Globalization and Modernization as Drivers for Tax Reform in the Socialist Market Economy

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The unprecedented economic changes taking place in China over the past three decades have led to significant new fiscal pressures for the central and provincial governments. The relative decline of public ownership and rise of the private sector has forced governments to substitute revenues from new taxes for the funds formerly provided by public enterprises. The shift from profit distribution to tax revenues has led to a realignment of power between local governments and the central government while the growing disparity in wealth between have and have-not provinces has increased the pressure on the central government to further consolidate control over tax revenues and to apply the enhanced revenues to fund fiscal redistribution transfers. At the same time, modernization of the economy and the influx of foreign investment have created pressure to revamp tax laws and tax administration so both resemble more closely western market economy norms. These processes may lead to an irreversible shift of fiscal power from provincial governments to the central government and a consequent consolidation of political power, changing forever the political economy of modern China.

I. Setting the Scene

Political observers view the proclamation of the People's Republic of China on October 1, 1949 as a milestone — the birth of a communist state that grew to be a nuclear-armed socialist regional superpower. Many historians

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are more sanguine about the event, however, viewing it in wider context as simply another regime change in a largely coherent and unbroken story stretching back for more than two millennia. The emperor may have donned new clothes and, in the process, a somewhat different political agenda, but in the context of long-term perspectives of Chinese political foundations, the revolution was perhaps not so revolutionary.

The same may not be true of the much more recent reengagement by China in the global economic system. Contemporary globalization may one day be viewed as having yielded much more profound shifts in China's political and economic structures than the initial nineteenth-century European carve-up of China, the fall of the last emperor in 1911 and subsequent establishment of the Republic of China, or Mao Zedong's triumph just over half a century ago. The shift to a market economy following Deng Xiaoping's reforms in the late 1970s, reaching almost full integration with China's entry into the WTO in late 2001, may have opened the door to a new era in Chinese history, one marked by a gradual shift of economic power from local governments to the center.

The relative power bases of provincial governments and the central government have always waxed and waned in China. Central power had dissipated almost entirely by the end of the Qing Dynasty, the last in the era of Imperial rule, with a number of southern provinces no longer recognizing the authority of Beijing. Many remained largely autonomous in the brief period of the Kuomintang rule following the establishment of the Republic of China in 1912, with the Japanese invasion and regional stranglehold by local warlords acting as catalysts to national fragmentation.[1] A strong central government was finally reestablished with the creation of the People's Republic, but centralization was in many ways confined to military and national political control, with provincial governments actually enjoying a resurgence of local authority in almost all practical matters. Beijing might have set the agenda, but local governments carried it out and enjoyed immense economic power in the process. Indeed, provincial power arguably reached an apex under socialist rule during the first three decades of modern China (the pre-market economy period) as the central

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1 The virtual separation of the southern province of Guangdong illustrates well the disintegration at the periphery of the nation. *See* John Fitzgerald, *Increased Disunity: The Politics and Finance of Guangdong Separatism, 1926-1936*, 24 MODERN ASIAN STUD. 745 (1990). Van de Ven argues that the rise of the warlords was exacerbated by the fragmented revenue system inherited by the Republic and competition with regions for tax revenues. *See* Hans J. van de Ven, *Public Finance and the Rise of Warlordism*, 30 MODERN ASIAN STUD. 829 (1996).

government relied on decentralization as the key to economic growth. The central government sought to maintain a hand on the tiller through expenditure guidelines and planning decrees (which were often overlooked by provinces when they concluded that central edicts might interfere with local growth),[2] but day-to-day planning and management was firmly in the hands of the local governments. The focus of the center's role was its broad redistribution program through the appropriation of surplus revenue in wealthier provinces and transfer payments to poorer ones, though there is some debate as to how strongly the redistribution program was pursued and its effectiveness.[3]

The shift to a market economy in the last two decades of the twentieth and first decade of the twenty-first century altered, perhaps forever, the relative economic fortunes of provincial governments and the central government. The transfer of a significant slice of the nation's economic power from state-owned enterprises to private enterprises forced the governments to shift their revenue bases from profit collection to taxation. As a consequence, modernization of the tax system emerged as a priority for the state after late 1978 when Deng Xiaoping started China on the road to a market economy. While tax modernization was a continuous process, developments fell into three broad phases, which roughly aligned with the three decades following the opening of the economy. In broad terms, the first period was one of learning, marked by ad hoc and piecemeal policies as governments sought to shift their revenue bases from profit appropriation to taxation. The second period was an intermediate phase in which early levies were consolidated into more conventional tax bases, with complementary changes in tax administration and a significant shift of revenue from the provinces to the center. The third, and current, period has been one of modernization and further revenue shifting in the direction of the central government.

Much of China's recent political history reflects the fluctuating and ongoing debate on the merits of economic and political decentralization versus centralization. Centralization removes economic incentives for local economic actors, while decentralization makes national economic order and equity problematic.[4] The economic and political debate is mirrored by a debate on the appropriate tax bases to impose on economic activity and the

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2 *See* Audrey Donnithorne, Comment, *Centralization and Decentralization in China's Fiscal Management*, 66 CHINA Q. 328, 339 (1976).

3 *See id.*; see also Lardy's reply to Donnithorne — Nicholas R. Lardy, Reply, 66 CHINA Q. 340 (1976).

4 The debate over decentralization versus centralization is summarized well in Zheng Yongnian, *Institutional Economics and Central-Local Relations in China: Evolving Research*, 3 CHINA: INT'L J. 240 (2005) (from which this sentence largely derives).

distribution of tax revenue. In a highly localized economy, taxes on movable factors (profits and to a lesser extent consumption) are feasible. In a national economy, the feasibility of local profit taxes and even consumption taxes is questionable, given the ease with which profits and consumption can be shifted across local borders. Not surprisingly, the growth of modern national economies has often led to a degree of tax centralization of the principal profit and consumption taxes as has the pressure for fiscal redistribution to achieve a more even spread of economic benefit across the nation. The pattern may be repeated in China as it further modernizes its economic and tax systems, in the process possibly altering forever the balance of power between provincial governments and the central government.

II. OPENING OF THE MARKET ECONOMY DOOR: THE RISE OF TAXATION IN MODERN CHINA[5]

A. New Taxes for a New Economy

The world's longest continuous civilization provides a helpful illustration of Oliver Wendell Holmes' truism that taxes are the price of civilization.[6] The revenue needs of governments responsible for establishing a civilized society prompt the development of new taxes, and it is thus not surprising that China is the home of one of the world's first income taxes.[7] One of the first legislative acts of the newly created People's Republic of China was the adoption of a new, national, unified tax jurisdiction based on fourteen types of taxes. Nevertheless, taxation played a truly insignificant role in the financing of government in socialist China.[8] Virtually all enterprises of value were owned by the state, and the state's revenue needs could be satisfied from

5 The subtitle derives in part from Pak Yeyeung's description of this period of taxation development as the "post-open door" period. *See* Pak Yeyeung, *Taxation Trends and Issues in the People's Republic of China*, 62 BULL. FOR INT'L TAX'N 248, 249 (2008).

6 Compania General de Tabacos de Filipinas v. Collector of Internal Revenue, 275 U.S. 87, 100 (1927) (Oliver Wendell Holmes, J., dissenting).

7 A 10 percent tax was imposed on all incomes other than income from agriculture by Emperor Wang Mang in 10 A.D. *See* Greg Anderson, *To Change China: A Tale of Three Reformers*, 1 ASIA PAC. PERSP. 1, 7 (2001).

8 For a review of taxation and funding government by way of distribution of "surpluses" from state enterprises prior to the 1980s, see Jan C. Ting, *Preliminary Notes on Taxation in the People's Republic of China*, 5 REV. SOCIALIST L. 347 (1979); and, for a more detailed look at the tax side only, see Richard D. Pomp & Stanley S. Surrey, *The Tax Structure of the People's Republic of China*, 20 VA J. INT'L L. 1 (1979); Wang Chuanlun, *Some Notes on Tax Reform in China*, 97 CHINA

profit appropriations akin to "dividends." The central, provincial, and even township and county governments owned enterprises and relied on profit distributions to fund public expenditure for goods and services not provided by the enterprises.

In a system based on public ownership of the means of production, direct expenditures by the state were modest. Government-owned and collective enterprises provided directly many services that would be borne by the state outside a socialist economy of this sort. Employers were responsible for almost all aspects of their employees' welfare, supplying housing, many meals in work canteens, childcare, medical attention, and education. Higher education was organized primarily along ministerial lines, with each national and provincial ministry running universities or technical colleges to train the personnel needed for the enterprises owned by the ministries. Even the army was partly self-funded through profits from army-owned enterprises and operated its own universities and comprehensive social welfare programs for its personnel.

The shift to a "socialist market economy" led to a number of changes that had an impact on the government's ability to raise revenue. One that would prove very significant in the longer term was the opening of the door to foreign investment, a development that shifted profits away from government enterprises to foreign owned and joint ventures. A second change, which paralleled the growth of foreign investment was the privatization of growing parts of the Chinese economy, a process that started slowly, but picked up over time. The third, and most significant from a revenue perspective, was corporatization, the process of reconstituting state-owned enterprises into companies with share capital. The primary source of revenue for the state — distribution of enterprise surpluses — fell away to a large extent following corporatization as company directors seeking to grow businesses resolved to retain larger portions of profits for expansion and modernization. The low revenue yields of existing taxes could not possibly fill the gap. Development of a modern tax system became "absolutely essential."[9]

The need for new tax laws raised an interesting political question — which body should assume responsibility for tax measures. Two bodies had the legal power to enact such measures, the National People's Congress, a legislative body with the power to enact "laws," and the State Council, an

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Q. 53 (1984); Robert F. Dodds, Jr., *State Enterprise Reform in China: Managing the Transition to a Market Economy*, 27 LAW & POL'Y INT'L BUS. 695 (1996).

