who reside in China for a year or more, but less than five years, are taxable on foreign-source income only to the extent that it is remitted to China. In practice, however, foreigners working in China for non-Chinese enterprises who do not intend to become permanent residents in China are not taxed on foreign source income at all.⁶² Individuals residing in China for less than a year are taxed only on income gained within China.⁶³ The regulations further provide that remuneration paid by employers outside China for individuals whose continuous or cumulative residence in China does not exceed 90 days in a calendar year is exempted.⁶⁴ Individuals not resident in China at all are taxed on the total amount of their income obtained from personal services, royalties, rental income, and upon interest and dividends received from Chinese sources.

Taxable income under the IIT is divided into six categories: wages and salaries; compensation for personal services; royalties; interest, dividends and extra dividends; income from the lease of property; and other kinds of income specified as taxable by the Ministry of Finance.

(i) Employment Income

Only income from wages and salaries is taxed at progressive rates. A monthly deduction of 800 yuan is allowed with the excess taxed at rates rising from five percent to forty-five percent, the top rate being payable on earnings in excess of 12,000 yuan per month. From August 1, 1987, the tax on wages and salaries of foreign personnel working for non-Chinese enterprises in China was reduced by half.⁶⁵

(ii) Compensation for Personal Services

This type of income includes compensation received for providing personal services, such as designing, installation, drafting, medical practice, law practice, accounting, consulting, lecturing, news reporting, broadcasting and entertaining.⁶⁶ It is taxed at a flat rate of 20 percent. A deduction is allowed for expenses of 800 yuan if the amount received in a single payment for a piece of work is less than 4,000 yuan. For payments of 4,000 yuan or more, a deduction of twenty percent is allowed.⁶⁷ The remainder is taxed at twenty percent. Rents and royalties received by a

62. Notice of the General Tax Bureau of the Ministry of Finance, *Cai Shui Zi*, No. 62 (March 7, 1983).

63. This includes income from work and personal services performed in China and dividends, royalties and interest from Chinese sources, whether or not the place of payment is in China. IIT Regs., *supra* note 58, art. 5.

64. Art. 5 of IIT Regs. as amended by Ministry of Finance (Feb. 13, 1988).

65. Interim Provisions of the State Council of the People's Republic of China Concerning the Reduction of Individual Income Tax on the Income from Wages and Salaries Derived by Foreign Personnel Working in China, *issued on* Aug. 8, 1987.

66. IIT Regs., *supra* note 58, art. 4(2).

67. IIT Law, *supra* note 58, art. 5(2).

non-resident are taxable in full without any deduction.

(iii) Interest and Dividends

Income from interest, dividends and extra dividends is taxed at a flat rate of twenty percent without deduction.⁶⁸

(iv) Exemptions and Reliefs

Certain categories of income are exempted from tax, notably: prizes and awards for scientific, technological or cultural achievements, interest from deposits in state banks, welfare benefits, certain pensions or severance pay, and salaries of foreign diplomatic and consular officials.⁶⁹

(b) Individual Income Regulatory Tax (Geren Shouru Tiaojie Shui)

When the IIT Law was introduced in 1980, it was intended primarily to satisfy the needs of the "open" policy and was designed mainly to tax foreigners living and working in China. Within a few years of the economic reform it became apparent, however, that an appreciable number of Chinese citizens were receiving substantial incomes without paying tax. Basic exemption limits, which appeared to be quite reasonable for foreign executives having to live in scarce and expensive apartments or in hotels, were nevertheless many times higher than the average Chinese wage or salary. The large difference between average incomes and the incomes of this newly emerging wealthy class necessitated regulation, and a new personal tax was thus introduced in September 1986.⁷⁰

The Individual Income Regulatory Tax (IIRT) applies to Chinese citizens who have a residence in China⁷¹ and obtain personal income.⁷² It differs from the IIT Law in two important respects: tax rates are more steeply progressive and there is some aggregation of the different categories of income.

68. IIT Law, *supra* note 58, art. 3(2).

69. *Id.* at art. 4. For further discussion, see O.E. Bell, *People's Republic of China — Personal Income Tax*, 11 GA. J. INT'L & COMP. L. 373 (1981); Easson and Li, *supra* note 47, at 683-92; M.H. Byres and A. Shum, *Individual Income Tax in the PRC*, TAX PLAN. INT'L REV., 16 (March 1986); R.D. Pomp, T.A. Gelatt and S.S. Surrey, *The Evolving Tax System of the PRC*, 16 TEX INT'L L.J. 11 (1981); and Wang Desheng, *A General Talk on Our Country's Individual Income Tax System*, FAZHI JIANSHI (LEGAL CONSTRUCTION), No. 3, at 54 (1987) (Chinese version).

70. See Li Jinyan, *People's Republic of China: The New Regulatory Tax on Individual Income*, 41 BULL. FOR INT'L FISCAL DOCUMENTATION 167, 168 (1987); Editorial Notes in *Zhongguo Fazhi Bao* (Chinese Jurisprudence Newspaper), Dec. 12, 1986 (Chinese version).

71. "Chinese citizens who have a residence in China" is defined as a Chinese citizen who has Chinese nationality, a household registration and actually stays in China. See IIRT Regs., *supra* note 60, art. 2.

72. IIRT Law, *supra* note 60, art. 2.

(i) Taxable Income

The IIRT adds a new category of taxable income, namely "income from contractual and sub-contractual fees."⁷³ These fees are earned by individuals who contract with a state enterprise, a collective enterprise or a joint enterprise to manage the business, or some part of the business, and to be responsible for the profit or loss thereof.⁷⁴ Additionally, the IIRT has two categories of "royalty" income; income from transferring patent rights and providing non-patented technology, and income from writing and translating.⁷⁵

(ii) Tax Rates

Unlike the IIT Law, the IIRT Law provides for a measure of aggregation of the various types of income. The two types of royalty income are taxed at a flat rate of 20 percent, after an expense deduction similar to that under the IIT Law.⁷⁶ Dividend and interest income is taxed at twenty percent on the gross amount received. However, employment income, income from contractual fees, remuneration for personal services and rental income are aggregated monthly and are taxed under an elaborate progressive rate schedule.⁷⁷ Tax becomes payable, at a rate of twenty percent, when the individual's monthly income exceeds four times the "basic regional taxable amount"⁷⁸ and increases to a rate of sixty percent on the excess above eight times that amount. Consequently, the effective rate varies from region to region.⁷⁹ The overall effect is that a Chinese citizen living in Beijing will pay the highest rate of sixty percent, on income in excess of 800 yuan per month, whereas this amount is the same as that at which a foreigner begins to pay the lowest, 2.5 percent, rate under the IIT Law. As with the IIT Law, a number of categories of income are exempted.

The introduction of the IIRT Law has led to a considerable increase in the number of Chinese citizens, particularly artists, athletes, writers, business managers, and scientists, who are liable to pay personal income tax and to a great increase in the tax burden upon those who already were paying IIT. In Shanghai, for instance, there were 300,000 individuals

73. *Id.* at, art. 3(ii).

74. IIRT Regs., *supra* note 60, art. 4(ii).

75. IIRT Law, *supra* note 60, art. 3(v) and (vi).

76. *Id.* at, art. 7(i).

77. *Id.* at, art. 5.

78. The "basic regional taxable amount" ("BRTA") ranges from 100 to 115 yuan. The starting point for tax is consequently 400 yuan, or 460 yuan in regions with the highest BRTA.

79. The BRTA is determined by reference to wages and price levels in the different regions. It appears to have a built-in incentive to encourage workers to go to the remote regions. The BRTA tax is heaviest in the capital, Beijing, and least heavy in areas such as Tibet and Xinjiang. See Li, *supra* note 70, at 169.

who paid IIRT in the 1987 taxation year.⁸⁰

(c) Private Investors Individual Income Regulatory Tax (Siyang Qiye Touzizhe Geren Shouru Tiaojie Shui)

This tax was introduced in June 1988 together with the Private Enterprise Income Tax.⁸¹ Individual investors in private enterprises are liable to IIRT on their wages or salaries paid by the enterprises. If the private enterprise distributes income to its investors out of its after-tax profits, the investors are taxed under the Private Investors IIRT Law. The enterprise is required, however, to put aside not less than 50 percent of its retained earnings in a production development fund. The investor is exempted from tax on his reinvestment in the production development fund. He must, however, pay the tax at 40 on the amount distributed to him for personal consumption. Where the investor takes funds out of the production development fund, or gets funds by disposing of enterprise business assets for personal consumption purposes, he will also be liable for the regulatory tax at 40 percent of the amount.⁸²

2. Business Income Taxes

In contrast to personal income taxes, there are six or seven separate taxes imposed upon business income, depending on the type of business entity being taxed. Two of these taxes are levied on enterprises with foreign investment, and the rest are imposed on domestic enterprises.

(a) Income Taxes on Enterprises with Foreign Investment

(i) Joint Venture Income Tax (Heying Qiye Suode Shui)

A foreign company intending to do business in China must choose between establishing a "branch"⁸³ operation, or forming a subsidiary by setting up a joint venture with one or more Chinese co-venturers or incorporating a wholly foreign-owned enterprise.⁸⁴ A distinction is commonly drawn between equity joint ventures⁸⁵ and cooperative joint ventures.

80. Renmin Ribao, Jan. 15, 1988, at 1 (Chinese version).

81. Provisional Regulations of the People's Republic of China on Private Enterprise Income Tax, *adopted* June 3, 1988 and *promulgated* June 25, 1988 by the State Council [hereinafter PEIT Law].

82. Private Investors IIRT Law, *supra* note 61, art. 3. See Li Jinyan, *People's Republic of China: Taxation of Private Business and Private Investors*, 42 BULL. FOR INT'L FISCAL DOCUMENTATION, 415, 417-8 (1988).

83. Generally, it is not possible for a foreign enterprise to establish a branch plant operation. But it may open a representative office which is permitted to transact business in a limited way. In addition, a contractual joint venture is treated in a manner similar to that of a branch.

84. Under the Law on Enterprises Operated Exclusively with Foreign Capital, *adopted* April 12, 1986.

85. An equity joint venture can be established in accordance with the Law on Joint Ventures Using Chinese and Foreign Investment, *adopted* by the 2nd Session of the 5th

Prior to 1988, a cooperative joint venture created no separate legal entity and the relationship of the parties resembled that of a partnership. All this has been changed since the promulgation of the Cooperative Joint Venture Law in April, 1988.⁸⁶ Under this law, a cooperative joint venture can choose whether to take the form of a partnership or that of a Chinese legal person. Under the existing tax system, a cooperative joint venture is normally not regarded as a taxable person, the profit of the venture is divided among the participants in accordance with the contractual stipulation and is taxed in the hands of the participants. Thus, the Chinese party may pay the State Enterprise Income Tax or Collective Enterprise Income Tax while the foreign party pays the Foreign Enterprise Income Tax.⁸⁷

By contrast, an equity joint venture is a separate legal person, incorporated under Chinese law and taxed under a separate tax statute.⁸⁸ The Joint Venture Income Tax (JVIT) is levied on income of Chinese-foreign joint ventures from production, business and other sources, including the income from branches inside and outside China.⁸⁹ Taxable income is defined as "the excess of gross income in a tax year over its deductible costs, expenses and losses".⁹⁰ Tax is charged at a flat rate of 30 percent, in addi-

National People's Congress on July 8, 1979 [hereinafter JV Law]; and the Detailed Rules and Regulations for the Implementation of the Law on Joint Ventures Using Chinese and Foreign Investment, *adopted* by the State Council on September 21, 1983.

86. Law of the People's Republic of China on Chinese-Foreign Cooperative Joint Ventures, adopted at the 1st Session of the 7th National People's Congress on April 13, 1988, promulgated and effective on the same date [hereinafter Cooperative Joint Venture Law].

87. At present it is unclear how a cooperative joint venture which chooses to be constituted as a legal person, under the Cooperative Joint Venture Law, will be treated. It seems that the party can agree to share after-tax profits, rather than before-tax profits, and it may be that in such a case the venture will be taxed in the same way as are equity joint ventures.

88. Income Tax Law concerning Joint Ventures with Chinese and Foreign Investment, *adopted* by the 3rd Session of the 5th National People's Congress on September 10, 1980 [hereinafter JVIT Law]; Detailed Rules and Regulations for the Implementation of the Income Tax Law concerning Joint Ventures with Chinese and Foreign Investment, *promulgated* by the Ministry of Finance on December 14, 1980 [hereinafter JVIT Regs.]. For further discussion of the law, see EASSON and LI, *supra* note 47, at 672-76; D.R. Simon, *Taxation of Joint Ventures in China: A Legal Analysis in the Context of Current Chinese Economic and Political Conditions*, 15 VAND. J. TRANSNAT'L L. 513 (1982); T.A. Gelatt and R.D. Pomp, *Tax Aspects of Doing Business with the People's Republic of China*, 22 COLUM. J. TRANSNAT'L L. 21 (1984); H.J.F. Bloomfield, *Legal Aspects of Joint Ventures in China*, 14 INT'L BUS. LAW. 327 (1986).

