

Journal of Chinese Tax & Policy

中国税收与政策

RECTIFYING INCOME REDISTRIBUTION IN CHINA:
HOMOGENISING PUBLIC SERVICE PROVISION
OR TAX REGULATION?
BIN YANG

BUSINESS ETHICS, CORPORATE SOCIAL RESPONSIBILITY
AND TAXATION- CHINESE POLICY AND PRACTICE
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STIMATION BASED ON PROVINCIAL DATA FROM 2000-2010
JINZHI TONG, XING LI AND JIAJIE WANG



THE UNIVERSITY OF
SYDNEY

(2013) Volume 3, Special Issue

JOURNAL OF CHINESE TAX AND POLICY

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SUBSCRIPTION

Months of Distribution: February and August
Current Edition: 2013 Special Issue
ISSN: 1839-065X (Online)

For information relating to the submission of
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ABOUT THE JOURNAL

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

The Journal of Chinese Tax & Policy focuses on the policy, administrative and compliance aspects of the Chinese tax system. It also welcomes comparative studies between China and other countries. The Journal is an internationally peer-reviewed scholarly publication.

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Forward

China's economic development – a journey full of wonders

Dongsheng Jin

In 1978, the introduction of the 'reform and opening up' policies marked the beginning of China's transformation from a traditional planned economy to a socialist market economy. In the subsequent 35 years, the reform has been widespread and highly influential, despite experiencing numerous ups and downs. Its success is undeniable: China has now become the second largest economy in the world with an annual GDP of RMB 51.9 trillion (US\$8.36 trillion) in 2012.

In the process of implementing a socialist market economy, China has been developing its taxation system and theories and has accumulated empirical feedbacks for its tax policies. Integrating taxation theories, systems, policies and tax administration experiences from developed countries, but tailored to domestic circumstances, China has developed a modern taxation system with distinct Chinese characteristics that can preliminarily accommodate the needs of a socialist market economy. The tax system has lent essential support to China's economic and social development. In 2012, the national tax revenue increased 12.1 per cent to reach RMB 10.06 trillion (US\$1.62 trillion).

Through economic globalisation, China has become an integral part of the international community. The *Journal of Chinese Tax and Policy*, hosted by The University of Sydney, Australia, delivers the latest Chinese tax research to the international community, sharing the Chinese experience in tax policies and reforms and facilitating international communication among scholars and specialists. The *Journal's* work is an invaluable contribution to such a worthwhile cause and I wish it every success.

Dongsheng Jin

Consulting Editor of the Journal of Chinese Tax and Policy

The deputy chair and Researcher of the Fiscal Science Research Centre of the State Administration of Taxation of the People's Republic of China.

10 March 2013

中国经济发展道路奥妙无穷

靳东升

自从 1978 年中国实行“改革开放”的国家政策，开始了由传统的计划经济体制向社会主义市场经济体制的转变。经过 35 年波澜壮阔，艰难曲折的经济体制改革历程，经济建设取得了巨大成功，中国已经成为全世界第 2 大经济体，2012 年 GDP 总量达到 51.9 万亿元人民币（约 8.36 万亿美元）。

在实施社会主义市场经济体制的过程中，中国的税收理论不断发展，税收制度逐步建立和完善，税收政策经验越来越丰富。在学习发达国家的税收理论、税收制度、税收政策和税收管理经验的基础上，结合中国的实际，建立了初步适应建立社会主义市场经济体制要求的，具有中国特色的现代税收制度，有力支撑了经济建设的发展和社会事业的提升。2012 年全国税收总收入达到 100,600.88 亿元人民币（约 16200 亿美元），同比增长 12.1%。

在经济全球化的背景下，中国已经融入国际大家庭。中国离不开世界，世界需要中国。澳大利亚悉尼大学《Journal of Chinese Tax and Policy》及时将中国税收研究的理论成果介绍给国际社会，分享中国税制改革和税收政策的经验教训，促进专家学者的国际交流，大有裨益。让我们携起手来，把这项事业越做越好。

我衷心祝愿专刊取得成功！

靳东升

《中国税收与政策》 顾问编辑

中华人民共和国国家税务总局税收科学研究所

2013-3-10

Editorial

The 2013 special issue of the Journal of Chinese Tax and Policy features articles invited for the Inaugural International Conference of Chinese Tax and Policy 2012.

The first article, 'Business Ethics, Corporate Social Responsibility and Taxation – Chinese Policy and Practice', authored by Vivienne Bath, looks at Chinese legislation on business ethics and corporate social responsibility compared with international practice, focusing on the significant role of tax and tax policy in CSR and ethical conduct.

The second article, 'On the Development Strategy of China's Value-Added Tax (VAT) Reform', authored by Dongsheng Jin and Weifu Jin, examines the course of VAT reform in China, primarily analysing the proposed implementation of the VAT pilot program in Shanghai and comparing China's VAT with modern VAT.

The third article, 'Tax Transplants and the Critical Role of Processes: A Case Study of China', authored by Jinyan Li, examines the critical role of processes in legal and tax transplants through a case study. The paper comes to the conclusion that that processes decide the chances of success of tax transplants in the recipient country as they are the product of local political, socio-legal culture.

In the fourth article, 'Fair Competition and Preferential Taxation Policy for Small & Medium Retail Stores in China: A Comparative Study', George Tian explores the question of whether preferential taxation policy for small-medium retail stores could serve as an alternative solution for the distortion issue caused by slotting allowances to fair competition order in China.

Tong, Li and Wang present a quantitative paper relating to the impacts of the 'horizontal strategic interaction' among local governments, as well as the 'vertical common reaction' between central and local governments on the non-tax burden of various regions in the fifth article, 'Fiscal Decentralization,

Multi-level Government Competition and Local Non-tax Revenue: Dynamic Spatial Panel Model Estimation based on Provincial Data from 2000-2010’.

In the sixth article, ‘Rectifying Income Redistribution in China: Homogenising Public Service Provision or Tax Regulation? In Consideration of Changing the Income Redistribution Rectification Effects of the Factors of Production Flow Asymmetry Arising from Economic Globalisation’, Bin Yang identifies the gradual implementation of public service provision homogenisation and the changing of the factors of production flow asymmetry arising from economic globalisation as the most effective solutions to the issue of unequal income distribution.

The final article, ‘China’s Tax Legislation: Legalism or Functionalism?’, authored by Yansheng Zhu, explains a variety of modern theories on taxation legalism and functionalism, as well as the influence of the functional approach on the development of China’s taxation framework.

The unifying theme of these articles is that the gradual reforms in a range of tax and business areas have all in their own ways helped China adapt to a more diverse economy in the background of globalisation. Our first international conference has witnessed a vibrant exchange and communication of insights and opinions on this phenomenon.

Eva Huang

Sydney, November 2013

Corrigendum

We would also like to issue an erratum to the editorial of the February 2013 issue of the Journal of Chinese Tax and Policy: the article ‘Research on Tax Incentives for Charitable Donations of Non-monetary Assets by Chinese Corporations’ is authored by Zhaohui Long and Xiaoling Hu.

Rectifying Income Redistribution in China: Homogenising Public Service Provision or Tax Regulation?

In Consideration of Changing the Income Redistribution Rectification Effects of the Factors of Production Flow Asymmetry Arising from Economic Globalisation

Bin Yang[★]

Abstract

Currently the labour income ratio in China is normal relative to its economic development; the income differential between industries requires solutions from the continuing establishment of a market economic system and the reduction of monopolistic practices. The important income redistribution issues that require public finance mechanisms are geographic differences and urban / rural differences. Both theory and practice have evidenced that using tax mechanisms to adjust income distribution is ineffective. The most effective path to solve the issue of unequal income distribution is to gradually implement public service provision homogenisation. Further, through political means, changing the factors of production flow asymmetry arising from economic globalisation will also play an important role.

Undoubtedly unequal income distribution is the issue that receives the most attention in China today. This paper proposes new ideas for research consideration, in relation to the reasons of and rectification solutions to the unequal income distribution in China.

[★]The author is from the Department of Public Finance, Xiamen University.

1. Discussion on the Reasons of Unequal Income Distribution and its Rectification Solutions

According to the current theories and methods of measuring income distribution (mainly the Gini Coefficient), China's income distribution is inequitable. However, this inequality differs from that in western countries. It does not simply present itself as the wealth or income disparity between the rich and the poor; but it is represented by the continuing trend of a lower share of compensation for labour in the first stage of income distribution. What this means is that the income gaps between industries (between different urban dwellers), between geographic localities, between urban and rural dwellers are relatively large and continue to grow¹.

Scholars have engaged in much research in relation to the reasons for the abovementioned situation, a summary of major viewpoints follow:

- a. Reasons for the trend in a low share by labour compensation in the first stage of income distribution.

Most scholars were of the opinion that there is a lack of authority and system for workers to participate in the negotiation of payments. Their view was that during wage negotiations, employers effectively have monopolistic power, workers lack the ability and opportunity to negotiate². A further reason is that the worker's right to join unions or collective bargaining is not protected. Other scholars think, stimulated by the separation of public finance powers between different levels of government, local

¹ 国家发展改革委员会, 《中国居民收入分配年度报告》(2011). National Development and Reform Commission, *Annual Report of Chinese Residents' Income Distribution* (2011).

² 常兴华 et al [Chang Xinghua et al], 《促进形成合理的居民收入分配机制研究》[Research on Promoting the Formation of a Rational Residents' Income Distribution Mechanism], (2010) 25 *经济研究* *Review of Economic Research* < <http://www.cnki.com.cn/Article/CJFDTotal-JJGA200905005.htm> >.

governments sacrifice labour protection to achieve economic growth. The internal migration restrictions arising from *hukou* policies, limitations to land transfer, limitations of engaging in the finance industry, and education opportunity discrimination, etc. have in turn lowered the bargaining power of workers³. Empirical research has shown that FDI and the labour income ratio is negatively correlated, concluding that this was the result of the operation of ‘bargaining power’ during the competition to gain investment⁴. According to other scholars, the reason for the lowering of the labour income ratio is that the supply of labour is greater than its demand from the rural population⁵.

Researchers have analysed the income distribution structure change between the three sectors of China’s economy — enterprises, government and residents, based on the cash flow statement prepared after the economic census of 2004. The research showed that between 1992 and 2005, at the first stage of income distribution, the share by the residents sector decreased by 10.71 per cent; but the share by enterprises and the Government has increased by 7.49 per cent and 3.21 per cent respectively. During redistribution, the residents and enterprise sectors’ shares lowered 2.01 per cent and 11.16 per cent respectively, but the Government’s share increased by 3.17 per cent. The enterprise sector played a larger role in lowering the resident sector’s share of

³ 李祥云, 祁毓 [Li Xiangyun and Qi Yu], 《中国的财政分权、地方政府行为与劳动保护——基于中国省级面板数据的分析》 [China’s Fiscal Decentralization, Local Government Behaviour and Labour Protection — Analysis Based on Chinese Provincial Panel Data] (2011) 3 经济与管理研究 *Research on Economics and Management* <http://rem.cueb.edu.cn/ch/reader/view_abstract.aspx?file_no=20110348&flag=1>.

⁴ 罗长远, 张军 [Luo Changyuan and Zhang Jun], 《劳动收入占比下降的经济学解释——基于中国省级面板数据的分析》 [Economic Explanation of the Decline in the Labor Income Share- Analysis Based on Chinese Provincial Panel Data] (2009) 5 管理世界 *Management World* <<http://www.fdiwe.fudan.edu.cn/userfiles/file/20110916110209437.pdf>>.

⁵ 陈宗胜, 高玉伟 [Chen Zongsheng and Gao Yuwei], 《关于公有经济收入差别倒 U 理论的讨论与验证(上)》 [Public Ownership Income Distribution Inverted-U Hypothesis: Discussions and Tests] (2012) 2 经济社会体制比较 *Comparative Economic & Social Systems* <http://www.cctb.net/llyj/llyj/llwz/201206/t20120626_33991.htm>.

total income. However, redistribution not only did not rectify the inequality during the first stage of income distribution, it increased the Government's share of wealth.⁶

The above research was based on data before 2009; the cash flow statement provided by the Statistics Yearbook (2012)⁷ also only included data up to 2009. However, observations show that as the labour shortage became apparent, the wave of wage raises started by Foxconn in 2010 lead to rapid increases in labour compensation rates; this increase is not normal gradual increases, but doubling previous wage levels. The monthly wage rates of factory workers have increased to above RMB 2,000 from less than RMB 1,000 per month. In 2012, the minimum wage of Foxconn workers is RMB 4,400 per month, it was RMB 900 before 2010⁸. In some cities, the average monthly wages of household workers (nannies) have increased from around RMB1,000 to around RMB3,000. The so-called trend of low labour compensation has been changed, the reason possibly is a significant change in the demand and supply relationship in rural labour supply; as well as the improvements in rural living standards, competition in the labour markets and the pauperisation of higher education.

Some scholars also considered that the low share of labour in relation to total income in China is another misjudgement arising from the misguidance of statistics. In the past, the income of individual business operators was accounted for as labour income, leading to a higher ratio of labour income; after 2004, statistics departments no longer considered this income as part of labour income, thereby leading to the lowering of the share of labour income in relation to total income. Also, statistics departments

⁶ 白重恩, 钱震杰 [Bai Chong'en and Qian Zhenjie], 《谁在挤占居民的收入——中国国民收入分配格局分析》 [Who is the Predator, Who the Prey? — An Analysis of Changes in the State of China's National Income Distribution] (2009) 5 中国社会科学 *Social Sciences in China* <<http://xuewen.cnki.net/CJFD-CHJJ200900012.html>>.

⁷ 《中国统计年鉴 (2012)》 [*China Statistics Yearbook (2012)*].

⁸ 段郴群 [Duan Chenqun], 《富士康两年内或四次加薪: 员工叫好同行叫累》 [Foxconn May Raise the Pay for Four Times Within Two Years: The Staff Applaud and the Counterparts Complain] 《广州日报》 *Guangzhou Daily* (Guangzhou), 25 May 2012.

reclassified the income of farmers in accordance to income from wealth or income from labour. This reclassification also changes results. Scholars who take this view calculate according to international comparable measurements, the result was that the share of labour income has continued to grow, and it far exceeded developing nation levels; it also leads in the comparison with other BRIC countries; they were of the opinion that it is a misconception to consider that increasing this ratio means the wealth gap is reduced⁹. Income distribution in China could also be considered as the balancing of the interests between individuals, enterprises and the Government; thereby allocating profit between the factors of production such as labour, capital, technology and management.¹⁰ Some scholars think that disregarding the issues from the change of measurement in 2003 to 2004, the most important reason of the lowering of the labour income ratio is the structural change from agriculture to non-agricultural industries, therefore this change is due to industry structural change, and this industry structural change is reasonable, and it is a necessary stage of economic development.¹¹

b. Considering industry differentials.

There is much literature in relation to the reasons of income differentials between the urban employees of different industries. According to some scholars, the reason to this difference is systematic, such as changes in ownership structure and changes in wage structure, as well as the structural changes and technological advances during fast economic growth. Other researchers think the major reason is the rising income of

⁹ 华生 [Hua Sheng], 《劳动者报酬占 GDP 比重低被严重误读》 [Low Labor Compensation Share of GDP is a Serious Misreading] 《中国证券报》 *China Securities Journal* (online), 14 October 2010 <http://www.cs.com.cn/xwzx/03/201010/t20101014_2623590.html>.

¹⁰ 齐桂珍 [Qi Guizhen], 《独特的中国收入分配模式给世界带来了新的曙光——中外分配模式比较》 [Chinese Unique Pattern of Income Distribution Has Brought to the World A New Dawn — Comparison of Chinese and Foreign Allocation Model] (2011) 9 宏观经济研究 *Macroeconomic Research* <<http://www.cqvip.com/QK/96811B/201109/39249137.html>>.

¹¹ 云小纾 [Yun Xiaoshu], 《麦肯锡：中国居民收入占 GDP 份额在下降》 [McKinsey: China's household income to GDP ratio is falling] <http://blog.sina.com.cn/s/blog_5308f7670100ppsq.html>.

monopoly industries and its associated market division^{12 13}. Some scholars discovered, the differences in labour income between industries is more influenced by fringe benefits than actual cash wages, the reason is monopoly and profitability, monopoly is the larger factor.¹⁴

c. Considering income differential between localities.

In the past, scholars explained income differences between residents of different areas by natural endowments and government macro policies. Recently, many scholars discovered other factors. According to some, globalisation is an important contributor to geographic income differences and its effects are increasing; internal capital from a country has become the most significant factor that affects the income differential between areas; the effects of privatisation on this differential is also growing; education, geography and urbanisation is beneficial in reducing geographical inequality¹⁵. To some scholars, globalisation is the deciding factor for income inequality between localities¹⁶. Some scholars have also analysed in detail the effects of different factors on income distribution in China, that is trade globalisation, production and investment production, financing, scientific advances and education

¹² 陈钊, 万广华, 陆铭 [Chen Zhao, Wan Guanghua and Lu Ming], 《行业间不平等:日益重要的城镇收入差距成因——基于回归方程的分解》 [Inter-industry Inequality: An Important Source of the Urban Income Gap—Regression-based Decomposition] (2010) 3 中国社会科学 *Social Sciences in China* <<http://www.wise.xmu.edu.cn/youth-forum2008/paper/陈钊, 万广华, 陆铭--行业不平等: 日益重要的城镇收入差距成因.pdf>>.

¹³ Sylvie Démurger et al., 《中国经济转型中城镇劳动力市场分割问题——不同部门职工工资收入差距的分析》 [The Problem of Urban Labor Market Segmentation in China's Economic Transformation – Gap Analysis of the Wage Income of Workers in Different Departments] (2009) 3 管理世界 *Management World* <<http://glsj.cbpt.cnki.net/WKB/WebPublication/paperDigest.aspx?paperID=5F0E68DD-DCFB-413A-A5F6-4EF1C503D17F>>.

¹⁴ 罗楚亮, 李实 [Luo Chuliang and Li Shi], 《人力资本、行业特征与收入差距——基于第一次全国经济普查资料的经验研究》 [Human Capital, Industry Characteristics and Income Gap — Empirical Research Based on the First National Economic Census Data] (2007) 10 管理世界 *Management World* <<http://glsj.cbpt.cnki.net/WKB/WebPublication/paperDigest.aspx?paperID=40EEDE15-4009-4C12-BACA-4EC056FD165C>>.

¹⁵ Guanghua Wan, Ming Lu and Zhao Chen, ‘Globalization and Regional Income Inequality: Empirical Evidence From Within China’ (2007) 53(1) *Review of Income and Wealth* 35, 35–9 <<http://ssrn.com/abstract=966534> or <http://dx.doi.org/10.1111/j.1475-4991.2007.00217>>.

¹⁶ Yingru Li and Yehua Dennis Wei, ‘The Spatial-Temporal Hierarchy of Regional Inequality of China’ (2011) 30 *Applied Geography* 303, 303–16 <<http://ssrn.com/abstract=1757251>>.

levels. They concluded that the development in finance has the greatest effect on the inequality in income distribution in China; technological advances, improvements in education and the labour flow from lower sectors to higher sectors to a certain extent closes the income gap¹⁷. Some other scholars think that the key contributor to geography income differences is the average capital of employees and the productivity of capital¹⁸.

d. Consider the income differences between urban and rural dwellers.

Research shows that the urban rural income differential is the greatest income differential in China. Scholars have calculated according to the Theil index, the contribution ratio of urban rural income differential to total resident income differential is as high as 64.45 per cent¹⁹. Other research shows that the contribution ratio of urban rural income differential to total income differential is close to 50 per cent.²⁰ The literature regarding the reasons for urban rural differential is numerous. Yang has summarised them into ‘six theses’ and commented on them, such as: ‘national industrialisation strategy’, ‘Government’s discrimination against the three agricultural groups’, ‘stratified social structure’, ‘production capacity differences’, ‘differences between human capital and reproduction rate’ and ‘ineffective policies to eliminate income inequality’. The conclusion was that these popular viewpoints cannot completely point out the source of the issue, the existence of the reverse

¹⁷ 张汉林, 袁佳 [Zhang Hanlin and Yuan Jia], 《经济全球化、中国收入分配与“人口红利陷阱”》 [Economic Globalization, Income Distribution in China and Demographic Dividend Trap] (2011) 6 财经研究 *Journal of Finance and Economics* <<http://www.cnki.com.cn/Article/CJFDTOTAL-CJYJ201106007.htm>>.

¹⁸ 陈建东 [Chen Jiandong], 《海外关于中国收入不平等问题的研究进展》 [Overseas Research Progress on the Issue of Income Inequality in China] (2012) 4 经济学动态 *Economic Perspectives* <<http://mall.cnki.net/magazine/Article/JJXD201204020.htm>>.

¹⁹ 常兴华 et al [Chang Xinghua et al], above n 2.

²⁰ 杨灿明, 孙群力 [Yang Canming and Sun Qunli], 《中国居民收入差距与不平等的分解—基于 2010 年问卷调查数据的分析》 [Chinese Residents’ Income Gap and Inequality Decomposition — An Analysis Based On the 2010 Survey Data] (2011) 11 《财贸经济》 *Finance & Trade Economics* <http://d.wanfangdata.com.cn/periodical_cmjj201111008.aspx>.

fiscal mechanism is the root and hidden reason for the increase in urban rural income differentials and the difficulties in grassroots-level public finance²¹.

In summary, Yang agreed that the current labour compensation ratio in China is normal in the process of economic development. Using merely legal or administrative means to increase wage and salary levels would not only achieve an increase in compensation for workers, it would also decrease employment opportunities, thereby cancelling out the increased level of labour income²². Further, practices in many western countries show that the decision-making mechanism for increasing wage and salary rates through worker / employer negotiations is not advantageous to balancing the relationship between workers and employers. A better mechanism is a model in which employees can share profits (such as employee share schemes and profit participation, etc).²³ The solution to industry differentials is mainly in continuing to develop the market economic system to decrease monopolistic power.

Therefore, the income distribution issues that we need to focus on are geographic differences and urban rural differences. So, the question on adjusting income distribution becomes what are the most effective mechanisms to solve geographic income differences and urban rural differences. The methods applied by governments are just taxation, fiscal expenditure (public services), and other political and legal mechanisms. Therefore, the question we are researching is whether tax mechanisms or fiscal expenditure is more effective to adjust income inequality? And what are the

²¹ 杨斌 [Yang Bin], 《对关于城乡收入差距拉大和县乡财政困难原因的诸种观点的辨析——并论中国财政机制的逆向特征》 [The Discrimination of Various Views on the Widening Urban-Rural Income Gap and Financial Difficulties of Counties and Villages – Discussion on the Reverse Characteristics of Chinese Fiscal Mechanism] (2010) 6(1) 《公共经济学评论》 *Public Economics Review*.

²² 白重恩 [Bai Chong'en], 《居民可支配收入占 GDP 比例逐年下降》 [Residents' Disposable Income to GDP Ratio Declines Year by Year] 《财经网》 *Caijing* (online), 2 February 2010 <<http://www.caijing.com.cn/2010-02-02/110370724.html>>.

²³ 齐桂珍 [Qi Guizhen] above n 10.

necessary political and legal mechanisms to solve the effects on the income of residents in different places arising from globalisation. The following is a discussion.

2. The Ineffectiveness of Taxation on Adjusting Income Distribution

Theory and practice both evidence that using tax mechanisms to adjust income distribution is ineffective; it is also ineffective in relation to geographic differences and urban rural differences.

In the 1960s to 1970s, represented by the Optimal Tax Theory of Mirrlees and the general equilibrium theory of Harberger²⁴, scholars proved in detail the theory that a higher tax rate should be levied on higher income earners and its associated application on adjusting income through income tax. In practice, based on the negative effects of the multiple tax rates and high tax rates from levying progressive income tax, western countries represented by the US are implementing individual income tax rate system reform. The general trend is to reduce marginal rates and to decrease the number of brackets, even implementing a flat tax.

Practice also shows that it is impossible to design and effectively operate an individual income tax system that is able to adjust income distribution²⁵. In order to achieve fairness in an individual income tax system, the only possibility is increasingly complex systems and regulations. In 2005, statistics showed that the federal law in relation to income tax in the US, i.e. the Internal Revenue Code and its Regulations, amounted to 7.064 million words, this is an increase of 23.4 per cent from the 1995 level and almost 10 times the figure in 1955. Data provided by the US Tax Foundation showed that the compliance cost of the federal income tax is consistently high: this

²⁴ 杨斌 [Yang Bin], 《税收学原理》[*Tax Principles*] (高等教育出版社[Higher Education Press], 2008), 125.

²⁵ 杨斌 [Yang Bin], 《个人所得税能够对收入分配不公起有效的调节作用吗?》[Can Personal Income Tax Regulate the Unequal Income Distribution Effectively?] (2012) 6 《涉外税务》*International Taxation in China*.

amounted to 14.1 per cent in 1990, 24.8 per cent in 2003, 24.4 per cent in 2004, and between 22–23 per cent in recent years. In 2012, it was 21 per cent²⁶.

Recently, there has been empirical research through new research methods on the income distributive effects of income tax on the 1990 to 2000 data of the US, Germany and France. This research also showed that the income redistributive effects of income tax are not significant, and it may be opposite to its aim²⁷. Other researchers analysed cases in Italy between 2000 and 2005, it also showed that income tax almost had no effect on income distribution²⁸. The OECD in its report in 2008, performed empirical research on 24 OECD countries in relation to the income distribution of the past 20 years and concluded that inequality and relative poverty is worsening. It also pointed out that income tax and fiscal expenditure only have short term effects on income inequality and relative poverty. In the long run, the opposite always happens — it not only increases income inequality but leads to fiscal crisis. Wealth tax such as the real estate tax also is not very effective on income distribution.²⁹

There are other scholars who have researched the relationship between taxation and income distribution in China and concluded that the current tax system is ineffective for income distribution. For example, the empirical research by Li Shaorong and Geng Ying showed that in China's current economic system and tax structure, increasing the revenue ratio of turnover taxes, income taxes, resource taxes and wealth taxes would

²⁶ Scott A Hodge, J Scott Moody and Wendy P Warcholik, 'The Rising Cost of Complying with the Federal Income Tax,' *Tax Foundation Special Report No 138* (January 2006) <<http://www.taxfoundation.org/files/federalcompliancecosts-20061026.pdf>>.

²⁷ Cecilia García-Peñalosa and Stephen J Turnovsky, 'Taxation and Income Distribution Dynamics in a Neoclassical Growth Model' (2011) *Journal of Money, Credit and Banking* 1543, 1543–77.

²⁸ Carlo Declich and Felice Russo, 'Evaluating the Income Tax Redistributive Impact: A More Comprehensive Approach' (2009) *The Journal of the Italian Economic Association* 71, 71–106.

²⁹ 杨斌 [Yang Bin] (笔名夏商末) (Professional name: Xia Shangmo), 《房产税：能够调节收入分配不公和抑制房价上涨吗》 [Property tax: is it able to adjust the unequal income distribution and curb price increase?] (2011) 4 《税务研究》 Tax Research.

increase the gap between income from capital and income from labour.³⁰ Bai Yanfeng and Xu Manman performed empirical research on the income redistributive effects on the current proposal of increasing the general deduction ratio for individual income tax; it also showed that this policy has minimal effects on adjusting the income distribution of residents.³¹

3. The Homogenisation of Public Service Provision is the Effective Solution to Solving the Geographical Income Gap and the Urban Rural Income Gap

The public finance in China currently reflects greater internal privileges. People are fairly required to pay taxes according to taxation laws; but the benefits of fiscal expenditure are largely enjoyed by public servants or quasi-public servants. The formal and actual income of public servants is higher than all labour income earners who do not work for a monopoly. After the market reform of normal state-owned enterprises, the urban rural differential is mainly reflected by the income differential between rural workers (including village level officials) who have relatively lower income and social security levels (some are without social security for the long term); and some public servants and quasi-public servants (employees of Government agencies that are funded by public finance or special self-funded agencies), who are urban residents. Geographic differentials are related to unequal public service provisions due to the system of separate public finance powers. The land finance part of public finance worsened the inequality in income distribution. In form, land is

³⁰ 李绍荣、耿莹，《中国的税收结构、经济增长与收入分配》，《经济研究》，2005年第5期。Li Shaorong and Geng Ying, 'The Effects of Tax Revenue Structure on Economic Growth and Income Distribution', *Economic Research Journal*.

³¹ 白彦锋、许嫚嫚，《个税免征额调整对政府税收收入和居民收入分配影响的研究》，《财贸经济》，2011年第11期。Bai Yanfeng and Xu Manman, 'The Impact of Personal Income Tax Adjustment on Government Tax Revenues and Residents' Income Distribution', *Finance & Trade Economics*.

owned by all people but in reality it is owned by the local city. Revenue from land is spent on the minority of urban dwellers; thereby during the process where the local government receives land income, there is double deprivation. The first layer is the deprivation of the people in the country, with the exception of those who benefit from the land. The second layer is purchasers of commercial housing (the major part of housing price is the land income of governments). Such public finance not only contributes nothing to income redistribution, itself is the largest contributor to income inequality, and it is the major contributor to urban/rural differential and geographical differential. Liang Dongli's empirical research showed, the share of the residents sector of the economy decreased by a large percentage in the first stage of income distribution, it continues to decrease in redistribution, this is an illustration that public finance not only did not perform its income distribution role, it worsened income inequality³². Empirical research by Zhang Mao et al showed that government expenditure increased the income distribution gap.³³ Increases in fiscal expenditure will increase the Gini coefficient, thereby worsening the equality in income distribution.

Therefore currently, rectifying the internal inequality in the Government itself is the best adjustment to the inequality in income distribution. What this means is the best path to solving income inequality is to gradually achieve homogenisation of public service provision. Since China's unbalanced social and economic development between rural and urban areas and in different geographic areas has been established through a long time, it is difficult to change in the short run, its associated imbalance

³² 梁东黎 [Liang Dongli], 《国民收入的分配、转移格局:理论表达与我国实情》 [Distribution of National Income, Transfer Pattern: The Theoretical Expression and the Real Situation of Our Country] (2011) 7 《经济学家》 *Economists* <<http://www.cqvip.com/QK/97161X/201107/38332120.html>>.

³³ 张崧, 王青, 乔东艳 [Zhang Mao, Wang Qing and Qiao Dongyan], 《财政政策对经济增长和收入分配的长期影响效应分析》 [The Long-term Effects Analysis of Fiscal Policy to Economic Growth and Income Distribution] (2010) 2 《经济与管理》 *Economy and Management* <<http://xuewen.cnki.net/CJFD-JJGL201002005.html>>.

in public service provision also cannot be eradicated easily in the short run. Therefore, now it is necessary to begin with 'basic' public services and aim for gradual change, in order to achieve the complete homogenisation of public service provision required by a harmonious society.

Basic public service is the provision of public goods that are essential in the lives of people by the government, initiated to meet the basic needs of the residents. It includes the following:

1. public goods that are necessary for the safety of the people: defence, police, law and foreign affairs;
2. public goods that are closely related to the living environment: transport, communication, infrastructure, environmental protection, etc;
3. public goods that are closely related to improving the quality of life of the people, such as compulsory education, employment services, social security, health and housing security.

Basic public service provision homogenisation is where residents have the same rights to enjoy the same basic public services provided by the government through tax revenue. From the government's point of view, this is the dynamic development of the standard for basic public services based on financial resources, and applying this standard equally to all residents within the jurisdiction, regardless of their place of residence, their social status, their nationality or the amount of wealth they possess. The aim of homogenisation is to eradicate the privileges in public services, eliminating the possibility of some members of society profiting from the public domain, thereby achieving fairness and efficiency. The narrower the term 'basic' is being defined, the greater the residual possibility for public privileges. It is thereby harder to achieve a fair and efficiently coordinated harmonious society. For the long-term prosperity and

security of the nation and the harmonious development of the society, these ‘basic’ needs continue to grow, until all public services are homogenised, thereby creating the conditions for opportunity equality in this society.

Homogenisation of basic public services cannot be simply understood as equal public servant wages and equal government public funding in all localities in China. In reality, the government needs to distinguish basic public services at each period according to its fiscal ability, in order to set the standards for public resources according to objective factors (geography, demography, environment, ecological function, development and strategic position etc), then apply this standard equally to all residents within their governing domain. Of course, this homogenisation does not mean the government should divide the benefits from basic public services equally through a budget regardless of whether the resident needs the services (in reality, due to the non-rivalry and non-excludability nature of public services, such distribution is not possible; it means that residents have an equal right to enjoy basic public services, and that they should not be treated differently because they lived in a different area, occupy different positions in society, are from different ethnic groups, or are of a different gender or age.

The core goal of current basic public service homogenisation is to achieve equal provision of basic public services in urban and rural areas. Over the years, China has developed a “dual” structure arising from the differences in industrial and agricultural policies and the productivity differences in rural and urban areas, an urban-rural divide in administrative mechanisms that is developed around the residency registration (*hukou*) system as its foundation, and an urban-rural income differential arising from institutional arrangements as a result of the reverse fiscal mechanism or from human intervention. Apart from making fiscal expenditure in favour of urban areas, China’s public finance even considers rural villages, agriculture and farmers to be outside the

system (the expenditure for the “three agriculture” policies has therefore been regarded as “supportive agriculture” expenditure for a long period of time). In reality, a reverse fiscal mechanism against rural areas has been arranged (also known as asymmetric financial mechanisms)³⁴. The reverse fiscal mechanism is where public finance not only did not perform its income distribution role, in order to achieve some balance in society, it achieved the opposite to extort from the poorer farmers^{35, 36}. The author analysed the systematic characteristics of China’s public finance between 1998 and 2007 (including normal budget, fund budget and social insurance budget). The research showed that China’s public finance does have a reverse fiscal mechanism against farmers, villages and agriculture, i.e. the Government extorts more from the poorer farmers than the amount of public goods provided to them.

Therefore, the fundamental issue in homogenising basic public service provision between urban and rural areas is that the Government needs to provide public goods to the rural sector at a faster pace than that to the urban sector; in order to achieve homogenisation on the basis of ‘repayment of debt’. This means that to achieve basic public service provision homogenisation between urban and rural areas, ‘inequality’ is required, that is to provide more and ask for less from the rural sector to achieve homogenisation. Two paths can be taken:

³⁴ 杨斌 [Yang Bin], 《非对称财政机制：财富从农村自动地转移至城市》 [Asymmetric Financial Mechanisms: Wealth from Rural Areas Transfer to Urban Areas Automatically] (2002) 12 《涉外税务》 *International Taxation in China* <http://d.wanfangdata.com.cn/periodical_sws200212001.aspx>.

³⁵ 杨斌 [Yang Bin], 《中国财政的特殊规律：逆向财政机制——城乡收入差距拉大和多数县乡财政持续困难的隐性原因》 [The special law of Chinese finance: the reverse fiscal mechanism — Hidden reasons for the widening income gap between urban and rural areas and the majority of the county and township finances continue to be difficult] (Paper presented at 2009 年公共经济学与管理国际论坛 [2009 International Conference on Public Economics and Administration], 厦门大学 [Xiamen University], 28-29 November 2009).

³⁶ 杨斌 [Yang Bin], 《卸下农民“七重负担”实现城乡统筹发展》 [Remove the peasants’ seven burden to achieve overall development of urban and rural areas], (2004) 17 《理论前沿》 *Theory Front*, 18-9.

1. From now on, have uniform policies for the provision of basic public services for the urban and rural sectors, in order to discontinue different administration for the two sectors and prejudicing over rural areas in favour of urban areas;
2. Repay debt as compensation, apply appropriate methods to return to rural areas from urban areas, and return to agriculture from industry, compensate reasonably the historical debt to the ‘three agriculture’ groups. Appropriate methods of compensation can be to provide special public goods to the rural sector as a whole, including establishing a fair and competitive market to encourage collectivisation, and establishing an economic organisational structure suitable for rural economic development. It could be a financial system established according to the production characteristics of agriculture, which is a mechanism that ends the rural capital outflow and attracts capital into rural areas; a mechanism that establishes liveability in rural areas that attracts human capital and technology into rural areas; and an employment support system that reduces human capital outflow and changes the quantitative labour advantage in rural areas into a large supply of quality human resource from rural areas.

In order to achieve basic public service homogenisation, it is also necessary to establish a new finance allocation system, that is the majority of fiscal revenue should belong to central government, but local governments, especially lower level governments should do more of the spending to establish an unmatched public finance system.

To make local governments at the grassroots level the major spender of tax revenue is to require central and provincial level governments (prefecture-level cities and planning cities should be included where necessary) to collect revenue and transfer financial authority to the local governments through reasonable transfer payments, according to the requirements and standard set for the purposes of basic public services homogenisation. Local governments of underdeveloped areas, in particular, should be provided with more transfer payments. The mechanism is a bottom-up

levelling and balancing mechanism. This means that county governments will balance the financial abilities of villages and townships that are within its governing domain, if the villages' standard is below the standard in the county, the county spends to balance its fiscal ability; after balancing, if the total level in the county is lower than the province (county level city or independently funded city), the province (county level city or independently funded city) will be responsible for the balance; if the result from provincial balance is below national level, the central government will spend to balance.

4. Changing the Asymmetry in Factors of Production Flows Arising from Globalisation

It has been mentioned above that globalisation is an important factor that affects income imbalance between geographic areas. In order to solve geographical and urban/rural income differentials, other than the policy to homogenise public services, reasonable political and legal mechanisms to change the asymmetry in factors of production flow arising from economic globalisation is also necessary.

The majority of workers in China do not only receive fewer benefits from public services (especially those who live in less developed areas), they also become the objects of exploitation by multinational corporations, or even normal citizens of developed nations. The fundamental reason is that economic globalisation is an incomplete, unequal globalisation. In its current stage of globalisation, China still bears the responsibilities of the major manufacturing centre of the world. Through intellectual property agreements, financial services agreements, etc. developed nations allowed sectors at the two ends of the parabolic curve, namely intellectual property, financial services, design and marketing to enjoy the majority of the newly-grown wealth pie. A large part of this was transferred to governments through taxes, and

governments were able to use it to redistribute to the poor, through social security and subsidies to improve the living standards. At the same time, these nations are enjoying the lowly-priced goods continuously provided by Chinese enterprises. This is the important foundation to the social stability in developed nations.

To further consider the reasons for the above situations, at this stage of economic globalisation, there is asymmetry in two factors of production flows – labour and technology. Through international regulations such as those of the WTO, developed nations require the achievement of free flow of capital and goods, but place strict limitations on the movements of people and technical expertise. Western developed nations strictly limited the flow of normal labour through migration laws, but allowed skilled migration and investment migration. They welcomed quality human resources, but limited the entry of normal labour. The strict limitation and asymmetry of the flow of labour, and the limitation of the export of high technology, meant that the most treasured and lively part of factors of production could not be appropriately allocated.

The WTO has not established a mechanism for the encouragement of the free transfer and trade of technical expertise. On the contrary, it established a mechanism that restricts the free flow of technical expertise. Reasonable protection of intellectual property is advantageous to encourage research, development and other types of creative pursuits. However, over protection, lengthy protection, over pricing are all disadvantageous to advance social welfare in the world, and it creates a single direction flow of benefits.

At the moment, over 90 per cent of patents are in the hands of developed nations. Relying on technical endowments and international regulations that are based on these technical endowments, developed nations and their multinational companies engage in a monopoly of the global market, especially that of the high technology market,

thereby profiting highly in the process. For example, due to a lack of core technology, Chinese enterprise has had to give up 20 per cent of the sales price of mobile phones, 30 per cent that of computers, 20–40 per cent that of numerical control machine tools (NCM tools) to foreign patent owners. Further, relying on their technical prowess, developed nations control strategic resources that are relevant to big picture or future development issues, such as space, ocean and biology.

On the other hand, in order to maintain their competitive advantage, developed nations place restrictions on the transfer of technology or high technology products to developing nations through intergovernmental means to prevent military usage; these restrictions are not seen as against the non-discriminatory principle and the preferential treatment nation principle. What this means is, even if you are willing to buy or to pay the licensing fees for the use of monopolistic intellectual property, you can't do so. During the cold war period, there was the Coordinating Committee for Multilateral Export Controls to limit export of high technology and strategic material. After the end of the cold war, this situation did not change as the call for free trade continues. Thirty-two nations headed by the US signed the Wassenaar Agreement on Export Controls for Conventional Arms and Dual-Use Goods and Technologies, to continue and strengthen limitations on the export of sensitive technologies. Therefore actual core technology is difficult to acquire through normal trading means. Therefore, underdevelopment in technology makes it difficult for developing nations to establish new industries that are globally competitive, and for them to establish competitively advantageous industries that have economies of scale. Polarisation becomes inevitable. On the one end, developed nations can call for nation building through intellectual property, they can profit from global production centres from patents, in order to maintain their improving social welfare and living environment. The other end is the majority of developing nations who bear the responsibility of actual production by low

priced labour and limited natural resources, they ‘enjoy’ the ‘treatment’ of lack of power resources, environmental pollution and non-harmonious societies.

Since this asymmetry between the two factors of production – labour and technology — exist, although economic globalisation promotes global economic development, it not only does not change the polarisation between the ‘core’ and ‘peripheries’, it divided ‘wealthy nations’ and ‘poor nations’ further³⁷. Economic globalisation does not automatically bring wealth equally to the world at the same time. In order to achieve national benefits, the method of opening to the world needs to change, importing ‘foreign wisdom’ needs to be promoted, to break through the asymmetry in the allocation of these two factors of production. It is impossible to be dependent on the off chance that developed nations and large capitalists will actively lower the price and benefits of intellectual property and its services, initiate simple labour compensation and complex labour compensation, and to achieve rationalisation between the interests of labour and capital. The following needs to be done:

1. Establish competitively advantageous industry with scale. When there are no free labour movements in a country, it can only reap welfare gains from free trade with competitively advantageous industry with scale. To establish comparatively advantageous industry, technological advancements are necessary; and the precondition for technological advancements is the training and aggregation of human resources. Firstly, optimise the management of national research funding, improve effective research, prevent low quality and waste, encourage creative young talent, and encourage innovation and business establishment; secondly, reform the research structure, gradually achieve the fusion of the academy of sciences system, universities and departments of research institutions, where research should be lead by enterprises or collaborated between enterprise and

³⁷ 张雷声 [Zhang Leisheng], 《从世界资本主义体系的形成与发展看经济全球化的本质》 [The Formation and Development of the World’s Capitalism System and the Nature of Economic Globalization] (2002) 2 《中国人民大学学报》 *Journal of Renmin University of China*.

universities. The government should gradually cease to directly participate in research management, but utilise a government research funding model, to focus high quality foundational research in key areas. In implementing a concise research approach limited funding can be applied to effective scientific research, thereby allowing the Chinese people to own more advanced intellectual property. Thirdly, use the discipline instead of universities as the carrier of research; choose and focus fiscal funding on the key areas, and encourage donations from the society; bring in top talent to form teams, thereby developing competitively advantageous technology and industry.

2. Achieve uniformity of the flow of factors of production through negotiations, encourage different methods of migration to developed nations. Governments should make migration their national strategy. Next stage, the nations' population strategies should move away from birth plan strategies (e.g. one child policy) to emigration to developed nations, especially to the US, in order to allow labour to enjoy the welfare transferred from China to developed countries.

We can bravely assume that if the free flow of goods and services leads to the simultaneous free flow of the population, then according to international trade theories based on the theory of comparative interest, arranging for international division of labour can lead to improvements in welfare. As the goods or capital that a country has a comparative advantage in is imported into another country, this leads to the demise of the related industry in the other country and workers become unemployed. If people can move freely, then when the country that is disadvantaged is unable to settle the large population of unemployed, those people can move to the country with outflow of goods or capital, or other countries, to develop their other resources such as idle land, therefore free trade is able to lead to an increase in welfare for all nations in reality. However, if there are limitation to the flow of people, only choosing talent that is advantageous for one's own country, where unemployment would be entirely borne by the goods or capital

importing country, then for the country that does not have comparative advantage in most industries, it will not be able to achieve increases in welfare through free trade, rather the opposite happens; in the long run, the higher the level of international free trade, the larger its welfare loss. For these nations to protect its foreign reserve balance for export purposes, they have to continue to exploit natural resources, use primary products that have very low prices in exchange for imported goods, causing the ecological environment of this country to worsen (as can be seen from the situation in Africa); or they face long term foreign reserve imbalance, thereby having to rely on foreign debt (as can be seen from South American countries such as Argentina in recent years).

3. Restart Communist International that represents the interest of workers and farmers. “Unite working men of all countries”, establish an international alliance of workers, to allow labour to have the same bargaining power as finance oligarchs and intellectual property oligarchs, and to increase the overall wage levels of underdeveloped nations. Any response tactics that international capitalists may employ should be prevented to avoid the situation where the internal departments of developing nations lower land prices, labour prices, as well as provide tax incentives in order to attract FDI. Only these policies will change the situation in income distribution, where complex labour will only cost a few times more than simple labour, rather than dozens or hundreds of times.

Business Ethics, Corporate Social Responsibility and Taxation – Chinese Policy and Practice

Vivienne Bath^{*}

International organisations, corporations and governments, including the Chinese government, have come to support both the concepts of the responsibility of business enterprises to adopt and implement codes of corporate social responsibility ('CSR'), and of the need for businesses to act in an ethical fashion. Thus, in China, the government and its agencies, including the Chinese stock exchanges, actively encourage the adoption by Chinese corporations of codes of social responsibility and the conduct of business in compliance with standards of social and business ethics. Chinese regulatory requirements in relation to ethical conduct and the implementation of principles of social responsibility for enterprise and corporations are specifically extended to the operations of Chinese companies, both state-owned and private, outside China. The content and substance of ethical conduct in the business context and the relationship of ethics to concepts of corporate or enterprise social responsibility is, however, difficult to define. One aspect which is of increasing interest is the relationship between corporate ethical responsibilities, CSR and taxation. The purpose of this article is to look at the international and Chinese concepts of ethics and CSR, primarily as manifested in Chinese legislation and regulation, with a focus on the role of tax and tax policy in requirements relating to business ethics and social responsibility.

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Business ethics and corporate social responsibility

Joyner and Payne¹ define business ethics as the ‘interaction of ethics and business, where values are ‘the core set of beliefs and principles deemed to be desirable (by groups) and individuals’ and ethics are ‘the conception of what is right and fair conduct or behaviour.’². CSR incorporates concepts of ethical behaviour by corporations and is therefore also discussed in this article, but is an expression which has a number of different meanings despite the widespread use of the expression both internationally and domestically. For example, there are differences both in the ways commentators analyse it conceptually (for example, by examining CSR from the viewpoint of social issue management as opposed to analysis from the viewpoint of stakeholder management)³ and in the approach taken to CSR by governments, NGOs and other bodies.⁴ Joyner and Payne define corporate responsibility as ‘categories or levels of economic, legal, ethical and discretionary activities of a business entity as adapted to the values and expectations of society.’⁵ The World Business Council for Sustainable Development defines CSR as the ‘commitment of businesses to contribute to sustainable economic development by working with employees, their families, local community and society at large to improve their lives in ways that are good for business and development.’⁶ Implicit in both of these definitions is the recognition of the importance of ethics and ethical behaviour by corporations and businesses.