9 Barry Naughton, *Implications of the State Monopoly over Industry and Its Relaxation*, 18 MODERN CHINA 14, 36 (1992).

executive body composed of ministers with the power to enact substantive laws as "regulations" or "provisional regulations."[10] In addition, the Ministry of Finance could issue rules that in effect imposed taxes as interim steps on the way to imposition of a National People's Congress law or State Council regulation. The regulation route had the advantage of speedy passage, as the National People's Congress could only pass laws during its formal sessions, while the State Council was assembled on a regular basis. Also, the legislative route involved internal and external consultation, while the regulation path relied primarily on advice from the Ministry of Finance. For the same reasons, laws tended to be viewed by external investors as more stable and conventional, given the more formal and lengthy process of enactment and, perhaps, because legislative tax laws were more familiar in terms of their own systems.

In the first two periods of tax modernization, the State Council emerged as the primary sponsor of tax measures, although it was a law of the National People's Congress that arguably marked the start of the first phase of modernization. The adoption of new taxes to cover the shortfalls resulting from corporatization, some subsequent privatization, and the rise of the private-sector economy commenced in 1980, two years after Deng Xiaoping started China on its new path, with the adoption by the National People's Congress of the individual (personal) income tax law[11] and an enterprise income tax for the first enterprises involving foreign capital, at the time known as "Sino-foreign joint ventures."[12] The Ministry of Finance followed the legislative initiative in 1983 with a rudimentary income tax for state-owned enterprises based on an administrative regulation.[13]

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10 *See* Li Jin, *Teaching Taxation Law in China*, 62 BUL. FOR INT'L TAX'N 183, 184 (2008).

11 Individual Income Tax Law of the People's Republic of China (promulgated by the Nat'l People's Cong., Sept. 10, 1980, effective Sept. 10, 1980), *available at* http://www.npc.gov.cn/wxzl/gongbao/2000-12/11/content_5004392.htm (Chinese); http://fgk.chinalaw.gov.cn/article/flk/198009/19800900125124.shtml (Chinese); http:// 202.108.90.130/n6669073/n6669088/6888498.html (English) (rev'd Oct. 31, 1993).

12 Enterprise Income Tax for Sino-Foreign Joint Ventures (promulgated by the Nat'l People's Cong., Sept. 10, 1980, effective Sept. 10, 1980), *available at* http://www.npc.gov.cn/wxzl/gongbao/2000-12/10/content_5004395.htm (Chinese); http://fgk.chinalaw.gov.cn/article/flk/198009/19800900124853.shtml (Chinese) (rev'd Sept. 2, 1983, repealed July 1, 1991).

13 Experimental Provisions on Substituting Profits for Tax in State-Owned Industrial Enterprises (promulgated by the State Council, Apr. 24, 1983, effective Jan. 1, 1983), *available at* http://fgk.chinalaw.gov.cn/article/xzfg/198304/19830400126017.shtml (Chinese).

The 1983 regime distinguished between large and medium scale, on the one hand, and small scale, on the other, state-owned enterprises, imposing a 55 percent tax rate on the former and an eight step progressive rate (ranging from 10 percent to 55 percent) on the latter.[14] Profits after tax were also turned over to the state, with four mechanisms used to appropriate after-tax profits. The initial rules were replaced in 1984 by a broader regime constructed once again on administrative regulations.[15] The more formal system retained the initial dual track rate scale[16] but replaced the four mechanisms for appropriating after-tax profits from large scale enterprises with a single "adjustment tax".[17] The tax regime for state-owned enterprises was followed in 1985 by an income tax for collective enterprises,[18] and in 1988 by an income tax for private domestic enterprises.[19]

Meanwhile, in 1984 the State Council added to existing product taxes

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Arguably the real start of the shift from profit distribution to taxation occurred two years earlier when the Ministry issued a rule that treated profit distributions as if they were tax obligations. The object of that change was to remove the discretionary element in distributions that had allowed many firms to avoid paying stipulated percentages of profits, and some to avoid any payments at all. *See* Tinggang Lu & Jiliang Yang, *Profit Distribution and Tax Reform in China*, 13 INT'L TAX J. 65 (1987).

14 Hotels, restaurants, guest houses and catering service companies were subject to a 15 percent tax rate.

15 Regulations on State-Owned Enterprise Income Tax of the People's Republic of China (draft) (promulgated by the State Council, Sept.18, 1984, effective Oct. 1, 1984), *available at* http://fgk.chinalaw.gov.cn/article/xzfg/198409/19840900125644. shtml (Chinese); Experimental Provisions on the Second Step Scheme of Substituting Profits for Tax in State-Owned Industrial Enterprises (promulgated by the State Council, Sept. 18, 1984, effective Oct. 1, 1984), *available at* http://fgk.chinalaw. gov.cn/article/xzfg/198409/19840900125767. shtml (Chinese).

16 The preferential rate for hotels, restaurants, guest houses and catering service companies was removed and these enterprises subject to the same rates as small scale state-owned enterprises.

17 Provisions on the Collection of Adjustment Tax in State-Owned Industrial Enterprises (promulgated by the State Council, Sept. 18, 1984, effective Oct. 1. 1984), *available at* http://fgk.chinalaw.gov.cn/article/xzfg/198409/19840900125756. shtml (Chinese).

18 Provisional Regulations on Collective Enterprise Income Tax of the People's Republic of China (promulgated by the State Council, Apr. 11, 1985, effective Apr. 11, 1985), *available at* http://fgk.chinalaw.gov.cn/article/xzfg/198504/1985040 0126081.shtml (Chinese) (repealed Dec. 13, 1993).

19 Provisional Regulations on Private Enterprise Income Tax of the People's Republic of China (promulgated by the State Council, June 25, 1988, effective June 25, 1988), *available at* http://fgk.chinalaw.gov.cn/article/xzfg/198806/19880600126461.shtml (Chinese) (repealed Jan. 1, 1994).

a new sales tax described as a "trial" value added tax (VAT) for domestic enterprises to partially replace the rudimentary general turnover taxes imposed since shortly after the revolution. While the so-called VAT had the same name as the European consumption tax, it was in fact a very different creature, taking the form of a sales tax on twenty-four selected items.[20] In 1988, a stamp duty on transfers of shares and selected contracts was adopted,[21] perhaps in part in anticipation of the reopening of the Shanghai Stock Exchange and creation of the Shenzhen Stock Exchange in 1990, although a much wider selection of instruments were also subject to the duty.

B. The Diverging Interests of the Central Government and Provincial Governments

The decade-and-a-half following Deng Xiaoping's declaration of the shift to a "socialist market economy" was a period of unparalleled economic growth in China. The economy in 1993 was almost ten times its size when the process started. The next fifteen years produced far more wealth in absolute terms, but in a proportional sense enjoyed only half the growth of the first decade-and-a-half of the market economy.[22] Governments at both the provincial and central level struggled to keep up with the social and economic changes. Revenue needs grew exponentially as well. The physical infrastructure needed to accommodate the growth and ensure its continuation was enormous. Social infrastructure needs were equally great. An increasing portion of the workforce labored for private sector employers or for themselves and had no access to the education, housing, childcare, healthcare, and social welfare systems that had been the responsibility of state-owned enterprises. Private-sector providers could take up some of the slack, but many of the services could only be provided by government. Significant resources were needed, too, to build the human capital needed

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20 The key taxes, which are noted in the preceding paragraph, and the host of other smaller taxes that formed the basis of the government revenue system during this period, are described in some detail in Jinyan Li, *China's Tax System: An Evaluation*, 17 DENV. J. INT'L L. & POL'Y 527 (1989); See also A.J. Easson & Jinyan Li, *The Evolution of the Tax System of the People's Republic of China*, 23 STAN. J. INT'L L. 399 (1987), covering this and earlier periods.

21 Provisional Regulations on Stamp Tax of the People's Republic of China (promulgated by the State Council, Aug. 6, 1988, effective Oct. 1, 1988), *available at* http://202.108.90.130/n6669073/n6669088/6888398.html (Chinese).

22 CHINA STATISTICAL YEARBOOK 2008 tbl 2-5 (2008), *available at* http://www.stats.gov.cn/tjsj/ndsj/2008/indexeh.htm ("Indices of Gross Domestic Product," under heading "National Accounts").

for continued development. Sector-specific institutions of higher learning operated by ministries to generate staff for their sectors of the government-controlled economy had to be replaced with modern general universities, imparting the skills needed to participate in a continuously evolving economy.

A wide range of often ad hoc fiscal arrangements between the central government and provinces had been tried in the period prior to 1979[23] and the development of new fiscal models accelerated as the economy shifted from state control to a market economy. In this first phase of reform, the central government provided broad economic guidelines but provincial governments enjoyed almost free reign in microeconomic management. Taxes were collected by local offices of the national tax authority, the State Administration of Taxation (SAT), and a variety of arrangements were used to share the revenues between the local provincial government and the central government. Arrangements changed over time and from province to province, but all featured a "bottom-up" approach toward revenue division that required provincial offices to submit a portion of revenues while permitting them to keep everything above the required transfer. The exceptions to the general rule were the company and individual income taxes, which were evenly split between the two levels of government. The array of sharing and subsidy agreements was sometimes augmented by central government policies to smooth economic growth by curbing spending, in some instances through the use of forced loans back to the center.[24]

Although the gap between central government revenues and provincial revenues actually decreased over the first half of the 1980s, it widened again over the second half, and by the close of the decade provincial revenue was 40 percent higher than central revenue as a percentage of GDP.[25] At the same time, the overall revenue pie as a percentage of national wealth shrunk, even as the economy grew,[26] leaving less in relative terms for the center to redistribute and exacerbating the growing inequality between regions. Provinces in the east

23 The breadth of this range is illustrated by the retentions allowed to provinces under the consolidated industrial and commercial tax base, stretching in 1980 from 0 percent to over 88 percent. *See* Audrey Donnithorne, *New Light on Central-Provincial Relations*, 10 AUSTRALIAN J. CHINESE AFF. 97 (1983).