89. JVIT Law, *supra* note 88, art. 1. "production" and "business" are defined as "operations in industry, mining, communications and transportation, agriculture, forestry, animal husbandry, fishing, poultry-farming, commerce, tourism, catering, service trades and other lines of business." "Other income" is defined as "income from dividends, extra dividends and interest income, and income from the lease or transfer of tangible property, patent rights, proprietary technology, trademark rights, copyrights and other property": JVIT Regs., *supra* note 88, art. 2. Note that capital gains are also taxed as "other income": see Ministry of Finance Ruling, (87) Cai Shui Wai Zi, No. 033 (Feb. 22, 1987).

90. JVIT Law, *supra* note 88, art. 2. Profits of joint ventures must be computed and accounts drawn up, in accordance with the Accounting Regulations for Joint Ventures Using Chinese and Foreign Investment, *promulgated* March 3, 1985 by the Ministry of Finance.

tion to which a local income tax of 10 percent of the assessed tax is payable, bringing the effective rate to 33 percent.⁹¹ For joint ventures established in the Special Economic Zones, or other special development areas, the rate is commonly reduced to 15 percent, with no additional local income tax. A special dividend withholding tax of 10 percent is also payable on profits remitted outside China.⁹² By contrast, when a participant in a joint venture reinvests its share of the profits in China for a period of not less than five years, the participant is eligible for a refund of 40 percent of the central tax paid by the joint venture in respect of the reinvested amount.⁹³ A participant who withdraws reinvested funds within the five year period must repay the amount refunded.⁹⁴ A joint venture to which the JVIT Law applies is taxed on its world income, but foreign tax paid on income from non-Chinese sources may be credited against tax due under the JVIT Law.⁹⁵

Certain tax holidays are provided in legislation to encourage foreign investment in joint ventures. For instance, newly established ventures scheduled to operate for ten years or more may be exempted from the JVIT in the first two profit-making years and are allowed a 50 percent reduction in the following three years. Joint ventures engaged in certain low-profit operations, in particular farming and forestry, or located in remote or under-developed regions, may be allowed a further reduction for up to ten years.⁹⁶ Joint ventures which are "export-oriented enterprises"⁹⁷ or "technologically advanced enterprises"⁹⁸ will continue to enjoy the 50 percent reduction after the expiry of the normal tax holiday period, in the case of a technologically advanced enterprises for an additional three years, and in the case of an export-oriented enterprise for as long as it continues to qualify as such.⁹⁹

Art. 9 of the JVIT Regs. expressly prohibits certain deductions in the computation of profits, notably interest on capital, losses covered by insurance, donations other than those for public welfare in excess of 1% of gross business income. Capital expenditures are not deductible, but depreciation or amortization is permitted normally on a straight line basis over prescribed periods corresponding to the estimated useful life of the asset in question: arts. 10-17 of the JVIT Regs., *supra* note 88.

91. JVIT Law, *supra* note 88, art. 3.

92. *Id.* at art. 4. This tax is commonly exempted in Special Economic Zones, Economic and Technological Development Zones and other open coastal areas.

93. JVIT Law, *supra* note 88, art. 6.

94. *Id.*

95. *Id.* at art. 15.

96. *Id.* at art. 5.

97. These are enterprises whose output value of exported products amounts to more than 70 percent of the total output. See art. 8 of the Provisions of the State Council for the Encouragement of Foreign Investment, *adopted and promulgated on October 11, 1986* [hereinafter Foreign Investment Provisions].

98. *Id.* at art. 9. The certification procedures, for both "export enterprises" and "technologically advanced enterprises", are set out in the Implementing Measures of the Ministry of Foreign Economic Relations and Trade on the Confirmation and Examination of Export-Oriented Enterprises with Foreign Investment, promulgated on Jan. 27, 1987.

99. Qualifying enterprises located in the SEZs, where the normal tax rate is reduced to

(ii) Foreign Enterprise Income Tax (Waiguo Qiye Suode Shui)

A foreign enterprise that carries on business in China in any form except that of an equity joint venture is liable to the Foreign Enterprise Income Tax (FEIT) on income earned in China by that enterprise.¹⁰⁰ The FEIT consequently applies to wholly foreign-owned enterprises incorporated in China, to the foreign participant in a cooperative joint venture, and to foreign enterprises doing business in China through a representative office, branch or other establishment. For the purposes of the legislation, "foreign enterprise" means a foreign company, enterprise or other economic organization having an establishment in China engaged in independent business operations or cooperative production or joint business operations with Chinese enterprises.¹⁰¹ Foreign enterprises which do not have establishments in China are subject to a flat-rate withholding tax of 20 percent on income from dividends, interest, rentals, royalties and other sources in China, which tax must be withheld by the paying unit.¹⁰²

A foreign enterprise having an establishment in China is taxed on income earned there at progressive rates ranging from 20 percent on the first 250,000 yuan of taxable income for the year to 40 percent on income in excess of one million yuan.¹⁰³ A local income tax of an additional 10 percent is also levied, bringing the total rate to a maximum of 50 per-

15 percent, pay a reduced rate of 10 percent rather than receiving a 50 percent reduction: see the Implementing Measures for the Preferential Taxation Provisions of the State Council Provisions for the Encouragement of Foreign Investment, adopted by the Ministry of Finance on January 31, 1987. In most of China's tax treaties, these tax holidays are accorded "tax sparing" treatment. See EASSON and LI, *supra* note 47, at 693-4.

100. Income Tax Law of the People's Republic of China concerning Foreign Enterprises, adopted by the 4th Session of the 5th National People's Congress and promulgated on Dec. 13, 1981 [hereinafter FEIT Law]; Detailed Rules and Regulations for the Implementation of the Income Tax Law of the People's Republic of China concerning Foreign Enterprises, promulgated by the Ministry of Finance on February 21, 1982 [hereinafter FEIT Regs.]. For further discussion of the tax, see Li Jinyan and A.J. Easson, *Taxation of Foreign Investment in China*, GUOJI MAOYI WENTI (INTERNATIONAL TRADE JOURNAL), 1987, No. 1, 27 (Chinese version), P.D. Reynolds, *Doing Business with the People's Republic of China: Tax Considerations*, 14 INT'L LAW. 49 (1980); J.Horsley, *Comments on Laws and Legal Developments Affecting Foreign Investment in China*, 3 CHINA LAW REP. 175 (1986); T.A. Gelatt and E. Theroux, *Tax Treatment in China*, CHINA BUS. REV. 22 (Jan.-Feb. 1984); and A. Ness and S.J. Mitchell, *Taxing US Offices in China*, CHINA BUS. REV. 36 (Sept.-Oct. 1986).

101. FEIT Law, *supra* note 100, art. 1. A foreign individual who carries on business in China may be regarded as an "enterprise" for the purposes of the FEIT Law: see Ministry of Finance Ruling (82) *Cai Shui Wai Zi*, No. 99, Aug. 2, 1982.

102. FEIT Law, *supra* note 100, art. 11. Certain types of interest and royalty income are exempted or taxed at reduced rates. Interest on loans to the Chinese government, to the state banks or to the National Offshore Oil Corporation are entirely exempted and a reduced rate of 10 percent is charged on interest on loans made between 1983 and 1990 and on income from leasing equipment to Chinese concerns: see rulings from the Ministry of Finance, (82) *Cai Shui Zi*, No. 326, Dec. 13, 1982; (83) *Cai Shui Zi*, No. 348, Jan. 7, 1983; and (86) *Cai Shui Zi*, No. 1, Jan. 6, 1986.

103. FEIT Law, *supra* note 100, art. 3.

cent.¹⁰⁴ Consequently, except in the case of small operations, an equity joint venture will pay less tax on its profits than will a branch operation or cooperative joint venture, though there will be an additional tax of 10 percent on profits remitted outside the country by the joint venturers. Foreign enterprises operating in SEZs or other special areas and enterprises which are "export-oriented" or "technologically advanced" are taxed at the same preferential rate as equity joint ventures.¹⁰⁵

The term "establishment" is interpreted to mean "organizations, places or business agents established in the Chinese territory by foreign enterprises and engaged in production and business operations,"¹⁰⁶ which mainly include "management offices, branches, representative offices, factories and places where natural resources are exploited and where contracted projects of building, installation, assembly and exploration are operated."¹⁰⁷ The definition is, on its face, fairly broad. Nonetheless, in practice, the word seems to correspond to the notion of "permanent establishment" used in the tax treaties signed so far by China.¹⁰⁸

As in the case of joint ventures, the Chinese authorities provide tax holidays to attract foreign investment. Enterprises scheduled to operate for a period of ten years or more in farming, forestry, animal husbandry or other low-profit activities may be exempted from tax in the first profit-making year and allowed a fifty percent reduction in the following two years, with further reduction for an additional period of up to ten years.¹⁰⁹

(iii) Draft Law on Income Taxation of Enterprises with Foreign Investment

A draft version of the Income Tax Law of People's Republic of China on Enterprises with Foreign Investment (Draft) (the "Draft Tax Law") has been under review by the State Council and might become law sometime in 1989. The draft law consolidates the JVIT Law and FEIT Law, lowers the general tax rates and offers more incentives to foreign investors. The Draft Tax Law will apply to all enterprises with foreign investment, including equity joint ventures, cooperative joint ventures, wholly foreign-owned enterprises, as well as foreign enterprises which have an establishment in China. The tax rate will be either 25 percent with an additional 5 percent local tax, or 30 percent with a 3 percent local tax.

104. *Id.* at art. 4. It should be noted that this local rate is not, unlike that under the JVIT Law, expressed as a percentage of the tax otherwise payable. The local tax authorities may reduce or waive this tax.

105. Foreign Investment Provisions, *supra* note 97, art. 8.

106. FEIT Regs., *supra* note 100, art. 2.

107. *Id.*

108. See EASSON and LI, *supra* note 47, at 677-9; and Li Jinyan, *A Discussion of Tax Agreements*, JINGJI YU FALU (ECONOMICS AND LAW), 1987, No. 4, 7 (Chinese version).

109. FEIT Law, *supra* note 100, art. 5. These concessions are also accorded "tax sparing" treatment in China's tax treaties, except that with the U.S.

Enterprises established in the Special Economic Zones and Economic and Technological Development Zones will be taxed at 15 percent and productive enterprises established in the open coastal areas will be taxed at 20 percent. The tax reductions and exemptions provided under the JVIT Law and FEIT Law will be maintained. Business losses will be allowed to be carried forward forever. The Draft Tax Law also includes a new provision which authorizes the tax authorities to reasonably adjust the amount of income where a taxpayer does not deal at arm's length with its affiliated companies.

(b) Income Taxation of Domestic Enterprises

(i) State Enterprise Income Tax (Guoying Qiye Suode Shui)

Despite the recent impressive growth in the number of foreign enterprises, joint ventures, collective and private enterprises, the Chinese economy remains dominated by state enterprises.¹¹⁰ The growth in the importance of tax revenue, from less than half of the total budget revenue a few years ago to the present over 90 percent, is due to the substitution of tax payments for profit delivery by state enterprises. The main purposes of *li gai shui* are to maintain a proper balance between state interest and that of enterprises. The *li gai shui* establishing a system whereby enterprises are responsible for profits and losses after tax, and enables them, under the guidance of state macroeconomic planning, to have motivation and become more vital, so that they will be able to perform their roles as relatively independent commodity producers.¹¹¹

State Enterprise Income Tax (SEIT) is charged in accordance with the State Enterprise Income Tax Law and Regulations.¹¹² The tax is imposed upon the profits of state enterprises engaged in industry, commerce, transportation and communications, construction and installation, finance and insurance, catering and services, culture, education, public health, supply and marketing of goods, urban utilities and other work.

110. By the end of 1985, there were approximately 833,000 state enterprises, 3,347,000 collective enterprises, and around 17 million people engaged in individually-owned businesses, the number of which is variously estimated at from 5.8 to 11 million. The key industries and sectors of the economy are in the hands of state enterprises. See China Daily, Jan. 27, 1986 and Oct. 23, 1986.

111. For further comments, see the Tianjin Investigation Team on Substituting Taxes for Delivery of Profits, *The First Stage in Substituting Taxes for the Delivery of Profits*, Jingji Guanli (Economic Management), 1984, No. 1, 20; Xu Riqing and Li Liangru, *A Brief Discussion on the Question of the Role of Substituting Tax Payment for Profit Delivery for State Enterprises*, Jingji Wenti (Economic Issues), 1984, No. 1, 38; and Tian Jiyun, *Several Questions on Improving the System of Substituting Tax Payment for Profit Delivery*, Jingji Ribao (Economic Daily), Jan. 12, 1984 (Chinese versions).

112. Regulations of the People's Republic of China on State Enterprise Income Tax, promulgated by the State Council on Sept. 18, 1984 [hereinafter SEIT Law]; and the Detailed Rules and Regulations for the Regulations of the People's Republic of China on State Enterprise Income Tax, issued by the Ministry of Finance on Oct. 18, 1984 [hereinafter SEIT Regs.].

