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Post-WTO China Tax Law System Reform and the Rule of Law: Progress and Prospects

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POST-WTO CHINA TAX LAW SYSTEM REFORM

AND

THE RULE OF LAW

PROGRESS AND PROSPECTS

by

TIANLONG HU

A dissertation submitted in partial fulfillment
of the requirements for the degree of
Doctor of the Science of Law (S.J.D.)
in The University of Michigan

2011

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Professor Wei Xiong, Wuhan University

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獻給我的外祖母陳寶雲女士

DEDICATION

I dedicate this thesis to my parents, my loving wife, my two wonderful children Alan and Juanita, and my elder brother. Without their patience, understanding, support, and most of all love, the completion of this work would not have been possible.

ACKNOWLEDGEMENTS

First and foremost, I am heartily grateful to my advisor Professor Reuven S. Avi-Yonah, a knowledgeable, gracious mentor who demonstrates that rigorous scholarship can and must be accessible to everyone, that social change is central to intellectual work and, as such, scholars have a responsibility to take the privileges of academia to imagine and create a better globalized world.

To Professor Douglas Kahn, with highest respect, for his continuous support, invaluable encouragements, thoughtful comments, and time and attention over the past decade.

To Professor Whitmore Gray for his insightful guidance and constant encouragement over the past decade.

To Professor Wei Xiong for his precious support, incisive comments and wonderful friendship.

To Dean Virginia Gordan for her support and help over the past years.

To professors and friends for showing me by example and through rewarding coursework how to think, teach, and teach others to think about taxation, finance and law: David Hasen, James Hines, Kyle Logue, Carl Schneider, Joseph Vining, Joel Slemrod, Jinyan Li, Yan Chen, Michael Livingston, Yulu Chen, Liming Wang, Zhenmin Wang, Shouwen Zhang, Jianwen Liu, Dingjian Cai, Jinyun Liu, Xiaohui Guo, Baoxia Ma and Joseph Lee.

To my dearest friends for sharing their wisdom on life and my work: Nick Stephens, Wenhuan Lü, Huilian Guo, Dr. Guoqing Chang and Dr. Li Han.

To my parents, Puliang Hu and Xiuzhi Wang, and my elder brother Tianhu Hu, for their love, support, patience, and understanding during the long years of my education.

And finally, to my loving wife, Ms. Dongdong Han, for her love, trust, support and sacrifice throughout the past years, and for taking care of our two wonderful children Alan and Juanita. Without her love and support I could not come so far. I also thank my parents-in-law for their help and support in all aspects.

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LIST OF ABBREVIATIONS

In this thesis, unless the context otherwise requires, the following terms shall have the meanings set out below.

AB	Appellate Body of the WTO
AOUSC	<i>Administrative Office of the United States Courts</i>
APA	Administrative Procedure Act of the U.S.
APL	Administrative Punishment Law of the P.R.C.
Art	Article
ASBE	Accounting Standards for Business Enterprises
BECZ(s)	Border Economic Cooperation Zone(s)
Catalog	Industry Guidance Catalogue for Foreign Investment of the PRC
CCP	China Communist Party
CDF	Comprehensive Development Framework
CEOR(s)	Coastal Economic Open Region(s)
China / PRC/P.R.C.	the People's Republic of China and, except where the context requires and only for the purposes of this thesis, references in this thesis to the PRC, P.R.C., or China do not apply to Taiwan and / or the Hong Kong and Macau Special Administrative Regions
CICT	Consolidated Industrial and Commercial Tax
CJV(s)	Contract Joint Venture(s)
COC(s)	Coast Open City(s)
CPA(s)	Certified Public Accountant(s)
DE(s)	Domestic Enterprise(s)
DEIT	Domestic enterprise income tax

DEITL	Provisional Rules for Enterprises Income Tax for domestic enterprises
DSB	Dispute Settlement Body
DSU	Dispute Settlement Understanding
EIT	Enterprise Income Tax
EJV(s)	Equity Joint Venture(s)
EJVL	Equity Joint Venture Law
ETDZ(s)	Economic and Technology Development Zone(s)
EU	European Union
FDI	Foreign direct investment
FEITL	The Income Tax Law of the People's Republic of the PRC Concerning Foreign Enterprises
FIE Income Tax Law	China Foreign-Invested Enterprises and Foreign Enterprises Income Tax Law
FIE(s)	Foreign-Invested Enterprises and Foreign Enterprise(s)
FOIA	Freedom of Information Act (FOIA)
FTC	Foreign Tax Credit
FTZ(s)	Free Trade Zone(s)
GAAR	General Anti-Avoidance Rule
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GONGO(s)	government operated non-government organization(s)
GPCL / Civil Law Code	General Principles of Civil Law of the PRC
Hong Kong or HK	The Hong Kong Special Administration Region of the PRC

ICT	The Industrial and Commercial Tax
IFI(s)	International Financial Institution(s)
IIRTL	Individual Income Regulatory Tax Law
IIT	Individual Income Tax
IMF	International Monetary Fund
IP	Intellectual Property
IRC / I.R.C.	Internal Revenue Code of the U.S.
IRS / I.R.S.	Internal Revenue Service of the U.S.
JVITL	The Joint Venture Income Tax Law
MCA	Ministry of Civil Affairs of the PRC
MFN	Most-favored-nation
MOF	Ministry of Finance of the PRC
MOFCOM	Ministry of Commerce of the PRC
NAFTA	North America Free Trade Agreement
NGO(s)	Non-government organization(s)
NPC	National People's Congress of the PRC
NT	National treatment
OECD	Organization for Economic Cooperation and Development
OLD(s)	Old Urban District(s)
P(pp)	Page (pages)
PNEU(s)	Private non-enterprise unit(s)
Protocol	Accession of the People's Republic of the PRC, WT/L/432 (Nov. 10, 2001)
PWDL	Public Welfare Donation Law of the PRC

Renminbi / RMB	Renminbi yuan, the lawful currency of the PRC
SAIC	State Administration for Industry and Commerce of the PRC
SAT	State Administration of Taxation of the PRC
S-Case	Small Tax Case in the U.S.
SCM	Agreement on Subsidies and Countervailing Measures
Sec.	Section(s)
SEZ(s)	Special Economic Zone(s)
SO(s)	Social Organization(s)
SOE(s)	State-owned Enterprise(s)
SOEIRT	State-owned Enterprise Income Regulatory Tax
SOEIT	State-owned Enterprise Income Tax
SPC	Supreme People's Court of the PRC
STJ	Special Trial Judges of the U.S. Tax Court
Tax Collection Law / TCL	The Law of the People's Republic of the PRC Concerning the Administration of Tax Collection
Tax Court	The U.S. Tax Court
The 2008 EIT Law	Enterprise Income Tax Law of the PRC, as enacted by the tenth NPC on 16 March 2007 and effective on 1 January 2008, as amended, supplemented or otherwise modified from time to time
The Proclamation	Proclamation on the Rights and Obligations of Taxpayers released by SAT in December 2009
Treas. Reg.	Treasury Regulations (U.S.)
TRIM	Trade-Related Investment Measures
TRIPS	Trade Related Aspects of Intellectual Property Rights
TRM	Transition review mechanism

TVE(s)	Town and village enterprise(s)
U.S. / US/ USA	United States of America
US\$ / USD / \$	United States dollars, the lawful currency of the United States
VAT	Value-added Tax
WFOE(s)	wholly-owned foreign enterprise(s)
WTO	World Trade Organization

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CHAPTER I

INTRODUCTION

I. Background

Economic globalization¹ promises growth and success in development of the international community. There has been a huge increase in transnational economic activity such as foreign direct investment, and the international capital flows in global financial markets are enormous. Economic globalization has been realized not only through supranational legal regimes such as the World Trade Organization (WTO), but through reforms to regulatory regimes and national laws advocated by international institutions including the World Bank and International Monetary Fund. These reforms have furthered deliberate policy choices to liberalize trade and capital mobility, deregulate markets, increase commercial participation, and eliminate cross-border transactional barriers.

¹ See Vito Tanzi, *Globalization, Tax Competition and the Future of Tax Systems* (IMF, Working Paper No. 141, 1996), summarizing the benefits of economic globalization as: (a) world resources are better allocated and output and standards of living rise; (b) individuals enjoy a greater range of choice in goods and services because of the greater access to foreign goods; (c) individuals are able to visit faraway places because the cost of travel has fallen significantly; (d) the amount and range of information available to individuals has increased enormously while the cost of getting information has fallen dramatically

The post-World War II development strategy of many developing or transitional economies has included a special role² for tax policy, which is employed as a means of intervention into the economy.³ All types of taxes, particularly trade related taxes, are legitimate tools of the state in monitoring the development process. Today, tax reforms mainly aim to establish a diverse mix of taxes that will encourage savings and capital investment in open market economies, because development priorities have shifted from promoting self-sufficiency and subsidizing domestic industry to encouraging export-led growth and improving global market participation. At the same time, driven by a need to fund government activities and reduce debt or government deficits, another key focus of tax reform has been tax revenue growth and socially conscious wealth redistribution.⁴ In particular, following the epidemic debt crisis in the 1980s, developing countries were forced to achieve and maintain a fiscal surplus in order to clear their debts to international financial institutions and other creditors⁵ as well as strive for a healthy economic settings.

A key feature of modern tax reforms is the prioritization of tax administration including resident registration, computerized compliance systems, stricter

² See Dharam Ghai, *Introduction to the IMF and the South: the Social Impact of Crisis and Adjustment* (Dharam Ghai ed., 1991), noting that states use tax reform to manage the process of economic growth, giving high priority to the goals of industrialization, diversification, and modernization

³ See *Id.*, stating that in part the tax policies meant tariff protection for domestic industry, input subsidies, and favorable domestic tax regimes (containing tax concessions or incentives) for industry. The agricultural and mineral sectors are highly taxed through mechanisms such as export taxes, heavy taxation of mining surpluses, and low expenditures).

⁴ See Malcolm Gillis, *Tax Reform in Developing Countries* 16-17 (Malcolm Gillis ed., 1989) [hereinafter *Tax Reform* (Gillis)]

⁵ See generally Glenn P. Jenkins, *Tax Reform: Lessons Learned in Reforming Economic Systems in Developing Countries* at 293-95 (Dwight H. Perkins & Michael Roemer eds., 1991)

collection efforts, auditing, evasion control and tax law enforcement.⁶ Therefore, tax reforms have been regarded as a subcategory of public finance or economic policy. At the same time, legal system reforms typically involve transplanting legal theories and institutions across borders. Tax governance, with its focus on institutional reform and (re)construction, has been a focal point to facilitate legal system construct.

As tax reform has been a crucial component of economic development initiatives and structural adjustment programs for developing countries, the sheer number and scope of international institutions has dominated developing countries' tax reforms. Tax reforms usually focus on universal development goals including a single-rate, broad-based VAT to replace older-style sales taxes, a low-rate, broad-based corporate and personal income tax, tax neutrality, and the reduction or eventual elimination of tariffs. Moreover, the WTO distinguishes its role by *indirectly* interfering in domestic tax law reforms of its member countries under the aegis of protecting free trade in domestic tax systems. The recognized, comprehensive advantages of WTO accession provide a rational for the globalization tax standards that other international institutions could not require. The General Agreement on Tariffs and Trade (GATT) underlying all WTO activities includes the key principles of *non-discrimination* and *liberalization* of trade, which drive much of developing countries' tax reforms. The non-discrimination obligation is comprised of the Most-favored-nation (MFN)

⁶ See Vito Tanzi & Howell H. Zee, *Tax Policy for Emerging Markets: Developing Countries*, 3-4 (IMF Working Paper No. 35, 2000), <http://www.imf.org/external/pubs/ft/wp/2000/wp0035.pdf> (last visited on March 15, 2011)

principle,⁷ which demands that trade concessions granted to any country be extended equally to all other WTO members, and the National Treatment (NT) principle,⁸ which requires that no internal tax, charge, law, regulation or other measure should discriminate between domestic and foreign suppliers.

A decade after China formally became the 143rd member of the WTO on December 11, 2001,⁹ its developing country status does not substantially relieve it from its obligations as a member of the WTO. The WTO provides technical advice and certain concessions to existing or potential developing economies, including China. Although these concessions supposedly allow for extended transition periods to implement principles of the WTO Agreements, only rarely has any country been allowed to use the extended transitional grace period, which has essentially been reserved for developing countries that were founding members of the GATT.

The WTO's technical assistance is about more than plugging up loopholes or to crafting an implementation structure; rather, it aims to imbue tax reforms with broader legal theories and structures conducive to international trade. Before this thesis develops a discussion of the tax system reform, an overview of China's rule of law order and post-WTO legal reform is necessary. These narratives are crucial underlying factors even in the analysis of reforms of specific areas of the tax laws. In particular, the establishment of a "socialist rule of law order" and commitments by the government to act "in accordance with law" have been incorporated as

⁷ See *General Agreement on Tariffs And Trade*, Oct. 30, 1947, Art. I, 61 Stat. A-11, T.I.A.S. 1700, 55 U.N.T.S. 194.

⁸ *Id.*, Art. III

⁹ For detailed description of China's efforts for WTO accession, see <http://www.wto.org> (last visited March 15, 2011)

amendments into China's Constitution. Consideration is also given to contested rhetorical conceptions of the rule of law. Debates between instrumental and substantive, positivist and natural law, and thin and thick models of the rule of law, as well as the economic development rhetoric discussed *ad infinitum* in the literature are all reviewed. This thesis aims to prepare a reasonable, handy and realistic foundation with which to evaluate the progress of the Chinese tax law reform. Pushing this goal further, this thesis tentatively submits – on the basis of debates on the rule of law and understanding of the WTO principles applicable to China – a tailored, pragmatic and practical set of proposals for the tax reform under China's current legal infrastructure. The proposals are underpinned by instrumental notions of, *inter alia*, generality, clarity, consistency, enforceability, stability, congruence, and substantive notions of judicial independence, human rights and the limitations of bureaucratic government with regard to the nonprofit sector.

However, one inescapable attribute squeezed into debates on China's legal reform, in which the tax law reform is embedded, is the imposition of a standard based upon a specific conception of the rule of law. Is there a need to conceptualize a "rule of law-Chinese tax laws reform *rhetoric*?" This theoretical challenge is too grand and too premature to undertake, even though the tax law context is viewed as one of most receptive sectors to legal transplant. The development of a socialist rule of law is a paradox, being receptive to market economy principles and modernizing state and private enterprise governance on the one hand, while unabashedly preserving an autocratic form of socialism on the other. Such a

paradox can only be described as “the socialist rule of law with Chinese Characteristics.” with vague description of “characteristics” and re-interpretative conceptions of “socialism”. The tax law reform, which contains elements of traditional conceptions of the rule of law, cannot be understood independently from China’s social, political, economic and legal inheritances. Different from Western jurisdictions with liberal democratic frameworks, under China’s quasi-socialist, soft authoritarian system, the social-political evolution influences the theory and interpretations of the rule of law in many ways.

China’s accession into the WTO has been a double-edged sword. Optimists maintain that China’s entry will benefit the global community as well as China’s domestic economy and society by promoting the rule of law, undercutting the state’s control over administration, and accelerating the transition to a market economy. In addition, the WTO membership helps modernize accounting practices, banking frameworks, taxation systems and environmental protections, while at the same time, bringing hostility to bear on corruption and protectionism. By contrast, pessimists contend that China has agreed to more than it can deliver. This is evidence, they say, of its lack of commitment to abide by WTO rules, and its plan to free-ride on the benefits of the global trade system and export its socio-economic problems.

A close examination of China’s accession commitments reveals that effective economic reform and trade liberalization call for substantiations from a matching legal infrastructure reform. For example, taxpayers’ rights protection should be viewed in terms of broader political and civil rights reform. Indeed, a number of

the values featured in the WTO principles and the rule of law framework encourage China's further integration into both the global trade network and the international human rights regime. This is particularly evident in the Chinese tax law context. WTO principles and the rule of law requirements must be introduced and evaluated together in tax law reform proposals. WTO principles of transparency, uniform and impartial administration, judicial review match the instrumentalist's rule of law elements of consistency, generality, predictability, enforceability, stability and congruence, and the substantive rule of law framework's requirements of democracy, limited government, accountable administrative decision-making, and judicial independence.

China's accession to the WTO requires reform not only of China's substantive laws, but also of its institutional arrangements, to which the Chinese government has given inadequate consideration. Without real institutional reforms creating an independent and functional administrative framework or judiciary, any substantive economic reforms are likely to fall in nascent or vague – the tremendous economic success will be held back when ill-designed incentives are spoiled or exploited. The transparency requirement scattered in various provisions of the WTO Accession Agreement is an elevated burden for China. The uniform and impartial administration principle demands the removal of subtle trading barriers such as local protectionist practices. More importantly, independent judicial review of administrative actions challenges the *status quo* of slow judicial reform in China – requiring that China's courts meet WTO standards of independence, impartiality and non-arbitrary enforcement of judgments.

China's tax law system is administrative in nature but this characterization is complicated by legislative and judicial functions in the tax law. In this sense, the tax law reform benefits from as well as is circumvented by the post-WTO legal reform. The accession to WTO bounds China calling for transparency, consistency, simplicity and certainty in terms of tax legislations at both national and local levels. The hierarchical tax administration structure should not impede enforcement of tax laws. Uniform and impartial administration of tax regulations at various local levels should be improved to a level acceptable to guarantee well-grounded tax administrative decisions and facilitate tax judicature independence. Given the growing awareness of taxpayers' rights, tax authorities should not dwell at the stereotype "monitor" position proclaiming obligation to pay tax, rather, a workable system of protections should be established and honored. Moreover, the tax treatment of the nonprofits sector as the third sector of the society should be formulated and enforced.

China's tax reform cannot be expected to fit any pre-designed, transplanted model. The project here is to build a versatile tax system, which takes opportunities to streamline, track, and propel economic development.

II. Purpose

The purpose of this thesis is to develop a framework for post-WTO tax law reform in China. A historical overview of China's current tax system is an important starting point. It sets out the scope from which a reform proposal or

policy orientation may derive, and ensures that the analyses are historically balanced but not constructed to cater to any particular viewpoint or political stances. Realistically, this thesis is founded on a theoretical notion of the rule of law rhetoric, which provides indispensable background to understand the Chinese tax law reform. Moreover, it provides a discussion of the impacts of WTO accession on China's legal system construction in general and applications to China's tax law reform in specific. In addition to its discussions of the relevant historical and theoretical bases of China's tax reform, this thesis provides targeted analysis of tax legislation, tax judicature, taxpayer's rights, and tax treatments of the nonprofit sector from a comparative law perspective, all considering the administrative nature and hierarchical structure of China's tax law system.

Space limitations preclude detailed analysis of each of the major topics covered in this thesis. However, the whole provides a comprehensive discussion on historical background, theoretical overview, origins of problems, interpretations of proposals, and feasibility of implementation. The thesis employs a mix of synopsis and analysis drawn from a wide variety of materials across disciplines and jurisdictions. The goal is to bring together threads of legal theories with consideration of the realities of China's tax system. This thesis therefore seeks to provide practical understanding of China's tax law system for the sake of further reform.