¹ Brenda E. Joyner and Dinah Payne, ‘Evolution and Implementation: A Study of Values, Business Ethics and Corporate Social Responsibility’ (2002) 41 *A Journal of Business Ethics* 297. .

² *Ibid* 299.

³ See, for example, the discussion in Yongjiang Gao, ‘Corporate Social Performance in China: Evidence from Large Companies’ (2009) 89 *Journal of Business Ethics* 23, 24 on different methods of analysing CSR from the viewpoints of social issue management and from the viewpoint of stakeholder management.

⁴ See brief summary in Michel Doucin, ‘Corporate Social Responsibility: Private Self-Regulation is Not Enough’, *Private Sector Opinion*, Issue 24 (online), International Finance Corporation, 2011 <http://www.wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2011/12/22/000386194_20111222042002/Rendered/PDF/661030BRI0Box365730B00PUBLIC00PSO0240CSR.pdf>.

⁵ Joyner and Payne, above n 2, 300.

⁶ World Business Council of Sustainable Development, *The Business Case for Sustainable Development* (2002) <<http://www.wbcsd.ch/DocRoot/rZNj49UF0okxGvdLfDte/business-case.pdf>>.

The idea of the importance of CSR and the appropriate behaviour of corporations is not limited to domestic corporate activity. There is an influential international movement directed specifically at the conduct of multinational corporations in their activities abroad. In this context, a major emphasis in terms of ethical considerations is placed on the question of corruption and the role which strong business ethics can play in combating corruption in business operations. Thus the preamble to the *United Nations Convention Against Corruption*, to which China and many other nations around the world have acceded, expresses concern about the role of corruption in undermining ‘ethical values and justice’.⁷ The 1997 *OECD Convention on Combating Bribery of Foreign Officials in International Business Transactions*⁸ and its accompanying documents strongly emphasise corporate codes of ethics, on the basis that they will assist in reducing corruption.⁹

There is also strong support at the international level for the promotion of business ethics more widely, mainly promoted by social organisations and non-government organisations, and more recently by major international agencies. The *United Nations Global Compact*¹⁰ promotes compliance by business with ten core principles, based around human rights, labour, the environment and anti-corruption. The *OECD Guidelines for Multinational Enterprises*¹¹ (a wide-ranging set of recommendations for the good governance and good conduct of multinational enterprises) sets out voluntary principles for multinational enterprises. Both of these aim to establish codes

⁷ United Nations General Assembly, *United Nations Convention Against Corruption: Resolution Adopted by the General Assembly*, 21 November 2003, A/RES/58/4, available at <http://www.refworld.org/docid/3fdc4d3e7.html>.

⁸ See Organisation for Economic Co-operation and Development, *Bribery and Corruption* <http://www.oecd.org/corruption/oecdantibriberyconvention.htm>.

⁹ See, in particular, OECD, ‘Good Practice Guidance on Internal Controls, Ethics, and Compliance’ 8 Feb 2010, adopted by the OECD Council as an integral part of the Recommendation of the Council for Further Combating Bribery of Foreign Public Officials in International Business Transactions of 26 November 2009, and OECD, ‘Recommendation of the Council on Tax Measures for Further Combating Bribery of Foreign Public Officials in International Business Transactions,’ 25 May 2009 –C(2009)64. This is a very confusing reference.

¹⁰ See the United Nations Global Compact website <http://www.unglobalcompact.org/AboutTheGC/index.html>.

¹¹ Organisation for Economic Co-operation and Development, *OECD Guidelines for Multinational Enterprises* (2011) <http://dx.doi.org/10.1787/9789264115415-en>.

of conduct and principles to guide the business behaviour of corporations internationally. In the case of the *Global Compact*, businesses are encouraged to sign up to and report on their adherence to the principles, which involve changes to business operations, promotion of the principles and reports to stakeholders.¹² The OECD Guidelines work on the basis of government adherence to the Guidelines, and the establishment of National Contact points which both promote the Guidelines and receive and respond to complaints.¹³

China is not a member of the OECD and there is no contact point in China to respond to or deal with complaints under the OECD Guidelines for Multinational Enterprises, although China was invited to participate in the most recent update to the Guidelines.¹⁴ China does, however, participate in the Asian Development Bank and OECD Anti-Corruption Plan for Asia and the Pacific.¹⁵ Chinese companies also participate in the UN Global Compact. In 2013, 303 participants from China were listed as participating in the Compact, including 231 businesses (of whom 32 are listed as being state-owned), and 72 non-government organisations, business associations and academic institutions. Of the businesses, however, 99 are listed as being non-communicating or inactive.¹⁶

Both the UN Global Compact and the OECD Guidelines for Multinational Enterprises place a strong emphasis on ethical business practices. The OECD Guidelines, for example, strongly favour the adoption of codes of conduct, with an emphasis on

¹² See United Nations Global Compact, *How to Participate* <http://www.unglobalcompact.org/HowToParticipate/Business_Participation/index.html>.

¹³ See, for example, the website of the Australian National Contact Points, AUSNCP, at <<http://www.ausncp.gov.au/content/Content.aspx?doc=anpc/contactpoint.htm>>, for a summary of the activities of the Contact Point.

¹⁴ Organisation for Economic Co-operation and Development, *OECD Guidelines for Multinational Enterprises Report by the Chair of the 2011 Meeting of the National Contact Points* (2011) <<http://www.oecd.org/daf/inv/mne/49247209.pdf>> 2.

¹⁵ See Asian Development Bank and Organisation for Economic Co-operation and Development Anti-Corruption Initiative for Asia and the Pacific, *Anti-Corruption Plan for Asia and the Pacific* <<http://www.oecd.org/site/adboecdanti-corruptioninitiative/anti-corruptionactionplanforasiaandthepacific.htm>>.

¹⁶ See UN Global Compact, *Participant Search* <<http://www.unglobalcompact.org/participants/search>>.

corporate governance and internal conduct, ethics and compliance (with a focus on the prevention of corruption). Thus Paragraph 34 of the Guidelines refers with approval to codes of conduct setting out ‘commitments to ethical values in such areas as the environment, human rights, labour standards, consumer protection or taxation.’

There is an extensive range of other international instruments which deal with CSR or corporate ethical concepts, which are not listed here for reasons of space. The European Commission lists as the most significant of these the UN Global Compact, the OECD Guidelines, the *ISO 26000 Guidance on Social Responsibility*, the *United Nations Guiding Principles on Business and Human Rights* and the *International Labour Organisation Tripartite Declaration of Principles concerning Multinational Enterprises on Social Policy*.¹⁷ The ISO guidance, for example, takes as the core subjects of CSR the following areas: human rights, labour practices, the environment, fair operating practices, consumer issues and community involvement and development.¹⁸

Ethics, CSR and Taxation

Considerations of the ethical conduct of corporations may include a range of areas. The discussion at an international level has not so far placed tax at the forefront, although there are, of course, a variety of possible ways in which ethics, corporate social responsibility and tax overlap.¹⁹ Governments have, for example, a strong interest in the collection of tax to pursue their policies, and the view is often taken that

¹⁷ See European Commission, *Enterprise and Industry* <http://ec.europa.eu/enterprise/policies/sustainable-business/corporate-social-responsibility/guidelines-principles/index_en.htm>. For reasons of space, it is not possible to summarise or discuss these documents in this article.

¹⁸ See summary in International Organization for Standardization, *ISO26000 Social Responsibility — Discovering ISO 26000* (2010) <http://www.iso.org/iso/discovering_iso_26000.pdf>.

¹⁹ See summary in Jeffrey Owens, ‘Good Corporate Governance: the Tax Dimension’ (Paper presented at the Symposium on Tax and Corporate Governance, Munich, 8–9 December 2006 and co-organised by the International Network for Tax Research (INTR), the Max Planck Institute for Intellectual Property, Competition and Tax Law and the German IFA branch), available at <<http://www.itdweb.org/documents/Owens.pdf>>.

tax evasion, which may limit the ability of the government and the community to implement domestic policies, is unethical. (Although there is a line of theoretical argument which contests that view).²⁰ Governments utilise tax policy to provide support for particular kinds of conduct which they wish to encourage, through preferential tax policies such as reduced rates of tax and rebates. For example, there is support at both international and domestic levels for the encouragement of ethical conduct in relation to charitable activities by allowing tax-deductibility for charitable purposes or disaster relief. Conversely, the OECD strongly encourages domestic legislators to ensure that corporations cannot claim amounts paid as bribes as tax deductions as a means of reducing corruption.²¹ As Owens notes, the relationship between tax policy and business ethics can also be seen by the creation of perverse incentives through the structure of taxation (for example, by encouraging behaviour that is contrary to the interests of the corporation or its shareholders) as well as the important question of the role of tax policy in encouraging corporate transparency, which is essential to the public monitoring and supervision of corporate activities and vital if corporations are to be encouraged to behave ethically.²²

At the corporate level, the relationship between taxation and corporate governance or business ethics can be a difficult issue to analyse. What ethical responsibilities are involved in the business activities of a corporation? Does a corporation have an ethical responsibility to pay tax? How far does this extend? Are policies whereby the corporation actively structures its international operations so as to legally minimise tax (and thus presumably increase value for its shareholders) within the sphere of ethical business behaviour? The recent worldwide controversy in relation to tax strategies of

²⁰ See discussion in Marian Eabrasu, Philipp Bagus, Walter Block, David Howden and Jérémie Rostan, 'The Ethics of Tax Evasion' (2011) 116(3) *Business and Society* 375.

²¹ See Organisation for Economic Co-operation and Development, *Recommendation of the Council on Tax Measures for Further Combating Bribery of Foreign Public Officials in International Business Transactions* (25 May 2009) C(2009) 64 <<http://www.oecd.org/ctp/crime/43188874.pdf>>.

²² Owens, above n 19.

such major corporations as Starbucks²³ and Apple²⁴ suggests that community views of ethical business behaviour in relation to tax go beyond compliance with legal requirements. Michael Carmody, the Commissioner of Taxation in Australia, laid out the issues quite clearly in a speech given in 2009, where he said that:

we should as a community place a value on taxation that distinguishes it from other expenses. There are in my view two good reasons for doing that.

The first is the nature of taxation. It is in reality health care, education, security and services for Australians. There is a community nature and responsibility that distinguishes it from, for example, the cost of parts or other supplies.

The second is a recognition of the high cost to the community of a prevailing or at least substantial culture of accepting taxes as just another field for entrepreneurial and cost cutting techniques.²⁵

Commentators have attacked the question of ethics, tax and corporate social responsibility from a number of different angles. Some studies suggest that companies that subscribe to CSR principles are less aggressive in their tax minimisation strategies.²⁶ Sartori makes the argument that public shareholders in particular are opposed to aggressive tax planning because they regard corporate tax obligations as a form of corporate social responsibility; good corporate governance leads to transparency, and transparency discourages aggressive tax planning and shareholders in public companies diversified risk, which means that in order to attract investment corporations should be risk neutral. Aggressive tax planning is not risk neutral.²⁷

²³ Mike Lewis, 'Is Tax Just a Question of Ethics?', *New Statesman* (online), 7 December 2012 <<http://www.newstatesman.com/business/2012/12/tax-just-question-ethics>>.

²⁴ Charles Duhigg and David Kocieneiewski, 'How Apple Sidesteps Billions in Taxes', *The New York Times* (online), 28 April 2012 <<http://www.nytimes.com/2012/04/29/business/apples-tax-strategy-aims-at-low-tax-states-and-nations.html?pagewanted=all>>.

²⁵ Michael Carmody, 'Ethics and Taxation' (Speech delivered at the Edmund Rice Business Ethics Forum, 28 October 2009) <<http://www.ato.gov.au/corporate/content.aspx?doc=/content/00106432.htm&pc=001/001/001/002/001&mnu=0&mfp=&st=&cy=0>>.

²⁶ See summary of literature in Fariz Huseynov and Bonnie K Klamm, 'Tax Avoidance, Tax Management and Corporate Social Responsibility' (2012) 18 *Journal of Corporate Finance* 804, 805.

²⁷ Nicole Sartori, 'Corporate Governance Dynamics and Tax Compliance' (2010) 13 *International Trade and Business Law Review* 264.

Others studies suggest a link with CSR by observing that corporations that do engage in aggressive tax planning may be more inclined to claim that they engage in CSR or to highlight their social and philanthropic contributions in their CSR reports in order to stake their claim in relation to community involvement and responsibility.²⁸

As noted above, insofar as there is an accepted scope for CSR, this does not necessarily explicitly include obligations in relation to tax. Some commentators have, however, turned their attention both to the obligation to pay tax and the question of the ethics involved in tax structuring on the basis that tax contributions should indeed be considered to be part of a corporation's corporate responsibilities²⁹. The complexity of modern taxation systems, the ability of corporations to shift income and ownership of intangible assets and other assets between jurisdictions, and the distinction that is drawn in Western countries between tax avoidance, tax evasion and tax minimisation means that the issue of tax planning is one to which significant resources are given in the corporate context. Determining the corporation's tax strategy is a business decision, not merely a legal or accounting one. This certainly suggests that, as with decisions on policies relating to labour, human rights, the environment and corruption, which clearly involve ethical considerations and corporate policy, the ethical and social responsibility aspects of tax planning and tax strategies should be given full consideration. Giving definition and structure to this proposition is, however, not an easy matter.

Tax is not mentioned in the UN Global Compact. The *OECD Guidelines for Multinational Enterprises*, which were reissued in 2011, do, however, attempt to set out balanced principles in relation to taxation in Chapter XI.³⁰ The Guidelines specify

²⁸ Ibid. See also R Lanis and G Richardson (2012) 31 *Journal of Accounting and Public Policy* 86.

²⁹ See, for example, Thomas Scheiwiller and Susan Symons, 'Corporate Responsibility and Paying Tax,' *OECD Observer*, undated
<http://www.oecdobserver.org/news/fullstory.php/aid/3132/Corporate_responsibility_and_paying_tax.html>.

³⁰ Organisation for Economic Co-operation and Development, *OECD Guidelines for Multinational Enterprises*, above n 11.

that, on the one hand, it is important that enterprises contribute to the public finances of host companies by making timely payment of tax liabilities. Multinational corporations ‘should comply with both the letter and spirit of tax laws and regulations of the countries in which they operate’ by ‘discerning and following the intention of the legislature.’ However, this does not require enterprises to pay amounts which are in excess of the amounts legally required. In addition, tax governance and tax compliance should be treated as an important part of the company’s oversight and risk management systems ‘to ensure that the financial, regulatory and reputational risks associated with taxation are fully identified and evaluated.’ The commentary included after these provisions refers to co-operation with the tax authorities, particularly disclosure of information and the need to ensure that corporate boards oversee tax risk and transfer pricing. Notably, paragraph 100 notes that ‘[t]ransactions should not be structured in a way that will have tax results that are inconsistent with the underlying economic consequences of the transaction unless there exists specific legislation designed to give that result.’

Chapter XI and the commentary are thus quite cautiously drafted in an attempt to balance the obligation to pay tax which is legally and ethically due with the right of the corporation not to pay amounts in excess of that. Considerable emphasis is placed on the role of the corporate board and on the financial, regulatory and reputational risks associated with taxation.

Chinese approaches to CSR and business ethics

Although China was relatively slow to adopt the concept of corporate social responsibility, it has come to see the advantages of such a concept.³¹ Advocates include the Chinese government and its regulatory agencies, the Stock Exchanges of

³¹ Wenjing Li and Ran Zhang, ‘Corporate Social Responsibility, Ownership Structure, and Political Interference: Evidence from China’ (2010) 96(4) *Journal of Business Ethics* 631.

Shenzhen and Shanghai, non-government organisations and trade organisations, and an increasing number of Chinese corporations, both private and public.³² A number of reasons have been suggested for the push for Chinese corporations to engage in CSR, including as a response to the exploitation of Chinese workers by suppliers (both Chinese and foreign) in the multinational supply chain, CSR practices introduced by multinational companies operating in China, environmental damage in China itself resulting from unconstrained development and a succession of natural disasters in response to which philanthropy from the corporate sector has become increasingly prominent and important.³³ In addition, as discussed in more detail below, Chinese government ministries have responded to Chinese outbound investment by paying more legislative attention to corporate governance and behaviour of Chinese corporations outside as well as inside China.

The role of the government in responding to the concept of CSR is of particular interest in view of its substantial presence in the Chinese economy. This is not just because of the government's role as regulator, but also through its ownership of state-owned enterprises. The government and various government ministries thus see it as their role both to include ethical concepts and requirements in legislation and to issue guidelines and principles which are designed to guide the activities and operations of Chinese businesses. The legislative force of these provisions varies and studies indicate that, as in other countries, acceptance of the need for ethics in business and compliance with policies requiring the adoption of CSR principles varies.³⁴

³² Joseph Sarkis, N Na and Qinghua Zhu, 'Winds of Change: Corporate Social Responsibility in China' (2011 Jan/Feb) 75(1) *Ivey Business Journal* 1.

³³ See, for example, discussion in Liwen Lin 'Corporate Social Responsibility in China: Window-Dressing or Structural Change?' (2010) 28 *Berkeley Journal of International Law* 64.

³⁴ Hongliu, 2010. China's Corporate Social Responsibility Report: 40% of China's Top Corporations are CSR Bystanders. *Hauser Center (online)* (Compiled Xin Li, based on Chinese article <http://news.hexun.com/2009-10-18/121379000.html>). Edited Wanxin Cheng. [I can't read the article to gather bibliographic details.] ? There is no need to gather that for this particular report

References to both ethics and social responsibility can be found in a range of Chinese legislative instruments. The expression *shangye daode* (商业道德) is generally translated as ‘commercial’ or ‘business’ ethics,³⁵ while the expression *qiye shehui zeren* (企业社会责任) is translated as ‘enterprise social responsibility’³⁶ (often loosely referred to as ‘CSR’). It is important to note that although social responsibility is increasingly emphasised and promoted in Chinese legislation and policy, what it encompasses is not necessarily the same as the scope as laid out in international or western contexts.

In 2005, amendments to the *Company Law* introduced a requirement in Article 5 that Chinese companies bear social responsibilities, although the details of that requirement are not spelled out in the law.³⁷ The first paragraph of Article 5 of the *Company Law* provides that: ‘In its operational activities, a company shall abide by laws and administrative regulations, observe social morals and commercial ethics, persist in honesty and good faith, accept supervision by the government and the public, and assume social responsibility’.³⁸ A similar formulation is found in Article 7 of the *Partnership Law* of 2006³⁹ which provides that: ‘Partnerships and their partners shall abide by the laws and administrative regulations, observe social morals and business ethics and bear social responsibilities.’⁴⁰ Article 5 of the 2011 *Regulations on*

³⁵ Used in Article 5 of the *Company Law* (People’s Republic of China), Standing Committee of the National People’s Congress, 2005, Art 5 (中华人民共和国公司法).

³⁶ Used in Article 3(5) of Ministry of Information, *Implementing Opinions of the Ministry of Industry and Information Technology on Further Encouraging and Guiding Private Capital into the Telecommunications Industry*, 2012, (工业和信息化部关于鼓励和引导民间资本进一步进入电信业的实施意见).

³⁷ See discussion on the drafting history of Article 5 in Lin Li-Wen, ‘Corporate Social Accountability Standards in the Global Supply Chain: Resistance, Reconsideration, and Resolution in China’ (2007) 15 *Cardozo Journal of International and Comparative Law* 321.

³⁸ 公司从事经营活动,必须遵守法律、行政法规,遵守社会公德、商业道德,诚实守信,接受政府和社会公众的监督,承担社会责任。

³⁹ *Partnership* (Please confirm if correct?) *Law* (People’s Republic of China), Standing Committee of the National People’s Congress (2006) (中华人民共和国合伙企业法).

⁴⁰ 合伙企业及其合伙人必须遵守法律、行政法规,遵守社会公德、商业道德,承担社会责任。

Individual Businesses provides that businesses should comply with ‘social morals and business ethics’ and ‘adhere to the principle of good faith and trustworthiness’.⁴¹

In 2006, the Shenzhen Stock Exchange issued the *Shenzhen Stock Exchange Social Responsibility Instructions to Listed Companies*,⁴² which require listed companies to perform their social responsibilities, engage in regular evaluations and report on performance. The *Instructions* focus on duties to shareholders and creditors, employees, suppliers, customers and consumers and also include provisions on environmental protection and sustainable development, as well as public relations and social welfare in addition to institution building and disclosure. This example was followed by the Shanghai Stock Exchange in 2008.⁴³

CSR in China is also encouraged by the establishment of standards in different industries, with or without international input, with which Chinese companies can obtain accreditation to demonstrate their CSR commitment.⁴⁴ The role of the government and policy is particularly important in relation to the implementation of CSR policies in China, whether as a way of implementing the ‘harmonious society’⁴⁵ or of improving China’s reputation overseas or for a variety of other related reasons. Thus, government regulation, combined with direct government control over major Chinese state-owned corporations, is important both in shaping the content of what is considered to be CSR and in determining where it is applied. Government regulation is

⁴¹ *Regulations on Individual Businesses* (People’s Republic of China), State Council, 16 April 2011 (个体工商户条例): “个体工商户从事经营活动,应当…遵守社会公德、商业道德,诚实守信…”

⁴² Shenzhen Stock Exchange, *Shenzhen Stock Exchange Social Responsibility Instructions to Listed Companies* (25 September 2006) <<http://www.szse.cn/main/zxgx/9300.shtml>> (Chinese) and <<http://www.szse.cn/main/en/RulesandRegulations/SZSERules/GeneralRules/10636.shtml>> (English translation).

⁴³ Shanghai Stock Exchange, *Notice On Issuing the Shanghai Stock Exchange Listed Company Environmental Disclosure Guidelines in order to Strengthen Social Responsibility Work of Listed Companies* (2008); Shanghai Stock Exchange, *Notice on Strengthening Social Responsibility of Listed Companies* (2008).

⁴⁴ Lin Li-Wen, above n 37.

⁴⁵ Rowan Callick, ‘Corporate Responsibility Helps Keep China’s Harmonious,’ *The Australian* (online), 24 November 2008 <<http://www.theaustralian.com.au/news/opinion/keeping-china-harmonious/story-e6frg7e6-111118117380>>. See Geoffrey See, ‘Mapping the Harmonious Society and CSR Link1’ (2008) *Wharton Research Scholars Journal*.

not, however, limited to state-owned enterprises. Article 5 of the *Company Law* applies to all limited liability and joint stock companies set up in China (including foreign investment enterprises), and the Stock Exchange rules apply to all listed companies. Nevertheless, it can be observed that more stringent requirements are placed directly on the state-owned sector. Another significant factor comes from China's concerns for its international reputation, which have resulted in the imposition of standards of behaviour on all Chinese companies operating outside China. This is discussed in more detail below.

As noted above, there is not one definition of what is encompassed by the concept of CSR, although the focus of the UN Global Compact on human rights, labour, the environment and anti-corruption is indicative of international views in relation to CSR. The *Shenzhen Stock Exchange Social Responsibility Instructions to Listed Companies* states that 'social responsibilities refer to the obligations listed companies should assume for social development, for the natural environment and resources, and for interested parties, including their shareholders, creditors, employees, customers, consumers, suppliers and communities.'⁴⁶ Thus the *Instructions* deal with the protection of the interests of shareholders and creditors, protection of employee interests, protection of the interests of suppliers, customers and consumers, environmental protection and sustainable development and public relations and social welfare. The question of corruption is not mentioned specifically in the *Instructions*, although there is a focus on ethical behaviour. Several provisions refer to the obligation to be honest and trustworthy toward suppliers (Art 3), the requirement to observe moral and business ethics and the obligation not to seek improper benefits 'by bribery, smuggling and other unlawful activities, nor infringe upon other people's intellectual property.' (Art 4)

⁴⁶ Shenzhen Stock Exchange, above n 42, Art 2.

In 2007, the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) issued the *Guidelines to the State-owned Enterprises Directly under the Central Government on Fulfilling Social Responsibility*.⁴⁷ The *Guidelines* contain a comprehensive list of requirements in relation to the fulfilment of social responsibility obligations and which cover a broad range of areas. These include legality and honesty in business operations; making sustainable profits; improving product quality and service; resource conservation and environmental protection; promoting independent innovation and technical advances; ensuring production safety; protecting the legal rights of employees; and participating in social public welfare programs. In addition to establishing awareness of CSR, including a system for implementation and a system for information release, Communist Party branches and their members are encouraged to take the lead in performing CSR, as well as trade unions, the Communist Youth League and the Women's Federation.

The 2009 *Guidelines for China's Banking Sector and Financial Institutions on Corporate Social Responsibilities*⁴⁸ include economic, social and environmental responsibility as the minimum responsibilities for enterprise social responsibility. Social responsibility is guided by an operating ethos that complies with 'social ethics' (社会道德) and the public interest. It includes educating consumers, promoting the importance of honesty and integrity, focussing on employees, community service and charitable donations and public welfare.⁴⁹

Social responsibility (loosely referred to as 'CSR') in these documents therefore extends beyond the four main topics covered in the UN Global Compact, and includes

⁴⁷ State-owned Assets Supervision and Administration Commission of the State Council, *Guidelines to the State-owned Enterprises Directly Under the Central Government on Fulfilling Social Responsibility*, 29 December 2007 (关于中央企业履行社会责任的指导意见).

⁴⁸ Chinese Banking Sector and Chinese Financial Institutions, *Guidelines for China's Banking Sector and Financial Institutions on Corporate Social Responsibilities* (12 January 2009) (中国银行业金融机构业社会责任指引), Art 3.

⁴⁹ *Ibid* Arts 11–15.

a broad range of activities relating to corporate activities and conduct. It puts an emphasis on protection of shareholders and creditors, and on product quality and technical innovation. Where a distinction can generally be drawn between corporate governance, which addresses internal matters of efficiency in the operation of a business, and CSR, which involves principles of social justice and involving external accountability,⁵⁰ both the *Instructions* and the *Guidelines* include a comprehensive list of matters which relate both to business management and operations and to social justice issues.

It will be noted from the discussion above that CSR in the Chinese context clearly incorporates the concept of ethics, particularly the elusive ideas of ‘social morals and business ethics’. The *Guidelines to State-owned Enterprises*, for example, include as a requirement of legality and honesty in business operations by compliance with laws and regulations, social morals and business ethics and industry rules.⁵¹ However, just as the concept of ethics is difficult to define in English, Chinese legislation does not attempt to give a precise meaning to the term in Chinese. The frequent use of the term ‘business ethics’ in conjunction with the concept of ‘social morals’ or ethics (社会公德 *shehui gongde*) or honesty, however, certainly indicates an emphasis on commercial honesty and morality.

It should be noted that apart from these general exhortations in relation to ethical conduct, the legislation does not spell out what is actually involved or define the concept in terms which could reasonably be considered to be legally enforceable. In the *Company Law*, for example, in contrast to the general obligations relating to social responsibility and ethical conduct set out in Article 5, provisions detailing the duties of directors and officers (in Article 149, for example) list activities in which directors and

⁵⁰ Pitman B Potter, ‘Co-Ordinating Corporate Governance and Corporate Social Responsibility’ (2009) 39 *Hong Kong Law Journal* 675.

⁵¹ Ministry of Information, above n 47, Art 3(8).

officers are not permitted to engage with some specificity, and without reference to the general obligation of ethical conduct. The 2008 *Implementing Opinions on Special Administration in Regulating the Services and Charging by Trade Associations and Market Intermediaries*⁵² aims to wipe out, among other things, the provision of false information and vicious competition by market intermediaries which violate business ethics and cause harm to the interests of the enterprises and the public.⁵³ The specific details of the manner in which this should be achieved are however left to the State Administration for Industry and Commerce.

The Ministry of Commerce emphasised the idea of ‘integrity’ and ‘credibility building’ in the *Guiding Opinions on Enhancing Credibility Building in the Commercial Sector during the ‘Twelfth Five-year Plan’ Period*,⁵⁴ which provides that concepts of integrity, fairness, compliance with rules, sales of goods at reasonable prices and quality services are all to be promoted as part of business ethics and commercial operating philosophy.⁵⁵ A similar emphasis can be found in the 2012 *Implementing Opinions of the Ministry of Industry and Information Technology on Further Encouraging and Guiding Private Capital into the Telecommunications Industry*.⁵⁶ Article 3(5) of this requires telecommunications enterprises to ‘carry out

⁵² Issued by the National Development and Reform Commission, the State Council Office for Rectifying Misconduct, the Ministry of Civil Affairs, the State Administration for Industry and Commerce, the State Commission Office for Public Sector Reform, the People’s Bank of China, the State-owned Assets Supervision and Administration Commission of the State Council, the Legislative Affairs Office of the State Council, and the Ministry of Finance, Fa Gai Chan Ye [2008] No.2351 on 29 August 2008 (关于规范行业协会、市场中介组织服务和收费行为专项治理工作的实施意见).

⁵³ Ibid Art 3(3).

⁵⁴ Ministry of Commerce, *Guiding Opinions on Enhancing Credibility Building in the Commercial Sector During the ‘Twelfth Five-year Plan’ Period* (9 November 2011) (商务部关于“十二五”期间加强商务领域信用建设的指导意见).

⁵⁵ Ibid Art 3(1).

⁵⁶ Issued by the Ministry of Industry and Information Technology, *Implementing Opinions of the Ministry of Industry and Information Technology on Further Encouraging and Guiding Private Capital into the Telecommunications Industry* (27 June 2012) (工业和信息化部关于鼓励和引导民间资本进一步进入电信业的实施意见).

business activities in a lawful, honest and trustworthy manner, and actively perform their corporate social responsibility.’⁵⁷

References to ethics which occur in other contexts in Chinese legislation similarly do not provide much assistance with the question of definition. Article 24 of the Constitution refers to building a socialist society by promoting education in, among other things, ethics (道德).⁵⁸ *The Various Rules on Probity in Governance for Member Leaders and Cadres of the Communist Party of China* forbid cadres from engaging in activities ‘that are contrary to social morality, professional ethics and family virtues.’⁵⁹ Again, however, it is not at all clear what this conduct would involve, although the previous five categories of prohibited activity (such as making false reports on work performance) are quite clearly spelled out in the *Rules*.

Attention to the question of the activities of Chinese corporations overseas is generally the primary responsibility of the Ministry of Commerce, which approves both inbound investment into China and the overseas investment activities of Chinese corporations going overseas. Thus, recognition of the significance of complying with ‘enterprise social responsibility’ can be found in Article 10 of the *Detailed Rules on Verification and Approval of Overseas Investment and Establishment of Enterprises*, issued by the Ministry of Commerce in 2005. This requires consideration of enterprise social responsibility when considering an investment made by way of merger or acquisition. In 2009, however, when the Ministry of Commerce reissued its *Measures for the Administration of Overseas Investment*, ‘social responsibility’ was not mentioned in the code of conduct for enterprises investing overseas. Nevertheless, one of the matters to be examined and evaluated by the joint inspection teams of the Ministry of

⁵⁷ ‘依法经营,诚实守信,积极履行企业社会责任。’

⁵⁸ 中华人民共和国宪法 (*Constitution of the People's Republic of China*).

⁵⁹ Issued by the Central Party Committee of the Communist Party of China, *The Various Rules on Probity in Governance for Members Leaders and Cadres of the Communist Party of China* (18 January 2010) (中国共产党党员领导干部廉洁从政若干准则), Art 8(6) ‘(六) 从事有悖社会公德、职业道德、家庭美德的活动。’

Commerce and State Administration of Foreign Exchange (which conducts an annual review of Chinese overseas investments) includes a number of important matters generally included in the CSR concept: ‘Whether there is any issue or dispute concerning, *inter alia*, the quality, safety, environment friendliness and labour-management relationship in the operations of the foreign enterprise (full score being 10). 10 points shall be given if there is no such issue or dispute and zero points shall be given if any of the said issues or disputes arise’.⁶⁰

In 2010, the concept of enterprise social responsibility and social responsibility had gained additional importance in the *Guiding Opinions of the Ministry of Commerce on the Work Regarding the Nationwide Work in Overseas Investment and Cooperation in 2010*. The Ministry of Commerce called for training and cooperation with other Chinese government agencies in relation to a number of matters, including enterprise social responsibility (Art 3(2)(4)), and guiding enterprises to fulfil their social responsibilities (Art 3(2)(5)). The emphasis in relation to fulfilling social responsibilities is part of an overall objective of increasing publicity for the ‘go-global’ initiative and generally improving public relations for China’s overseas investment drive. The question of the behaviour of Chinese enterprises abroad and the role of CSR is dealt with in the last article of the *Guiding Opinions* as follows:

Regulate overseas operational behaviour; create a good image; advocate operations in accordance with the law and regulations; strengthen the awareness that enterprise social responsibility is key to the success of cultivation of multinational companies; expedite the study and formulation of long-term mechanisms and policy measures that regulate enterprises' orderly

⁶⁰ Notice of the Ministry of Commerce and the State Administration of Foreign Exchange on Joint Annual Inspection of Overseas Investments, *Measures for the Administration of Overseas Investment*, (28 December 2009), Shang He Han [2009] No. 60 (商务部、国家外汇管理局关于境外投资联合年检工作有关事项的通知); Art 3(2)).

commencement of overseas investment cooperation; supervise and guide enterprises to uphold the principle of seeking a win-win situation that brings mutual benefits; observe the law and discipline; respect local religious custom; actively fulfil social responsibilities; create harmonious relationships; and strengthen the capability for sustainable development.

The emphasis of the Ministry of Commerce is almost entirely on China's objectives in encouraging investment overseas and, although some weight is given to the protection of China's international image, specific references to the non-investment activities of corporations are focussed on efficiency, responsibility, security and, to a minor extent, training. The scope of 'social responsibilities' and how Chinese corporations operating overseas should fulfil them is not defined in these *Guiding Opinions*. Environmental protection is barely mentioned, labour is dealt with mainly in the context of overseas labour cooperation contracts and the issue of corruption is not mentioned at all. The scope of CSR or social responsibilities appears to be left to the companies themselves to define and to implement.

By 2012, however, government ministries clearly felt that Chinese corporations operating overseas needed a much more comprehensive explanation of what is meant by business ethics. Article 2(6) of *Some Opinions on the Cultural Development of Overseas Chinese Enterprises*⁶¹ provides as follows:

Strengthening ethical norms. The ethics of an enterprise embody the culture of the enterprise. 'Small victories rely on knowledge, big victories rely on ethics.' Overseas enterprises shall establish the concept of "using ethics to make the enterprise flourish." They will strengthen education of their employees in ethics, develop and expand traditional virtues, enhance the

⁶¹ Issued by the Ministry of Commerce and Seven Other Ministries, *Shang Zheng Fa [2012] No.104*, on 9 April 2012 (商务部等七部委关于印发《中国境外企业文化建设若干意见》的通知).

*concept of honour and disgrace, and foster good ethical quality; shall fully understand the harmfulness of unethical conduct, such as forgetting all moral principles at the sight of profits, being intent on nothing but profit and damaging consumers' interests; shall lay equal emphasis on ethical principles and profits, and incorporate the sense of morality and the concept of ethics in the whole process of their business operation and management.*⁶²

CSR, in China, as elsewhere, has given rise to an industry of CSR commentators, reporters, awards and accreditation agencies. What is less clear is the extent to which Chinese companies as a whole have genuinely embraced and implemented the concept of CSR. On this, views differ. On one view, despite the actions of the stock exchanges in encouraging CSR compliance and reporting, compliance by listed companies has been disappointing.⁶³ In contrast, a study conducted in 2006 found that Chinese managers supported the importance of ethics and social responsibility as strongly as the American managers surveyed.⁶⁴ Other studies take an optimistic view towards CSR in China, although it is notable that considerable emphasis in the Chinese context has been placed on financial contributions in the case of emergency.⁶⁵ For example, foreign corporations were publicly criticised in China in the aftermath of the Sichuan Earthquake in 2008 for what was seen as a slow and ungenerous response.⁶⁶

⁶² “强化道德规范。企业道德是企业文化的集中体现。“小胜于智,大胜于德。”境外企业要树立“以德兴企”的观念。加强对员工的道德意识教育,弘扬传统美德,增强荣辱观念,养成良好的道德品质。深刻认识见利忘义、唯利是图、损害消费者利益等不道德行为的危害性。坚持义利并重,将道德感、伦理观渗透到企业经营和管理的全过程。”

⁶³ Hongliu, above n 34.

⁶⁴ William E Shafer, Kyoko Fukukawa and Grace M Lee, ‘Values and the Perceived Importance of Ethics and Social Responsibility: The US and China’ (2007) 70 *Journal of Business Ethics* 265.

⁶⁵ Zhao Meng, ‘How Corporate Social Responsibility Leaders in China and Russia do Philanthropy (Parts I and II)’ (2011) *Caixin Online*.

⁶⁶ Ariel McGinnis, James Pellegrin, Yin Shum, Jason Teo and Judy Wu, ‘The Sichuan Earthquake and the Changing Landscape of CSR in China’, *Knowledge@Wharton*, 20 April 2009 <<http://knowledge.wharton.upenn.edu/article.cfm?articleid=2213>>.

Ethics, CSR and Taxation – the Chinese Regulatory Approach

Does the Chinese view of corporate (or personal) ethics extend to obligations in relation to taxation? As noted above, there is an increasing amount of scholarly discussion and support internationally for a link between corporate taxation policy and ethics, and the contention that tax (and obligations to pay appropriate amounts of tax) should be (or is) included in corporate social responsibility. This is most fully documented in the OECD *Guidelines for Multinational Enterprises*.

A study of Chinese legislation and policies suggests that although this connection is not strongly drawn in the legislation, there is arguably an increasing amount of awareness of the significance of tax in relation to CSR and ethical conduct. Chinese legislation contains a number of references to the obligation to pay tax in accordance with law.⁶⁷ Article 56 of the Constitution sets out the basic principle which provides that it is the duty of citizens of the PRC to pay taxes in accordance with law.⁶⁸ The emphasis in the Chinese tax system on ensuring that foreign corporations do not engage in transfer pricing (which would reduce the amount of Chinese enterprise income tax which is payable)⁶⁹ indicates that Chinese policymakers are aware of, and are not sympathetic to, tax planning structures which are aimed at minimising Chinese tax payments. Recent newspaper articles have reflected international criticism of Apple's tax structuring by claiming that it has been evading tax on online orders of 'apps'.⁷⁰ On the other hand, considerable attention in Chinese legislative and

⁶⁷ For example, Art 37 of the *Partnership Law*; Art 25 of the *Law of the People's Republic of China on Lawyers*, issued by the Standing Committee of the National People's Congress on 28 October 2007, as amended (中华人民共和国律师法). [I'm not sure which Law this is in reference to but it is cited incorrectly here.]

⁶⁸ *Constitution of the People's Republic of China*, above n 58.

⁶⁹ For example, *Notice of the State Administration of Taxation on Strengthening the Monitoring and Investigation of Cross-border Affiliated Transactions*, *Guo Shui Han* [2009] No. 363, issued 6 July 2009 (国家税务总局关于强化跨境关联交易监控和调查的通知) and *Opinions of the State Administration of Taxation on Further Bettering the Service and Administration regarding the Taxation from 'Go Global' Enterprises*, *Guo Shui Fa* [2010] No. 59, issued 10 June 2010 (国家税务总局关于进一步做好“走出去”企业税收服务与管理工作的意见).

⁷⁰ Bien Perez and Sophie Yu, 'Apple's Tax Practice in China Subject of Fierce Debate,' *South China Morning Post* (online), 27 June 2013 <<http://epaper.legaldaily.com.cn/fzrb/content/20130510/Page06TB.htm>>. This

enforcement activity in relation to tax is on evasion and fraud.⁷¹ The problem of evasion of individual income tax is also a significant issue for Chinese authorities.⁷²

As noted above, the *Shenzhen Stock Exchange Social Responsibility Instructions to Listed Companies* do not refer to the obligation to pay tax as part of a corporation's social responsibilities. Similarly, neither the *Guidelines for China's Banking Sector and Financial Institutions on Corporate Social Responsibilities* nor the *Guidelines for the Application of Internal Control in Enterprises — No. 4 Social Responsibilities*⁷³ contain any reference to tax or the obligation to pay tax. Article 2 of the *Guidelines for the Application of Internal Control in Enterprises* refer only to 'social duties and obligations that an enterprise shall perform in its operation and development process', which include work safety, product quality, environmental protection, resource conservation, promotion of employment, protection of employee rights and interests, and so on.

Nevertheless, the China Securities Regulatory Commission, in its self-assessment of corporate governance in China which was compiled as part of the OECD-China Policy Dialogue on Corporate Governance,⁷⁴ does draw the connection between tax, tax policy and standards of corporate behaviour in a number of contexts. It notes that tax incentives are available for certain activities which are included in the scope of CSR

criticism may of course be part of a general campaign against Apple conducted by various government agencies in China. See also David Vrinicar, 'China Bashes Apple for Tax Evasion', *TechWorldNews* (online), 13 May 2013 <<http://www.technewsworld.com/story/78020.html>>.

⁷¹ See, for example, the list of important areas set out in the 2009 *Several Opinions of the State Administration of Taxation on Strengthening the Administration of Tax Collection, Cracking Down on Tax Evasion and Ensuring Tax Income Growth*, *Guo Shui Fa* [2009] No. 85, issued 29 April 2009 (国家税务总局关于加强税种征管促进堵漏增收的若干意见).

⁷² Zhou Junsheng, 'Tackling Income Tax Evasion', *China.org.cn*, 19 March 2013 <http://www.china.org.cn/opinion/2013-03/19/content_28288542.htm>.

⁷³ Issued by Ministry of Finance; China Securities Regulatory Commission; National Auditing Office; China Banking Regulatory Commission; China Insurance Regulatory Commission, *Cai Kuai* [2010] No. 11 (15 April 2010) (企业内部控制应用指引第4号——社会责任).

⁷⁴ Organisation for Economic Co-operation and Development, *Corporate Governance of Listed Companies in China: Self-Assessment by the China Securities Regulatory Commission* (2011) OECD Publishing <<http://dx.doi.org/10.1787/9789264119208-en>>.

such as engagement in environmental protection.⁷⁵ It refers to the tax-deductibility of charitable expenses,⁷⁶ and to the Shanghai Stock Exchange *Notice on Enhancing Social Responsibility of Listed Companies*,⁷⁷ pursuant to which a company's CSR report should include annual taxes paid as part of the company value created for stakeholders.⁷⁸ Thus, reports by such large state-owned enterprises as CIMC⁷⁹ and Sinopec⁸⁰ include reports on payment of tax to show the contributions that are made to Chinese society in the form of tax payments.

In line with this, the *Guidelines to State-owned Enterprises*⁸¹ include the requirement to pay tax in the scope of the obligation to carry on business in a legal and honest manner. Article 8 requires that centrally-owned enterprises 'comply with regulations and laws, public ethics and commercial conventions, and trade rules. They should also fulfil their tax obligations, undertake the interests of investors and creditors, protect intellectual property rights, keep business creditability, oppose improper competition and eradicate corruption in commercial activities.' (The *Guidelines* were issued shortly after the issue of the 2007 *Interim Measures for the Administration of Collection of Proceeds of State-Owned Capital from Central Enterprises*,⁸² which were designed to ensure returns were made to the State from the profits made by state-owned enterprises.)

⁷⁵ Ibid 95.

⁷⁶ Ibid 99.

⁷⁷ Shanghai Stock Exchange, above n 43.

⁷⁸ Organisation for Economic Co-operation and Development, above n 74, 100.

⁷⁹ China International Maritime Containers (Group) Ltd, *Corporate Social Responsibility Report* (2011), 15 <<http://www.cimc.com/en/about/csreport/201106/P020110613544592714657.pdf>>.

⁸⁰ See a summary of the 2009 CSR Report in 'Sinopec Releases Its Annual CSR Report,' *China CSR* (online), 11 May 2010 <<http://www.chinacsr.com/en/2010/05/11/7593-sinopec-releases-its-annual-csr-report/>>.

⁸¹ State-owned Assets Supervision and Administration Commission of the State Council, above n 47.

⁸² Issued by the Ministry of Finance and the State-owned Assets Supervision and Administration Commission, 11 December 2007 (中央企业国有资本收益收取管理暂行办法).

Similarly, the *Guiding Opinions on Accelerating the Cultivation of New Advantage in International Cooperation and Competition*⁸³ emphasise the importance of compliance with laws and regulations and the active performance of social responsibilities.⁸⁴ Considerably more detail is found in the 2012 *Some Opinions on the Cultural Development of Overseas Chinese Enterprises*.⁸⁵ Article 2(5) of the *Opinions* focuses on compliance with laws and regulations in which overseas enterprises operate. In particular, it requires them to ‘take the initiative to pay tax according to law.’

The State Administration of Taxation, as might be expected, is also concerned with the conduct of corporations. The 2009 *Notice on Circulating Guidance on Tax Risk Management of Large Enterprises (Trial)*⁸⁶ has as its purpose the ‘reasonable control of tax risks, prevention of tax related illegalities [and] performance of taxation obligations in accordance with legal provisions’.⁸⁷ The *Notice* does not refer to the concept of business ethics of enterprises, although it does emphasise the need for personal integrity in the case of employees dealing with tax.⁸⁸ It does, however, state that one of its purposes is to ensure that corporations can avoid damage to their reputations arising from failure to comply with tax laws. Article 1.2 sets out in some detail the obligations relating to tax compliance. It moves beyond the simple requirement that businesses comply with law, however, by providing that ‘[t]ax planning shall have reasonable business purposes and comply with the provisions of tax laws.’⁸⁹ Despite the lack of a direct link between the concepts of business ethics

⁸³ Issued by the State Council on behalf of the National Development and Reform Commission and Other Relevant Departments, *Guo Ban Fa* [2012] No. 32, 24 May 2012 (国务院办公厅转发发展改革委等部门关于加快培育国际合作和竞争新优势指导意见的通知).

⁸⁴ *Ibid* Art 3(13).

⁸⁵ National Development and Reform Commission et al, above n 61.

⁸⁶ *Guo Shui Fa* [2009] No. 90, issued 5 May 2009 (国家税务总局关于印发《大企业税务风险管理指引（试行）》的通知), followed by the *Notice of the State Administration of Taxation on Issues Concerning Tax Risk Management Information System for Designated Contact Enterprises*, *Guo Shui Han* [2010] No. 513, issued on 27 October 2010 (国家税务总局关于定点联系企业税务风险管理信息系统有关问题的通知), which emphasises the link between risk and tax planning.

⁸⁷ *Ibid* Art 1.

⁸⁸ *Ibid* Art 2.5.

⁸⁹“税务规划具有合理的商业目的,并符合税法规定”

and CSR referred to in other items of legislation, and the emphasis on the link between risk, reputation and tax planning, the *Notice* does suggest that the prudent corporate manager should look not just at the payment of tax but the implications of tax strategy.