Not all state enterprises, however, are taxed under the SEIT Law. Those enterprises which are not the subject of *li gai shui*, such as some military enterprises, enterprises engaged in postal and telecommunications, civil aviation enterprises, foreign trade corporations and agriculture, etc., are not subject to the SEIT Law. They still deliver all their profits to the state.¹¹³

Under the SEIT Law, only those enterprises which keep independent economic accounts are considered to be taxpayers. Therefore, joint corporations which are formed by several enterprises in order to enjoy economies of scale are not necessarily taxpayers of the SEIT as such. If a separate legal and accounting entity is established, the joint corporation pays the tax as an independent taxpayer. If no such entity is formed, especially those established among state enterprises and collective or private enterprises, each participating enterprise remains liable for tax on its share of profits.¹¹⁴ For certain nation-wide corporations formed by enterprises in the same industry, the joint corporation may pay the income tax as an independent taxpayer and receive a credit for taxes paid by its subsidiaries.¹¹⁵

The taxable income of a state enterprise includes net income from production, transportation, commerce, services and other income. "Other income" is interpreted as dividend income received from a joint corporation or other enterprise, interest income on bonds (except state bonds) and other non-business income.¹¹⁶ In calculating taxable income, the following deductions are specifically permitted: profits and dividends distributed to its shareholders by a joint corporation before paying the SEIT; certain interest payments on loans approved by the Ministry of Finance; losses incurred in previous years; and some prescribed deductions, such as net profits from utilizing waste liquid, gas or materials, profits from processing for a foreign enterprises, etc.¹¹⁷ The following items are not deductible: wages, bonuses or subsidies paid out of a after-tax fund (such as wage-increase fund, bonus fund); payments of bonus tax, construction tax and purchasing state bonds.¹¹⁸

A state enterprise is taxed on its world income. Income from a foreign-source must be computed separately from domestic income and a reduced rate of 20 percent is applicable to the foreign income.¹¹⁹ Taxes

113. *Ding, supra* note 18, at 229-30.

114. Arts. 2 and 9 of the SEIT Law, *supra* note 112 and art. 4 of the SEIT Regs., *supra* note 112, and arts. 24-27 of the Decision of the State Council on Questions Regarding Further Improving the Horizontal Economic Cooperation of Enterprises, March 23, 1986 by the State Council.

115. See DING, *supra* note 18, at 230-1; and Zhang Lianshun, *A Brief Discussion of the Question of Levying Income Tax on Joint Enterprises*, *Zhongguo Shuiwu*, 1985, No. 8, 26 (Chinese version).

116. SEIT Regs., *supra* note 112, art. 9.

117. *Id.* at art. 10.

118. *Id.* at art. 11.

119. Arts. 1 and 4 of the Interim Regulations on the Levy of State Enterprise Income

paid in foreign countries are deductible in calculating taxable income.¹²⁰ A company incorporated for the purposes of carrying out contracting businesses in foreign countries is exempted from income tax for the first five years from its incorporation, and further reductions in tax may be available subject to approval by the tax authorities.¹²¹

State enterprises are divided into two categories for tax purposes. Large and medium-sized enterprises pay a flat rate of 55 percent on their profits. Small enterprises,¹²² food servicing enterprises and enterprises in the hotel business pay an eight-grade progressive tax, which rises from 7 percent to 55 percent. Certain industries are subject to the 55 percent rate regardless of the size of the enterprise. These include enterprises engaged in publishing, construction and installation, finance and insurance, wholesaling, trading centres, friendship hotels,¹²³ petroleum stores (including gas stations), overseas shipping companies.¹²⁴

The distinction also applies to the treatment of after-tax profits. Small enterprises and enterprises paying the progressive rates assume sole responsibility for profits and losses and, after payment of taxes, the state generally makes no further appropriation. Only those which have a large amount of "extra" profits are required to pay a contractual or leasing fee to the state.¹²⁵ As for the large and medium-sized enterprises a number of experimental systems have been tried. Initially, a further part of the profit was turned over to the state under specially negotiated contractual arrangements. However, for many enterprises this system has been superseded by a separate regulatory tax which seeks to address the wide disparities in the profitability of different enterprises which may reflect circumstances other than the efficiency of management, such as geo-

Tax on State Enterprises Engaging in Contractual Projects in Foreign Countries, adopted by the Ministry of Finance on March 11, 1985: (85) *Cai Shui Zi*, No. 058.

120. It should be noted that it is a *deduction* method instead of credit method which is adopted here.

121. (85) *Cai Shui Zi*, No. 058, *supra* note 120. See Zhang Lianshun and Sun Wushan, *Comments on Levying Income Tax on State Enterprises' Income from Contracting Projects in Foreign Countries*, *Zhongguo Shuiwu*, 1985, No. 5, 32 (Chinese version).

122. "Small enterprises" are defined as those whose fixed assets, profits and workers do not exceed a certain level which varies from region to region. In Beijing, Shanghai and Tianjin, the three largest cities in China, a small industrial and transportation enterprise is one whose fixed assets do not exceed 4 million yuan, annual profits do not exceed 0.4 million. In other regions, a small enterprise is one whose fixed assets do not exceed 3 million yuan and annual profits do not exceed 0.3 million yuan. Small enterprises in commerce in Beijing, Shanghai and Tianjin are defined as those whose number of workers does not exceed 60 and annual profits do not exceed 0.2 million. See art. 15 of the SEIT Regs., *supra* note 112.

123. In China, special stores are designated as "friendship stores" to serve the needs of foreigners and overseas Chinese. Generally, local currency is not accepted in these stores and the goods are normally not easily available in local shops.

124. SEIT Regs., *supra* note 112, art. 15.

125. The amount of the leasing fee is determined by local government. See Tao Shengyu, *The Contents of Policies in the Second Phase of Li Gai Shui*, *Qiye Guanli* (Enterprise Management), No.10 and 16, at 17 (1984) (Chinese version).

graphical location, availability of natural resources, level of previous capital investment, the condition and age of the plant and machinery and the state pricing policy. A resource tax is also levied as a form of excess profits tax on large and medium-sized enterprises, aimed at eliminating disparities between enterprises brought about by different physical conditions.

(ii) State Enterprise Income Regulatory Tax (Guoying Qiye Tiaojie Shui)

This tax is imposed on large and medium-sized state enterprises whose after-tax profits exceed a "reasonable" amount of retained profits. This amount is equated to the reasonable amount of retained profits of an enterprise in 1983, after paying the SEIT and the State Enterprise Income Regulatory Tax (SEIRT).

Unlike other income taxes, there are no tax rates provided in the SEIRT Measures.¹²⁶ The SEIRT Measures do, nonetheless, provide that the appropriate rate is determined according to the following formula:

$$\text{Tax rate} = \frac{\text{Base Year Profit} \times (1-55\%) - 1983 \text{ Retained Profit}}{\text{Base Year Profit}} \times 100\%$$

The "base year profit" refers to the amount of profits realized by an enterprise after deducting payments of Product Tax, VAT, Business Tax and Resource Tax.¹²⁷ Once the tax rate is determined, it is valid for seven years, commencing from 1985, to ensure that subsequent increases in profitability in response to the new incentives are not nullified by the tax. Enterprises whose current year profits exceed that of the base year can enjoy a 70 percent reduction in the regulatory tax on the excess amount.

Although declared temporary, the regulatory tax is criticized from Chinese writers. They claim that it retains vestiges of the former profit delivery system and, by penalizing success, is like "beating the fast running cow."¹²⁸ Due to the existence of those factors causing disparities of profitability among enterprises, the SEIRT is likely to remain in order to allow the state to appropriate the amount of profits realized by enterprises which benefit from advantageous factors and to encourage enterprises to improve their technology by reducing the SEIRT payable.¹²⁹

126. State Enterprises Income Regulatory Tax Collecting Measures, promulgated by the State Council on Sept. 19, 1984 [hereinafter the SEIRT Measures].

127. *Id.* at art. 6.

128. See Chen Lanying, *Should Not Undervalue the Historical Function of the Regulatory Tax*, *Zhongguo Shuiwu*, No. 6 at 30 (1986); and Tang Sheng, *Is the Regulatory Tax Beating the Fast Running Cow?*, *Zhongguo Shuiwu*, No. 3 at 18 (1987) (Chinese versions).

129. See Tao Shengyu and Lu Bing, *To Actively Create Conditions for Enliven Large and Medium-Sized Enterprises by Doing a Good Job in Reducing Regulatory Tax*, *Cai Zheng* (Finance), No. 5 at 15 (1986). As a matter of fact, many state enterprises enter into contracts with the state to "promise" to hand in a certain amount of taxes, including SEIT and SEIRT, to the state for a number of years in accordance with the Interim Provisions concerning the Financial Affairs of Large and Medium-Sized State Enterprises which Implement Contractual Responsibility System, issued by the Ministry of Finance on August 21,

(iii) Collective Enterprise Income Tax (Jiti Giye Suode Shui)

Collective enterprises had been subject to the Industrial and Commercial Income Tax until 1985 when a separate tax law — the Collective Enterprise Income Tax Law ("CEIT Law")¹³⁰ was promulgated. The tax applies to all collective enterprises engaged in industry, commerce, service trades, construction, installation, communications, transportation and other fields of work, which have independent accounting systems. Collective enterprises in China take a variety of forms, ranging from small partnerships to relatively large concerns which are incorporated and, in some cases, have made public offerings of stock.¹³¹ The essence of a collective is that it is collectively-owned, rather than state-owned, and is "non-governmental." The collective's production plan is not incorporated directly as part of the State Economic Plan and it does not account to the state for its profits. Due to the rapid development of collective enterprises in urban and rural areas, the percentage of national industrial revenue contributed by the collective sector increased from 6.8 percent in 1978 to 15 percent in 1984 and collectives also generate 43.7 percent of national revenue from light industry.¹³² The number of collective enterprises far exceeds that of state enterprises.¹³³

Collective Enterprise Income Tax ("CEIT") is levied upon total income after deduction of expenses, according to an eight grade progressive

1987, (87) *Cai Gong Zi*, No. 407. This saves the problem of calculating the SEIRT for each year but it may cause confusion of profit delivery and tax payment. For further discussions, see Xu Jingan and Zhou Shaohua, *Remodel the State Economic Management Pattern*, *Shijie Jingji Daobao* (World Economic Herald), Nov. 31, 1987, at 15; Wang Shaofei, *Contractual Responsibility System and Tax Reform May Promote Each Other*, *Renmin Ribao*, Feb. 5, 1988, at 5; Xia Yang, *The Defects of Signing a Contract with Guaranteed Tax Payments*, *Guangming Ribao*, Dec. 5, 1987, at 3; and *Renmin Ribao*, March 14, 1988, at 1 (Chinese versions).

130. The Interim Regulations of the People's Republic of China on Collective Enterprise Income Tax, *promulgated* by the State Council (April 11, 1985) [hereinafter CEIT Law], and the Detailed Rules for the Interim Regulations of the People's Republic of China on Collective Enterprise Income Tax, *adopted* by the Ministry of Finance (July 22, 1985) [hereinafter CEIT Regs.].

131. At present, collective enterprises are the only type of domestic enterprises which are officially permitted by the government to issue stocks: see *Zhongguo Fazhi Bao*, April 4, 1987 (Chinese version). See further Chen Huiren, *The Practice of Stock System of Zhongxingcun and Inspiration therefrom*, *Jingji Gaige* (Economic Reform), No. 1, at 43 (1987) (Chinese version); Zhang Hong, *Certain Questions on the Shareholding System of Collective Enterprises*, *Jingji Gaige*, No.1, at 47 (1987)(Chinese version); and *China Tries out Shareholding System* written by the Investigation and Research Group of the State Commission for Economic Restructuring, *BEIJING REV.* 22, Oct. 5, 1987.

132. Wang Chuhong, *Collective Economy Shall be The Basis of our Country's Ownership System*, *Guangming Ribao* (Guangming Daily), Feb. 7, 1987, at 3 (Chinese version).

133. By the end of 1985, there were 833,400 state enterprises, and 3,347,000 collective enterprises. See *Renmin Ribao* (Hawaii Ban), July 11, 1986. Rural township collectives have been developing rapidly since the late 1970s and the gross revenue therefrom exceeded the gross revenue from agriculture in 1986 for the first time: *Renmin Ribao* (Hawaii Ban), Nov. 14, 1986.

scale, as is the case with small state enterprises. However, income from agriculture is not taxed under this tax.¹³⁴ Profits and dividends received from other enterprises are deductible in computing taxable income. Nonetheless, the deduction of the following items are specifically prohibited: losses from previous years; payments of wages and bonuses paid to workers;¹³⁵ penalties; Construction Tax; government bonds; and dividends to shareholders.¹³⁶

The tax is levied annually, and must be prepaid monthly or quarterly.¹³⁷ Special reductions or exemptions are given for certain types of enterprises, especially those enterprises ancillary to agriculture, village and township collectives established in minority-inhabited areas or remote and border areas.¹³⁸

As in the case of small state enterprises, collective enterprises are free to dispose of retained profits after payment of the income tax subject to the following conditions: not less than 55 percent of the retained profits must be allocated to the production development fund, and not more than 20 percent to the workers' welfare fund, not more than 10 percent to the workers' bonus fund and not more than 15 percent to the dividend account.¹³⁹

(iv) Individual Industrial and Commercial Household Tax (Geti Gongshangyehu Suode Shui)

Since the introduction of the economic reforms and the open policy in 1979, private businesses have been revived and have become an inseparable part of the national economy.¹⁴⁰ By the end of 1987, there were more than 13 million individually owned businesses employing more than 20 million people conducting industrial, commercial and service activities.¹⁴¹ Like collectives, individual households were until recently liable to pay the Industrial and Commercial Income Tax. A new tax, introduced in 1986,¹⁴² now applies to all industrial and commercial households engaged

134. CEIT Regs., *supra* note 130, art.9.

135. Payment of wages and bonuses to workers by collectives in accordance with the specified standard are treated as a cost of production and therefore deductible. Payments beyond the standard must be paid from retained earnings: art. 28(1) of the Financial Adminstrating Measures on Urban and Township Industrial Collective Enterprises, *adopted* by the Ministry of Finance (Dec. 31, 1986) [hereinafter Collective Enterprise Financial Measures].