24 The arrangements in place from 1979 until 1985 are detailed in Michel Oksenberg & James Tong, *The Evolution of Central-Provincial Fiscal Relations in China, 1971-1984: The Formal System*, 125 CHINA Q. 1 (1991), and for the following five years in WORLD BANK, CHINA: REVENUE MOBILIZATION AND TAX POLICY, A WORLD BANK STUDY (1990).

25 Yasheng Huang, *Central-Local Relations in China During the Reform Era: The Economic and Institutional Dimensions*, 24 WORLD DEV. 655, 660 (1996).

26 *Id.*

in particular, enjoying both natural endowments conducive to manufacturing and trade and human capital to exploit the opportunities created by those endowments, grew wealthier at a pace many times that of poorer provinces to the west and northwest. The provinces that had negotiated the best deals had a strong motivation to increase economic growth and derive higher tax revenues,[27] but spending increased in all provinces and the need for fiscal redistribution to alleviate poverty in the areas left behind in the rush to economic growth became acute. The post-1979 financial system was failing to provide the resources needed for redistributive purposes.[28] In short, the central government needed more cash to carry out its economic program.[29]

The shrinking of central government revenues may have caught central officials by surprise. Central deficits and inflation rose as central authorities found it difficult to reduce expenditures in the face of declining revenues.[30] If the center could not recapture fiscal dominance and, more importantly, find the resources needed for redistribution, the asymmetrical growth the nation was experiencing would become even more lopsided in favor of the fast-growing eastern provinces. Some even suggested that the growth of provincial autonomy could have led to disintegration of the central authority,[31] and while

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27 Christine P.W. Wong, *Fiscal Reform and Local Industrialization: The Problematic Sequencing of Reform in Post-Mao China*, 18 MODERN CHINA 197, 208 (1992). But see Chien-Hsun Chen & Hsiu-Ling Wu, *Fiscal Structures and Regional Economic Growth: Evidence from China's Fiscal Contract System*, 41 J. DEVELOPING AREAS 119 (2008), who argued that higher tax revenues may have inhibited growth in some of these provinces in this period.

28 A helpful case study illustrating the dilemma in the case of Shaanxi, one of the poorest provinces in the nation, is in Albert Park, Scott Rozelle, Christine Wong & Changqing Ren, *Distributional Consequences of Reforming Local Public Finance in China*, 147 CHINA Q. 751 (1996). Tong argues that the disparity in basic services such as healthcare and education did not grow significantly over the decade, but concedes that by the end of the 1980s the poorer provinces were alarmed over the prospect of greatly increased disparity if the revenue-sharing arrangements were not changed and coastal provinces continued their growth paths. *See* James Tong, *Fiscal Reform, Elite Turnover and Central-Provincial Relations in Post-Mao China*, 22 AUSTRALIAN J. CHINESE AFF. 1, 27 (1989).

29 Cheung suggests that the depletion of revenue was the key explanation for the 1993 reforms. *See* Gordon C.K. Cheung, *An Analysis of the 1993 Chinese Taxation Reform*, 27 J. CONTEMP. ASIA 511, 512 (1997).

30 Christine P.W. Wong, *Central-Local Relations in an Era of Fiscal Decline: The Paradox of Fiscal Decentralization in Post-Mao China*, 128 CHINA Q. 691 (1991); Rajiv Lall & Bert Hofman, *Decentralization and the Government Deficit in China*, *in* MACROECONOMIC MANAGEMENT AND FISCAL DECENTRALIZATION 173 (Jayanta Roy ed., 1995).

31 Jae Ho Chung, *Studies of Central-Provincial Relations in the People's Republic*

the threat may have been exaggerated, it did seem clear that the post-1979 tax system was inimical to macroeconomic management at a national level[32] and led to inefficiencies at the provincial level as well.[33] The haphazard array of taxes and revenue division regimes was simply unsustainable from the central government's perspective.

A related and growing concern in many quarters was the growth of off-budget revenue-raising by the imposition of fees for "services" in lieu of taxation and the sometimes questionable use of the revenue raised in this way. Easily collected by state departments providing monopoly services, the often burdensome and sometimes onerous fees provided these entities with sometimes non-accountable funding completely outside the ordinary budget system. In the decade from 1985, taxes as a percentage of GDP halved while fees more than trebled.[34]

It is unlikely that officials looking forward from the beginning of the reform era could have anticipated the speed with which fiscal factors would change, a fact illustrated by the ever-changing miscellany of ad hoc taxes and charges and sharing arrangements adopted over the following decade. There was little evidence that the finance arm of government had a clear vision of the role and structure of taxes in a modern market economy. By the early 1990s, however, officials had been well briefed by external experts and acquired an understanding, if somewhat tempered by non-market concepts, of revenue raising and public finance principles in a market economy.[35] The stage was set for a fundamental change of direction in the second stage of tax modernization.

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of China: A Mid-Term Appraisal, 142 CHINA Q. 487 (1995). For a rejection of this view, see Le-Yin Zhang, *Chinese Central-Provincial Fiscal Relationships, Budgetary Decline and the Impact of the 1994 Fiscal Reform: An Evaluation*, 157 CHINA Q. 115 (1999).

32 *See* Mario Blejer & Gyorgy Szapara, *The Evolving Role of Tax Policy in China*, 14 J. COMP. ECON. 452, 462 (1990).

33 *See* Chien-Hsun Chen & Hsiu-Ling Wu, *supra* note 27.

34 Ray Yep, *Can "Tax-for-Fee" Reform Reduce Rural Tension in China? The Process, Progress and Limitations*, 177 CHINA Q. 42 (2004).

35 Among the sources of advice was a 1998 World Bank mission that yielded a comprehensive report whose recommendations remain important in the current round of reforms. *See* WORLD BANK, *supra* note 24.

III. The Intermediate Era: The 1990s

In contrast to the ad hoc responses and often seemingly uncoordinated changes that seemed to epitomize lawmaking in the first decade of the shift to a market economy, developments in the second decade after the opening of the economy appear to have been both coordinated and well thought out. There were two elements to the changes: modernization of the accounting rules used as the base for income tax and indirect tax calculations; and a comprehensive overhaul of the tax system involving the rewriting of income tax laws and regulations and wholesale replacement of indirect tax regulations, the adoption of a standardized tax revenue sharing formula to replace the inconsistent and largely ad hoc central-provincial agreements that had been used in the first decade of market economy reform, and a complete restructure of the tax administration.[36] On the surface, the changes appeared to shift China's economy and fiscal system towards a model that would be recognizable in most market economies. A legacy of socialist perspectives and the political compromises needed to secure support for the changes left the execution far from optimal, however.

A. Reforms of the 1990s

1. Reform of the Accounting Rules

A key reform of the second decade of economic modernization was the promulgation by the Ministry of Finance in 1992 of a new set of financial accounting rules for domestic companies. The standards, labeled Accounting Standards for Business Enterprises (ASBE),[37] were broadly modeled on international accounting standards, but were set out in a far more basic format and contained a large number of variations from conventional standards.

The accounting changes were long overdue. While almost no country's tax system aligns taxable income completely with accounting profits, accounting records are generally used as the starting point for determining taxable income. Accounting standards provide the fallback characterization and timing rules that are then adjusted to accommodate concessions or

36 Pak Yeyeung, *supra* note 5, describes this period of Chinese tax development as the "Pacific Rim Era," tying tax developments with China's entry into the group of rising Asian-Pacific rim economies.

37 Accounting Standards for Business Enterprises (promulgated by the State Council, Nov. 30, 1992, effective July 1, 1993), *available at* http://fgk.chinalaw.gov.cn/article/xzfg/199211/19921100125910.shtml (Chinese).

disincentives set out in the tax legislation and, in Anglo countries, the further modifications of the tax base resulting from judicial interpretations of basic concepts of income and non-deductible capital outlays. Prior to the shift to a market economy, there was no private-sector accounting profession and no independent body that could issue an agreed set of accounting standards in China. Accounting within state-owned enterprises was undertaken by employees of the organizations, and the Chinese accounting standards issued by the Ministry of Finance for state-owned enterprises were fundamentally different from conventional market-economy accounting standards and applied in many variations — state-owned industrial enterprises were using more than seventy different accounting methods![38]

2. Modernization of the Tax Laws and Regulations

The first limb of the three-pronged tax reform program involved the replacement of existing income tax laws and regulations and the adoption of new indirect taxes. The process commenced in 1991, just over a decade after the legislature had started the tax modernization process, when the National People's Congress enacted a new company (enterprise) tax law for foreign firms and firms with foreign ownership interests[39] to replace its 1980 Sino-foreign joint ventures income tax law. While the replacement law still looked primitive by contrast with those of developed market economies, it was an improvement on the law it replaced. Importantly, too, it signaled the intention of the legislature to retain responsibility for tax laws that applied to foreign investors, a commitment that was to prove important a decade-and-a-half later when the domestic— and foreign-owned company tax laws were consolidated. Two years later, in 1993, the National People's Congress passed amending legislation to modernize somewhat its 1980 personal income tax law.[40]

The 1991 foreign company tax law left a great deal of room for the use of incentives and concessions to attract investment and concessions became the norm in many provinces. They may have been relatively ineffective — some of the highest effective tax rates were found in the jurisdictions that

38 Lan Cao, *Chinese Privatization: Between Plan and Market*, 63 LAW & CONTEMP. PROBS. 14, 40 (2000).

39 Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises (promulgated by the Nat'l People's Cong., Apr. 4, 1991, effective July 1, 1991), *available at* http://202.108.90.130/n6669073/n6669088/6888509.html (Chinese).