Conclusion

The significance of ethical conduct and social responsibility is acknowledged in Chinese legislation and practice, just as it is internationally. The role of tax and tax policy in CSR and the ethical business practices of businesses, although increasingly acknowledged in law and practice both internationally and in China, is still undeveloped in China. In particular, the connection between ethics and the obligation to pay tax is not clearly defined or stated. There does, however, appear to be a consensus in China that it is the duty of a business to pay tax in accordance with local laws. The fact that this extends to Chinese corporations operating abroad, and to listed companies which should use tax as part of its calculation of its social contribution, indicates that this extends beyond a legal requirement to comply with Chinese law and includes concepts of the appropriate and ethical behaviour owed by a business to the community in which it operates.

This does not, however, deal with the difficult issues relating to complex tax structuring and the extent to which corporations should contribute to societies in which they operate through tax even if they are not strictly obliged to do so by local law. The OECD Guidelines attempt to deal through the carefully worded provisions of Chapter XI but do not seem to have been addressed as yet in China, with the exception of the notices issued by the State Administration of Taxation discussed above.

These issues will, however, become increasingly significant. As noted above, the attention paid to transfer pricing, and the recent discussion in the press about multinationals such as Apple, will give additional impetus to Chinese authorities' consideration of the issue. The publicity given to Chinese enterprises operating

overseas has already resulted in a number of notices (discussed above) where government Ministries, led by the Ministry of Commerce, attempt to set out codes of conduct, including in relation to taxes, which will improve the behaviour and reputations of Chinese companies abroad. An example is Article 3(3) of the *2010 Opinions of the State Administration of Taxation on Further Bettering the Service and Administration regarding the Taxation from 'Go Global' Enterprises*,⁹⁰ which requires Chinese tax authorities to strengthen tax collection administration over enterprises operating abroad in relation to such matters as transfer pricing and compliance with local tax laws and regulations in order to avoid risk. Indeed, it can be expected that Chinese companies — like other multinationals operating abroad — will be under increasing scrutiny in relation to their compliance with tax rules and their contributions through taxation to the countries in which they operate.⁹¹ It can be expected that as this area develops internationally more attention will be given by Chinese authorities and stock exchanges to the ethical responsibilities of businesses in relation to tax structuring and planning, both in relation to Chinese companies and multinationals operating in China and Chinese companies reporting on their operations overseas.

⁹⁰ See n 69. [There are two references in Footnote 70. I'm not sure which this is in reference to.] – the 2nd

⁹¹ See, for example, Guo Peiyuan, Dylan Meagher, Wu Yanjing and Anna-Sterre Nette, *Transparency Matters: Disclosure of Payments to Government by Chinese Extractive Companies* (January 2013), ed Global Witness <http://www.syntao.com/Uploads/%7BF8F4754C-383E-4019-A227-4F11E70D2D78%7D_transparency%20matters%20EN.pdf> . [I could not open this link to fix the footnote reference.] it is a downloading page

Tax Transplants and the Critical Role of Processes: A Case Study of China

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-This research is generously supported by the Osgoode Fellowship and an Insight Grant from the Social Sciences and Humanities Research Council, Canada. The author is indebted to Leo (Xin) Xu, Titus Halaczek and Stephen (Xiaoyi) Ji for their excellent research assistance. She is also grateful to participants at the Chinese Tax Conference - held 24-25 November - 2012 in Guangzhou, China for their valuable comments on an earlier version of this paper presented at the conference.

1. Introduction

- Daughter: Daddy, my friends and I will get a gift basket tomorrow for our fundraising efforts at school.
- Father: Good. Make sure you let your friends choose first and you take whatever is left.
- Daughter: No. We will take turns in picking what each of us wants, one at a time, until we divide up all the gifts.
- Father: That sounds good, too.

The conversation above is between my daughter and her dad. Although both agree that sharing the gifts is important, they have a different approach to sharing. The daughter has a process that is fair to both her and her friends. The father's idea of sharing requires his daughter to be virtuous and to put her friends' interests first. Having grown up in Canada, the daughter is accustomed to using rules and processes, whereas the father holds traditional Chinese values dearly and emphasises personal virtues.

How does this dialogue relate to tax transplantation? It makes me contemplate the importance of process in transplanting good tax ideas or 'scientific' tax rules from the West to China. China and Western countries share the same general objectives of taxation: to generate revenue to finance public expenditures, to redistribute social income, and to regulate private economic and social activities. China and the West also face similar tax problems, such as how to tax high income earners and multinational corporations. Yet China and the West have different ways of achieving these objectives and dealing with these common problems. To begin with, the political and legal systems of China and the West are different. The relationship between individuals and the state and the approach to problem solving are also viewed from different angles. When China implements a tax rule from the West to solve an apparently similar tax problem, to what extent do processes matter? In other words, if

the outcome of a process in the West is transplanted to China, can it work well in China without similar processes?

This paper seeks to explore the above question by drawing insights from existing literature. The existing body of literature is rich in documenting the phenomenon of legal transplants, theorising why legal transplants take place and presenting the debate on the relevance of local culture to the adaptation of the transplants. In terms of tax transplants, there is an emerging strand of literature that examines the unique characteristics of tax transplants, the common core of tax law, and the global tax convergence. However, there is a lack of analysis focusing on the critical role of processes in legal and tax transplants. Through a case study of the Chinese tax transplants, this paper seeks to test the theories of legal transplants and to demonstrate the importance of process in successful transplants. It examines two types of processes: tax processes and transplantation processes. Tax processes include the political process, administrative and compliance process, and dispute resolution process. Tax transplantation processes include the process of selection, translation, adoption and adaptation.

The central claim of this paper is that processes matter in tax transplants. Taxation science is capable of being borrowed and duplicated. Tax processes in a country are defined by its general political, legal and institutional culture, and thus vary from country to country. Many tax rules or principles are the outcomes of tax processes in the country of origin and their implementation depends on a certain set of administrative processes. The transplantation of a tax rule or principle is likely to fail if it is done without the necessary processes, or at least, without a full appreciation and accommodation of the differences in processes.

The rest of this paper proceeds as follows. Part 2 provides a brief review of the existing literature on legal transplants and the emerging literature on tax transplants. It notes the debate about tax common core and culture-specific tax transplants and the

phenomenon of tax transplants in China. Part 3 discusses tax processes and argues why tax processes should be considered in tax transplants from one culture to another. Tax law is the result of a political and legal process. Taxation is more like science than art. Like other scientific disciplines, such as medicine, taxation is about both knowledge and process. Part 4 presents a case study of the Chinese tax transplants and the importance of selecting and adapting transplants. It shows that the transplantation of the arm's length principle is more successful than the transplantation of the progressive tax principle, largely because China introduced the necessary tax processes in respect of the former, but not the latter. Part 5 concludes the paper with some observations and comments.

2. Legal (Tax) transplants

2.1 Evidence of Legal and Tax transplants

'Legal transplants' is a term coined by Alan Watson that refers to the 'moving of a rule or a system of law from one country to another, or from one people to another'.¹ There is a rich body of literature documenting the evidence of legal transplants as the 'most fertile source of legal change in the world'.²

2.1.1 Global Tax Convergence

As an observable fact, tax law appears to be convergent at a global level in terms of the choice of taxes (income, property, sales or consumption), the underlying principles (fairness, efficiency and simplicity) and the levels of tax burdens.³ When faced with essentially the same tax problems, countries tend to adopt similar laws to solve these

¹ A Watson, *Legal Transplants: An Approach to Comparative Law* (1974), at 95.

² *Ibid*; O Kahn-Freund, 'On Uses and Misuses of Comparative Law' in O Kahn-Freund, *Selected Writings* (Stevens Publishing, London, 1978).

³ M Livingston, 'Tax Culture, Tax History and the Limits of Convergence: A Comment on Professor Likhovski's Article' (2010) 11(2) *Theoretical Inquiries in Law* 18.

problems, which results in convergence. In the area of VAT, there is a remarkable degree of similarity in the over 100 countries that have adopted VAT.⁴ To a lesser degree, corporate income tax has recently enjoyed a greater degree of convergence, thanks to a greater mobility of capital and to globalisation.⁵

Convergence in tax policy amongst members of the European Union and the Organization for Economic Co-Operation and Development (OECD) is perhaps the most comprehensive.⁶ Some tax rules and norms are virtually universal; for example, the arm's length principle is found in virtually every one of 3000 or so bilateral tax treaties and the domestic law of most countries.⁷ The convergence of tax laws has reached such a stage that it is unthinkable for any country to adopt a new consumption tax that is vastly different from the VAT. It is equally unthinkable for any country to create an income tax system for the first time that deviates from the accepted international norms. Global tax issues, such as base erosion, profit shifting and stateless income tax planning (that is, moving income from the production and market countries to low-tax jurisdictions),⁸ are expected to lead to further convergence in tax laws governing the taxation of multinational corporations.

⁴ R Bird and P Gendron, *The VAT in Developing and Transitional Countries* (Cambridge University Press, 2007); K James, 'An Examination of Convergence and Resistance in Global Tax Reform Trends' (2010) 11 *Theoretical Inquiries in Law* 475.

⁵ J Slemrod, *Are Corporate Tax Rates, Or Countries Converging?* (2001) <<http://www.bus.umich.edu/OTPR/WP2001-12paper.pdf>>; C Garbarino, 'An Evolutionary and Structural Approach to Comparative Taxation: Methods and Agenda for Research' (2009) 57 *American Journal of Comparative Law* 677; R S Avi-Yonah, *International Tax As International Law: An Analysis of the International Tax Regime* (Cambridge Tax Law Series, Cambridge University Press, 2007); R S Avi-Yonah, N Sartori and O Marian, *Global Perspectives on Income Taxation Law* (Oxford University Press, 2011); R S Avi-Yonah, 'Tax Convergence and Globalization' (July 8, 2010). U of Michigan Law & Econ, Empirical Legal Studies Center Paper No. 10-019; U of Michigan Public Law Working Paper No. 214. Available at SSRN: <http://ssrn.com/abstract=1636299> or <http://dx.doi.org/10.2139/ssrn.1636299>.

⁶ For further discussion, see F J Delgado and M J Preseno, *Tax Policy Convergence in EU: An Empirical Analysis* (2008) <<http://www.ugr.es/~montero/XVIeep/93.pdf>>; G Vintila, *Fiscal Pressure and Tax Mix Convergence in the European Union* (2012) <<http://www.ibimapublishing.com/journals/JEERBE/2012/295339/295339.pdf>>; Ken Messere, Flip de Kam and Christopher Heady, *Tax Policy: Theory and Practice in OECD Countries* (Oxford University Press, 2003), and V Tanzi, *Tax Systems in the OECD: Recent Evolution, Competition and Convergence* (2010) <<http://aysps.gsu.edu/isp/files/ispwp1012.pdf>>.

⁷ Avi-Yonah, above n 5; Garbarino, above n 5.

⁸ H J Ault, 'Some Reflections On the OECD and the Sources of International Tax Principles' (2013) 70(12) *Tax Notes International* 1195, 1195–201; OECD Report For The G8 Summit, 'A Step Change In Tax Transparency: Delivering a Standardised, Secure and Cost Effective Model of Bilateral Automatic Exchange for the Multilateral

2.2.2 Tax Transplants in China

The modern evolution of Chinese law is largely a process of legal transplants in the name of modernisation.⁹ Chinese tax law is a clear example. Transplanting foreign tax laws into China is a recent phenomenon. China's traditional tax system originated in 2023 BC when the first state was created. It was home-grown until the Opium War in 1842.¹⁰ Traditional taxes included land taxes and excises on salt, tea, liquor and other goods. After the Opium War, Western influences became a factor and China introduced toll charges (*li jin* 厘金), stamp duties and customs duties.¹¹ Income tax was drafted by the Nationalist Government in 1928 but was never enacted.¹² All of these taxes were abolished and replaced with a new system soon after the establishment of the People's Republic.¹³ The function of taxation diminished when the socialist economic structure was entrenched and private ownership of property and entrepreneurship were limited. Taxation revived during the late 1970s, when China embarked on the path of economic reforms-and non-public actors were allowed to operate in the economy and some individuals were allowed to become rich first. The

Context' (June 2013) <<http://www.oecd.org/newsroom/oecd-reports-to-g8-on-global-system-of-automatic-exchange-of-tax-information.htm>>; E D Kleinbard, 'Through a Latte, Darkly: Starbucks' Window into Stateless Income Tax Planning', Center in Law, Economics and Organization, Research Papers Series No. C13-9; Legal Studies Research Paper Series No.13-10, available at <http://ssrn.com/abstract=2264384>; J G Gravelle, *Tax Havens: International Tax Avoidance and Evasion*, CRS Report for Congress, (23 January 2013) <www.crs.gov>, R40623; and H Grubert and R Altshuler, 'Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax' (1 April 2013) <<http://www.wrn.com/abstract=2245128>>.

⁹ J. Chen, 'Modernisation, Westernisation and Globalisation: Legal Transplant in China' in J Oliveira and P Cardinal (eds), *One Country, Two Systems, Three Legal Orders: Perspectives of Evolution* (Springer, 2009) 91.

¹⁰ For an excellent account of the history of taxation in China and its relationship to culture, see Weng Lihua, *Comprehensive Analysis of Chinese Fiscal and Tax Culture* (China Finance and Economics Press, 2nd ed, Beijing, 2011) (in Chinese).

¹¹ Ibid at 68–9.

¹² Ibid at 70.

¹³ The Administrative Council promulgated 'Rules for the Implementation of National Tax Policies' in January 1950, which created a new tax system for China. For more discussion of the evolution of the Chinese tax system, see J Li, *Taxation in the People's Republic of China* (1991) *New York: Praeger*. [Publisher and edition details if available]

notion of income tax was introduced in Article 8 of the 1979 Chinese-Foreign Equity Joint Venture Law.¹⁴

The first pieces of modern income tax legislation are the Chinese-Foreign Equity Joint Venture Income Tax Law and the Individual Income Tax Law.¹⁵ These two tax laws include features found in income tax laws of other countries, but are not a carbon copy of any specific country's law. The structure of the law and many key concepts reflect the so-called international tax norm. For example, tax liability is based on personal and territorial nexus with China, the tax base is net income, and foreign taxes are creditable.¹⁶ American tax scholars, such as Harvey Dale, Oliver Oldman, Stanley Surrey, Richard Pomp and Jerome Cohen, were among the early international experts who provided training to Chinese officials.¹⁷ Evidence of their teachings can be found in these two laws. The 1981 Foreign Enterprise Income Tax Law¹⁸ has 19 articles and provides for Chinese source-based taxation of foreign enterprises. Subsequent income tax laws, especially the 2007 Enterprise Income Tax Law,¹⁹ continue to include foreign tax principles, norms, concepts and rules. As such, the current income tax system in China is a hybrid of home-grown and transplanted laws.

¹⁴ It states: 'From the gross profit earned by an equity joint venture, after payment of the venture's income tax in accordance with the provisions of the tax laws of the People's Republic of China ... and the net profit shall be distributed to the parties to the venture in proportion to their respective contributions to the registered capital'.

¹⁵ The Income Tax Law of the People's Republic of China Concerning Joint Ventures with Chinese and Foreign Investment adopted by National People's Congress and promulgated on 10 September 1980. The Income Tax Law applicable to Foreign Enterprises, adopted by the National People's Congress in 1981. Both were abolished with the promulgation of Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises, promulgated by the National People's Congress on 9 April 1991. For an overview of the history of the Chinese tax system, see A Easson and J Li, 'Taxation of Foreign Business and Investment in the People's Republic of China' (1985–1986) *New Jersey International Law & Business* 666.

¹⁶ Ibid Easson and Li.

¹⁷ R D Pomp and S S Surrey, 'The Structure of Taxation in the People's Republic of China' (1979) 20 *Virginia J of Int'l L* 1.

¹⁸ The Law of People's Republic of China on Foreign Enterprise Income Tax, promulgated on 8 December 1981 by the 4th Session of the National People's Congress.

¹⁹ Enterprise Income Tax of the People's Republic of China Art 58 (promulgated at the 5th session of the 10th National People's Congress of China on 16 March 2007 and issued by Order of President No 63 on 16 March 2007) (the 'EIT Law'); Implementation Regulations for the Enterprise Income Tax Law of the People's Republic of China, National Legislation IBFD was promulgated by State Council on 28 November 2007 and issued by the Order of the State Council No 512 on 6 December 2007 (the 'EIT Regulations'). See J Li, 'Fundamental Enterprise Income Tax Reform in China: Motivations and Major Changes' (2007) 61 *Bulletin for Intl Taxation* 12; and J Li and H Huang, 'Transformation of the Enterprise Income Tax: Internationalization and Chinese Innovations' (2008) 62 *Bulletin for Intl Taxation* 275.

The Chinese Value-added Tax (VAT) was also a transplant. It was first introduced in 1980 to apply, on a trial basis, to companies manufacturing machinery, agricultural equipment and domestic appliances.²⁰ VAT then expanded to apply to all domestic enterprises in 1984²¹ and to foreign-investment enterprises and foreign enterprises in 1994.²² The scope of the VAT does not cover services (with the exception of processing, repair and maintenance), which are subject to a single-stage Business Tax. In 2011-2012, VAT was expanded to some services in selected pilot jurisdictions, such as Shanghai, Tianjin and Beijing.²³ The VAT system is a transplant, with major modifications to suit China's needs. One major modification is the denial of input credits for capital expenditures and another is the limitation of the tax base to goods.²⁴

Evidence of tax transplantation and tax convergence goes beyond formal laws. The interpretation of domestic laws by reference to international tax norms and best practices is often adopted. One example is the “Measures for the Implementation of Special Tax Adjustment (Trial)” issued by the State Administration of Taxation (SAT) in 2009. This document reflects the international tax norms on transfer pricing.²⁵ China's extensive tax treaty network also encourages the convergence of Chinese tax

²⁰ Ministry of Finance, *Notice on the Levy of VAT on a Trial Basis on Industrial Companies and Reform Industrial and Commercial Tax Collection Methods* (11 July 1980).

²¹ Regulations of the People's Republic of China on VAT (Draft), promulgated by the State Council on 18 September 1984.

²² Interim Regulations of the People's Republic of China on Value-Added Tax, promulgated by State Council on 13 December 1993. On 22 February 1994, the Standing Committee of the National People's Congress issued The Decision to Subject Foreign Investment Enterprises and Foreign Enterprises to VAT, Consumption Tax, Business Tax and other Taxes, effective on 1 January 1994.

²³ China Daily, 'China Expands Value-added Tax Reform', 2 October 2012 <http://www.chinadaily.com.cn/business/2012-10/02/content_15795129.htm>.

²⁴ For further discussion of Chinese VAT, see Y Xu, 'Putting the "Value Added" in China's VAT' (2010) 58(6) *Tax Notes International* 487.

²⁵ State Administration of Taxation, (2009) *Guo Shui Fa* No 2, 8 January 2009, effective on 1 January 2008. Administrative circulars issued prior to 2008 were revoked. The SAT has issued several sets of measures related to transfer pricing, such as 'How to Deal With the Enterprise Income Tax on the Service Charges Paid to a Parent Company by a Subsidiary Company' (2008) *Guo Shui Fa* No 86; 'Related Tax Policy Issues on the Pre-tax Deduction Standard of the Interest Expenses Paid to Related Parties' (2008) *Guo Shui Fa* No121; 'Trial Measures on the Application for Mutual Agreement Procedures (MAP) by Chinese Residents and Citizens'; SAT circular, (2005) *Guo Shui Fa* No 115.

laws with those of other countries.²⁶ Such convergence is part of the trend of global tax convergence.

2.2 Literature on legal transplants

2.2.1 Theories on why legal transplants take place

“The act of borrowing is usually simple. To build up a theory of borrowing on the other hand, seems to be an extremely complex matter”.²⁷ Comparative law scholars have traditionally been more interested in observing the occurrence of legal transplants than in offering a theoretical explanation of why legal transplants happen.²⁸ At the moment, the main theories are grounded in prestige, efficiency (or law and economics), law and development, and globalisation.

According to the theory of prestige, foreign law enjoys certain prestige over domestic law, especially when the foreign country is perceived as more advanced.²⁹ The prestige theory is related to the theory of formants, which focuses on law as a social activity and argues that legal process is seen as a competitive arena with different groups of elites (or formants), such as lawmakers, judges, lawyers, and legal scholars, including foreign advisors.³⁰ The incentives for these actors in legal transplantation are

²⁶ See J Li, ‘The Rise and Fall of Chinese Tax Incentives and Implications for International Tax Debates’ 8 *Florida Tax Rev* 670 (also available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1087382); [LINK TITLE DOES NOT MATCH] and W Cui, ‘The China-United Kingdom Tax Treaty’ (2013) 67(6) *Bulletin for International Taxation* 271.

²⁷ A Watson, ‘Aspects of Reception of Law’ (1996) 44(2) *American Journal of Comparative Law* 335, at 335. See also A Watson, ‘Legal Transplants and European Private Law’ (2000) 4.4 *Electronic Journal of Comparative Law* <<http://www.ejcl.org/ejcl/44/44-2.html>>.

²⁸ U Mattei, ‘Three Patterns of Law: Taxonomy and Change in the World’s Legal Systems’ (1997) 45(1) *American Journal of Comparative Law* 5; J Smits, ‘The Harmonization of Private Law in Europe: Some Insights from Evolutionary Theory’ (2002) 31 *Georgia Journal of International and Comparative Law* 79; E Örüçü, ‘A Theoretical Framework for Trans-Frontier Mobility of Law’ in R Jagtenberg, E Örüçü and A J De Roo (eds), *Transfrontier Mobility of Law* (Kluwer Law International, 1995) 14.

²⁹ R Sacco, ‘Legal Formants: A Dynamic Approach to Comparative Law’ (1991) 39(1) *American Journal of Comparative Law* 343; A Gianmaria, ‘By Chance and Prestige: Legal Transplants in Russia and Eastern Europe’ (1995) 43(1) *American Journal of Comparative Law* 93.

³⁰ *Ibid* Sacco; H Spamann, ‘Contemporary Legal Transplants — Legal Families and the Diffusion of (Corporate) Law’ (2009) *Brigham Young University Law Review* 1813; J Ohnesorge, ‘Beijing Consensus Anyone?’ (Symposium: The Future of Law and Development, Part V) (2010) 104 *Northwestern University Law Review Colloquy* 257; D M Trubek and A Santos, *The New Law and Economic Development: A Critical Appraisal* (2006).

significant factors in determining what to transplant and how well the transplants work.³¹ Judges and lawyers play a unique role in transplanting foreign laws.³²

The efficiency theory is advocated by some comparative law and economics scholars.³³ It suggests that economic efficiency is the main reason for legal transplants. If a doctrine enjoys a wide success in the competitive arena of international legal thinking and practice, it means that this doctrine is more efficient than its alternatives. Borrowing legal rules may also reduce the cost of developing indigenous rules. Where ideological concerns are less strong, efficient convergences are more likely to occur. Laws that regulate economic transactions in one country can be more readily transplanted to another country.³⁴

The law and development movement includes transplanting the Western rule of law, institutions and legal doctrines to less developed countries.³⁵ The Western legal system is advocated by local policy makers as enhancing economic development. The logic seems quite straightforward: Western economies are more developed and such development is predicated on the legal system. International institutions, such as the World Bank and the International Monetary Fund, have tied financial assistance packages to countries with legal reforms.

³¹ F Schauer, 'The Politics and Incentives of Legal Transplantation' in Joseph S Nye (ed), *Governance In A Globalizing World* (Brookings Institution Press, 2000).

³² N Garoupa and A Ogus, 'A Strategic Interpretation of Legal Transplants' (2006) 35(2) *Journal of Legal Studies* 339.

³³ W Ewald, 'Comparative Jurisprudence (1): What Was It Like to Try A Rat?' (1995) 143 *Penn L Rev* 1889; Mattei, above n 28; A Ogus, 'Competition Between National Legal Systems: A Contribution of Economic Analysis to Comparative Law' (1999) 48 *The International and Comparative Law Quarterly* 405.

³⁴ E Buscaglia and W E Ratliff, *Law and Economics in Developing Countries* (2000).

³⁵ See, for example, D Berkowitz, K Pistor and J F Richard, 'The Transplant Effect' (2003) 51(1) *American Journal of Comparative Law* 163; A Gelpern, *Law & Development Narrow and Law & Development Broad*, In *Symposium: The Future of Law and Development, Part I* (2009) 104 *Northwestern University Law Review Colloquy* 164; F Schauer, 'The Politics and Incentives of Legal Transplantation' (2000) Working Papers at Centre of International Development at Harvard University, <http://www.hks.harvard.edu/var/ezp_site/storage/fckeditor/file/pdfs/centers-programs/centers/cid/publications/faculty/wp/044.pdf>; R Peerenboom, 'What Have We Learned About Law and Development? Describing, Predicting and Assessing Legal Reforms in China' (2006) 27 *Michigan Journal of International Law* 823.

In the age of globalisation, competitive pressures force many less developed countries to harmonise their legal systems with those of capital-exporting countries by incorporating foreign legal frameworks that firms in advanced economies think will enhance their security and productive efficiency. Even among developed countries, there is a growing ‘Americanization’ of laws in the European Union and amongst members of the OECD.³⁶ Yet, the transplantation of American laws has not led to a complete harmonisation due to well-entrenched social and political differences among countries.³⁷

All of the above theories seem to help explain the phenomenon of legal transplantation to China. China rationalises the borrowing of Western laws governing economic transactions on the ground that they are rational and advanced.³⁸ China’s desire to attract foreign direct investment during the early years of its economic reform made it imperative for China to adopt laws that appear similar to foreign investors, including tax laws, corporate and commercial laws, and intellectual property laws. China’s accession to the World Trade Organisation also deepens the transplantation process. China borrowed Western laws even in areas of public law, such as criminal procedures.

2.2.2 Determinants of Successful Legal Transplants

There is little agreement among scholars on what makes a transplant work and how to measure success.³⁹ However, literature suggests that, in general, whether or not a transplant can adapt and survive depends on both internal and external factors. Internal

³⁶ L A Mistelis, ‘Regulatory Aspects: Globalization, Harmonization, Legal Transplants, and Law Reform — Some Fundamental Observations’ (2000) 34 *International Lawyer* 1055.

³⁷ R A Kagan, ‘Globalization and Legal Change: The “Americanization” of European Law?’ (2007) 1 *Regulation & Governance* 99; J Mertus and E Breier-Sharlow, ‘Power, Legal Transplants and Harmonization’ (2003–4) *University of Detroit Mercy Law Review* 81; T C Halliday and P Osinsky, ‘Globalization of Law’ (2006) 32 *Annual Review of Sociology* 447–70.

³⁸ J F Chen, *Chinese Law: Context and Transformation* (Martinus Nijhoff Publishers, 2008) 70.

³⁹ H Kanda and C Milhaupt, ‘Re-examining Legal Transplants: The Director’s Fiduciary Duty in Japanese Corporate Law’ (2003) 51(4) *American Journal of Comparative Law* 887.

factors would be the quality of the rule itself (in organisms these would be the genes or the DNA). External factors include local legal culture, social norm, political conditions and economic conditions, which is collectively referred to as environmental factors.⁴⁰

A legal system or rule has a greater chance of success in transplantation if it is of good quality. Quality can be measured by factors such as: whether it is regarded as ‘good’ in the home jurisdiction, whether it has been transplanted into a different country and taken root in that country, whether it has been codified into an international treaty, whether it is controversial at home or abroad, and whether it is based on a sound theory. For example, the system of rule of law has been tested in Western democracies and embraced by many developing countries, and its genetic quality is arguably good.

The type of transplants also matters. Some laws and rules are more ‘mechanical’ or ‘technical’ and thus are easier to transplant. Examples include laws regulating economic relations and market transactions. The ‘invisible hand’ that regulates market behaviour is arguably ‘global’. On the other hand, some laws and rules are more ‘personal’ or ‘social’ and are therefore more sensitive to the social environment. Examples include laws regulating social relationships and the relationships between the state and its citizens (such as constitutional law, criminal law, and family law). As such, public law is harder to transplant than private law. For example, Kahn-Freund distinguishes between various ‘mechanical’ and ‘organic’ transplants and argues that transplants of the ‘organic’ type depend mainly on their interlocking with specific power structures of the societies involved.⁴¹

The relevance of environmental factors, such as social, legal and political culture and economic conditions, to the success of legal transplants is controversial. One school of

⁴⁰ J L Nolan, *Legal Accents, Legal Borrowing: The International Problem-Solving Court Movement* (2009); G Teubner, ‘Legal Irritants: How Unifying Law Ends up in New Divergences’ in P A Hall and D Soskice (eds), *Varieties of Capitalism* (Oxford University Press, 2001).

⁴¹ Kahn-Freund, above n 2, 303.

thought maintains that the process of legal transplantation is indicative of the autonomy of law. The representative of this school is Alan Watson, the ‘father’ of legal transplants. Laws are instruments to solving common problems in different societies. Legal evolution takes place rather insulated from social changes. The success of legal transplants can be explained by a highly developed autonomy of the modern legal profession.⁴² The recent export of Western laws and institutions to developing and transition countries seems to be influenced by this thinking.

Another school of thought argues that law is embedded in society and that legal institutions and norms transferred from one system to another can only survive if there is a fit between the two systems and the environment of the borrowing country. This is the culturalists’ position which is also consistent with the evolutionary theory of law that sees adaptation of a rule to the local culture as critical for its survival because ‘law is deeply ensconced in a particular cultural context’.⁴³ The culturalists maintain that a legal transplant is like a kidney transplant.⁴⁴ The key question to ask is: ‘Can it be adjusted to the new body or will the new body reject it?’ The culturalists recognise that while legal rules have their inherent ‘logic’, they are also inextricably tied to culture.⁴⁵ Teubner also asserts that the dialectical nature of the relationship between the transplant and local culture is a process of ‘co-evolution’: “Legal irritants” cannot be domesticated; they are not transformed from something alien into something familiar, not adapted to a new cultural context, rather they will unleash an evolutionary dynamic in which the external rule’s meaning will be reconstructed and the internal context will undergo fundamental change.’⁴⁶

⁴² A Watson, ‘From Legal Transplants to Legal Formants’ (1995) 43(3) *American Journal of Comparative Law* 469.

⁴³ Nolan, above n 40, 28.

⁴⁴ Kahn-Freund, above n 2.

⁴⁵ Nolan, above n 40; Teubner, above n 40.

⁴⁶ Teubner, above n 40, 12. F A Hayek, ‘Notes on the Evolution of Systems of Rules of Conduct’ in F A Hayek (ed), *Studies in Philosophy, Politics and Economics* (Routledge, 1967) 66.

Others maintain that '[b]ecause law is a product and a carrier of culture, when it moves from one place to another, it not only functions differently in the importing country (i.e. adapts), but it will skew the receiving culture in profound ways.'⁴⁷ They further argue that because law is deeply embedded in culture, legal transplants are exposed to the insurmountable differences of cultural organisms; they cannot survive the surgical operation. Legal transplants are thus literally 'meaningless' because 'as it crosses boundaries, the original rule necessarily undergoes a change that affects it *qua* rule.'⁴⁸

2.3 *Emerging Literature on Tax Transplants*

2.3.1 'Touchy' issues about tax law

During the past two decades or so, the body of literature on comparative tax law has been growing.⁴⁹ However, because of language barriers and the complexity of tax laws, comparative tax law research is 'torturous'⁵⁰ and has a minoritarian position in the global tax discourse.⁵¹ The transplantation of tax laws is a 'touchy' issue.⁵²

⁴⁷ Nolan, above n 40, citing Jack Hiller, 439.

⁴⁸ P Legrand, 'The Impossibility of 'Legal Transplants' (1997) 4 *Maastricht Journal of European Comparative Law* 111; P Legrand, 'The Return of the Repressed: Moving Comparative Legal Studies Beyond Pleasure' (2001) 75 *Tulane Law Review* 1033; P Legrand, 'What 'Legal Transplants'?' in D Nelken and J Feest (eds), *Adapting Legal Cultures* (Hart, 2001); P Legrand, 'The Same and the Different' in P Legrand and R Munday (eds), *Comparative Legal Studies: Traditions and Transitions* (Cambridge University Press, 2003) 240 and P Legrand, 'Paradoxically, Derrida: For a Comparative Legal Studies' (2005) 27 *Cardozo Law Review* 631.

⁴⁹ D Ring, 'The Promise of International Tax Scholarship and Its Implications for Research Design, Theory and Methodology' (2010) 55(1) *St Louis University Law Journal* 307; O Marian, 'The Discursive Failure in Comparative Tax Law' (2010) 58(2) *American Journal of Comparative Law* 415; Avi-Yonah et al, above n5[above n 5?], H Ault & B J Arnold, *Comparative Income Taxation: A Structural Analysis* (Kluwer Law International, 3rd ed, 2010); V Thuronyi, 'What Can We Learn from Comparative Tax Law?' (2004) 103 *Tax Notes* 459; M A Livingston, 'Law, Culture, and Anthropology: On the Hopes and Limits of Comparative Tax' (2005) 18(1) *Canadian Journal of Law and Jurisprudence* 119; M A Livingston, 'From Milan to Mumbai, Changing in Tel Aviv: Reflections on Progressive Taxation and "Progressive" Politics in a Globalized but Still Local World' (2006) 54(3) *American Journal of Comparative Law* 555; M A Livingston, 'From Mumbai to Shanghai, with a Side Trip to Washington: China, India, and the Future of Progressive Taxation in an Asian-Led World' (2010) 11(2) *Theoretical Inquiries in Law* 539; and Livingston, above n 3.

⁵⁰ Ibid Ault and Arnold.

⁵¹ Marian, above n 49; Avi-Yonah et al, above n 5. [Does this also refer to n 5?]

⁵² Livingston, above n 3.

Transplanting ‘universal tax norms’ such as the arm’s length principle, appears easy. International institutions, such as the International Monetary Fund, have ‘transplanted’ Western tax laws and norms to developing and transition countries.⁵³ OECD member countries have been borrowing tax laws from each other in reforming their domestic tax laws, especially those related to corporations and international transactions.⁵⁴ Transplanting progressive income tax either by imposition (as in the case of colonisation) or by voluntary borrowing reflects the belief that it is a ‘good’ tax. However, the problem lies in implementation. For example, Likhovski demonstrates that the law on the books, which was transplanted from Britain to Mandatory Palestine, did not differ much from that in other British dominions, but the law in action did because of local cultural and institutional factors.⁵⁵ Infanti argues that the risk of the rejection of tax transplant is multiplied if the tax rules are being ‘cloned’.⁵⁶ If local conditions are ignored, the transplants may cause harm to the receiving country.⁵⁷ On the other hand, since the level of taxation reflects social and democratic values, it is suggested that tax transplants can promote democratic policy and human development.⁵⁸

Comparative tax scholarship is primarily descriptive and doctrinal, aimed at advancing the understanding of alternative solutions to common problems and providing practical guidelines to policy makers and their international tax advisors.⁵⁹ This type of scholarship is considered important because of the special features of tax law, such as the inherently global nature of this field, the complexity of tax laws, the importance of

⁵³ Thuronyi, above n 49; M Stewart, ‘Global Trajectories of Tax Reform: Mapping Tax Reform in Developing and Transition Countries’ (2003) 44 *Harvard International Law Journal* 140.

⁵⁴ Ault and Arnold, above n 49; Garbarino, above n 5.

⁵⁵ A Likhovski, ‘Is Tax Law Culturally Specific? Lessons from the History of Income Tax Law in Mandatory Palestine’ (2010) 11(2) *Theoretical Inquiries in Law* 725.

⁵⁶ A C Infanti, ‘Spontaneous Tax Coordination: On Adopting a Comparative Approach to Reforming the US International Tax Regime’ (2002) 35 *Vanderbilt Journal of Transnational Law* 1105; A C Infanti, ‘The Ethics of Tax Cloning’ (2003) 6(3) *Florida Tax Review* 251.

⁵⁷ Stewart, above n 53.

⁵⁸ W B Barker, ‘Expanding the Study of Comparative Tax Law to Promote Democratic Policy: The Example of the Move to Capital Gains Taxation in Post-Apartheid South Africa’ (2005) 109(3) *Penn State Law Review* 703.

⁵⁹ Ault and Arnold, above n 49; Thuronyi, above n 49.

detailed knowledge of both the international tax systems and the likely planning techniques, and the influence of norms and ‘soft law’.⁶⁰ There is a premium on developing an understanding of the complex ways in which tax policies form on a global scale — how norms are established and how countries influence each other’s policy choices.⁶¹

In terms of general characteristics, tax laws are in the nature of public law with profound social and economic implications for the private sector. Among the types of taxes, some are more value-based and organic, while others tend to be more ‘technical’. For example, personal income tax expresses the societal sense of distributive justice and fairness, and is thus deeply rooted in the social, economic and political environment. VAT tends to be more ‘technical’ and is used to maximise revenue while minimising tax distortions. Its dependence on the environment is mostly in the area of administration and compliance. Corporate income tax is most vulnerable to global influences due to the mobility of capital and the pressures of international tax competition, and thus it is more susceptible to transplantation. A common feature of all tax laws, however, is their complexity and high level of technicality. As such, expertise is required in drafting, implementing and complying with tax laws.

2.3.2 Common Core

The general debates about the autonomy of law (hence legal transplantation) and the relevance of culture (adaptation and modification of transplants) extend to the transplantation of tax laws. Evidence on Chinese tax transplant is abundant in supporting both schools. Chinese tax transplantation occurs at different levels of the hierarchy of taxation. Starting from the top is the mix of taxes, tax policies, tax

⁶⁰M Livingston, ‘Reinventing Tax Scholarship: Lawyers, Economists, and the Role of the Legal Academy’ (1998) 266, *Cornell Law Review* 83[There aren’t any 1998 Livingston publications at 49?]; A Christians, ‘Critical Issues in Comparative & International Taxation: Case Study Research and International Tax Theory’ (2010) 55(1) *St Louis University Law Journal* 331; D Ring, above n 49.

⁶¹ Avi-Yonah, 2007, above n 5.

structures, tax concepts, and tax rules. The higher level a transplant is in the hierarchy, the more autonomous the law is because it reflects the ‘common core’⁶² of modern taxation. Another way of looking at the common core is from the perspectives of the functions of taxation and the design of tax laws. The need for taxation as a revenue source and as a policy instrument is common, and hence tax laws perform the same functions in different countries. The tax design features that address common problems are generally adopted by many jurisdictions.

During the past three decades, the Chinese tax system has evolved from a primarily turnover tax system to a system of mixed income taxes and VAT/turnover taxes. The types of taxes that China could introduce to facilitate the transition from a centrally-planned economy to a market-based economy were limited to those commonly used in other countries. Taxation was regarded as a field of ‘science’.⁶³ As such, the scientific theories and proofs developed in other countries were applicable to China. For example, income taxes which were non-existent until 1980 have become increasingly important in China in generating revenue. Income tax revenue accounted for 15 per cent of total tax revenue in 1994 and 24 per cent in 2010.⁶⁴ As discussed below, however, the design and implementation of income taxes and VAT in China differ significantly from the ‘common core’ of these taxes in OECD countries.

From the design perspective, some general principles or ideas of taxation are common. One example is the principle of progressive taxation. The Chinese Individual Income Tax has progressive rates for employment income and business income.⁶⁵ Other examples include the principle of deferring to financial accounting in determining corporate income and the principle of recognising the legal form of transactions.

⁶² The notion of ‘common core’ of tax rules is used in Avi-Yonah, Sartori and Marian, above n 49, at 6–7; Ault and Arnold, above n 49.

⁶³ See, for example, Jin Xin, *Collection of Papers by Jin Xin* (China Tax Press, 2008) (in Chinese).

⁶⁴ See tax revenue statistics on the SAT website at www.chinatax.gov.cn; Gongliang Tang (ed), *Annual China Tax Report- Forecasting China Tax Reform in the 12th Five-Year Plan Period* (2011) 17 (in Chinese).

⁶⁵ For a study of the Chinese Individual Income Tax and its comparison with personal income tax in other countries, see L Liu, *Progressivity of Income Tax and Income Redistribution* (2011) (in Chinese).

The basic structural design of Chinese income taxes and VAT is consistent with the common core by including: who is taxable, what is taxable, how much is taxable, when is tax payable, and how are taxes paid and disputes resolved. The basic structure of international taxation includes the taxation of residents — with respect to their foreign-source income, the taxation of non-residents in relation to their domestic income and rules to protect the integrity of these two elements (i.e., anti-avoidance rules). The structure of a tax is perhaps the most scientific or mechanical element of any tax law.

The basic concepts in Chinese income tax laws and VAT law also share some commonality with those in Western countries. For example, income from employment, which accounts for the biggest portion of the tax base for personal income tax, is taxable, generally on a gross basis, and is subject to withholding at source.⁶⁶ A corporation is taxed as a separate person and special rules of consolidation are needed to overrule this fundamental principle.⁶⁷ ‘Residence’ determines the scope of a person’s tax liability in a jurisdiction. ‘Place of consumption’ and ‘export tax refund’ mean that VAT is levied on consumers not producers.

Specific tax rules tend to be more divergent, depending on local environment, including drafting conventions and tax culture. However, a common core is still discernible in some areas. For example, the transfer pricing rule in China looks similar to that in other countries. The transplantation of the tax common core does not mean that the transplanted tax, policy, principle, concept or rule remain unchanged in China. Even if the transplants remain unchanged in form, they inevitably acquire some ‘Chinese characteristics’ in reality.

⁶⁶ Ault and Arnold, above n 49.

⁶⁷ Ibid; G Cooper, ‘Policy Forum: A Few Observations on Managing the Taxation of Corporate Groups – The Australian Experience’ (2011) 59(2) *Canadian Tax Journal* 265; A Ting, ‘The Unthinkable Policy Option? Key Design Issues Under A System of Full Consolidation’ (2011) 59(3) *Canadian Tax Journal* 421.

2.3.2 Culture-specific

Tax ideas or rules are generally more difficult to transfer if they are embedded in local socio-economic culture. In general, rules affecting individuals and governing domestic transactions are more culture-specific than those affecting capital and corporations and governing international transactions respectively. The transplantation of the tax ‘common core’ does not mean complete tax convergence because the convergence of tax laws does not necessarily lead to convergence in the institutions or processes for tax law in general. This means that transplanted tax laws are formulated and administered by institutions through processes that are as divergent as before. There is also little evidence on the convergence of tax culture or tax environment.⁶⁸ As such, the gap between tax laws on the book and tax laws in action is, presumably, quite significant in different countries. The progressivity of income tax will be used as an example.

Progressive income taxation was first introduced in Prussia (Germany) in the late 19th century, which led to a rise in tax rate from 0.67 to 4 per cent. Though some other Continental countries soon followed Prussia, it took nearly twenty years for the movement to reach the Anglo-Saxon powers. In 1910 and 1913, Great Britain and the United States adopted graduated income taxes rising to 8.25 and 7 per cent, respectively. During World War I and the post-war years, the top rate subsequently reached 97 and 91 per cent. Other Western democracies and developing countries followed suit.⁶⁹ Even though the recent adoption of ‘flat tax’ in some Eastern European countries⁷⁰ erodes the idea of progressivity as a universal idea, progressive

⁶⁸ Livingston, above n 3.

⁶⁹ For an excellent discussion of the history of the debate about equity and efficiency and the idea of progressive taxation, see D J Ventry Jr, ‘Equity Versus Efficiency and the U S Tax System in Historical Perspective’ in J J Thorndike and D J Ventry, Jr (eds), *Tax Justice: The Ongoing Debate* (2002) 25; and W J Blum and H Kalven Jr, *The Uneasy Case for Progressive Taxation* (1963). For a discussion about progressive taxation and democracy, see [S Steinmo](#), *Taxation and Democracy: Swedish, British and American Approaches to Financing the Modern State* (Yale University Press, 1996).

⁷⁰ Examples are Russia, Romania and the Czech Republic.

taxation remains a powerful symbol of a society's notion of fairness, equity and tax justice. High-income countries and low-income countries tend to have similar top marginal personal income tax rates.⁷¹

The superficial level of global convergence on progressive taxation cannot be confused with the great variations in the practice of progressive taxation across countries. Personal income tax accounts for about 25 per cent of total tax revenue in OECD countries (and higher ratio in the United States and Common-law countries) and less than 10 per cent in low-income countries. In China, the ratio is about 6 percent, meaning that progressive taxation has a greater impact on tax fairness and justice in higher-income countries than in lower-income countries.⁷² The variation is attributable to differences in political factors, economic factors, societal attitudes, institutional factors, and effectiveness in tax administration.

Research finds that political will is the 'sine qua non of any successful tax reform' and a country's tax system, especially, personal income tax system, reflects its political institutions.⁷³ 'The main reason many developing countries do not tax themselves more may be that increasing tax is not in the interest of those who dominate the political institutions of such countries'.⁷⁴ In Latin America, for example, the difficulty in implementing progressive taxation is due to a lack of 'an (implicit) social contract between governments and the general populace of the kind that is embedded in taxation and fiscal principles and practices in politically more stable parts of the world'.⁷⁵ In the United States, on the other hand, there is a political process for finding

⁷¹ See K Sabirianova and S Buttrick, 'Global Reform of Personal Income Taxation: 1981–2005: Evidence from 189 Countries' (2010) 63 *National Tax Journal* 447.

⁷² R Bird and E Zolt, "Redistribution Via Taxation: The Limited Role of the Personal Income Tax in Developing Countries" (2005) 52(6) *UCLA Law Review* 1.

⁷³ R Bird, 'Managing Tax Reform' (2004) 58 *Bulletin for International Fiscal Documentation* 42.

⁷⁴ R Bird, J Martinez-Vazque and B Torgler, 'Tax Efforts in Developing Countries and High Income Countries: The Impact of Corruption, Voice and Accountability' (2008) 38 *Economic Analysis & Policy* 55.

⁷⁵ V A Schneider and M Moore, *Pro-Poor Tax Reform in Latin America: A Critical Survey and Policy Recommendations*, IDS, Sussex, (March 2003).

the right balance between competing demands of social equity, economic incentives and the need to pay for an expanding government.⁷⁶

The level of economic development tends to coincide with the actual level of progressive taxation. The tax system in OECD countries is more progressive than that in lower-income countries. In the latter, because per capita income is low, the number of taxpayers is also low. The existence of a large informal sector in developing countries makes it difficult to observe and assess personal income tax.⁷⁷ Moreover, corruption has a larger negative impact on income taxes compared with consumption taxes,⁷⁸ and corruption-resistant features are often missing in the design of taxes in developing countries.⁷⁹

‘Tax administration matters – a lot!’⁸⁰ The best tax policy on paper means nothing if it cannot be effectively administered. A large body of literature has examined tax administration difficulties — faced by developing countries. The main challenges include the size of the agricultural and informal sector, the use of the financial sector (in relation to the economic environment in which tax administrators operate), the organisational change and the political will to reduce corruption, rent seeking and improvement in the accountability of tax administration, and the use of technology in tax administration.⁸¹

Local culture also plays a role in the divergence of progressivity. Livingston demonstrates that institutional and attitudinal differences in China, India, Israel, Italy

⁷⁶ S R Weisman, *The Great Tax Wars* (Simon and Schuster, 2002).