136. CEIT Regs. *supra* note 130, art.12.

137. *Id.* at art.6.

138. *Id.* at art. 4.

139. Collective Enterprise Financial Measures, *supra* note 135, art. 4(3). The exact percentage is for the enterprise to decide.

140. See Gao Jikang, *A Summary of Discussions on Legal Questions Regarding Private Economy*, Zhongguo Fazhi Bao, Oct. 28, 1986, at 3 (Chinese version).

141. Renmin Ribao (Hawaii Ban), Dec. 30, 1987; and Zhongguo Fazhi Bao, Sept. 5, 1986 (Chinese versions).

142. Interim Regulations on Income Tax concerning Urban and Rural Individually-operated Industrial and Commercial Households, *promulgated* by the State Council (Jan. 7,

in industry, commerce, service trades, construction and installation trades.

The Households Income Tax is levied on profits after deducting costs, expenses, salaries and losses.¹⁴³ The deductible amount of salaries payable to employees, the number of which may not exceed seven, shall be in line with the amount payable to workers in state enterprises in the same industry and the same region.¹⁴⁴ The net profits are taxed according to a ten-grade progressive scale which rises from 7 percent to 60 percent. In addition, a surtax of from 10 to 40 percent is imposed on taxable income in excess of 50,000 yuan a year. Since most individual households operate on a small scale,¹⁴⁵ the surtax is only applicable to a few households to effectively regulate the profit level of those enterprises.

Special reductions in the tax are accorded to the childless elderly, handicapped and those providing badly needed services requiring high labour intensity.¹⁴⁶ Individual doctors, dentists and veterinarians are exempted from the tax on income earned through private practice if the fees charged are reasonable.¹⁴⁷ Households engaged in farming activities or water transportation are also exempted.¹⁴⁸

(v) Private Enterprise Income Tax (Siyang Qiye Suode Shui)

As of July 1, 1988, individuals are officially allowed not only to conduct business in the form of individual households but also through private enterprises registered under the Private Enterprise Law¹⁴⁹ in the form of a sole proprietorship, a partnership or a corporation with limited liability.

Private enterprises established under the Private Enterprise Law are currently taxed under the Private Enterprise Income Tax Law (PEIT

1986) [hereinafter Households Income Tax Law]. Unlike other tax laws, the implementing rules will not be promulgated by the Ministry of Finance, but by local governments: art. 16 of the Households Income Tax Law.

143. It should be noted here that, in contrast, losses in previous years are not deductible for collective enterprises. See art. 12 of the CEIT Regs., *supra* note 130.

144. Art. 4 of Certain Policy Regulations concerning the Urban and Rural Individually-operated Industrial and Commercial Households Income Tax, *adopted* by the Ministry of Finance, (86) *Cai Shui Zi*, No. 091 (April 18, 1986) [hereinafter Households Tax Policies].

145. Households are restricted to hire more than seven employees. See Renmin Ribao (Haiwai Ban), March 12, 1988, at 1; Meng Qingyaun, *Several Questions on Private Economy*, Zhongguo Fazhi Bao, Aug. 27, 1984, at 3; State Council Interim Regulations on Individually-operated Industrial and Commercial Households in the Countryside, *issued* on Feb. 27, 1984: (1984) *Guo Fa*, No. 26; and the Provisional Regulations on the Management of Individual Industrial and Commercial Households in Urban and Rural Areas, *issued* by the State Council (Aug. 5, 1987) (Chinese versions).

146. Households Income Tax Law, *supra* note 142, art. 5.

147. Households Tax Policies, *supra* note 144, arts. 6 and 9.

148. *Id.* at art. 7.

149. The Provisional Regulations on Private Enterprise of the People's Republic of China, *adopted* by the State Council (June 3, 1988), *promulgated* on June 25 and *effective* as of July 1, 1988 [hereinafter Private Enterprise Law].

Law) on their profits derived from engaging in industry, construction, transportation, commerce, catering or other service industries. The tax is imposed on profits after deducting costs, expenses, turnover taxes and non-business expenses allowed by the State.¹⁵⁰ Unlike the Households Income Tax, a flat rate of tax of 35 percent is charged on the taxable amount and no surtax is levied.¹⁵¹ Moreover, business losses incurred by a private enterprise can be carried forward for three years.¹⁵²

Exemptions and reductions are granted if a private enterprise manufactures goods by using waste water, gas or materials, or where the taxpayer is in financial difficulty due to storm, fire, flood, earthquake or other natural disaster.¹⁵³

As previously explained, profits distributed by a private enterprise are taxed again, in the hands of the investor, at a flat rate of forty percent.¹⁵⁴ Consequently this provides a measure of integration of the taxation of enterprises and investors and creates a system not unlike the "classical" system of corporation tax employed in the United States and some other Western countries.

C. Agriculture Tax

Agriculture taxes existed in China, in one form or another, for at least four thousand years. This is not surprising considering that China always has been mainly an agricultural country. Whether to classify these taxes as taxes on income is questionable. At some times — for instance with the "nine-square" system — the tax resembled the medieval European "tithe" and could be considered to be a tax on production or on income.¹⁵⁵ At other times, the assessment was based upon the value or area of the land itself, approximating a property, or annual wealth, tax. The system, in force since 1949, is based upon the estimated yield of the average harvest for the land in question, and might therefore be described as a sort of hybrid property and income tax.

The agriculture tax is of major importance not only because of its antiquity but also because it affects some eighty percent of the population of the People's Republic. However, its budgetary importance gradually diminished over the past three decades as the degree of industrialization increased. Even in the predominantly agricultural areas, it has ceased to be a major source of tax revenue.¹⁵⁶ That does not mean that

150. PEIT Law, *supra* note 81, art. 2. For a discussion of the tax, see Li, *supra* note 82, at 417.

151. *Id.* at art. 3.

152. *Id.* at art. 6.

153. *Id.* at art.4.

154. Under the Private Investors IIRT Law, *supra* note 81.

155. See Easson and Li, *supra* note 1, at 429.

156. According to one study in a primarily agricultural county, the agriculture tax had accounted for thirty-two percent of the total tax revenue in 1957, but for only nine percent in 1983. See Zheng Jiaju and Ye Shaokun, *Thoughts on Reforming Agriculture Taxes*,

the contribution by peasants to the national revenue has decreased, since the state also secures its share of agricultural income through a "concealed tax" — compulsory procurement.

The first agriculture tax law in the People's Republic was promulgated in 1950.¹⁵⁷ The tax was assessed on the basis of the average annual harvest for land of the particular type and levied on a progressive scale according to the total production of the household owning the land. By 1958, with the formation of mutual-assistance groups and then the communes, there was no longer a need for a progressive tax system and a new flat-rate system was introduced.¹⁵⁸ This is the system which, with some modifications, remains in force today.

As under the previous system, tax is charged on all units and individuals deriving agricultural income from the production of grain, varieties of potatoes, cotton, hemp, tobacco, sugar and oil-bearing crops, as well as income from horticultural crops and cash crops.¹⁵⁹ The tax is assessed on the basis of the estimated average annual yield of the land. The assessment usually remains in force for five years. This has the advantage of providing an incentive to increase production as the taxpayer has a complete tax holiday on the increment in output over the normal level until the date of the next assessment of normal output.¹⁶⁰ The tax rates vary from thirteen to nineteen percent in different regions, with a national average of 15.5 percent.¹⁶¹ Local governments may impose an additional local surcharge of up to fifteen percent (in the case of grains) or thirty percent (in the case of cash crops) of the basic tax.¹⁶² A ten to fifty percent surtax may also be levied upon income derived by individual farmers.¹⁶³ The amount of tax is calculated in monetary terms based on the price paid by the state for medium-quality grains when it buys from the production unit. However, until recently the tax was normally paid in kind and was collected twice a year following the summer and autumn harvests.

The Agriculture Tax has failed to keep pace with crop yield and with rising rural incomes. Since Liberation (1949), despite some setbacks, agricultural production has risen steadily. By 1978, total output value stood at 3.63 times that of 1949, and the vital grain output had risen by 270

NONGYE JINGJI WENTI (AGRICULTURAL ECONOMIC ISSUES) April 23, 1985, at 36-8 (Chinese version).

157. Interim Regulations on Agriculture Tax in Newly Liberated Regions, promulgated by the 9th Session of the Central People's Governmental Committee (Sept. 5, 1950).

158. Regulations on Agriculture Tax of the People's Republic of China, adopted by the Standing Committee of the National People's Congress (June 3, 1958) [hereinafter Agriculture Tax Law].

159. *Id.* at arts. 3 and 4.

160. See A.R. Khan, *Taxation, Procurement and Collective Incentives in Chinese Agriculture*, 6 *WORLD DEV.* 827, 829 (1978).

161. Agriculture Tax Law, *supra* note 158, art. 10.

162. *Id.* at art. 14.

163. *Id.* art. 13.

percent.¹⁶⁴ Production rose still more sharply following the introduction of the "responsibility system" in 1978.¹⁶⁵ In contrast, tax assessments rose barely, with the result that an average nominal tax rate of fifteen percent amounted in reality to a real rate of three percent or less.¹⁶⁶ Consequently, in the past few years, pressure has been mounting for a major reform of the Agriculture Tax in line with the tremendous changes which have taken place in rural China. The "responsibility system" has meant that the state has considerably relaxed its control over agriculture. Until 1985, the state almost totally monopolized grain supplies; taxes were mostly paid in grain and the remainder of the state needs were met by quota deliveries at state-fixed prices.¹⁶⁷ This policy has been changed. The state now obtains most of its grain requirements on a contract basis. In more backward areas, tax continues to be paid in kind, but elsewhere the current policy is cash payment.¹⁶⁸ Peasants, in turn, have greater freedom to determine what shall be grown on the land leased to them. Many have switched from grain production to cash crops which yield higher incomes;¹⁶⁹ stories abound of a new generation of 10,000 yuan-a-year peasants. To reduce the difference between growing grains and cash crops, new regulations were adopted in 1983¹⁷⁰ to levy a five to fifteen percent tax on income from producing fruits, natural rubber, silkworm and other cash products.¹⁷¹

The agricultural tax system designed for conditions existing thirty years ago is no longer suitable for modern conditions, and is under attack

164. Zhang Yulin, *Readjustment and Reform in Agriculture*, in CHINA'S ECONOMIC REFORMS 124 (eds. Lin Wei and A.Chao 1985).

165. See, R.Delfs, *Growing Troublesome: China's Rural Reforms Have Produced Some Unexpected Results*, FAR EASTERN ECONOMIC REVIEW, Feb. 18, 1988, at 66. For a general discussion of the rural economic reform, see also, Keith Griffin and Kimberley Griffin, *Institutional Change and Income Distribution*, and A.K. Ghose, *The New Development Strategy and Rural Reform in Post-Mao China* in INSTITUTIONAL REFORM AND ECONOMIC DEVELOPMENT IN THE CHINESE COUNTRYSIDE, (K. Griffin, ed., 1984), 20 and 253 respectively.

166. Ministry of Finance, *Great Achievements in Finance Administration in the Past 35 Years*, CAI ZHENG, (FINANCE) 1984, No. 10, at 1.

167. See, Cai Nong, *Several Questions on the Collection and Accounting of Agriculture Tax*, CAI ZHENG, 1987, No. 11, at 36 (Chinese version).

168. The method of calculating the tax has also been changed to reflect the new procurement policy. It is now set in the "reverse ratio of 3:7," that is to say, 30% of the price component is the price formerly set for the state monopoly purchase of grain while the remaining 70% is based on the purchase price for grain surplus to the production quota: see, *Guo Fa*, No. 71; and Cai Nong, *To Pay in Cash rather than in Kind is a Major Reform in Agriculture Tax Collection*, CAI ZHENG (Finance), 1985, No. 6, at 19 (Chinese versions).

169. For example, citrus crops yield three-and-a-half times as much income as a double crop of rice due to the lowly state-fixed purchasing price for grains. See, Zhang and Ye, *supra* note 156.

170. Measures concerning the Collection of Agriculture Tax on Income Derived from the Specialized Products of Rural Households, adopted by the State Council (Nov. 12, 1983).