40 The changes are detailed in Howard Gensler, *The 1994 Individual Income Tax of the People's Republic of China*, 26 CAL. W. INT'L L.J. 115 (1995).

attracted considerable investment relying on natural and human resource endowments rather than tax concessions.[41] Still, the concessions may have played an important socio-psychological role in the earliest stages of foreign investment, signaling to foreign capital that the days of the Cultural Revolution had truly passed and the country was open for business.[42]

Ultimately, however, it was the work of the executive, in particular a series of regulations by the State Council, that changed forever the face of Chinese tax rules and shifted the country's revenue system to one based on taxes that in title, but to a far lesser extent in form, were similar to the foundation taxes found in almost all modern economies. One income tax and three indirect tax regulations adopted by the State Council in 1993 (with effect from 1994) were to prove pivotal.

The income tax regulation amalgamated the three domestic enterprise income taxes into a single provisional domestic enterprise income tax.[43] The consolidation of the enterprise income taxes was an important step along the road to modernization, but one that had few geopolitical consequences in terms of revenue distribution The same could not be said of the State Council's indirect tax reforms in the form of three new indirect taxes to replace a hodgepodge of turnover taxes and the somewhat primitive "trial" VAT: the consumption tax (an excise tax on alcohol, petroleum products and selected luxury items ranging from golf balls and equipment to high-end watches and yachts),[44] the business tax (a turnover tax on the supply of services),[45] and a revised VAT applying to the supply of goods.[46] The modifications to the

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41 Yu Zheng, *Fiscal Federalism and Provincial Foreign Tax Policies in China*, 15 J. CONTEMP. CHINA 479 (2006).

42 Jinyan Li, *Development and Tax Policy: Case Study of China* (Comparative Research in Law & Political Econ., Research Paper No. 27/2007, 2007).

43 Provisional Regulations of the People's Republic of China on Enterprises Income Tax (promulgated by the State Council, Dec. 13, 1993, effective Jan.1, 1994), *available at* http://202.108.90.130/n6669073/n6669088/6888563.html (Chinese). The evolution of the different income tax rules into a unified enterprise income tax is reviewed in detail in Isabella Lam, Stella Cho & Aldous Mak, *The Historical Development of Income Tax Law for Domestic and Foreign Enterprises in China*, 22 INT'L TAX J. 51 (1996).

44 Provisional Regulations of the People's Republic of China on Consumption Tax (promulgated by the State Council, Dec. 13, 1993, effective Jan. 1, 1994), *available at* http://202.108.90.130/n6669073/n6669088/6888623.html (Chinese).

45 Provisional Regulations of the People's Republic of China on Business Tax (promulgated by the State Council, Dec. 13, 1993, effective Jan. 1, 1994), *available at* http://202.108.90.130/n6669073/n6669088/6888583.html (Chinese).

46 Provisional Regulations of the People's Republic of China on Value-Added Tax (promulgated by State Council, Dec. 13, 1993, effective Jan. 1, 1994), *available at*

indirect tax system, along with ancillary administrative and revenue-sharing arrangements, would set the stage for a rebalancing of central-provincial relations.

3. Revenue Sharing

The second limb of the 1993 tax reform package was the adoption of a non-legislated revenue-sharing formula intended to replace the former inconsistent *mélange* of agreements with fixed rules and, in the process, to significantly shift the revenue base toward the center, which was suffering a serious shortfall in revenues. The new rules gave provincial governments 100 percent of the revenue from the new business tax on the supply of services and 25 percent of the revenue from the VAT on the sale of goods, while their share of company and individual income tax was scheduled to fall from 50 to 40 percent, albeit over an extended period. The agreement was the result of complex negotiations between provincial and central authorities, including a central government guarantee of transfer payments that would leave no province with less than the base revenue it had in 1993.[47] While the division looked at first glance to be generous to the provinces, in fact it was very deliberately tilted far in favor of the center, with the center's weighting based on the higher-yielding and growing taxes, even if the provinces were able, as some suspected would be the case, to delay the planned division of income tax revenues.[48]

4. The Splitting of Tax Administration

The third limb of the central government's overhaul of the tax system in 1993 was the adoption of a new tax administrative system. The replacement of negotiated revenue-sharing arrangements with a fixed formula helped focus the attention of the provinces on the business tax base they had been handed. Provincial authorities wished to have control of the assessment and collection processes for taxes that were assigned entirely to them.

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http://202.108.90.130/n6669073/n6669088/6888727.html (Chinese).

47 Yu Zheng, *supra* note 41, at 482.

48 Tsang Shu-ki & Cheng Yuk-shing, *China's Tax Reforms of 1994: Breakthrough or Compromise?*, 34 ASIAN SURV. 769 (1994). As it turned out, the doubts were well founded. The planned shift to a 60 percent share for the central government was ultimately shelved until the third stage of reform a decade later. *See* Guo Fa [State Council Promulgation] (1993) No. 85, Decision on Fiscal Administration Regime for Executing Tax-division System (promulgated by State Council, Dec. 15, 1993, effective Jan. 1, 1994), *available at* http://fgk.chinalaw.gov.cn/article/fgxwj/199312/19931200121993.shtml (Chinese).

Devolution of tax administration was seen by the center as a politically acceptable concession to mitigate opposition to the new revenue-splitting formula.

Prior to the 1993 reforms, provincial governments were able to levy various fees and charges and had departments responsible for collecting these revenues but only the central government had established full-fledged taxation and customs departments. The limited transfer of tax administration powers and structures to the provinces was accomplished by means of a State Council circular that hived off part of the provincial offices of the central government's tax collection body, the SAT, to create separate provincial tax offices under the control of provincial governments.[49] Apart from the initial filling of places by transferred SAT officers, positions in the provincial offices, or "local" tax offices, as they became known, were the responsibility of provincial governments. The commissioners of provincial offices were jointly appointed by the provincial government and SAT. Operational funding for the new provincial agencies came partly from provincial governments and partly through a retention formula, under which provincial governments allowed the local tax authorities to deduct administrative costs from payments to the tax department in its capacity as recipient of central government transfers.

The creation of provincial tax offices was directly tied to the second limb of the 1993 tax reforms, the adoption of revenue-sharing rules, particularly the assignment to provincial governments of all revenue from the new business tax (the turnover tax applying to the provision of services) and the individual income tax. Provincial authorities wished to have control of the assessment and collection processes for the business turnover tax that had been assigned entirely to them. In addition, they were handed the responsibility for applying the revamped company income tax to provincially-owned and private companies. The central SAT generally retained responsibility for assessing company income tax on centrally-owned companies, publicly listed corporations, and foreign-owned firms. However, exceptions to these broad rules applied to joint ventures between centrally-owned and provincially-owned companies and between provincially-owned companies and foreign firms.

In addition to responsibility for collecting income tax from foreign and centrally-owned firms, the regional offices of the centrally administered SAT had responsibility for applying the VAT and the consumption tax to all enterprises. They were also given responsibility for applying the business tax to selected national industries, namely the insurance industry,

49 Guo Fa [State Council Promulgation] (1993) No. 85, *supra* note 48.

banking industry and railways, and for imposing the individual income tax on non-citizens.

B. Suitability and Sustainability of the 1993 Reforms

In form, at least, the 1993 reforms appeared to have shifted China's tax system towards a modern fiscal regime. Individuals and companies were subject to income tax, an excise tax applied to consumption-generating negative externalities and some luxury items, a business tax and a VAT applied to consumption, and a modern accounting system could be used as the basis for creating company accounts and determining taxable profits. In substance, however, it was a different story.

Questions about the suitability of the legislation fell into four broad camps. One set of questions related to the structure of the income tax laws and concerns about their suitability for transactions in a modern market economy. A second concerned the economic distortions caused by the indirect tax laws. The third concerned the distortions caused by lower-tier governments seeking to maximize their share of revenues under the new allocation formulas. A fourth concerned the suboptimal administrative capabilities caused by the division of labor between the provincial and central government tax offices and between different parts of the central government's tax offices.

A fifth question was whether the new arrangements would be sustainable in terms of revenue adequacy. Wherever credit for the growth may lie, it proved to be very uneven, with some provinces, particularly along the coast, able to exploit natural location and human capital resources to enjoy a much higher growth rate than others.[50] Fiscal equalization between wealthier and poorer provinces became a moral and political necessity that could only be accomplished through central government redistribution policies. Whether the revenue allocation formula was appropriate given the redistributive aim

50 The extent to which governments have played a central role in China's remarkable growth since shifting to a "socialist-market" economy is the subject of considerable debate. Some attribute the growth in part to a deliberate decentralization policy and fiscal empowerment at the provincial level which fostered economic growth locally. *See, e.g.*, Zhu Suli, *'Federalism' in Contemporary China — A Reflection on the Allocation of Power Between Central and Local Government*, 7 SING. J. INT'L & COMP. L. 1, 13 (2003). Others argue that this view fails to attribute sufficient weight to the role of the central government's broad economic guidance. *See, e.g.*, Daniel Treisman, *Fiscal Decentralization, Governance, and Economic Performance: A Reconsideration*, 18 ECON. & POL. 219 (2006).

and whether the growth in revenue would be sufficient to achieve genuinely adequate redistribution remained open questions.

1. Suitability of the Income Tax Laws for a Modern Market Economy

The operation of the 1991 foreign company income tax and 1993 personal and domestic company income tax regimes was troublesome in policy terms in several respects. The starting point for the company income taxes were accounting records, but the 1992 accounting standards deviated in a number of ways from the international accounting standards on which they were loosely modeled. The initial basic standard was later supplemented with sixteen further specific standards adopted over the next decade which helped to improve and further modernize the rules, but some distortions remained, reflecting the origins of the standards in reporting for state-owned enterprises. As a consequence, measurement of taxable income across different sectors and different enterprises within sectors could vary significantly, with many opportunities for discretion by both taxpayers and tax collectors

The laws themselves were at best rudimentary — very short documents comprising a handful of operative provisions. Implementing regulations issued by the State Council fleshed out very slightly some of the operative principles but the real operational rules were established in Ministry of Finance and SAT circulars. These were issued on a continual basis as new issues arose or new decisions were taken by authorities. There was no overall structure or organization to the raft of circulars issued, as each addressed particular, and often isolated, aspects of income taxation. Causing particular frustration for both taxpayers and some tax officials were the inconsistent overlaps between different rulings and the many lacunae between them into which so many transactions might fall.