⁷⁷ S Mahdavi, ‘The Level and Composition of Tax Revenue in Developing Countries: Evidence from Unbalanced Panel Data’ (2008) 17 *International Review of Economics and Finance* 607.

⁷⁸ V Tanzi and H R Davoodi, ‘Corruption, Growth, and Public Finance’ (IMF Working Paper WP/00/182, 2000).

⁷⁹ M Emran, and Joseph E Stiglitz, ‘Development Oriented Tax Policy’ (Columbia University and GWU Working Papers, 2006).

⁸⁰ R Bird, ‘Taxation and Development’ (2010) The World Bank <<http://siteresources.worldbank.org/INTPREMNET/Resources/EP34.pdf>>, no 34, 4. [Kindly note the link doesn’t work].

⁸¹ See Bird, above n 73; J Alm, J Martínez–Vazquez and S Wallace (eds), *Taxing the Hard-to-Tax: Lessons from Theory and Practice* (Elsevier Science Ltd, 2005).

and the United States have some effect on progressive taxation, even though the precise effect is difficult to discern.⁸² He also notes that attitudinal differences (tax anthropology) are less important than institutional factors (tax sociology). Steinmo found that the different models of democratic culture in the United States, Sweden and the United Kingdom helped explain the different level of progressivity in these countries.⁸³

3. Tax Processes

The existing literature does not specifically address the relevance of process to legal or tax transplants.⁸⁴ This part of the paper discusses why processes are important and what the major differences are in tax processes between China and Canada (which is used as a representative of Western countries).

3.1 *Importance of Tax Processes in Tax Transplants*

Processes are important in studying tax transplants for several reasons. First, taxation is more of a science than an art. Second, taxation is about sharing and thus how to share is often as important as what is shared. Third, the desired effect of tax transplants is ‘practical’ and ‘real’ in the sense of generating revenue with minimal adverse impact on market efficiency and private choices, which means that the law in action is generally more relevant than the law on paper.

‘Taxation is a field of science’.⁸⁵ Science is both a body of knowledge and process. Science is ongoing, continually refining and expanding our knowledge. Scientific processes lead to new questions for future investigation. Science is a global human

⁸² Livingston, above n 3; Livingston (2006), above n 49.

⁸³ Steinmo, above n 69.

⁸⁴ For example, G Mousourakis, ‘Transplanting Legal Models Across Culturally Diverse Societies: A Comparative Law Perspective’ (2010) 57 *Osaka University Law Review* 87.

⁸⁵ Jin, above n 63.

endeavour. Taxation science can be learned and tax knowledge can be shared. Because of the necessity of raising money by taxes, the ‘most perfect knowledge of the science is required’.⁸⁶ How to raise the desired amount of taxes with minimal interference is one of the key scientific questions for tax researchers and policymakers. Experiences in one country can be learned by another country. The phenomenon of tax transplants illustrates the scientific aspect of taxation. Both the knowledge of taxation and the process of taxation can be learned, refined and expanded, and used to solve problems in different countries. The learning and borrowing of knowledge itself is never complete. Without scientific processes, knowledge may not be useful or be improved. As explained above, however, processes are embedded in culture. Incorporating scientific taxation processes into the local culture requires scientific transplantation processes, such as the process of selection, the process of translation, and the process of adaptation. More importantly, the transplantation of substantive tax rules or laws without transplanting the relevant tax processes will likely impede the chance of successful adaptation of the transplants.

Taxation is not just about raising the desired amount of money. It is also an act of laying a tax, i.e. the process by which the state, through its law-making body, raises revenue to defray the necessary expenses of the government. Much of the debate about taxation and tax policy surrounds the ‘how’ question, rather than the ‘how much’ question. Because the process of taxation is superimposed on the economic process (or market allocation of resources) and interacts with social relationships, its impact on the society is immense. That is why the standard policy criteria for assessing taxation are equity and fairness, neutrality and efficiency in administration. The equity and

⁸⁶ ‘If it were not for the necessity of taxation’, wrote Richardo in 1819, ‘the business of government regarding Agriculture, Commerce and Manufactures would be very easy indeed, --- all that would be required of them would be to avoid all interference, neither to encourage one source of production nor to depress another, but the necessity of raising money by taxes renders some interference necessary. The aim of the legislature should nevertheless be to press on all equally, so as to interfere as little as possible with the natural equilibrium which would have prevailed if no disturbance whatever had been given’. See C S Shoup, *Ricardo and Taxation (FinanzArchiv / Public Finance Analysis, New Series, Bd. 18, H. 1 (1957/58), 13–24* .

fairness criterion evaluates the spread of the tax burden among taxpayers. The neutrality criterion looks at the interaction between taxation and the market. The administrative efficiency criterion looks at the overall cost and efficiency of tax compliance and administration.⁸⁷

Taxation is about the political process of a country. There can be different models for making political decisions. Irrespective of the model, taxpayers are key players in the process. They can vote with their hand (election), their feet (emigration) or their arms (rebellion). They can ‘voluntarily’ comply with tax laws or resist taxation through lawful or unlawful means. The doctrine of no taxation without representation is embraced in the United States and other Western democracies. At the end of the day, taxation is not just about the end, but also the means. Taxation is the process of maintaining public trust in government. Because taxation affects almost every citizen as either taxpayers or as beneficiaries of public programs financed by tax revenue, the manner in which the government administers tax laws and deals with the public significantly affect public opinion about the government. In the absence of public trust, it is difficult, if possible at all, to operate a modern tax system.

The general objective of taxation is to raise revenue. The primary goal of tax transplants is to borrow foreign laws and incorporate them into the local system so that the system is more efficient in raising revenue while meeting other policy objectives. Ideally, the gap between the ‘law on paper’ and the ‘law in action’ should be as small as possible. The size of the gap, to a great extent, depends upon the similarity of the processes of making, interpreting and enforcing the laws. Owing to social, political

⁸⁷ It might be interesting to note that in spite of the significant reductions in tax rates during the past four decades, the average tax burden measured by the tax/GDP ratio has changed in the opposite direction! According to the OECD report, *Tax Reform Trends in OECD Countries* (2011) <<http://www.oecd.org/ctp/48193734.pdf>>, in the mid 1980s, the top personal income tax rate in OECD countries exceeded 65 per cent, and corporate income tax rate was rarely less than 45 per cent; in 2011, these rates were dropped to 41.5 per cent and 26 per cent respectively. Meanwhile, the average tax/GDP ratio actually increased from 30.5 per cent to 35 per cent. One might ask: whose tax burden was increased or decreased? How? Why? What processes led to such outcome?

and economic reasons, such processes are often different between countries, especially countries belonging to different legal families. The types of taxes and the level of taxation generally reflect the outcomes of the social choices or political decisions of a country. As such, tax processes are expected to be more divergent than tax policies or tax rules across countries. That presents challenges to successful tax transplants. The level of sensitivity of tax transplants to local culture and local processes may depend on the type of tax transplants. As mentioned earlier, VAT is arguably less sensitive than income taxes; corporate income tax is less sensitive than personal income tax; international tax rules are less sensitive than domestic tax rules; tax rules related to market transactions are less sensitive than those related to personal or social transactions; administrative tax rules are less sensitive than judicial procedures; policy-based rules (such as tax incentives and anti-avoidance rules) are less sensitive than basic charging rules. In terms of tax policy, equity-and fairness-oriented policies are more sensitive to local culture than efficiency-and growth-oriented policies. Cultural orientation towards fairness and equity is more evident in tax policy whereas efficiency and economic growth are influenced more by market forces and globalisation.

3.2 *Differences between China and the West*

It is beyond the scope of this paper to delve into the differences in the Western way of thinking and the Chinese way of thinking about processes. It suffices to note below some differences that may be relevant in thinking about taxation and tax transplants. Canada is used as an example of the West in the following discussions, but it is important to note that there are significant differences among Western countries.

3.2.1 Less Emphasis on Processes in China

Generally speaking, the Chinese way of thinking emphasises less on processes and more on results. There can be several explanations for this.

First, Chinese tend to think holistically, whereas Westerners tend to think analytically. Researchers find that ‘East Asians tend to be holistic, attending to the entire field and assigning causality to it, making relatively little use of categories and formal logic, and relying on “dialectical” reasoning, whereas Westerners are more analytic, paying attention primarily to the object and the categories to which it belongs and using rules, including formal logic, to understand its behaviour’.⁸⁸

Second, Chinese tend to adopt a compromise approach in dealing with seeming contradictions — retaining basic elements of opposing perspectives by seeking a ‘middle way’, whereas Westerners tend to follow a differentiation model that polarises contradictory perspectives in an effort to determine which fact or position is correct. Chinese prefer dialectical resolutions to social conflicts⁸⁹ and favour dialectical arguments over classical Western logical argumentation.⁹⁰ Westerners are keen on finding out who is right in an argument. On the other hand, it has been argued that the tendency to find the middle way has hampered Chinese’s efforts to seek out scientific truth through aggressive argumentation, the classic Western method for forging a linear path through contradictory information, which results in identifying right and wrong answers.⁹¹

Third, Chinese culture values collective interest, hierarchy and social harmony, whereas Western culture values individualism, recognises self-interest, and develops a common core through processes. Rules and processes are presumably more important

⁸⁸ R E Nisbett, I Choi, K Peng and A Norenzayan, ‘Culture and Systems of Thought: Holistic Versus Analytic Cognition’ (2001) 108 *Psychological Review* 291, 291.

⁸⁹ The Chinese apply dialectical thinking to social relationships, not to the physical material world or science. For example, the Chinese do not apply dialectical thinking to astronomy and geography to come to the conclusion that the sun can rise in both the East and the West. [Can you kindly clarify?]

⁹⁰ K Peng and R Nisbett, ‘Culture, Dialectics, and Reasoning about Contradiction’ <<http://www-personal.umich.edu/~nisbett/cultdialectics.pdf>>.

⁹¹ K Peng was quoted in ‘Americans and Chinese have Different Ways of Discovering Truth, Finds UC Berkeley Expert on Chinese Psychology’ <http://berkeley.edu/news/media/releases/98legacy/06_09_1998.html>. For further discussion, see K Peng, J Spencer-Rodgers and N Zhong, ‘Naive Dialecticism and the Tao of Chinese Thought’ in U Kim, K S Yang and G Huang (eds), *The Handbook of Indigenous and Cultural Psychology* (2005), 247–62; F E Blackwell, J Hagaman, J Grice and K Peng, *From Leadership to Parenthood: The Applicability of Leadership Styles to Parenting Styles. Group Dynamics: Theory, Research and Practice* (2006), 43–56.

in balancing competing interests among ‘equals’ than prescribing duties and obligations of the ‘subordinates’. In any society, people are both individual beings and social beings and most people look after their self-interest. In the West, individual rights and private property are recognised and respected and relationships (private-private and private-public) are regulated through law. The Chinese thinking is primarily top-down, whereas the Western thinking is more bottom-up, starting from the basic unit.

3.2.2 Approach to Problem Solving

Approaches to solving problems are different in the Chinese culture and Western culture. The Chinese approach tends to be more pragmatic, result-oriented, experts-led, and non-confrontational, whereas the Western approach tends to be more principled, process-driven, evidence-based, and encourages open debates. At the risk of oversimplification, the Chinese approach is represented by the two famous sayings: ‘crossing the river by feeling the stones’, and ‘A cat is a good cat no matter it is white or black’. In the West, a problem solving process typically consists of defining the problem, analysing the problem, generating possible solutions, analysing the solutions, selecting the best solution(s) and reassessing the solutions. The different approaches to problem-solving can be illustrated by the approach to tax reforms in Canada and in China.

One of the most thorough reform processes in Canada occurred in the 1960s. The problems to be addressed by the Commission arose from the ad hoc nature of the existing tax system. The federal income tax was introduced in 1917 in the frenzied atmosphere of a grave national emergency during World War I. Ad hoc changes were made during World War II and the Korean War. It was noted that:

The [Canadian] federal taxation was hastily thrown together at its origin, was subject to its greatest changes during periods of national

stress, that the alterations made in these conditions were on a purely pragmatic basis and tended to persist once the crisis had passed, and that never yet has there been thorough examination of its underlying objectives and philosophy. For half a century we have gone along on a hand-to-mouth basis that has produced each year more problems than it has ever solved. ... It was folly to continue it.⁹²

A Royal Commission on Taxation was appointed in September 1962 with a sweeping mandate to examine the federal tax laws of Canada and to make recommendations for their improvement. The order-in-council establishing the Commission was signed by Robert Bryce, then the Deputy Minister of Finance. Mr. Kenneth Carter, a chartered accountant in private practice, was the Chair of the Commission while Mr. Douglas Hartle, a young professor at the University of Toronto, was the Research Director. The Commission was persuaded that ‘only by establishing some basic underlying principles on which to build a solid structure is there any escape from ultimate complete frustration’.⁹³ The Commission spent four years studying the tax system in-depth. It engaged a large group of research staff (which included about 75 professionals) and held public hearings across the country. It eventually published 30 separate research studies and received over 300 briefs. The Commission delivered the final report to the Government in December 1966 and released it in February 1967. The final report contains 2,575 double-spaced, typed pages in six volumes. It was known as the Carter Report after its chairman and was described as ‘one of the most far-reaching, explosive, revolutionary sets of proposals ever put before the Canadian people.’⁹⁴ The Carter Report ‘is not a series of unrelated ideas and recommendations:

⁹² J H Perry, ‘Anatomy of a Tax System’ in *Twentieth Tax Conference* (1967) 7–30, 12.

⁹³ *Ibid.*

⁹⁴ N Brooks (ed), *The Quest for Tax Reform: The Royal Commission of Taxation Twenty Years Later* (Carswell, 1988), 4. [Note: Should this be ‘The Quest for Tax Reform: The Royal Commission of Taxation Twenty Years Later’]

it tells a story, and it tells the story with conciseness, clarity and passion. The story is premised on a clear vision of an equitable society'.⁹⁵

Public reaction to the Carter Report was mixed. The business community collectively opposed the recommendations, which emphasised tax equity and fairness. In 1969, the Government tabled a White Paper on Tax Reform, which was a watered-down version of the Carter Report. The Finance Minister at the time explained that the reasons for the initial abandonment of many of the recommendations 'were more political and administrative than philosophical'. The White Paper was publicly debated. In 1971, draft legislation was tabled in the House of Commons and the final legislation was passed and became effective in 1972, of which the structure and principles remain today. The whole process was open, consultative, evidence-based, principled, and led by experts who are not politically motivated.

China has undertaken several major tax reforms since the inception of the modern tax system in the early 1980s. The Chinese tax system was introduced during the period of economic transition, largely on an *ad hoc* basis. It contains legacies of the socialist system as well as transplanted foreign ideas and norms. It is certainly due for a thorough review, but a public process similar to that of the Carter Commission seems unlikely. The direction for reform comes from the top. For example, the 12th Five-Year Plan (2011-2015) by the Central Government calls for strengthening the regulatory effects on high-income earners,⁹⁶ 'making the sharing of the tax burden more fair', 'gradually establishing an individual income tax system that combines comprehension and scheduler features, and perfecting the system of collection and administration of individual income tax'.⁹⁷ Chapter 46 of the 12th Five-Year Plan states — that experts and public input must be sought in policy-making and

⁹⁵ Ibid 6.

⁹⁶ The 12th Five Year Plan was approved by the National People's Congress on 14 March 2011. It sets forth the objectives, strategies and measures of economic and social development. See Chapter 32, section 3.

⁹⁷ Ibid Chapter 47, section 3.

administrative accountability should be widely implemented in order to improve public confidence.⁹⁸ The role of public input is, in practice, limited to commentary on specific issues as opposed to ideas and principles or the structure of the tax.

3.3 Political processes

3.3.1 Taxation with(out) Representation

In Canada and other Western democracies, the issue of taxation is highly political. The modern notion of taxation is a system of compulsory contributions levied by government on individuals, corporations, and properties, primarily as a source of revenue for the government. The power of taxation proceeds upon the theory that the existence of government is a necessity. The basis of taxation is found in the reciprocal duties of protection and support between the state and the taxpayers or the idea of a social contract between citizens and the government. The relationship between the government and the people is governed by the rule of law. Tax laws are passed by the legislatures and the law-makers are elected by citizens. There is a political process for ‘consulting’ taxpayers about their choices. The government is accountable to the people about the use of tax revenues through budgeting processes and reporting.

In modern China, the political process is fundamentally different from that of Western countries. ‘Members of the National People’s Congress (NPC) are not directly elected by the people and most are members of the Chinese Communist Party (CCP). Key policy decisions are made by the CCP. Article 1 of the Constitution states that ‘The People’s Republic of China is a socialist state under the people’s democratic dictatorship led by the working class and based on the alliance of workers and peasants’. Many provisions of the Constitution spell out what the state promises to do for the people. Article 56 states: ‘It is the duty of citizens of the People’s Republic of

⁹⁸ Ibid Chapter 46.

China to pay taxes in accordance with the law'. In the true sense of 'socialism', there is no need for taxation because taxation is the means of mandatory transfer of wealth from the private sector to the government in order to finance public expenditures. In reality, it is acknowledged that China's 'socialism' is at an earlier stage and market is allowed as the main mechanism for regulating economic activities. As such, taxation is relevant.

The current Chinese system is rooted in the Chinese tradition that emphasises morality, duties, and vertical relationships. For example, the relationship between the state and taxpayers is framed in terms of a 'duty' to support the state.⁹⁹ The Chinese term for 'state' is 'guo jia' or 'nation family'. The government is analogised to the 'head of the family'. As the head of the family, the government regards the people as subjects or children, exercising a top-down model of governance. When the Xia Dynasty (BC 2235) levied agriculture tax, it named the levy 'gong' or 'tribute'.¹⁰⁰ The payment of taxes to the emperor was analogised to supporting one's parent.¹⁰¹ The taxpayers/children's duty to support the emperor/parent was 'unconditional' and it was regarded as a moral obligation.¹⁰² Emperors did not need to consult with, or account to, taxpayers about the level of taxation and the use of tax revenue. Imperial governments did not see themselves as providers of services to taxpayers. Without the

⁹⁹ Jing Fang, 'Zhongxi Fang Shuishou Falu Wenhua Bijiao Yanjiu' ('A Comparative Study on Chinese and Western Tax Cultures') (2003) 16 Journal of Yantai University (Philosophy & Social Science) 43; Li Linping, 'Zhong Xi Fang Shui Shou Wen Hua Zhi Bijiao' ('Comparison of Chinese and Western Tax Cultures') (2005) 8 Li Lun Daokan (Journal on Theory) 77, 77–8; Liu Rong & Du Jian, 'Na Shui Ren Quan Li Bao Hu Yu Wo Guo Shui Shou Si Fa Gai Ge' ('The Protection of Taxpayers' Rights and Chinese Taxation Judicial Reform') (2007) 1 Taxation Research 51; You Xiaofeng & Wang Zhifang, 'Shui Shou Qi Yue Yu Na Shui Ren Quan Li Zhi Bao Hu' ['Taxation Agreement and the Protection of Taxpayers' Rights'] (2008) 2 Taxation Research 69 (in Chinese). (Note: As the journal titles are originally in Chinese, can you kindly spell out the abbreviations? Thanks)

¹⁰⁰ Weng, above n 10, 4.

¹⁰¹ Fang, above n 99; Li, above n 99; Yang Bin, 'Zhong Xi Fang Wen Hua Chaiyi Yu Shui Zhi Gai Ge' ('Differences Between Chinese and Western Cultures and Tax Reform — A Case Study of VAT and Personal Income Tax') (2005) 5 Shui Wu Yan Jiu [Tax Research] 14; Yu Daqing & Peng Jiming, 'Zhong Ying Chuantong Shuishou Wenhua Bijiao' ['Comparison Between Chinese and English Traditional Tax Cultures'] (2003) 16 Journal of Xi'an Institute of Finance and Economics 14 (in Chinese). [Please spell out journal title in full]

¹⁰² Li Qian and Han Yu, 'Qi Ye Suo De Shui Fa, Yi Ban Fan Bi Shui Tiao Kuan Ping Xi' ('Some Comments on General Anti-Avoidance Provisions in the Enterprise Income Tax Law of the People's Republic of China') (2008) 8 International Taxation in China 68; Wang Jianping, 'Na Shui Ren Quan Li Li Nian Yu Zheng Fu — Na Shui Ren Guan Xi De Zhuan Xing' ['The Concept of Taxpayers' Right and the Relationship Between the Government and Taxpayers'] (2008) 4 International Taxation in China 57 (in Chinese). [Please spell out journal title in full]

possibility of participating in tax-law making or having an impartial arbiter in resolving tax disputes, taxpayers resorted to tax evasion and tax resentment.¹⁰³

3.3.2 Rule of Law

Modern taxation was created in Western countries where the rule of law, market and social contract co-existed and operated in tandem. For example, the Canadian tax system is based on the principle of rule of law. The principle signifies that ‘all elements of Canadian society — public and private, individual and institutional — are subject to and governed by known legal rules’.¹⁰⁴ Competing and conflicting interests and values are managed through an open, political process and the majority or compromised view is expressed through legislation. Political leaders and government agencies are accountable to the people and the elected legislative respectively. Economic relations are regulated by free markets that demand fair dealing, transparency, equal exchange, resulting in a win-win outcome. Private property and individual rights are protected and regulated by law. There is an implicit social contract between taxpayers and the state: the state uses tax revenue to pay its expenses on public services whereas taxpayers receive the benefits and protection from the government, which attempts to level the playing field and to provide a fair opportunity to all of its citizens to realise their potential. These processes are generally open, transparent and have built-in checks and balances.

In a tax context, the rule of law means that taxes must be imposed through a proper parliamentary process rather than through administrative or judicial discretion. The government as well as the taxpayers must comply with tax laws. The rule of law also implies that tax laws must be reasonably capable of discovery and that taxpayers should be able to reasonably predict, in advance and with a sufficient degree of

¹⁰³ Liu, above n 65, 224.

¹⁰⁴ Beverley McLachlin, Chief Justice of Canada, Forward to G L Gall, *The Canadian Legal System* (5th ed, 2004).

certainty, the tax consequences of their actions. It also implies the separation of powers and the independence of the judiciary, so that taxpayers can rely on the courts to resolve their disputes with the government.

The Chinese legal system is different; it is not based on the Western notion of the rule of law that restrains state power. In ancient China, the ruler was accountable to no one and was above the law. The law functioned as an instrument of control. The political process required no participation of the people. Regime changes were driven by bloody conflicts. The administrative process was highly sophisticated and top officials were selected through the *keju* system. ‘Administrative bureaucracies in China have long dominated the process of governance, to the extent that administrative decision making virtually eclipsed the law-making authority of the [law maker].’¹⁰⁵ Under that system, bureaucrats not only enforced laws, but also adjudicated disputes. There was no independent judiciary. In modern China, some of these traditions remain. ‘Law is not a limit on state power, rather, it is a mechanism by which state power is exercised, as the legal forms and institutions that comprise the Chinese legal system are established and operate to protect the Party/state’s political power.’¹⁰⁶ Deputies to the NPC are becoming more active in proposing legislation, ‘although broader data suggests that the Party and state bureaucracies continue to dominate most legislative proposals’.¹⁰⁷ The judiciary is subordinate to the NPC.

In the Chinese tax context, tax ‘laws’ are promulgated by the NPC, implementation regulations are promulgated by the State Council, and specific tax measures are introduced by the SAT or the Ministry of Finance. The power to interpret tax laws, regulations and measures lies with the body that has the power to enact them, that is, the NPC, the State Council and the SAT or the Ministry of Finance. Courts have no

¹⁰⁵ P B Potter, *The Chinese Legal System: Globalization and Local Legal Culture* (2001), 20–1.

¹⁰⁶ *Ibid* 10.

¹⁰⁷ *Ibid* 17.

general power to interpret tax legislation. Interpretations and decisions of the SAT are not generally subject to judicial review. For the first time in Chinese history, starting in 1989, certain bureaucratic actions (primarily enforcement actions and penalty decisions) became reviewable by the court in accordance with the Administrative Litigation Law.¹⁰⁸ This law was intended to hold decisions by administrative agencies more accountable and to provide remedies for administrative misconduct.¹⁰⁹

3.4 Tax Policy Process

The process of making tax policy is dictated by the institutional structure and processes of each country. In Canada, the Department of Finance is responsible for tax policy, which includes formulating amendments to existing statutes, such as the Income Tax Act (the ‘Act’), or introducing a new tax:

- Many amendments are announced in the Minister’s annual budget. The Minister of Finance presents a budget to Parliament each year, usually in February or March. The budget provides an estimate of the government’s revenues and expenditures for the next financial year, which starts on April 1. Because of the significance of income taxes for the revenue side, the budget usually proposes a set of changes to the Income Tax Act.
- The Department of Finance is responsible for starting the legislative process in amending the Act. It often prepares a ‘notice of ways and means motion to amend the *Income Tax Act*,’ which lists and describes all the amendments to the Act that have been proposed. The notice of ways and means motion is followed by legislation in draft form. Since 1983, the Department of Finance has followed the practice of issuing explanatory notes (or technical notes) to

¹⁰⁸ Administrative Procedure Law of the People’s Republic of China, Adopted at the Second Session of the Seventh National People’s Congress on April 4, 1989, promulgated by Order No 16 of the President of the People’s Republic of China on April 4, 1989, and effective as of October 1, 1990). For further discussion, see W Cui, ‘The Rule of Law in Chinese Tax Administration’ in C Evans et al, (eds), *The Delicate Balance: Tax, Discretion and the Rule of Law* (2011) 362–3.

¹⁰⁹ The impact of this law can be limited. Potter, above n 105, notes at 24: ‘Since Chinese regulations are drafted to give officials maximum discretionary authority and so are often intentionally vague and ambiguous, it is difficult, if not impossible, to establish that any but the most egregious conduct was actually in violation of existing regulations. And since the courts have expressly been denied power to pass judgment on the propriety of administrative decisions that are not in violation of specific laws and regulations, administrative decisions that represent abuses of discretion but are technically within the law may not be overturned under the [Administrative Litigation Law]’.

accompany the draft legislation. This material is helpful in explaining the purpose of amendments, which are often exceedingly difficult (even for tax professionals) to understand on their own. The purpose of issuing the legislation in draft form initially is to provide an opportunity for the tax community to comment on the legislation. In fact, commentary is received and sometimes does lead to changes in the legislation.

- Eventually, a bill amending the Act is introduced into the House of Commons by the Minister of Finance. That bill then follows the normal legislative process, which includes scrutiny by standing committees of both the House of Commons and the Senate, and is enacted into law in due course.¹¹⁰

Tax policies in China generally originate from either the SAT or the Ministry of Finance. The process of tax policy making in China has become more transparent over the past three decades. Public input was sometimes sought and given. An example is the 2011 amendment of the Individual Income Tax. In the case of the unprecedented process for public input in amending the Individual Income Tax, the process seems to be as follows:

- The Ministry of Finance started the process by involving the relevant department of SAT and created a first draft. This draft was submitted to the Legal Affairs Office of the State Council, which consulted with relevant ministries and departments of government and then generated the second draft.
- On 1 March 2011, the executive meeting of the State Council approved the ‘Draft Amendment to the Individual Income Tax Law’. The State Council submitted the Draft Amendment to the Standing Committee of the 11th NPC.
- On 20 April 2011, the Standing Committee of NPC considered the draft Amendment,¹¹¹ and officials from the Ministry of Finance and SAT answered questions about the proposed amendment in public.¹¹²

¹¹⁰ For further discussion, see B J Arnold and H Kerr, ‘The Canadian Tax Policy Process’ in Kerr, McKenzie and Mintz, *Tax Policy in Canada* (2012), Ch 3; and S D Pollack, ‘Arenas of Federal Tax Policy’ (2012) *Tax Notes* 1499–514.

¹¹¹ In accordance with the Chinese Law Making Law, upon the receipt of a draft legislation, the Standing Committee of the National People’s Congress can ask a committee to examine the draft and prepare a report and then include the draft legislation on the agenda of the meetings of the Standing Committee. In the case of the proposed Individual Income Tax Amendment, the Finance and Economics Committee reviewed the draft and suggested changes.

¹¹² See Officials from the Minister of Finance and State Administration of Taxation Answering Questions from the Media, at <<http://www.gov.cn>>, 20 April 2011 (in Chinese).

- On 25 April 2011, the Office of the Standing Committee of the NPC published the Proposed Amendment to the Individual Income Tax Law of the People's Republic of China (Draft) and sought public input.
- From 25 April 2011 to 31 May 2011, 82,707 'netizens' (Internet Users) provided input, 181 people wrote letters, and 11 experts and 16 members of the public were invited to attend a hearing and give comments on the proposed draft amendment.¹¹³
- On June 30, 2011, the Standing Committee of the NPC promulgated the decision

The draft was presumably made public by the State Council when published on its website on 2 March 2011.¹¹⁴ As a result of the amendment, 60 million individuals were removed from the tax net.¹¹⁵ In general, however, the law-making process in China is more opaque: public input is not often allowed and policy debates are not made in public.

3.5 Tax Administrative Process

3.5.1 The Agency

In Canada, federal tax laws are administered by the Canada Revenue Agency (CRA). According to the *Canada Revenue Agency Act* (S.C. 1999, c. 17),¹¹⁶ the CRA is responsible for, among others, supporting the administration and enforcement of tax legislation. The CRA's website¹¹⁷ states that 'the CRA is the model for trusted tax and benefit administration, providing unparalleled service and value to its clients, and offering its employees outstanding career opportunities'. The CRA undertakes to

¹¹³ Liao Wengen, 'Netizens Actively Suggest Amendments to the Individual Income Tax Law: 82707 People Made 237684 Suggestions' <http://www.npc.gov.cn/huiyi/lfzt/grsdsfzx/2011-06/16/content_1659110.htm>. (in Chinese).

¹¹⁴ Office of State Council, 2 March 2011, State Council Discussed and Passed the Draft Amendment to the Individual Income Tax Law, at <<http://www.gov.cn>>.

¹¹⁵ Wu Yan, '60 Million Individuals Are Exempted From Paying Individual Income Tax and Experts Worry About Difficulties in Sharing Public Resources', *People's Daily*, 29 July 2011 (in Chinese) <<http://www.chinanews.com/cj/2011/07-29/3218426.shtml>>.

¹¹⁶ For the text of this legislation, see <<http://laws-lois.justice.gc.ca/eng/acts/C-10.11/page-2.html>>.

¹¹⁷ See <http://www.cra-arc.gc.ca/gncy/prgrms_srvcs/mssn-eng.html>.

contribute to the well-being of Canadians and to the efficiency of government by delivering world-class tax and benefit administration that is responsive, effective and trusted. It regards integrity as the foundation of its administration and aspires to treat people fairly and to apply the law fairly. Professionalism, respect of clients and co-operation are its key values. The CRA regards taxpayers as its clients and aims to provide ‘unparalleled service and value’ to its clients.

The SAT administers tax laws in China. In comparison to the CRA, the SAT has a much broader mandate. Providing services to taxpayers is among its main responsibilities, but not listed as the top one. Its main functions include drafting tax laws and regulations, providing tax policy recommendations, enforcing tax laws and regulations, interpreting tax law and policy, participating in research on macro-economic policy and making recommendations on central-local tax sharing, planning and organising a system of taxpayer services, protecting taxpayer’s lawful interests, formulating and implementing rules to regulate registered tax practitioners, and exercising vertical, exclusive control and administration of the national tax system and dual control over the local tax administration system. The SAT website makes no mention of its values and principles.

3.5.2 Rules and Procedures

In Canada, rules and procedures governing the main aspects of tax administration are provided in legislation. These rules and procedures are designed to ensure the operation of a self-assessment tax system. There are extensive provisions specifying the obligations of taxpayers and third parties (including banks, financial institutions, employers, etc.) to provide information to the CRA, the powers of the CRA to demand information from taxpayers, to audit and assess taxpayers, the duty of the CRA to

protect taxpayer information, as well as the duties of tax advisers to the tax system.¹¹⁸ The administrative process limits the scope of discretion of CRA officials and all parties are bound by the same law. The thrust of these rules is that taxpayers are presumed honest in reporting their tax obligations and the CRA's job is to assist taxpayers comply with the law and go after those who do not. Transparency is the key. Tax avoidance and tax evasion are dealt with differently: the latter is a crime and is punishable by imprisonment, whereas the former is lawful, and even if the avoidance scheme is found unsuccessful, there is no penalty imposed. The difference between tax avoidance and tax evasion lies in deceit: the latter involve fraud and intentional misrepresentation of facts, whereas the former involves taking advantage of legislative loopholes, but nothing is hidden from the CRA.

The Chinese Law on Tax Collection and Administration¹¹⁹ provides for many general rules that are similar to those in Canada, such as filing tax returns, withholding obligations, audit and investigation, and penalties. These rules appear to be 'heavy handed' in favour of the government as opposed to 'guides' for taxpayers to comply with the law. These seem to lack a sense of treating taxation as a 'social' enterprise, that is, banks, financial institutions, other third parties, as well as tax advisers all play a role in operating the tax system.

3.6 Tax Disputes Resolution Process

3.6.1 Judicial and/or Administrative Processes

Disputes between taxpayers and the tax administration are resolved through administrative reviews and judicial appeals. In Canada, the majority of tax disputes are

¹¹⁸ See Hogg, Magee and Li, *Principles of Canadian Income Tax Law* (8th ed, 2013), Chapter 18.

¹¹⁹ Law of the People's Republic of China Concerning the Administration of Tax Collection (hereinafter '*the Tax Administration Law*'), adopted at the 27th meeting of the Standing Committee of the Seventh National People's Congress on 4 September 1992; amended in 1995, 2001; Implementation Regulations for the Tax Administration Law, effective as of 15 October 2002.

settled administratively, while a small percentage of disputes end up in court. In China, judicial review is rare and administrative review is the norm.

The system of the rule of law requires an independent judiciary that has exclusive jurisdiction over statutory interpretation, including the Constitution and tax statutes. In Canada, the courts' role is to interpret and apply the tax legislation as it was adopted by Parliament. Judges are not accountable to the government or Parliament. Judges regard themselves as 'arbiters' of the tax battlefield between the government and taxpayers: 'The role of the court is as arbitrator between the Minister and the taxpayer. We are the protectors of neither the public nor the private purse'.¹²⁰ Courts generally interpret tax statutes on the basis of the textual meaning and construct the facts in accordance with their legal form (as opposed to their economic substance). Only in GAAR cases, judges take on the 'unusual duty' of going behind the words of the legislation to determine the object, spirit or purpose of the provision or provisions relied on by the taxpayer.¹²¹ The origin of the Canadian judicial approach towards tax avoidance goes back to the *Duke of Westminster* (1935) case.¹²² This case established the principle that a taxpayer is entitled to arrange his or her affairs to minimise tax. This principle is derived from the strict or literal approach to statutory interpretation

¹²⁰ In tax cases, the government and the taxpayer are equal parties before the court.

¹²¹ In *Copthorne v R* (2011), Justice Rothstein further clarifies that: '[I]f the Court is confined to a consideration of the language of the provisions in question, without regard to their underlying rationale, it would seem inevitable that the GAAR would be rendered meaningless' : at [66].

¹²² *Commissioners of Inland Revenue v The Duke of Westminster* [1936] AC 1 (House of Lords): 'The facts in *Duke of Westminster* were straightforward. The Duke of Westminster had a number of household servants. The then British Income Tax Act did not allow a deduction of wages of household servants, but allowed a deduction of annual payments made in pursuance of a legal obligation other than remuneration of servants. The Duke accordingly entered into deeds of covenant with each of his servants under which he undertook to pay each of them annual sums for a period of seven years. The payments were to be made irrespective of whether any services were performed by the promisee, and were without prejudice to the promisee's entitlement to remuneration if he or she did perform any services to the promisor. However, it was established by evidence that the understanding between the Duke and his servants was that they would rest content with the provision made for them by deed, and would not assert any right to remuneration. In this way, the Duke converted his non-deductible wages obligation into a deductible annuity obligation. The deeds were legally effective in that all legal formalities had been carried out. Nor were the deeds shams: the Duke had covenanted to pay the annuities for seven years, and had thereby assumed the risk of having to continue to pay an annuitant who had stopped working for him or who had insisted upon additional remuneration for working for him. Of course, the understanding that the faithful retainers would continue to work for him, and would do so without extra charge, virtually eliminated this risk. But the risk was genuinely assumed, and none of their lordships regarded the deeds as shams. The legal form of the transactions was found controlling and the Duke was entitled to deduct the payments.'

and the characterisation of transactions based on legal form.¹²³ When the government loses a case in court, it can only reverse the decision prospectively through legislative amendment.

The Tax Court of Canada is a specialised court. Although based in Ottawa, the court hears cases in different locations across the country. There are two sets of procedures for the Tax Court. The informal procedures apply to cases involving a small amount and taxpayers do not need to have legal representation. The general procedures apply to other cases and require taxpayers be represented by a lawyer. The decision of the Tax Court is final unless the losing party appeals the decision to the Federal Court of Appeal. The Court of Appeal may overturn or uphold the decision of the Tax Court and its decision cannot be automatically appealed to the Supreme Court of Canada. A leave for appeal must be granted by the Supreme Court before a formal appeal is filed. The Supreme Court hears tax cases only when there is an issue of national importance.

In China, courts do not have the final power of statutory interpretation. The lawmaker is also the ‘legitimate’ interpreter. For example, the Constitution provides that the NPC has the power of interpretation regarding ‘laws’ and the State Council has the power to interpret ‘regulations’. Chinese courts adjudicate a small number of tax disputes that may shed some light on the meaning of tax legislation. Case law is not a source of law in China. In reality, the SAT has the actual power of interpretation that binds taxpayers. Courts generally hear administrative cases that involve taxpayers suing tax officials for their ‘misconduct’.¹²⁴ These cases are generally concerned with

¹²³ According to strict interpretation, tax could only be imposed if a taxpayer’s situation was literally covered by the words of a charging provision; and a taxpayer’s situation was determined by reference to the legal rights and obligations created by the taxpayer, not the economic substance. If, therefore, a taxpayer arranged the legal rights and obligations so that the statute did not literally apply, tax was avoided despite the fact that the arrangement, especially if construed in accordance with its economic substance, might have been within the spirit of the statute.

¹²⁴ The Administrative Procedure Law of the People’s Republic of China (adopted on 4 April 1989 at the Second Session of the Seventh National People’s Congress, effective 1 October 1990.) The SAT has issued guidelines to help local tax offices prepare for the defence, make arguments in court, file appeals and enforce court decisions. See Operational Guidelines on Responding to Tax Administrative Appeals (effective 1 January 1995), available at the SAT website.

actions in assessing penalties, enforcing collections, or other aspects of tax administration.¹²⁵

3.6.2 Role of Tax Professionals

Lawyers and accountants play an important role in the tax system. In Canada, lawyers may represent a client in a controversy with the CRA at the stage of audit, administrative appeal within the CRA, or in courts. In this context, the lawyer serves as an advocate. Among the duties and obligations, candour towards the tribunal and the duty of confidentiality to the client are particularly important. In tax litigation, as in other litigation, the lawyer's duties of honesty and candour require that the lawyer be scrupulous to never mislead his or her opponent or the court by misstating the facts or the law, or by failing to inform the court of a relevant authority. The failure to inform the court of a relevant authority is a breach of legal ethics, even if the authority is adverse to the client and has been overlooked by the opponent's lawyer. This is an example where the lawyer's obligation to the system trumps or mitigates his/her duty of loyalty to the client. Within these constraints, a lawyer is free to urge on behalf of the client any position that is fairly arguable, even if the lawyer regard that position as unmeritorious. In the role of an advocate (as opposed to an adviser), the lawyer is not asserting his or her opinion as to the correct legal position, but is simply submitting arguments on behalf of the client. The lawyer leaves the task of evaluating the strengths of competing arguments and of determining the correct legal position to the court. Traditionally, the ethical obligations of tax lawyers do not differ much from the ethical obligations of other lawyers. The same rules of professional conduct apply to the practice of tax law. In recent years, however, there has been a trend in Canada and

¹²⁵ For an empirical study of tax administrative cases in China, see Ji Li, 'Dare You Sue the Tax Collector! An Empirical Study of Administrative Lawsuits Against Tax Agencies in China' at <<http://ssrn.com/abstract=2256021>>.

elsewhere to impose additional obligations on tax practitioners, who by virtue of their expertise, are viewed as gatekeepers for the tax system.

In China, tax disputes are resolved primarily through administrative reviews as the courts play an insignificant role. Tax practitioners are primarily accountants and tax agents.¹²⁶ Lawyers are involved in tax practice in a more limited manner. Tax agents are required to ‘abide tax laws and regulations, to be independent and honest in their work, to safeguard state interest, and protect the lawful rights and interests of clients’.¹²⁷ Their duty to the state and duty to the client are parallel, although the former is expected to trump the latter in case of any conflict between the two. It is interesting to observe that a large tax agency firm, UniTax, states on its website in Chinese that its ‘enterprise tenet’ is to ‘serve for national tax, serve for taxpayer’, but the order was in their English translated website changed — to ‘serve for taxpayer, serve for national tax’.

3.7 Horizontal versus vertical relationships

Overall, the tax processes in Canada and other Western countries are more ‘collaborative’ and the Chinese processes tend to be top-down, dominated by the SAT. For example, in Canada, each of the tax institutions (legislature, judiciary, the CRA, and tax professionals) plays a role in developing tax law:

- The legislature formally enacts tax legislation and is the supreme body of law-making.
- The judiciary contributes to tax law development in at least three ways. First, courts clarify the meaning of statutory provisions through the exercise of

¹²⁶ SAT issued Interim Regulations on Tax Agents in September 1994; Interim Regulations on the Qualifications of Registered Tax Agents on 22 November 1996 (together with the Human Resources Ministry); and Interim Regulations on the Administration of Registered Tax Agency Firms, effective 1 February 2006. Registered tax agents and tax firms are emerging. Some tax firms, such as UniTax (<http://www.uni-tax.com>), are employing over 1,000 people and rendering tax services to some prominent clients. One of its founders, Mr Zhizhong Liu, has recently been appointed as a member of the Tax Appeals Review Committee of the SAT.

¹²⁷ Ibid. Art 19 of the Interim Regulations on the Administration of Registered Tax Agency Firms.

statutory interpretation. For example, the concept of ‘income’ has been interpreted by Canadian courts to exclude gambling winnings or gifts. Second, court decisions that are deemed incorrect are overruled through legislative amendment. Finally, some tax principles are well entrenched in the tax culture but not codified into tax statutes. These principles include: the right of taxpayers to arrange their affairs in any manner possible to minimise taxation, the characterisation of facts in accordance with the legal form, and that any ambiguity in a statutory provision should be interpreted in favour of the taxpayer.

- The CRA contributes to the development of tax law by participating in tax policy formulation, tax law drafting, and enforcing tax rules, especially the general anti-avoidance rule (GAAR).
- Tax professionals, especially tax planners and tax litigation lawyers, often push the limit of tax law by taking advantage of the ‘loopholes’ or advancing innovative positions on statutory interpretation. In court proceedings, lawyers representing the taxpayer provide the court with legal arguments to support their client’s case in a manner that is grounded in law and reasoning. In an adversarial system, the two parties battle to win the case, each acting as the adversary of the other. It provides a procedure for the parties to present and resolve their case, in as fairly a manner as possible. The court is thus presented with two sets of arguments and its decision is thus better informed than otherwise.

Before the law, taxpayers and the CRA are equal. Tax compliance and tax planning can be analogised to a card game. The CRA’s cards are all on the table, faced up; the taxpayer does not need to show his or her cards until the end of the game. In case of any disputes, the referee (i.e., the court) decides the winner. If the CRA does not like the cards or the decision of the referee, it must go back to the legislature for new cards or new rules of the game. The taxpayer and his or her tax advisors have opportunities to say if the new cards or new rules are fair. The game then continues.

4. Case Study of China’s Tax Transplants

The phenomenon of tax transplants in China discussed earlier confirms the validity of the theory that legal borrowing is a main source of legal change. This Part of the paper discusses some challenges in transplanting foreign tax laws into China and the

experiences drawn from the transplantation of two tax principles: progressive income tax and arm's length principle.

4.1 Processes of Transplantation

4.1.1 Selection

China has not transplanted an entire tax system or tax law from the West. It has always selected appropriate tax concepts, rules or principles that solve a specific tax problem and suit China's needs. Throughout Chinese history, there has been no Western religion, language, medicine or law that could displace the indigenous Chinese counterpart. For example, Western medicine co-exists with traditional Chinese medicine. Thus, foreign transplants must meet China's needs.

Potential candidates for transplants can be identified through various means, including research using print or online sources, in-country presentations by foreign experts, short-term study visits to foreign countries, officials studying in a foreign country for an extended period of time (including LLM in tax programs), and attending international tax conferences. Since it is often easier to find a specific rule or legislative provision (law on paper) than to find the rationale for such provision (the political or policy process) and how it is actually applied (administrative process and judicial process), what tends to be transplanted is the substantive rule.

4.1.2 Life Cycle

Whether a transplant meets China's needs depends on many factors. One of the factors is the 'life cycle' of the transplant. A tax system or tax idea may have a 'life cycle'. For example, it was suggested that progressive taxation becomes a concern at the early state of national economic development and becomes less pressing when a country

reaches a more mature phase.¹²⁸ A tax system undergoes changes at different stages of maturity. A tax norm that suits the need of a mature economic system may not be appropriate for an emerging economy.

China has transplanted tax norms from mature tax systems, whose specific context for introducing the norm and the stage of the ‘life cycle’ of the tax system differ significantly from that of China. For example, the general anti-avoidance rule (GAAR) was recently introduced in Australia (1981), Canada (1988), and the United States (2010), almost a century after the introduction of income tax, in order to counter aggressive tax planning structures that were held acceptable by the courts.¹²⁹ China introduced the GAAR as part of its consolidated Enterprise Income Tax Law (2007). Its motivations were different from, for example, that of Canada. To begin with, introduction of the GAAR was not in reaction to any adverse court decision. The main purpose of the GAAR is to combat ‘hidden’ or ‘unforeseeable’ tax avoidance transactions. ‘No matter how airtight the tax law system is, loopholes always exist’.¹³⁰ GAAR seems to mainly target cross-border transactions. Another possible motivation is ‘scientific’ drafting so that the law on paper looks comprehensive. Compared with the Canadian GAAR, the Chinese GAAR is primarily meant to be proactive, empowering the SAT to attack emerging aggressive tax planning transactions.

¹²⁸ Livingston, 2010, above n 3, 38.