171. *Id.* at arts. 2 and 4. For further comments, see *Collection of Taxes on Rural Specialized Products*, CAI ZHENG, No. 1, at 11 (1984); and Cai Nong, *Agriculture Tax Rates*, CAI ZHENG, No. 4, at 45 (1985) (Chinese version).

by many writers in China.¹⁷² It is likely that, before long, a whole new system, an income tax with progressive rates, will replace the present Agriculture Tax.¹⁷³

1. The Concealed Agriculture Tax

Direct agricultural tax is not the only contribution made by the agriculture sector to the state revenue. It also makes a contribution through sales to the state if prices are below those which might otherwise have been obtained. After the founding of the People's Republic, the Government commenced an industrialization program to catch up with developed countries. Due to the nature of an agricultural state, capital was hard to obtain internally and more difficult externally because of the trade embargo imposed by the United States and its western allies. The only source available for China to raise capital was from the contributions of the peasants. There were two possible means of acquiring revenue from the agricultural sector by the state: direct taxation and compulsory purchase by the state at artificially low prices. By using the latter method, the state was able to procure raw materials from the agricultural sector at low prices and allocate them to industry, or sell them to urban workers at low prices, to keep down the cost of production of industrial enterprises and then to collect profits and taxes from these enterprises. As the basis of the economy, the agricultural sector has made a tremendous contribution to the nation's industrialization process by contributing 600 billion yuan in the form of "concealed tax"¹⁷⁴ and 96.5 billion yuan in the form of Agriculture Tax between 1953 and 1983.¹⁷⁵

Before 1985, there were two types of procurement of agricultural products.¹⁷⁶ A lower price was paid on a basic quota which had to be fulfilled by all collective units; this was called *gongliang* (public grains). Over and above the compulsory quota, all production units were free to sell additional quantities to the state; this was commonly referred to as *yuliang* (additional grains). On such voluntary sales the units received a price which was approximately 30 percent higher than the price received from compulsory sale.¹⁷⁷ The units sold *yuliang* voluntarily to the state because it was an honorable obligation of each citizen or unit to contrib-

172. Su Ting and Huang Zhengang, *Discussions on Reforming the Agriculture Tax System*, CAIJING YANJIU, No. 1, 13 (1985); Zhao Yong, *An Attempt to Discuss the Agriculture Tax Reform*, CAI ZHENG, No. 7, 26 (1984); and Zhao Ganqi and Cai Jianhua, *To Readjust the Agriculture Tax Burden and Implement Rural Economic Policies*, CAI ZHENG, No. 11, 37 (1987) (Chinese version).

173. China Daily, Oct. 22, 1986, at 2; and Yan Chu, *A Summary of Discussions at the 1986 Seminar on Tax Theories*, ZHONGGUO SHUIWU, No. 4, 22, at 23 (1987) (Chinese version).

174. Zhou Qiren, Dai Shaojing, *Peasants, Market and Bringing Forth New Ideas*, JINGJI GUANLI, No. 1, 3, at 5 (1987) (Chinese version).

175. *Id.*; Ding, *supra* note 18, at 971.

176. See, R. ALLEY AND W. BURCHETT, CHINA: THE QUALITY OF LIFE 26 (1976).

177. A.R. Khan, *supra* note 160, at 829.

ute to the national development, and also because there were hardly any buyers except the state during that period.

Under the new purchase system inaugurated in 1985, peasants sign quasi-voluntary contracts with the state to supply grain to the state-marketing system. The state pays the base-procurement price for twenty to thirty percent of the contracted amount and a higher, above-quota price for the remaining seventy to eighty percent. The exact proportions vary in different areas and for different grains.¹⁷⁸ The state purchases about 50 million tons of grains, and sells it to urban residents at low, fixed, retail prices. Peasants sell another 50 million tons in further negotiated sales to the state and in free markets. The latter are mainly in rural areas, though some premium quality grain is sold in cities. The rest of the crop is retained by the peasants for their own consumption, reserves and seed. As a result of this procurement system, the state controls eighteen to twenty percent of total grain production, three-quarters of the market supply and nearly all urban grain trade.¹⁷⁹

D. *Additional Taxation of After-Tax Profits*¹⁸⁰

In addition to income taxes levied on state and collective enterprises, taxes are also imposed upon certain retained profits to allow the state to participate in the allocation of funds, guide and supervise the use of those profits, control the overall investment level and prevent excessive increase in consumer consumption. This type of tax is not uncommon in other state-planned economies.¹⁸¹

1. Construction Tax (Jianzhu Shui)

The Construction Tax¹⁸² was introduced to curb the country's increasing capital construction expenditure, to readjust the investment structure, and to direct its limited capital to key projects. The tax is imposed on state enterprises, collective enterprises, private enterprises, and other organizations, which undertake investment in: (1) capital construction, (2) investment in construction as part of a technology renovation project; or (3) investment in construction not listed in the State's Fixed Assets Investment Plan by using the following funds; (a) capital funds outside the state budget, (b) local reserve funds and bank loans (including foreign exchange loans) and (c) various private funds of an enterprise

178. R. Delfs, *How the System Works*, FAR E. ECON. REV. 68 (Feb. 18, 1988).

179. *Id.*

180. This title may seem self-contradictory but the taxes covered in this part are levies payable by enterprises with their retained earnings.

181. DING, *supra* note 18, at 257.

182. The tax is levied under the Provisional Rules of the People's Republic of China on Construction Tax, (June 25, 1987) by the State Council [hereinafter Construction Tax Law]. The Construction Tax Law replaced the Interim Measures on Collecting Construction Tax and their detailed implementing rules, promulgated by the State Council on Sept. 20, and Nov. 18, 1983, respectively.

or public institution; or other self-raised funds.¹⁸³

This tax is charged at 10 percent on investment made by state enterprises or public institutions in a capital construction project or investment in construction as part of a technology renovation project which is a project listed in the state plan;¹⁸⁴ and on an investment in a construction project in urban areas by collective or private enterprises.¹⁸⁵ The tax rate is twenty percent on an investment in a project not listed in the state plan, and 30 percent on constructing a hotel, guest house, convalescent hospital, theatre, auditorium, conference hall, office building or exhibition centre which is not listed in the state plan.¹⁸⁶

The Construction Tax is exempted on investment in constructing facilities for the development of energy resources, communication facilities, educational facilities for a school, hospital or scientific and research facilities. The tax is also exempted on investment in a project financed with a loan provided by an international financial institution or a foreign government, or donations from abroad, as well as investment in a social welfare project or a pollution control and environment protection project.¹⁸⁷

To make the Construction Tax more effective, the tax must be paid with self-raised funds and is not deductible in calculating taxable income.¹⁸⁸ Taxpayers are not permitted to pay the tax with funds allocated to them by the state or from bank loans. The tax payments cannot be counted as part of the cost of the fixed assets and therefore cannot be amortized.

2. State Enterprise Wages Regulatory Tax (Guoying Qiye Gongzi Tiaojie Shui)

This tax is only imposed upon those state enterprises which have adopted a floating-wage system whereby the level of wages floats with the economic efficiency of the enterprise.¹⁸⁹ It is levied on the portion of

183. Construction Tax Law, *supra* note 182, at art. 2. Individuals constructing houses for commercial use in urban areas are also liable for the tax. See ZHONGGUO SHUIWU, No. 10, at 41 (1985) (Chinese version).

184. A "project listed in the state plan" refers to construction investment which is organized by a provincial, autonomous region, directly-administered municipal planning commission, economic commission or one of the various State Council departments in charge, in accordance with the annual plan of the State Planning Commission on self-raised investment in capital construction or investment in construction as part of a technology renovation project, and relevant regulations. See art. 4 of the Construction Tax Law, *supra* note 182.

185. Construction Tax Law, *supra* note 182, arts. 3(i), 3(iii).

186. *Id.* arts. 3(ii), 3(iv).

187. *Id.* art. 5; Ministry of Finance Notice (87) *Cai Shui Zi*, No. 234 (Oct. 6, 1987).

188. See SEIT Regs., *supra* note 112, art. 11(3); CEIT Regs., *supra* note 131, art. 12(4).

189. The "economic efficiency of an enterprise" refers to the amount of taxes and profits paid to the state, which includes SEIT, Product Tax, VAT, Business Tax, Resource Tax, SEIRT and Urban Maintenance and Construction Tax. See art. 3 of the Detailed Rules for the Implementation of the Provisional Regulations on State Enterprise Wages Regulatory Tax, promulgated September 18, 1985 by the Ministry of Finance [hereinafter SE Wages

wages exceeding the specified amount.

Prior to the current economic reform, wage levels were generally set by the state and enterprises had no power to increase the amount of wages to their workers. Honorary awards or awards in kind were normally granted to "model workers." As part of the urban economic reform, the wage system is undergoing reform, and various methods are being implemented which are aimed at giving workers more incentives and to breaking the system of "everybody eating from the same pot." For certain large and medium-sized state enterprises, wages float with the economic achievement of the enterprise. As a result, the more profitable an enterprise, the more after-tax profits can be retained and the more money is available for the "wage increase funds."¹⁹⁰ For other state enterprises and public institutions, the basic wage level was maintained, but they could increase the remuneration to workers and staff by granting bonuses. Consequently, enterprises tended to use up all their funds to increase wages or bonuses to their employees and certain enterprises operating at a loss were unable to do so. In order to limit the wage increase to a reasonable level, to regulate the wage difference between enterprises and to ensure that wages increase at an appropriate speed to avoid a "demand-pull" inflation, the Wages Regulatory Tax and Bonus Tax (explained in next section) were introduced in 1985.

The State Enterprise Wages Regulatory Tax is charged only on the amount of wages that exceeds the amount of wages specified by the state for the previous year by seven percent.¹⁹¹ The amount of wages includes various forms of wages, salaries, bonuses, subsidies, allowances and awards in kinds.¹⁹² Where the increase is not more than seven percent, no tax is payable. The rate ranges from thirty percent to 300 percent for the 1985 tax year¹⁹³ and 20 to 200 percent for the 1987 tax year.¹⁹⁴ The amount of tax payable in the previous year is not included in the speci-

Regulatory Tax Regs.].

190. A steel manufacturing enterprise in Hubei Province adopted this system upon approval by the provincial government in 1981. Under the system, the enterprise "promised" to increase its profitability by not less than seven percent based on the 1983 level and wages were to increase by 0.75 percent for every one percent extra increase in profits. See Wuhan Iron and Steel Corporation, *To Link Wages with Profits and Taxes, the Enterprise Increases its Vitality by Times*, Qiye Guanli, 1987, No. 1, at 17 (Chinese version).

191. Art. 4 of the Provisional Regulations on State Enterprise Wages Regulatory Tax, promulgated by State Council on July 3, 1985 [hereinafter SE Wages Regulatory Tax Law].

192. SE Wages Regulatory Tax Regs., *supra* note 189, art. 6.

193. For 1985, the tax was levied at thirty percent for an increase between seven percent and twelve percent; one hundred percent for an increase between thirteen percent and twenty percent; and three hundred percent for an increase of more than twenty percent. See Appendix to the SE Wages Regulatory Tax Law, *supra* note 191.

194. The tax rate was cut in 1987 to twenty percent for an increase between seven and twelve percent; fifty percent for an increase between thirteen and twenty percent; one hundred percent for an increase between twenty one and twenty seven percent; and two hundred percent for an increase of more than twenty seven percent. See Jingji Ribao (Economic Daily), Feb. 24, 1987 (Chinese version).

fied amount of that year and thus does not form part of the basis for the following year.

3. State Enterprise Bonus Tax (Guoying Qiye Jiangjin Shui)

Those state enterprises which have not implemented the floating-wage system are subject to the State Enterprise Bonus Tax on bonuses paid to workers.¹⁹⁵ It should be noted that this tax, as well as the State Enterprise Wages Regulatory Tax, is levied on the enterprise rather than on the workers. Workers are taxed according to the Individual Income Regulatory Tax on their monthly income received that exceeds four hundred yuan.

The tax rates vary in accordance with the amount of the bonus that exceeds the amount of four month's standard wages.¹⁹⁶ The standard monthly wage amount is sixty-seven-and-one-half yuan or more, depending upon the skill and experience of the worker and the regional wage.¹⁹⁷ If the total yearly bonus exceeds four months wages but is not more than six months, the tax rate is 30 percent. The top rate under this tax is three hundred percent where the yearly bonus amount exceeds the standard wage amount by six month's wages.¹⁹⁸

The tax is exempted on bonuses paid to employees as invention awards, awards for rational proposals on technical transformation, awards for speed unloading of foreign freighters, and bonuses issued to workers working in mining, transportation, construction, or oil and gas exploitation.¹⁹⁹

4. Collective Enterprise Bonus Tax (Jiti Qiye Jiangjin Shui)

All collective enterprises are liable for the Collective Enterprise Bonus Tax on bonus payments to their employees in accordance with the rules provided in the State Enterprise Bonus Tax Law.²⁰⁰ The taxable bonus includes all payments made from the workers's award reserves and bonus reserves, as well as wages, subsidies, labour dividends and stock

195. Art. 2 of the Provisional Regulations on State Enterprise Bonus Tax, *adopted by the State Council on June 28, 1984 and amended and promulgated on July 3, 1985* [hereinafter SE Bonus Tax Law]. This tax was imposed on all state enterprises in 1984 before the SE Wages Regulatory Tax Law was introduced.