One aspect that complicated the application of the laws to the private and privatized sector was a strong socialist legacy that shaped the laws so they continued to reflect the socialist notions held by their designers and the executive politicians who enacted them. The clearest example was use of an "enterprise" income tax rather than a company income tax. The concern of central planners in the transition to a market economy was the licensing of private businesses allowed to operate outside the sphere of state ownership. The legal form of the businesses — public or private companies, partnerships, or simple sole traders — was of little importance in a world which divided business between public and private. The domestic "enterprise" income adopted for persons deriving business income reflected this dichotomy, and the same rules were intended to apply to individuals through to the largest corporations. That made it difficult to develop subordinate rules appropriate for different legal forms of business and created some confusion and arbitrage opportunities for individuals potentially straddling the enterprise and individual tax regimes. In contrast, the tax systems in most developed market economies segregate companies and individuals, with the latter subject to the individual (and almost inevitably progressive) rate scale regardless of whether they derive income through an enterprise or from another source.

The substantive provisions of the law also reflected the socialist bias of the designers. For example, the law contained a limitation on the deductibility of advertising expenses, a feature of tax laws not uncommon in many former socialist states. The restriction reflects the socialist-era bias in favor of investment in capital assets and the production of industrial outputs rather than goods intended for final consumption by individual consumers. Expenditures incurred to promote and sell final consumption goods were viewed as less worthy than expenditures to acquire productive facilities and equipment. It also reveals the naivety of the laws' designers, who assumed that the black and white distinctions that could be easily legislated in the socialist era when the state controlled all business were transplantable to a market economy, the key hallmarks of which are virtually unlimited flexibility and innovation. In practice, such features proved to be more of an annoyance than an impediment, as undefined "advertising" expenses could easily be recharacterized as fully deductible outgoings, but they did require attention and yield some distortions in business practice.

A much more serious example of socialist-era line drawing transplanted to the tax law is the distinction between goods and services, with the former subject to the VAT and the latter subject to the business tax. The distinction was clearly viable in the socialist economy, where most supplies were tangible and services largely limited to social services. It has ceased to be meaningful in the modern economy and taxpayers dividing their business activities into two camps to fulfill their tax obligations are carrying out a truly artificial function in an era of hybrid supplies acquired by consumers who make no distinction between the tangible elements of purchases and the accompanying services. Taxpayers can sidestep the legislative provisions which treat services related to goods (warranty, repair, training, etc.) as goods for VAT purposes, but the process involves some rearrangement of transactions and segregation of single supplies into two contracts, and often two businesses, yielding suboptimal tax driven business practices.

Similar problems arise in respect of transactions shifted into the business tax. In addition to supplies of services, the business tax applies to financial supplies such as loans, intangible assets, and immovable property. Simple construction of premises on land generates a host of potential tax conflicts as taxpayers and authorities take different views as to which elements of the premises are attached to and become part of the immovable property subject to business tax and which parts are separable goods subject to the VAT.

The indirect tax dichotomy may also have a serious impact on compliance from an administrative perspective, with separate tax offices auditing firms for business tax and VAT purposes, potentially leaving both without the full picture required for effective tax audits.

2. Suitability of the Indirect Taxes for a Modern Market Economy

Of the three main indirect taxes applying to sales, the consumption tax was probably the least distorting, even if it was as much an exercise in deliberate market bias as it was a mechanism for pricing consumption correctly to reflect negative externalities and social costs for items such as petrol, cigarettes or alcohol. Extension of the tax to selected "luxury" items reflected the political biases rather than sound tax policy. The application of the tax to selected "luxury" goods was at worst an attempt to impose a preconceived consumer morality and at best a crude mechanism for redistribution that ended up encouraging offshore and cross-border (Hong Kong) shopping.

More troublesome in terms of macro outcomes were the distortions caused by the cascading business tax on supplies of services and the cascading VAT on sales of goods. The shift to modern consumption taxes in Western market economies in the second half of the twentieth century resulted in part from recognition of the economic cost of cascading taxes based on business turnover. A system based on cascading taxes which imposes tax on tax as supplies move through the production and sales chain favors large and possibly inefficient integrated businesses over possibly more efficient firms that specialize in the goods or services needed at each stage in the production chain. Avoiding taxes on intermediate transactions that occur within a single integrated firm allows possibly inefficient but integrated firms to sell for less than businesses selling goods or services that have borne tax at each stage of a far more efficient production process. In a closed economy, the inefficiencies encouraged by the cascading tax system lead to reduced overall output and higher costs for consumers. In an open economy, they place local firms at a distinct disadvantage.[51]

To avoid this outcome, half a century ago most market economies replaced

51 The disadvantages of a cascading tax are summarized in ALAN TAIT, VALUE ADDED TAX: INTERNATIONAL PRACTICE AND PROBLEMS 9, 15 (1988). The flaws and economic consequences of the limited VAT system are documented in Yang Ping & Jin Wanjun, *Ideas on the Perfection of China's Value Added Tax System*, 11 INT'L VAT MONITOR 106 (2000).

cascading turnover taxes with final consumption taxes in the form of a retail sales tax, in which the tax is suspended for business-to-business sales, or a VAT, in which tax is imposed on all sales but then rebated by way of credit or refund for business-to-business transactions.[52]

By way of contrast, both of China's main indirect taxes suffered from cascading, falling on intermediate businesses rather than final consumption. The business tax, with rates ranging from 3 to 20 percent, was unambiguously a cascading tax, imposed on all services, whether provided to intermediate businesses or final consumers. So, too, albeit to a lesser extent, was the "consumption tax" (the excise tax), with rates ranging from 3 to 45 percent.

The VAT, which became the most important tax in terms of percentage of revenue provided, was a partial cascading tax. The general VAT was imposed at two rates — 17 percent for most goods, with a reduced rate of 13 percent for selected reading materials, farming inputs, agricultural and aquatic outputs, and household fuels and related items. Small businesses were subject to two lower rates — 4 and 6 percent. Small business taxpayers were never entitled to recover VAT on their acquisitions and businesses subject to the higher rates were only allowed to recover VAT included in the price of inventory; no claims could be made for VAT paid on capital goods used to produce inventory.[53]

With relatively high rates and most often cascading application, the VAT generated plenty of revenue for the central and provincial governments but clearly generated economic inefficiencies and prejudiced businesses with longer production chains. The lack of relief for input business tax caused similar economic distortions and prejudiced businesses with a greater reliance on services.

A second set of distortions resulted from the imposition of separate company tax laws on enterprises owned by foreigners and those owned by Chinese citizens and entities. Different tax rules and, more importantly, different rates favored foreign investors and prejudiced locally-owned enterprises. It also distorted patterns of investment by local entrepreneurs who sought to structure investments by way of interposed offshore entities to take advantage of the rates applying to foreign firms.

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52 Some jurisdictions such as New Zealand, Canada, and Australia moved later to replace single stage intermediate taxes such as manufacturers' sales taxes or wholesale sales taxes with a VAT designed to tax final consumption.

53 Rules for the Implementation of the Provisional Regulations on Value Added Tax of the People's Republic of China, art. 19 (promulgated by the Ministry of Fin., Dec. 12, 1993, effective Jan. 1, 1994), *available at* http://202.108.90.130/n6669073/n6669088/6888650.html (Chinese).

Finally, a highly distorting system used to provide VAT tax relief for exports of goods and the absence of any relief for exports of services generated a host of serious biases and inefficiencies. The VAT is intended to be a tax on final consumption, not business inputs, and to achieve this goal it operates on what is known as a "destination" basis. This means that tax is removed completely by the source country in the case of exports, allowing room for a final consumption tax in the destination jurisdiction. The relief of tax in the exporting country is achieved by providing the exporter with a credit for all tax incurred on inputs to produce the export or a refund of the input taxes if the exporter does not have a sufficiently high tax liability to absorb the entire credit.

While the Chinese VAT notionally provided a full credit for input tax incurred by exporters, the general rule was subject to discretion by the executive to provide lower rates of relief. Five rates of relief, ranging from the full tax rate of 17 percent down to a minimal 3 percent rebate, could be applied to exports. With a strong legacy from the socialist era of direct state intervention in economic decision-making, the executive deliberately used selective relief as a tool of economic management, subsidizing industries it favored from time to time and penalizing those whose exports were not viewed as meriting support.[54] As the government intended, shifting tax burdens on exporters shifted investment across industries and sectors, substituting state interventionist biases for the rigor of the market. No relief at all was available for exported services.

Compounding the cascading problem of the business tax was its extension to interest payments on loans. In theory, enterprises other than licensed banks are not permitted to provide loans in China and direct inter-corporate loans are thus impossible, although not surprisingly businesses find ways of circumventing the prohibition through back-to-back and other substitute arrangements. Most loans come from banks, however, and all of these bear business tax, increasing the cost of capital for firms reliant on debt financing

54 The selective entitlement to credits remains the practice until the present. See Cai Shui [Joint Circular of Ministry of Fin. & SAT] (2006) No. 139 (promulgated by the Ministry of Fin., the Nat'l Dev. & Reform Comm'n, the Ministry of Commerce, the Gen. Admin. of Customs & the State Admin. of China, issued Sept. 14, 2006, effective Sept. 15, 2006), *available at* http://202.108.90.146/guoshui/action/GetArticleView1.do?id=1074&flag=1 (Chinese), which reduced the credit allowed for "high energy consumption and high polluting" products and increased the credit for "high technology and other encouraged industries."

and creating distortions in the market between firms, depending on their need for debt.