The selection of topics, rules and standards is not comprehensive. Rather, it aims to make connections across different sectors of the tax law system, which have been under-discussed or neglected, sometimes from comparative or international

perspectives. In many parts, it is more than summarizing the limited extant literature on the Chinese tax system. The proposals for reform herein are often nuanced to suit the current Chinese tax law context and limited to what is meaningful, reflective or practical with appreciation of applicability in China's actual position.

III. Limits and Assumptions

This thesis relies significantly on the common law jurisdiction in cases or examples it furnishes and the theories it refers to. This is a typical weakness behind the analysis of China's law and legal institutions, although for certain ideas the thesis uses Japan or Germany as reference points. This thesis is also limited by a dearth of materials in English to certain extent. However, this weakness does not undercut the analyses, which reflect a compilation of international treaties, surveys and documents discussed. Although this thesis covers certain comparative review, it has a strong U.S. emphasis or bias, partly because the U.S. tax system provides justification to this thesis and is widely valued as one of the best examples of tax system operation and structure.

Analysis in this thesis is also constrained by a dilemma created by a scarcity of available materials on many of the topics covered and a vast overabundance of literature on others. In particular, literature on China's tax judicature, taxpayers' rights and its nonprofit sector is very limited. However, the rule of law, WTO principles, and Chinese legal reform in general are all covered in great depth and

breadth. Therefore, this thesis has to selectively lay particular emphasis on generally accepted principles or discussions to provide a basis for analysis while developing its own analysis of certain of the topics covered.

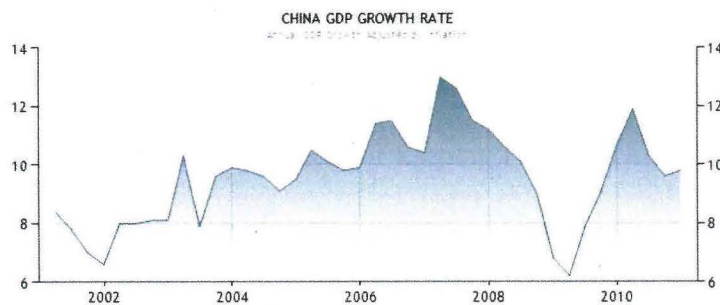
The target of this thesis is not to summarize existing literature on specific topics or theories. It is also unnecessary to provide detailed tax codes or render exact wordings of tax regulations to substantiate the proposals raised herein except insofar as they are directly relevant. This thesis also provides a wide survey of relevant literature but certain significance references are contained in the footnotes.

IV. Data Analysis

Before this chapter develops an outline or synopsis of its theories, principles and analyses or raises reform proposals on specific tax law topics, it is useful to engage a brief empirical survey of relevant data. The short statistical analysis below in every means does not pretend to expand topics to be covered in this thesis, rather, it aids understanding of the rationales behind the discussion. In this sense, the overall circumstances of social and political settings, economy size, position in global trading, international voicing power, national treasury scale, and composition of tax revenue call for a set of quality proposals in the Chinese tax context.

The past decade of China's economic development is eventfully marked. In 2010, China's GDP was valued at approximately \$5.87 trillion, surpassing Japan's

\$5.47 trillion, and became the world's second largest economy after the U.S. (Figure 1). China's currency reserves came close to approximately \$2.82 trillion at the end of 2010, about half of which is in U.S. dollars (Figure 2). In 2009, China celebrated the 60th birthday of the People's Republic. In 2008, china celebrated 30 years of economic growth and the holding of its first Olympic Games. Considering China's starting point with a GDP of approximately \$60 billion in 1978 and its intermediate, pre-WTO GDP of approximately \$1.15 trillion in 2001, the enormous economic development is remarkable, and without a doubt, the accession to the WTO is a primary contributor in the past decade.

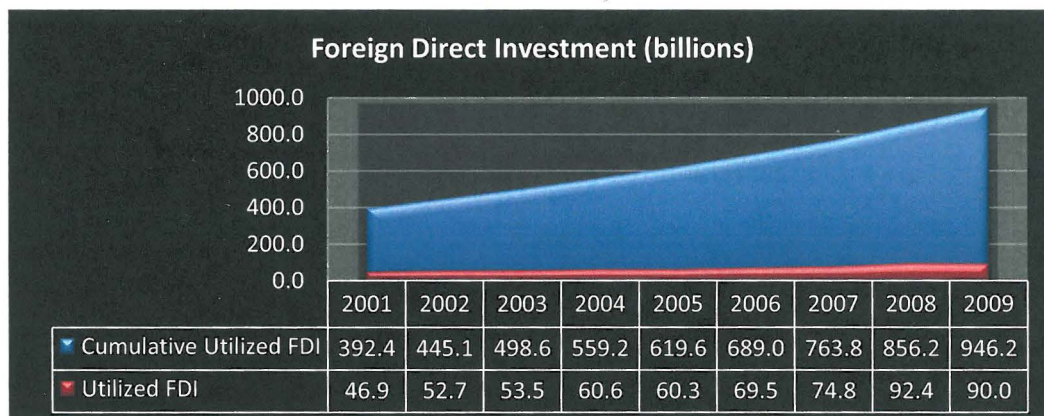


(Figure 1)

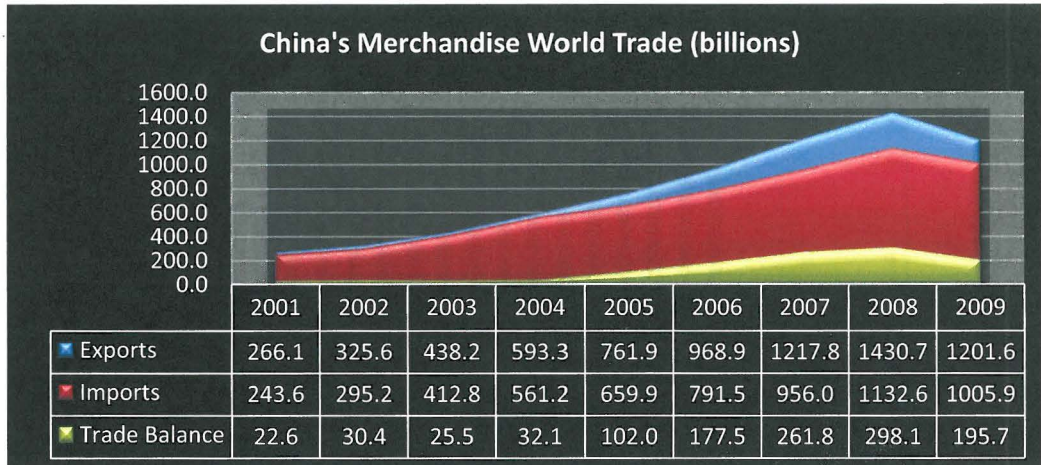


(Figure 2)

After China’s accession to the WTO in 2001, its utilized foreign direct investment doubled from approximately \$46.9 billion in 2001 to approximately \$97 billion in 2010 (Figure 3). Meanwhile, China’s trade balance increased about 10 times from approximately \$22.6 billion to approximately \$197 billion by the end of 2010 (Figure 4) from mostly five largest trading partners including the U.S. and Japan, but not the European Union (Figure 5). To this end, given the revenue-wise contribution made by China’s accession to the WTO, there is a set of legitimate reasons to keep the Chinese tax law reforms in line with WTO principles. First, China’s economic development remains export driven. As probably the largest “global” manufacturer and distributor of products, China’s tax mix must keep it attractive to, for example, the European Union markets. Second, China’s tax regime started as FDI-oriented and investment-friendly, however, formulas of tax incentives should be adjusted for keeping FDI but circumventing profit transfers after exploiting tax preferential policies. Third and more importantly, the tax law system should comply with WTO principles or requirements in terms of providing robust taxpayer protections and an established tax judicature system.



(Figure 3)

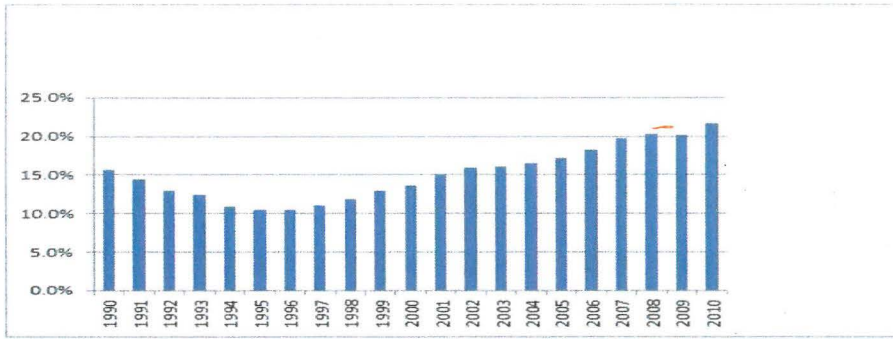


(Figure 4)



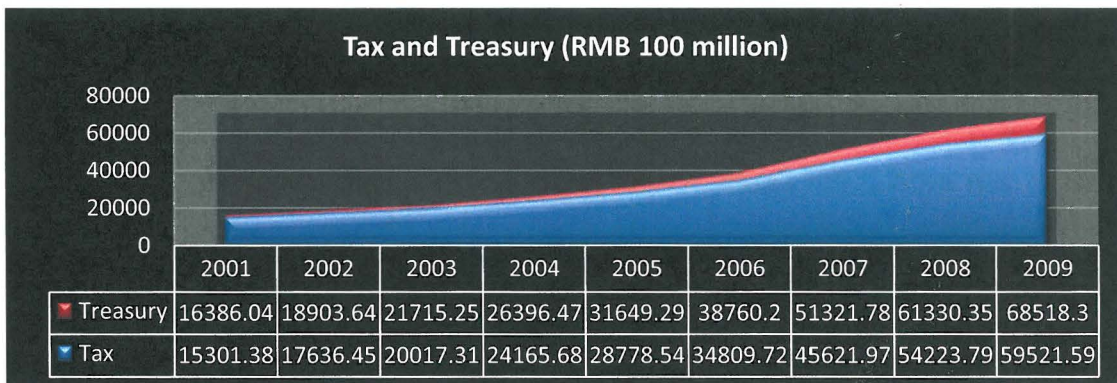
(Figure 5)

At the same time, a careful reading of the numbers above reveals that China's tax revenues beat out GDP growth. China's tax revenues jumped to \$1.17 trillion (RMB 7.74 trillion) in 2010, 22.64% more than that recorded in 2009 (RMB 6.31 trillion) and doubled that of 2005 (RMB 3.76 trillion) (Figure 6).



(Figure 6: Tax Revenue vs. GDP, 1990-2010)

In terms of the composition of tax revenue in overall treasury income in China, surprisingly, there is a declining trend since China's accession to the WTO (Figure 7). The weight of tax revenue in the treasury dropped from approximately 95% in 2001 to approximately 87% in 2009 (Figure 8).



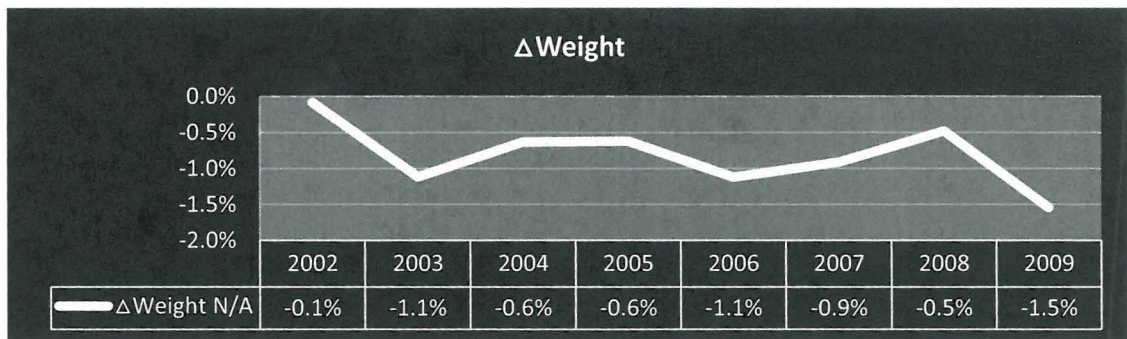
(Figure 7)



(Figure 8)

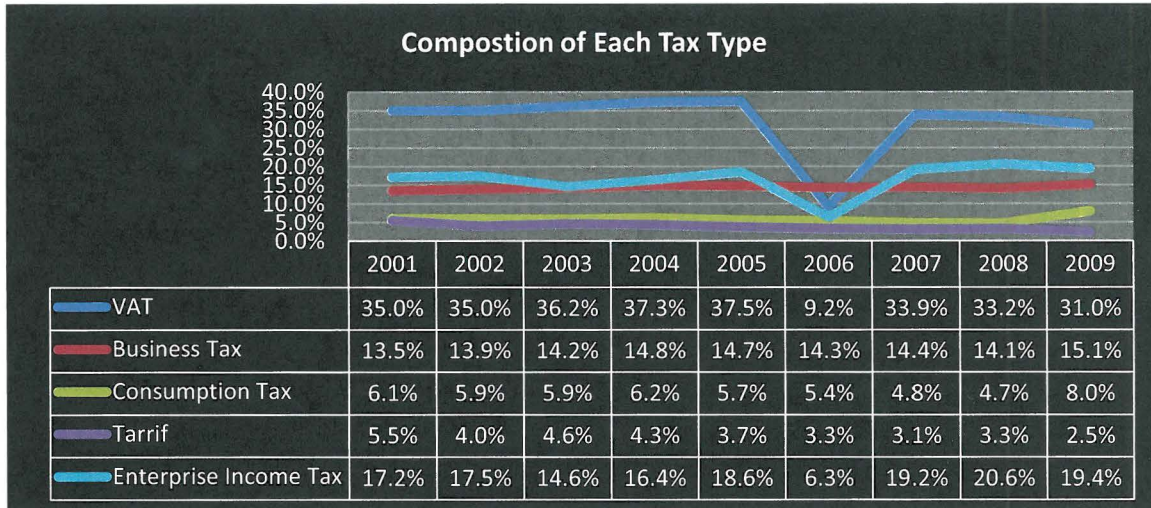
Meanwhile, such weight displayed a fluctuation due to various factors such as the SARS and global financial crises, which influenced exportation and domestic needs (Figure 9). There are three major causes in this connection. First, extra-budgetary revenue such as educational surcharges, urban real estate surcharges and tariffs contributed a relatively larger share of the treasury during this period. Second, the roaring local real estate market kept a larger share of revenue within localities. Certain localities have adopted protectionist local tax exemptions or incentives, which also decrease overall tax collection. Third, the redistribution of revenue was twisted by an increased focus on low-growth or weak tax-generating needs such as urban infrastructures and government expenses.

On the other side of coin, considering the “smaller government, larger society” movement in China since the 1990s, the illustrations show that revenue contributed by the non-taxable, or nonprofit, sector now plays a much larger role in social wealth distribution. More importantly, it helps reduce the notorious expansion of government scale in terms of expenses, benefits of public servants and the shrinking allocations for public services. As long as the non-taxable nonprofit sector manifests a balance between slightly lower revenue contribution and much larger role in reducing government expenses, its development should be encouraged with appropriate tax preferential policies.



(Figure 9)

Returning to the tax revenue itself, its composition deserves further analysis, which suggests the direction tax law reform may head (Figure 10). A few observations can be drawn therefrom. First, China's tax revenue is still dominated by turnover taxes including the VAT, Business Tax and Consumption Tax. Based on the revenue sharing formula between the central and local governments in China, any reform of the turnover tax will have important ramifications in terms of tax administration and enforcement. Second, the enterprise income tax contributes a steadily growing portion of tax revenue after unification and simplification. Third, quite different from Western tax jurisdictions, revenue contribution made by individual income tax is quite undersized. Fourth, taxpayer rights protection and tax judicature reform must consider the impacts they may have on revenue collection for each major type of tax.



(Figure 10)

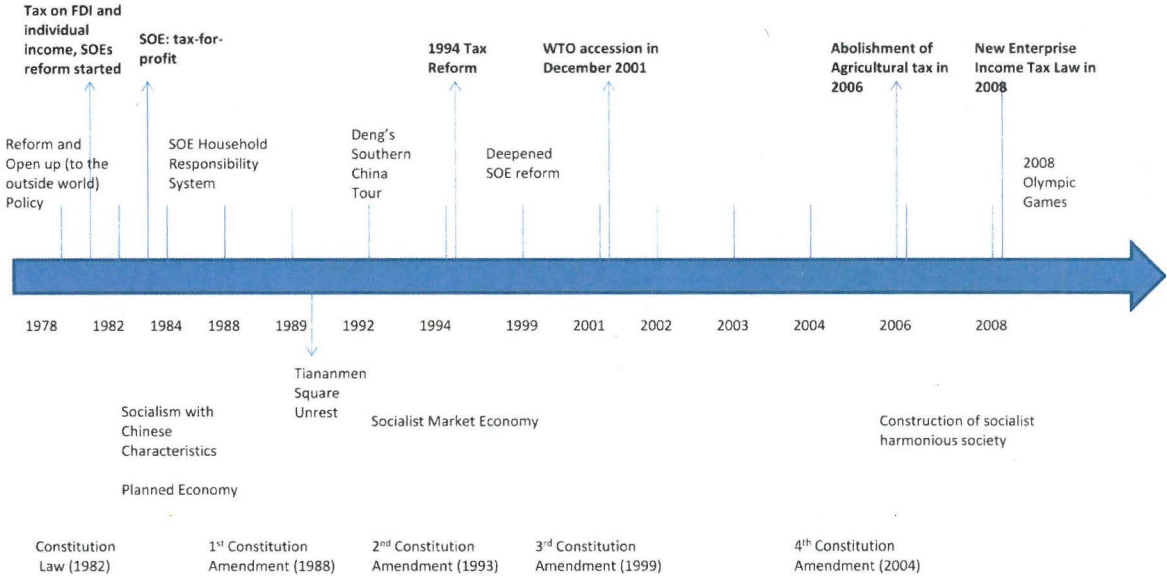
In summary, the overall circumstances of China's economic size, position in the world market, trade balance, national treasury scale, and composition of tax revenue have dramatically changed over the past three decades, especially after China's accession to the WTO ten years ago. The tax law system, although it has had some success overhauling in legislation, needs a more tailored and guided reform to fulfill challenges from both the WTO and the socialist rule of law in which it is embedded.

V. Outline and Synopsis

Chapter II

Chapter II of the thesis provides an overview and analysis of China's taxation system since the establishment of the People's Republic. It sets out the scope and rationale for subsequent chapters to develop a formulation of China's tax law

system reform. For decades of political, economic and social upheaval and strife, China's taxation system is shaped by China's political and economic settings as well as is influenced by the western or capitalist ideological raiding (Figure 11). *Chapter II* summarizes a two-pronged reform agenda contributed by the Chinese tax law system and policies: (1) reforming domestic economic system with increased revenue and macroeconomic control, and (2) opening China up to outside world. Both prongs are commingled with political concerns of increasing social welfare, reducing income disparities and monitoring foreign investment. In particular, a key objective is to be internationally competitive, granting various tax incentives to promote investment in designated areas or industries but being cautiously aggressive in contracting bilateral or multilateral tax treaties with trading partners to address foreign investors' concerns regarding double taxation.