¹²⁹ In Canada, the triggering court case is *Stuart Investments Ltd. v. The Queen* [1984] 1 S.C.R. 536. In that case, the taxpayer transferred the business losses of one subsidiary to another subsidiary for tax purposes through a series of transactions on paper. The Income Tax Act treats each corporation as a separate entity and does not generally allow a consolidation of losses between related companies. The taxpayer achieved consolidation by selling the profit-making business to the loss company and then appointing the profit-making company to manage the business as an agent. There are specific anti-avoidance rules, but the Supreme Court of Canada found these rules inapplicable. Furthermore, the Court relied on the number and variety of these specific anti-avoidance measures that were in existence at the time to buttress its conclusion that the Court of its own motion should not create a business purpose test that had not been enacted by Parliament. Since none of the specific anti-avoidance measures caught the situation in that case, the Court reasoned that it should not assume the power to disregard genuine legal arrangements simply because of their tax avoidance motivation. The lesson that the Department of Finance drew from the reasoning in *Stuart* was that the Income Tax Act ought to include a general anti-avoidance rule, which would cover such a broad range of tax avoidance activity that an unforeseen device such as that employed in *Stuart* would not fall through the cracks again. The GAAR was enacted as a “defensive” measure and as the last resort.

¹³⁰ SAT, Guidelines for Public Education of the Spirit of the New Enterprise Income Tax Law, Circular No 59, 5 Feb 2008, available at the SAT website: <[http:// www.chinatax.gov.cn](http://www.chinatax.gov.cn)>

The GAAR is used in mature tax systems to ‘invite’ the courts to play a more active role in protecting the tax base, but such use is currently not an issue in China — the life cycle of the GAAR is comparable, the life cycle of the tax system is not. As a result, the operation of the GAAR is bound to be different in China. An appreciation of the different processes that led to the enactment of the GAAR in Canada, US and Australia may shed more light on the application of the GAAR in China, especially with respect to multinational companies based in these countries.

4.1.3 Translation

One of the first steps of tax transplantation is to translate a foreign rule into Chinese.¹³¹ Anyone who speaks more than one language and has attempted translation can attest to the fact that it can be truly difficult, if possible at all, to achieve perfect translation. The criteria for ‘good’ translation include: a faithful reproduction of the information given in the source language text, correct, taking implicit factors and complementary information into account.¹³² Literal translation is generally not good enough. Faithful and correct translation requires more than linguistic skills.

Translation of foreign tax laws into Chinese imposes an additional layer of complexity because of the technical aspects. The translator should ideally have linguistic skills as well as tax knowledge. To do a good translation, the translator should ideally understand the context in which the tax norm is used. In other words, it is not just words that are translated, but the concepts or even the way of thinking. It cannot be denied that some concepts are not easy for translation. For example, both ‘tax equity’ and ‘tax fairness’ are translated into ‘*shui shou gong ping*’ (税收公平). The Chinese words ‘*gong*’ and ‘*ping*’ together imply justice and proportionality and not much of

¹³¹ Ibid.

¹³² See P Newmark, *About Translation* (Multilingual Matters Limited, 2nd ed, 1993), 162; S W Chan, *A Dictionary of Translation Technology* (Chinese University Press, 2004), 90; J Munday, *Introducing Translation Studies: Theories and Applications* (Routledge, 1st ed, 2001). [Please provide publisher details too. Thanks.]

procedural fairness as it was embedded in the English concept. Another term is ‘arm’s length’. The literal meaning of ‘arm’s length’ is to ‘the length of one’s arm’. ‘Arm’s length principle’ is translated into ‘独立交易原则’ (‘principle of independent transactions’) in Enterprise Income Tax Law, Article 41.

The translator may misread the source country or misunderstand its own country. Legal doctrines or institutions evolve and develop over time, often not in response to a particular objectively defined social need, but as a result of a complex interplay of social forces with different agendas.¹³³ Understanding the cultural context in its home country (often the United States) is important to the accuracy of the translation and the fate of the transplant in China. Because taxation is an important public policy instrument, it is by nature a field of contestation for different groups with radically differing goals. The final tax law reflects a compromise of various competing interests or an outcome of processes that may be unique to the source country. The lack of proper understanding of the different processes in China and the West may result in superficial translation.¹³⁴

4.1.4 Adaptation

The process of adopting foreign tax rules into domestic law and the process of ensuring the borrowed rules adapt to the local environment are related and critical to the success of tax transplants. Several considerations may be relevant. Presumably, adopting a foreign rule that has a good ‘genetic’ quality and fits well in more than one country, especially one that has some similarities with the Chinese environment, would have a better chance of adaptation in China. In the area of personal income tax, an example might be the jurisdictional principles that look at a person’s residence or the territorial source of income. Moreover, adopting a scheme of taxation as opposed

¹³³ D C Clark, ‘Lost in Translation? Corporate Legal Transplants in China’ (Public Law Research Paper No 213, George Washington University Law School, 10 July 2006) <<http://ssrn.com/abstract=913784>>.

¹³⁴ Ibid.

to a specific rule out of context would have a better chance of adaptation. Similarly, transplanting the necessary tax processes along with the substantive tax rules would facilitate the adaptation of the transplants.

The gap between law on paper and law in action is often determined by administrative conditions and institutional capacity. Tax rules that are sound in tax policy and work well in a developed country may not function well in China. One key condition is the compatibility of a transplanted rule with Chinese tax processes. For example, the progressive tax principle is most sensitive to local political and administrative processes, whereas the arm's length principle is less sensitive to political process, but very sensitive to administrative processes. On paper and in reality, China is successful in transplanting the arm's length principle, but not the progressive tax principle.

4.2 Progressive tax Principle

Progressive taxation is a fundamental Western principle of personal income taxation. Personal income tax is particularly adaptable to the graduated rates that makes it progressive. This is because taxpayers typically cannot shift the tax to others. It can be designed to take account of the personal circumstances of each taxpayer, and in particular the total amount of the taxpayer's income, his or her family circumstances, and other factors which bear on the taxpayer's ability to pay. That is why personal income tax is the only progressive tax in Western countries.

The idea is that tax burdens should be proportionate to the taxpayer's ability to pay reflects a society's sense of fairness.¹³⁵ Fairness is sometimes considered the glue of a democratic society.¹³⁶ It is a key issue to consider when designing a tax regime. Once

¹³⁵ 'The search for fairness is one of the most enduring of the shared goals of a civilized society': Brooks, above n 94, 6 (citing Douglas Hartle's remarks about the Royal Commission on Taxation created in 1962 to study tax reform in Canada).

¹³⁶ R M Bird and J S Wilke, 'Chapter 2: Tax Policy Objectives' in *Tax Policy in Canada*, above n 110, at 2:3.

a certain level of government spending and taxation is accepted, how the tax burden is shared among the taxpayers becomes the tax policy question. The benefit principle and the ability to pay principle provide some insights into thinking about the fairness question.

The benefit principle suggests that taxpayers contribute in proportion to the benefit they derive from the government. It assumes that taxes are the purchase of governmental services by taxpayers. In Canada, a person's ability to earn income depends to a substantial extent on a number of factors, such as the existence of a vibrant civil society, good legal system, health care, educational and public safety systems, and opportunities produced by a dynamic economy, which, in turn, depend on a sound legal system that defines and protects property rights and regulates the function of the markets.

The ability to pay principle suggests that contributions to the expenses of government should be apportioned so that each person 'shall feel neither more nor less inconvenience from his share of the payment than any other person experiences from his'.¹³⁷ This principle demands that persons with greater ability to pay tax do so at a higher rate. A person with a low income needs all or most of the income simply to survive. A person with a high income can provide for necessities and have a substantial amount left over. The taxpayer's ability to pay taxes is determined by the amount of income available for discretionary use. In general, the greater the total income, the higher the fraction of that income is available for discretionary use. The ability to pay principle dictates not merely that upper-income taxpayers should pay more dollars in tax than lower-income taxpayers, but that upper-income taxpayers should pay a greater proportion of their income in tax than lower-income taxpayers. This conclusion necessitates a progressive rate schedule.

¹³⁷ Mill, *Principles of Political Economy* (Longmans, Green, 1923), Bk 5, Ch 2, sec 2. (Note: Any publisher details available?)

The Western notion of fairness based on ability to pay or benefit theory does not have a natural fit in the Chinese culture. The Chinese tradition is derived from the Confucianism and from its assumptions about authority and hierarchy in social organisation.¹³⁸ The Confucian concept of *li* (propriety or virtue) dominated the regulation of social relationships and held that these were inherently unequal. The hierarchical social structures resulted from the *li* were deemed essential to the orderly existence of society. On the other hand, the inherent inequality of social relations was accepted as it proceeded from an assumption of the basic natural equality of men and that man was born with equal natural abilities and characteristics, and any achievement of status was deemed to be the result of superiority in acquired virtue.¹³⁹ In other words, higher social status can be earned through hard work, education and exam writing skills. During imperial China, the bureaucracy was open to men who passed the highly demanding examinations (*ke ju kao shi*) and higher-level positions were offered to higher scorers. Those who aspired to a career in the imperial service had to submit to three stages of gruelling tests conducted in specially built exam centres. It was the most able and most driven candidates who passed the examination.¹⁴⁰ In ancient times, the exams were virtually the only path to a privileged life for common people and that made the national *keju* competition extremely fierce. Once successful, power and perks accompany the position obtained. A old Chinese saying goes ‘*yi ren de dao, ji quan sheng tian*’ (When a man becomes an official, even his chickens and dogs receive privileges.) The society accepted the inequalities in social standing, economic wealth, and/or political power as natural and as merely the

¹³⁸ Potter, above n 105, 7.

¹³⁹ Ibid 8–9. See also D J Munro, *The Concept of Man in Contemporary China* (University of Michigan Press, Ann Arbor, 1977), 1-22.

¹⁴⁰ But with its strong emphasis on the Four Books and Five Classics of Confucianism, with their bewildering 431,286 characters to be memorised, and the rigidly stylised eight-legged essay introduced in 1487, it was an exam that rewarded conformity and caution. It was fiercely competitive, no doubt, but it was not the kind of competition that promotes innovation, much less the appetite for change. See N Ferguson, *Civilization: The West and the Rest* (The Penguin Press HC, 2011), at 43.

result of varying degrees of attained virtue.¹⁴¹ There was no popular demand for redistribution.

In contemporary China, the attitude towards tax equity and fairness has evolved. Until the economic reforms, income inequality was not a major concern. Income disparity started to grow after the adoption of the policy to ‘let some people become rich first’.¹⁴² Some people became rich through entrepreneurship, investment and speculative adventures. Some amassed wealth through rent seeking or profited from each wave of reforming/privatising state-owned enterprises or assets. Overall, it can be said that the main reason for the growing disparity is that income was earned through monopoly and illegal activities.¹⁴³ There has been a growing public resentment of such disparity. And yet, the official policy of allowing some people to become rich first is at odds with progressive taxation. The Chinese Individual Income Tax is progressive only with respect to wages, salaries and income from private businesses. It does not capture grey income arising from rent seeking, illegal income or income from the informal sector. There is no clear consensus or a political process for developing such consensus on the ways of improving equity and fairness.

Progressive tax rates were part of the new Individual Income Tax Law introduced in 1980. The political process that resulted in progressive taxation in the West was not transplanted, for obvious reasons. The administrative processes to ensure reporting and paying progressive taxes by individuals were not transplanted. Instead of self-assessment, reinforced by third-party information reporting of income and source withholding of taxes, the Chinese Individual Income Tax relies on final withholding of taxes on a payment-by-payment basis, which makes it impossible to impose tax based on the ability to pay. There is also strong social support for the collection of this tax as

¹⁴¹ Potter, above n 105, 9.

¹⁴² Attributable to Deng Xiaoping, the leader of China who started the economic reforms in the late 1970s.

¹⁴³ Liu, above n 65, 138.

banks, institutions and payers [this is right and understandable by our readers]of investment income (such as corporations) are not legally required to assist the government in collecting the tax. As a result, although it has been part of the Chinese tax system since the inception of the modern tax system, the progressive tax principle has not taken root in China.¹⁴⁴

4.3 Arm's Length Principle

The arm's length principle is a widely adopted principle that deals with the problem of transfer pricing. Transfer pricing refers to practices of multinational corporations to price their intra-group transactions prices in order to minimise their global tax liability.¹⁴⁵ The arm's length principle is found in the tax laws of OECD countries and many developing countries. The OECD Transfer Pricing Guidelines are regarded as standard guidelines. These Guidelines provide detailed commentaries and guidance on the meaning of the arm's length principle, the methodologies for determining the arm's length price, and processes for diagnosing transfer pricing problems, procedures for documenting and reporting information by taxpayers, processes for negotiating advance pricing agreements, and the process of resolving tax disputes. The CRA has incorporated these guidelines into its administrative policies in administering section 247 of the *Income Tax Act*.¹⁴⁶

The arm's length principle was not introduced in China until 1988, even though the first corporate income tax was introduced in 1980.¹⁴⁷ It was codified into law in

¹⁴⁴ For further discussion, see R Krever and H Zhang, 'Progressive Income Taxation and Urban Individual Income Inequality' (2011) *Asia-Pacific Tax Bulletin* 192; Jinyan Li, 'China's Individual Income Tax: A 26-Year-Old Infant' (2006) *Tax Notes International* 297; Liu, above n 65.

¹⁴⁵ Organisation for Economic Cooperation and Development (OECD), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) (the 'OECD Guidelines') <<http://www.oecd.org/ctp/transfer-pricing/transfer-pricing-guidelines.htm>>.

¹⁴⁶ Canadian Revenue Agency, *Information Circular, IC87-2R International Transfer Pricing* (27 September 1999) <<http://www.cra-arc.gc.ca/E/pub/tp/ic87-2r/>>.

¹⁴⁷ Supra note 15. [Which reference in footnote 15? Please clarify] – there is only one A Easson and J Li, 'Taxation of Foreign Business and Investment in the People's Republic of China' (1985–1986) *New Jersey International Law & Business* 666

1991.¹⁴⁸ Almost simultaneously, the SAT issued interpretation circulars to provide more details on the implementation of the arm's length principle.¹⁴⁹ Following several years of experience with transfer pricing, the SAT revised the transfer pricing circular in 1998 — 'Tax Administration Rules and Procedures for Transactions between Associated Enterprises' (Trial).¹⁵⁰ The revised circular marked the beginning of China's transfer pricing administration system.¹⁵¹ It incorporated much of the OECD Transfer Pricing Guidelines and reflected some of the best practices in other countries. In 2004, the SAT further revised the transfer pricing circular¹⁵² and released a new circular on APAs — 'Implementation Rules for Advance Pricing Agreements Governing Transactions between Related Enterprises (Trial)'.¹⁵³ The year 2004 was known in China as the year of anti-avoidance.¹⁵⁴ In 2005, the SAT established a national anti-avoidance case monitoring and management system.¹⁵⁵ The arm's length principle was included in the current Enterprise Income Tax Law (EIT Law) and the Implementation Regulations, promulgated in 2007.¹⁵⁶ The SAT issued a revised, more detailed circular specifying the methodologies and processes for implementing the

¹⁴⁸ *Law of the People's Republic of China Concerning the Administration of Tax Collection*, adopted at the 27th meeting of the Standing Committee of the Seventh National People's Congress on 4 September 1992; amended in 1995, 2001; Implementation Regulations for the Tax Administration Law, effective as of 15 October 2002.

¹⁴⁹ In 1992, the tax authorities published a circular entitled 'The Implementation Measures for the Tax Administration of Transactions between Associated Enterprises' (*Guo Shui Fa* No 237 (1992)), to explain the standards for the identification of associated enterprises, annual information to be reported and other fundamental issues.

¹⁵⁰ *Guo Shui Fa* No 59 (1998) (hereinafter 'the 1998 Transfer Pricing Circular'). This circular was comprised of 52 articles which are organized in 12 chapters. In October 2002, the State Council introduced Implementation Rules for Tax Collection and Administration Law, Articles 51 to 56 of which provide detailed rules for transfer pricing, which incorporated many provisions in the 1998 Transfer Pricing Circular.

¹⁵¹ For a rather detailed account of the history of the Chinese transfer pricing system, see *Transfer Pricing Tax System and Its Development in China*, which was purportedly prepared by the State Administration of Taxation, online: <<http://www.rrojasdatabank.info/chinatprice02.pdf>> (hereinafter '*the Unofficial SAT Document on Transfer Pricing*').

¹⁵² SAT Circular, *Guo Shui Fa* No 143 (2004).

¹⁵³ SAT Circular, *Guo Shui Fa* No 118 (2004).

¹⁵⁴ *China Tax News* (2 September 2009).

¹⁵⁵ *Ibid.* By the end of 2007, 174 taxpayers had been subjected to transfer pricing audits, 152 of which had been reassessed, resulting in over RMB1.2 billion.

¹⁵⁶ EIT Law, above n 19.

arm's length principle — 'Measures for the Implementation of Special Tax Adjustment (Trial)' (2009). These Measures largely track the OECD Guidelines.¹⁵⁷

Judging by the volume of rules and procedures introduced by the SAT and the near complete 'transplantation' of the OECD Guidelines, the Chinese transplantation of the arm's length principle is a huge success. In fact, the Chinese SAT has become very sophisticated in implementing the arm's length principle and recently begun to play a role in further refinement of principle through the work of the United Nations.¹⁵⁸ As such, judging by the gap between the transplanted law on paper and the law in reaction, the Chinese transplantation of the arm's length principle is also successful.

Unlike the transplantation of the progressive tax principle, the transplantation of the arm's length principle is less dependent on the political process. Securing a fair share of the profit of multinational corporations for Chinese tax purposes serves China's national interest. In order to secure China's 'fair' share of global profit, China needs to follow the international norms that are defined by the OECD and followed by other countries. Chinese traditional values and culture are less relevant to the transplantation of the arm's length principle and its associated processes because the problem of transfer pricing is new and solutions could not be home-grown. Moreover, because the arm's length principle relies on effective administrative processes for implementation, it 'fits' with the strong bureaucratic tradition in China. It is the transplantation of the processes that ensures the successful transplantation of the arm's length principle.

5. Conclusions

This paper teases out some arguments about the importance of process in tax transplants. Because processes are arguably sensitive to local political, socio-legal and

¹⁵⁷ See Explanation of the EIT Regulations published on SAT's website: <<http://www.chinatax.gov.cn>>.

¹⁵⁸ United Nations, *Transfer Pricing Manual* — China (2012)
<http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf>.

economic conditions of a country, it is imperative that they are taken into consideration in the process of tax transplants. To the extent possible, the transplantation of substantive rules, principles or norms should be accompanied by transplanting the necessary processes. Alternatively, the recipient country should beware of the demands for processes of the transplanted tax law and strive to create the necessary processes to ensure its adaptation. The correct selection and translation of Western tax laws is a precondition to successful transplants.

In terms of contribution to literature, this paper singles out tax processes as a key factor that affects the success of tax transplants. The case study of the Chinese tax transplants builds on existing literature on the theories of legal transplants and on the unique features of tax transplants. This paper adds to existing literature by demonstrating that the apparent convergence in tax law (e.g., progressive tax principle and arm's length principle) in Canada and China does not mean convergence in reality, owing to different tax processes. The paper also contributes to literature by demonstrating that tax processes are the product of local political, socio-legal culture. If a transplanted tax principle or rule is accompanied with a transplant of the associated processes, it has a greater chance of success in the recipient country.

Research for this paper has several limitations. One limitation is the lack of any standard to measure the success of the Chinese transplantation of progressive tax principle or the arm's length principle. The paper relies, instead, on presumptive evidence, such as the extent of legislative and administrative rules. The other limitation is the lack of empirical evidence that links the effectiveness of tax transplants to tax processes. Hopefully, these drawbacks can be remedied by further research.

Fair Competition and Preferential Taxation Policy for Small & Medium Retail Stores in China: A Comparative Study

By Dr George Tian^{}*

Introduction

In recent years, the use of slotting allowances and other shelf-access payments by retail stores and supermarkets has reportedly increased in China. Many Chinese commentators criticised such conduct as significantly distorting the fair competition order in the retail market and harming the legitimate benefits of consumers, suppliers and small-medium retailers in China.¹

Chinese governmental agencies have attempted to eliminate slotting allowances by launching national campaigns to investigate and crack down on the illegal conduct of large-scale retailers against suppliers.² However, it is still not clear whether government intervention is the most appropriate and effective solution. After several campaigns, it seems that the slotting fee problem still exists. Indeed, slotting

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¹靳博, 贺林平 [Jin Bo and Linping He], 聚焦超市乱收费: 一筒薯片六成利润被超市拿走 ——大型超市收费现状调查 [Focusing on arbitrary charges by the supermarket: 60 per cent of the profits from a tube of potato chips are taken away by supermarkets – a Survey on Charges by Large-scale Supermarkets], 人民日报 The People Daily (online), 1 February 2012 <<http://finance.people.com.cn/GB/16985496.html>>; David Dai and Lawrence Hu, 'China Cracks Down on Supermarket Charges by Large-Scale Retailers', *McDermott Will & Emery Web* (online), 13 March 2012, <<http://www.mwe.com/China-Cracks-Down-on-Supermarket-Charges-by-Large-Scale-Retailers-03-13-2012/?PublicationTypes=d9093adb-e95d-4f19-819a-f0bb5170ab6d>>.

² As a recent response, five Chinese government agencies — the State Administration of Taxation, China's Ministry of Commerce, the National Development and Reform Commission, the Ministry of Public Security, and the State Administration of Industry and Commerce — launched a nationwide campaign to investigate and crack down on the illegal conducts of large-scale retailers against suppliers from December 2011 to June 2012. Dai and Hu, above n 2.

allowances have been a very controversial issue around the world. It remains a debatable question whether competition law is the best instrument to resolve the slotting allowance issue.³

This paper examines whether preferential taxation policy for SME retail stores could serve as an alternative solution for the slotting allowances issue in China. Part I examines the status quo of supermarket slotting allowances in China and Part II compares this with similar practices in other jurisdictions — particularly in the United States (the US) — by examining both the benefits and the harms of slotting fees. Part III examines the disadvantageous situations of SME retailers and suppliers in the Chinese retail market and explores the main reasons and rationales for them. It further considers the major problems with the existing laws and policies on slotting fees and the SMESME businesses in China, focusing in particular on the problems with the current taxation system. Part IV and Part V compare and critically reflect on how other countries use special laws or taxation policies to help promote the development of SME enterprises and to contribute to the resolution of slotting fee issues. By extracting lessons from the relevant laws and policies in Germany, Japan, the United Kingdom (UK) and the Hong Kong Special Administrative Region of China (HK), the paper provides some practical suggestions for future law and policy reforms. Finally, it concludes that a more heterogeneous approach should be taken and that it is important to make competition law and taxation policy work collaboratively to solve these problems.

³ Kenneth Kelly, 'The Antitrust Analysis of Grocery Slotting Allowances: The Pro-Competitive Case' (1991) 10(1) *Journal of Public Policy & Marketing*, 187.

Part I: Slotting Allowances – Existing Situations in China

1.1 Definition and major forms of slotting allowance

While there is no standard definition of the term ‘slotting allowance’, it can be narrowly defined as ‘a one-time, lump-sum payment to a retailer by a supplier in exchange for which the retailer allocates retail space for the supplier’s product, which are often new products’.⁴ In practice, this term has been used to cover a wide range of payments by suppliers to retailers. In China, increasing numbers of large-scale retailers have taken advantage of their dominant market positions, and imposed ‘more and more slotting fees’ on suppliers, particularly on SME suppliers who do not have strong bargaining power. Some typical forms of fees include:

- festival fees,
- new opening fees,
- decoration fees,
- bar-code fees,
- contract re-signing fees,
- information fees,⁵
- store-entry fees,
- sales bonus returns

1.2 Costs of slotting allowances

As an illustrative example of slotting allowances, a recent survey shows that a supplier who sells potato chip tubes to a foreign- owned supermarket in Tianjin has to pay various fees in order to obtain retail space for his products. These fees include:

- store-entry fees (one-off payment) 50,000 CNY (8,333 USD),
- promotion management fees 50,000 CNY (8,333 USD),

⁴ Edward C LaRose and Patrick J Poff, ‘Slotting Allowances and the Emerging Antitrust Enforcement Debate’ (2000) LXXIV(10) *The Florida Bar Journal* 42. Moreover, the 2001 FTC Report indicated that the term (slotting fees) has been used to describe ‘a lump-sum fee paid for new product introduction’. Saskia Kim, *Background Paper — Shelf-Access Payment: Slotting Fees, Pay-to-Stay Fees and Exclusivity Deals* (7 January 2005) Senate Office of Research, <<http://sor.govoffice3.com/vertical/Sites/%7B3BDD1595-792B-4D20-8D44-626EF05648C7%7D/uploads/%7B56E4C129-EACC-41D1-B575-86A0E6692716%7D.PDF.>>

⁵ Dai and Hu, above n 2.

- festival fees 30,000 CNY (5,000 USD),
- new opening fees 10,000 CNY (1,667 USD),
- bar-code fees 5,000 CNY (833 USD),
- end-year bonus 150,000 CNY (25,000 USD) at least, and
- other fees, about 50,000 CNY (8,333 USD).⁶

This means that in order to sell a tube of potato chips (valued at ten CNY), the supplier has to pay at least three CNY to the supermarket, which amounts to 60 per cent of his total profits.⁷ Further, in order to obtain preferential display space for their products, suppliers often have to offer a ‘red packet’ (hidden fees or bribes) to the supermarkets’ internal staff.⁸

Moreover, according to the information provided by a staff member working for the purchasing division of a Korean-owned large supermarket, supermarket charges (slotting allowances) are not a ‘hidden rule’ any more. All fees for suppliers have now been explicitly written in the mutual agreements between retailers and suppliers.⁹ Generally speaking, the store-entry fee (payment for a product to be carried in the store) for each brand in a large supermarket is around 30,000-50,000 CNY (around 5,000 – 8,333 USD). In comparison, the store entry fee in a small supermarket is around 5,000-10,000 CNY (833 – 1,667 USD).

In addition to these various types of slotting fees, supermarkets often impose a mandatory ‘*sales bonus return*’ provision in their contracts with suppliers, which is a major way for them to gain profits. For example, a mutual contract may require a supplier to meet an annual sales goal of 10 million CNY (1.6 million USD), and to return a ‘safe bonus’ amount worth 15 per cent of its planned annual sales – 1.5 million CNY (250,000 USD) – to the supermarket regardless of whether that goal is achieved or not. Some contracts may contain even tougher provisions and provide for

⁶ Jin and He, above n 2.

⁷ Ibid.

⁸ Ibid.

⁹ Ibid.

a monetary penalty, which amounts to three per cent of the planned annual sales, in cases where the annual sales goal is not achieved.¹⁰

1.3 Comments and remarks

High slotting allowances may create entry barriers, which affect small suppliers in particular. Therefore, many Chinese commentators have criticised ‘large retailers for *abusing their market power* to maximise their commercial interests’, and that such abusive conduct has ‘*significantly distorted the fair competition order* in the Chinese retail market’, harming ‘the legitimate interest of consumers, suppliers and SME retailers’ in China.¹¹ These criticisms seem to represent the mainstream views on the likely effects of slotting allowance practices in China as slotting fees are anti-competitive in nature and should be banned. The recent national campaigns, which were launched against slotting fees, seem to have reaffirmed such mainstream views.¹² For example, from December 2011 to June 2012, five Chinese government agencies – the State Administration of Taxation (SAT), the Ministry of Commerce (MOFCOM), the National Development and Reform Commission (NDRC), the State Administration of Industry and Commerce (SAIC), and the Ministry of Public Security (MPS), launched a nationwide campaign to investigate and crack down on the illegal conducts of large-scale retailers against suppliers. These campaigns mainly aim to punish large-scale supermarkets that obtained monopolistic profits by misusing their comparative advantages/market power.¹³

¹⁰ Ibid.

¹¹ Ibid; 崔鹏[Cui Peng], 《商务部市场秩序司负责人回应: 禁止滥用市场优势地位乱收费》 [Responses from the director of the Market Order Division of the Ministry of Commerce: Stop abusing the dominant market position to charge illegal fees] 人民日报 *The People Daily* (online) 2 February 2012 <<http://finance.people.com.cn/GB/17061426.html>>.

¹² Dai and Hu, above n 2.

¹³ Ibid.

However, it is noteworthy that the survey results and national actions introduced above may not be sufficient to support the mainstream views on the anti-competition-nature of slotting fees. Firstly, although the surveys introduced above provided some typical examples of the seriousness of the slotting allowance issue in China and its potential impacts on the Chinese suppliers and consumers, it seems that these surveys were mainly conducted by journalists or consumer protection groups. The voice from retailers — particularly large retailers — seem to be absent from such surveys. As such, these surveys may not necessarily be able to precisely reflect the true situation of the Chinese retail market as a whole.

Secondly, although a few nationwide campaigns against slotting allowances were launched, it seems that the Chinese competition law enforcement agencies have not yet conducted any systemic investigation on the nature of slotting fees and their potential impacts on the competition order of the Chinese retail market — more details to be introduced in later sessions). These campaigns were mainly launched through joint administrative decisions, and were not a result of the enforcement of competition law. Thus, it seems that it is still too early to conclude whether various slotting allowance and related payment arrangements are all anti-competitive in nature.

Part II: Benefits and Harms of Slotting Allowances on Competition

2.1 Benefits and Costs Analysis by the FTC

As introduced above, the slotting allowance issue is also relevant in a global context.¹⁴ It has also been a controversial issue in the US since the 1990s. The US competition

¹⁴ For example, the slotting fee practices in Canada were discussed in Subrata Bhattacharjee and Gregory Sullivan, 'The Treatment of Slotting Allowances and Category Management under Canadian Competition Law' (Paper presented at the British Institute of International & Comparative Law Practitioner Workshop, London, 25 October 2005); Emek Basker and Michael Noel, *White Paper: Competition Challenges in the Supermarket Sector with an Application to Latin American Markets*, prepared for the Regional Competition Center for Latin America under the World Bank-Bank-Netherlands Partnership Program, *Strengthening Competition Policy in Latin American Countries*

law enforcement agency, the Federal Trade Commission (FTC), conducted a systemic investigation into the potential pro- or anti- competition nature of slotting allowances and related payments by suppliers to retailers.

In May 2000, the FTC sponsored a public workshop on the antitrust implications of slotting allowances in the grocery industry.¹⁵ In this workshop, the FTC brought together different stakeholders to assist the agency in its undertaking of the shelf-access practice and included representatives of large chain retailers, small retailers, wholesalers, small manufacturers and others familiar with the grocery industry.¹⁶

Following the workshop, the FTC issued a *Report on the FTC Workshop on Slotting Allowances and Other Marketing Practices in the Grocery Industry* in February 2001 (*FTC Report 2001*),¹⁷ which provided ‘an analytical framework for future antitrust scrutiny of these practices in retail industries’.¹⁸ Furthermore, in November 2003, the FTC issued a follow-up case study entitled *Slotting Allowances in the Retail Grocery Industry: Selected Case Studies in Five Product Categories* (2003 FTC Case Study).

Put simply, the views of various stakeholders can be divided into two distinct schools of thought: the ‘Market Power School’ and the ‘Efficiency School’.¹⁹ Those in the ‘Market Power School’ see slotting allowances as ‘an anti-competitive tool used by dominant suppliers to preclude smaller competitors from bringing new products to

(December 2012); this white paper details competition challenges in the supermarket sector, drawing on cases and experiences worldwide, including the US, the UK, Australia, Germany, Mexico, Chile, Colombia, Argentina, and other countries.

¹⁵ LaRose and Poff, above n 5, ‘Background’ session.

¹⁶ Kim, above n 5, 1. See also LaRose and Poff, above n 5, 42: ‘On April 14, 2000, three trade groups concerned with the potential anti-competitive aspects of slotting allowances, the Independent Bakers Association, the Tortilla Industry Association, and the National Association of Chewing Gum Manufacturers (collectively “petitioners”), jointly asked the FTC for the issuance and enforcement of industry guidelines to govern slotting allowances in the grocery industry’.

¹⁷ Kim, above n 5, 1: ‘This report summarized the information presented at the workshop and identified areas where additional information was needed to better understand these practices’.

¹⁸ LaRose and Poff, above n 5, ‘Background’ session.

¹⁹ *Ibid.*

market'.²⁰ They contended that the competition law enforcement authority should issue and enforce 'industry guidelines to govern slotting allowances in the grocery industry'.²¹

Proponents of the 'Efficiency School' see slotting allowances as 'an effective way to promote product innovation and to allocate risks and retail start-up costs between retailers and suppliers'.²² They contend that slotting fees are 'neither always benign nor always anti-competitive'²³, see 'no competitive harm flowing from slotting allowances' and view 'guidelines or a tougher government enforcement approach as detrimental to a legitimate form of promotional spending'.²⁴ Moreover, they contend that the current FTC enforcement schemes are sufficient to address minor abuses of slotting fees, and that 'the FTC's *Fred Meyer Guides* have already provided practical guidance on how to comply with terms of the *Robinson-Patman Act*, which relate to slotting allowances'.²⁵ As such, any tougher guidelines are 'unnecessary, unworkable and anti-competitive'²⁶ within this school of thought.

The FTC eventually decided that no further detailed guidelines on slotting fees would be issued before a more sophisticated investigation has collected persuasive evidence or is complete.

2.2 Comments and Remarks

The FTC's experiences with the slotting fees issue are arguably valuable for their Chinese counterparts attempting to address similar issues. However, when drawing on

²⁰ Kim, above n 5, 1 (The FTC found that 'some view as anti-competitive and others view as enhancing efficiencies in the market place').

²¹ LaRose and Poff, above n 5, 'Market Power School v Efficiency School' session.

²² Kim, above n 5, 1.

²³ *Ibid.*

²⁴ LaRose and Poff, above n 5, the text between footnotes 49–51.

²⁵ *Ibid.*

²⁶ *Ibid.*, the text between footnotes 48–9.

lessons from the experiences of the US, China does need to take into account its own specific situations.

Firstly, like the US FTC, Chinese governmental authorities should be a bit more careful and cautious before initiating any nationwide actions against slotting fees. It is necessary to examine the true nature of slotting allowance arrangements in China in a more systemic way. Given the variety of slotting fees and the complexity of market structures, not every slotting allowance arrangement definitely harms the competition order in the Chinese market. If an arrangement is not anti-competitive in nature, a governmental intervention may harm rather than promote the competition order in and the efficiency of the Chinese market.

Secondly, although the FTC eventually decided that no further detailed guidelines on slotting fees were necessary, China may still need to strengthen its domestic law-making in this area. It is noteworthy that the pre-condition of the FTC's decision is that the US already has (1) the *Robinson-Patman Act* (RPA) which was originally designed to protect S&E businesses and (2) the FTC's *Fred Meyer Guides* which provided practical guidance on complying with the *Robinson-Patman Act* when dealing with slotting allowances. By contrast, the Chinese *Anti-Monopoly Law 2008* (AML) does not contain any RPA-style provision which is particularly designed to protect SME stores. Further, the Chinese competition law enforcement agencies have not issued any detailed guidelines on the AML compliance relating to slotting fees.

Part III: The Disadvantages For SME Businesses & the Reasons Behind Them

3.1 Lack of Regulations & Disadvantageous Situation of Suppliers

In China, only a few ministerial regulations, such as the Administrative Measures for Fair Transactions between Retailers and Suppliers (2006), and the Administrative Measures for the Sales Promotion Acts of Retailers (2006), directly govern the relationship between retailers and suppliers. The level of legal protection is relatively low, and the level of penalty is inadequate.²⁷ As mentioned above, there is also no competition regulation that specifically addresses this issue.

As some commentators noted,

“[i]n the absence of regulation at first inception, Supermarket Charges were justified by mutual agreements between retailers and suppliers. However, given the dominant market powers of large-scale retailers, more and more slotting fees, in the name of festival fees, new opening fees, decoration fees, bar-code fees, contract re-signing fees, information fees and so on, are being imposed on suppliers, particularly small and medium suppliers who do not have the bargaining power to stand up for their own rights.”²⁸

Indeed, the absence of regulation and the dominant position of large-scale retailers have arguably put suppliers, particularly the SME suppliers, in a very difficult situation. Traditionally, most suppliers in China are small and medium enterprises (SMEs), which produce similar products. They often compete against each other intensively, and it is difficult for them to form a strong industrial alliance. The

²⁷ 崔鹏[Cui Peng], above n 12. See also Lisa Hui, 'Slotting Fees Hit Suppliers', *China Foreign Trade* (online), 19 October 2011 <<http://cib.shangbao.net.cn/c/59664.html>>, which stated: '[t]he regulations' failure, which has been blamed on high investigation and redress costs as well as low fines, has finally forced the government's hand'.

²⁸ See Dai and Hu, above n 2.

development of supplier associations or unions in China is slow, and they do not have a strong voice yet.²⁹ This has arguably intensified the disadvantageous situation that suppliers find themselves in when bargaining with large-scale retailers.

3.2 Current Taxation Regime vs. Disadvantageous Situation of SME Retailers

In a fully competitive market, suppliers would have numerous options to trade with various SME retailers, which would have fewer bargaining powers and charge less (or no) slotting fees. However, the current Chinese taxation regime sets up a high barrier for SME retailers to enter the retail market.³⁰

Generally speaking, the tax rate of the commodity trading industry is higher than those of other industries in China. Based on the data provided by the China Chain Store & Franchise Association (CCFA), the tax rate of the Chinese commodity trading industry is around 26.4 per cent, which is 4.6 per cent higher than that of the real estate industry, 5.8 per cent higher than that of the financial and insurance industry, and 13.6 per cent higher than the information communication industry.³¹ As a result, many retailers have attempted to reduce their costs by charging more slotting fees (in order to avoid high tax).

More specifically, under the current taxation regime in China, retailers only need to pay their business tax (BT) (3 per cent) for the collected slotting fees.³² But, for profits obtained from product sales, retailers need to pay the value-added tax (VAT) (6%-

²⁹ 崔鹏[Cui Peng], above n 12.

³⁰ Ibid.

³¹ Ibid.

³² PWC, *Overview of PRC Taxation System*

<http://www.pwccn.com/home/eng/prctax_corp_overview_taxation.html>: 'Business tax applies to the provision of services (excluding processing services and repair and replacement services), the transfer of intangible properties and the sale of real estate properties in China'.

11%), which is higher than the rate of the BT.³³ As a result, retailers are inclined to charge more slotting fees rather than obtain profits through product sales.³⁴

In comparison with other jurisdictions, the tax burden for SMEs in China is arguably too high. According to a recent survey conducted by Beijing National Accounting Institute, the average tax rate for SMEs could reach more than 40 per cent, and 'high tax burden has even replaced financing to become the top problem for SMEs in 2013'.³⁵ As the Chinese University of Hong Kong (CUHK) Economics Professor Lang noted, the current business registration procedures and the required taxation items for opening a grocery store are as complicated as those opening a department store in China.³⁶ A grocery store needs to pay no less than 15 types of tax or fee. Examples include the business tax (5 per cent); the VAT (4 to 7 per cent), the urban and township construction tax (7 per cent of the sum of business tax and VAT), the local education fee (3 per cent of the sum of business tax and VAT), the local education fee (the rate is 2 per cent of the sum of business tax and VAT), the stamp tax, the urban and township land use tax and so forth.³⁷ It is the same as what a large-scale department store would need to pay.

In addition, it may need to pay some other fees upon specific circumstances, such as the SAIC fee, and the Culture Bureau examination and approval fee.³⁸ Thus, it is clear that the current taxation regime has set a high bar for SMEs to access the Chinese

³³ Ibid: 'Value-added tax applies to the sale of goods, except real estate properties, and the provision of labour services in relation to the processing of goods and repair and replacement services within China'.

³⁴ 崔鹏[Cui Peng], above n 12.

³⁵ 'Increasing Tax Burden Becomes Chinese SMEs' Top Concern, Survey Shows', *Caijing* (online), 3 May 2013 <<http://english.caijing.com.cn/2013-05-03/112737668.html>>.

³⁶ 郎咸平 Lang Xianping, 谁摧毁了中国的个体零售业, 'Who Destroyed Individual Retail Industry in China', 国际财经时报 *International Business Times* (online), 29 June 2012 <<http://finance.irj.com.cn/opinion/2012/07/19101513846467-5.shtml>>.

³⁷ Ibid.

³⁸ Ibid. (It further stated that 'for franchise businesses (such as salt, tobacco, wine and medicine), in addition to paying relevant fees, special registration and recording processes of the Public Security Bureau need to be followed'.)

retail market with its barriers to entry which is not amenable to the maintenance of a sound competition environment in China.

Part IV: Possible Solutions - Lessons from other Countries and Regions

4.1 Preferential Tax Policy for SMEs

As suggested above, governmental interventions (national campaigns) may not be the most effective and sustainable method to combat slotting allowances. Although competition law may serve as a useful instrument against slotting fees in the long term, the required amendments to Chinese competition law and the issuance of relevant enforcement guidelines/regulations cannot be achieved overnight. Thus, during the interim period, the government could consider addressing the slotting fee issue by reforming the existing taxation policy to create a better policy and legal environment for SMEs to more easily access and thrive in the retail market.

4.1.1 The HK Approach

The HK serves as a sound example. As we know, there are widespread small shops and grocery stores in its Central Business District (CBD) and other residential areas. This can be mainly accredited to the readiness of its business registration regime and taxation regime. Unlike in mainland China (where there are at least 15 types of tax), retail stores in HK only need to pay two types of tax: (1) stamp tax, which amounts to 0.1 per cent of the registered capital of its business; and (2) profit tax, which amounts to 17 per cent of its profits.³⁹

³⁹ The Government of the Hong Kong Special Administration Region Inland Revenue Department, *Profit Tax* (28 June 2013) <http://www.ird.gov.hk/eng/tax/bus_pft.htm#a01>: 'Persons, including corporations,

Regarding the profit tax, the assessable profits are ‘the net profits (or loss) [other than profits (or loss) arising from the sale of capital assets] for the basis period, arising in or derived from Hong Kong’.⁴⁰ In other words, a business does not need to pay the profit tax if its ‘net profits’ are negative. In contrast, grocery stores in Mainland China need to pay at least 15 types of tax or fees (as alluded to above). Even if their net profits are negative, they still need to pay various taxes and fees. It is clear that the market entry level for SMEs in mainland China is much higher than that in Hong Kong. It is therefore very hard for SMEs, particularly newly-established retail stores, to enter the market and compete with existing large-scale retailers.

However, this approach is not limited to Hong Kong; it seems that it has become an international tendency to apply low tax to SMEs. For example, nine European Community (EC) member countries apply a low VAT (with a tax rate of 5 per cent), including Belgium, Greece, Spain, France, Italy, the UK, Luxembourg, Netherland, and Portugal.⁴¹

4.1.2 Possible Solutions

China’s policy makers may consider reducing the bar of retail market entry by applying a more preferential tax policy for SMEs. This would not only enhance the development of the SMEs, but also give suppliers more power to choose their trading partners. They can elect to trade with SME retailers, which have less bargaining power and charge less (or no) slotting fees, in favour of large-scale supermarkets.

partnerships, trustees and bodies of persons carrying on any trade, profession or business in Hong Kong are chargeable to tax on all profits (excluding profits arising from the sale of capital assets) arising in or derived from Hong Kong from such trade, profession or business’.

⁴⁰ Ibid. ‘The Assessable Profits (or Adjusted Loss) are the net profits (or loss) [other than profits (or loss) arising from the sale of capital assets] for the basis period, arising in or derived from Hong Kong, calculated in accordance with the provisions of Part IV of the IRO’.

⁴¹ 郎咸平 Lang Xianping, 税改需要灵魂 ‘Soul of Tax Reform’, 理财周刊 *Money Weekly* (online), November 2011 <<http://finance.eastmoney.com/news/1371,20111114176147727.html>>.

More specifically in the first instance, the Chinese policy makers could, as one commentator suggested, consider simplifying the registration procedures for SMEs, and reduce or waive some taxes that SME retail stores have to pay.⁴² Instead of maintaining 15 types of tax, the government could require SME stores to only pay the Enterprise Income Tax (EIT) (which is similar to the profit tax in the HK). Further, the government could waive the tax of any community store which is less than 30 square meters in size.⁴³

As a result, many small retail stores could arguably co-exist within one community, and compete with each other. They could offer lower-priced products and more convenient services to community residents and arguably put pressure on larger retail stores to reduce product prices in order to attract more customers, and force them to stop collecting slotting fees from suppliers – as long as a large store requires a slotting fee from a supplier, the supplier can simply choose to trade with other small convenience stores instead.⁴⁴

Secondly, in the event that Chinese policy makers do not find it possible or appropriate to transplant the HK or the EC taxation regimes on SMEs to China, they could consider at the very least reducing the VAT rate for SMEs. For example, they could either waive the SMEs' VAT altogether or reduce it to a rate of less than 3 per cent (which would be below the rate of the BT). This would not only reduce the tax burden on SMEs, but also help reduce large-scale retailers' incentives to avoid the tax by charging slotting fees. (More detailed suggestions will be introduced in Part V).

⁴²郎咸平 Lang Xianping, above n 37.

⁴³ Ibid.

⁴⁴ Ibid.

4.2 *Special Laws in Limiting Large-scale Retailers*

4.2.1. Special Laws as a Solution

In addition to competition law and preferential taxation policy, many countries (particularly developed countries) have also enacted various special laws in order to directly limit the development of large-scale retailers and to enhance the development of SME retailers. For example, in the US, the *Robinson-Patman Act* (RPA) was enacted in 1936 (as mentioned above). The Act was created for the purpose of limiting the ability of large and powerful buyers to gain price discounts and an unfair advantage or monopoly through the use of their buying power.⁴⁵ In Japan, the *Large Scale Retail Store Law* was enacted in 1974 in order to balance the benefits of SME retail stores.⁴⁶ In Germany, the *Shop Closing Hours Regulation* was enacted in 1996 in order to limit the trade hours of big outlets.⁴⁷

By contrast, it seems that China does not have any similar laws to protect SMEs. In order to change the disadvantageous market situations of SME retailers and suppliers, the Chinese regulators should consider enacting similar laws in order to directly limit the expansion of large-scale supermarkets and to create more market spaces for SME retailers.⁴⁸

Nevertheless, it is important to note that transplanting laws has never been an easy task. Different countries share different legal traditions and have different social and

⁴⁵ Orner & Orner Law Firm, *The Robinson-Patman Act* <<http://www.theornerfirm.com/practice-areas/business-litigation/the-robinson-patman-act/>>; see also David Luhman, *The Japanese Large Scale Retail Store Law* (20 June 1994) <<http://luhman.org/japanese-reports/sell-to-japan/040-the-japanese-large-scale-retail-store-law>> which stated: 'The law originally provided a system whereby a large retailer would simply notify local retailers of plans to build a large store in the area. Local shopkeepers then would have a chance to comment on the new store. However the national law was revised to prevent almost any new store over 500 square meters, or 5,400 square feet, from being established.'

⁴⁶ Tokumi Odagiri and Paul Riethmuller, 'Japan's Large Scale Retail Store Law: A Cause of Concern for Food Exporters?' (2000) 22(1) *Agricultural Economics* 55, 55–65.

⁴⁷ 郎咸平 Lang Xianping, above n 42.

⁴⁸ *Ibid.*

economic circumstances. A law which suits one country may not necessarily suit other countries. Thus, when importing other countries' laws, it is necessary to examine the legislative history of relevant countries as well as both the feasibility and obstacles of legal transplants.