196. SE Bonus Tax Law, *supra* note 195, at art. 3.

197. Ministry of Finance Notice, (86) *Cai Shui Zi*, No. 082 (April 2, 1986).

198. *Id.* In 1987, the rates were reduced to 20% and 200%. See Ministry of Finance Notice, (87) *Cai Shui Zi*, No. 010 (Feb. 17, 1987).

199. SE Bonus Tax Law, *supra* note 195, at art. 6. For further discussion of the tax, see Yan Zhiping & Yu Leigui, *Certain Questions on Taxing Bonuses*, *Gongren Ribao* (Workers Daily), May 5, 1984 (Chinese version).

200. Arts. 1 and 2 of the Provisional Regulations on Collective Enterprise Bonus Tax, *promulgated by the State Council on Aug. 24, 1985* [hereinafter CE Bonus Tax Law]; and arts. 2 and 3 of the Detailed Rules for Implementing the Provisional Regulations on State Enterprise Bonus Tax, *promulgated by the Ministry of Finance on Nov. 2, 1985* [hereinafter CE Bonus Tax Regs.].

dividends that exceed the standard amount.²⁰¹ "Labour dividend" is a form of remuneration made by a collective to its workers at the end of the year to allow them to share in the profits of the enterprise. This payment is taxable only if the amount of the labour dividend is more than one month's standard salary.²⁰² "Stock dividends" are dividends declared and paid by a collective which has issued stock to its employees. These stock dividends are taxable if the amount paid is more than fifteen percent of the paid-in capital.²⁰³ Food subsidies and price subsidies granted to workers by collective enterprises by referring to those given by state enterprises²⁰⁴ are not taxable. If a collective enterprise pays wages under the standards set by the state for state enterprises, the taxable bonus is computed in the same way as for a state enterprise. If wages are paid according to other standards, the monthly wage is calculated based on sixty yuan per worker.²⁰⁵

Tax rates and exemptions are similar to those applicable to state enterprises except that collectives engaged in agricultural activities are exempted from the tax.²⁰⁶

E. *Resource Taxes*

1. Resource Tax (Ziyuan Shui)

The Resource Tax, introduced in 1984,²⁰⁷ was aimed at eliminating profit disparities brought about by favorable physical conditions and encouraging an efficient use of the natural resources of the country. This tax is now being levied on units and individuals engaged in exploiting crude

201. CE Bonus Tax Law, *supra* note 200, at art. 5.

202. *Id.* at art. 7.

203. *Id.* at art. 8.

204. In China, wages are only a part of the workers' actual income received from state enterprises. A greater part of their remuneration is in the form of labour insurance and price subsidies. Labour insurance and welfare payments are about 37% of the basic wage bill in state enterprises. All employees in state and collective enterprises enjoy free medical care. Because of the price policy on agricultural and sideline products, the government has to purchase cereals, oil crops, eggs, pork and coal, etc., and sell them to city residents at a loss in order to keep the wage level down. State enterprises may also give certain food subsidies to their employees in various forms. From early 1988, the "hidden" food subsidy became apparent in Beijing by paying a 10 yuan food subsidy to each qualified person (such as workers and university students) per month in return for allowing the market to decide the price of vegetables, eggs, sugar and pork. In addition, houses in cities are built and distributed by government departments and enterprises according to an overall plan, and rents are artificially low. The total cost of these subsidies makes up 85% of the remuneration in state enterprises of which 70% consists of subsidies for housing. See Yu Haitao, *Difference in Wage Systems*, BEIJING REV., Jan. 18-24, 1988, at 25-26.

205. CE Bonus Tax Law, *supra* note 199, at art. 10. There have been some complaints about this standard monthly wage amount being too low. See Shijie Jingji Daobao (World Economic Herald), Dec. 28, 1987, at 2.

206. CE Bonus Tax Law, *supra* note 200, at art. 13.

207. Regulations of the People's Republic of China on Resource Tax (Draft), promulgated Sept. 18, 1984 by the State Council [hereinafter Resource Tax Law].

oil, natural gas, coal, metal and non-metal products.²⁰⁸ The progressive tax rates are calculated according to the sale profit rate of the taxable products.²⁰⁹ The higher the sale profit rate, the higher the Resource Tax rate. The basic sale-profit rate is 12 percent, and the tax is only imposed if the profit rate is higher than the basic rate. For each 1 percent increase in the sale-profit rate, the rate is .5 percent of the sales income of the product if the profit rate is between 12 to 20 percent. The tax rate is .7 percent for each 1 percent increase on the excess portion where the sales-profit rate exceeds 25 percent.²¹⁰ Products consumed by the taxpayer are deemed to be sold at the stipulated prices for the purpose of the tax.²¹¹ Small-scale mining businesses can be granted a 50 percent reduction in tax. Other taxpayers may also be entitled to an exemption from or reduction in the tax if special encouragement is deemed appropriate by the government.²¹² The payment of this tax is deductible when computing the taxable income of the taxpayer.

2. Special Tax on Burning Oil (Shaoyou Debie Shui)

This tax was introduced in 1982²¹³ to restrict domestic oil consumption in order to encourage the domestic use of coal, thereby increasing the export of petroleum abroad.

Enterprises which burn crude oil or heavy oil for boilers, industrial kilns and furnaces are subject to this tax based on the amount of oil burned.²¹⁴ The tax is levied at the rate of 40 to 70 yuan per ton on crude oil and 70 yuan per ton on heavy oil.²¹⁵

F. Local Taxes

Considering China's size, both in terms of geography and population, its tax system and legal system are highly centralized. Local government

208. *Id.* at art. 1. Foreign enterprises and Chinese-foreign joint ventures are not currently subject to this tax. Tax on metal and non-metal products has been postponed. See art. 1(1) of the Provisions on Several Questions of Resource Tax, in Ministry of Finance Notice, (84) *Cai Shui Zi*, No. 296.

209. The "sales-profit rate of a taxable product" calculation is:

$$\frac{\text{Sale profit of the product}}{\text{Sale income of the product}} \times 100\%$$

Resource tax = sale income of the product \times tax rate

210. Resource Tax Law, *supra* note 207, at art. 2.

211. *Id.* at art. 4.

212. *Id.* at art. 7. For a discussion of the tax, see Guo Hongde and Yang Yimin, *The Status of Implementing the Resource Tax and Ideas for Perfection of the Tax*, *Zhongguo Shuiwu*, 1986, No. 4 (part 1), 13-5. and No. 5 (part 2), 11-2; and Hong Chu, *The Deep Meaning of Start Levying Resource Tax*, *Zhongguo Shuiwu*, 1985, No. 1, at 18 (Chinese versions).

213. Trial Regulations on Levying of Special Tax on Oil Burning, promulgated by the State Council on April 22, 1982 [hereinafter Oil Burning Tax Regs.].

214. *Id.* at art. 1.

215. *Id.* at art. 3.

authorities derive their taxing powers from the central government so that the taxes that they are empowered to levy, and the maximum rates of such taxes, are prescribed by the central government.²¹⁶ However, local governments have extensive powers to promulgate implementing rules with respect to the local tax laws promulgated by the central government. The local government also may have powers to grant reductions or exemptions from local taxes.

Taxes designated as local taxes by the central government include Real Estate, Urban Land Use, Farmland Use, Vehicle and Vessel Use, Slaughter, Stamp and Banquet.²¹⁷

1. Real Estate Tax (Fangdichan Shui)²¹⁸

An Urban Real Estate Tax was imposed in China in 1951 on both buildings and land.²¹⁹ It was replaced in 1986 by the Real Estate Tax,²²⁰ but the 1951 version still applies to foreign individuals and enterprises with foreign investment. The Real Estate Tax is levied in cities, counties and townships. This tax is payable in respect of houses or buildings owned by units or individuals. It is charged at 1.2 percent of the residual value of a property if the taxpayer is also the property owner. The "residual value" is usually between 70 and 90 percent of the original cost of the property, the exact percentage being determined by the local government.²²¹ If the property is leased, the tax is imposed at 12 percent of the rental income from the property.²²² Properties owned by government agencies, armed forces, and individuals for non-business purposes are exempt from the tax. Temples, parks and historical places are also exempt.²²³

2. Urban Land Use Tax (Chengzhen Tudi Shiyong Shui)

The Urban Land Use Tax was introduced in July 1988 and became

216. The Principal Rules of 1950 provided that tax legislation which is within the jurisdiction of a county, municipality or province must be submitted to the central authorities for approval. In practice, most local tax legislation is promulgated by the central government in the first place. They are referred to as local taxes because the revenue accrues to the local governments and the local governments have the right to promulgate implementing rules.

217. See Regulations concerning the Implementation of a Fiscal Administration System of Delineating Taxes, Checking and Ratifying Revenue and Holding Different Levels of Government Responsible, issued by the State Council on March 21, 1985.

218. The term "real estate" does not include land as all land in China remains the property of the state under the CONSTITUTION OF THE PEOPLE'S REPUBLIC OF CHINA, art. 10 (adopted on Dec. 4, 1982, by the 5th Session of the 5th National People's Congress).

219. See Provisional Regulations Governing the Urban Real Estate Tax, promulgated Aug. 8, 1951 by the Administrative Council.

220. Provisional Regulations of the People's Republic of China on Real Estate Tax, issued by the State Council on Sept. 15, 1986 [hereinafter Real Estate Tax Law].

221. *Id.* at art. 3.

222. *Id.* at art. 4.

223. *Id.* at art. 5.

effective as of November 1, 1988. All units and individuals who use land located in cities and towns are subject to the tax.²²⁴ The tax rates vary from 0.5 to .10 yuan in large cities to between 0.3 and 0.6 yuan in county towns and mining areas, the exact rate of which is determined by the local government.²²⁵ The tax is not imposed on land used by the government agencies, armed forces, temples or parks, or used for the purposes of constructing energy, transportation and water facilities.²²⁶

3. Farmland Use Tax (Gengdi Zhanyong Shui)

The Farmland Use Tax was introduced in 1987.²²⁷ It was aimed at encouraging citizens and businesses to make better use of land resources, strengthen land control, and protect farmland.²²⁸

Any unit or individual that occupies farmland to build a house or engage in other non-farm business is a taxpayer and is liable for the tax at rates ranging from one to 10 yuan per square meter, depending on the location of the land. The exact rate of the tax is determined by the people's government of the province, autonomous region, or municipality directly under the Central Government.²²⁹ These rates may be raised by not more than 50 percent in the Special Economic Zones and other areas open to foreign investment.²³⁰ Land is also exempt from tax if it is used for such things as military purposes, railways and airports, schools, kindergartens and hospitals.²³¹

4. Vehicle and Vessel Use Tax (Che Chuan Shiyong Shui)²³²

This tax was levied on units and individuals using motor vehicles and motor boats of most types, plus some types of non-motored transport. It is within the jurisdiction of the province, autonomous region or municipality directly under the Central Government, and is normally paid yearly as a form of license fee.

224. Art. 2 of the Interim Provisions of the People's Republic of China on Urban Land Use Tax, *adopted* by the State Council on July 12 and effective as of Nov. 1, 1988 [hereinafter Urban Land Use Tax Law].

225. *Id.* at arts. 4 and 5.

226. *Id.* at art. 6.

227. Provisional Regulations of the People's Republic of China on Farmland Occupation and Use Tax, *promulgated* by the State Council on April 2, 1987 [hereinafter Farmland Use Tax Law].

228. "Farmland" is defined to be land used for growing crops. *See id.* at art. 2.

229. *Id.* at art. 5.

230. *Id.*

231. *Id.*

232. This tax was previously called Vehicle and Vessel License Plate Tax under the Provisional Regulations Governing the Vehicle and Vessel License Plate Tax, *promulgated* Sept. 13, 1951 by the Administrative Council of the Central People's Government. On Sept. 15, 1986, a new law was issued by the State Council based on the 1951 law — the Provisional Regulations of the People's Republic of China on Vehicle and Vessel Use Tax. The 1951 law still applies to foreigners and foreign businesses in China.

5. Slaughter Tax (Tuzai Shui)

The Slaughter Tax is charged when pigs, sheep and cattle are slaughtered. The tax is imposed at a rate fixed by the local government in accordance with the Slaughter Tax Regulations.²³³

6. Stamp Tax (Yinhua Shui)

A stamp tax was levied from 1950 until 1958 when it was incorporated into the Consolidated Industrial and Commercial Tax. A new Stamp Tax Law was passed in June, 1988, and became effective October 1, 1988.²³⁴ Under the Stamp Tax Law, all individuals and entities who write or obtain a specified document are liable for the tax. The "specified documents" include: (1) contracts for; (a) purchases and sales, (b) undertaking of processing work, (c) construction projects, (d) leasing property, (e) transportation of goods, (f) storage and custody, (g) lending funds, (h) insuring property and technology; (2) conveyances; (3) business accounts books; (4) registration certificates for rights and licenses; and (5) other documents determined taxable by the Ministry of Finance.²³⁵ Tax rates vary in accordance with the nature of the documents. For example, purchase and sales contracts are taxed at 0.003 percent of the sale price, while construction and installation contracts are taxed at 0.003 percent of the fee charged; contracts for the undertaking of processing work and transportation of goods are taxed at 0.005 percent.²³⁶ Taxpayers are required to pay the tax at the applicable rate by purchasing and affixing tax stamps which must be pasted on the taxable document.²³⁷ The tax is not levied on duplicates or manuscript copies of documents on which the stamp tax has already been paid, nor on instruments written by the owner of property when such property is donated to the government, a social welfare entity, or a school.²³⁸

7. Banquet Tax (Yanxi Shui)

A Banquet Tax was introduced in September 1988, to guide reasonable consumption and discourage waste.²³⁹ Entities and individuals who hold banquets in restaurants, hotels and other catering places are subject

233. Provisional Regulations on Slaughter Tax, *issued by the Administrative Council on Dec. 19, 1950.*

234. Provisional Regulations of the People's Republic of China on Stamp Tax, *adopted by the State Council on June 24, 1988, and effective as of Oct. 1, 1988 [hereinafter Stamp Tax Law].*

235. *Id.* at art. 2.