(Figure 11)

Chapter II firstly reviews the drastic and recurrent changes experienced by China's tax law system in adapting to political-economic philosophies and in

strengthening its revenue designation by way of steady incorporation into the international tax norms. Mostly, for the Chinese tax context, it discusses the evolution from a centralized, planned and closed “socialist economy” to a market driven, open economy and then to China’s accession to WTO in 2001 and thereafter. The tax law system has intertwined with other laws contributing to the development of competent and internalized legal institutions in China. Tax mix in China, as part of the macroeconomic regulatory system, has its singularity and irreplaceable function in adjusting commercial activities of corporate and individual taxpayers. It is even said that the tax law field is the only field brought in line with and integrated into the international norms.

Chapter II outlines the evolution of the Chinese tax law system and structures shaped by China’s socio-economic forces, fiscal and governmental reforms, administration reforms, fiscal decentralization, and the implications of its WTO accession. It introduces the four broad stages of China’s tax law system development since 1949: the pre-1978 period (1949-1978); the economic reform period (1979-1993); the market economy period (1993-2000); and the post-WTO accession period (2001-present). Three major phases of tax law reform in China, especially those associated with FDI, enterprise governance modernization and legislation consolidation in the 1980s, the indirect tax reform and establishment of a revenue sharing system in 1994, the merge of the two-track enterprise income tax treatments, and WTO related tax policy adjustments, all have improved the structure of Chinese tax law system. *Chapter II* further emphasizes that China’s tax system is administrative and hierarchical in nature, therefore, the reform of tax

administration would be better targeted by discussing it in specific sectors in the Chinese tax law context, such as tax legislation, tax judicature, taxpayers' rights and nonprofits tax treatment in this thesis.

The thesis then discusses social and economic policies that have influenced the development of China's tax law system by documenting the framework of China's tax law system. In particular, the SOE modernization process is shown to have had a decisive impact in structuring the painful process of China's tax law reform.

Chapter II also explores the fiscal decentralization reforms over the past three decades and outlines possible reform orientations in tax administration, especially regarding how to structure a tax framework for improving efficiency and equity. In this connection, China has experienced cycles of fiscal and administrative decentralization and recentralization dominated by a socialist legacy and alignment of political compromises with a significant consideration for transactional costs and budgetary constraints. China's decentralization efforts have been endogenous to the centralized, planned economic system featured by heavy industrialization development strategy to a market economy-oriented revenue sharing scheme with international inputs. Although fiscal decentralization for market-oriented reforms helped strengthen provincial and local incentives to foster economic growth, it was plagued by impotent central redistributive powers and growing interregional inequality. Bearing only a rough articulation of the division of intergovernmental expenditure responsibilities and egalitarian fiscal transfer provisions, the recentralization since 1994 has significantly impaired

local capacity to provide decent public goods and services, and witnessed serious local governance issues such as land-requisition-based local GDP growth and scattered social unrest. Moreover, tax farming by the central government on the one hand fortifies central revenue and authority. On the other hand, decentralization allows for the growth of local autonomy in designing local-friendly tax incentives and flexibility in carrying out centrally authorized tax policies. The game of intergovernmental bargaining resulting from this balance of power employs the tax administrative hierarchy. Local jurisdictional competition for (foreign) investment and local development leads to inefficient and irrational local tax concessions such as over-extended contractual land leases for plant constructions. It also creates a detrimental fiscal culture of fortifying local GDP by concentrating tax levies on only a few tax bases such as real estate development and land sale.

Chapter II notes that China's local autonomy and intergovernmental balance is not a westernized federalism model based on separation of powers. Rather, decentralization is a regulatory compromise to align different political and administrative hierarchies. Since the rural tax was officially repealed in 2004, some local governments in agricultural regions have increasingly relied on government transfers and off-budgetary revenue sources. Such reductions in local tax bases suggests how the central government can provide sufficient transfers and also how it can maneuver transfers and end local notions of a soft budget constraint without discouraging local resource mobilization. A centralized party-sate bureaucratic system inevitably leads to a shortage of local government

accountability due to the central government's inability to monitor widespread corruption and distorted local tax practices. In the long run, a robust tax governance system will only result from a more decentralized administrative and fiscal system that includes a sound inter-governmental transfer arrangement. Such an arrangement must entail wider local political participation and competition under free elections, and ultimately, of stronger capital mobility across regions.

Chapter II further posits that the central-local two-track tax administration is not uniformly institutionalized across the nation. Diversity or irregularity in local tax administration especially at sub-provincial levels evidences the cooperation or competition between local business and governments to evade central control or to avoid contributing taxes upward in favor of serving local economic interests. Local administrations may lose their incentive to provide locally adequate public goods and services as long as more shares of transfers are not assigned for specific local needs. Moreover, the inflated but untailed extra-budgetary and off-budgetary revenues are a responsive effort to seize more resources outside central control and to keep larger tax revenues for local development. Such extra-budgetary and off-budgetary revenues translate into consequential informality in the system, which exacerbates interregional disparity and rampant corruption, and therefore inevitably erodes the tax base.

Chapter II concludes that, the past six decades of tax law reform in China are embedded in the context of enormous economic development, ups and downs with overall legal reform, a socialist political system, efficiency concerns, tax equity considerations, cultural factors, assimilation to internationally accepted

accounting standards, and fulfillment of WTO principles and international tax norms. This varied context contributed to the evolution of a modern and internationalized Chinese tax system, albeit one with Chinese characteristics. The tax authorities reshuffled. An ever-growing need for transparent, uniform and impartial tax administration pose vital challenges and opportunities for tax reform. Tax laws in China, in the first place, are designated to promote revenue collection with the hope of enlarging tax bases and improving living standards of citizens with sound enforcement and compliance regimes. Meanwhile, the concerns of balancing tax treatments of domestic and foreign enterprises and minimizing interregional disparities consist of underlying considerations for tax law administration, enforcement, and fiscal transfers. Returning to fiscal and administrative decentralization, tax farming by the central government increases central authority and revenue collection, even as it increases local autonomy by allowing local bargaining in an intergovernmental compromise, which can be seen as a result of *ex ante* limiting while developed into a hotbed for *ex post* opportunism. The central-local two-track tax administration system fails to institutionalize a framework to manage growing extra-budgetary and off-budgetary revenues. The abolishment of rural tax and perverse local GDP development practices add another layer of complexity to fiscal decentralization and transfers. From this perspective, the large scale of China's economy creates urgency to adopt fiscal policies and develop China's tax system in terms of legislation, administration, judicature and internationalization.

Chapter III

Chapter III summarizes the theoretical debates regarding conceptions of the rule of law, the evolution of the Chinese socialist rule of law rhetoric, and progress that Chinese legal reform has made to date. In this sense, it attempts to evaluate how the rule of law rhetoric has impacted Chinese legal reform, particularly on the post-WTO accession framework and the major implications of this impact. Because materials on these topics are voluminous, discussion in this chapter is cautiously limited to those directly relevant to this thesis. This chapter posits that China's legal system, in which China's tax law and its reform are embedded, has experienced dynamic evolution and reform in an expansive, novel, and globalized fashion for the past three decades in China. However, China's unprecedented, ongoing legal reform is intertwined with its enormous economic development, and more importantly, burdened by a deep introspective ambivalence on the part of its reformers. After ten years of WTO membership, China has rigorously overhauled its legal system to a postural stability by incorporating both international and domestic norms.

Chapter III argues that discussions of Chinese legal system development should not be ahistorical. China's contemporary legal system is neither fundamentally inherited from its imperial tradition nor entirely a western transplant – various eventful turning-points in the 20th Century are critical to evaluating the progress and troubles arising from China's legal reform.¹⁰ China's adoption of a "Socialist

¹⁰ China endured critical turning points such as massive foreign invasion and semi-colonization from the late nineteenth century by western forces, republican democratic revolution, various civil

Market Economy” in 1992 and “protection of property rights” in 2004 Amendments to the Chinese Constitution signaled a breakthrough in China’s self-conscious westernization. The CCP also officially endorsed such notions in its Party Charter.¹¹ China’s WTO commitments have driven China’s immense, if disorganized, legal infrastructure increasingly into compliance with a decidedly non-Marxist international legal order.

Chapter III introduces the significance of another turning point in Chinese legal reform – the triumph of the “rule of law” (“fa zhi” 法治) over the “rule of men” (“ren zhi” 人治). The CCP’s commitment to subject itself to law finally offers domestic reformers and foreign observers a limited but expanding arena, in an authoritarian society, to advocate liberal ideals of limiting the arbitrary use of power, establishment of the rule of law, and possibly democratic political reform. Market economy development has been a crucial stimulus for creating the rule of law in the contemporary Chinese legal system.¹² This is primarily because the market economy requires “the establishment of legal rules governing the rights and duties of those carrying out transactions.” *Chapter III* also argues that, for the past three decades, the Chinese legal system development has focused on

wars and wars against Japanese fascists, Communist revolution (civil war with the KMT Regime), socialist construction and transformation in the 1950s, Cultural Revolution, opening to the outside world and consequent globalization, the development of market economy, and accession to the WTO, among other major transformations. However, several important elements of China’s traditional legal system survived this century-and-a-half of uncommon upheaval and transformation

¹¹ Political slogans such as “performing in accordance with international standards” and “assimilation or harmonization with international practice” materialized in the official propaganda agenda and daily political and legal settings

¹² From Deng’s “reform and open door” orientation to its WTO accession in 2001, China has arguably implemented a setting in which “acting according to law” is conceived as the “objective demand of a socialist market economy.” The economic reform, based on autonomy, equality, credit and honesty, and fair competition, needs to be maintained primarily by legal tools

absorbing westernized legal norms, modernizing legal practice, and conforming to the demands of a globalized market-based order.

Chapter III further suggests that an objective assessment of China's legal reform should acknowledge the successes of China's law reforms in laying the foundation for constructing the rule of law, albeit "with Chinese characteristics." Notably, China agreed to initiate sweeping reform measures "designed to implement the WTO market access, national treatment and transparency standards, to protect intellectual property rights, to limit the use of trade-distorting domestic subsidies and to make other changes to bring its legal and regulatory system in line with those of other WTO members." China has put tremendous effort into honoring such commitments.

Chapter III critically analyzes the rule of law rhetoric developed by western jurists and philosophers in order to show the rule of law for the contested concept it is. It then questions whether identifying and designing a rule of law model for China is necessary. Usually, literature authored by western jurists and theorists selectively creates and insinuates a rule of law model into the Chinese legal system. This methodological setting is not without merit, but it risks reifying a biased and contested standard in mind in advance before making quality evaluation. There are a number of debated categorizations of the rule of law rhetoric in general and formulations for China's legal system in specific. For example, the instrumental and substantive definitions, positivism and natural law ideals, the bifurcated thin and thick models, the rule of law – development

rhetoric, views of futility in application¹³ or radical proponents of overhaul reconstruction, all advocate different approaches to developing the rule of law. *Chapter III* submits that conceptualizing a perfect model of rule of law for the China's legal system is not practical for its current social, economic, and legal settings. Rather, notions of necessary elements of the rule of law are considered and suggested as reasonable priorities for China's legal reform.

Chapter III further presents that democracy is still a sensitive, but not untouchable topic in China. It suggests that democracies benefits should be explained and arrived at through a practical lens such as a discussion of taxpayer rights. It notes that China's rule of law reform has strong inner political, economic and social drives and support from top glitterati, a growing middle class, and broader constituencies including farmers and low-income groups. However, China does not enjoy the luxury of the historical, religious, and philosophical traditions out of which western and American models of democracy organically arose. When discussing the relationship between democracy and the rule of law, especially in the Chinese context, a normative conception of Chinese rule of law should

¹³ The legal orientalism rhetoric in part may present an example. It is over the capacity of this thesis to detail discussion on legal orientalism given the voluminous theoretical discussion on this subject. Therefore, this thesis respectfully disregards the radical and partially distorted categorization charged by the legal orientalism rhetoric against Chinese legal system. This thesis also respectfully notes that Professor Ugo Mattei now serves as the editor-in-chief, and together with Professor Teemu Roskola, owns editorships of the latest (7th) version of the remarkable book "Schlesinger's Comparative Law" (2009). For instance, orientalism favored by Professor R. B. Schlesinger (Mattei's advisor) by itself is an unsubstantiated concept contaminated by limited knowledge of historical civilization development and unfounded ethnocentric discrimination. Moreover, the understanding and description of Chinese legal system, ancient or contemporary, are inaccurate and intentionally twist deep-rooted morality law in China. Professor Mattei mostly advocated the "tripartite taxonomy": rule of professional, rule of political law and rule of traditional law, which is contrast with stereotyped common law – civil law bifurcation. Thesis fails to accept the notion of "rule of traditional law", to which Mattei purposefully disregard legal system diversity and evolution by non-analytically grouping the Islamic legal regimes and most of Asian or Confucian-based legal systems together which all bear pre-designed traditional orientalism stigma.

therefore be confined to discussions of judicial independence, while democracy has to be viewed from a historical and developmental perspective. This approach may seem over-simplistic, but it is realistic. The rule of law as a political and democratic theory should not be exaggerated and abused, and should be used carefully in a comparative context. After all, empirically and conceptually, a full-scale Chinese conversion to a western style of politics and democracy may not translate into a stable political and economic order, on which the establishment and development of rule of law is conditioned in China. It is difficult to substantiate whether a democratic government that might invite social turmoil and political chaos is better than failing to implement certain political ideals or romanticized legal conceptions, so this thesis will limit its focus to legal and judicial reform independent from democratic developments.

Chapter III tentatively offers the following positions regarding China's legal reform. First and foremost, securing the independence of legal system as an institution, even in a relatively self-sufficient manner, is the foundation for transformation to the rule of law. Political barriers in China are evidently against reaching the autonomy of the legal system because "political science" and "law" conceptions (*zhengfa* 政法) have never been officially separated in the governmental reform agenda. One notorious example is the CCP controlled "politics and law committee" (*zhengfawei* 政法委), which has the highest authority in the legal and judicial system administration. In this sense, the Chinese legal system as an independent infrastructure promises considerable reform opportunities. Second, transparency and public accountability are normative

catalysts for promoting the publicity of laws, judicial decisions and administrative processes. The very limited success of “law dissemination campaigns” (*pufa yundong* 普法运动) and the prevalence of “black box” practices including “backstage operations”, affiliated trading and secret deals all have plagued the legal system in China. Third, the independence of the judicial system and the autonomy of legal professionals, especially those presiding in lower courts, are threatened by many sources. Finally, the sensitive role of human rights in China’s rule of law development should be addressed in a flexible and realistic manner. Although the Chinese government claims that it acknowledges and respects meaningful, universally accepted human rights and values, it caveats that cultural, economic, historical and social facts must be accounted for in order to understand and to honor basic human rights. China’s government with political withering and ideological rigidity has to identify a balanced and healthy relationship among goals of economic development, human rights protection, and related substantive norms of the rule of law. Human rights can be interpreted in various ways, but at a minimum level – for example, a citizen’s ability to contribute to and benefit from the economic behaviors she chooses – a citizen has the right to know into which area her taxes go and how they are distributed. Flexible and strategic interpretations of human rights can therefore be a boon to efficient administration and contract enforcement protection. Therefore, for the purpose of this thesis, a list of pragmatic and proactive taxpayers’ rights walks a middle ground on the issue of human rights, which is both morally defensible and politically viable.

Chapter III concludes by examining the often-paradoxical forces exerted on

China's rule of law development – historical roots, ideological interferences, economic development, and dynamic reforms in the past thirty years. China's young modern legal system suffers from infrastructural deficiencies, domestic political intrusions, understaffing, and difficult demands from the outside world. But it has already embraced many traditional rule of law characteristics, albeit in a somewhat unique socialist rearticulation, respectfully acknowledging universal basic human rights, creating room for scholastic submissions and debates, and more importantly, inviting foreign observation and attempting compliance with international norms. *Chapter III* further shows that, despite valid critiques, Chinese legal system does embody both a normative and an instrumental sense, which must be respected and accommodated. Solutions and upgrades are essential to tackle technical misidentification, but implementation (*zhixing* 执行) and enforcement have priorities in nursing difficulties arising at all times. When outlining a meaningful tax law reform structure, an objective assessment of China's historical, political and social traditions is necessary for targeted, objective and meaningful promotion of China's rule of law construct.

Chapter IV

Chapter IV assesses the impacts of the accession to the WTO on China's legal reform in general. The analyses continue those in Chapter III by considering the normative impact of WTO accession in order to better understand the factors underlying China's post-WTO tax law system reform. The objective of this

chapter is twofold: (1) presenting the progress that has been made to bring China in line with WTO principles and China's commitments; and (2) considering the extent to which the elements of the rule of law rhetoric and the WTO setting together may impact China's legal reforms.

Chapter IV posits that China, overall, benefits from its accession to the WTO. The benefits encompass productive reforms in many aspects driven by accession to the supervisory and adjudicative oversight of the WTO. The Protocol contains extraordinary concessions in terms of intensifying economic reforms, improving administrative efficiency and transparency, localizing international norms, and removing trade barriers. In many respects, China accepted much higher and carefully calculated accession standards than any other WTO member state. Analytically, the accession to the WTO is driven by political reliance on external forces and international outreach to sustain economic development and foster global competitiveness in Chinese industries. China's post-accession development is also coupled with serious issues such as cross-region disparities, fluctuating trade scales, financial market turbulence, an irregular labor force, overheated local infrastructure construction, environmental degradation and shortages of natural resources. China's continuous endeavor to overhaul its legal system in preparation for and compliance with the accession is obvious including a completed pre-WTO massive legislative clean-up and marvelous resources engaged in promulgating new WTO-compliant laws for a national and local synchronization of WTO practices. On the other hand, the integration into the globalized trading system also brings in heightened complaints over perceived violations of national

treatment and fair competition in terms of protectionism, economic nationalism and profit transfer constraints. Following the WTO principles, China's legal reform embodies a long list of international pursuits and domestic ambitions, which would better its participation in the international legal order and realization of domestic legal reform targets. Moreover, the scope of China's undertaking of WTO obligations and principles is remarkable and unprecedented. Improving market access and fulfillment of WTO principles requirements obligates China's market economy development to conform to international standards through its legal system to a much greater degree. This swift liberalization process has brought dynamic yet astringent changes and reforms to China's legal system in many areas.