3. Distortions Caused by Revenue Maximization Behavior

From 1994, provincial authorities were provided with 25 percent of VAT revenues collected in their province. In addition, they were entitled to 50 percent of company tax revenue generated by subsidiaries located in their provinces or branches that carried on business in the provinces (as opposed to branches which merely acted as agents for sales by the head office). To determine whether a branch should be treated as a separate entity for company tax purposes, authorities would look at whether it was registered for VAT purposes. The criteria used to require VAT registration — receiving payment for sales at the branch or issuing VAT invoices — were treated as reasonable indicia of carrying on a business for income tax purposes.

There was, therefore, a significant incentive for provincial governments to attract and retain VAT registrations. In some provinces, the incentive extended to the next tier of district administration and even through to a third tier of neighborhood administrations. While some provincial governments such as Beijing would allocate all tax revenue to the provincial consolidated revenue and then distribute to subordinate governments from the provincial pool, others such as Shanghai operated more decentralized budget systems and divided a portion of the provincial 25 percent share of VAT revenue to subordinate governments on the basis of another fraction. (Beijing is now moving towards a similar allocation.) For the lower-tier governments, attracting and retaining VAT registrations was a zero-sum game; every new VAT taxpayer brought local tax revenue, even if the net amount retained was far below the nominal allocation to the district or neighborhood.

The incentive gave rise to a "kickback" practice; enterprises would be offered a rebate of some of their VAT liability that would otherwise flow to a particular district or neighborhood administration, for registering in a particular district. Rebates were not labeled as such, of course — they were presented as incentive payments or subsidies to attract new investment — but a close examination of the basis for the payments would often reveal their true nature as partial kickbacks of tax revenue. Concerned about the distortions caused by this behavior, both the central government's Ministry of Finance and provincial governments have adopted processes to combat the practice, including recapture of the VAT paid to the lower-tier government and financial penalties. It is difficult to apply these disincentives, however, as neither the companies nor district or neighborhood governments openly acknowledge the practice or create easy-to-follow paper trials.

A related phenomenon found in provinces where VAT revenues are further partially subdivided down to lower-tier administrations is the reluctance of jurisdictions to relinquish registrations if a business wants to move to another district, which could be just across the road or in another part of the same city. The refusal of local administrations to deregister a firm moving to another district creates a dilemma for the business that is supposed to register in the district where it is located. In theory, a company caught in this trap could alert the provincial government, which in turn could direct the offending district to deregister a business that has moved to another district and impose financial penalties for the practice. Firms have been reluctant to take this action, however, and risk fracturing relationships with local officials.

4. Suboptimal Administrative Capabilities

Starting with a truly minimal knowledge base, the progress made by the SAT from 1980 until the 1993 reforms was, in relative terms, substantial. In absolute terms, however, measured against the capabilities of modern tax administrations in most developing countries and the capabilities of the private sector advisors used by taxpayers, the SAT's capabilities were limited. The 1993 splitting of the organization into national and provincial authorities did not, by itself, enhance or detract from the SAT's capabilities at the time, but almost certainly had a negative impact on the ability of the tax administrations as a whole to operate effectively in meeting the demands of a revenue agency in a market economy.

The administrative downside to the split was the reduced capacity of the tax administrations to address the three key differences between raising revenue by way of profit-taking in a state-run economy and raising tax revenue from enterprises in a market economy. The first of these differences is the large number of taxpayers in a market economy compared to their number in a state-run economy. The second is the continuous change in players in the first type of economy, as new enterprises commence and others close, while still more amalgamate and others split, compared to the stability of players in a command economy. And finally, the third difference is the enormous flexibility of enterprises in the market economy to continuously modify the form and structure of business transactions in response to taxation compared to the rigidity of business practice in a state-controlled economy.

In the context of a mass-participant revenue system with each player enjoying almost complete flexibility in terms of how transactions are conducted, tax administrations must rely on some form of self-assessment system, starting with calculations prepared by the taxpayer and using strategic risk analysis to identify taxpayers with a higher likelihood of avoidance and then to target auditing resources at those taxpayers.

Information collection is the key to risk analysis and successful audits will generate information needed for cross-correlation of data. The total picture only emerges when all the pieces of the puzzle are brought together. Facts relevant to a business tax audit are equally relevant to a VAT audit and an income tax audit. Facts relevant to a customs audit are relevant to all three of these taxes. However good the communication between separate agencies may be, enormous potential synergy is lost when information collection is segregated. The same is true when processes are segregated within the same institution, as would happen if one part of the organization audits a head office for income tax purposes while another part handles rebates of VAT on exports by the same firm and other parts look separately at the VAT of the firm in different provinces.

5. Revenue Adequacy

In cash terms, the center appeared to be the clear winner from the 1993 changes,[55] with its share of revenue more than doubling in a year.[56] While some question the extent to which the revenue shift to the center has actually strengthened the political influence of the center over local administrations' use of disbursed funds,[57] there is no doubt that the central government emerged from the changes as the dominant player in the central-provincial partnership and the stage had been set for further consolidation of fiscal power at the center.

The political imperative for further centralization of revenue powers derived not so much from the relative weighting of provincial and central revenue flows, but rather from the growing gap between the have and have not provinces. Although fiscal federalism based on direct sharing of tax revenues in theory applies neutrally across all provinces, in practice taxes imposed on supplies of services, particularly financial services and real property, and sales of goods will inevitably be skewed toward wealthier, higher growth

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55 Loo and Chow's case study of two wealthy provinces, Guangdong and Fujian, shows outflows from the provinces to the central government increased fourfold in the period 1995 to 2000. Becky P.Y. Loo & Sin Yin Chow, *China's 1994 Tax-Sharing Reforms*, 46 ASIAN SURV. 215, 226 (2006). (Much of the literature on China's tax reforms refers to the 1993 reforms as the 1994 reforms based on the year the new rules commenced to apply.)

56 In 1993, the share of revenue accruing to the central government was 22 percent while in 1994 it was 55.7 percent. *See* CHINA STATISTICAL YEARBOOK 2008, *supra* note 22, tbl 7-3 ("National Government Revenue and Ratio of the Central and Local Governments," under heading "Government Finance"); *see also* Dali L. Yang, *State Capacity on the Rebound*, 14. J. DEMOCRACY 43, 45 (2003).

57 Ray Yep, *Enhancing the Redistributive Capacity of the Chinese State? Impact of Fiscal Reforms on County Finance*, 21 PAC. REV. 231 (2008).

provinces in preference to poorer, less urbanized provinces. Income tax revenues are similarly skewed toward the wealthier provinces in which head offices, subsidiaries, and profitable branches of successful companies are found, along with more individuals with higher incomes. Conversely, the greatest revenue needs are likely to be found in the provinces that derive the smallest tax receipts under the fractional division of tax receipts system. Thus, while the central government's revenues increased in absolute terms as a result of the 1993 reforms, the political compromises it made to convince provinces to sign on to the revenue distribution formula favored the wealthier provinces that would have been in the best position to provide the revenues needed for redistribution.[58] In the end, the 1993 structural reforms may have exacerbated the growing divide, even as they shifted some resources to the center. The widening gap, in turn, increased the central government's need for further revenues.

Unintended behavioral responses to the changes, particularly the income tax arrangements, may have contributed to growing wealth disparity.[59] Despite the new revenue sharing arrangements, provincial governments retained revenue from provincially-owned enterprises and with the allocation of significant indirect tax revenues to the central government (100 percent of the consumption tax and 75 percent of the VAT), the importance of provincial enterprise income taxes was enhanced, prompting provincial governments to adopt ultimately economically inefficient policies to obstruct capital mobility that might lead to enterprises shifting location.[60] The effect in some cases was to lock state investment in local failing businesses. At the same time, however, the shift from profit distributions to income taxes aided successful businesses and contributed to growth in more prosperous regions. Under the former system, efficient enterprises would lose their profits to their owners. Replacing profit distributions with tax payments divided the profit take between the state and the enterprise, providing efficient and profitable enterprises, particularly those owned by lower-tier local governments, with abundant, and inexpensive, capital for expansion.[61]

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58 Pak K. Lee, *Into the Trap of Strengthening State Capacity: China's Tax-Assignment*, 164 CHINA Q. 1007 (2000).

59 Kay-yuen Tsui, *Local Tax System, Intergovernmental Transfers and China's Local Fiscal Disparities*, 22 J. COMP. ECON. 173, 191 (2005).

60 Kay-yuen Tsui & Youqiang Wang, *Between Separate Stoves and a Single Menu: Fiscal Decentralization in China*, 177 CHINA Q. 71, 80 (2004).

61 Xun Wang, *One Country, Two Systems: China's Economic Policies Towards State and Township/Village-Owned Enterprises, 1978-1992*, 24 J. THIRD WORLD STUD. 163, 171-72 (2007).

Meanwhile, one response to the increased revenue needs of the central government was to protect nationally-owned monopolies and encourage them to extract higher monopoly profits from individuals and privately-owned firms with the object of generating higher tax revenues from the state-owned companies. The system penalized consumers and non-monopoly firms and discouraged privatization and the breakup of possibly inefficient monopolies.[62]

In essence, the 1993 reforms ushered in an era of vertical fiscal imbalance, with the central government deriving increasing shares of tax revenue while expenditure responsibilities remained at the provincial government level.[63] Redistribution efforts lagged far behind the revenue shifts and were subject to significant leakage on the path to provincial governments and down to lower-tier administrations. From the perspective of the poorest provinces and the poorest persons in those provinces, the 1993 changes have been described as a genuine fiscal crisis, with the scramble for revenue at the lowest level of government, the township, causing considerable hardship for the poorest peasants, particularly in agricultural provinces.[64]

One problem not addressed by fiscal equalization at the provincial level is the often ineffective and inefficient redistribution at the sub-provincial level.[65] The institutional reforms needed to address this problem are arguably distinct from the broader redistribution question but for those at the receiving end or, more importantly, those missing out, the development of policies to address this issue is as important as the macro-redistribution question.