4.2.2. Legal Transplants: Feasibilities and Obstacles

The US *RPA 1936* was passed during the Great Depression following the emergence of large, successful grocery-store chains. The original bill was drafted by the US Wholesale Grocers Association, and reflected major concerns of small, independent grocery stores and their suppliers, namely that 'large chains have exercised their superior buying power to achieve price discounts, driving small grocers out of business'.⁴⁹ However, it seems that the Act has not struck a sound balance of different stakeholders. Many critics of the Act point out that the 'Congress passed the act with the protection of small grocers and their wholesalers in mind, rather than the welfare of competition or the consumer'.⁵⁰ In practice, it seems that the *RPA* has been rarely used.⁵¹ As such, the *RPA* may not serve as a sound example for legal transplant.

The Japanese *Large Scale Retail Store Law 1974* was 'designed primarily to protect smaller shops by restricting the operations of retail giants located close to the weaker players'.⁵² The law required a large retailer to notify local retailers of its plans to build any large store in the area. Local retailers would then have a chance to comment on the new store. However, the law was later revised to prevent almost any new store

⁴⁹ Farlex, 'Robinson-Patman Act', *Legal Dictionary* <<http://legal-dictionary.thefreedictionary.com/p/Robinson-Patman%20Act>>.

⁵⁰ Ibid.

⁵¹ Ibid: '[a]lthough the act remains an important antitrust statute, private parties do not use it nearly as often as they use the *Sherman Act*, in part due to the Robinson-Patman Act's convoluted and complicated language.' See also Terry Calvani and Gilde Breidenbach, 'An Introduction to the Robinson-Patman Act and Its Enforcement by the Government' (1990–91) 59(3) *Antitrust Law Journal* 765.

⁵² See *A New Era in Japan's Retailing Market — Deregulation Paves the Way for Inroads by Foreign Groups*, Special Report 4 <<http://ratthapr.files.wordpress.com/2007/10/14-15p.pdf>> .

over 500 square meters from being established.⁵³ Thus, this law has been criticised as ‘a major obstacle to foreign businesses’.⁵⁴ However, it is noteworthy that Japan has started a deregulation process since the early 1990s. As a part of the deregulation in Japan's retail sector, the *1974 Law* was replaced by the new *Large-Scale Retail Store Location Law* in June 2000. The *2000 Law* ‘focuses more on such issues as the impact a large store has on the environment, embodying the shift of policy emphasis from regulation to ‘coexistence’.⁵⁵ It seems that the deregulation in large stores had ‘an immediate effect’.⁵⁶ Many major players in the world retail market, such as membership warehouse clubs (Costco), hypermarkets (Carrefour) and membership food wholesalers (Metro), started to expand their presence in Japan by setting up new stores at a rapid pace. Furthermore, in 2002, Wal-Mart, the world's largest retailer, acquired a controlling stake in The Seiyu Ltd, the sixth largest supermarket operator in Japan. As some commentators have observed, ‘deregulation paves the way for inroads by foreign groups’.⁵⁷ As such, Japan’s legislative model on large-scale retail stores may not be a sound mechanism that effectively limits the expansion of large-scale retail stores.

The German *Shop Closing Hours Regulation* 1996 was designed to limit the trade hours of big outlets. In fact, Germany has introduced comprehensive shop closing legislation since the early 1900s. Regarding the rationale of the legislation, it was first introduced mainly for religious reasons.⁵⁸ Later, worker-protection reasons were also

⁵³ Ibid: ‘The law required retail operators looking to open large stores to go through a time-consuming and painstaking “adjustment” process with local retailers, which often resulted in official orders to reduce business days or floor space’.

⁵⁴ Ibid.

⁵⁵ Ibid: ‘[T]he relaxation of the government's regulatory grip on retail businesses has triggered a rush by foreign retailers to establish operations in Japan’.

⁵⁶ David Luhman, *The Japanese Large Scale Retail Store Law* (20 June 1994)

<<http://luhman.org/japanese-reports/sell-to-japan/040-the-japanese-large-scale-retail-store-law>>:

‘Whereas large store openings before deregulation numbered about 200 a year in the 1980s, in 1990 nearly 700 large stores opened’.

⁵⁷ *A New Era in Japan's Retailing Market*, above n 53,15.

⁵⁸ Christian Kirchner and Richard W Painter, ‘The Economics of Germany's Shop Closing Hours Regulation’ (1999) *U Illinois Law & Economics Research Paper No. 00-05*, 5-6: ‘Until the late nineteenth century, the Church was the predominant interest group (the Protestant Church in the North and the

articulated. But, as some commentators have noted, there was a further rationale ‘to protect shopkeepers from too much competition’.⁵⁹ The legitimacy of such a regulation has been subjected to heated debate. Some have even suggested that the shop closing regulation should simply be abolished. For example, the Institute for Economic Research (ER Institute), a Munich-based think tank, published the *Report on Germany’s Shop Closing Laws* in 1999. In the report, the ER Institute analysed the results from a survey of shop owners and consumers and proposed to abolish any such shop closing hour regulation for weekdays and ‘leave it to the “Laender” (the German states) to regulate closing hours on Sundays and holidays’.⁶⁰ As such, it may be too early to conclude whether the German legislative model can serve as a sound example that limits the expansion of large-scale retail stores and the abuse of slotting fees.

Summary

In summary, although special-law-resolutions in different jurisdictions have limited the expansion of large-scale retailers in a limited time period (as considered above), they have also incurred wide-ranging criticisms. They may not be able to provide sufficient protection for the SME retailers and suppliers in the long run. As such, it seems that the legislative models in the US, Japan and Germany might only serve as temporary measures /second best solutions and cannot resolve the slotting allowance issue completely in China. By contrast, it seems that the preferential tax policy for SMEs may serve as a more feasible and reliable solution.⁶¹ Indeed, the SMEs deserve

Catholic Church in the South), and in some cities and towns shops had to be closed on Sundays and holidays (all of which were religious holidays)’; and ‘It is also no secret that some groups of shop owners were favored over others. The Sunday closing law, for example, disproportionately disadvantaged Jewish shop owners who observed Saturday instead of Sunday as their Sabbath and therefore would have to remain shut on both days. Likewise, the law protected Christian shop owners from losing a portion of their business to Jewish competitors on Sunday’.

⁵⁹ Above n 5. [Is it ibid or n 5??]

⁶⁰ Ibid. 郎咸平 Lang Xianping, above n 42.

⁶¹ 郎咸平 Lang Xianping, above n 37.

stronger protection, since they contribute to 85 per cent of the entire national tax revenue, and create 80 per cent of the new employment opportunities in China.⁶²

Part V: Recent Development & Recommendations for Further Reform

5.1 Recent Development of Tax Law

In order to implement the preferential tax policy for SMEs, it may be necessary to revise the existing Chinese tax law and raise the VAT and Business Tax (BT) threshold for SMEs. Over the past few years, it seems that the Chinese State Council has realised that it is important to implement more fiscal and taxation policies, including preferential tax policies, to help SMEs tackle financing problems.⁶³ It has reduced the 'VAT rate leviable on small-scale taxpayers' to '3 per cent'.⁶⁴ The *Tentative Regulations on Value-added Tax (Revised) 2009* provides:

Article 12

- (1) The VAT rate leviable on small-scale taxpayers shall be 3%
- (2) The adjustment to the leviable rate shall be determined by the State Council.

⁶²郎咸平 Lang Xianping, above n 42.

⁶³ Zhang Dan, 'China Releases Fiscal and Tax Policies to Support SMEs', CCTV (online), 27 April 2012 <<http://english.cntv.cn/program/newshour/20120427/116450.shtml>>. (Stated: 'China's State Council has announced plans to implement more fiscal and taxation policies, to help small and medium-sized enterprises tackle financing problems. These include preferential tax policies to promote development, through raising the value-added tax and sales tax thresholds for small and micro-enterprises, and reducing enterprise income tax until 2015').

⁶⁴ 中华人民共和国增值税暂行条例 (修订) 2009 [*The Tentative Regulations on Value-added Tax (Revised) 2009*, 10 November 2008, Art 11 and 12; see also 深圳市国家税务局 [Shenzhen Municipal Office of SAT] 中华人民共和国增值税暂行条例释义 [Interpretation of the PRC Provisional Regulations on VAT] (online), 14 September 2009 <http://www.szgs.gov.cn/files/internet/zwgk200802/bsgk/zcjd/t20090914_290147.htm> Provisional Regulations of the PRC on Value-Added Tax (China) [Zhang Chuanfang trans] (online) <<http://www.doc88.com/p-640851203011.html>>.

Furthermore, in 2011, the Ministry of Finance (MoF) further stipulated the Decision on Revising the Implementation Details on Interim VAT Provisions and the Implementation Details on Interim BT Provisions' (MoF Decree No.65) in order to lift both the VAT free sales value and the BT threshold.⁶⁵

According to Article 37 of the Implementing Rules for the PRC Tentative Regulations on Value-added Tax (2nd Revision) 2011,⁶⁶ the current thresholds are:

-For 'VAT-free sales value of goods: Monthly sales of RMB5,000 to RMB20,000 (increasing from the previous RMB2,000 to RMB5,000),

-For VAT-free sales value of taxable services: Monthly sales of RMB5,000 to RMB20,000 (increasing from the previous RMB1,500 to RMB3,000)

-For VAT-free sales value of each transaction: Sales of RMB300 to RMB500 per transaction/day (increasing from the previous RMB150 to RMB200)'⁶⁷

Finally, according to Article 23 of the *Implementing Rules for the PRC Tentative Regulations on Business Tax (2nd Revision) 2011*, the current tax-free thresholds for BT collection are as follows:

-'Tax-free threshold for termly BT payment: Monthly business turnover of RMB5,000 (USD 833) to RMB20,000 (increasing from the previous RMB1,000 to RMB5,000)

⁶⁵ 'China Lifts Tax-free Thresholds for Business Tax and VAT Collection', *China Briefing* (online), 1 November 2011 <<http://www.china-briefing.com/news/2011/11/01/china-lifts-tax-free-thresholds-for-business-tax-and-vat-collection.html>>.

⁶⁶ 中华人民共和国增值税暂行条例实施细则(2011 修订), *The Implementation Rules for the Tentative Regulations on Value-added Tax (Revised) 2011* (online), <http://www.110.com/fagui/law_386892.html>; See also 关于修改《中华人民共和国增值税暂行条例实施细则》和《中华人民共和国营业税暂行条例实施细则》的决定 [The *Decision on Revising the Implementation Details on Interim VAT Provisions and the Implementation Details on Interim BT Provisions*' (MoF Decree No.65) (online), <http://www.chinaacc.com/new/63_67_201110/31e2887997058.shtml>.

⁶⁷ See 'China Lifts Tax-free Thresholds for Business Tax and VAT Collection'.

- Tax-free threshold for BT payment on each transaction: Business turnover of RMB300 (USD 50) to RMB500 per transaction/day (increasing from the previous RMB100) ⁶⁸

Although some progress has been made, it is clear that the current VAT and BT thresholds for SMEs are still too low. As some commentators have criticised, even monthly business turnovers of RMB5,000 (USD 833) or RMB 20,000 (3,333 USD) may not be able to cover the monthly operational costs (for example, rental costs) of most retailers in major cities (such as Beijing and Shanghai).⁶⁹ According to a recent survey conducted by the DTZ, the rent in the five selected retail hubs in Shanghai shows ‘an increase of 2.81 per cent quarter-on-quarter (q-o-q), which has reached RMB 59.46 (US\$9.51) per sqm per day’.⁷⁰ This means that, for a 30-sqm retail store, its monthly rental will be RMB 53,604 (USD 8,559), which is 10 times higher than the existing threshold.⁷¹ As a result, most retail stores are not able to meet the requirements to qualify as a ‘small scale taxpayer’. Therefore, they cannot really benefit too much from the preferential tax policy for the SMEs.

Furthermore, over the past three years, the global financial crisis and the change in the Chinese foreign currency exchange schemes have greatly affected the dynamic of the Chinese market. Notably, the inflation rate in China continues to grow.⁷² This arguably further increases the operational cost (including but not limited to rental costs) of the businesses operating in China. Thus, it is important to make sure the current tax policy

⁶⁸ Ibid.

⁶⁹ 小微企业免税降低创业成本 [Tax Waiver for SMEs & Opening Cost Reduction] 中国青年报, *Chinese Youth Daily* (online), 2 July 2013 <http://finance.ifeng.com/a/20130729/10286214_0.shtml>.

⁷⁰ Steven Cheng and Ray Zhang, ‘Office Occupancy Remains Stable’, *Property Time Shanghai Q4 2012* (online), 15 January 2013

<http://www.hsbc.com.cn/1/PA_1_083Q9FFKG80E20RA9Q00000000/content/china/personal/hsbcpremium/images/DTZ_Shanghai_en.pdf>. See also Regina Yang, *Knight Frank Residential Research: Shanghai Expatriate Housing Market Insights* (2013), 4 <http://www.hkej.com/hkej_upload/news_report/20130328/20130328_White%20Paper.pdf>

⁷¹ Monthly rent = daily rent x 30 days.

⁷² Langi Chiang and Jonathan Standing, ‘China Data Highlights Weak Economy’, *Reuters* (online), 9 June 2013 <<http://uk.reuters.com/article/2013/06/09/uk-china-economy-inflation-idUKBRE95800P20130609>>.

and regulations always keep up with the current market dynamic. It is necessary to lift the tax-free thresholds even further in order to provide real support to the SMEs.

5.2 Counter-arguments and Review Regime

As mentioned above, most developed nations- particularly the European countries - have developed sophisticated laws to limit the expansion of large-scale retail stores and to protect SME retail stores. Nevertheless, some recent studies show that some EC countries have also started to rethink whether such a strategy is always appropriate. In a recent study, Harvard University Economics Professor Raffaella Sadun analysed a planning regulation reform launched in the UK in the 1990s, which introduced entry regulation against big retailers to protect independent retailers. It found that ‘entry regulations may in fact accelerate the decline of independents by increasing the attractiveness of smaller in-town store formats for retail chains’.⁷³

It seems that planning regulation countries have started to consider implementing a more relaxed regulatory framework for the development of large-scale retailers. Further, as many critics have noted, the competition law is designed to protect ‘competition’ and ‘it is not designed to protect competitors from competition’.⁷⁴ As such, when implementing preferential tax policy or laws to enhance the development of the SMEs, China should also closely follow up with the recent global developments in this vein and make sure that existing policies and laws are always pro-competition in nature.

⁷³ Raffaella Sadun, ‘Does Planning Regulation Protect Independent Retailers?’ (Working Paper No 12-044, Harvard Business School, 16 December 2011) <<http://www.hbs.edu/faculty/Pages/download.aspx?name=12-044.pdf>>. See also Jonathan E Haskel and Raffaella Sadun, ‘Regulation and UK Retailing Productivity: Evidence from Microdata’ (2012) 79(315) *Economica* 425.

⁷⁴ Eleanor M Fox, ‘We Protect Competition, You Protect Competitors’ (2003) 26(2) *World Competition* 149, 149.

It may be necessary to set up a national review mechanism (either based annually or triennially) to assess the effectiveness of its legal and taxation policies against the slotting fees and make necessary policy adjustments in a timely fashion. In doing so, a sound balance is struck between enhancing the development of the SMEs and maintaining a fair competition order in the Chinese retail market.

Conclusion

This paper has introduced and examined the existing problems raised by supermarket slotting allowances in China, and the underlying reasons and rationale behind them. It also identified some major problems with the existing laws and policies in preventing slotting fees and in protecting SME businesses, and focused in particular on the problems with the current Chinese taxation system. It then compared and critically examined how other countries use special laws and taxation policies to help promote the development of SMEs and contribute to the resolution of slotting fee issues. Finally, it provided some specific suggestions for reforming Chinese laws and policies in preventing slotting fees and promoting the development of SMEs.

It contends that, when seeking a solution, future regulators should think more holistically and not solely through the lens of competition law. It is imperative to take a more heterogeneous approach, which allows the direct legislative approach and the preferential taxation policy approach work collaboratively to resolve the problem. Before the central government takes any further actions against the slotting allowance arrangements, the Chinese competition enforcement authority needs to conduct a more systematic FTC-style study on the competitive nature of various slotting allowance arrangements. In the long run, it is necessary for the national competition enforcement authority to issue comprehensive guidelines or regulations on antitrust scrutiny of the slot allowance practices in retail industries. But during the transitional period, the preferential taxation policy for SMEs may serve as the stopgap measure for

immediately stopping slotting fees against suppliers and for creating more space for the growth of SME retailers. Finally, the government needs to set up a national review mechanism to evaluate the effectiveness of the existing regulations and taxation policies against the slotting fees on a regular basis and make sure that the existing laws and policies are always in line with the healthy development of the Chinese retail market. It is imperative that competition law and taxation policy operate in conjunction to solve these problems.

Fiscal Decentralization, Multi-level Government Competition and Local Non-tax Revenue: Dynamic Spatial Panel Model Estimation based on Provincial Data from 2000-2010

Jinzhi Tong, Xing Li and Jiajie Wang [★]

Abstract: With the application of dynamic spatial panel model under China's decentralization framework, this paper elaborates the impacts of the “horizontal strategic interaction” among local governments, as well as the “vertical common reaction” between central and local governments, on the non-tax burden of various regions. The results indicate that there exists non-tax horizontal strategic imitation among local governments, with the degree from land remise revenue, extra-budgetary funds to budgetary non-tax revenue in descending order, in line with the structural trend of non-tax revenue. In terms of vertical common reaction, local governments present policy emulation towards central government in extra-budgetary funds, with an increasing degree of policy violation in budgetary non-tax revenue, while the reaction transforms from policy violation to emulation in land remise revenue. Fiscal decentralization produces negative influence on non-tax revenue, varying among revenue categories, with substantial impact on land remise revenue, followed by extra-budgetary funds, and negligible effect on budgetary non-tax revenue. This paper proposes related analysis based on current non-tax system, as well as corresponding policy implications.

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1. Introduction and summary of works

In recent years, non-tax revenue became the main source of local government's income as the growth of tax slows. Therefore, it has received tremendous attention from the public. According to statistics, the total scale of local government's non-tax revenue has continuously expanded over the last few years, rising sharply from 122.98 billion Yuan in 1993 to 4077.11 billion Yuan in 2007, a 33-fold increase. In percentage of GDP terms, it tripled from 3.4% in 1993 to 10.2% in 2010, which is a three times increase.¹

Current research generally attributes the source of this growth to the deficiencies of the separation of fiscal and administrative powers. Tax reforms in 1994 caused centralization of fiscal powers and decentralization of administrative powers, this caused the inability of local governments to meet their growing expenses, and they have turned to non-tax revenue to obtain additional public finance.²

Wang Zhi Gang and Gong Liu Tang used different indicators of separation of fiscal and administrative powers to conduct empirical research on this issue and its effects on local governments' non-tax revenue. The research showed that increasing separation of fiscal and administrative powers and self-sufficiency of the local government's financial powers reduced reliance on non-tax revenue.³ Li Wan did empirical research on the separation of fiscal and administrative power's effect on growth of non-fiscal income, the research suggested under the current scheme of separation, local governments lack independent fiscal powers, which is forcing them

¹ China Statistical Yearbook 1994-2011, China Financial Statistical Yearbook 1994-2011, China Land Statistical Yearbook 1995-1998 and China Land and Resources Statistical Yearbook 1999-2011.

² Gu kang and Bai Jing Ming, 'Chinese Government's Sources of Income and Comprehensive Policy Review' (1998) 6 *Economic Research Journal* 46; Bai Yu Fei, Zhang Yu Lin and Zhang Guo Sheng, 'Empirical Analysis of the Scale and Factors of Chinese Government's Non-Tax Revenue' (2009) 5 *Economic Theory and Business Management* 43.

³ Wang Zhi Gang and Gong Liu Tang, 'Separation of Fiscal and Administrative Powers and Governmental Non-tax Revenue – Based on Provincial Financial Data' (2009) 5 *World Economic Papers* 17.

to use less coercive non-fiscal sources of income to realize financial expansion.⁴ Jiang and Xie reached similar conclusions on the expansion of non-fiscal income, and pointed out that increasing local financial income would decrease the proportion of non-fiscal income.⁵

However, separation of fiscal and administrative powers cannot completely explain the internal structural changes to non-tax revenues. Based on differences mandated by fiscal management,⁶ local government's non-tax revenue can be classified into three main types: fiscal non-tax revenue (or budgeted non-tax income),⁷ governmental fund income (mainly land remises revenue) and non-fiscal revenue. The three non-tax income showed different trends as non-tax revenue expanded. Fiscal non-tax revenue displayed the biggest growth from 0.12% of GDP in 1993 to 1.73% in 2010. In contrast, non-fiscal revenue's proportion to GDP has decreased since 2000, reaching 1.3% of GDP in 2010, the smallest of the three types of non-tax revenue, and yields from leasing government land steadily rose from 0.5% of GDP in 1997 to 4.5% in 2010, and is currently the largest component of non-tax revenue.⁸

What factors caused these structure changes? Current research has yet to provide a satisfactory answer. Under a framework of separation of fiscal and administrative powers in a multi-level government, local governments showed vertical common reaction to central government's action and horizontal strategic interaction with other governments at the same rank according

⁴ Li Wan, 'Research on Chinese Separation of Fiscal and Administrative Powers and Expansion of Local Governments Non-budgetary Revenue' (2010) 3 *Collected Essays on Finance and Economics* 24.

⁵ Jiang Ke Zhong and Xie Ce Min, 'Local Government's Expansion of Non-budgetary Revenue under the Background of Separation of Fiscal and Administrative Powers – Empirical Research Based on Provincial Panel Data' (2012) 8 *Zhejiang Social Sciences*.

⁶ According to the regulations of *Decision of the State Council on Strengthening the Administration of Extra Budgetary Funds* (Issued 1996 No. 26) issued by the State Council and the *Budgetary Administrative Measures on Governmental Funds* (Issued 1996 No. 435) issued by the Ministry of Finance, from 1997 to 2011 all non-tax revenue management consisted of fiscal budget, governmental fund income budget and non-budgetary income. The three categories existed concurrently until 2011 where all non-budgetary income are included into budgetary management.

⁷ In this essay, fiscal non-tax revenue is the fiscal income of an area less the tax income, profits and losses from state owned enterprises for that area. That is the sum the local government's non-tax revenue excluding those national profits or losses.

⁸ China Statistical Yearbook 1994-2011, China Financial Statistical Yearbook 1994-2011, China Land Statistical Yearbook 1995-1998 and China Land and Resources Statistical Yearbook 1999-2011.

to Revelli, Devereux and others' research on local government behavior.⁹ Inter-governmental competitions between governments of the same or different levels can provide a new perspective for research on China's non-tax revenue.

In recent years, Chinese scholars have researched intensively on tax competitions between local governments, the most representative of which are works by Chen and Fu, Li and Chen, Guo and Li and Wang and Lin.¹⁰ The researches show that tax competition does exist in China, and horizontal competitions between local governments on the one hand and vertical interaction between local and central governments on the other have a very significant impact on local governments' taxing.

Non-tax revenue is a very important part of China's fiscal income, and can become an extension of local government's tax competition. From a perspective of the implementation of separation of fiscal and administrative powers, local governments have the potential and incentive to develop horizontal strategic interaction with respect to non-tax revenues. Firstly, under the current system of separation of fiscal and administrative powers, local governments are the de facto decision makers for non-tax revenue. They can impose new fee items, amend fee scales or enter into new governmental land leases. With these powers local governments can determine the scale and structure of non-tax revenue. This implies that China's non-tax revenue has some similarity to a federation's taxing methods, and can become a subject of horizontal strategic interaction between local governments.

⁹ Revelli, F, 'Spatial Patterns in Local Taxation: Tax Mimicking or Error Mimicking?' (2001) 33 *Applied Economics* 1101; Devereux, M. P., B. Lockwood and M. Redoano, 'Horizontal and Vertical Indirect Tax Competition: Theory and Some Evidence from the USA' (2007) 91 *Journal of Public Economics* 451.

¹⁰ Chen Kun Rong and Fu Wen Lin, 'Tax Competitions, Local Feuds and its Effects on Growth' (2006) 6 *Economic Research* 16; Li Yong You and Chen Kun Rong, 'Competition between Regions, the Regional Feature of Strategic Fiscal Policy and its Effects on FDI Growth' (2008) 5 *Economic Research* 58; Guo Jie and Li Tao, 'Research on Competition between Chinese Local Governments – Based on Chinese Provincial Panel Data' (2009) 11 *Management World* 54; Wang Mei Jin, Lin Jian Hao and Yu Zhuang Xiong, 'Identification of Features in Chinese Local Government Fiscal Competitions: Does "Brotherly Competition" and "Father-son Arguments" Exists?' (2010) 3 *Management World* 22.

Secondly, as the scale of this non-tax revenue increases, it will slowly transform from being a supplement of fiscal income to being a substantial part of fiscal income. Not only will it relieve the pressure caused by the separation of fiscal and administrative powers, but it can be used as a source of finance to develop local economies. This is an internal drive for local government to expand non-tax revenue.

Also, seen from China's centralization of political powers, policy from the central government may have important impacts on local government policies. Since the late 90s tax/fee reforms, the planning and administration of non-tax revenue has been in the spotlight for China's fiscal reforms. To this end, the Central government enacted a series of laws and regulations to regulate local government's non-tax revenue collecting activities, strengthened budgeting requirements for non-tax revenue, clarified the scope of management for non-tax revenue, regulated governmental funds income, implemented special accounts for non-fiscal funds, and implemented Separation of Revenue and Expenditure reforms, with local governments implementing supplementary policies for non-tax revenue. The "top down" approach can be said to be China's basic approach to non-tax revenue reforms, with local governments showing significant vertical interaction with the central government's policy.

Based on the above, the essay will refer researches on Dynamic Spatial Panel Data, on the basis of the indicators of the separation level, introduce the Spatial Lag Model for non-tax revenue and include observable central government non-tax revenue policies as a variable, identifying and estimating horizontal strategic interactions and vertical common reactions. Additionally, we will demonstrate the impact of multi-level inter-governmental competition under the separation of fiscal and administrative powers, using it as a mean to control the expansion of non-tax revenue expansion, improving the management of non-tax revenue.

The Structure of Panel Data and Selection of Inputs

The structure of Panel Data

According to modern tax competition theories, local governments have a reactionary function when setting the local tax rate.¹¹ From our above discussion, China's non-tax income is similar to taxing methods in federated countries, therefore local governments have a similar "non-tax reactionary function" $z_i = f(z_{-i}, X_i)$. The non-tax burden z_i of location i is not only determined by local social-economic factors X_i , but is also determined by other area's non-tax burden z_{-i} . The development of spatially variable economics provides the possibility to confirm strategic interactions between local governments, and the Spatial Lag Model is specially recognized as a suitable empirical model to verify equilibriums between governmental interactions, and is used in researches dealing with governmental competition extensively in and out of China.¹²

To research local government's vertical common reaction to central government policies, this essay will borrow methods used by people such as Revelli (2003) and Devereux (2007), while introducing central government policy as an observable variable in our empirical model.¹³ Additionally, in consideration of the impact of separation of fiscal and administrative powers and non-tax revenue path dependencies, our model will incorporate variables on the separation of fiscal and administrative

¹¹ Brueckner J., 'Strategic Interaction among Governments: An Overview of Empirical Studies' (2003) 26 *International Regional Science Review* 175

¹² Ladd H., 'Mimicking of Local Tax Burdens among Neighboring Counties' (1992) 20 *Public Finance Quarterly* 450; Case, A. C., H. S. Rosen and J. R. Hines. 'Budget Spillovers and Fiscal Policy Interdependence: Evidence from the States' (1993) 52 *Journal of Public Economics* 285; Li Tao, Huang Chun Chun and Zhou Ye An, 'Tax, Tax Competition and Chinese Economic Growth' (2011) 4 *The Journal of World Economy* 22.

¹³ Revelli, F, 'Spatial Patterns in Local Taxation: Tax Mimicking or Error Mimicking?' (2001) 33 *Applied Economics* 1101; Devereux, M. P., B. Lockwood and M. Redoano, 'Horizontal and Vertical Indirect Tax Competition: Theory and Some Evidence from the USA' (2007) 91 *Journal of Public Economics* 451.

powers, and a lagged variable on non-tax revenue burden, resulting in the following lagged dynamic spatial panel data:

$$z_{it} = z_{it-1} + \alpha \sum_{j \neq i} w_{ij} z_{jt} + \gamma cz_t + \eta fd_{it} + X_{it} \beta + \mu_i + \lambda_t + \varepsilon_{it}$$

z_{it} is the non-tax revenue in area i in time period t , z_{it-1} is the non-tax revenue in the same area but a period earlier. w_{ij} represents the spatial weight matrix showing the spatial relationship between different areas, $\sum_{j \neq i} w_{ij} z_{jt}$ represents the spatial lag variable for the non-tax variable in area i (the spatial strategic interaction variable), cz_t represents the variable for the central government's non-tax revenue policy, which is independent of areas and changes only with time. fd_{it} is used to gauge indicators of the separation of fiscal and administrative powers, X_{it} represents social-economic factors which affects the non-tax revenue burden of area i . Following previous researches in China and abroad, X includes the degree of economic development, composition of industries, economic cycles, degree of openness, degree of urbanization, ratio of investments to assets and tax burden in all areas. μ_i and λ_t indicates the independent effects of time and area respectively, and ε_{it} is the residue. α , β , γ and η are corresponding coefficients for the above. We can determine the existence, direction and magnitude of inter-governmental interactions with the correlation, positivity and size of α and γ . A significantly positive α means a copying strategy exists between the local governments (strategic supplementation), and a significantly negative α means a distinction strategy exists between the local governments (strategic substitution). If α is not significant, it means there is no strategic interaction between local governments on non-tax revenue policies. A significantly positive γ means the local governments are following the Central

government's non-tax revenue policy, and conversely if γ is significantly negative it means the local governments are following opposite policies to the ones the central government is pursuing. A non-significant γ means the changes in local government policy is not related to central government policy. Similarly, the coefficient η can be used to determine if the separation of fiscal and administrative powers affects a local government's non-tax revenue.

As our model includes not only two-way fixed effects variable for time and area, but also dynamic changes to the explained variables and other lagged variables, if traditional OLS estimation is used, it will create bias and non-uniformity in our estimations. According to research by Madariaga and Ponce, System Generalised Method of Moments can be used to control the fixed effects of time and area and cope with the endogenous issues caused by dynamic explained variables and lagged variables,¹⁴ we will utilize this method to conduct our estimation.

Sources of data and selection of indicators

In consideration of data availability and integrity, we will use panel data of all 31 provinces in China between 2000 and 2010. Our main sources of data are from the China Statistical Yearbook, China Compendium of Statistics (1949-2008), China Land and Resources Statistical Yearbook, China Financial Statistical Yearbook and the Chinese Economic Database (CEIC databases). The explained variable in this model z_{it} is the level of burden of non-tax revenue for area i in time period t , that is the ratio of all the non-tax revenue to GDP for the area. It is separated into total burden of non-tax revenue, burden for budgeted non-tax revenue, burden for non-budgeted non-tax

¹⁴ Madariaga, N. and Poncet, S., 'FDI in Chinese Cities: Spillovers and Impact on Growth' (2007) 30 *World Economy* 837.

revenue and burden from the income by leasing government land. cz_t is the central government's policy on non-tax revenue in period t , it is worth noting that as income from land is predominately a local government's affair, there is a lack of direct measure for the corresponding central government policy variable. Therefore we will use the ratio of land centrally approved for construction to total land approved for construction in the country as a substitute variable. The variable for the separation of fiscal and administrative powers, fd_{it} , is defined as the ratio of local fiscal expenditure per capita to the sum of local and central fiscal expenditure per capita. This is a frequently seen indicator in the other articles, such as works by Zhou Ye An, Zhang Quan, Li Tao, Huang Chun Chun and Zhou Ye An, it anticipates the effects of population size and transfer payments.¹⁵

Each controlled variable X includes: the level of economic development (aver-GDP), as the real GDP for each area calculated using prices from 2000; industry structure, as the proportion of GDP contributed by the second and tertiary industries of that area; openness as the ratio of import and export to the area's GDP; urbanization rate as the percentage of non-rural persons compared to the total population of an area; ratio of investments in fixed assets is investments in fixed assets expressed as a percentage of GDP; tax burden is tax over GDP for an area; economic cycle is the per capita GDP growth from 2000. Considering the variable's panel data can be non-linear and be a non-stationary series causing estimation issues, we have used the natural logarithm function as Guo Jie and Li Tao did, and accordingly added the prefix "Ln_" to all the variables.¹⁶

¹⁵ Zhou Ye An and Zhang Quan, 'Separation of Fiscal and Administrative Powers, Economic Growth and Variations' (2008) 3 *Management World* 6; Li Tao, Huang Chun Chun and Zhou Ye An, 'Tax, Tax Competition and Chinese Economic Growth' (2011) 4 *The Journal of World Economy* 22.

¹⁶ Guo Jie and Li Tao, 'Research on Competition between Chinese Local Governments – Based on Chinese Provincial Panel Data' (2009) 11 *Management World* 54

Furthermore, for our selection of spatial weight matrix we have referred to Lin Guang Ping and others in relation to the determination of the economic weight matrix.¹⁷ Based on the commonly used binary contiguity weight W_{ij} , we have considered the effects of differences in economy in different areas, and reset the economic spatial weight matrix, that is $W_{ij}^E = W_{ij} \cdot E_{ij}$, to better emulate the economic correlations between the areas. E_{ij} is a matrix that represents economic differences between areas:

$$E_{ij} = \frac{1}{|y_i - y_j|}, \quad \bar{y}_i = \frac{1}{t_1 - t_0 + 1} \sum_{t_0}^{t_1} y_{it},$$

in this formula, y_{it} represents the actual per capita income for area i in the year t . To increase the reliability and stability for repeating results, our work will use W_{ij}^E as our weight for this research, and all weight matrix will be standardized, by making the sum of every row equal to 1, before lagged variables are introduced.

III. Positive analysis and its results

The suitability of GMM adopted in this article has been assured by the results of both AR and Hansen's tests and their results are contained in Table 1 and Table 2. Table 1 contains the result of calculation of the panel data from all samples. In Table 2, the results are separately calculated from the samples ranged from year 2000-2004 and from year 2005 to 2010. The necessity of Table 2 is produced by that, in year 2004, ministry of finance published 'Notice of improving the government's management of non-tax revenue, which explicitly stated that all the non-tax revenue should be paid into the treasury or special financial account. Further, the governments are required to take into account the non-tax revenue when planning the budget. Consequently, in

¹⁷ Lin Guang Ping, Long Zhi He and Wu Mei, 'Empirical Research on Room for Contract of Chinese Local Economies: Years 1978-2002' (2005) 4 *China Economic Quarterly* 67

year 2005, there was a remarkable structured surge¹⁸ in the scope and proportion of the non-tax revenue that were calculated in the budget, which indicates that there has been a significant influence received by the local governments in their way of regulating the non-tax revenue from the Notice. Therefore, it is necessary to study this influence by sub-dividing the samples. (1) Horizontal Strategic Interaction

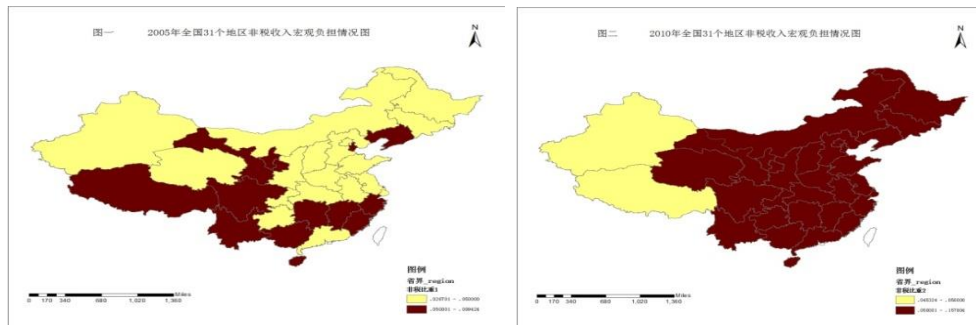
As to the overall burden of non-tax revenue, the reading is positive in both Table 2 and Table 3, which indicates there is a notable horizontal strategic imitation between the local governments in relation to the burden of non-tax revenue. However, the horizontal strategic imitation has led to increase of the burden of non-tax revenue. As it can be seen from Diagram 1 and Diagram 2, in year 2005, there were only 13 provinces which were under excessive burden of the non-tax revenue, which are marked by deep colour. Till 2010, the number of such province has increased to 29. The reason of this is that, due to the system of government performance examination) which substantially focuses on the financial development, local governments spontaneously engage in contests for GDP, which gives a strong incentive to expand the expenditure, where the non-tax revenue provides an extra means of stable financial revenue. When a certain local government experiences a successful policy involving non-tax revenue, the governments from surrounding locations will begin to draw on the successful experience and adopt the policy. It can be said that the strategic imitation adopted by local governments under the current government evaluation system leads to the burst of the non-tax revenue. Increasing the burden of non-tax revenue will not be sustainable in a long term because it will not only challenge the status of tax, distort the financial structure of the local governments, increase the systematic risk but also increase the non-tax burden for corporations and residents,

¹⁸ There was a surge of the budgeted non-tax revenue from 189.378 billion to 298.538 billion, an increase of 57.6%. Further, the proportion of non-tax revenue in GDP increased from 1.185% to 1.614%, an increase of 42.9%. There was a remarkable change compared to the results in other years.

frustrating investment, suppressing the consuming. These are all detrimental to the sustainability and long-term economic development.

As to the categories of non-tax revenues, there is a similar strategic imitation between the local governments, but both levels of influences and variation tendency are different. In aspect of the levels of imitation in local governments, the transferring of land produces the most incomes, which is followed by out-budget revenue and the least is budgeted non-tax revenue. As it is indicated by the Table 1, the Spatial Lagged Variable is 0.83 at its most, which means that the increased proportion of land-transferring income within GDP is 1% in the surrounding areas and 0.83% in the local; the out-budget revenue is 0.65, which means that the increased proportion of out-budget revenue is 1% in the surrounding areas and 0.65% in the local; the budgeted non-tax revenue is 0.52, which means that the increased proportion of budgeted non-tax revenue is 1% in the surrounding areas and 0.52% in the local. In terms of variation tendency, combined with the progress of innovation of non-tax revenue management, the strategic imitation of the local government in relation to the land-transferring gradually intensifies, while the imitation in relation to the out-budget revenue is weakening. As to the budgeted non-tax revenue, the strategic imitation is reflected as the non-existent strategic interaction, which has a close relation with the structured change of the various non-tax revenues. As it can be seen from Diagram 3, since year 2003, the land-transferring income has become the majority in the non-tax revenue and the proportion of it grows up stably from less than 20% in year 2000 to around 70% in year 2010; The out-budget revenue always occupies a minor proportion in the non-tax revenue and it has decreased consistently. On the contrary, though the budgeted non-tax revenue occupies a small proportion in the non-tax revenue, the number has been climbing remarkably since 2004, gradually has established itself an important component of the non-tax revenue. Therefore, we can reach the judgement

that the local governments adopt different strategic imitations in accordance with the importance of various non-tax revenues.



Graph 1, general tax burden of China in 2005 Graph2, general tax burden of China in 2010

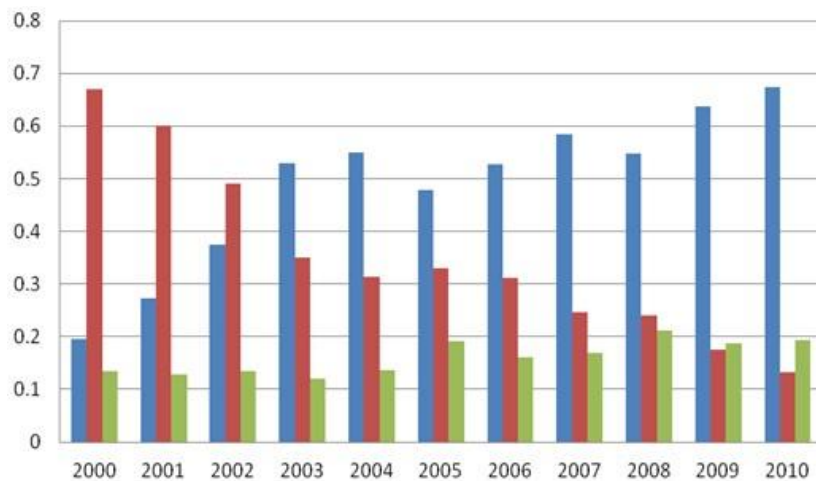
(2) Vertical Common Reaction

As it can be seen from Table 1 and Table2, the variable of central government policy does not have strong influence over the burden of non-tax revenue when analysed in the full sample and it can be drawn from the results of the sub-samples that the central government' s policy did not have a strong influence until the change of budget and non-tax revenue policy. Therefore, the local governments did not represent a notable common reaction towards the central government' s policy. However, the change of policy of non-tax revenue reinforces the influence of central government' s policy and leads to strategic imitation between the local governments.

In view of categories of revenues, the variable of central government' s policy is -0.044 in relation to budgeted non-tax revenue in the combined samples and -0.014 before the change and -0.11 after the change in the separate samples. The statistic indicates that local governments have shown a common reaction which is contradicted to the central government' s policy in relation to the budgeted non-tax revenue, further the intensity and visibility of this reaction are increasing. This result is confirmed by the tendency of change of budgeted non-tax revenue between the central government and the local governments, as it is shown in the Diagram 4 that the local governments take the lead

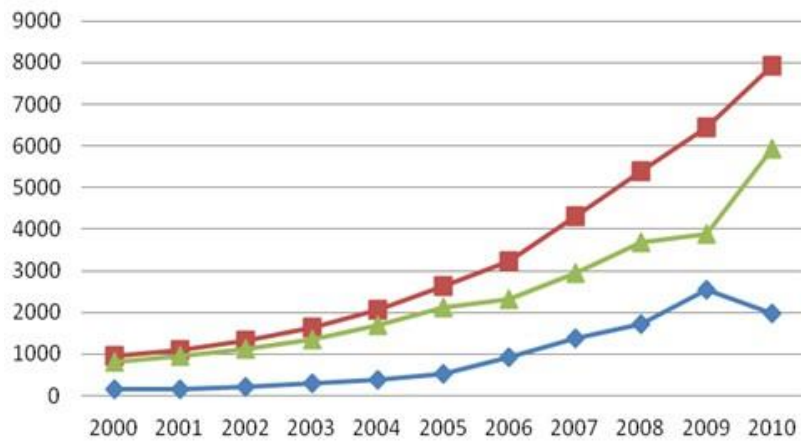
in the increase of budgeted revenue, especially since 2005 the non-tax revenue has grown much faster in the local governments than the central government, the gap of budgeted non-tax revenue between the central government and local governments grows bigger, which means that central government policy towards the budgeted non-tax revenue only has a limited influence over the local governments. The variable of central government's policy's influence towards out-budget revenue is positive and number is 0.21 in combined samples and, in the separate samples, they are 0.19 before the change and 0.15 after the change, which indicates that the local governments demonstrate a common reaction towards the central government in respect of out-budget revenue. The policy of central governments significantly contributed to the decreasing burden of local governments' out-budget revenue, which can be affirmed by Diagram 5 which indicates a common decline of the proportion of out-budget revenue in the entire fiscal revenue of the central government and local governments. The variable of central government's policy does not cast a strong influence on the land-transfer related revenue when examined in the combined samples. To the contrary, the situation differs if seen in the separate samples, which is -0.19 and 0.20 before and after the change respectively, which shows that prior to the change of management of non-tax revenue budget the local governments represented a contradicting common reaction to the direction of the central government's policy concerning to land and the reaction changes into strategic following after the change. To reaffirm this conclusion, as we can see from the Diagram 6, before 2004, whether the central government imposed a relaxed or strict policy of land had no impact on the situation where both the number of land permission for construction granted by local government and land-transfer revenue received have increased dramatically. For example in year 2002, the number of permission given to land for construction by central government declined from 72615.95 in year 2001 to 44372 in year 2002, a drop of 40%. By contrast, the statistic in the level of local governments had

experienced an increase to 183540.14, a 10% increase compared with 166988.04 in 2001, accompanied by the increase of land-transfer revenue from 1796.22 in 2001 to 3092.94 in 2002, a dramatic increase of 70%. After 2004, there is a consistency between the proportion of land-transfer revenue in total local fiscal revenue and the proportion of land permissions for construction granted by the central government in the total number of permissions. The publications of “Decision of further Reform on Land Administration” (National 【 2004 】 number 28) and “Notification of Transform Right of Use on National Owned Land” (National 【2006】) by the state council in 2004 and 2006 have an immediate influence on the issue. These rules not only regulate the procedure of permission given to land, intensify the concerning inspection, but also improve the management of land-transfer revenue, assure the increasing authority of central government to exercise macro-economic control. All these add up to the cost when local governments choose to disregard the policy from central government, and therefore, drive the common reaction from violating to following.