Chapter IV further argues that China's WTO accession impacts its tax law reform in several ways. *First*, China's market economy designation is not acknowledged by a few major economies such as the U.S. and EU. Certain "WTO-plus" obligations requiring market economy behavior, foreign investment, and domestic governance may complicate the legal reform as those provisions contain discriminatory measures against Chinese exports. *Second*, the jurisdictional reach of the WTO dispute settlement mechanism requires that China develop its capacity to litigate before the WTO Appellate Body as well as adept participation of international legal order. Gradually dropping its passive approach to international participation, China has been diplomatic in resolving trade crises with its trading partners. The Chinese government, on one hand, takes cooperative steps with domestic enterprises in resolving discrepancies before cases are

submitted against China under the WTO, but it also preemptively initiates complaints to seek protection of its own national interests against peer WTO members, mostly the U.S. and EU. *Third*, fulfillment of China's commitments also invites the fore issues of domestically financed competition with FDI. National treatment requirements have given rise to demands by domestic enterprises to enjoy privileges usually enjoyed exclusively by foreign investments, but overall China's approach remains focused on attracting foreign investment. It is also observed that, after "spoiling" FDI for thirty years, China increasingly imposes tightened controls to monitor the foreign investment in terms of quality, performance, and eliminating local graft. As per the TRIMs, to liberate capital mobility and promote free trade, China must eventually eliminate performance requirements or supervisory measures on technology transfers, foreign exchange, and R&D acts. Meanwhile, China earnestly honors its market access commitment by culling the list of restricted industries. All these impacts of WTO accession contribute to a well-rounded legal framework from which to conduct reform in specific areas of law including the tax law. A key example is the enactment of the new Enterprise Income Tax law, which unifies treatments for foreign and domestic enterprises. *Fourth*, the accommodation to FDI aggregates an overhaul of the trade law framework, which is more directly associated with the WTO regime. The Chinese government did significant work in upgrading the trade laws with pragmatism and essentialism, such as substantially reducing tariffs and non-tariff barriers, enacting a new Foreign Trade Law and full-scale legislative suite to conform to its TRIPs obligations. Implications for the tax law

in this context are vividly apparent, but in many aspects tax law reforms start from the trade law regime and end with a better-formulated statutory framework. *Fifth*, the normative implications of the WTO accession are not limited to the trade regime. Although the WTO system does not demand a well-established modern or westernized legal system, it requires various key features of such a system, which directly impact the tax laws reform. The requirement of transparency applies to all aspects of the legal system. Although foreign investors are plagued by concerns as to transparency in making commercial and operational decisions, observers should be optimistic regarding the prospect of refining transparency in legislation, administration and procedural compliance. Another normative value is the uniform and impartial administration of laws. Because the Chinese legal system generally inherits the imperial tradition of the over-reaching arm of the state and people still typically have a consciousness of obedience, compliance with this norm in large part depends on the political determination of central and local governments to honor it by, for example, instituting a reporting system to eliminate noncompliance. Judicial review is also an established compliance requirement – an independent, effective and true judicial authority is essential to remedy discretionary administrative actions. It is not realistic for China to set up an American style system of judicial review, however compliance with the WTO judicial review requirement should be prioritized to ensure impartiality and uniformity in administration, and to foster judicial independence and the competency of judges.

Chapter IV further specifies that WTO accession as a whole has two major

impacts on China's tax law system. *First* are the direct implications of WTO commitments in specific tax law legislation and administrations. In particular, tax issues such as export subsidies, tariff or non-tariff barriers, and FDI related tax matters based on principles including the national treatment and most-favored-nations commitments will directly impact tax reform. This implication is relatively straightforward and identifiable. Jurisprudentially, even those trade-related laws that might not directly implicate the tax laws may have far-reaching and frequent encounters with the tax laws. For example, intellectual property protections under TRIPs invite a full set of tax considerations on transfer pricing and international technology transfer. Therefore, the *second* prong goes to comprehensive or normative changes in the tax law area in terms of substantive characteristics of the rule of law, such as *transparency, uniformity, impartiality, judicial review* and *procedural justice*, which once were hard to insert into the tax system. Although this part of the ramifications should not be exaggerated or overromanticized, it bears significant jurisprudential value to incorporate them into studies of specific sectors of Chinese legal reform –such as the tax law. In this sense, the overall tax law structure including tax legislation, tax judicature, taxpayers' rights and tax treatment in the NGO sector is considered.

Chapter IV further summarizes that the impact of WTO accession on the rule of law development in China is profound. The force of WTO principles and rules is sharp and straightforward in conforming China to both instrumental and substantive conceptions of the rule of law: legal institutions, transparency, uniformity, impartiality, judicial independence, limited government, and a culture

seasoned with “common law” principles of *stare decisis*, and judicial review. In this sense, the WTO system and the rule of law order are meaningfully intertwined to incorporate positivist implications to the Chinese legal system, in which the tax laws reform is embedded.

Chapter V

Chapter V involves a detailed discussion of post-WTO *tax legislation* reform based on discussions in chapters II, III and IV. Considering the administrative nature of China’s tax law system, tax legislation manifests the impacts of the WTO principles and the rule of law in a straightforward and formal manner. For tax legislation, China is unique in a number of respects as the largest developing economy and a communist sovereign. *Chapter V* further points out that the voluminous literature on the WTO’s implication for China’s legal reform usually falls in to one of two traps – either fantasizing about the WTO’s capacity to overhaul the whole Chinese legal system or by imagining the CCP out of China’s political reality. Some are more instrumentally oriented by fine-texturing details in specific areas of law such as transplanting banking regulations or environmental protection measures. As it applies to the area of tax laws, *Chapter V* suggests that all these paradigmatic discourses are wrong.

Chapter V acknowledges that the traditional distinction between trade law and tax law is vague under multilateral trading agreements such as the WTO. Meanwhile, the line between tax administration and tax legislation is somewhat blurred in

China. *Chapter V* further submits that the Chinese tax law reform embodies the WTO principles in a visible but constrained manner, however, the normative value targeted and contributed by those WTO principles would accommodate the tax law reform for the rule of law construct effectively – it richly applies to tax legislation which is embedded in the tax law system of administrative nature.

Chapter V draws two inferences for the Chinese tax legislation framework. *First*, starting from the pre-WTO massive regulation clean-up, tax legislation reform is particularly evident in trade related areas, such as lowering tariffs or non-tariff barriers, turnover tax reformulation, income tax compliance updates, and transplantation of international tax practices. Without any doubt, this aspect of tax legislation is popular for scholars concentrating on WTO or trade related areas. Although certain tax legislation updates are not ideal or are subject to fairly constant change, tax laws generally remain stable and enforceable. *Second*, modern tax thoughts should be adopted in a more vibrant way. For example, advanced pricing agreements for curbing tax evasion should be employed or the actual enterprise tax payment should be lowered. It is not without merit or political substantiation to take cautious steps in transplanting modern tax conceptions; however, such vigilance might be better achieved by experimental practices in appropriate localities or industry lines. Given China's marvelous expansion in revenue collection over the past three decades, the time is ripe to introduce reform measures on certain types of taxes. Another dissonance in tax legislation is the irregular orientation of tax administrative documents. Local tax administrative rulings, notices or directives are out of true "legislation", however,

the administrative nature and centralization efforts somewhat validate the enforcement of local tax legislation given China's nascent tax judiciary system. *Chapter V* also briefs the binding tax-related provisions of the WTO Agreement in terms of the nondiscrimination principles and the dispute settlement procedures, but it divides its discussion into normative and formal implications.

Chapter V argues that the tax law system is not isolated; rather, it intertwines with other sectors of law. The normative impact of WTO agreements on China's tax legislation interlaces China's tax system with more general areas of legal reform. Tax legislation also contributes to improving tax administration and protection of taxpayers' rights through the Tax Collection Law, which sets forth clear rules for combating inconsistency in tax collection and promoting transparency to assure predictable tax consequences of transactional behaviors. In addition, it requires an improved tax judiciary system to review tax administrative decisions and legislative actions. In particular, the binding effects of the WTO agreements manifests in three WTO principles: transparency, impartial and uniform administration, and judicial review.

Chapter V suggests that the transparency principle raises three separate issues: (1) secrecy and lack of transparency in the tax legislation system partially stem from China's basic hierarchical organization structure. The process of tax legislation as to policy orientation and opinion collection should be open to public review before final promulgation; (2) although the SAT released the "New Measures for Normative Documents," reckless or manipulative inconsistency or irregularities in local tax legislation in different localities still creates ambiguity; (3) intervention

from other administrative apparatuses at different hierarchical levels also complicates tax legislation reform by issuing overlapping and less formal notices and supplemental circulars.

The uniform and impartial administration requirement sets a high standard for China's tax legislation: (1) tax authorities usually suffer from insufficient discretionary capacity to administer ill-designed tax laws: those drafted in vague terms and those of too much details with narrow applicability; (2) modern legislative techniques are missing in local tax legislation, which leads to a proliferation of overlapping, repetitive, ambiguous or contradictory tax laws at various hierarchical levels of government; (3) various extra-legal factors impede the neutral and righteous implementation of tax laws, such as political intervention, corruption of local tax officials, and local protectionism; (4) China's favorable economic policies toward coastal areas create unbalanced uniformity and predictability. Given the political stakes put on local economic performance, many ill-drafted, ambiguous and contradictory tax laws and regulations are enforced for local benefit, which causes disparity and unpredictability.

The judicial review requirement creates its own specific issues in the Chinese tax context. A key concern is the amount of independence that China's judges can exert to review and correct tax administrative decisions.

Chapter V further details implications of the national treatment and the most-favored-nation principles. *First*, certain inconsistencies with the national treatment principle are diagnosed even after a few major tax legislative pieces came into place in the decade after WTO accession. However, the irregular

treatments for Chinese domestic enterprises may be validated. The benchmark is that the national treatment principle by and large serves to restrict, not to enlarge state's taxing powers. *Second*, while China has made tremendous efforts in its tax legislation to accord with the MFN principle, even the definitions of many key words or commonly accepted practices thereunder are subject to broad interpretation. Two inferences are made based on a mix of different tax treatments towards FIEs and DEs: (1) the economic structure and development priorities incentivize flexible treatment of specific industry lines. Tax preferential measures are direct and enforceable without necessarily resulting in discrimination; (2) complaints from foreign investors over non-transparent government procurement processes may simply be a response to the fact that preferential treatments are not available to foreign investors in negotiated procedures with competition bidding for government contracts. The tax implication of the government procurement process is not given enough attention according to the MFN principle of eliminating barrier to facilitate the mobility of goods and services among member countries.

Chapter V then considers, from a formal perspective, the impacts of WTO accession to China's tax legislation system at length. In particular, rules and principles of WTO Agreements call for China's turnover tax, enterprise income tax and individual income tax legislation and reform to incorporate non-discrimination principles and the transparency requirement to a significant extent. However, a careful review of tax legislations in China reveals that some basic elements of the instrumentalist concept of the rule of law are missed. This is

specifically evident in the IIT legislation reform, which is in need of immediate attention – *Chapter V* provides a detailed account of current drawbacks and related reform proposals. Meanwhile, even the 2008 EIT Law contains modern tax concepts, it remains unclear how to realize both tax equity and efficiency by balancing central and local tax authorities. Another aspect of Chinese tax legislative reform is setting up a tax administration system with efficiency with internalized rules and structure.

Chapter V further contends that the WTO regime has limitations in pushing tax legislative reforms. Although the WTO principles and rules impose constraints such as the adoption of export subsidies and enforcement of AB decisions, a member country may, by literally complying with WTO principles, provide same economic benefit by manipulating domestic tax policies. Lessons learnt from the US FSC/ETI and the Sino-US semiconductor cases exemplify the inherent weakness of the WTO for compelling substantive tax reform.

Chapter V concludes that the tax legislation reform has endured a painful process of simplification, unification and the revenue sharing scheme. Tax legislation started as FDI driven and incentive-focused, and so the structure of tax legislation was imbalanced from the very beginning without honoring tax equity and efficiency. For example, the dual-track enterprise income tax system for aroused frustration from both DEs and FIEs. The design of IIT Law does not manifest revenue contribution and social wealth redistribution as it should be. Even as turnover taxes dominate tax revenue in China, the structure of VAT and Business Tax is still plagued by a few fundamental issues such as the transition to a

consumption type VAT. *Chapter V* further summarizes that China's tax legislation reform is complicated under WTO Agreements and the rule of law order. In particular, rules and principles of WTO Agreements call for China's turnover tax, enterprise income tax and individual income tax legislation and reform to incorporate non-discrimination principles and the transparency requirement.

Chapter V further shares and agrees with Avi-Yonah's proposal that, answers to fine-tune China's tax legislation system might be found in an international tax arena through a multilateral solution. It is essential that the fundamental goals of taxation and WTO principles should be achieved in terms of revenue collection, social wealth redistribution, transparency, uniform and impartial administration, and judicial review. Equally important is to incorporate elements of the rule of law order as well as to integrate China's tax legislation with an international perspective of facilitating development and institutionalization of the tax system.

Chapter VI

Chapter VI continues along the same lines as Chapter V to analyze another sector of China's tax laws – the tax judiciary reform. This chapter is disadvantaged by the scarcity of materials available in relevant topics. Similar to other chapters, the administrative nature of China's tax system encourages the preference to incorporate related tax administration topics in this chapter. The Chinese tax judiciary is a complicated interaction between three objects of study: tax

administration, the general Chinese judicial setting, and taxpayer rights. Tax judicature reform is not an isolated undertaking. China's tax law framework has its peculiarities. The role of tax judicature should not be prolonged for overhauling the whole tax law arena or be left until the end of the tax reform. Flaws and institutional propensities of China's judicial system translated into the tax judicature must be carefully examined and evaluated. All tax judicature reform proposals must be proactively reviewed in light of the judicial institution in China. Under China's socialist legal system construct, the tax judicature should ground itself in honoring the rule of law order emphasizing a *fair, transparent, certain, consistent, equitable, effective, and clear* consideration of cases before it. Meanwhile, the WTO principles of *transparency, uniformity and impartiality and judicial review* should be incorporated to the utmost extent with a set of niceties and convenient courses of action, even those principles might not directly apply to the tax judicature. Overall, "China's tax judicature should account for China's social and economic development settings before introducing pragmatic reform proposals".¹⁴

In general, the tax judicature structure consists of two layers: the dispute settlement between tax authorities and taxpayers as to an assessment of tax; and if a settlement is not achieved, a tax lawsuit is presented to a court against such tax administrative decision. Different from a common law system such as the United States, tax controversies in China are mostly litigated as administrative cases, supplemented by civil and criminal proceedings as necessary. The awkwardly

¹⁴ See Xu Shanda *Zhongguo Shuiquan Yanjiu* [China Tax Jurisdiction Research] 6, (China Taxation Press, 2004)

small number of tax-wise lawsuits in China makes the tax judicature reform one-sided. That is to say, Chinese tax authorities dominate related reform proposals while taxpayers are quite noiseless in initiating advanced rights protection. Meanwhile, there is a legitimate need to advance the reform in terms of fulfilling the WTO principles that China has committed under the socialist rule of law construct.

Chapter VI suggests that China's tax judicature system falls in the general judiciary framework permeated with controversies and deficiencies. Paralleled with alleged shortage of administrative impartiality, judicial review and a system of elaborated rights, remedies and procedures for taxpayers would be of little merit in the absence of an independent, impartial and competent judiciary in general. The reality is that the independence of Chinese tax judiciary was inextricably linked to or disadvantaged by the system of formal courts. The independence of the China's judiciary sector has been notoriously plagued by the judges' insecurity of tenure as well as the judiciary's own traditions of knowledge, integrity and technique and the law of contempt. Therefore, the ideal undertaking that China's tax judicature properly exercises its jurisdiction presupposes at least three broad intertwined features: technical competence; commitments to the rule of law; and finally; institutionalized independence embracing domestic causes and international demands such as the WTO principles. Regrettably, all these three factors are neither substantiated nor even straightforwardly identifiable.

Chapter VI further sets out *three* parts analyzing the following questions for China's tax judicature reform before contributing a few reform proposals: What is the procedure for administrative and judicial appeal and how predictable for the taxpayer to process a reasonable case? Is all or a portion of the tax to be paid pending appeal, and if so, how secured the taxpayer is in obtaining relief from this requirement? Is there any realistic need to establish a judicial tribunal for tax cases specifically, if so, why and in which format? Is the appeal process impaired by corruption?

For the *first* part, *Chapter VI* discusses the rationales for structuring the tax judicature system as it is. Chinese tax judicature reform is substantiated by various legitimate drives. The administrative law reform expects tax authorities' discretion to be efficiently limited by a functional judicial review process. Taxpayers' awareness raises the request to find a more taxpayer-friendly and just judicial setting for rights protection. At the same time, legislations in the tax areas are comprehensive, verbose, and arcane, and thus embrace an assimilation of a sophisticated judicature system. More importantly, the market economy and the rule of law order urge the tax judicature to accommodate diversified economic interests and social needs in a fair, impartial, accessible, efficient and clear-cut manner. Pressures from international interests such as the WTO principles raise the bar high for Chinese tax judicature reform according to transferable practice from other tax jurisdictions. In addition, a tax judicature system contributes competitive advantages to Chinese overall economic setting in keeping foreign investments and improving revenue collection.

For the second part, Chapter VI imports a comparative approach to expand and justify potential proposals for China's tax judicature reform. It submits that there is no uniform model that could be globally applied in tax judicature system. It discusses the U.S. tax judicature system but does not initially aim to furnish a critical review of the U.S. judicial model. Rather, a few factors in the U.S. tax judicature system are identified and put together as reference to submit a meaningful proposal catering to potential reform needs of China's tax judicature system. In particular, *Chapter VI* offers a selectively tailored description of the U.S. tax judicature system where taxpayers and the tax authorities share similar concerns. Those concerns are the discretion of the court, timelines, cost-efficiency, complexity of the issue, settlement potential, trial and appeals. And these takeaways should be considered under the general framework of the judicial system, overall financial capacities and social policy needs.

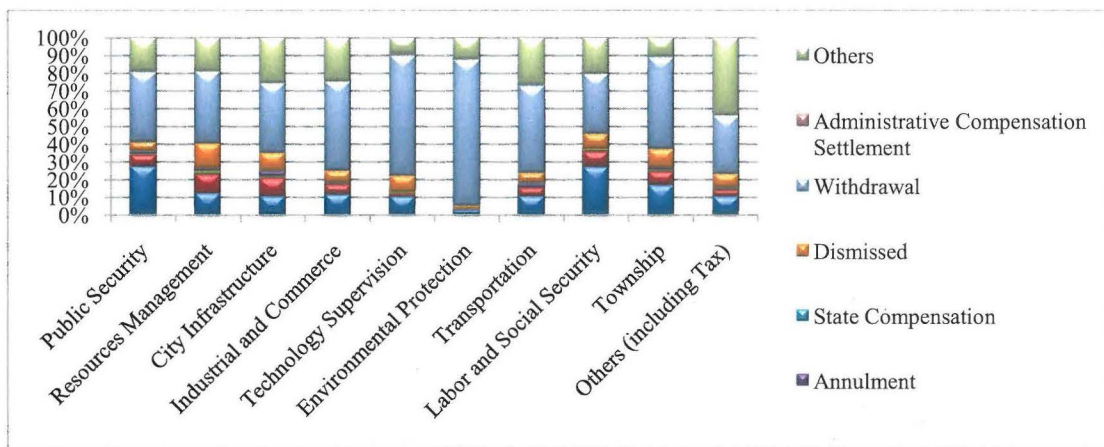
For the second part, *Chapter VI* further describes three co-existing factions of thoughts to exemplify current "wretched" debates in terms of the imaginary Chinese tax court system: oppositionists, supporters and a midlist view, but each has its merits and drawbacks. Equally important is that they share a few similar reform proposals such as removal of the pre-trial administrative reconsideration and abolishment of the full-payment rule. Overall, the oppositionists prefer a mild but pointed plea without inviting an overhaul of the current system. The supporters, on the other hand, are more aggressive or optimistic to take the tax court as a rare breakthrough opportunity to reform both the judicial system and tax administration framework. A middle ground midlist but slacker view looks

good at the first glance, but its transitory nature and over-conformism misidentify a few key considerations in the construct. Again, this chapter notes that there is no right or wrong answer to the speculative pursuit of upgrading the tax judiciary reform. The establishment of the tax court system co-opted for political and social policy pursuits rather a solemn focus on the Chinese legal reform agenda.