IV. The New Millennium

At first glance, the 1993 changes to the tax system were truly a great leap forward. The nation moved from a fragmented, ad hoc set of levies to reliance on key taxes that in form, if not substance, resembled the principal taxes in almost all modern economies. The success or failure of a tax ultimately depends on its substance and not its form, however, and the substance of

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62 Shuanglin Lin, *The Decline of China's Budgetary Revenue: Reasons and Consequences*, 18 Contemp. Econ. Pol'y 477, 488 (2000).

63 Gang Guo, *Vertical Imbalance and Local Fiscal Discipline in China*, 8 J. East Asian Stud. 61, 65 (2008).

64 An Chen, *The 1994 Tax Reform and Its Impact on China's Rural Fiscal Structure*, 34 Modern China 303 (2008).

65 Xiaobo Zhang, *Fiscal Decentralization and Political Centralization in China: Implications for Growth and Inequality*, 34 J. Comp. Econ. 713, 725 (2006).

the taxes was problematic, as were the administrative arrangements for collection of the taxes and the fiscal arrangements for the division of tax revenues. The artificial (in the context of market flexibility) distinction between the business tax and VAT generated arbitrage opportunities. The cascading feature of the business tax and VAT apart from inventory led to economic inefficiencies. The limited system of rebates for exports prejudiced exporters. The discrimination between domestic— and foreign-owned firms created economic distortions and inhibited the growth of locally-owned enterprises. The broad sweep of the business tax distorted investment forms. Limitations to administrative capabilities impacted revenues. Not surprisingly, at the turn of the century, attention began to crystallize on the next stage of reform.

Outside the fiscal sphere, reform moved with deliberate speed, but continuously forward. Outgoing President Jiang Zemin's announcement in 2002 that the Communist Party would welcome capitalists into its fold was largely symbolic, but proposed legislation that would enshrine private property rights, which followed the announcement, was seen by many who supported the shift to a market economy as a cornerstone for future economic development. The change in property law was to be complemented by a range of commercial, company and consumer laws needed for an effectively functioning market economy. Resistance to the property law change (including a constitutional challenge) by those opposed to the retreat from socialist principles delayed its passage until 2007, when it was finally passed after its eighth reading in the National People's Congress.

A. Change to the Income Tax Revenue-Sharing Ratio

The first significant change to the tax system in the twenty-first century was the modification in 2003 of the arrangements for splitting individual and corporate income tax in 2003. The change was actually an implementation of a policy that had been announced a decade earlier. When tax revenue sharing was first adopted in 1993, the provinces and central government agreed the division would move over time from an equal 50:50 split of income tax to a 60:40 split in favor of the central government.[66] But, anxious to cement the split arrangements, the central government refrained

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66 Guo Fa [State Council Promulgation] (2003) No. 26, Circular of State Council on Specifying the Ratio of Revenue Shared by Central and Local Governments (promulgated by State Council, Nov. 13, 2003, effective Nov. 13, 2003), *available at* http://fgk.chinalaw.gov.cn/article/fgxwj/200311/20031100120295.shtml (Chinese).

from a quick shift and it was a full decade before the ratio was changed. The change had an impact on the relative finances of the two levels of government, but more importantly sent a signal to the provinces of the center's intention to consolidate its revenue base. The prospect of further modifications had implications for the other taxes, particularly the business tax that was paid entirely to the provinces.

B. Extension of Input Tax Deductions from Inventory to Capital Assets

The second major tax change of the new century began as a trial program. In 2003 the government announced it would allow a selected group of eight industries, including oil, chemicals, auto manufacturing and metallurgy, located in three poorer provinces of the northwest, a limited deduction for VAT inputs on capital equipment. The aim was not so much tax reform — the change would have moved the VAT much closer to a neutral, modern VAT system that does not impose a final tax burden on intermediate businesses — but rather as a stimulus to encourage investment in the poorer areas of the country. To protect the revenue base, the deduction was phased by way of what was called an "incremental amount deduction" that limited the deduction to VAT payable in excess of VAT payable in the previous year. Originally scheduled to commence on April 1, 2004, the change was delayed until July 1 of that year when fixed asset investments rose unexpectedly in the first quarter of the year.[67]

The program was expanded in two rounds in 2007 and 2008 to encourage modernization in twenty-six old industrial centers of the central region and five cities in Inner Mongolia. A third expansion round followed later in 2008 to a further fifty-one counties and cities of the three provinces that suffered serious damage in the devastating earthquakes of that year. Unlike the case in the original adoption and subsequent two expansions, the regime adopted in the earthquake region was not limited by incremental deductions but instead businesses were allowed recognition for the full amount of input tax on acquisition of fixed assets (and, as had previously been the case, inventory). Also, subject to a very small number of restrictions, the new rules were available to all industries, not the limited field that could use it in other regions.[68]

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67 The program is described in Rao Lixin, *China's Gradual Transition to a Pure VAT*, 16 INT'L VAT MONITOR 427 (2005).

68 Cai Shui [Joint Circular of Ministry of Fin. & SAT] (2008) No. 108, Provisional Regulations on Extending the Scope of Value-Added Tax Deduction in the Severely Affected Areas of Wenchuan Earthquake (promulgated by the Ministry of Fin. &

Over the period 2007 and 2008, there was considerable discussion in academic and government circles on the desirability of shifting the VAT towards a more neutral and economically efficient final consumption tax, allowing full input tax deductions as is done in the true VAT systems used in full market economies.[69] Resistance to the idea was usually based on concerns about the impact on revenue. Ultimately, however, it was not the object of improved efficiency that prompted the next stage of reform so much as the growing economic slowdown. In November 2008, the Standing Committee of the State Council announced that deductions for VAT input tax on acquisitions of fixed assets would be extended to all industries in all parts of the country from January 2009.[70]

The fiscal impact of the change has yet to be determined, as the commencement coincided with the onset of a global financial crisis and significant downturn in investment. The more significant impact will be the consequence of a shift from a tax on production to one on consumption. This will have the effect of moving the tax base from areas of production to areas of final consumption, which is likely to mean a shift in revenues from poorer to richer provinces. If the loser provinces are to be compensated by transfer payments from the central government based on the increased VAT collected in the winner provinces, the ratio for dividing VAT revenues might need to be altered.

C. Accounting Standards

In 2005, the government made the decision to shift from the uniquely Chinese Accounting Standards for Business Enterprises to the International Financial Reporting Standards that have increasingly been adopted as the basis of national standards, at least for listed companies, in Western economies.

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the State Admin. of Taxation, Aug. 1, 2008, effective July 1, 2008), *available at* http://www.chinatax.gov.cn/n480462/n480513/n480902/8067281.html (Chinese).

69 Three meetings involving domestic and foreign experts, organized by the Budget Affairs Committee of the National People's Congress, in cooperation with the Stated Administration of Taxation and Ministry of Finance, pushed the debate forward considerably. The first two of these are noted (but attributed to the Ministry of Finance) in Xiaoqiang Yang, *Merger of Business Tax into VAT in China*, 20 INT'L VAT MONITOR 120 (2009).

70 Cai Shui [Joint Circular of Ministry of Fin. & SAT] (2008) No. 170, Some Specific Issues About the Implication of Value-Added Tax Reform on National Scale (promulgated by the Ministry of Fin. & the State Admin. of Taxation, Dec. 19, 2008, effective Jan. 1, 2009), *available at* http://www.chinatax.gov.cn/n8136506/n8136593/n8137681/n8532970/n8532994/8745435.html (Chinese).

In February, 2006 new Accounting Standards for Business Enterprises, broadly in line with the international standards, were released by the Ministry of Finance and their use became mandatory for listed companies and state-owned enterprises, with broader adoption over time envisaged.[71]

While the new standards generally replicate the international standards, they contain several differences prompted by China's unique "socialist" market economy structure. Among other things, the Chinese rules have very relaxed related-party disclosure rules, different standards for the treatment of reversals for impaired assets, and cost rather than market pricing for certain assets.[72] The first of the differences is needed because of the continuing dominance of state-owned enterprises, which would mean an overwhelming number of transactions between related parties as defined in the international standards, while the last is mandated because of the difficulty of determining "market value" in areas such as farming that are subject to price controls. No similar practical rationale applies to the intervening difference with respect to impaired assets. Rather, this difference is based on a more fundamental philosophical basis, namely Chinese authorities' concern that the revaluation rules allowed by international standards could be exploited by firms.

Notwithstanding these differences, which may be ameliorated over time, the adoption of international standards marked an important step towards international norms by China, in effect an endorsement of China's participation in the international capital market.

D. Amalgamation of Foreign and Domestic Company Tax Laws

China's next major tax initiative came about as a result of the country's accession to the World Trade Organization (WTO) in 2001. China's separate income tax regimes for foreign-owned and domestic enterprises violated China's neutrality obligations under the WTO agreement, a problem that was resolved with the enactment in 2007 (with effect from 2008) by the National People's Congress of a consolidated enterprise income tax that integrated the formerly separate domestic enterprise income tax law and the foreign-owned enterprise income tax regulation.[73] The executive had

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71 The rules are analyzed in Yuri Biondi & Qiusheng Zhang, *Accounting for the Chinese Context: A Comparative Analysis of International and Chinese Accounting Standards Focusing on Business Combinations*, 5 SOCIO-ECONOMIC REV. 695 (2007).

72 The divergences are reviewed in John Ryan, *The Clouds Part — China Converges*, A PLUS, Jan. 2008, at 16, *available at* http://www.hkicpa.org.hk/APLUS/0801/16-19.pdf.

73 Enterprise Income Tax Law of the People's Republic of China (promulgated by

previously sought to consolidate the two laws into a unified company tax law but had been unable to obtain support from the National People's Congress until the international obligations of the WTO shifted the stance of that body.

Adoption of the unified company tax was an important development in three respects. Its immediate impact was to end the discrimination faced by domestic firms vis-à-vis foreign-owned businesses and put all companies operating in China on a more or less level playing field.