236. *See* Table of Tax Rates for Stamp Tax Items annexed to the Stamp Tax Law.

237. Stamp Tax Law, *supra* note 234, arts. 5 and 6.

238. *Id.* at art. 4.

239. Interim Regulations of the People's Republic of China on Banquet Tax, *adopted by the State Council on Sept. 9, 1988, and promulgated Sept. 22, 1988 [hereinafter Banquet Tax Law].*

to this tax.²⁴⁰ The tax is charged at fifteen to twenty percent of the banquet price exceeding 200 to 500 yuan, the exact amount of which is subject to determination by the local government.²⁴¹ The owner or manager of restaurants and hotels which provide the banquet are required to withhold the tax from the price charged.²⁴²

8. Market Transaction Tax (Jishi Jiaoyi Shui)²⁴³

This is a tax imposed on individuals or entities (mainly farmers) selling domestic animals, meat, fruits, local products and home-made handicrafts. The rate is generally 10 percent of the sale price and local governments are empowered to impose the tax at lower or higher rates.

9. Livestock Transaction Tax (Shengchu Jiaoyi Shui)²⁴⁴

Entities or individuals purchasing cattle, horses, donkeys, mules and camels are liable to this tax. The tax rate is 5 percent of the purchase price. The tax is payable to the local tax office and accrues to the province, autonomous region or municipality directly under central control. Enterprises with foreign investment may also be liable to this tax if they purchase taxable livestock for business purposes.²⁴⁵

III. AN OVERALL EVALUATION OF THE CHINESE TAX SYSTEM

Despite its long historical antecedents, China's present tax system is the creation of the past eight or nine years and is the result of the new economic policy. Although further major changes and reforms can certainly be expected, the basic structure of the system now seems to be complete. Because China is both a developing and a socialist country, the criteria which would commonly be applied in assessing a Western capitalist economy may be inappropriate in evaluating China's recent achievements.

A. *Functions of Taxation in China*

Taxation in China performs not only the function of raising revenue for the government, but also acts as an economic regulator to implement the state economic plans and various state policies. Since 1980, when the Joint Venture Income Tax Law was promulgated, taxation also has played an important role in attracting foreign investment.

240. *Id.* at art. 2.

241. *Id.* at art. 3.

242. *Id.* at art. 5.

243. The tax is charged under the Interim Regulations on Market Transaction Tax, adopted on April 16, 1962 by the State Council.

244. It is levied under the Interim Regulations on Livestock Transaction Tax, issued on Dec. 13, 1982 by the State Council.

245. *Cai Shui Wai Zi*, July 19, 1984, No. 130 (Ruling by the General Tax Bureau of the Ministry of Finance).

1. Raising Revenue

As in any other system, taxation in China performs the function of raising revenue and reallocating income. Taxes are levied on the "principle of using what is taken from the people in the interest of the people."²⁴⁶ Since the establishment of the People's Republic, more than 800 billion yuan has been collected in the form of taxation, and this has played an important role in promoting socialist construction. Prior to the recent tax reform, tax revenue accounted for only 40 to 55 percent of state revenue while the rest came from profits delivered by state enterprises.²⁴⁷ In 1986, this figure had been increased to over 90 percent.²⁴⁸ This function of raising revenue is considered to be the primary function of taxation in China.²⁴⁹

2. Regulating the Economy

Another function of taxation is to regulate the economy. In China, numerous "economic levers" are used to implement the state economic plans, including controls on prices, credit, interest rates, wages and profits, as well as taxation. The most important of these at present are pricing and taxation. The state uses taxation to guide and control the production and consumption of products and to fulfill various planned targets by stipulating different tax rates, tax base and exemptions to suit various requirements.²⁵⁰ Frequently, however, taxation is used in combination with price controls to regulate the economy.

Taxation is also used as means of readjusting differences in income among enterprises caused by various "objective factors," such as fixed prices, quality of existing equipment, availability of resources and the locality of the enterprise. By levying taxes on profits earned from taking advantage of favorable conditions, the state can make enterprises compete on a equal basis.²⁵¹

246. Commentator's article, *Fundamental Ways to Increase Tax Revenue*, Renmin Ribao, April 14, 1984, at 1 (Chinese version).

247. Wang Kun, *supra* note 1, at 20.

248. See Jin Xin, *The Principles and Practice of Constructing China's Tax System*, ZHONGGUO SHUIWU, No. 12, at 4 (1987).

249. See Liu Zuo, *The First Function of Socialist Taxation Is Organizing Fiscal Revenue*, ZHONGGUO SHUIWU, No. 6, at 23 (1986); and Xu Jianguo, *Functions of Socialist Taxation*, ZHONGGUO SHUIWU, No. 12, at 17 (1986). Agriculture Tax is not very important in providing revenue, but it does secure the supply of grains to the state. See Cai Nong, *Characteristics, Functions and Policy of Our Country's Agriculture Tax*, CAI ZHENG, No. 2, at 37 (1985) (Chinese version).

250. See further Wang Ruichang, *A Brief Discussion of the Characteristics of the Economic Lever Function of Taxation*, ZHONGGUO SHUIWU, No. 1, at 16 (1986); Deng Ziji, *A Brief Discussion of Taxation Lever*, ZHONGGUO SHUIWU, No. 4, at 24 (1986); and Lu Renzhi, *The Comparison and Choice of Public Debt Lever and Taxation Lever*, CAIMAO YANJIU, No. 11, at 60 (1986) (Chinese version).

251. Yuan Zhenyu, *Functions of Socialist Taxation*, ZHONGGUO SHUIWU, No. 4, at 33 (1985); and Tang Tengxiang, *From Economy to Finance*, ZHONGGUO SHUIWU, No. 11, at 42

(a) Prices Versus Taxes

China used to have a highly centralized, planned economic system. The overwhelming majority of commodities and services were controlled by the state pricing management organs, and principal aim of pricing policy had been to maintain the stability of market prices.²⁵² Since the late 1970s, when new economic policies were adopted, China has been experimenting with a combination of market forces and state planning in order to regulate the economy. By the end of 1987, the degree of central planning of the economy reduced from 100 percent to about 55 percent.²⁵³ Two new pricing systems also were adopted in addition to the previous system. Under these systems the state stipulated a single price known as state stipulated prices." These two systems are "state guided prices" and "market adjusted prices." The term "state stipulated prices" refers to prices of products and rates of service fees determined by the Commodity Price Department and the competent departments of local governments. "State guided prices" are commodity prices and service fee rates determined by enterprises within the guidelines prescribed by the Commodity Price Departments and the competent departments of local government by setting a basic price fluctuation range, a rate differential, a profit rate, a ceiling price or a minimum reserve price.²⁵⁴

State stipulated prices are determined as not only the same as the value of the commodity, reflecting supply and demand conditions, but also to meet state policy requirements.²⁵⁵ Prior to 1979, most goods and services were subject to state price control. State policy required that agricultural products, raw materials and necessities be priced artificially low in order to reduce the cost of industrialization; by contrast, luxury goods and some industrial products were priced very high.²⁵⁶ Consequently, enterprises producing highly-priced goods, such as watches and bicycles, were profitable whereas those producing lowly-priced products suffered losses or made little profit no matter how well they were managed.²⁵⁷

Since price reform commenced in 1979, goods subject to state stipulated prices decreased from more than three hundred categories to twenty-six by the end of 1987. However, basic production materials listed

(1986) (Chinese version).

252. HE JINMING, *JINGJI GONGZUO SHOUCE (ECONOMIC WORKING HANDBOOK)* 455 (1984) (Chinese version).

253. *Renmin Ribao* (Overseas Edition), Nov. 9, 1987, at 1 (Chinese version).

254. Regulations of the People's Republic of China on Price Control, art. 8, promulgated Sept. 11, 1981 by the State Council [hereinafter Price Control Regs.].

255. *Id.* art. 7.

256. It is argued by some writers that whenever prices are set above marginal costs, the part of price over the marginal costs can be deemed as an indirect tax on the product payable by the purchasers. See R.H. Floyd, *Equivalence of Product Tax Changes and Public Enterprise Price Changes*, 28 IMF Staff Paper 338 (1981).

257. For a discussion of the disparities caused by the previous price policy, see Wang Zhenzhi and Wang Yongzhi, *Epilogue: Prices in China, CHINA'S ECONOMIC REFORMS* 220 (1982).

in the state plan, such as petroleum, natural gas, electricity, acid and coal, are still uniformly priced by the state. The majority of industrial products are, however, subject to the state guided prices and some goods are totally priced by market forces. Certain products may be subject to three different prices, depending upon whether they are inside or outside the state plan. In most cases, the stipulated price is lower than the guided price, which is lower than the market price.²⁵⁸ Enterprises used to be indifferent to their profits, since they accounted for all their profit and loss to the state and everyone ate from the "same big pot." The current economic reform requires these enterprises to be economically independent and responsible for their own profits and losses. Although the price reform has rationalized the pricing system, the reform cannot be completed within a short period of time due to various existing problems. Further, inflation is too high to allow further readjustments.²⁵⁹

To balance the "bitter and the sweet" among enterprises manufacturing different products, Product Tax and Value Added Tax (VAT) were introduced in 1984.²⁶⁰ The tax rates of these two taxes were designed on the assumption that price levels would be relatively unchanged.²⁶¹ Where prices are higher than the value of products,²⁶² profits made by enterprises from the price over the actual value should be handed over to the state in the form of tax, whereas enterprises that suffer losses due to the price being set below the value should be granted financial subsidies in the form of lower tax rates or special tax exemptions. Therefore, tax rates are high for products which are sold at high prices and where the govern-

258. For example, rice is subject to three type of prices. When state purchases rice pursuant to a contract signed with peasants, the price is state stipulated. Where peasants sell extra amounts to the state, they can sell it at the state-guided price. If the rice is sold on the market directly, peasants can get whatever price they can determined by supply and demand. See Bao Xiansen, *A Discussion of the Effect of Li Gai Shui on Price Factors*, CAIMAO YANJIU, No. 3, at 27 (1985) (Chinese version).

259. An obvious difficulty of rationalizing the price system is how to increase prices for previously lowly priced goods, (mainly raw materials, agricultural products and necessities) without causing a cost-push inflation. The inflation rate in 1987 was 7.3 percent, in general, but around 20 percent for non-staple foods in cities. See Ge Wu, *Prices and Economic Situations*, Beijing Review, March 7-13, 1988, at 4; and Song Yangyan, Wang Haidong and Du Duanhua, *Reflections on and Designs of Price Reform*, JINGJI LILUN YU JINGJI GUANLI (ECONOMIC THEORY AND ECONOMIC MANAGEMENT), No. 3, at 21 (1987) (Chinese version).

260. The ICT performed similar functions as these two taxes but on a smaller scale.

261. See Liu Deming, *A Brief Discussion of the Relationship between Price Lever and Tax Lever*, ZHONGGUO SHUIWU, No. 3, at 8 (1985) (Chinese version).

262. The value of a product equals the cost of production plus wages and average social profit which is the average profit made by all enterprises manufacturing the same products. See CHEN GONG, HOU MENGHUA AND YUAN ZHENYU, CAIZHENG JIAOCHENG (TEACHING MATERIALS ON FINANCE) 155 (1985) (Chinese version). The price of a product theoretically equals the value of the product plus Product Tax or VAT. The amount of the Product Tax or VAT is not shown on price tags and consumers do not know how much tax they pay when they purchase goods. Normally, when taxes are increased, prices are not increased at all, or are increased by a smaller amount, depending upon whether the state intends to maintain the price level of the product or not. Thus, increased taxes are borne by producers.

ment does not intend to encourage over-production of these products. Lower tax rates or exemptions are applied to products which are lower priced, and the production of which is necessary and needs to be encouraged. To influence consumption of taxable goods, higher rates are applied to those the consumption of which needs to be limited due to limited supply or social policy. Conversely, lower rates are set for products of which the government encourages the consumption and for products receiving financial subsidies, such as foods and other necessities.²⁶³ This explains why the Product Tax has as many as 26 tax rates applicable to 270 taxable products.