For the third part, *Chapter VI* discusses the “triple whammy” embarrassments of Chinese tax judiciary reform, i.e. deficiencies in the three pillars of tax judiciary: tax administration, the Chinese general judicial situation and taxpayers’ rights.

Historical improvements of the Chinese tax judiciary system were an irregular adaptation of the general administrative procedures in the tax context, a lack of thoughtful attention to taxpayers and intractable interference from political and administrative intricacies. The tax dispute resolution system uncontrollably takes over and absorbs similar problematic deficiencies of the general administration judiciary framework into which it is embedded. Therefore, the Chinese tax judiciary reform primarily falls into two prongs: the peculiarities built in the tax system and the upgrade of the overall Chinese judiciary reform for dispute resolution. Due to space limitations, *Chapter VI* focuses on the first prong, i.e., the flaws and debates about the current tax judiciary; and to a much less extent the second prong, i.e., the competence, autonomy and independence of Chinese judiciary in general. In terms of peculiarities, *Chapter VI* summarizes that Chinese tax disputes generally includes two strides: tax administrative reconsideration and tax administrative litigation. However, the tax judiciary system is plagued by a few flaws in practice. The condition of the pre-trial tax

administrative reconsideration renders tax authorities' discretion too expansive to avoid arbitrary administration. The full payment requirement for disputes arising from tax collection holds scarce jurisprudential substantiation and receives vehement criticism from both judges and scholars. Moreover, due to limited number of less complex tax cases (Figure 12) accepted by the administration court, the competence of judges in tax laws is not markedly improved, nor is the application of the doctrine of *stare decisis*.



(Figure 12)

All these defects, coupled with tax authorities adamant efforts to increase revenue collection, call for an upgrade of the Chinese tax judicature reform from three respects:

- a) *Chapter VI* shows that tax judicature reform is a legitimate need of Chinese tax administration, which composes probably the *foremost* pillar in structuring modernization of China's tax system. In China, tax law remains heavily reliant on tax administration. The enforcement and reconsideration of adverse decisions of the tax administration are inherently hierarchical. Subordinate tax officials' position in tax

administrative hierarchy determines that superior's reconsideration is the simplest, direct or the most cost-efficient manner to seek reliefs. Therefore, tax administrative reconsideration has its tradition within China's general administration framework. China does not have a court hearing tax cases only; rather, the administration tribunal within the People's Court system is the only available channel to seek judicial remedies. Taxpayers' position therefore is disadvantaged given the dominance and authority of tax administrations. In spite of various prescribed rights, taxpayers are hindered in filing tax disputes against tax authorities in terms of procedure, financial capacity and political pressure.

Chapter VI then summarizes that tax administration has failed the tax laws reform in a few ways despite progress it has made. (1) The irregular local enforcements of tax laws and regulations applicable nationwide creates discrepancies, which invite tax disputes. Moreover, provincial and local tax bureaus are entitled with too expansive discretion in handling tax collection and dealing with taxpayers. (2) The expertise and independence of tax authorities are subject to challenge and improvement in many ways. The dualism of superior and subordinate tax officials may make taxpayers' claims seem futile and impractical. Records of such hierarchical internal communication such as reports, requests, instructions and directives were mostly kept out of public availability. Therefore, taxpayers' right to know is severely discounted by tax authorities' persuasion to encourage a settlement. (3) Tax administration's resourcefulness and commitment to

preventing tax controversies cause distortions in the system. The issue is how committed it is to honoring taxpayers' legitimate requests. Advance ruling, in this sense, exemplifies one of the cost-efficient approaches available to tax administrations.

b) *Chapter VI* also expands discussion on the tax judiciary through the lens of judicial review – the *second* pillar. In this connection, the rule of law order in terms of judicial review¹⁵ requires that only an ordinary court can punish criminals but equality must be guaranteed regardless of social, economic, or political status in terms of substance and procedure. Raz further details that uniformity, independence, transparency and procedural justice should be established in the judicial review construct towards a rule of law order. Meanwhile, an independent, effective and true judicial authority is essential to compliance with China's WTO commitments. The Protocol mandates the establishment of tribunals, contact points and procedures for the prompt review of all administrative actions relating to the implementation of the laws, regulations, judicial decisions, and administrative rulings of general application referred to in the WTO rules. Obviously, the tribunals must be independent of administrative organs and thus are required to be "impartial and independent of the agency entrusted with administrative enforcement and shall not have any substantial interest in the outcome of the matter." The tribunals may be administrative or judicial, however, right to appeal must be granted if the case is originally submitted for an administrative review following due process.

¹⁵ See generally Albert Dicey, *An Introduction to the Study of the Law of the Constitution* (1885).

Chapter VI further notes that judicial review of tax administrative discretion is doctrinal. Tribunals hearing tax cases with judicial review power should examine tax authorities' actions that are incompatible with the constitution, written tax laws and regulations, and related procedures. Meanwhile, the tax judiciary system is a key component of modern tax governance. Since China does not embody a polity of separation of powers, the tax judiciary is a strong impetus for improving the general judiciary system associated with the Party-state's hierarchy of administration structures. However, expectations of the role of the tax judiciary must be realistic. The tax context has its peculiarities and is colored by a pragmatic bent in Chinese legislation and administration.

Chapter VI then reviews, to a limited extent, flaws in the general judicial review system in China that are attached to China's tax judiciary deficiencies. *First* is the non-uniformity of tax law application. Distorted understanding and peculiarities of the tax laws and locality self-interests create non-uniform adjudication of tax disputes. Cross-jurisdiction irregularity in judgment may be brought against the same taxpayer and lead to jurisdiction shopping for tax adjudicators. However, there is a possibility to reach national uniformity under the supervision of the Supreme People's Court and the SAT. *Second* regards political intervention under the aegis of supervision from the local People's Congress and local tax authorities. *Third* it considers impartiality in terms of the flawed disparity in favor of tax administration in the adjudication

practice. A few factors contribute to such a disparity such as assignment of the burden of proof, merits of tax cases, litigation experience and techniques, and over-expansive discretion enjoyed by the tax administration. *Fourth* involves in the tax expertise of local tribunal judges. Deficiency of tax expertise is caused by weakened training, shortage and irregularities of the caseload, and dominance of expertise concentrated within the tax administration. *Fifth* goes to the arguably narrow scope of judicial review in the tax context. This flaw has two parts: (1) the scope should include abstract administrative acts such as local tax rulings, notices and directives, *if* they clearly violate laws of higher authority; and (2) tax disputes derived from uncontrolled, over-meticulous and voluminous local tax administration acts should not be unconditionally filed. The “case-merit control” should be incorporated but not limited to an upgraded pre-trial tax administrative reconsideration “filter”.

c) *Chapter VI* also includes a very brief discussion of taxpayers’ rights, *third* and last cornerstone of a robust tax judiciary framework.¹⁶ As to China’s tax judiciary reform, the most substantive reforms concern taxpayers’ right to know, right to plead, right to a fair hearing and right to appeal. The right to know guarantees predictability of tax consequences after a taxpayer learns details of applicable tax laws and regulations. The right to plead refers to tax authorities’ responsibility to explain details and evidences for reaching an adverse decision against a taxpayer. The right to

¹⁶ See *infra* Chapter VII for details on the protection of taxpayers’ rights in China.

a fair hearing envisions a process in which taxpayers and tax authorities can present arguments during a pre-trial process. Usually, this happens when an administrative reconsideration is filed. The right to appeal is the last resort that a Chinese taxpayer may rely on; however, in many cases it leads to a settlement between the taxpayer and tax authorities. To this end, the issue centers on the realization of taxpayers' protections but not those listed in legal documents.

Chapter VI further reminds that it might be overly cynical to understate the progress and merits as to rights protection present in China's tax system even if some frustrations of taxpayers' rights protection do exist. Overall, China's tax system still provides a formulated, yet promising, framework to channel available legal remedies, administrative and judicial, for taxpayers. In particular, the administration lawsuits filed by taxpayers attain more respect and identification all the time, although such awareness is discounted by the "non-contentious" or "settlement-preferred" culture in China.

Chapter VI then contributes the theoretical and details of a few proposals for China's tax judiciary after discussing the "triple whammy". Mostly, *Chapter VI* structures these proposals based on the following theoretical analysis: (1) the tax context is particular. The tax judiciary's role therefore should not be exaggerated in overhauling or extending to the whole tax law field. (2) Flaws and established settings of China's judicial framework translated into the tax law must be

carefully examined and evaluated. (3) The tax judicature should ground itself in the rule of law order emphasizing a *fair, transparent, certain, consistent, equitable, effective, and clear* consideration. (4) The WTO principles of *transparency, uniformity and impartiality* and *judicial review* should be fulfilled to the utmost extent possible, even those principles might not directly apply to the tax context.

Chapter VI submits the following proposals for China's tax judicature reform (1) Similar to many other tax scholars, I contend that the full-payment rule should be abolished. For an adverse tax collection decision, a taxpayer does not need to pay the assessed payment or provide guarantee at the first place before filing an application for a tax administrative reconsideration. (2) This thesis contributes the novel notion that a summary judgment procedure should be established for small tax cases as a tax collection procedure. Summary judgment has several advantages: keeping the current reconsideration procedure untouched, promoting tax expertise of judges, lower burden of proof, less discovery practice, relatively cooperative procedural standards at trial. (3) China should design a better scheme for administrative reconsideration, but the structure must be calculated and designed. (4) Tax expertise can be strengthened by teaming up more experienced personnel with specialty in tax. (5) At county or lowest hierarchical government levels, abstract administrative acts should be subject to judicial review, and this reform may start as experimental at a few coastal localities with better tax talents. (6) Echoing the debates regarding the imaginary Chinese tax court system, this chapter submits a tentative proposal. The desirable structure is to adopt a circuit

tax courts framework exercising both original (conditioned first instance) and appellate jurisdiction sitting permanently in six to eight regions covering nationwide territory and reporting to the SPC Tax Tribunal based in Beijing. The designated High Tax Tribunal should be an SPC subsidiary and should have the ultimate appellate jurisdiction over tax cases appealed at circuit tax courts and provincial high courts, and perform tax court system administration or management. Meanwhile, the transitory, costly and overhauling midlist “spin-off” structure should be denounced based on tax policy routines.

Chapter VI concludes that the tax judicature reform in China should consider both the idea of permanence and that of flexibility. It must balance the dynamic between tax administration, the general judiciary framework, and taxpayers’ rights. As law supports the government’s political authority as well as the power of the legal system, the principles and tenets of the tax judicature system should be enshrined in a jurisprudential manner, honoring the rule of law order.

Chapter VII

Chapter VII endeavors to review China’s taxpayer’s rights framework and proposes reform guidelines to examine mechanisms for enforceable taxpayers’ rights. The discussion has two prongs. *First*, it contributes a review of the *status quo* of China’s taxpayer’s rights framework. Taxpayers’ rights are based on a dynamic interaction between State, the tax mix and taxpayers. *Second*, it

examines China's mechanisms for enforcing taxpayers' rights under the rule of law conception and WTO principles and offers a reform proposal.¹⁷

Chapter VII starts the discussion by giving historical background on Chinese taxpayers' rights protection. *First*, the awareness of taxpayers' rights has fashioned China's tax law reform in the past decade. A recent wave of taxpayer consciousness sparked a movement to challenge the rights protection *status quo* in China. As China was charged as the most miserable Asian country in terms of tax, Chinese taxpayers are increasingly burdened by various tax levying coupled with the inflationary currency and high CPI sensed. Moreover, enlarged tax bases enrage taxpayers who compare them with the public benefits they receive in return. *Second*, the Chinese government's official endorsements of universal values and generally accepted human rights principles advance the debate on reframing China's legal and social settings. However, traditional tax policy discourse lacks a framework for exploring whether or how a taxpayers' rights paradigm may guide and encourage China to pursue the sensitive human rights protection goals that would help promote social order and international image in which individual rights and freedoms can be fully realized.

Chapter VII contributes that the perspective of taxpayers' right protection could help articulate a responsive approach to the problems of social welfare and economic inequality in China. For instance, a list of pragmatic and proactive taxpayers' rights promotes human rights protection, which is both morally defensible and politically viable. *Chapter VII* suggests that the concept and protection of taxpayers' rights presumes a generalized enabling framework of

¹⁷ See *infra* Chapter VII Section 4.2.4.

human rights. At the same time, approaching human rights through the lens of taxpayers' rights supports a focus on fairness in social policy orientations, and brings in efficiency aspects in evaluating of a social policy by considering the potential obligation against taxpayers. Ultimately, human rights protection might be better served if a set of taxpayers' rights tends to uphold a professional institutional order that balances state and taxpayers' interests. In this connection, the situation of China's taxpayers is awkward: the human rights framework is not fully embodied in the legal system, and the tax laws system itself is in its nascence.

Chapter VII contends that the concept of taxpayers' rights is not isolated. It is generally defined to limit the state power to promulgate, administer and enforce the tax laws and to bindingly obligate uniformity, transparency and procedural justice. The setting of rule of law in this sense warrants taxpayers' reliance on creditable rights protection. On an international level, the protection of taxpayer rights has received widespread attention and legislation from various sources is available to define, provide, and defend taxpayer rights. Many tax administrations and international organizations have formulated bills, declarations and manuals specifically designed for the protection of taxpayer rights. The competitive advantage from an international market further ensures that interference to taxpayers' rights is limited, and the WTO exemplifies a robust multilateral regime embracing capital mobility and free trade. Rights exercised by taxpayers demand an internationally formulated standard to be incorporated into China's tax law system to safeguard both revenue collection and fuel economic development.

Chapter VII further briefs the rationale for taxpayers' rights based on the relationship between taxation and the state. The discussion is founded on the state theory that legal rights are meaningless unless they are honored with accessibility and enforceability to enjoy, and therefore, taxpayers' rights are primarily part of civil and political rights as to harmonizing taxpayers' rights and duties to the state.

Chapter VII also reviews the *status quo* of taxpayers' right protection in China and suggests the legitimate need to develop a set of rules for scoping and protecting taxpayers' rights, the awareness of which emerge in a meaningful and pragmatic manner for bettering outcomes of economic behavior and social policy implementation. *Chapter VII* critically assesses the Chinese taxpayers' rights mix in terms of constitutional interpretation, primary rights and secondary rights, administrative rights and the principles of good conduct of tax authorities available for Chinese taxpayers. An examination of the primary and secondary taxpayers' rights in China reveals that almost all deficiencies and drawbacks of human rights protection and the tax laws system fall onto the taxpayers' rights.

Chapter VII then proves why such deficiencies are not surprising. The constitutional fortification of primary taxpayers' rights is weak because of an absence of the word "taxpayers' rights" in China's Constitution, but also because of a discontentedly misunderstanding of how to situate taxpayers to claim or interpret primary legal rights. Secondary taxpayers' rights are supposed to be enriched with enough clear-cut rules in detailing taxpayers' administrative and legislative rights, while China's current framework fails to contribute those

details. Rather, somehow it misidentifies the roles played by administrative primary rights and secondary legal rights. Following the positivist rule of recognition, the result is that an amalgamation of laws, rulings, and notices is displayed out-of-order, and there lacks a systematic certainty to elevate protection of taxpayer's rights. Although the Tax Collection Law, the Proclamation of Taxpayers' Rights and Duties and relevant administrative procedural laws all facilitate, to some extent, the clarification and expansion of rights available to taxpayers at first glance, those stipulated rights remain short of jurisprudential significance and practical value, showing the necessity to identify each category of taxpayers' rights in detail. Paradoxically, taxpayers' rights are expanding simultaneously with the expanding economy scale and a larger tax enforcement force.

Chapter VII identifies the necessity to design each category of taxpayers' rights with enough details. Chinese tax authorities should feel the insufficiency to set up a hasty comprehensive framework of tax without polishing taxpayers' rights and obligations. The connection between the general administrative law framework with the tax law context should be better solidified to determine whether an application in taxpayers' circumstance is appropriate or not. This comprehensive approach should include both legal and administrative rights, embracing diverse factors that may affect taxpayers.

Chapter VII then evidences that Chinese taxpayers' rights are limited by the inherent deficiencies in the general tax framework. This is particularly manifested by the discrepancy in the internal management of tax authorities. Moreover,

because secondary legal rights, administrative rights and the principles of good conduct of tax authorities are put together in the Tax Collection Law and the Proclamation, the protection of each right is not guaranteed with enough singularity and attention, and the separation of those rules and its impact should be considered.

Chapter VII summarizes that, being mindful of deficiencies in taxpayer rights protection in China, it is excessive to understate or neglect the progress and merits as to the rights protection regime in China's tax context. Overall, China's tax system still provides a problematic, yet promising, framework to channel available legal remedies, administrative and judicial, for taxpayers. From the Tax Collection Law and the Proclamation, continuous efforts and attention are put forward by China's tax authorities to advance taxpayers' awareness and rights recognition. In particular, the administrative lawsuits filed by taxpayers attain more respects and identification, although such awareness is discounted by the "non-contentious" or "settlement-preferred" culture in China. *Chapter VII* also acknowledges the frustration due to the paucity of resources in modulating related research, since many questions of this topic left unaddressed in full extent or some questions are just not answerable given current development stage of the tax legislation reform.

Chapter VII supports the protection of taxpayers' rights centers as a key element substantiating China's construct of the rule of law order and fulfillment of WTO principles. Chinese taxpayers' rights should theme with a *fair, transparent, certain, consistent, equitable, effective, and clear* manner within the framework of

the tax laws. Meanwhile, the WTO principles attach assimilation into international taxpayers' rights routine and vitality in designing and rectifying Chinese taxpayers' rights in terms of administration and adjudication. China's tax laws should embody and honor the *transparency, uniformity and impartiality* and *judicial review* principles with a full set of niceties and convenient courses of action in taxpayers' protection.

Chapter VII concludes a summarized proposal for refining China's taxpayers' rights protection, based on the positivist view in jurisprudence for taxpayers, the rule of law order, and WTO principles. This proposal balances practical significance and largely is underpinned by points of consensus among tax authorities and taxpayers alike. In this sense, it is not a reordering or rearrangement of existing prescribed rights, rather, it is submitted being reflective of daily practice.