It also marked a small shift in the direction of tax law based on legislation rather than administrative rulings. While the unified company tax law is still skeletal compared to most Western company tax laws, it is much more detailed than either of the two predecessor laws that it incorporates. And, importantly, unlike the predecessor laws, it does not delegate substantive interpretation powers to the SAT or Ministry of Finance. The administrative agency and Ministry will interpret the application of provisions, but they will not have the ability to establish substantive rules as in the past, where they could actually choose aspects of the tax base or the quantum of tax.

Third, and significantly, it may indicate a tilting of responsibility for tax law from the executive to the legislature. The executive had been effectively snookered on the issue of company tax unification because the foreign company income tax had been enacted as a law, and the only way it could be replaced would be if the legislature repealed it, which it would only do if it had responsibility for the replacement law. The same situation exists with respect to the VAT and business tax; most likely, the two indirect taxes will only be consolidated in the future if the legislature plays a key role, even if the technical design were to be undertaken by the Ministry of Finance and SAT.

The central government was stymied on one aspect of its reform. Although the domestic and foreign enterprise income taxes were both based on national laws, they were administered by local offices of the central tax administration. Each provincial government was entitled to half of the tax revenue collected in the state and there was, as a result, pressure by provincial governments to treat each branch of an enterprise with operations across more than one province as if it were a separate entity for tax purposes. There was, however, no obvious mechanism for allocating profits across branches and as a result the risk of inconsistent allocations by two tax offices

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the Nat'l People's Cong., Mar. 16, 2007, effective Jan. 1, 2008), *available at* http://fgk.chinalaw.gov.cn/article/flk/200703/20070300125109.shtml (Chinese); *see also* Jinyan Li & He Huang, *Transformation of the Enterprise Income Tax in China: Internationalization and Chinese Innovations*, 62 BULL. FOR INT'L TAX'N 275 (2008).

was not insignificant, as was the risk that a local office of the SAT would characterize an operation as a branch while the SAT where the company's head office was located would regard it as an agent or representative office only.

The 2008 unified income tax was intended to solve the problem by requiring companies across provinces to file on a consolidated basis, meaning income for all branches of a business would be reported on the single return of the head office. This approach would have solved the allocation problem but in the process would have shifted the provinces' 50 percent share of company income tax to those provinces in which head offices were located, leading to pressure to attract head offices and fairly significant revenue shifts to the wealthier provinces in which head offices tend to be located. Facing enormous pressure from the provinces, the central government backed down and agreed to a compromise arrangement that would see a continuation of the current system of dividing income, subject to some constraints. Provisional tax payments (the pre-payments of current year tax liability over the course of the year, based on the previous year's final liability) continue to be allocated across businesses, but based on a common formula that applies across the country. The apportionment formula used is not dissimilar to that used in other multi-state jurisdictions such as Canada and the U.S. (and currently proposed for the European Union), looking at payroll, sales, and assets.

The formula apportionment only applies to companies' provisional tax payments and the final reconciliation is done on a consolidated basis. This means that the head office provincial government will receive half of the excess of actual tax liability over the provisional tax payments, without regard to the apportionment formula. However, if the tax paid by way of provisional installments is greater than the final tax liability (as would be the case, for example, if the company were to suffer a loss or significant reduction in sales with an economic downturn), the head office jurisdiction will bear half the cost of the refund to the company (with the central government picking up the remainder).

V. THE FUTURE

In the three decades since China embarked on the path from a command system to a market economy, the Chinese tax system has undergone remarkable change. Initially, following the shift from profit appropriation to taxation and the development of more modern looking tax laws, national taxes were collected locally by branches of a national administration, and profits and sales allocated primarily on the basis of place of registration or point of sale. Most tax revenues were paid to local governments. The shift to a market economy led to a more modern tax structure. Uneven economic development had given rise to a need for fiscal equalization payments and revenue allocation was shifted in favor of the central government for the growth taxes, particularly the VAT. In return, the provinces gained the right to establish local tax administrations and retain all profits from the consumption tax. In a second phase of modernization, the company income taxes and later the VAT were modernized. The changes have yielded three broader political-economy outcomes: a shift of revenues from provinces to the center, which can redistribute on the basis of fiscal equalization criteria rather than income source; a slow and slight shift of tax-making power from the executive to the legislature; and a shift of de facto lawmaking power from the tax administration and Ministry of Finance to the executive (State Council).

Chinese developments largely parallel those of many advanced economies. As was the case elsewhere, a combination of capital mobility within the jurisdiction and political pressure for fiscal equalization has led to a shift from local to central tax legislation, while the pressures of unequal development have led to a growth of the central government's share of tax revenues to fund fiscal equalization programs. The process of change has not been entirely rational from a tax policy or administration perspective, however, and as a result, the current system may be neither stable nor sustainable. The continuing pressures of modernization and globalization of the economy are likely to lead to further reforms and those reforms are likely to result in further consolidation of revenue powers by the central government, which in turn may enhance the political power of the center at the expense of the provinces.

Change will affect tax administration, tax law design and drafting, and the tax base. While there will likely be institutional resistance to change, the SAT will over time have no choice but to modernize its approach and adopt contemporary assessment and audit techniques. Pressure from investors seeking stability in the tax system will shift tax law further from regulation to legislation, a development that will strengthen the role of the National People's Congress in the tax design process.

The most significant changes, however, will be in the definition of the tax base and entitlement to the revenues generated by key taxes, particularly the VAT. The distinction between goods and services and the application of separate taxes to supplies of goods and services is not sustainable in the long run. The distinction itself is wholly artificial in a modern economy based on truly hybrid supplies. The distinction gives rise to arbitrage opportunities for business and generates inefficiencies, compliance costs, and administrative costs. The corresponding division of responsibility for administering two separate and incompatible taxes seriously undermines tax administration. Not only does the division violate the fundamental "whole of business-undivided transactions" approach on which modern tax administration techniques rest, but separation of information into two distinct agencies makes it impossible to realize the synergy gains available through basic administrative processes such as data matching and cross-tax auditing.

Separately, the modernization of the VAT to transform it from a cascading production tax to a more neutral consumption tax by extending the input tax deduction to acquisitions of capital assets is exposing the inefficiencies and economic costs of the distorting, cascading, production-based business tax biased against businesses that rely on services and those that rely on debt financing. It is, therefore, not surprising that local commentators regard the incorporation of the business tax into the VAT as inevitable.[74]

To be sure, the political hurdles that consolidation of the business tax into the VAT will face are significant. Without the business tax, there is little point to maintaining the provincial tax bureaus which would, presumably, have to be reintegrated into the SAT offices from which they originated. Those with vested interests in a separate administration can be expected to oppose any reform plans. Wealthier provinces will also be opposed or at least hold out for some compensation for the transfer of taxes on the supply of services and intangible assets from the business tax to the VAT — a division yielding 25 percent of VAT on these transactions is not equal to a 100 percent allocation of business tax, even with the rate differential. If the business tax moves into the VAT, it is thus inevitable that wealthier provinces will find they have lost revenue to the central government that will redistribute it elsewhere.

Meanwhile, modernization of the VAT will put further pressure on the current system of imposing VAT liability on the basis of mechanistic proxies — where payment is made or where the VAT invoice is issued. The artificial territorial segregation of integrated business arrangements into notionally separate provincially-based transactions, and in particular the use of local VAT registration as the proxy to identify local supplies, is incompatible with the operation of a true VAT, which bases VAT liability on the total supplies by a business offset by its total inputs and imposes the actual burden of tax only in the jurisdiction in which final consumption actually takes place. Even

74 *See, e.g.*, Xiaoqiang Yang, *supra* note 69; Wei Cui, *Business Tax: China's Quasi-VAT*, 20 INT'L VAT MONITOR 291 (2009).

without the incorporation of the business tax into the VAT, the distortions from the current structure are great, with windfall gains and losses generated by transactions crossing provincial borders as one province grants credits for transactions that will generate positive income in another province. The misallocation will only grow if services and intangible supplies are brought into the VAT. To avoid these problems, VAT is normally imposed on a consolidated basis, with only the head office of a business registered as a VAT taxpayer and all transactions of the various parts of the registered entity treated as transactions of the head office.

Additional pressure for a modernization shift to impose VAT on a consolidated basis derives from the ongoing problems of VAT "kickbacks" and difficulties obtaining deregistration in provinces that subdivide VAT revenue down to district and neighborhood authorities.

As with the move from a business tax to VAT, modernization of the VAT by moving to consolidated assessments would shift tax revenues, in this case mostly to wealthier provinces, which would increase pressure for the central authority to take a much higher proportion of revenues for redistributive purposes.

Another modernization pressure point will be the treatment of exports in the VAT. The use of export VAT rebates as a means for heavy-handed central interference in the market will eventually give way to full VAT treatment as the international economic downturn highlights the need to improve the efficiency of industry across the board, an outcome that only a neutral VAT can help deliver. This means there will eventually be full refunds of VAT input tax related to all exports. This development, in turn, will lead to pressure to reintegrate the export VAT refund division of the SAT into the ordinary business tax division to ensure modern auditing and verification processes can be used to verify entitlement to VAT refunds.

The political solution to all these problems may lie in the use of generous transitional measures, perhaps similar to those used in 2003 when the company income tax moved to a consolidated head office return that included the income of interstate branches. Guaranteeing the continuation of base year revenues will deflect a great deal of opposition to reform. At the same time, employment guarantees and skills upgrade training for provincial tax authority officers reintegrated into a unified tax administration could significantly reduce opposition to reform from that organization. Retraining and skills upgrading could also yield a valuable byproduct by providing the SAT with the resources needed to modernize its assessment and auditing processes.

Robust tax systems best suited to flexible and ever-evolving markets increasingly tend to be centrally legislated and administered. They tend to settle on taxes modeled on neutrality objectives, namely income taxes on businesses and individuals and final consumption taxes in preference to production taxes. Because market economies generate uneven growth and uneven wealth, the centralization of revenue-raising for fiscal equalization purposes is a common phenomenon in states with subordinate provinces or states. The political-economy implications of tax reform in China are profound. They may also be inevitable.