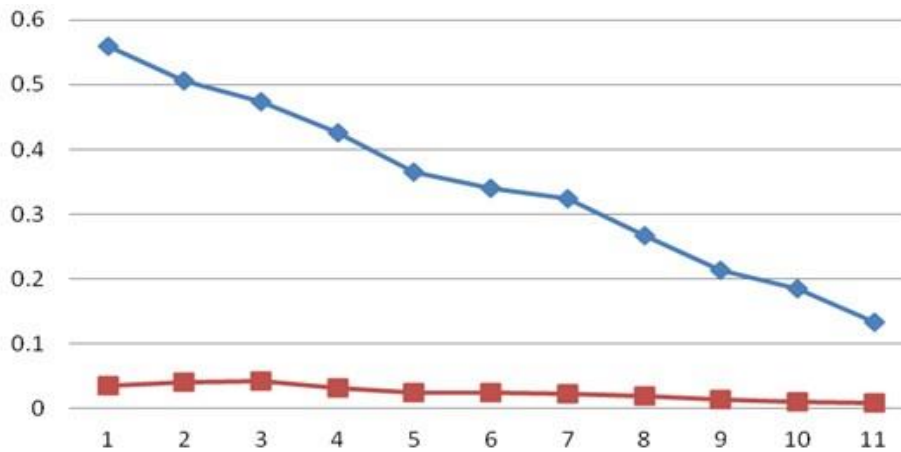
Graph3 Trend of Non-tax Income

(Blue: Income from rent of land, Red: Regional extra-budgetary revenue, Green: Regional Budget revenues)



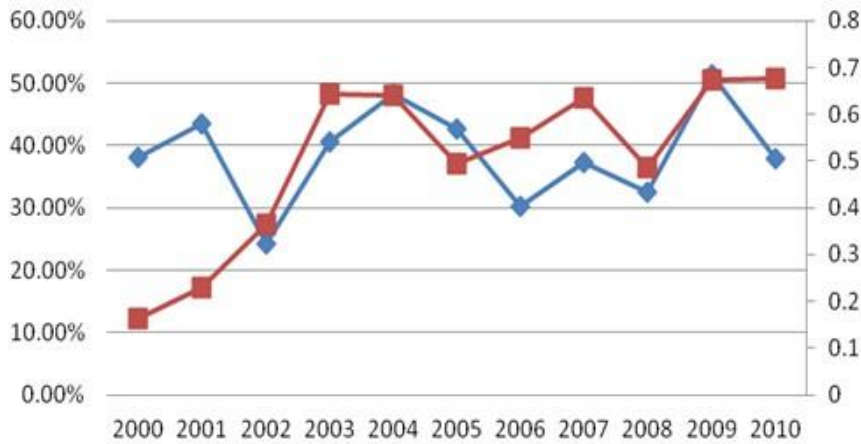
Graph 4 Trend of non-tax income for central and regions

(Blue: Central non-tax budget income, Red: Regional non-tax budget income, Green: Differences between central and regions)



Graph 5 Trend of proportion changes in scales of non-tax income

(Blue line: regional non-tax income proportion, Red: Central non-tax income proportion)



Graph 6 Trend of changes in land rented

(Blue: Central land rented, Red: Regional Land rent)

3 Decentralisation of Fiscal Powers

As it can be seen from result of the regression analysis in Table 1 and Table 2, decentralisation of fiscal power has a negative influence on the burden of non-tax revenue, which means the promotion of centralisation of fiscal power contributes to the relief of reliance on non-tax revenue of local governments, which echoes with the research of Zhigang Wand and Liutang Gong¹⁹. However, the level of influences differs according to the types of non-tax revenue, among which it has the strongest influence on land-transfer revenue, followed by out-budget revenue, and then budgeted non-tax revenue which only receives a very weak influence. In the Combined samples, the reading of land-transfer revenue is -0.57, and -0.22 of the out-budget revenue and -0.04 of the budgeted non-tax revenue. This means, with the decreasing level of decentralisation of fiscal power, the local governments rely on the land-transfer revenue to make up the fiscal deficiency, due to the merits of land-

¹⁹王志刚、龚六堂 [Wang Zhigang and Gong Liutang], 《财政分权与地方政府非税收入——基于省级财政数据》, [Decentralisation of Fiscal Power and Non-tax Revenue of Local Government] 《世界经济文汇》 2009 年 5 期 [[Collection of World Economical Articles, 2009 Vol. 5]

transfer revenue which is effective and convenient when compared with other revenue. The land-transfer revenue is the revenue received by local governments from the primary land market for the monopoly of land supply. It is an effective means to raise fund with fewer short-time side effects and thus the first choice for local governments to obtain extra revenue. This is the reason that land-focused development or fiscal policy has become the norm in the local governments. However, the land-focused policy is not sustainable: a stronger reliance on the land-focus economy will increase the structural risk in local public finance. Therefore, decentralisation of fiscal powers may provide a solution to the problem of land-focused economy.

The coefficient of business cycle remains negative when examined in both combined and separate samples, which shows a countercyclical reaction to the non-tax revenue. When the economic burst slows down, the local governments will increase the revenue to make up the fiscal deficiency by the less tax collected, which echoes the situation that there is a surge of non-tax revenue at the age when the increase of tax revenue slows down. The lagged variable of the time of the non-tax revenue has a positive influence over the overall amount of the non-tax revenue and various revenue when examined in the combined samples, which means that there is a path-dependence by the local governments on the non-tax revenue. However, coefficient calculated from the separate samples of 2005-2010 is quite small. One hypothesis is that the fluctuation of the macro economy and administrative intervention by the central government in the real estate market lead to a significant fluctuation of the land-transfer revenue. The level of economic development has a negative influence on the non-tax revenue, budgeted and out-budget revenue. Namely, when the level of economic development is low, there are fewer tax resources and their quality is low as well. In such situation, the local governments are likely to increase the non-tax revenue via fees to make up the tax deficiency. This tendency has no significant impact on the coefficient of the land-transfer revenue, which indicates there is no

direct relation between proportion of land-transfer revenue in the GDP and the level of economic development and such method is a common practice among local government. As to other variables, level of openness, industrial mix, urbanisation, investment on real estate have various influences on the burden of non-tax revenue, which will not be examined separately here.

Table 1 Result of Total Sample of Provincial Government Non-tax Income Burden and the Evaluation

variable	2000-2010			
	Total Burden on Non-tax Income	Budget revenues burden	extra-budgetary revenue burden	Burden on rented state owned land
\ln_Z_{it-1}	0.2436183*** (6.72)	0.5054018*** (8.92)	0.6313131 *** (7.63)	0.2035555*** (5.60)
$\ln_ \sum w_y z_p$	0.8656277*** (7.38)	0.5230007*** (4.66)	0.6548027*** (8.12)	0.6755298*** (11.25)
$\ln_Central$	-0.0050835 (-0.08)	-0.0446889** (-2.54)	0.2125383*** (3.95)	-0.0598366 (-1.63)
$\ln_decentral$	-0.29861*** (-5.84)	-0.0425457*** (-0.90)	-0.2214616*** (-3.81)	-0.5719273*** (-6.26)
$\ln_Avergdp$	-0.2884664*** (-6.34)	-0.2649578*** (-4.68)	-0.2807176*** (-2.76)	-0.0375285 (-0.21)
$\ln_Egrowth$	-0.0294108 (-1.03)	-0.0041656 (0.29)	-0.0013298 (-0.06)	-0.0185996*** (-3.01)
$\ln_taxburden$	0.1412025*** (2.94)	0.066618 (1.45)	-0.1074034* (-1.68)	0.1596889* (1.70)

**Fiscal Decentralization, Multi-level Government Competition and Local Non-tax Revenue: Dynamic Spatial Panel
Model Estimation based on Provincial Data from 2000-2010**

ln_industrystructure	0.6382063 (0.88)	0.3965848 (0.87)	0.7884099 (1.12)	0.0224288 (0.02)
ln_investment	0.4362084*** (3.85)	0.3538041*** (2.88)	0.2189703 (1.16)	0.3797608 (1.02)
ln_cityrate	-0.0811438 (-0.52)	-0.0625922 (-0.68)	-0.0453139 (-0.45)	-0.4063047 (-1.63)
ln_openness	0.0016963 (0.04)	0.0636899 (1.32)	-0.0186465 (0.47)	-0.0151675 (-0.21)
_cons	3.750318*** (4.36)	3.179321*** (4.04)	2.735737*** (2.85)	0.074172 (0.03)
AR(1) testing-P value	-3.09*** (0.002)	-2.77*** (0.006)	-3.45*** (0.001)	-2.12** (0.034)
AR(2) testing-P value	-1.40 (0.161)	0.92 (0.358)	0.61 (0.542)	-0.89 (0.376)
Hansen testing-P value	20.12 (1.000)	17.38 (1.000)	23.04 (1.000)	22.23 (1.000)

**Table 2 Sub-sample Provincial Government Non-tax Income
Burden and the Evaluation**

variable	2000-2004				2005-2010			
	Total Burden on Non-tax Income	Budget revenues burden	extra- budgetary revenue burden	Burden on rented state owned land	Total Burden on Non-tax Income	Budget revenues burden	extra-budgetary revenue burden	Burden on rented state owned land

\ln_z_{it-1}	0.542065 *** (8.23)	0.5538462 *** (8.49)	0.4644371*** (3.83)	0.3786826*** (7.43)	0.1443891* (1.79)	0.3870361*** (6.73)	0.6439702*** (4.35)	-0.03584 (-0.56)
$\ln_ \sum w_y z_{y,t}$	0.489522*** (4.05)	0.0351728 (0.22)	0.4223772*** (3.56)	0.4199803*** (3.35)	0.6952605*** (5.65)	0.0081044** (2.06)	0.4892945*** (6.51)	0.5212485 *** (5.83)
$\ln_Central$	-0.0071871 (-0.06)	-0.0144066 (-0.53)	0.1963263*** (3.22)	-0.1912691*** (-3.15)	0.110369* (1.79)	-0.1112648*** (-2.86)	0.1517883* (1.94)	0.2027771** (2.28)
$\ln_decentral$	-0.3607531 *** (-5.66)	-0.0784909 (-1.09)	-0.1893158*** (-2.56)	-0.9324498*** (-4.28)	-0.2842388*** (-6.11)	-0.0203524 (-0.45)	-0.0198 (-0.43)	-0.660502*** (-5.92)
$\ln_Avergdp$	-0.4773385*** (-3.86)	-0.0033039 (-0.02)	-0.8527343*** (-3.89)	-0.6521932* (-1.95)	-0.2880275** (-2.51)	-0.2864098*** (-5.22)	-0.1174909 (-0.87)	0.1100338 (0.51)
$\ln_Egrowth$	0.0753197 (1.48)	-0.0125463 (-0.61)	-0.0455495 (-0.69)	0.0643039 (0.42)	-0.0063907 (-1.12)	-0.0172446* (-1.82)	-0.0173431 (-0.98)	-0.0002388 (-0.02)
$\ln_taxburden$	-0.1189714 (-1.25)	0.0109245 (0.15)	-0.2040492** (-2.30)	-0.6977157** (-2.31)	0.3585963*** (5.33)	0.0357827 (0.46)	0.1720039 (1.09)	0.3808217*** (2.96)
$\ln_industrystructure$	0.894412** (2.43)	-1.356781* (-1.65)	0.8468895 (1.45)	1.671558 (1.24)	-1.247219* (1.74)	-1.300882*** (-4.02)	0.0066212 (0.01)	-4.923682 *** (-3.16)
$\ln_investment$	0.4474454*** (4.31)	0.4630815** (2.39)	0.0847823 (0.58)	1.440183 *** (2.97)	0.5454273*** (3.36)	0.3204705*** (3.37)	-0.1112935 (-0.82)	0.5612594 (1.55)
$\ln_cityrate$	0.1103514 * (1.78)	0.0187285 (0.21)	0.2585099** (2.40)	0.3383342 (0.92)	0.0080732 (0.15)	0.0219343 (0.29)	0.0087676 (0.05)	-0.3185607 (-1.27)
$\ln_openness$	0.0493489 (0.56)	-0.0007134 (-0.01)	0.2590801** (2.44)	-0.0353839 (-0.14)	0.0477556 (0.87)	-0.0209975 (-0.59)	-0.0529397 (-1.04)	0.0559367 (0.97)
$_cons$	5.249401 *** (4.31)	-1.653614 (-0.76)	7.584724*** (3.41)	5.242618 (1.37)	4.087363** (2.30)	0.3315925 (0.36)	1.952714 (1.46)	-1.997608 (-0.71)

AR(1) testing-P value	-1.86* (0.082)	-2.60 *** (0.009)	-1.78* (0.075)	-1.76* (0.079)	-2.64*** (0.008)	-3.11*** (0.002)	-1.92* (0.055)	-1.67* (0.097)
AR(2) testing-P value	-1.51 (0.132)	0.88 (0.378)	0.79 (0.428)	0.26 (0.795)	0.54 (0.587)	-1.33 (0.183)	-0.15 (0.880)	0.48 (0.634)
Hansen testing-P value	13.31 (0.762)	5.09 (0.532)	20.23 (1.000)	26.42 (1.000)	25.64 (0.897)	22.45 (0.935)	19.54 (1.000)	22.31 (1.000)

4. Conclusion and Policy Advices

In the framework of decentralisation of fiscal power, this article examines the influence of the strategic interaction between different levels of governments on the burden of non-tax revenue and the research finds out that: Firstly, there is a clear horizontal strategic interaction between the local governments, the consequence of which is the increasing burden of the non-tax revenue, and the fundamental reason of it is the economy-focused system of government evaluation. As to the level of strategic imitation, there is the highest level of imitation in the land-transfer revenue, followed by out-budget revenue, and then budgeted revenue and the tendency of change reflects the change of structured non-tax revenue. Secondly, vertical common reaction of local governments to the central governments is gradually reinforced by the deepening progress of non-tax revenue management. As to the categories of revenues, there is a contradicting reaction on the issue of budgeted non-tax revenue from the local governments to the central government but a clear following reaction over the issue of out-budget revenue. The reaction over the land-transfer revenue experienced a change from being contradicting to following. Thirdly, the increase of decentralisation of fiscal power is helpful to relief the reliance on the non-tax revenue by the local governments, which has the strongest effect on land-transfer revenue, and then out-budget revenue and then the budgeted non-tax revenue, which indicates the local

governments rely on land-transfer revenue to make up the financial deficiency when there is a lack of fiscal autonomy.

All these findings provide an idea to control the size of non-tax revenue and improve the management of non-tax revenue. This article gives out three elements to improve the management. Firstly, to build up and perfect safeguard mechanism of basic finance in accordance to the fiscal power, to increase self-sufficiency of local governments, to reinforce the priority of taxation in the local fiscal policy through purging fees and establishing taxes, to increase the autonomy of the local finance, to relieve the reliance on the non-tax revenue especially the land-transfer revenue of the local governments. Secondly, to change the system of government evaluation, to restrain local government's impulse to expand the expenditures, to build a comprehensive evaluation system in the future, to break the GDP-primacy limit, fundamentally restraining the impulse of the expenditure expansion in order to eliminate the incentives to burst the short-term economic increase by collecting the non-tax revenue. Thirdly, to continue the innovation to the management of non-tax revenue, reinforce the authority of inspection of central government over the local governments over the issue of non-tax revenue, the central government should combine the public fiscal budget and administrative fund budget, fulfilling the uniformity of the fiscal budget, measured by the published budget plan of the central government, promote the accountability of the fiscal budget top-down in aspects of scope and level, to achieve the hard constraint on the fiscal budget. Further, the central government should further its guidance, inspection and management over local governments concerning the non-tax revenue, such as cancelling the road-charge, regulating the scope and proportion of the use of land, to achieve better regulation of the non-tax revenue in the local governments.

China's Tax Legislation: Legalism or Functionalism?[☆]

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[Abstract] In China, tax legislation does not pursue traditional taxation legalism based on the concept of 'people's freedom and state intervention' due to the current system of shared legislative power under the centralized government with appropriate delegation. Therefore, the laws and rules on taxation issues are not absolutely covered by the state legislative power. Moreover, China's current taxation law making in practice has the tendency of being governed by the local government's delegated law making powers. This is based on the concept of 'people's freedom and national security' and a result of the impact of taxation functionalism.

[☆]The first draft of this paper was presented on 24-25 November, 2012 at the academic exchange conference on "Chinese Tax Policy: A Multi-Dimensional Dialogue" held by the University of Sydney Business School "Journal of Chinese Tax and Policy", Monash University Law and Policy Research Center and Department of Finance, and Xiamen University, Guangzhou, China. This paper expresses its special thanks to Professor Eva Huang of the University of Sydney Business School, and Professor Jinyan Li of Osgoode Hall Law School, York University, Canada for their valuable comments on this paper. The paper also gives its special thanks to the journal editors for their assistance in the English translation. This paper is funded by the People's Republic of China Ministry of Education, Humanities and Social Sciences Planning Fund (10YJA820141).

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Since China entered its era of reform and opening-up, the nation has endeavoured to accommodate its taxation policies to economic developments. The Global Financial Crisis in 2008 increased China's desires in seeking a taxation policy which would benefit its economic recovery and development, thereby accelerating China's tax reform process. Although it is common for tax reforms to be first piloted in local areas before the relevant policies and measures are extended nationwide, there are divided opinions on whether the pilot property tax reforms in Chongqing and Shanghai since 2011¹ has effectively regulated and controlled real estate markets.² There are also on-going discussions about the legality of the local government's legislation in these pilot reforms.³ People are strongly divided on the issue of whether the local government's legislation in pilot reforms is in conformity with taxation legalism.⁴ Unlike value-added tax, sales tax and resources tax reforms in the past, the new property tax pilot reform schemes are conducted via local rules promulgated by the local government, not administrative measures by the Ministry of Finance or the State Taxation Administration.

Strictly speaking, all of the abovementioned reforms raise the issue of taxation legalism. The question is whether the State Department, its subordinate ministries and

¹In January 2011 as agreed in the executive meetings of the State Council, Chongqing and Shanghai drafted and implemented 《上海市开展对部分个人住房征收房产税试点的暂行办法》（沪府发[2011]3号） and 《重庆市人民政府关于进行对部分个人住房征收房产税改革试点的暂行办法》（重庆市人民政府令第247号） to work on the property taxation pilot reforms on individual housing. Their purposes are to adjust and control the property market using property tax. Currently, there has been some indication to expand the scope of the pilot reforms. See Yu JiaLi 李宇嘉, "New Property Tax or Property Adjustment Trump Card" 《新版房产税或成地产调控杀手锏》, <http://finance.ifeng.com/news/house/20120831/6967561.shtml>, accessed on August 31, 2012.

²Whether the reform on property tax will exhibit its function of adjusting and controlling the property market is beyond the scope of discussion of this paper.

³This issue became one of the hot topics discussed by the representatives to the National People's Congress (NPC) and Chinese People's Political Consultative Conference (CPPCC) Members who attended the Two Sessions held in Beijing, March 2011. See "Analysis of six inquiries on property tax: NPC and CPPCC's discussion on property tax reform" 《解析房产税六大疑问——代表委员热议房产税改革》, http://www.gov.cn/jrzq/2011-03/02/content_1815041.htm, accessed on 9 March 2011.

⁴For positive opinions, see "Legal experts argue inadequate validity over the pilot reforms on property tax" 《法律专家称沪渝试点房产税存合法性不足问题》, <http://news.sina.com.cn/c/2011-02-13/035521945340.shtml>; for negative opinions, see "Legal Daily published article yesterday to clarify the seven big misconceptions on property tax" 《法制日报昨日发表文章澄清房产税的七大误读》, http://news.ifeng.com/mainland/detail_2011_02/08/4578744_0.shtml, accessed on 23 February, 2011.

commissions, and local governments can and to what extent legislate on other taxation matters under China's current legislative system. Clearly, the answer to this question brings us to our theoretical understanding of taxation legalism, further discussion will involve our understanding of the relationship between individual freedom and China's state functions under the current socio-economic conditions. This paper attempts to explain a range of modern opinions and understandings on taxation legalism and functionalism. We will also demonstrate the impact on the development of China's taxation framework under the influence of a functional approach to taxation, and the trend of Chinese tax legislations under this influence. The first chapter of this paper summarises China's legislative structure and the manifestation of taxation legislation under such structure. The second chapter analyses the content and theoretical basis of taxation legalism. The third chapter shows how modern society's attention to the function and utilisation of tax macro-management and adjustment caused the doctrine of functionalism to impact on taxation legalism, and analyses the change in people's understanding of the role of the state in this background. Chapter Four shows the trend of Chinese taxation legislation under the influence of taxation functionalism.

1. China's Legislative Structures and Forms of Taxes

1.1 China's Legislative Structure

People generally recognise that state power in fact has multiple compositions, but in practice many are accustomed to dividing state powers by type into the legislative, executive and judicial powers, each of which has its own complex framework.

Legislative power is the power to draft, approve and amend the manifestations of legal control such as the Constitution, laws, administrative measures, and regulations. It involves the power to draft, approve, amend, supplement and repeal laws; tabling,

examining and voting on bills drafted, and to issue, accept or deny laws.⁵ Although the principle of sovereignty by the people stipulates that the modern state's legislative power should belong to the people and not be exercised by any single person, legislative power is still exercised by specific state organs, whether it be a federated state or a unitary state. However, due to the differing circumstances of each state, the state organ of each country may form various systems to separate legislative powers such as a single-level unitary legislative system, a multi-level unitary legislative system, a compound legislative system, and a system of separation of powers.⁶

In China, not only can legislative power be divided into two categories: authority legislation (power to legislate) and authorised legislation (power to enact delegated legislation), but it can also be divided into three levels: state legislative power, central government legislative power and local legislative power. Legislative power in each category and each level can target different issues with regulations of varying level of effectiveness. Some scholars have described this system of legislative power as a legislative power sharing system led by the central government involving appropriate levels of delegation with multiple categories and levels of law-making power.⁷

Authority Legislation

Authority legislation is the power for relevant state organs to conduct legislative activities based on the authority under the Constitution or other laws. There is close connection between authority legislation, the state's political structure and the state's structural framework. Authority legislation can be subdivided into state legislative power, central government legislative power, and local legislative power.

State Legislative Power

⁵Wangsheng Zhou 周旺生, 'Laws on Legislative Powers' (立法学), 1998, 法律出版社, p 223.

⁶Wangsheng Zhou 周旺生, 'Laws on Legislative Powers' (立法学), 1998, 法律出版社, pp 148-152.

⁷Wangsheng Zhou 周旺生, 'Laws on Legislative Powers' (立法学), 1998, 法律出版社, p 153.

State legislative power is the power exercised on behalf of the state, which holds supremacy in the legislative power system. Laws made with the state legislative power are often used to adjust the most basic and macro social relationships. It has the highest level of legal effectiveness. According to the Constitution of the People's Republic of China, the National People's Congress (NPC) and its Standing Committee can exercise the state legislative power including the power to make or amend constitutions, law-making power, and legislative oversight power.⁸ As the Constitution does not stipulate any issues that the NPC and its Standing Committee cannot legislate upon, theoretically it can be understood to have powers to make laws on any issue within its sphere of authority, including any issues to be regulated by law under the Constitution.⁹ On this basis, state legislative power is the most complete, comprehensive and broad form of legislative power. The Legislation Law of the People's Republic of China completely affirms this.¹⁰ The Legislation Law also establishes the exclusive power of the NPC and its Standing Committee to legislate on certain issues and items.¹¹

Central Government Legislative Power

⁸ Constitution of the People's Republic of China 《中华人民共和国宪法》 Articles 58, 62, 67.

⁹Some people argue that any matters stipulated under the Constitution of the People's Republic of China 《中华人民共和国宪法》 that are "...protected by the Nation according to the law", can be adjusted by the laws made under the State legislative power. Therefore, the NPC and the Standing Committee can legislate the matters related to Articles 2,9,10,11,13,16,17,18,19,31,34,37,39,40,41,44,50,51,55,56,59,72,73,75,77,78,86,89,91,95,99,102,104,107,109,111,115,124,125,126,130,131 of the Constitution. See Wangsheng Zhou 周旺生, 'Laws on Legislative Powers' (立法学), 1998, 法律出版社, p 299.

¹⁰The Law of the People's Republic of China on Legislation 《中华人民共和国立法法》 Article 7 stipulates that the NPC and its Standing Committee can exercise the state legislative power.

¹¹The Law of the People's Republic of China on Legislation 《中华人民共和国立法法》 Article 8 stipulates that laws can only be enacted on the following matters: (1) matters concerning state sovereignty; (2) the formation, organisation, functions and powers of the people's congress, people's governments, people's courts and people's procuratorates at various levels; (3) the national regional autonomy system, special administrative region system and grass-roots mass autonomy system; (4) crimes and punishment; (5) compulsory measures and penalties such as deprivations of citizens' political rights and restrictions on personal freedom; (6) acquisition of non-state-owned property (7) the basic civil system; (8) basic economic system and basic systems of finance, taxation, customs, banking and foreign trade; (9) procedural and arbitration system; (10) other matters on which the NPC or the Standing Committee must enact laws.

The central government legislative power is the power exercised by the State Council, the highest state administration executive organ. According to the Constitution of the People's Republic of China, the State Council has a series of executive and administrative powers such as issuing administrative measures and regulations in accordance with the Constitution and other laws, as well as enacting administrative regulations, issue decisions and orders.¹² The scope of items that the State Council can issue regulations on is divided into two areas: 1) matters for which the enactment of administrative regulations is required in order to implement a national law; 2) matters within the scope of the State Council's administrative authority.¹³ Due to the broad executive and administrative powers of the State Council, the State Council can enact regulations on matters not regulated by the NPC and the Standing Committee, unless the matter falls within the scope of Rule 8 of the Legislation Law. In other words, aside from matters to be exclusively regulated by state legislative power as stipulated by the Legislation Law, there are no other limitations placed on the scope of matters that the State Council can enact administrative regulations on.

The 'central ministries legislative power' is related to the central government legislative power. The power belongs to subordinate organs to the ministries and commissions under the State Council, including the People's Bank of China, China National Audit Office, and direct subsidiary bodies with executive and administrative functions. The power allows these bodies to make regulations of their own, within their authority and in accordance with general law and the State Council's administrative regulations, decisions and orders. These subordinate bodies can exercise the central ministries legislative power to execute laws on the one hand, and execute the State Council's administrative measures, decision and orders on the

¹²Constitution of the People's Republic of China 《中华人民共和国宪法》 Article 89.

¹³Constitution of the People's Republic of China 《中华人民共和国宪法》 Article 56.

other.¹⁴ Compare the central ministries' legislative power with the central government legislative power, we can see that the powers overlap when administering laws. This means that under some circumstances, the State Council can choose not to enact administrative regulations, but to make decisions and orders requiring its subordinate ministries and commissions to make regulations instead.

1.1.1 Local Legislative Power

Local legislative power is related to the form of state structure, it exists in countries where central governments appropriately delegate to local governments. China's local legislative power itself is a multi-tiered legislative system, it includes general local municipalities legislative power, legislative power in the ethnic autonomous areas, and general local government legislative power.

According to the Constitution of the People's Republic of China, the general local municipalities' legislative powers are enjoyed by the provincial and municipal level NPCs and their Standing Committees. Provided that they do not violate the Constitution, general law and administrative regulations, they can make local regulations on the scope of matters including:¹⁵ firstly, matters where the enactment of a local decree is required in order to implement a national law or administrative regulation in accordance to the actual situation of the jurisdiction; secondly, matters of local affairs requiring local regulations; and thirdly, matters other than prescribed matters in the Law of the People's Republic of China on Legislation, which the State has not yet enacted any laws or formulated any administrative regulations on, and the

¹⁴Constitution of the People's Republic of China 《中华人民共和国宪法》 Article 90, The Law of the People's Republic of China on Legislation 《中华人民共和国立法法》 Article 71.

¹⁵Constitution of the People's Republic of China 《中华人民共和国宪法》 Article 100.

specific conditions or requirements of the locality makes it necessary to enact local laws.¹⁶

The legislative power in the ethnic autonomous areas is the power to allow the People's Congress of national autonomous areas to enact autonomous regulations in light of the political, economic and cultural characteristics in the areas concerned.¹⁷ Provided there are no contradictions to basic principles of laws or administrative regulations, autonomous laws and separate regulations may provide for adaptive provisions on laws and administrative regulations. This does not extend to the Constitution, the Law on Regional National Autonomy and other applicable laws.¹⁸

The general local government legislative power refers to the power to make laws on provinces, autonomous regions, municipalities and larger cities based on the laws, administrative regulations and local regulations of the provinces, autonomous regions and municipalities under the central government. The matters which local government may legislate upon include: 1) matters which the formulation of rules is required for the purpose of implementing laws, administrative regulations and local regulations and; 2) matters of specific administration of their own administrative areas.¹⁹

Compared with the scope of matters that can be regulated by the state legislative power, it is not hard to see that the central government legislative power and local legislative power are limited. The same restrictions are imposed on them by the Law of the People's Republic of China on Legislation, which requires that the relevant legislative matters to the authority legislation must be in its nature necessary for the implementation of the provisions of the laws; or the matters must be within the scope of the administration of the state organs or local administrative areas. If a matter is not

¹⁶Constitution of the People's Republic of China 《中华人民共和国宪法》 Article 64.

¹⁷Constitution of the People's Republic of China 《中华人民共和国宪法》 Article 116.

¹⁸Constitution of the People's Republic of China 《中华人民共和国宪法》 Article 66(2).

¹⁹Constitution of the People's Republic of China 《中华人民共和国宪法》 Article 73.

within the relevant scope of the administration of state organs or local administrative areas, the state organ shall not exercise its authority legislative power. It is evident that while the state legislative power is comprehensive, complete and exclusive, the central government legislative power and local legislative power are limited, supplementary and temporary.

Furthermore, it is important to note that there is the technical concept in China's current legislative practice of the 'law should be broad rather than narrow'. Under this concept, there are various provisions relatively principle-based and abstract, and the gap between each provision is considerably wide lacking practicality in practice and execution. This thus requires the State Council to enact further administrative regulations or for the local government to lay down local regulations and rules in order to refine the relevant provisions to improve their practicality, and fill the gaps between the provisions to improve the coverage density of the laws.²⁰ As a result, the function and effect of the central government legislative power and local legislative power are substantial in the state's rule of law system.

²⁰ The technical concept of China's current legislative work "should be broad rather narrow" originated from the former Chinese leader, Deng Xiaoping's legal thought. Before the era of reform and opening of China in 1978, Deng Xiaoping published a paper titled "Emancipating the mind and seeking the truth from facts towards solidarity" 《解放思想，实事求是，团结一致向前看》 stating that: "The current legislative workload is large and there is not enough manpower. Therefore, legal provisions should start off broad and gradually improve. Some regulations can be tested locally first and after review for improvement, they can then be implemented nationwide. You should engage in a process of changing and amending the laws rather than waiting for a "completed set". In summary, it is better to have laws than not have laws, and to engage in a quick job than a slow job." See "Selected Works of Deng Xiaoping" 《邓小平文选》 Vol. 2, People's Publishing House 人民出版社, 1983, p 147. Deng Xiaoping's legal thought garnered support from Peng Zhen, who served as the vice-chairman of the NPC Standing Committee as well as the director of the NPC Legislative Committee since June 1979; and secretary of the CPC Central Committee of the Political Committee in 1980. He became the chairman of the Sixth NPC Standing Committee in June 1983, and left his post in 1988. Peng Zhen has made an outstanding contribution by leading the Chinese to enter the early stages of reform and opening up of the socialist legal system for approximately 10 years. He inherited Deng Xiaoping's thought on legislative techniques that "for a large country like ours, the local political, economic and cultural developments are too uneven, which is why the law can only solve the basic problems. Laws cannot be specified too narrowly, as it would then become difficult to apply to the whole country. In order to solve the problems according to the local conditions, once a law has been made, it would generally require the enactment of implementation rules and make specific provisions. Nationwide implementation rules should be formulated by the State Council, while local implementation rules should be formulated by NPC and the Standing Committee of the provinces, autonomous regions and municipalities." See PengZheng, "On the new era of Socialist Democracy and Legal System" 《论新时期的社会主义民主与法制建设》, 中央文献出版社, 1989, p 246.

1.1.2 Delegated Legislation

Aside from the aforementioned authority legislation, there is another form of legislative power known as delegated legislation in China's legislative system. Delegated legislation refers to the relevant state organs without legislative power to regulate over relevant matters, which may obtain limited powers to legislate on these matters if other organs with specific authority delegate them the power to do so. With the delegated legislative power, the organs with such power shall legislate only within the scope provided by the organ that delegates the power; otherwise it will defeat the purpose of delegated legislation. China's current delegated legislation includes two aspects: 1) the special laws about special administrative regions which delegates the legislative power to the special administrative areas;²¹ 2) the two delegated legislations regulations of the People's Republic of China on Legislation, which allows the NPC and the Standing Committee to delegate legislative powers to the State Council and Special Economic Zones. The former is to solve the problem of the issue of sovereignty and the principle of 'one country, two systems' in the Special Administrative Regions of Hong Kong and Macau. While this delegated legislation is a part of China's legislative power system, it has little relevance to what this article aims to discuss. Therefore, the article will not attempt to further explain this delegated legislation and only focus on the discussion of the latter aspect.

1.1.3 Delegated Legislative Power to the State Council

The practice of delegation of the legislative power by the NPC and the Standing Committee to the State Council to regulate over certain matters commenced before the implementation and operation of the Law of the People's Republic of China on

²¹ Article 2 of the People's Republic of China Hong Kong Special Administrative Region Basic Law 《中华人民共和国香港特别行政区基本法》 stipulates that the NPC authorises the Hong Kong Special Administrative Region a high degree of autonomy enjoying executive, legislative and independent judicial power in accordance with the provisions of this Act.

Legislation. For example, in 1984, the 7th Meeting of the Standing Committee of the Sixth National People's Congress made a decision on delegating legislative power to the State Council to release the draft of relevant taxation provisions on the commercial tax system reform, and permitted the State Council in the process of implementing the state-owned enterprise tax and commercial tax system reform, to draft relevant tax regulations. The draft was then to be released for trial implementation. Later, according to the experience of the trial implementation, the draft can be revised and submitted to the NPC and the Standing Committee for deliberation.²² In 1985, the 3rd Meeting of the Standing Committee of the Sixth National People's Congress decided to delegate the power to the State Council and allowed it to enact temporary regulations or rules in relation to the reform of the economic system and the opening-door policy. The State Council is delegated the power to lay down provisional regulations or rules in relation to the reform of the economic system and the opening-door policy, enact, implement and submit to the NPC Standing Committee for the record. Once they are tested and the time is ripe, the NPC or the Standing Committee will enact the law.

After the enforcement of the Law of the People's Republic of China on Legislation, the abovementioned experience with delegated legislations is summarised and a relatively more complete regulation is made. Aside from matters concerning crimes and punishments, compulsory measures and penalties such as deprivations of citizen's political rights and restrictions on personal freedom and the judicial system, the NPC and its Standing Committee can authorise the State Council to formulate administrative regulations based on the actual needs. Such authorisation shall clearly

²² According to the 9th Meeting of the Standing Committee of the Eleventh National People's Congress in 2009, the meeting adopted the decisions about abolishing some of the laws. This particular delegated decision has been abolished. The reason for abolishment is that in 1985, the NPC has delegated another legislative power to the State Council to enact temporary regulations or provisions in relation to the reform of the economic system and the opening-door policy. This later decision overrides the previous delegation. According to the later delegation, the State Council has enacted a series of provisional regulations and has not released any draft form taxation regulations in relation to the same type of taxes to be implemented for trial.

define the purpose and scope of such power, and the organ being authorised shall exercise the authority strictly in accordance to the purpose and scope of authorisation. Furthermore, the organ being authorised shall not transfer the authority to any other organ. When the conditions are ripe for enacting a law on an authorised legislative matter through practice, the NPC and its Standing Committee should enact a law in a timely manner, and the authorisation of such legislative matter is thereby terminated.²³

1.1.4 Delegated Legislative Power to the Special Economic Zones

Similar to the practice of the delegated legislative power to the State Council by the NPC and its Standing Committee, before the Law of the People's Republic of China on Legislation laid down any regulations upon the delegated legislative power in relation to the special economic zones, the NPC and its Standing Committee can already make the decision of individual authorization. The NPC and its Standing Committee delegates the legislative power to the NPC and the Standing Committee of the provinces, municipalities and local level which have the current existing special economic zones to lay down regulations and rules within the limits.²⁴ The Law of the People's Republic of China on Legislation institutionalised this particular delegated legislation through two aspects: 1) to admit that 'the people's congresses and their

²³The Law of the People's Republic of China on Legislation 《中华人民共和国立法法》 Articles 9, 10, 11, 56.

²⁴ The decisions for delegations are: In 1981, the 21st Meeting of the Standing Committee at the Fifth National People's Congress passed a resolution to authorise the NPC and the Standing Committee of Guangdong province, Fujian province to lay down regulations and rules over their special economic zones; In 1988, the 1st Meeting of the Standing Committee of the Seventh National People's Congress passed a resolution to establish Hainan special economic zone and authorise the NPC and the Standing Committee of Hainan province to lay down regulations and rules over their special economic zones; In 1992, the 26th Meeting of the Standing Committee of the Seventh National People's Congress passed a resolution to authorise the NPC and the Standing Committee of Shenzhen and Shenzhen municipal government to lay down regulations and rules over Shenzhen special economic zone; In 1994, the 2nd Meeting of the Standing Committee of the Eighth National People's Congress passed a decision to authorise the NPC and the Standing Committee of Xiamen and Xiamen municipal government to lay down regulations and rules over Xiamen special economic zone; In 1996, the 4th Meeting of the Standing Committee of the Eighth National People's Congress passed a decision to authorise the NPC and the Standing Committee of Shantou and Zhuhai, and Shantou and Zhuhai municipal governments to lay down regulations and rules respectively over their special economic zones. Under these decisions, the special economic zones associated local NPC and the Standing Committee have the delegated legislative power to lay down regulations in accordance to the rules in the Constitution and the basic principles of laws and administrative regulations. The Law of the People's Republic of China on Legislation 《中华人民共和国立法法》 has not regulated upon the delegated legislative power in relation to the special economic zones involved in these decisions.

standing committees of provinces and cities where the economic special economic zones are located formulate regulations in accordance with the decision of authorization by the NPC and operate within the limits of special economic zones; 2) if the regulations of special economic zones lay down the adaptive provisions for laws, administrative regulations and local regulations upon the authorisation, their provisions can only operate within their special economic zones.’²⁵

It should be noted that as distinguished from the delegated power to the State Council, the Law of the People's Republic of China on Legislation does stipulate when to terminate the delegated power by the NPC and its Standing Committee to the special economic zones. This delegated legislative power to special economic zones is rich in the characteristics of local legislative power as it is about the legislation over relevant special economic zones matters, which have been regulated by the laws, administrative regulations or local regulations. However, the delegated power to special economic zones allows the adaptive provisions to be laid down for laws, administrative regulations and local regulations upon the authorisation in accordance with the actual circumstances and needs of the special economic zones, as long as it complies with the regulations of the Constitution of the People's Republic of China, laws, administrative regulations and basic principles. Obviously, this particular delegated power to special economic zones is similar to the legislative power enjoyed by the NPC and its Standing Committee of national autonomous areas. Therefore, the delegated power to the special economic zones in practice should be understood as the NPC and its Standing Committee delegating some degree of right of autonomy to the special economic zones. This is a new relationship between the central and the local government formed in response to China's reform and opening-up activities. Each

²⁵ The Law of the People's Republic of China on Legislation 《中华人民共和国立法法》 Articles 65, 81.

special economic zone has thus obtained the local legislative power under the authority legislation as stated in the Constitution of the People's Republic of China.

1.2 China's Tax Legal Form

As a product of the division of the legislative power system, China's current tax legal form is diverse as it involves central level laws, administrative regulations and departmental rules, as well as local laws and regulations at the local level.

There are only four legal forms within the central level tax laws, which are Personal Income Tax Law, Corporate Income Tax Law, Tax Law on Vehicles and Ferries, and the Law on the Administration of Tax Collection. Out of the 19 types of taxes collectible, only 3 of the abovementioned Personal Income Tax, Corporate Income Tax and Tax Law on Vehicles and Ferries of the highest level legal norms take legal forms, while other remaining taxes exist in the form of administrative regulations. Aside from the laws and administrative regulations laid down by the central level on the basic system of the relevant types of taxes, departmental rules, local regulations and laws have also laid down detailed regulations individually for the specific implementation of each type of tax, which forms a legal norm system based on each type of tax.

Except for the abovementioned 19 types of taxes, there does not yet exist a type of tax regulated by the regulations laid down by the State Council and relevant organs or the local regulations by the local government as the highest-level legal norm. This in practice suggests that under the current legislative power system, it is the NPC and the Standing Committee that enjoy the legislative power to develop a new type of tax. Other legislative bodies do not enjoy the legislative power on these matters under this system. Furthermore, the current practice of taxation legislation suggests that, the legislative power enjoyed by the NPC and its Standing Committee is almost unlimited, and as such legislating over taxation matters should be within the legislative power of

the NPC and its Standing Committee. However, the current actual circumstances of taxation legislation illustrates that the NPC and its Standing Committee do not adequately exercise their power, instead, most of the legislation on types of taxes are the products of the exercise of power by the State Council.

It should be noted that in accordance with the Constitution of the People's Republic of China, the State Council enjoys the central government legislative power as well as delegated legislative power on specific matters by the NPC and its Standing Committee. Consequently, it is worthwhile to further research into what is the nature of the legislative power enjoyed by the State Council based on prior discussion on the legislative power based on the administrative regulations on taxes. In fact, the legislative power enjoyed by the State Council to lay down administrative regulation on the basic system of relevant types of taxes belong to the scope of delegated legislative power. The delegation was obtained and evidenced in the aforementioned two decisions by the NPC and its Standing Committee in 1984 and 1985, while the Law of the People's Republic of China on Legislation further ascertains the delegation through legal formality, which clearly states that the NPC and its Standing Committee can authorise the State Council to lay down administrative regulations in relation to matters about the basic system of tax collection provided there are no pre-existing laws. However, this type of delegation cannot be transferred to other organs.²⁶ Accordingly, the power to lay down administrative regulations on the 'basic system' of relevant taxes belongs to the delegated legislative power of the State Council. In other words, the central government legislative power itself as enjoyed by the State Council under the Constitution does not include the power to lay down administrative regulations in relation to the matters on the basic system of taxes.

²⁶ The Law of the People's Republic of China on Legislation 《中华人民共和国立法法》 Article 10.

2. Taxation Legalism and its Theoretical Basis

2.1 *The Connotation of Taxation Legalism*

Amongst China's current taxation theories, more and more people have come to accept the concept of taxation legalism, while the understanding of its theoretical connotation has also become gradually united. In China, the current general thought is that taxation legalism involves three levels: taxation elements legalised, taxation elements clarified, and the taxation procedures legalised. Taxation elements legalised means that all taxation elements, including the subject of taxation, object of taxation, tax rate and so on, should be regulated by the laws laid down by the national representative institutions. Taxation elements clarified means that the taxation elements regulated by the taxation law should be actually operational or practical and predictable. The concepts used in regulating each taxation element should be communicated clearly, precisely and specifically described. Taxation procedures legalised means that the tax collecting organs should comply with the tax collection procedures laid down in the tax collection and procedure law.²⁷ If the above three aspects are analysed in detail, it can be observed that each of the three aspects show different intrinsic values.

²⁷ It should be noted that scholars do not express the same explanation to the connotation of taxation legalism. However, to summarize their opinions, the connotation of taxation legalism can be sorted into three aspects: taxation elements legalized; taxation elements clarified; and the taxation procedures legalized. See more for different opinions from scholars on the connotation of taxation legalism in Liu & Xiong 刘剑文、熊伟, 'Taxation Basic Theories' 《税收基础理论》, 2003, 北京大学出版社, pp 103-105.

2.1.1 Taxation Element Legalised and the Democratic Characteristic of Taxation Law

Taxation element legalised is the most basic connotation of taxation legalism, which also implies its pursuance to the democratic values of taxation law. When the scholars who support and agree with taxation legalism introduce and describe taxation legalism, they all start with the history of taxation legalism and connect it with the Western bourgeois revolution. The most significant ones are the English Revolution, the American Revolution and the French Revolution. They describe a story in which the right of tax collection established in these revolutions should have the people's consent. Against this historical background, the national taxation shall obtain people's consent, and 'no taxation without representation' has thus become an irrefutable principle. From the perspective of supporters of taxation legalism, people's consent can only be expressed via representative institutions elected by the people, and only the national representative bodies can develop and adopt the legal form of taxation law.

In fact, this understanding means that: 1) laws laid down by the representative bodies are the only way to express and reflect the people's will, yet the question as to whether the representative bodies have actually extensively collected the public opinions when they lay down the taxation laws is not considered; 2) other state organs do not possess the function of expressing people's will. If these other state organs lay down taxations laws, they will directly infringe taxation democracy even when the organs have gone through the specific legislative procedure, which requires extensive collection of public opinions. Evidently, there exists a tendency to simplify the form of democratic characteristics of taxation law into a unique aspect of the legislative bodies, instead of effectively linking the democratic characteristics of taxation law with the extensive basis of public opinion.

2.1.2 Taxation Elements Clarification and the Predictability of Taxation Law

The predictability of taxation law is the most important element in the rule of law. Law as a social norm formulated by the state and its enactment will guide, evaluate and educate the people's activities. Therefore, the people who arrange their activities according to taxation laws will be able to predict the legal consequences and understand the scope of their freedom. In fact, the realisation of the values of taxation law predictability does not depend on the level of the legislative body in the legislative power system, but only relies on the two preconditions: 1) the taxation legislation content and the intention of the norms should be clear and; 2) the taxation legislation content and the intention of the norms should be expressed accurately in the actual words and texts of the laws.

Tax legislation content and the clarity of intention of norms require that legislators know the type of tax laws they are going to make, the aims of norms, the scales of time and space, the range of people affected, the scope of behaviours and the degree of norms. These boundaries have to be defined. This means that legislators do not intentionally and subjectively blur the content and intention of the norms of the legislation, which is not to leave a subjective loophole in the written law. The legislators unwittingly create subjective legal loopholes when they intentionally use many abstract or uncertain terminologies and phraseologies, or summarise clauses to blur the contents and intention of the norms of the legislation.

The purpose is to allow people to have multiple interpretations of its meaning. The formation of the subjective legal loophole may be traced to the legislators' indolence, or to a conscious effort to ensure the adaptability of the laws to the fluctuant life. In a modern country under the rule of law, there should be efforts to get rid of legislative indolence. However, if we only consider the latter situation - while it may be reasonable to some degree - there should not be an excessive use of such abstract or uncertain terminologies in a written legal document to blur the contents and intention

of the norms of the legislation. Otherwise, the law would lose its true meaning of dictating behavioural norms.

To be distinguished from the first precondition, the second precondition is that the legislation content and the intention of the norms should be expressed accurately in the actual words and texts of the laws. It requires the legislators to use appropriate legislative techniques to allow legal documents to accurately, completely and adequately express legislative content and intentions of norms. It can also promote the succinct expression of legislative contents and norms, and prevent unhelpful omissions, thereby excluding the legal loophole. Obviously, the issue of legislative techniques in relation to the accurate expression of legislation is significant. In this respect, the objective level of efficiency of legislative techniques will determine the degree of realisation of legislative predictability. In reality, although the legislators do subjectively pay great attention to improving their legislative techniques, it should be recognised that, as to the specific legislators in a certain period of time, their legislative technical capabilities are objectively on a relative level. Therefore, subject to these technical limitations in this certain period of time, the value of the predictability of the laws is on a relative level as well.

2.1.3 Taxation Procedures Legalised and Due process

Simply speaking, taxation procedure legalised means that the tax authorities on tax collection and activities should be run on the rule of law track and in compliance with the procedure laid down by law. Generally, the state's tax activities are achieved under the substantive law of taxation and the tax procedural law. The substantive law of taxation regulates the substantive requirements of national taxation, whereas the tax procedural law guarantees the successful completion of the activity when the substantive requirements have been satisfied. Since tax collection and paying activities cannot be completed by a single participation of either the taxpayer or the

representative of the national tax authorities, tax procedural law needs to make adjustments on both sides in relation to their individual behaviours and limits on this tax collection and paying activity. Thus, according to the different stages of the implementation of the tax levy activities, the taxation procedures have been divided into different stages. The tax procedural law will then implement the adjustments on both sides of their conduct of behaviours and limits at different stages, through their individual procedural rights and obligations set in the various stages. For example, the People's Republic of China's Law on the Administration of Tax Collection Management Act divides the tax collection process into tax registration, book management, tax declaration, tax collection, tax inspection and other different stages. It also provides the relevant rights and obligations of both the taxpayer and the tax authorities at each stage.