Chapter VIII

Chapter VIII contributes a comparative study of the tax treatments for the nonprofit sector in the U.S. and China for three reasons. First, the development of China's nonprofit sector¹⁸ has been tremendous in the past two decades, but much less comprehensive studies have been initiated on reforming China's nonprofit tax

¹⁸ See Evelyn Brody, *Institutional Dissonance in the Nonprofit Sector*, 41 Vill. L. Rev. 433-440 (1996), discussing that when referring to the third sector, the terms "charity" and "nonprofit" are often used interchangeably. See also generally D.B. Reobertson, *Should Churches be Taxed?* 40-68 and Chapters II, III and IV (Westminster Press, 1968). The same problem exists in the limited research in China as to the definition or description of "*cishan*" or "*gongyi*", i.e., "charity".

system – the crucial component that clinches an attainable nonprofit sector as a partner of the state. Echoing China’s success in economic growth in the past decades, literature on Chinese tax typically focuses on tax incentives for foreign direct investment and tax policies catering economic development. Second, collaterally, the rule of law construct in the past decade invites some ambitious scholarship as to modernizing China’s charity sector with an “all-in” charity code or cultivating expansive grassroots NGOs. This idealized study, however, suffers from ignorance of the tax treatment for the nonprofit sector and an unrealistic understanding of China’s legal and political situation. Third, this analysis has strong commercial implications that are often neglected by many commentators. China’s integration into the WTO or the globalized trade system arouses heightened complaints on national treatment and fair competition from both foreign and domestic enterprises. A key issue arising is that the profitability of foreign investment shrinks as the tax preferential treatment is gradually being phased out.¹⁹ However, there is no materially meaningful tax law as to the nascent NGO sector – how NGOs, as foreign investment vehicles, might be profitable.

¹⁹ See generally Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 Harv. L. Rev. 1573 (2000), presenting the relationship between tax incentives and revenue; Professor Avi-Yonah examines the increased use of tax incentives as weapons in the international competition to attract investment. Professor Avi-Yonah argues that the establishment of tax havens allows large amounts of capital to go untaxed, depriving both developed and developing countries of revenue and forcing them to rely on forms of taxation less progressive than the income tax. Professor Avi-Yonah contends that both economic efficiency and equity among individuals and among nations support limits on international tax competition, and he presents a proposal that accommodates the competing concern for democratic states’ ability to set their tax rates independently. He proposes the coordinated imposition of withholding taxes on international portfolio investment, with the goal of ensuring that all income may be taxed in the investor’s home jurisdiction. Professor Avi-Yonah also proposes that multinational corporations be taxed initially in the jurisdictions where their goods and services are consumed. Professor Avi-Yonah outlines that, both developed and developing nations would be able to preserve the progressivity of the income tax and to broaden and stabilize their tax bases in time to stave off the fiscal threat to the welfare state

Chapter VIII takes two positions are methodologically and jurisprudentially meaningful to a comparative study²⁰ of Chinese tax.

First, modern tax studies are debated predominantly in Western terms such as progressivity, equity and efficiency, but the scarcity of decent comparative legal tax scholarship fails to generate a “lively debate on comparative tax works and their methodologies”. Meanwhile, “a shortage of paradigmatic discourse in comparative tax invites the simultaneous existence of bluntly conflicting arguments, taking parallel courses, yet never engaging each other”. Although some frameworks of comparative tax studies are proposed or compiled, the formulas enclosed therein remain hypothetical than practical— a pragmatic concern is that only very limited areas of tax are forcefully analyzable by tax comparativists. This embarrassment is particularly challenging to scholars in the Chinese tax context who want to exploit the “tax transplant” methodology. In this connection, this chapter contributes that a comparative tax study relating to China might be better achieved by focusing on a “tax law sub-discipline” rather than on a specific tax concept. One reason is that a tax concept, usually a transplanted vocabulary of western tax origin, is too narrow to substantiate a patulous comparative analysis. The other reason is that it lacks full-range expandability to scrutinize other subsidiaries of tax law – an international tax concept at the

²⁰The literature on comparative tax and federalism is voluminous. See Reuven Avi-Yonah, Preface to *Comparative Fiscal Federalism: Comparing the European Court of Justice and the US Supreme Court's Tax Jurisprudence*, by R.S. Avi-Yonah, J. R. Hines Jr. and M. Lang, co-editors, xvii-xviii. EUCOTAX Series on European Taxation, 14. Alphen aan den Rijn, The Netherlands: Kluwer Law International, 2007; Michael A. Livingston, *From Milan to Mumbai, Changing in Tel Aviv: Reflections on Progressive Taxation and “Progressive” Politics in a Globalized but Still Local World*, 54 AM. J. COMP. L. 555 (2006). Professor Livingston is one of the major contributors of the comparative tax literature and has conducted extensive research. See also Victor Thuronyi, *Comparative Tax Law*, Kluwer Law International (2004) for a detailed account of comparative tax methodologies and comparison of tax systems of over 20 jurisdictions

maximum can only throw in scrappy value to other major tax areas such as turnover tax or income tax.

Second, the tax cultural traditions and social, political and legal settings of a systematic tax governance framework usually are much less discussed or even purposefully excluded from tax comparativists' theorizations. This "snooping" methodology unavoidably provokes abundant "contemptuousness" and skeptics from orthodox tax scholarship against tax comparative studies. A tax study ultimately has to be accommodating to the general cultural, social, political and legal systems in which a tax system is embedded. Otherwise, a comparative study may easily turn into a descriptive, mechanical, and perfunctory analysis. The practical and scholastic significance of comparative tax studies cannot be achieved by way of a limited comparison falling on the technical elements of tax. The "big-picture" setting perspective must be addressed to formulate a comparative study of Chinese tax. The same rationale applies to both the rule of law construct and assimilation to the WTO system as well. This thesis tentatively incorporates comparative tax culture considerations to compare prime elements of nonprofit tax schemes of U.S. and China.

Chapter VIII argues that the development of China's nonprofit sector in the past decade has been remarkable, especially following recent natural disasters, the 2008 Beijing Olympic Games, and celebrity donation scandals. Regulatory deficiency regarding the treatment of nonprofit organizations demonstrates the Chinese party-state's failure to maintain its rich tradition of philanthropy and the exacerbation of the disparity between rural and urban livelihoods. Surges of

grassroots NGO activity, millions of affectionate “netizens” at the time of natural disasters, and faithful volunteers for the Olympic Games demonstrate the poor administration and misallocation of charitable resources. Meanwhile, the Chinese government has seriously identified the indispensable role played by the nonprofit sector in alleviating bureaucracy, downsizing government, stimulating wealth mobility, reducing regional inequalities, and, ultimately, promoting a harmonious society.

Chapter VIII highlights the current dysfunctions in the Chinese legal framework in establishing an enabling an operative nonprofit sector – namely that the state fails to regulate it through a potent tax system which creates various tax preferences and ensures no abuse of those preferences. Even though it has been suggested that a comprehensive charity law should be enacted, the existing charity tax laws and regulations remain discordant, anachronistic and inoperative. Worse is that bureaucratic mismanagement and unprofessional administration have jeopardized the incentives and confidence for reforming the nonprofit sector.

Chapter VIII aims to examine comparison between current nonprofit tax rules in China and U.S. in practice, and highlights suggestions that may benefit charity tax law reform in China. From a comparative point of view, the United States system of tax treatment for nonprofit organizations is well established and sought-after model for decades. Although there is no single pattern fitting in various global needs, the U.S. model includes established principles of federalism, fiscal incentives, and economic adaptability which are markers of a powerful system.

Chapter VIII also presents a brief overview of China's current charity laws and regulations – the historical development of charity tax laws and those in practice – especially of charitable tax exemptions. In addition, *Chapter VIII* outlines a number of institutional and theoretical backgrounds of the current U.S. charity tax exemption systems. The U.S. tax system for the nonprofit sector arguably embraces maturity, objectivity, flexibility, and accountability. Evolving throughout the course of U.S. history, the U.S. scheme relies solidly on regulatory authority, checks and balances, and confidence in the rugged individualism of American democracy. The prerequisite to enjoying the benefit of the tax exemption is objective and subjects to minimum level of discretionary review. Meanwhile, as an outcome-based set of measures, it enables the nonprofit sector to adapt to new economic developments and strike a continuous balance between external regulation and internal government.

Chapter VIII then suggests that the expansion of the nonprofit sector in the past decades has caused many problems in China's tax framework. Dubious of the suggestion of promulgating a comprehensive charity law, *Chapter VIII* does not yield any unrealistic idea of transplanting *all* valid and enabling values under the U.S. tax exemption system to China. The prime incentive of tax deduction has not been solidly rooted in the general public. There is a lack of stimulating push for the tax authorities and MCA to adopt a systematic responsive reform measures. However, some positive reforms especially on the tax exemption and tax deduction in the nonprofit sector are more implementable and manageable.

Chapter VIII contributes the following observations after comparing the tax treatment in the U.S. and China on nonprofit sectors. *First*, the public benefit or charity purpose of nonprofit organizations has not been coherently defined. This confusion predictably inhibits the development of the nonprofit sector by stalling interested corporate and individual donors from taking exemptions and tax deductions. *Second*, China has not set up an enforceable fiscal incentive system to promote charitable donations. The administrative procedure of obtaining a tax exemption certificate is arduous and discourages donors either to donate or withdraw from obtaining the certificate, which worsens the efforts to modernize the scheme. *Third*, there are still burdensome requirements for the application and registration of nonprofit organizations, such as dual management, high thresholds of capital endowment for foundations, and a prohibition on cross-regional development. *Fourth*, the administration and supervision of the internal management, human resources, and financial and accounting management of nonprofit organizations is very weak. China's complex administration system on the nonprofit sector, including the MCA, MOF, and SAT, mismanages fund raising, the appropriate usage of donations, and profit-making from donations. Corruption also became a major concern of the general public to make donations. *Fifth*, the determination of tax-exempt status and review of such status is *ad hoc* and different from locality to locality. Such irregularities, on the one hand, invite unethical manipulation of tax preferential policies, and create resistance to making donations through locally available venues.

Returning to a jurisprudential focus, *Chapter VIII* contributes a new methodology in terms of situating comparative law in the Chinese tax context. In this connection, this chapter holds that a comparative tax study relating to China might be better achieved by focusing on a “tax law sub-discipline” rather than on a specific tax concept. A western-originated tax concept might be too narrow to substantiate a comprehensive policy orientation, and it lacks full-range of expandability to scrutinize other subsidiaries of tax law. Moreover, the tax cultural traditions and social, political, and legal settings of a systematic tax governance framework should be included in tax comparativists’ theorizations. A tax study ultimately has to be conducted from a “big-picture” perspective in which a tax system is embedded. This chapter holds that a comprehensive tax transplant effort of valued ideas and practices, although it may seem bold and uncomfortable at the beginning, is what China needs to build up a robust nonprofit sector embracing broad visions rather than incremental, piecemeal reforms.

Chapter IX

Chapter IX concludes the whole thesis by reiterating a few remarks. First, this thesis aims to prepare a reasonable, handy and realistic foundation with which to evaluate the progress of the Chinese tax law reform. Second and pushing this goal further, this thesis tentatively submits – on the basis of debates on the rule of law and understanding of the WTO principles applicable to China – a tailored, pragmatic and practical set of proposals for the tax reform under China’s current legal infrastructure. The proposals are underpinned by instrumental notions of the

rule of law rhetoric, *inter alia*, generality, clarity, consistency, enforceability, stability, congruence, and substantive notions of judicial independence, human rights and the limitations of bureaucratic government with regard to the nonprofit sector.

Chapter II

An Overview of the Chinese Tax Law System

I. Introduction

Formed over decades of political, economic and social upheaval and strife, China's taxation system reflects its own political and economic experiences as much as its interactions with western, capitalist systems. Since its inception shortly after the founding of the People's Republic of China in late 1949, China's tax law system has experienced drastic and recurrent changes to adapt to new political-economic philosophies and to strengthen its revenue designation by way of steady incorporation of international tax norms. Evolving from a centralized, planned and closed "socialist economy" to a market driven, open economy and then to China's accession to WTO in 2001, China has gradually emerged as a market oriented economy. As such an equitable market framework for investments has taken shape, embracing a series of vigorous system restructurings completed after enormous foreign capital entered China upon implementation of the "reform and open door" policy in 1979. Moreover, the tax law system has intertwined with other laws contributing to the development of competent and

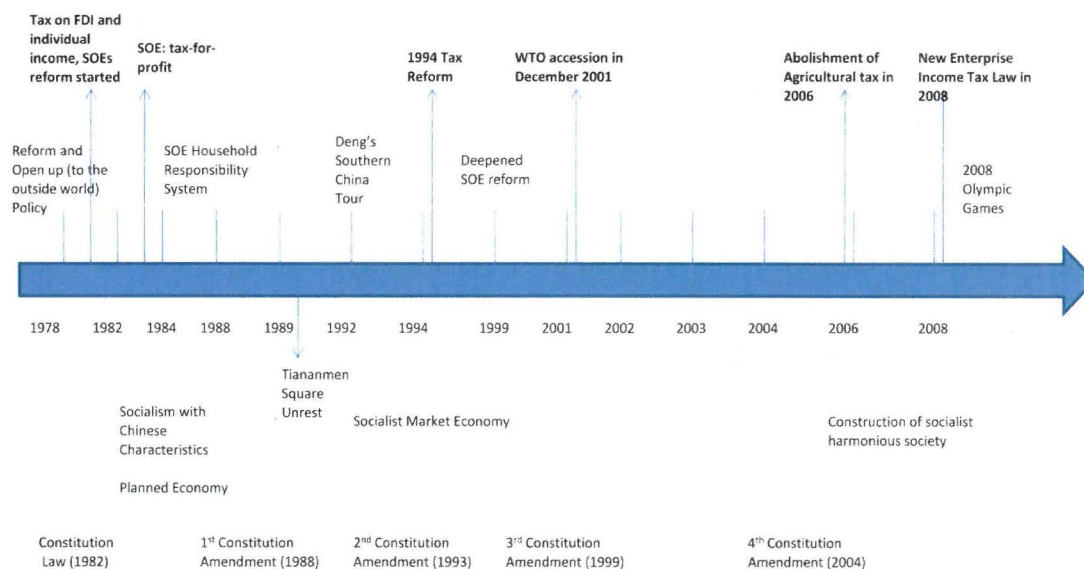
internalized legal institutions in China.

Tax laws and policies in China have been important instruments for Chinese government in realizing a two-pronged reform agenda: (1) reforming its domestic economic system with increased revenue and macroeconomic control, and (2) opening China up to outside world. Both of these prongs are commingled with political concerns of increasing social welfare, reducing income disparities and monitoring foreign investment. Tax law in China, as part of the macroeconomic regulatory system, plays an irreplaceable role in adjusting commercial activities of corporate and individual taxpayers. It is even said that Chinese tax law is the only area of Chinese law brought in line with and integrated into the international norms¹.

For instance, one of China's key tax policy objectives is to be internationally competitive. The Chinese government has adopted practical approaches to realize this goal. Particularly, China has designed tax rates that are competitive with those in neighboring Asian Countries, granting various tax incentives to promote investment in designated areas or industries. Tax incentives are used liberally, despite limited empirical research showing their direct effect on foreign direct investment in China.² Moreover, China has been strategically aggressive in contracting bilateral or multilateral tax treaties with trading partners to address foreign investors' concerns regarding double taxation. Chinese tax authorities are also receptive to international tax norms such as the arm's length principle, which serve foreign taxpayers.

¹ See generally, Jinyan Li, *The Rise and Fall of Chinese Tax Incentives and Implications for International Tax Debates*, 8 Fla. Tax Rev. 669 [Hereinafter *Rise and Fall*]

² *Id.*, at 670



(Figure 13)

This chapter aims to examine briefly the evolution of the Chinese tax law system and structures shaped by China's socio-economic forces, fiscal and governmental reforms, administrative reforms, fiscal decentralization, and WTO accession.³

³ For an overview of China's taxation system since the WTO accession, see Li *supra* 1; See Xu Shanda *Zhongguo Shuiquan Yanjiu [China Tax Jurisdiction Research]* (China Taxation Press, 2004) (Xu was the ex-Vice-Governor of the SAT). For an overview of the early China's taxation on foreign investors, see Michael J. Moser & Winston K. Zee, *China Tax Guide* 105-06 (2nd ed., 1993). For tax changes since the 1990s, see Jiang, *infra* 4; Stephen C. Curley & Darren R. Fortunato, *Tax Considerations for Investors in China*, 20 N.C. J. Int'l L. & Com. Reg. 531 (1995); Jeri C. Weber, Note, *Foreign Investment in the People's Republic of China: Tax Law Attempts to Provide Incentives*, 46 Tax Law. 275-93 (1992); Gerald A. Wunsch & Dingfa Liu, *Recent Chinese Tax Legislation Affecting Foreign Investment in China*, 2 Ind. Int'l L. & Comp. L. Rev. 415 (1992); Allison E. Wielobob, Note, *China's Choice: Tax Incentives to Fund Economic Development*, 9 Temple Int'l & Comp. L.J. 413 (1995). For the development of the tax regime governing foreign investment during the 1980s, see, e.g., Jinyan Li, *Taxation in the People's Republic of China*, Praeger, New York (1991); A.J. Easson & Li Jinyan, *Taxation of Foreign Investment in the People's Republic of China* (1989); Alex Easson & Li Jinyan, *Taxation of Foreign Business and Investment in the People's Republic of China*, 7 Nw. J. Int'l L. & Bus. 666 (1985), Richard D. Pomp et al., *The Evolving Tax System of the People's Republic of China*, 16 Tex. Int'l L. J. 11, 16-40 (1981); Paul D. Reynolds, *Doing Business with the People's Republic of China: Tax Consideration*, 14 Int'l L. 49 (1980). For tax enactments on foreign investment in the early 1980s, see William P. Alford & David E. Birenbaum, *Ventures in the China Trade: An Analysis of China's Emerging Legal Framework for the Regulation of Foreign Investment*, 3 Nw. J. Int'l. & Bus. 56 (1981); Carl A. Nordberg, Jr. & Irene Price, *The Income Tax Law of the People's Republic of China Concerning Foreign Enterprises*, in *Legal Aspects of Doing Business in China* 191 (Practising Law Institute 1983); Don R. Castleman, *Taxation in the People's Republic of China: The System and Its Function*, 46 Albany L. Rev. 776 (1982); David R. Simon, Note, *Taxation of*

This will provide a concise description of the specific economic, political, social, and cultural factors impacting the evolution of China's tax system after WTO accession. Subchapter II briefly explains China's tax law system development since 1949 in four broad stages: the pre-1978 period (1949-1978), the economic reform period (1979-1993), the market economy period (1993-2000), and the post-WTO accession period (2001-present). Subchapter III discusses social and economic policy orientations that affect the development of China's tax law system. Subchapter IV outlines the framework of China's tax law system. Subchapter V discusses the fiscal decentralization reform for the past three decades and outlines directions for possible reforms in tax administration, especially with regard to how to improve efficiency and fairness. Subchapter VI concludes briefly.

II. Historical Development of the PRC Tax Laws

Right after the Communist Party of China assumed governance of mainland China, taxes were imposed and collected to regulate the economy and rebuild the fragmented country. The reform and restructuring of China's tax system can be broadly divided into four stages: the pre-1978 period (1949-1978), the post-open-

Joint Ventures in the People's Republic of China: A Legal Analysis in the Context of Current Chinese Economic and Political Conditions, 15 Vand. J. Trans'l L. 513 (1982); Anna M. Han, *People's Republic of China's Foreign Enterprises Income Tax Law and Regulations*, 6 Hastings Int'l & Comp. L. Rev. 689 (1983). Timothy A. Gelatt & Richard D. Pomp, *China's Tax System: An Overview and Transactional Analysis*, in *Foreign Trade, Investment, and The Law in the People's Republic of China* 42 (Michael J. Moser ed., 1987); James W. Harrison, *Tax Aspects of Doing Business in the People's Republic of China - A Comparative Summary for U.S. Investors*, 5 Fla. Int'l L.J. 381 (1990)

door period (1979-1993), the market economy period (1994-2000), and the post-WTO accession period (2001-present).