It should be noted that, as long as the state controls prices, taxes will be used to regulate supply and demand. However, it has been recommended that when prices are rationalized, i.e., prices equal the true value of products, taxes should be "neutral".²⁶⁴

3. Attracting Foreign Investment

The Chinese government believes that lower tax rates will attract foreign investment to China and that taxing foreign investment in a favorable way will do no harm to the creation of a suitable environment for foreign investors. Therefore, tax incentives are offered to foreign enterprises and Chinese-foreign joint venture enterprises. These enterprises are taxed at very low rates — 10 percent in Special Economic Zones for export-oriented enterprises, whereas state enterprises are taxed at 55 percent and individual households are taxed at 60 percent or more. Foreign individuals working in China are also taxed at nominal rates compared to those applicable to Chinese citizens.

B. Equity

Before discussing the equitability of China's tax system, it should be mentioned that the equity dimension of tax policy, highly important in capitalist countries, is less important in China. Despite the fact that a rich class of citizens is emerging in China due to the flexible economic policies, large disparities of income are unlikely to appear in the near future because of the public ownership of land and means of production and state control over wage increases. The communist party and the government maintain a host of instruments other than income taxation to influence the distribution of incomes in the society. The government maintains these controls because of the communist philosophy and tradi-

263. See Dai Yuanchen, *A Discussion of the Relationship between Price and Public Finance, Taxation, Credit, Wages and other Economic Levers*, CAIMAO YANJIU, No. 1, at 9 (1986); He Zhaoqi and Tang Shunlu, *To Properly Use the Price and Taxation Levers to Promote and Speed up a Commodity Economy*, ZHONGGUO SHUIWU, No. 9, at 8 (1986); and Xu Riqing and Qian Wei, *A Study on Several Questions relating to the Socialist Tax Lever*, CAIMAO YANJIU, No. 1, at 14 (1986).

264. Xu Jianguo, *Relationship between Prices and Taxes*, ZHONGGUO SHUIWU, No. 5, at 19 (1987).

tional Chinese values which emphasize equal levels of income and wealth.

1. Vertical Equity

Marx and Lenin both called for a heavily progressive income tax in socialist states in order "to ensure that the incidence of taxation falls on those individuals best able to pay."²⁶⁵ Although China's Individual Income Tax (IIRT) is not heavily progressive, the recent Individual Income Regulatory Tax and the Private Investors Individual Income Regulatory Tax make it more so for Chinese citizens. Passive investment income is taxed at a flat rate of 20 percent. With the basic deductions permitted, the effective top marginal rate on royalties is a mere 16 percent for Chinese citizens. At first sight, China's system of taxing earned income more heavily than unearned, and taxing workers more heavily than the self-employed, seems contrary to socialist principles. Such an evaluation, however, is superficial. Employees do not begin to pay tax until their wages or salaries are several times greater than average Chinese monthly earnings. Even under the IIRT, tax becomes payable only when income exceeds approximately four times average monthly earnings. Employment income would have to exceed seven times the average before the total tax burden equals that of the flat-rate tax on interest and dividends.

For Chinese citizens, the IIRT aggregates income from employment, professional services and rents, with the two latter items now being taxed at progressive rates. In addition, business income of individuals, whether operating through private enterprises or individual households, is taxed at progressive rates, though technically it is the enterprise which pays the tax. In any event, it could be argued that a progressive income tax is not needed in China for purposes of redistributing income, since redistribution has already been achieved by other means. The relatively even distribution of income and wealth in China, and the absence (as yet) of any substantial class of "rich" individuals, reduces the need for a steeply progressive income tax.

A further possible cause of vertical inequity is the fact that personal income tax plays, at least for the present, an insignificant role in public finance. Heavy reliance is placed upon taxes on goods and services, which are generally considered to be regressive in nature. Taxes on essential items, such as the Salt Tax, clearly are regressive. In general, however, the structure of indirect taxes seems to be mildly progressive, with low rates applying to basic necessities and higher rates to luxuries, tobacco and alcohol. Further, in an economy where the prices of many commodities are controlled, the conventional view that indirect taxes are necessarily shifted to the consumer is no longer valid. Currently, Chinese officials feel that these taxes operate as taxes on enterprise profits, since they cannot be passed on in the form of higher prices. In the case of state enterprises this may make little difference, but as competition among different

265. M. NEWCITY, *TAXATION IN THE SOVIET UNION* 361 (1986).

types of enterprises increases in China, it may be legitimate to regard indirect taxes, at least in part, as being imposed upon the profits of private and collective businesses.

2. Horizontal Equity

In terms of horizontal equity, the present system stands up to scrutiny less well. A major reason for this is the essentially schedular nature of income taxation in China due to the state policy of taxing earned and unearned income differently, though the IIRT may be viewed as a step towards the eventual introduction of a comprehensive income tax since it introduces a measure of aggregation of the various sources of income. At present, however, there is a mixture of flat-rate and progressive taxation: an individual with a large salary may pay more tax than another individual with the same total income where that income is derived from dividends or interest, or from a combination of salary and investments. Since different types of income are taxed differently — rents and royalties on the one hand and dividends and interest on the other — distortions are inevitable and opportunities for tax planning and avoidance arise.²⁶⁶ Another potential cause of inequity is the taxing of certain types of income, notably rents, royalties and professional income, on the basis of gross receipts less a standard deduction, rather than upon actual profit.

C. Neutrality

Inequities will arise in the taxation of business income as well. Seven different taxes — eight if one includes the Agriculture Tax — are imposed on profits, depending upon whether the business is foreign-owned, a joint venture, a state enterprise, collectively owned, individually or privately operated. Each type of business pays tax according to its own rules and schedule of rates. Since these different types of business are in competition with each other, there is a risk that differences in tax burdens may cause distortions.²⁶⁷ Unfortunately, this situation may stay until a complete reform of the business income tax system has taken place. In any event, in a socialist state, the difference in ownership predetermines the difference in fiscal liability of enterprises towards the state. The difference will remain if the government adopts different policies towards

266. Little is known about the Chinese attitude toward tax avoidance. Tax evasion, by contrast, appears to be widespread and a serious problem. See, e.g., Renmin Ribao, May 13, 1985 (Chinese version); China Daily, Oct. 8, 1986. Nor is it a new problem. Ecklund records a massive campaign against tax evasion in 1955, and notes that of 2,071 firms audited in Wuhan, 1,760 were found to have evaded tax. G. Ecklund, *supra* note 19, at 41.

267. Different tax treatment, of course, may be designed to promote competition and to compensate for other factors which cause distortions. Nevertheless, some consequences may be unintended; for example, a large collective enterprises (in terms of profit) pays more tax than a small one, although, when profits are shared among the individual members each receives the same. Similarly, there are significant differences in the rates of tax applicable to contractual fees earned by an individual under the IIRT, and by a private business under the CEIT or Household Tax.

each type of enterprise.

Distortions also exist in the indirect tax system, due to the partially cumulative effect of the Product Tax and Business Tax. This leads one to wonder whether the value-added tax might eventually be expanded to replace those taxes. It should be noted, however, that some of the distortions are intended by the state to encourage or discourage the production and consumption of certain products or to use taxation as an economic lever to control the economy. Neutrality of the tax system is not yet one of the main criteria to evaluate the Chinese tax system.

D. Complexity

At first glance the Chinese tax system appears to be excessively complex. Where, in many Western countries, there is a single comprehensive income tax, or two taxes (one on individuals and one for corporations), China has nine or ten. Similarly, where other countries manage with two indirect taxes — a sales tax or value-added tax and an excise duty — China has four or five. Nevertheless, these differences are more apparent than real. Frequently, a country will have a single income tax code, commonly of considerable length, which treats various types of activity and income differently. Western tax codes are, at least, as complex as the multiplicity of separate tax laws in China. The number of separate taxes, therefore, is not important unless they are administered separately. Nevertheless, the existence of so many categories and rate schedules, both of direct and indirect taxes, inevitably gives rise to "grey" areas and to uncertainty, which in turn may give rise to disputes between taxpayers and authorities.

Simplification of China's tax system seems a distinct possibility. There has already been a substantial move towards VAT in the turnover tax system, but simplification cannot really take place until the pricing system is totally reformed. Taxes on enterprises may be, at least in part, integrated. A single income tax law on all enterprises with foreign investment has been drafted.²⁶⁸ The State Enterprise Income Regulatory Tax may be repealed due to the pressure from both academics and enterprises and we may eventually see a single enterprise income tax system in China in the future.²⁶⁹ The Individual Income Regulatory Tax has moved a step further in aggregating personal incomes.

IV. CONCLUDING REMARKS

As the current tax system is mainly a product of the new economic policies adopted in the late 1970s, it is bound to be reformed along with the further development of the economic and political reform in China.

268. Renmin Ribao (Haiwai Ban), July 7, 1988, at 3 (Chinese version).

269. Cao Ruitian and Zhou Caifeng, *To Organize Tax Revenue and to Regulate the Economy — a talk by Jin Xin, Director of the General Tax Bureau of the Ministry of Finance*, Renmin Ribao (Haiwai Ban), June 21, 1988, at 3 (Chinese version).

To a certain extent, in fact, the tax system has already lagged behind the development of the economic reform. For instance, the replacing of Product Tax with VAT has been very slow and has not taken into account the results of the pricing reform by amending and simplifying the rate structure when the price of more and more commodities are subject to market determination; the income taxation of domestic enterprises cannot completely meet the requirements of urban economic reform, which generates some new forms of business entities, such as corporate groups, formed by mergers among state enterprises, collectives or private enterprises, which are not at present clearly subject to any tax laws; and there have been tax laws providing for the taxation of enterprises and individuals where state enterprises are contracted, leased or sold to collectives or individuals. The existing tax system, also has many deficiencies in itself. The income taxes levied on business income cause unfair competition among different types of enterprises. Large and medium-sized state enterprises, which are the backbone industrial enterprises of the Chinese economy, are subject to heavy taxation and are short of funds for investment.²⁷⁰ The multiple-rate structure of the turnover tax system and the separate tax on each type of enterprise cause confusion among taxpayers and difficulty in administration. Tax evasion has already become a big problem and concern of the government.²⁷¹ Annual national tax inspections have been called to investigate serious tax evasion cases and penalize tax evaders.

To accommodate the economic reform and create an equitable and simple tax structure which fits in the socialist economy, the existing tax system needs to be reformed and perfected. It is anticipated that the future reform may be conducted in the following manner. The turnover taxes and income taxes will remain the two important components of the system, and neither of which can become the leading tax. In the turnover tax system, VAT will gradually replace product tax and, probably, business tax and an excise tax will be levied on some specific products. In the income tax system, income regulatory taxes may be abolished, various tax laws may be integrated, and progressive tax rates adopted. An agricultural tax may stay and be reformed to regulate the rural sector of the

270. See Zhou Shaoyun and Liu Jin, *The Problems Existed in the Current Income Tax System and Thoughts on Further Reform*, CAIJING YANJIU, No. 2, at 40 (1988) (Chinese version).

271. It has been reported that, in certain areas of the country, about 50 percent of state enterprises avoid tax and about 90 percent of individual households try to pay no tax at all. Tax evasion is becoming a commonplace. See Renmin Ribao (Hawaii Ban), May 4, 1986, at 1; Han Shaochu, *To Administrate Law with Law Is the Material Requirement of Taxation*, ZHONGGUO SHUIWU, No. 12, at 20 (1985); and *To Implement National Tax Law and to Guarantee State Tax Revenue*, ZHONGGUO SHUIWU, No. 1, at 17 (1988) (Chinese version).

economy. Local taxes may be further defined to make sure that the central government receives adequate revenue.²⁷²

272. See Jin Xin, *Principles and Practice for the Development of China's Tax System*, ZHONGGUO SHUIWU, No. 12, at 3 (1987); Xu Jianguo, *Principles for the Establishment of our Country's Tax System*, ZHONGGUO SHUIWU, No. 4, at 21 (1987); Ji Kan, *A Brief Discussion of the Reform of our Country's Fiscal System*, JINGJI GAIGE, No. 2, at 25 (1987); Xu Riqing, Du Yanshuang and Zhao Kaitai, *An Inquiry on the further Reform of our Country's Socialist Tax System*, CAIJING YANJIU, No. 5, at 8 (1985); Liu Liqun and Shi Xiaomin, *Reflections on and Choices of Tax Reform*, CAIMAO JINGJI, No. 6, at 26 (1987); Shen Liren, *Comments on "to eat from separate kitchens" and to Delineate Central and Local Taxes*, CAIMAO JINGJI, No. 11, at 24 (1987); Cai Xiuguo, *Several Ideas on the Third Stage of Li Gai Shui*, CAIJING YANJIU, No. 7, at 62 (1986); Sui Zongyan, *Theoretical Basis and Guiding Principles for Reforming and Perfecting our Country's Tax System*, ZHONGGUO SHUIWU, No. 5, at 20 (1986); Gao Wancong, *A Summary of Views of Discussions at a Seminar on Perfecting the Tax System and Tax Models*, ZHONGGUO SHUIWU, No. 2, at 27 (1987); and Xu Riqing, *Thoughts on the Develop Strategy of Our Country's Tax System*, ZHONGGUO SHUIWU, No. 6, at 21 (1988) (Chinese version).