The legal procedure of taxation is an extension of the taxation legalism doctrine at the level of taxation procedures, which is different from the general administrative procedures. Taxation procedures are governed by legal principles, which mean that the initiation and completion of the tax procedure are not only the rights of the tax authorities but also their obligations. The tax authorities do not have the power to decide whether and when the procedure should proceed. This is because tax authorities, as a 'trustee' of the whole group of taxpayers, has the task of strictly implementing the substantive law and regulations of taxation through tax procedures in order to achieve the equality of the taxpayers tax, rather than to maximise the benefit to the Treasury as opposed to the taxpayers.²⁸In this sense, the legal procedure of taxation aims to achieve its due process value, namely, the openness of the procedures, participation and transparency, the reflection of procedural fairness,

²⁸KechangGe 葛克昌, 'Administrative Procedures and Basic Rights of Taxpayers' 《行政程序与纳税人基本权》, 北京大学出版社, 2005, pp 7-14.

procedural justice and the protection of fundamental human rights, without allowing the procedures to become an arbitrary decision process.

2.2 The Theoretical Basis of Taxation Legalism: 'People's Freedom and State Intervention'

Indeed, despite taxation legalism has its intrinsic values in relation to the connotations of the above-discussed three aspects, they are connected to each other. The purpose is to collectively ensure the values of taxation democracy as taxation legalism pursues. In this sense, taxation element legalised is placed in the central position. Firstly, taxation element legalised means that the national representative bodies through legal formalities can only determine the taxation legislative matters. It is the establishment of the value of the democratic nature of the taxation law concerning whether democracy should be reflected in taxation law or not. Secondly, taxation element clarification will help promote democracy in taxation. In other words, will only be regarded as a matter of form conceptually unless the legislative contents and the intention of the norms are clearly and accurately expressed as required by the taxation element clarification, taxation element legalism . . . Finally, legal taxation administration will guarantee the substantive aspect of the democracy in taxation law. . . Namely, the democracy value in taxation can only be and eventually achieved for the benefit of all taxpayers through legal and legitimate tax administration.

The inherent theory of taxation legalism in pursuit of the values of taxation democracy is embedded in the concept of 'people's freedom and state intervention'. This concept can be sourced to the modern natural right theory and national theory, which can be found in the classic writings of Hobbes, Locke et al. Under this concept, people have the right to enjoy the freedom of property and personal freedom. This is the theoretical precondition of the existence of a state, and this in theory constitutes the status of pre-state, which is the natural right enjoyed by the people. Under the status of pre-state,

people obtain the material guarantee on their personal freedom and self-development through their own production that creates wealth. Based on the logical starting point of the private property theory, being a country of political organisation is to avoid the misfortunes of the people, the most serious being wars, under the status of pre-state. However, it can only play a negative role as a 'night watchman' with only an instrumental value, which protects the pre-existing rights enjoyed by the people under the former state situation in relation to their freedom of property and personal freedom. Obviously, this argument puts forward that personal liberty and property freedom are the two most fundamental freedoms of the people. They are also placed in an absolute supreme position in which they cannot be violated or deprived. The fundamental purpose and meaning of the existence of a state is to protect the two freedoms of people. In this sense, any deprivation of personal liberty or property freedom is illegitimate.

However, the state cannot perform its abovementioned functions without making certain restrictions and deprivation on the people's property and personal freedom. On the one hand, in order to protect the people's property and physical integrity from infringement, the state must impose penalties that will affect personal liberties to prohibit such infringements upon other people's property and physical integrity. On the other hand, since the state itself does not own the property, the state needs to obtain a certain amount of financial resources from the people's private property through the form of tax, in order to achieve the purpose of the presence of its instrumental value within the necessary limits. Therefore, in order to ensure penalties and tax collection – the state will make certain legitimate restrictions and interventions on the people's property and personal freedom, and when the state takes steps to tax and penalise, the state must obtain the people's consent. In the current society, this consent in practice is through the institutions created by the people's representatives expressed in legal form. Thus, this formulates the concept of 'Crime Legalism' in criminal law and 'Taxation Legalism' in tax law.

Obviously, under the concept of 'people's freedom and state intervention', the tax activities for the purposes of financial income of national organisations are construed as constituting an invasion and even deprivation on the people's private property. It relates to the issue of restricting people's fundamental rights to property as stated in the Constitution, a social contract between the people and the state. Therefore, the significance of attributing tax legislative matters to the state legislative power is to ensure that the state's taxation activities will be strictly controlled under people's consent and obtain democratic legitimacy through people's consent so as to prevent any infringement by the state taxation powers to the property rights enjoyed by the people under the Constitution.

This shows that under the concept of 'people's freedom and state intervention', taxation legalism requires that taxation laws be laid down by the legislative bodies with state legislative power expressed in legal formalities. The most fundamental consideration is to achieve the value of taxation democracy, in order to prevent the infringement of people's rights to the property by the state's tax activities. In contrast, the value of the predictability of taxation law is not the primary concern, even though taxation laws laid down through legal formalities are more stable and more conducive to achieving the value of predictability of law. Meanwhile, taxation legalism also regards the representative body itself as the only institution to express the people's consent, and excludes any democratic legitimacy of other state bodies making taxation laws. However, with the functional changes of tax in the modern economic society, the attention to the functions of taxes has given rise to taxation functionalism, which has significant impact on taxation legalism.

3. Taxation Functionalism and its Impact on Taxation Legalism

3.1 *The Rise of Taxation Functionalism*

As the economic and social development of modern nations proceed with a degree of complexity, state functions have morphed from the negative role of enforcing rules and laws that protect and safeguard civil liberties, to a positive function of promoting civil rights and public orders. In a modern society, the political organisational structure of rule-of-law countries plays a comprehensive organisational function in relation to social internal politics, economics, and social and cultural aspects. It has become a tool for the people to govern themselves, which not only maintains and protects the range of basic freedoms and rights enjoyed by the people, but also provides livelihood and welfare protection to the people. It allows the people to ultimately achieve freedom and self-development. In other words, the modern rule-of-law nation has moved towards a contemporary state ideal that considers the people's livelihood and welfare with no return.²⁹ Therefore, the modern country and society are increasingly closely connected. The people's enjoyment of the right to property and basic personal freedoms has become integrated with the country's status as one, which has become an inevitable product under the role of the state.

In modern society, the fact that the people's rights to various property and basic freedoms form an inevitable product of state action seems to create a new concept of 'freedom and national security' that differs from previously-held concepts. Under this new concept, the relationship between the people's freedom and the state and their right to property and basic freedoms cannot exist independently without state guarantee. In other words, unlike the concept of 'people's freedom and state

²⁹KechangGe 葛克昌, 'National Science and National Law: the Social State, Rental Tax State and the Rule of Law Country Concept' 《国家学与国家法:社会国、租税国与法治国理念》, 1996, 台湾月旦出版社股份有限公司, pp167-214.

intervention', the concept of 'people's freedom and national security' does not recognise the existence of a natural, inherent property right and basic freedoms under the status of pre-state. On the contrary, the new concept recognises that in particular societies, property ownership is closely associated with the function of the particular political structure within a society – the state, which leads to the possibility of differentiation and diversification of social property ownership. Thus, within a particular society, property ownership, in theory, does not necessarily have to be a private one, as there are possibilities to the existence of private, public or concurrent forms of ownership.

Related to the state function of protecting basic freedoms, from the perspective of functionalism, tax activities today are no longer purely state-organised financial income generating activities, but also an important functions in fostering adjustments to society. These tax activities and the state's other functional activities should be complementary and act together. On the whole, the taxation system has become an indispensable part of the state economic system. On the one hand, tax plays its function of organising state financial income, and to provide material protection to the people's various rights and basic freedoms. On the other hand, as part of the economic system of the state organisation of social wealth, tax also plays other aspects of macroeconomic regulation and control functions in the social economy. Therefore, tax has become a material guarantee to the realisation of the people's rights and basic freedoms.

In today's society, it is an indisputable fact that taxation increasingly and frequently plays all sorts of social and economic macro-control functions. Countries compete to employ tax measures as an induction tool of social macro-control in order to promote economic development, distribution of wealth, ecological and environmental

protection and other aspects of social improvement.³⁰ In other words, tax collection is no longer for the sole purpose of organising state fiscal income, but also for the other incidental purposes, and even for other purposes as the primary goal.³¹ In the context of changes to state functions and tax functions, the attention and emphasis have been placed upon the economic macro-control functions of tax in the modern tax economy and so it forms an understanding of taxation functionalism. Accordingly, in the theory of taxation law, people have begun to use the concepts of fiscal taxation law and regulations of taxation law to analyse the norms of taxation law at different levels.³²

3.2 The Impact of Taxation Functionalism on Taxation Legalism

The rise of taxation functionalism has impacted on the traditional understanding of tax and taxation law. It has aroused great interest in the role and efficiency of tax as a macro-control function, while the path to achieving taxation democracy as emphasised by taxation legalism has also changed.

3.2.1 The Effect on the Traditional Understanding of Taxation

Under the traditional understanding of taxation relied upon to establish taxation legalism, the purpose of tax is to obtain necessary financial resources to achieve state

³⁰ In order to deal with the global financial crisis since 2008, countries have exploited the full advantage of tax measures to deal with the global financial crisis according to its own conditions. See Huiwen Gong 龚辉文, 'Comparisons of Tax Policies used by Several Countries to Respond to Global Financial Crisis' 《若干国家应进金融危机的税收政策比较》, 'Public Economic Review' 《公共经济评进》, 2009, Vol. 12.

³¹ Given such changes to the functions of tax activities, the German General Tax 《德国税法通则》 Article 3 provides that, tax can organize state financial income for its incidental purpose. See Kechang Ge 葛克昌, 'Basic Problems of Taxation Law' 《税法基本问题》, 2005 Revised Edition (2005 年增订版), 台湾元照出版有限公司, p 286.

³² In China, the macro-control function of tax activities has been important for practitioners and theorists. Taxation policy has become an important tool in the state macro regulations and control system. Taxation law has also been regarded as a sub-discipline of the field of law of economics. In the study of taxation theories, tax is divided into financial tax and regulation of tax according to its purpose. Taxation law is also divided into financial tax law and laws on tax regulations in order to emphasize the meaning and functions of the various aspects of tax activities. See Shouwen Zhang 张守文, 'Principle of Tax Law' 《税法原理》 2nd Edition, 2001, 北京大学出版社, p 15; Gang Li 李刚, 'The Relationship between the Law of Tax Regulation and Basic Principles of Taxation Law' 《进税收进控法与税法基本原则的关系》, the Journal of Xiamen University 《厦门大学学报》 哲社版, 2008 Vol. 3.

instrumental value, which has the sole purpose of achieving financial income. Accordingly, the function of taxation law is to protect the people's right of property from violation by the state which tends to obtain excessively financial resources. However, faced with the evolution of state functions through time, the aim of taxation activities has evolved from the sole purpose of organizing financial income, to presenting a complex and diversified development. It also allows people to gradually accept the concept of other 'collateral purpose' or 'subordinate purpose' of taxation activities despite 'the purpose of financial income'.

In a situation where the role of taxation activities has not moved from the basic purpose of organising financial income, with other socio-economic purposes being merely 'collateral' or 'subordinate', the new function of tax achieved through time does not completely subvert the concept that 'tax is a deprivation of people's property', in which taxation law can still follow the traditional taxation legalism as before. However, if a new category of tax combines its financial income purpose with a specific other purpose as its main reason of existence, the financial income purpose will be reverted to a subordinate purpose. Such tax collection is, in reality, a way of conducting the nation's other specific administrative management activities. Accordingly, taxation laws relating to such taxes have only the appearance of taxation law, but in fact belong to the areas of the law of economics or society. Under the original concept of 'people's freedom and state intervention', the question of whether taxation legalism is applicable is not without doubt. In theory, such taxation law belonging to the world of economic or social law is not bound by taxation legalism as it is not based upon the traditional theoretical basis of taxation law. As such, legislation on such tax matters do not appear to have to necessarily adhere to the legal formalities as required and emphasised by taxation legalism.

Nevertheless, it is important to note that while there is a theoretical difference between tax with a financial income purpose and tax with collateral purposes of promoting

social and economic development or ecological protection, it is difficult in practice to make a clear distinction. For example, it is difficult to distinguish financial purpose norms from non-financial purpose norms in instances such as corporate income tax, which is traditionally regarded as a type of tax with the purpose of organising financial income under all the provisions of the Corporate Income Tax Law. Other examples include housing tax, environmental tax or carbon tax; although the introduction of such taxes may be to control the property market or protect the environment, it is difficult to deny the financial income purpose. At best, the purpose of obtaining financial income will be regarded as a side effect or by-product to the achievement of other regulatory purposes. In fact, theoretically, such divisions of fundamental purpose and incidental purpose, primary purpose and secondary purpose, only reflect the people's attention to a particular purpose of tax, rather than denying the simultaneous functions of tax in modern economic society.

It can be observed that in the context of the increasingly complex functions of modern taxation, tax has an instrumental value in adjusting and controlling the socio-economic development from various aspects. An accurate understanding of the functions of tax needs to be observed from a holistic and global perspective. From an overall point of view, a country's holistic taxation activities undoubtedly have a function of organising national financial income, and at the same time, holistic taxation cannot be separated from a specifically designed taxation system, and the specific definition of the choice and substantive taxation elements of each specific type of tax in both the qualitative and quantitative aspects. This specific design, specific choice and specific definition are inevitably connected to the nature of the factual reasons for the taxpayers to pay tax, the taxpayer's social economic behaviour, and the scope of the choice. Therefore, through the design of taxation system and the choice of types of tax and definition of taxation elements, taxation as a whole can also achieve its function of macro-control over the social economy.

3.2.2 The Emphasis on the Efficiency of the Tax Regulatory Function

Efficiency has always been an important element in taxation activities. In the context of where the tax is purely regarded as a tool to organise national financial income, the emphasis on the efficiency of taxation activities actually concerns the relationship between the financial income obtained through taxation activities and the administrative costs of the execution of taxation law and taxpayer's compliance. Therefore, the high efficiency of taxation activities means the maximisation of financial income and minimisation of the administrative and compliance cost. Tax efficiency in this sense not only allows people to pay attention to avoid the cost of tax enforcement activities, but also to warn people of the excessive intervention on their private property by the design of the tax system, so as to reinforce the emphasis on the implementation of tax legalism in tax legislative activities. The higher efficiency in the taxation function, the stronger the relevant tax design financial income organisational skills will be, and the greater the intervention to the taxpayer's personal property.

However, in the context where the functions of tax have become increasingly complex, tax is regarded as a tool to macro-control the social economy. When people are emphasising its efficiency, they are not only pursuing the maximisation of financial income. Instead, they are demanding to the greatest extent that the purpose of social and economic macro-control by tax is achieved. The high efficiency of tax activities in this sense means that the state is aiming to maximise the achievement of the purpose of control, not the maximisation of financial income. Thus, the rise of taxation functionalism made a change on the inherent meaning of the efficiency in the taxation system, and the factors used to determine the efficiency of taxation activities have become furthermore diversified. More importantly, in order to ensure the high efficiency of the macro-control function of tax, the necessity of using authority legislative power, delegated legislative power and others in order to enhance the flexibility of tax system changes have also been increasing.

3.2.3 The Changes to the Realisation of the Value of Tax Democracy

If we can come to accept the new concept of ‘people’s freedom and national security’ in the modern society, the value of tax democracy appears to no longer need to uphold the legislative concept of ‘no taxation without representation’, relying solely upon the monopoly of the representative bodies as to the tax legislative power, but instead relying upon the holistic tax law activities including tax legislation and application of taxation law in order to protect the value. This means that the democratic value of tax law and its maintenance is no longer an activity reserved for a single body within the state internal organisation, but rather requires the collective effort between the various state bodies including the state legislature, the executive and the judiciary to complete. Accordingly, we have reason to believe that under a modern country, the maintenance of the democratic value of tax law is a collective constitutional mission between the legislature, executive, judiciary.

Firstly, in terms of tax legislation, the legislation of tax matters does not have to be rigidly completed by the highest state organs, which are the NPC and its Standing Committee. Instead, there can be an appropriate allocation to authorities with different levels of legislative powers. In essence, the process of legislating on tax matters can take into account the strong relationship between the specific technical design of the relevant tax system and its willingness to achieve socio-economic regulatory functions. This is to ensure the level of the depth and breadth of the provisions or the normative matters that can flexibly adjust according to the level of strength of control, while the higher-level legislators can deliberately omit some contents from the relevant legislation. In other words, legislators intended not to lay down the provisions or to only regulate the framework in relation to the matters that should be stipulated in the law. The intentional omission of the legislation contents has a problem of the coverage density of the life facts regulated by legal norms. Objectively, it must ask the next level legislators, ‘for the needs of the implementation of the law’ to lay down the

relevant secondary norms in accordance to this legislation, and to fill in the blank area left by the intentional omission of legislative contents.

As mentioned earlier, the legislative practice in China conforms to the long-term guiding ideology of the principle of 'laws should be broad rather than narrow', which is an example of such intentional omission of legislative content and intentions of norms. However, the complementary relationship between the state legislative power exercised by the NPC and its Standing Committee, the central government legislative power exercised by the State Council and the local legislative power exercised by the local government in respect to the scope of legislative matters, institutionally ensures that the legislative practice of such intentional omission will not produce excessive damage to impinge the value of predictability of the laws. In fact, some kind of division of labour between the central level state organs or between the state organs at central and local level in respect of the management of tax legislative affairs can also ensure the allocation of tax matters legislation within the legislative power system, which embodies the pursuit of tax efficiency.

Certainly, the possibility of intentional omission of legislative matters in legislation can only occur in countries with a multi-level legislative power system. In a country of a single-level legislative power system, due to the lack of possibility of omitting matters and regulating complementary legislation by secondary legislation subjects, the legislative technique of intentional omission by leaving gaps within the law would be strictly restricted.

Secondly, in terms of the application and execution of taxation law, taxation legalism requires that the taxation elements are clearly defined and no subjective and objective legal loopholes in tax law. However, the legislators themselves have inherent limitations and the economic and social development may also have gone beyond the awareness of legislators. Given this, loopholes are inevitable in real life. Therefore,

complementary mechanisms are needed to fill the gap. The most direct way to address objective legal loopholes is that the legislator should immediately amend the legal provisions straight after they have discovered the loopholes. Such amendment needs to be made through legal interpretation by the executive and the judiciary before the legislator has the chance to pass a bill for it. Therefore, the complementary mechanisms for both objective loopholes and subjective loopholes are the same in terms of transparency, participation, fairness, openness and impartiality of the law.

There is a distinction between the broad and narrow interpretation of law. The narrow interpretation of the law discovers the exact meaning and specific intention of the language and terminology used in a legal provision. Through this narrow interpretation of law, the objective legal loopholes of the legislative language and terminology and the inappropriate expression of the legislative content and intention may be corrected, while subjective legal loopholes or abstract and uncertain language and terminology or relevant provisions may be gradually limited in its scope, as well as gradually specified and defined. In addition to the narrow interpretation of law, the broad interpretation of law also involves explaining the language and terminology of the provision in accordance with the needs of the laws and regulations, in order to create new legal norms in accordance with their own understanding of the normative content and specific intention. This legal interpretation by its very nature no longer belongs to the scope of legal interpretation, but is cloaked under the appearance of legal interpretation to conduct the activity of discovering laws and regulations forgotten by legislators, or to create new legal norms.³³ This innovative legal interpretation of legal norms necessarily affects the distribution of the state's legislative power. While this legal interpretation for the purpose of discovering forgotten legal norms in the legislative content and intention has its rationality in

³³ See ZonglingShen ed. 沈宗灵主编“Jurisprudence”《法理学》, Higher Education Press 高等教育出版社, 1994, pp. 427-428; [German] Karl Larenz: “Legal Methodology”, Translated by Aie Chen 陈爱娥译, 商务印书馆 2004, pp. 246-300.

correcting the limits in the legislative technique, yet the creation of new legal norms not only undermines the predictive value in law and the people's reasonable reliance on law, but also undermines the democratic value of law and limit the people's participation in legislative activities. Therefore, the existence and limitations of the two interpretation of law in a rule of law country involve the complex trade-offs and considerations of the various values and factors.

4. The Trend of Taxation Functionalism on China's Taxation Legislation

4.1 Taxation Legalism is not Absolute

China's current taxation legislation in practice shows that most of China's current tax legislation is not enacted in accordance with the legal formalities by the people's representative body, the NPC and its Standing Committee.

Therefore, strictly speaking, China's taxation legislative practices do not take the form of the so-called 'parliamentary reservations'. On the contrary, provisions in relation to the legislative scope on taxation matters in the Constitution and the Legislative Law make it clear that taxation legalism is not an absolute principle in China's current taxation legislative scope.

Firstly, the Constitution generally views people's property rights from the national economic system level, and does not see people's right to property as a pre-constitution (state) condition under the concept of 'people's freedom and state intervention'. In contrast, the Constitution consistently upholds the concept of 'people's freedom and state protection', and regards the freedom to private property as a result of the state's (legal) functions and actives. As such, the Constitution groups the system of private property as a part of the national economic system and makes

provisions for it and the system of state-owned property and the regime for collectively owned property under Chapter 1, 'General Principles', and not under Chapter 2, 'The Fundamental Rights and Duties of Citizens'. In addition, the Constitution clearly stipulates that the state will implement a socialist market economy, with the state introducing economic laws to perfect macro and micro-management, and giving the State Council the authority to lead and manage economic tasks and city and town development.

³⁴Secondly, we cannot draw the conclusion that the Constitution advocates taxation legalism by relying on Article 56 of the Constitution.³⁵ Although Article 56 of the Constitution provides the obligation for citizens to pay taxes according to law, the term 'law' cannot be understood to mean the laws enacted by the NPC and its Standing Committee only. The reason for this can be found in the development of the Constitution. This provision of the current Constitution was inherited from the relevant provisions of the Common Program of Chinese People's Political Consultative Conference and the 1954 Constitution. In the past when these constitutional legal documents came into effect, tax legislation was not solely made by the NPC and its standing committee. Moreover, from the multiple references to the term 'law' in the *Constitution*, even while the phrase 'according to law' was used multiple times, the relevant legislative practices referred to were not in the form of legislation by NPC and its Standing Committee.³⁶

³⁴Constitution of the People's Republic of China 《中华人民共和国宪法》 Articles 15, 89.

³⁵ There are different opinions as to whether China's Constitution has ascertained taxation legalism. See Gang Li and Junqi Zhou 李刚, 周俊琪, 'Looking at Article 56 and Taxation Legalism from the Perspective of Interpretation of Law – Discussion with Two Scholars, Jianwen Liu and Wei Xiong' 《从法解释的角度看我国〈宪法〉第五十六条与税收法定主义——与刘建文、熊伟二学者商榷》, *Studies on Taxation* 《税务研究》, 2006 Vol.9.

³⁶ According to Article 17 of the Constitution of the People's Republic of China, under the premise of compliance with the relevant laws, collective economic organisations have independent autonomy over economic activities. Collective economic organisations can exercise democratic management in accordance with the law to elect and dismiss management personnel and make management decisions on major issues. Although Article 17 has stipulated the above provisions, China's current urban collective enterprises and rural collective enterprises still abide to the "Regulations of the PRC urban collective enterprises" 《中华人民共和国城镇集体所有制企业条例》

Thirdly, *Legislative Law* does not regard taxation activities as intervening or limiting the freedom to private property under the concept of 'people's freedom and state intervention', and therefore it does not reserve legislation on taxation activities exclusively for State Legislative Power. Instead, under the influence of the concept of 'people's freedom and national security', *Legislative Law* regards taxation activities to be part of the national economic system according to the Constitutional provisions on State Council's functions and powers, allowing the State Council to be assigned legislative powers on tax matters. Also, the *Legislative Law* classifies different reserved legal matters, it classifies 'basic system of taxation' along with the state's basic economic system and basic systems of finance, customs, banking and foreign trade, which is distinguished from other categories, and it recognises that these are all legislative items on the state economic system and it is possible to delegate the reserved legislative powers on this item. At the same time, issues relating to crimes and penalties, compulsory measures and punishments that involve deprivation of citizen's political rights and limitation of personal freedom and the judicial system are differently classified and the possibility of delegated legislation is completely excluded.³⁷

4.2 The inclusion of some tax legislative matter into local legislative power's scope

As mentioned previously, the local legislative power is a multi-level legislative power system established on the basis of appropriate separation of powers between the central and local authorities. According to the *Constitution* and the *Legislative Law*, the entity that enjoys the local legislative power can lay down local regulations and

promulgated by the State Council (issued in September 1991, implemented in January 1992) and the "People's Republic of rural collective enterprises Ordinance" 《中华人民共和国乡村集体所有制企业条例》 (promulgated in June 1990, implemented in July 1990, revised in January 2011) when carrying out management activities.

³⁷The Law of the People's Republic of China on Legislation 《中华人民共和国立法法》 Article 8, 9.

provisions on the relevant matters of local affairs. Under the influence of taxation functionalism, on taxation matters after the 'basic system' of certain taxes have been provided for by laws or administrative regulations, the local authority or local government, in accordance with its local legislative powers, can certainly make a range of supplementary, technical and detailed provisions as the basic system is implemented to remedy the gap of the primary legislation to improve the regulatory coverage of the tax law. Therefore, the authority of the local legislative power in relation to these taxation matters seems to be unquestionable. There are no issues with authority to legislate from a higher authority, nor does it violate taxation legalism.

Naturally, it should be emphasised that while tax legislation-making can become matters within the local legislative power, when the local authority exercises such legislative powers, it must comply with the laws and administrative regulations or other primary legislation, and must not breach them. Otherwise, it will act *ultra vires* and undermine the unity of the state legislative system.

Taking the current local pilot real property tax law reform as an example, the so-called pilot legislation cancels the tax exemption originally provided for real properties that are in personal non-business use and adjusted the tax treatment of personally-owned real property accordingly, both under the basic system of the Provisional Articles on Real Property Tax, defining tax elements such as new tax rates and requirements for tax-breaks.

From a perspective of legal interpretation, this type of tax treatment adjustment can be understood as a further clarification and limitation on the term of 'non-business property' in Article 5 of the Provisional Articles on Real Property Tax. It falls within the scope of 'necessary regulations for the execution of laws, administrative regulations and local regulations' under Article 73 of the Constitution, forming a local implementation detail under Article 10 of the Provisional Articles on Real Property Tax. The purpose of this is to complement the State Council's need to macro-manage

the pilot real property tax reform. In other words, the local pilot legislation for the pilot real property tax reform is a result of the exercise of the local legislative power by the local authorities.

Obviously, the affirmative stance held by China's current taxation legislation practice in relation to property tax reform issues also fully illustrated that from the perspective of taxation functionalism, taxation activities are more understood as part of the state economic system, and its macro-control functions has achieved great attention. This in terms of connection between the central and local functions and powers based on the socio-economic activities regulatory efficiency consideration, led to a tendency which regards taxation legislative matters outside the basic tax system to be within the legislative scope of belonging to the local legislative power under certain conditions.

5. Conclusion

In summary, under China's current legislative power sharing system led by the central government with moderate decentralisation and multi-level co-existence of powers, China's taxation legal norms system also exhibits a multi-level system of legal norms. It shows that China's current taxation legislation practice negates the concept of 'people's freedom and state intervention' and the concept of taxation legalism supremacy. Moreover, in China, there appears to exist the concept of 'people's freedom and national security', which has led to the trend of understanding taxation from the standpoint of taxation functionalism, and taxation activities are more to be understood as part of the state economic system. Aside from serving the traditional function of organising financial income, it should also play its socio-economic macro-control functions. Therefore, in China, the appropriate allocation of legislative power of taxation legislative matters between different levels can even lead to the possibility of part of the taxation legislative matters to be within the legislative scope belonging to the local legislative power. China's current ongoing property tax, value added tax,

business tax, resource tax and other related tax reform legislation illustrate this case in point.

On the Development Strategy of China's Value-Added Tax (VAT) Reform

Dongsheng Jin and Weifu Jin [★]

Abstract:

Along with the official replacing of Business Tax with value-added Tax (VAT) for some business sectors in Shanghai's pilot zone, the issue of VAT reform has attracted widespread attention from the public. This paper will first outline the basic concept of VAT, and then briefly elaborate on the advantages and disadvantages of VAT, the emergence and development of VAT, the introduction of VAT to China and the course of VAT reform in China. The proposed implementation of the VAT pilot program in Shanghai is only a fundamental component of optimising the VAT system. In order to simplify and make the VAT system efficient, China must continue with its VAT reform in accordance with the standards of modern VAT.

On 26 October 2011, a State Council executive meeting decided that from 1 Jan 2012 onwards, the VAT system reform will be deepened in pilot zones for some regions and industries, thus gradually changing from imposing business tax on certain industries into levying VAT.

Expanding VAT reform is a highlight of the 12th Five-Year plan tax reform. After the trial, the VAT reform may extend from certain regions and industries to the entire country and more business sectors respectively, thus delivering benefits to related industries and enterprises. This reform is beneficial in lowering the price of goods and services, boosting consumption, improving welfare and accelerating the transformation of China's economic development model.

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1. The basic concept of VAT

VAT is a type of consumption tax placed on a product whenever value is added at each stage of production and distribution, or through the provision of labour. The so-called *value added* refers to the newly-created or added value as a result of taxpayers' engagement in production and operation related activities. In comparison with traditional sales tax, VAT has unique characteristics including: 1. Excludes tax in prices; 2. Divides taxpayers into general taxpayers and small-scale taxpayers; 3. Simplifies tax rate and adopts zero tax rate.

According to taxation computation theories, VAT is a type of turnover tax levied on value created at various stages of the production, circulation and labour service cycles or added value on products. Excluding tax in price means that consumers bear the burden of the tax and that tax is imposed only when value is added. In practice, however, it is difficult to accurately calculate a product's value that has been created or added during the production and circulation process. Therefore, China adopted the internationally used tax deduction method, which calculates output VAT based on revenue from the sale of products or the provision of services, and on the set tax rate. The amount of VAT paid to obtain these products and services, also known as the input VAT, is then deducted to determine the difference, which is the tax payable for the value added portion. This computation method reflects the principle of calculating tax based on the value added factor.

According to the difference in the scope of the tax base, VAT can be classified into three types, namely, production, income and consumption. The major differentiating factor between these three types of VAT is the difference in deduction of tax paid on capital assets, which results in a narrower tax base for each type. Production VAT permits the deduction of withholdings on input VAT contained in the purchase of non-capital assets but not capital assets. This type of VAT is labelled as 'production' because its tax base is equivalent to Gross National Product (GNP). Income VAT not only permits the deduction of withholdings on input VAT contained in non-capital assets, but also allows the deduction of input VAT in relation to the accrued depreciation of capital assets. Income VAT has its name because its tax base is comparable to Gross National Income (GNI).

Consumption VAT permits not only the deduction of withholdings on input VAT contained in the purchase of non-capital assets, but also allows the complete deduction of withholdings on input VAT contained in the purchase of capital assets. This type of VAT is named as consumption VAT because its tax base totals to consumption.

In the early stages of introducing VAT, some countries often adopt production VAT in order to ensure government revenue. Yet production VAT will restrict growth capital and limit the upgrading of facilities. Production VAT is also not conducive to expanding reproduction and increasing the export of goods and services, which in turn will adversely affect the sustained development of the entire social economy, eventually leading to economic depression, shrinking sources of revenue and decreasing tax revenue. At present, most countries that adopt VAT use consumption VAT; only a small number of countries use either income or production VAT.

From the theoretical discussion stage, VAT has demonstrated its unparalleled advantages. VAT retained sales tax's characteristic of levying on multi-stages and multi-levels, with the range of levies equally wide. In addition, the tax burden of VAT is related to the value added but not to the number of intermediaries. Moreover, the incidence of tax is pushed forward onto consumers, who ultimately bear the entire tax burden. The collection and administration of VAT in practice usually adopt the method of deduction on invoices.

In combination with its distinctive way of collection and administration, VAT has the below five advantages. 1. Equitable distribution of tax burden, which is beneficial to equal competition. The core advantage of VAT is that the same tax burden is imposed when the price is the same, regardless of the stage of stock turnover and the type of business operation. This fully reflects the principle of tax neutrality and brings the market's basic regulatory role into play, which is conducive to providing equal grounds for companies to compete fairly and to the socialisation and specialisation of cooperative commercial production amongst companies. 2. Wide tax base, which is beneficial to tax revenue stabilisation. The tax base of VAT is rather wide; VAT can be levied on not only production, but also

circulation and a variety of labour. It can be said that VAT is a type of turnover tax that can be imposed on the entire society. Furthermore, VAT can restrict tax reduction and exemption, which significantly reduces revenue loss and is thus conducive to promoting steady growth of tax revenue. 3. Automatic auditing, which is beneficial in enhancing the administration of tax collection. In calculating VAT, many countries adopt the method of deduction on invoices, thus strengthening the cross auditing relationship between the buyer and the seller. Owing to the enhanced audit function, the need to use invoices for reductions and the application of information technology, the possibility of tax evasion and tax fraud is greatly reduced and the rigor of the administration of tax collection is significantly improved. 4. Strengthens enterprise management. VAT will enhance companies' management because it requires companies to have a sound financial system. 5. Promotes the development of international trade. Countries that use VAT often exempt exported goods from VAT and impose import VAT on imported products, resolving the conflict of unfair distribution of tax burdens in international trade.

Many countries are attracted by VAT because of its advantages. Yet VAT is not flawless. Along with its advantages, evident disadvantages exist: 1. VAT is regressive. VAT adopts a smaller proportional tax rate and for taxpayers with large sales, it cannot levy more tax. 2. Increase in the cost of administration and collection. Adopting VAT will lead to a substantial increase in the amount of taxation administration work. The complexity of VAT operations is also a problem for many countries, especially the supervision and administration of export tax rebate, and thus the administration cost will escalate. Correspondingly, because of the various requirements of tax authorities, the cost associated with tax payment in order to meet these requirements will increase for taxpayers, which leads to a rise in tax expense. 3. Potential possibilities of tax evasion. The VAT deduction mechanism makes tax evasion extremely profitable. Taxpayers will dare to take this risk under the enticement of massive gains. If social order is unregulated, the potential loophole of reporting false tax deductions and forging special invoices can be very serious. Despite these shortcomings, the immense benefits of VAT

cannot be denied after weighing the advantages and disadvantages, which explains why VAT has been rapidly implemented across the world.

2. The emergence and development of VAT

The rise of VAT is second to none in the taxation history. No other types of tax have been warmly welcomed by numerous countries like VAT, which spread globally in a short time period of around 50 years, from theory to practice. In fact, the emergence and development of VAT is a taxation reform that followed the trends over time.

Prior to the emergence of VAT, sales tax or product tax was levied on intermediaries. The major shortcoming of this type of tax is the influence of its cascading effect. The specific problems of sales tax are represented under the following four aspects: 1. Sales tax is levied on the total value of the exchange, and thus creating the phenomenon of unequal tax burden simply because the same product is produced differently. This impedes the socialisation and specialisation of commercial production. 2. The addition of an extra intermediary will levy tax on the total value once more since sales tax is levied on the total value of the exchange. Moreover, intermediaries are after production phases and owing to the stepped increase in sales volume, the cascading effect will be more significant. 3. As sales tax rate can be determined separately according to the different categorisation of products, there can be a considerable difference in tax burden on the products that enter into international trade. This is not in accordance with the requirement of eliminating differential tax treatment on exports and imports, as stated in the General Agreement on Tariffs and Trade (GATT). Moreover, trade friction and international trade disputes are likely to happen. 4. Tax evasion and tax fraud become relatively easy with sales tax. Moreover, tax breaks can be easily given and such practice leads to a large loophole in tax collection.

It was due to these increasingly apparent disadvantages that countries made a greater effort to find better ways to levy taxes. From the mid-19th century to early-20th century, many countries pinned their hopes on the direct tax system. Income tax was regarded as the perfect type of tax, and the trend of thought of replacing

sales tax with income tax formed the global trend. However, it was proved in practice that income tax cannot replace the functions of sales tax. People then turned their attention again to reforming sales tax. Subsequently, VAT emerged in this context.

The taxation concept of imposing tax on the value added portion was first proposed in the early-20th century by Professor Thomas S. Smith from Yale University and by Dr. Wilhelm Von Siemens from Germany respectively. In 1954, France put this 'unusual but innovative idea' into practice. Henceforth, many countries started to follow what France did. In the 1950s, only France and a few former French colonies implemented this idea. The European Union paid great attention to this idea in the 1960s. As early as 11 April 1967, the Sixth VAT Directive was legislated by the EU. The Sixth VAT Directive prescribes that member states must abide by the VAT legislation enclosed in this directive and amend their respective VAT laws, which must be executed before 1 January 1978. The EU VAT legislation is divided into 19 Chapters and 35 Articles, enforcing unified legal requirements on taxpayers, levying scope, tax rates, tax base calculations, input tax deductions, tax rebates, tax payment locations and tax treatment for small businesses and farmers. Subsequently, the EU published a series of additional amendment Acts, which accelerated the process of VAT integration. In the early 1970s, all member states of the EU adopted VAT. Moreover, in the past 30 years, VAT has spread across many countries in Asia, Africa and Latin America. Over half a century, VAT has undergone the process of exploration, development and maturity. At present, around 170 countries across the world implement VAT.

3. The history of China's VAT reform

From the second half of 1979, China started to implement its VAT pilot program for only machinery and four other types of goods from Xiangfan, Shanghai and Liuzhou cities. The Ministry of Finance in 1982 legislated the *Interim Measures on Implementing Value Added Tax*, which stated that the pilot program would be implemented uniformly across some industries. The *Regulations of the People's Republic of China on Value Added Tax (draft)* promulgated by the State Council further clarified the imposition of nationwide VAT on 12 types of goods, including

machinery, automobile and steel. The execution of the *Regulations of the People's Republic of China on Value Added Tax (draft)* signifies that China has begun to officially implement selective VAT, thus taking its first step towards the introduction of VAT.

When China was carrying out its comprehensive industrial and commercial tax reform in 1993, the State Council promulgated the *Regulations of the People's Republic of China on Value Added Tax*, which provides that VAT will be levied on sales, imported goods and provision of processing, repairs and replacement services nationally, implementing a VAT system that levies tax generally. Since the 1994 industrial and commercial tax reform, VAT became the biggest tax in China, reaching 221.26 billion yuan that year, accounting for 43.3 per cent of the total tax revenue. This tremendous progress made is a solid second step towards the introduction of VAT. Although the new VAT established the uniform standard rate of tax, expanded the range of levies, and increased tax revenue, China's VAT is still production VAT and VAT contained in a business's capital assets cannot therefore be deducted. The double taxation element prevails as business tax is still levied on the majority of the tertiary industry. 'Restricted by a number of conditions at that time, China's VAT system built in 1994 was based on a period of economic transformation, and in comparison to VAT implemented in most other countries, the depth and breadth of the reform was not yet fully in place'.¹ To further deepen China's VAT reform is still a demanding task.

From 1 July 2004, the VAT transformation pilot program was implemented for eight industries in Northeast China. In addition, from 1 July 2007, the pilot program was put into practice for eight industries in 26 cities of Central China. Moreover, five cities in the east of Inner Mongolia Autonomous Region and regions that were devastated by the Sichuan earthquake started running the program from 1 July 2008. In order to encourage investment and to advance technological development, the State Council approved the amended *Regulations of the People's Republic of China on Value Added Tax*, which states that the VAT

¹ Xiao Jie, 'Continue to Push Forward the Reform of VAT System', *Economic Daily*, 1 April 2012.

transformation pilot program will extend from the existing pilot zones to the entire nation from 1 January 2009. This national implementation of VAT transformation reform included machinery and equipments into the scope of offset for VAT, and the purchase of machinery and equipments is now input VAT deductible. The transformation reform in 2009 is different from the pilot program. First, the purchase of new machines and equipment is deductible, without taking into account whether there is additional VAT for the business this year or whether VAT has increased. Secondly, the VAT transformation reform is implemented uniformly across all regions of the country and is not limited to certain industries, thus unifying China's VAT policies. Thirdly, the system of tax rebate for the purchase of fixed assets is replaced by calculating deductions directly from special VAT invoice, special bill of payment of Import VAT and other legitimate deduction certificates. The VAT transformation reform has strategic significance because it advanced the change from production VAT to consumption VAT, a third step towards reforming VAT in China.

In order to further resolve the problem of double taxation in commodity tax and service tax systems, make improvements to the tax system and support the development of modern service industry, the Fourth Session of the Eleventh National People's Congress approved and endorsed the Twelfth Five-Year Plan for National Economic and Social Development of the People's Republic of China proposing that 'the scope of VAT collection will be broadened and other types of tax such as business tax will be adjusted and reduced'. This marks the beginning of a new tax reform and indicates the initiation of China's VAT reform that lies ahead. A modernised VAT that has wide coverage, low tax burden, simplified tax system and rigorous collection and administration will emerge in China. In 26 October 2011, the State Council executive meeting decided that from 1 Jan 2012 onwards, the VAT system reform will be deepened in pilot zones for some regions and industries, thus gradually changing from imposing business tax on certain industries into levying VAT. The State Council decided that the first step is to launch the VAT pilot program in Shanghai, which serves as a demonstration for the entire nation. The second step was approved by the State Council in July 2012, which involves expanding pilot zones by replacing business tax with VAT for

transport and traffic industry and certain parts of the modern service industry. Moreover, this pilot program will extend from Shanghai to eight provinces (municipality) including Beijing. The pilot regions are: Beijing, Tianjin, Jiangsu, Anhui, Zhejiang (including Ningbo), Fujian (including Xiamen), Hubei and Guangdong (including Shenzhen). Starting from 1 August 2012, these regions organised the implementation of this pilot program oriented towards the society. Identifying and training taxpayers, administrating devices and debugging systems, distributing and installing tax invoice control systems, sales of invoices and other preparation work are carried out to ensure that the pilot program progresses smoothly and that the old tax system can be replaced with the new one on time. In 1 September 2012, Beijing replaced its old tax system with the new one completely. Jiangsu and Anhui ought to complete this replacement by 1 October 2012. Moreover, the old tax system is expected to be changed to the new one by 1 November 2012 for Fujian and Guangdong, and by 1 December 2012 for Tianjin, Zhejiang and Hubei. Relevant authorities will closely track the operation of the program in the various pilot regions, diligently summarise the experiences gained from the pilot and gradually expand the pilot zones with the aim of spreading this reform nationwide in the 12th Five-Year plan period. According to an estimate by the State Administration of Taxation, if the expansion of the VAT reform is achieved: 'Using 2009 as the basis, the change from Business Tax to VAT will lead to a tax cut of over 100 billion yuan and drive GDP growth by 0.5 per cent. Moreover, the added value for the tertiary industry and producer services industry will increase by 0.3 per cent and 0.2 per cent respectively, while the added value for high energy consumption industries will decrease by 0.4 per cent. Further, this change will result in consumer spending growth of 1.1 per cent, a 0.2 per cent increase in investment from society, export growth of 0.7 per cent, 700,000 newly created jobs, increased proportion of the tertiary sector and a decrease in the general price level'.² The expansion of the VAT reform is the fundamental fourth step to the VAT reform. Upon completion of this reform, China's VAT system will be much closer to the modern VAT system.

² Xiao Jie, 'Continue to Push Forward the Reform of VAT System', *Economic Daily*, 1 April 2012.

4. The development strategy of China's VAT reform

China's current VAT system was established in 1994 through the tax reform, meeting the requirements of improving the socialist market economic system. VAT is now the one of the most important principal taxes in China's current industrial and commercial tax system. With the improvement in living standards and in enterprise economic benefit, the share of income tax revenue out of total tax revenue increases continually and thus the proportion of VAT revenue will decrease. Yet VAT remains the status of being China's largest tax. In 2011, the domestic VAT income was 2.426663 trillion yuan, which accounts for 27.04 per cent of the total revenue.³ After the four-step VAT reform, China's tax system has been optimised. However, the reform needs to be continued in order to achieve the ideal VAT.

International Value Added Tax (VAT) experts categorise VAT into three types: (1) Less-than-complete VAT. China's VAT falls into this category. It has primary-stage VAT's multi-optional feature: incomplete scope of tax, atypical type, complexity of tax rate structure or excess special provisions. Thus, it is a type of VAT in the phase of reform. (2) EU VAT. This type of VAT is developed on the basis of French VAT. The same operation rules are established through the EU's orders so that VAT can operate uniformly in member states of the EU. However, owing to the difference in the existing tax systems of member states, the EU VAT retained many special clauses that are temporary in nature, thus increasing the complexity of the VAT system. International VAT experts perceive it as a product of political compromise. Hence, from a scientific perspective, it is not considered as a good type of VAT. (3) Modern VAT. Contemporary VAT operates through broad levy, complete chain, rigorous mechanism, single low tax rate, standard tax rebate and simplified administration and collection. Modern VAT can have a low tax burden because of its wide scope of levy and proper design. Thus, it has received favourable comments from experts.

³ Ministry of Finance, 'China's National Public Finance Income Statement 2011', http://yss.mof.gov.cn/2011qgczjs/201207/t20120710_665247.html. [Link to be provided]

Modern VAT has six characteristics: 1. Apart from particular industries such as finance and insurance, which are not subject to VAT by means of tax exemption but are subject to other taxes, modern VAT maximises the levy scope by including all goods and services into it. 2. Built a new taxpayer and levier relationship where taxpayers are not the main tax body. Therefore, small-scale businesses or individuals can choose to become taxpayers or not become taxpayers. 3. Levy VAT on goods and services at a single relatively low tax rate. 4. Besides tax exemption projects explicitly stated in taxation laws, arbitrary VAT exemption and reduction, arbitrary suspension or lowering of deduction standards is not allowed. 5. Appropriately established the registration standards for VAT taxpayers. Taxpayers above this standard all fall within the VAT scope and must uniformly pay tax according to VAT measures. Low income taxpayers below this standard are exempted from VAT (Except for an extremely small number of enterprises which are approved as VAT taxpayers through voluntary application). 6. Imported goods and services that promote international trade are taxed in full. Moreover, the refund collection system of charging zero tax rate on exports is implemented. Because modern VAT has the above characteristics, international VAT experts consider it as the best VAT system around today. Its numerous strengths include simplified tax system, rigorous mechanism, lowest level of distortion to the economy, lowest levy and collection cost, and ease of management.

There still exists a gap between China's VAT and modern VAT, meaning that further improvement is needed. China needs to continually deepen its VAT tax reform to ultimately achieve the modernisation and optimisation of VAT. First, China needs to expand the scope of VAT reform — changing from sales tax to VAT on the basis of its pilot program. The goal is to achieve a unified national VAT in the traffic and transportation industry and in the modern service industry before by end of the 12th Five-Year plan (2011–2015). Secondly, in the 13th Five-Year plan period (2016–2020), China should first include its construction industry, post and telecommunications industry, and rail transport into the VAT system after summarising the experience gained from the pilot program. Other industries should then be included into the VAT system, thus eliminating sales tax and achieving the full coverage of VAT. Thirdly, in the 14th Five-Year plan period (2021–2025), the

aim should be reducing the tax rate and unifying the tax rate, taxpayers(?) as well as tax rebate on exports in order to achieve the reformation goal of a simplified tax system, a broad tax base, low tax rate and rigorous tax collection and administration, and to eventually establish China's modern VAT system.

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