2.1. Pre-1978

For historical and political reasons, the pre-1978 tax law system had developed through political turmoil, economic mismanagement, and stagnation of popular living standards that marked China's Soviet economy as interpreted by Mao.⁴ Ideological debates and a ponderous copy of the Soviet Union's industrial structure made the taxation system a tool for class struggle and political control.⁵ Political interference during this period twisted and deprived the taxation system from developing according to modern theories of public finance and legal articulation. Taxation was "a vestige of capitalism destined from oblivion"⁶ and

⁴ See Zhaodong Jiang, *China's Tax Preferences to Foreign Investment: Policy, Culture and Modern Concepts*, 18 Nw. J. Int'l L. & Bus. 549 (1998), at 559 [hereinafter Jiang: China's Tax Preferences to FDI]; see, e.g., Thomas J. Klitgaard & Mayre Rasmussen, *Preferential Treatment for Foreign Investment in the People's Republic of China: Special Economic Zones and Industrial Development Districts*, 7 Hastings Int'l & Comp. L. Rev. 377, 384-90 (1984) (noting that various preferential measures as investment incentives). For a general discussion of Chinese measures intended to attract foreign capital in the 1980s, see Jerome Alan Cohen & Stuart Valentine, *Foreign Direct Investment in the People's Republic of China: Progress, Problems and Proposals*, 1 J. Chinese L. 161, 169-78 (1987)

⁵ This understanding is strengthened by Professor Whitmore Gray at the University of Michigan Law School, noting that China mostly follow Soviet Union's model for codification of important laws and such heritage still plays a huge part in jurisprudential research settings) (discussion notes on file with the author); See also Walter Gellhorn, *China's Quest for Legal Modernity*, 1 J. Chinese L. 1, 6 (1987) (observing that China has relied heavily upon Soviet Union for content of law, and training of judges, lawyers and legal staffs). for discussions in Chinese, See generally, He Qinhu, *Reexaminations of China's Transplantation of Soviet Union Legal System [Guanyu Xinzhongguo Yizhi Sulian Sifa Zhidu de Fansi]*, 2008) (何勤华《关于新中国移植苏联司法制度的反思》2008) <http://www.china-review.com/sao.asp?id=2836> (last visited on March 15, 2011)

⁶ From 1950 to 1997, China's flagship newspaper The People's Daily in total used the term "a vestige of capitalism destined from oblivion" for around 400 times. The usage of this term had two goals (1) strengthening the ruling of CCP and (2) discussing which direction that China's development may occupy. At the beginning, tax was specifically referred to as a "vestige". See, *How the History Gets Rid of the Vestige of Capitalism Destined from Oblivion [Cong Renmin*

was therefore used to depress industry and commerce held by private ownership. China's economy during this period hardly had any tie with the rest of the world and operation of foreign entities was rare.⁷ Tax laws were domestically oriented, applying to domestic and local enterprise, which induced a simplification of the tax regime to build up and implement a centrally planned socialist economy. Under the then existing socialist system of State Administration of Income and Expense, in all State-owned enterprises (SOEs) the government retained all earned profits (after reserving employee welfare), and then received governmental subsidies for operation and production. Most of the taxes during this time were levies on natural resources and in particular on individual wealth and consumption.⁸

2.1.1. The Foundation of the Socialist System 1949-1952

Right after the foundation of the PRC, the CCP faced a fragmented, or vacant, fiscal system left over from the KMT government, where the poorly functioning central government had to a significant extent lost control over localities, and the big bureaucratic capitalists and landlord classes levied taxes in their local jurisdictions. Therefore, in order to finance and solidify its ruling, the CCP had to design a tax system to unify localities and centralize fiscal control. To affect this the Chinese central government promulgated the Major Rules Implementing the

Ribao Kan Lishi Shi Zhenyang Gediao Ziben Zhuyi Weibade (《从<人民日报>看历史是怎样“割资本主义尾巴”的?》), China's leftists website <http://www.maoflag.net/?action-viewthread-tid-291762> (last visited on March 15, 2011)

⁷ See Li, Rise and Fall, *supra* 1 at 670

⁸ See Jiang *supra* 4 at 560

National Taxation System by the Government Administration Council in 1950, listing 14 types of taxes to be collected nationwide.⁹ They then adopted a uniform agricultural tax in March 1951 to protect farmers from exploitation by landlords. In the early 1950s, almost half of the Chinese government's revenue was generated through taxes.

2.1.2. Socialist Transformation (1953-1957)

China's first Five-Year Plan (1953-1957) was successful in achieving a Socialist social, political, and economic transformation. Capitalists were either asked to surrender their assets to State treasury or were forced to jointly operate their businesses with central or local governments as minority shareholders. Farmers were put together to form cooperatives or communes giving their surpluses to the government. Following the Soviet Union socialist model, taxation did more than simply generate state revenue to finance socialist industrialization, but also served as a class struggle tool to eradicate the exploitative class. During this period, state-owned enterprises were exempt from taxes, but recalcitrant private enterprises were squeezed through high income taxes to accept the CCP's ruling and reorder themselves to follow the larger transformation.¹⁰ As the Chinese government adopted a socialist transformation of ownership towards the end of the first five-year plan in 1953, taxation was used as a weapon to restrict capitalistic industry and commerce and transform them into socialistic or semi-

⁹ These 14 taxes are industrial and commercial enterprises tax, transaction tax, salaries tax, land tax, building tax, slaughter tax, salt tax, interest tax, inheritance tax, stamp duty, special excise tax, customs duties, commodity tax and vehicle license tax. For a general review of taxation over this period, see Jinyan Li, *Taxation in the People's Republic of China*, Praeger, New York (1991), at 25 *supra* 3

¹⁰ *Id.*, Li *supra* 1

socialist units and private enterprise were taxed more than SOEs.”¹¹ By 1956, private ownership of means of production was basically eliminated and SOEs were revitalized and supported as the dominant force of the socialist economy. A major change, enterprise income tax for the SOEs, was also introduced at this time. Under the established enterprise bonus system, SOEs could retain a portion of their surplus if there was excess production, or if their sales exceeded their target levels.¹² The retained surplus would be transferred to a bonus fund to pay for bonuses to workers or for improvements of the cultural and living conditions for all workers. SOEs were responsible for almost all aspects of their workers’ welfare, housing, medical treatment, education, and retirement, etc.¹³

2.1.3. Further Simplification of Taxation System (1958-1966)

After the socialist transformation, the CCP firmly controlled the political, social and economic status of the nation.¹⁴ Tax laws and policies started playing a diminished role in the centrally planned economic order.¹⁵ First, all earnings generated by SOEs belonged to the state treasury and private enterprises could only serve as distributors or agents of SOE products. Second, due to the simplification of economic activity and actors, the industrial and commercial tax was levied as the only major turnover tax, and industrial and commercial income tax was the only income tax in the modern sense. Such major taxes were simplified and consolidated as evidence of the success and totality of socialist

¹¹ See Wang Yanlai, *China's economic development and democratization* (Ashgate, 2003) at 87-89

¹² See generally, Li, *supra* 1

¹³ *Id.*

¹⁴ See Wang *supra* 11 at 63-65

¹⁵ *Id.*

transformation. In fact, as a result of the failure of the Great Leap Forward movement (late 1950s)¹⁶ and the Great Famine (early 1960s),¹⁷ tax revenues alone could not finance and support state operations, and the tax administration system stalled. Therefore, although the national taxation system was nominally retained, it was not an effective institution during this period. When China entered its second five-year plan in 1958, most taxpayers were SOEs and the emphasis of 1958 reforms were influenced by the Soviet “tax less” concept.¹⁸ Tax law was further simplified so that enterprises had to pay as few types of taxes as possible. The Consolidated Industrial and Commercial Tax (CICT) was introduced to combine all turnover taxes, and enterprise income tax was imposed for the first time. However, the enterprise bonus system that was applicable to the SOEs remained, as retained profits of the SOEs had increased significantly. The bonus system was retained until its replacement by the profit-contracting system under which the SOEs could hand over a pre-determined proportion of the surplus and retain the balance.

2.1.4. Cultural Revolution (1966-1976)

Rampant political turmoil and a stagnant economy meant that the Cultural Revolution period hardly witnessed any new promulgation of tax law except the

¹⁶ *Id.*, at 67-69

¹⁷ *Id.*, at 71

¹⁸ Following the period of reconstruction, the phase of socialist transformation (1953-1956) is perhaps best characterized by the consistency with which the majority of the CCP leadership subscribed to those norms. Borrowing from the Soviet Union was also reflected in the extent of practical Russian participation in the form of financial aid and scientific and technological guidance. *See, e.g.,* Roy W. Bahl, Jr., *Fiscal Policy in China: Taxation and Intergovernmental Fiscal Relations* (The 1990 Institute and the University of Michigan Press, 1999), *see also* M. Bakes, *Tax Reform in Central and Eastern Europe*, *Australian Tax Forum* 8(1) 117-128 (1991)

Draft Regulations on the Consolidated Industrial and Commercial Tax, enacted in 1972,¹⁹ which had a special political purpose of strengthening the military and machinery industries. Other than this small piece of tax law, the administration, collection, and adjudication the taxation system all collapsed with the downturn of social and economic order. After the “Gang of Four”²⁰ was removed from the political arena, the Chinese government reorganized the Ministry of Finance to coordinate all taxation related matters nationwide.²¹

During the early period of the Cultural Revolution (1966-1970), reflecting the increasingly negative perception of modern economic organizations as symbols of Western capitalism, China’s tax law system was again simplified in the 1973 reform by consolidating different types of taxes, reducing taxable items and tax rates, and unifying the obsolete tax collection system. The Industrial and Commercial Tax (ICT), a turnover tax, generated a major portion of the total revenue during this period.²²

Although the tax law was revamped repeatedly and played a definite role in China’s economic development before 1978, all such restructuring functioned to simplify the tax law system, streamline the socialist economy, consolidate similar taxes, reduce number of taxes and tax rates, and most importantly, to safeguard and build up a socialized economy deeply rooted in political and class struggle. Tax laws and policies, played an auxiliary and insignificant role in the financing of government and development of the socialist economy.

¹⁹ See Li *supra* 3

²⁰ See generally, William Brugger, *China Since the Gang of Four* (Croom Helm,1980)

²¹ See *History of Ministry of Finance of the PRC*, <http://www.mof.gov.cn> (last visited on March 15, 2011)

²² See, e.g., Li *supra* 3

2.2. The Economic Reform Period 1978-1992

After nearly three decades of political strife and socialist, central economic planning, China encountered serious image problems due to its previous policies and political polarity. In the early years of implementing reform and “openness” policy, Deng Xiaoping’ leadership in China sensed the gravity of crisis the country faced: a stagnant economy, very low living standards, and increasing mismanagement by the government.²³ Deng launched enormous construction plans to accelerate the country’s development. While such efforts turned out to be too ambitious in their first attempt, as indicated by the period of retrenchment that followed, the mentality of pursuing fast economic development persisted and was later translated into various reform programs including tax law and policy. China’s economic underdevelopment and poor technological infrastructure were an impetus for the openness policy, which aimed to improve conditions for foreign investment and reassert central control over localities. Preferential tax treatment, as a result, was considered vital to attracting foreign capital and technology. “Foreign taxation” (*Shewai Shuiwu*) became a specialized branch of state tax authority with the main objective of promoting foreign investment.²⁴

²³ This thesis benefits from Professor Jiang’s review of China’s tax regime since the 1980s. See generally Jiang, *supra* 4, at 561 and accompanying footnotes, presenting that, despite heroic investment rates and rapid growth since the late 1950s, the Chinese people’s living standards were still lagging because of stagnant productivity; see also e.g., Carl Riskin, *China’s Political Economy: The Quest for Development Since 1949* 261-66 (1987); Robert F. Dernberger, *The Chinese Search for the Path of Self-Sustained Growth in the 1980s: An Assessment, in China Under The Four Modernizations Part I* 19, 20-27 (Joint Economic Committee Congress of the United States ed., 1982), from which Jiang drew his notion

²⁴ See Jiang *supra* 4 at 562, discussing the adoption of foreign taxation to promote foreign investment; see, e.g., Niu Licheng et al., *Zhongguo Shuishou Zhinan [China Tax Guide]* 158 (1990)

A prominent attribute of China's legal system throughout this period was the different treatment under law for purely Chinese commercial activities and those transactions involving foreign interests.²⁵ Rather than promulgating a new package of income tax rules to govern foreign direct investment, however, the Equity Joint Venture Law (EJVL), promulgated in 1979, created preferential tax treatment for investments involving foreign actors.²⁶ Just as corrective rates under the ICIT were the legacy of policies that reflected past hostility toward foreign and private capital, the claimed preferential tax treatment in this first foreign investment legislation since 1949 was a milestone suggesting a favorable policy change. As confirmed by its implementation, the very word *youhui*, meaning preference, conveyed an encouraging signal. "Low tax burden, expansive preferences and high competitiveness" soon dominated official statements meant to convey the perception of a friendly and accommodating environment for foreign investment.²⁷ The Chinese government spent "a great deal of time and effort propagating new tax preference"²⁸ provisions overseas, not only for attracting investment, but also to send a strong message to the outside world of

(discussing China set up a separate foreign taxation branch for the opening-up policy); Du Mengkun, *Zhongguo Shehui Zhuyi Shuishou Jingji Lilun Yu Shijian [The Theory and Practice of China's Socialist Taxation and Economy]* 187 (1989) (emphasizing that the role of foreign taxation in the implementation of the opening up policy must not be underestimated)

²⁵ see *infra* Chapter III

²⁶ On July 1, 1979, the Chinese legislature adopted the Law on Chinese-Foreign Joint Ventures (P.R.C.), which permitted private foreign capital investment in Mainland China. See Zhonghua Renmin Gongheguo Zhong Wai Hezi Jingying Qiye Fa [*the Equity Joint Venture Law of the PRC*][hereinafter Equity Joint Venture Law or EJV Law]. Article 7 of the EJV Law stipulated tax reductions and exemptions for joint ventures using advanced technology by world standards as well as tax refunds for reinvestment of joint venture profits. Flexible approaches had been taken by the Chinese prior to the adoption of the JVITL, including the reduction of foreign investors' tax burden through contractual arrangements between the Chinese government and individual foreign interests.

²⁷ See Art. 7 EJV Law

²⁸ See Jiang *supra* 4, at 604 and accompany footnotes

China's intention to improve its economic development. "Widespread dissemination of preferential rules was viewed as necessary to the success to the promotion and execution of foreign investment projects."²⁹ Various preferential tax schemes were then set up over the next several years. Some supposedly applied nationwide and others were available only to those foreign investors settled in designated areas³⁰ with additional industry-specific fiscal benefits. Moreover, the government handed out special concessions that promoted investment projects by Overseas Chinese.³¹ With overlapping and sometimes inconsistent regimes, foreign taxation in general and tax preferences in particular looked so complicated and confusing that a prominent commentator at the time stated "calculating which tax provisions provide any single enterprise or investment possibility the most favorable treatment has become a considerable burden, and expense, for foreign investors."³²

In addition to the very significant changes on reforming tax law to cater to foreign investment, there are two additional revenue crisis concerns that forced the Chinese government to adopt a modern tax system to raise revenues and balance development. The first was the burgeoning of private economies after the early 1980s. The second, probably more significant, was the corporatization of SOEs. The previous model of submission of all profits to the state treasury – the primary

²⁹ *Id.*

³⁰ *Id.*, at 567

³¹ *Id.*, at 586, Professor Jiang specifically discussed how the factor of overseas Chinese influence the local tax incentives especially in designated special economic zones

³² See generally, James V. Feinerman, *Chinese Law Relating to Foreign Investment and Trade: The Decade of Reform in Retrospect*, in *China's Economic Dilemmas in the 1990s: The Problems of Reforms, Modernization, and Interdependence* 828, 832 (Joint Economic Committee, Congress of the United States ed., 1991), quoted by Jiang *supra* 4 at 562

source of state revenue – was denounced as leaders of SOEs sought to retain larger shares of profits for their own business expansion and modernization.

2.2.1. Foreign investment related tax law³³

The Equity Joint Venture Law (EJVL) promulgated in 1979 promised income tax preferences in two ways. EJVs were eligible for a reduction of or an exemption from their income tax for the first two to three profit-making years if they had advanced technology by world standard.³⁴ A foreign joint venture could apply for a refund of a portion of the income tax paid if it reinvested its net profit in China. The Joint Venture Income Tax Law (JVITL),³⁵ instituted an enterprise income tax for EJVs, in addition to providing normative rules and a regulatory framework for tax administration, the legislation included a number of tax preference measures.³⁶ Although the JVITL imposed an attractive nominal thirty-three percent tax rate before any preferential measure is adopted, in practice, due to many tax incentives and exemption offered to foreign investment, the actual tax rate was around

³³ For detailed description on development of China's foreign investment related tax laws, see Jiang *supra* 4, at 563-567; see generally, Li: *Rise and Fall*, *supra* 1; Gerald A. Wunsch & Dingfa Liu, *Recent Chinese Tax Legislation Affecting Foreign Investment in China*, 2 *Ind. Int'l L. & Comp. L. Rev.* 415 (1992); Allison E. Wielobob, Note, *China's Choice: Tax Incentives to Fund Economic Development*, 9 *Temple Int'l & Comp. L.J.* 413 (1995) at 415-418

³⁴ Art. 7 of EJV Law

³⁵ For discussion about JVITL, See generally Li, Harrison and Pomp, *supra* 3

³⁶ See Jiang *supra* 4, at 563-564, and Li: *Rise and Fall*, *supra* 1, at 671-679, for example, (1) newly established EJVs could apply for an exemption from income tax in the first profit-making year and a fifty percent reduction of income tax in the second and third years, provided that they were scheduled to operate for at least ten years; (2) following the expiration of this initial exemption and reduction, EJVs engaged in relatively low-profit sectors like farming and forestry or established in remote and economically underdeveloped regions were eligible for fifteen to thirty percent income tax reduction for ten more years, subject to the approval of the Ministry of Finance; (3) joint venture enterprises that reinvested their shares of profit in China for a period of at least five years could obtain, upon approval, a refund of forty percent of the income tax paid on the reinvested funds; (4) two provisions for computing the taxable income of EJVs were characterized as "preferential," including the use of accelerated depreciation of fixed assets in special circumstances upon approval, and the carry-over of losses to offset profits for five years

twenty-five percent rather than the nominal rate of thirty-three percent.³⁷

By promulgating The Income Tax Law of the People's Republic of China Concerning Foreign Enterprises³⁸ (hereinafter FEITL) in December 1981, Chinese government sets up a separate income tax to echo foreign investors who chose the investment form of wholly-owned foreign enterprise (WFOE) and Sino-foreign contractual joint venture (CJV). The FEITL offered fewer preferences to foreign enterprises than the JVITL does towards EJVs³⁹ and the tax on the income of a "foreign enterprise" was computed on a progressive rate schedule with five brackets⁴⁰.

A significant move forward unifying enterprise taxation in China came a decade

³⁷ See Li: Rise and Fall *supra* 1, at 675, noting that thirty percent plus an additional three percent local surcharge, and this rate is said to be designed because corporate income tax rates were around fifty percent in most developed countries and between thirty-five and forty percent in many developing countries

³⁸ *The Implementing Rules for Income Tax Law of the China Concerning Foreign Enterprises* was promulgated by the Ministry of Finance and became effective as of January 1, 1982. See Jiang *supra* 4, at 565, presenting that "Foreign Enterprises" are distinct from "foreign-invested enterprises" (FIEs) in the following ways: FIEs include Sino-foreign cooperative (contractual) joint ventures ("CJVs"), Sino-foreign Equity Joint Ventures ("EJVs"), and Wholly Foreign-owned Enterprises ("WFOEs"), all of which are characterized as having some form of physical presence inside China, whether it be production nor service oriented, but more importantly possess domestic legal person status. A foreign enterprise, on the other hand, may have a permanent establishment within China territory engaged in production or other business operations, or otherwise may derive income from sources inside the China without such an establishment; see also Li: Rise and Fall, *supra* 1, at 672-675

³⁹ See Jiang *supra* 4, at 566-569, briefing that (1) there was no general income tax exemption or reduction for newly established foreign enterprises; (2) only foreign enterprises engaged in farming, forestry, husbandry or other low-profit operations and scheduled to operate for ten years or more could apply for an exemption in the first profit-making year and a fifty percent reduction in the following two years. A fifteen to thirty percent reduction in income tax for another ten years could be available after the expiration of the foregoing exemption and reduction, subject to the approval of the Ministry of Finance; (3) unlike EJVs, foreign enterprises received no tax benefits under the FEITL for reinvesting their profits in China; (4) in computing taxable income, foreign enterprises like EJVs could carry forward losses for five years; (5) foreign enterprises could also use accelerated methods of depreciation of fixed assets, provided that the operation did not involve exploitation of offshore petroleum or other natural resources and subject to the approval by the Ministry of Finance; (6) foreign enterprises with small-scale production and low profit, provincial governments may waive or reduce local income tax to promote investment

⁴⁰ See Arts. 3 and 4, FEITL, the thresholds range from twenty percent for the annual income of up to RMB 250,000, to forty percent for the annual income exceeding RMB 1 million, and an additional ten percent local tax was levied on the taxable income

later, with the promulgation of the China Foreign-Invested Enterprises and Foreign Enterprises Income Tax Law⁴¹ (the FIE Income Tax Law) on April 9, 1991, which replaced the JVITL and FEITL⁴² and no longer distinguished based on the investment vehicle chosen.⁴³ The FIE Income Tax Law liberalized tax preference rules and practice. As a result of the FIETL's official sanctioning of various previously promulgated State Council regulations,⁴⁴ the two-year tax exemption and three-year tax reduction are available to productive WFOEs and CJVs,⁴⁵ which was previously offered to EJV's exclusively. The FIE Income Tax Law adopts a thirty percent flat rate to all FIEs, plus a three percent local surtax,⁴⁶ combining to effectuate a nominal rate of thirty-three percent in total. FIEs engaged in productive sectors and scheduled to operate for ten years or more are entitled to a two-year tax exemption, after they make a profit, followed by a three-year, fifty percent reduction.⁴⁷ FIEs engaged in agriculture, forestry, or husbandry, or those FIEs located in economically underdeveloped, remote regions

⁴¹ Zhonghua Renmin Gongheguo Waishang Touzi Qiye He Waiguo Qiye Suode Shui Fa [*Income Tax Law of the People's Republic of China Concerning Foreign Investment Enterprises and Foreign Enterprises*]

⁴² "Foreign investment enterprises" generally refers to EJV's, CJVs and WFOEs, see Jiang *supra* 4, at 565-566 and accompanying footnotes; see also generally, Li: Rise and Fall, *supra* 1; Gerald A. Wunsch & Dingfa Liu, *supra* 3; Allison E. Wielobob, *supra* 3, at 415-418

⁴³ see generally, Li: Rise and Fall, *supra* 1, discussing that "foreign enterprises" are divided into two categories: foreign companies and business entities that set up an establishment in China and those maintaining no establishment in China, but having earned an income with a source in China

⁴⁴ See Arts. 7-9, FIE Income Tax Law of the P.R.C.; see also Art. 68-75, Zhonghua Renmin Gongheguo Waishang Touzi Qiye he Waiguo Qiye Suodeshui Fa Shishi Xize [*Detailed Rules on the Implementation of the Income Tax Law of the People's Republic of China Concerning Foreign-investment Enterprises and Foreign-owned Enterprises*][hereinafter, Detailed FIE Income Tax Implementation Rules] which authorize provincial governments can waive or cut down local surtax for all kinds of FIEs in designated industries or sectors, not just for small scale and low profit foreign enterprises as under the FEITL

⁴⁵ Arts. 7-9, FIE Income Tax Law of the P.R.C.

⁴⁶ *Id.*, Art. 10

⁴⁷ Art. 8, FIE Income Tax Law of the P.R.C., but the tax holidays are not available, however, to petroleum, natural gas, rare metal, and precious metal exploitation projects, which are governed by separate government regulations; see Jiang *supra* 4, at 565 and accompanying footnotes; see generally, Li: Rise and Fall, *supra* 1; Allison E. Wielobob, *supra* 3, at 415-418

may obtain, upon application and approval, another fifteen to thirty percent reduction in income tax for ten more years after the expiration of such exemption and reduction.⁴⁸ The new regime retains provisions permitting carrying forward of losses⁴⁹ and the use of accelerated methods of depreciation.⁵⁰ While the JVITL allowed only EJVs to apply for the forty percent refund of the tax paid on the portion of any reinvested profit, the FIE Income Tax Law extends eligibility of this refund to all FIEs.⁵¹ The FIE Income Tax Law also raises the amount of deduction for business entertainment expenses⁵² and permits businesses to write off bad debts.⁵³ One change that adversely affects foreign investors is the revocation of tax holidays that the JVITL granted to EJVs engaged in non-productive and service sectors.⁵⁴ Pre-1991 EJVs may still retain JVITL tax holidays, until the end of the term of their joint venture contracts.⁵⁵

2.2.2. Domestic enterprise income tax law

Changes were also made over this period (1979-1993) to the taxation of Chinese domestic enterprises (DEs),⁵⁶ especially SOEs, which are divided into two groups: large and medium scale charged at a 55 percent tax rate, and small scale charged at an eight-step progressive rate (ranging from 10 percent to 55 percent). The

⁴⁸ Art. 8, FIE Income Tax Law of the P.R.C.

⁴⁹ *Id.*, Art. 11

⁵⁰ Arts. 34 and 40, Detailed FIE Income Tax Implementation Rules, *supra* 44

⁵¹ Arts. 8, 10 and 19(1), FIE Income Tax Law of the P.R.C., approving that qualified FIEs are automatically granted the two-year exemption and three-year fifty percent reduction without any prior application and approval, and profits received by foreign investors from FIEs are tax exempt

⁵² Art. 22, Detailed FIE Income Tax Implementation Rules, *supra* 44

⁵³ *Id.*, Art. 25

⁵⁴ See Jiang *supra* 4, at 567

⁵⁵ Art. 40, FIE Income Tax Law of the P.R.C.

⁵⁶ Another key aspect of China's tax reform during this period of time is the restructuring of separate income tax regimes governing domestically-owned enterprises; see generally Li, *supra* 3 and Jiang *supra* 4, at 567

1983 tax-profit substitution system introduced the State-owned Enterprise Income Tax (SOEIT) (effective from 1984), which subjected SOEs taxes on their profits, and replaced the then existing profit-contracting system.⁵⁷ However, the profit-sharing mechanism under the previous profit-contracting system⁵⁸ remained under the SOEIT as the central government's share of the after-tax profits from the SOEs. Furthermore, a regulatory tax, known as the State-owned Enterprise Income Regulatory Tax (SOEIRT), was imposed on the after-tax profits of the SOEs. The amount of tax was determined on a negotiated basis between the SOEs and the central government. In this sense, both the SOEIT and SOEIRT were taxes which were not based on taxing actual profits but a set of redesigned implementation schemes based on the previous profit-contracting system. In the case of non-SOEs which took three forms of ownership, namely, collective, private, and individual,⁵⁹ three different sets of taxation rules were promulgated to replace the previous ICIT.⁶⁰

Until 1984, all enterprises operating in the China were subject to a turnover tax known as the Industrial and Commercial Tax (ICT). In 1984, domestic turnover tax reform was launched and the ICT was replaced by four separate taxes, namely, Product Tax (PT), Business Tax (BT), and Resource Tax (RT) and a

⁵⁷ See generally in Jinyan Li, *China's Tax System: An Evaluation*, 17 Denv. J. Int'l L. & Pol'y 527 (1989)

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.* related rules include but not limited to *Provisional Rules for the Collective Enterprise Income Tax (CEITL)* (enacted in April 1985), *Provisional Rules for the Individual Industrial and Commercial Households Income Tax (IICHITL)* (enacted in January 1986); and *Provisional Rules for the Private Enterprise Income Tax (PEITL)* (enacted in June 1988). The IICHITL applied to the profits of individually owned domestic enterprises and hence was a quasi-personal income tax. The CEITL and PEITL applied to the business profits of collectively or privately owned domestic enterprises and hence a quasi-enterprise income tax

“trial” Value Added Tax (VAT). The trial VAT, however, was different in nature than a modern conception of VAT; instead it served as a sales tax at a twenty-four percent rate on select items.⁶¹ However, foreign enterprises continued to be subject to the ICT, which was once again renamed as the Consolidated Industrial and Commercial Tax (CICT) in 1984.⁶² Over this period (1979-1992), the tax system went through several phases characterized by many new, scattered, inconsistent and constantly changing taxes such as the VAT, PT, BT (for domestic entities) and ICT (for foreign entities), generating the major portion of the total revenue.

2.2.3. Individual income tax law

The Chinese government introduced the concept of personal income tax soon after 1979⁶³ to accommodate the disparity of income and foreign individuals working in China,⁶⁴ therefore, the Ministry of Finance adopted the Individual Income Tax Law on September 10, 1980 while the targeted subjects were mostly foreign taxpayers with high incomes⁶⁵. As of 1986, Chinese citizens were subject to income tax under the Individual Income Regulatory Tax Law (IIRTL)⁶⁶ and

⁶¹ See generally 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)

⁶² *Id.*

⁶³ See Jinyan Li, *China's Individual Income Tax – A 26 Years Old Infant*, *Tax Notes Int'l*, July 24, 2006, 297

⁶⁴ One important reason for doing so was that many individuals, including domestic Chinese citizens, built up their income and wealth following the adoption of “open door” policy in China. Starting with the IITL in 1980, a personal income tax was levied on income earned by foreign individuals working in the China

⁶⁵ Foreign citizens in China are subject to Individual Income Tax Law of the PRC

⁶⁶ Chinese citizens are subject to Individual Income Regulatory Tax Law of the P.R.C. (IIRTL) (《中华人民共和国个人收入调节税暂行条例》)

most private Chinese enterprises are subject to a different income tax.⁶⁷

Without a doubt, such classification is based on three legal complications creating many problems in enforcement and administration. First, the definitions of citizen and residency requirement are far from clear. There are many Chinese entrepreneurs who earned a salary comparable to foreign entrepreneurs but were still subject to the lower citizen tax rate. Foreign taxpayers also usually stayed in China for a quite short period of time. The residency requirement also lacked instructions for dealing with common situations such as temporary absences, business domiciles, and management centers. Second, due to administrative deficiencies, these laws were not applied consistently across different regions. Even in the same local tax jurisdiction, there were various approvals or special treatments applicable to different taxpayers. Finally the local tax administration had to set up three or more auditing teams for the collection of taxes given different treatments and various tax rates applied, and this creates huge administrative resource waste and irregularities. Therefore, a consolidated individual income tax law was passed in October 1993 according to the NPC's Decision on the Amendment of the Individual Income Tax Law.

Overall, individual income tax laws and regulations experienced a process of differentiation and consolidation, to achieve the goal of standardization of the individual income tax laws. However, given rapid economic development and improvement of individual income, many problems arising were suitably handled by the consolidated IIT Law, even as the old challenges of opaque

⁶⁷Chinese private entrepreneurs and sole-proprietorships are subject to the Entrepreneurs and Sole-Proprietorship Tax Law of the P.R.C.(《中华人民共和国城乡个体工商户所得税暂行条例》)

implementation and discretionary administration remained.

2.3. 1994 Tax Reform

In terms of tax policy, the 1994 tax law reform continues the Chinese tax system's most important joint objectives: raising revenue and stimulating the economy by encouraging exports and FDI. In comparison with the uncoordinated and inconstant changes made in the previous fifteen years, the 1994 tax law and policy designed a better synchronized system with determinative plans. A standardized revenue-sharing scheme was established and implemented in large part to adjust and balance the twisted and inconsistent relationship between the central and provincial government. This decentralization effort coincided with the most dynamic stage of SOE reform, which pushed SOEs to competitiveness through "true" market participation and resulted in millions of layoffs.

In addition, there were two phases of changes during this period reflecting China's shift to a market economy system: (1) the unification and modernization of accounting standards to determine the base for indirect tax and income tax; and (2) the comprehensive overhaul of the indirect tax laws and regulations and rudimentary tax administration echoing the tax revenue-sharing regime. At first glance, the changes appear to have emerged to modernize China's fiscal and economic system to a market economy driven model. However, tax equity and tax neutrality were still less emphasized than the economic benefits generated by these tax policy changes.

The objectives of the 1994 tax reform were to unify the tax laws or rules, to spread the tax burden more equitably, to simplify the tax system, and to share the

tax levying power more reasonably between the central and local government. The tax reforms brought changes in the areas of turnover taxes, personal income tax for all individuals, and Enterprise Income Tax (EIT) for domestic enterprises. As a result of this reform, the number of taxes has been reduced from 32 to 18. Following this reform, the rapid increase of foreign trade and FDI also pushed China to improve its tax system to conform with international tax best-practice. The 1994 tax system consists of indirect taxes (VAT, business tax, and consumption tax), enterprise income taxes (the FIE Income Tax Law and DEIT), an individual income tax, property taxes, and payroll taxes among others. Indirect taxes account for about 60 percent of the total tax revenue, while enterprise income taxes account for about 30 percent. Of all of the instrumental changes made to the tax law, the reform of accounting standards is the most important.

2.3.1. Accounting Standards

The lack of codified, standardized and uniform accounting rules has plagued China's tax law reform since the early 1980s. There was no established private-sector accounting standard ever released by government authorities before 1992. While, in general, taxable income cannot be solely determined on the basis of accounting profits, the accounting standards are indispensable when applied to obtain a straightforward understanding of taxable transactions. Accounting standards usually provide the means to measure revenue and cash, cost allocation, accounting period, and realization requirements for profits that are then adjusted to apply incentives set out in tax legislation to determine taxable income, all of which is subject to auditing assurance. A set of standardized accounting rules has

been a conspicuous hole in the tax law system.

An important piece of legislation enacted to fill in this gap is a new set of financial accounting rules for domestic enterprises, the Standards for Business Enterprises (ASBE), promulgated by MOF in 1992. Based on the generally accepted international accounting standards model, implementation of the ASBE, although it was loosely enforced, became particularly important given that most SOEs, following decades of public ownership of the means of production and expenditure, had developed a mixture of different accounting and booking routines. Measurements of taxable income varied across sector and even among different enterprises within the same sector. To be fair, the ASBE included many “socialist” provisions, as it was designed for domestic enterprises, and was later revised with sixteen supplemental detailed standards, all of which contributed to reducing distorted and discretionary reporting practices by taxpayers and tax administrators.

2.3.2. Value –added Tax

The Chinese VAT is a production-type VAT.⁶⁸ It has a broad tax base with limited exemptions, it applies to all taxable goods and services supplied in China, and the standard rate is 17 percent. A lower rate of 13 percent is applied to sales and imports of certain products.⁶⁹ VAT is collected at each level of trade on all

⁶⁸ See Zhonghua Renmin Gongheguo Zengzhishui Zanxing Tiaoli [*Provisional Regulations of the PRC on Value-Added Tax*](effective as of January 1, 1994, as amended) [Hereinafter VAT Regulations]

⁶⁹ See Art. 2, VAT Regulations, stipulating that the scope includes necessities such as grain and edible oil, running water, hot water, gas, residential coal products, and air conditioning; print publications, and agricultural related products such as feed, chemical fertilizers, pesticides, farm machinery and agricultural plastic film

taxable goods and services. To avoid cascading, suppliers are entitled to a refundable input tax credits for taxes paid on goods and services to the extent they were acquired for use in commercial activities. The effect of the input tax credit is to remove any VAT from the cost of business supplies. Only consumers pay the tax.

Exports are zero-rated, which means that while no output VAT is chargeable, all VAT charged at the interim stages in the production chain is effectively refunded to the exporter. Moreover, a special VAT rebate applies only to certain domestic production,⁷⁰ partly to encourage foreign investment.⁷¹ However, China does not grant a full VAT refund on the export of many products⁷² due to its fiscal deficiency and administration concerns. It is hard to argue whether VAT refund policies stimulate or restrict exportation by China, therefore whether the VAT refund is a WTO non-compliant policy is open to debate.

2.3.3. Business Tax

The business tax (BT)⁷³ applies to business activities that are not subject to VAT. Taxable activities include commercial activities, including but not limited to:

⁷⁰ See *Notice on Improving Measures for the Implementation of Import-Replacement of Steel*, Guo Shui Fa [1999] No. 68, April 16, 1999; see also Cai Shui Zi [1998] No. 117

⁷¹ See *Circular on Enterprise Income Tax Credit for Purchasing Chinese-Made Equipment by Enterprises with Foreign Investments and Foreign Enterprises*, Cai Shui Zi [2000] No. 049, January 1, 2000; See also, *Notice on the Trial Measures for the Administration of Tax Refunds to Foreign-Investment Enterprise Purchasing Chinese-Made Equipment*, Guo Shui Fa [1999] No. 171, September 20, 1999 (encouraging FIEs in using Chinese-made equipment by offering VAT refund)

⁷² For a review of export refund rate, see Xue Jianlan “*Analysis and Overview of China’s VAT Refund Policies*”, presented at the Michigan-Peking Tax Conference, October 1, 2010, in Ann Arbor, Michigan. For earlier discussions on this topic, see generally, *MOF and SAT on Adjusting Export Refund Rates*, Cai Shui [Finance and Taxation], 2003

⁷³ *Zhonghua Renmin Gongheguo Yingyeshui Zanxing Tiaoli [Provisional Regulations of the PRC on Business Tax]* (effective as of January 1, 1994, as amended) [hereinafter Business Tax Regulations]

transportation services, construction, banking and finance, insurance, post and telecommunications, cultural and sports activities, and entertainment and services, the transfer of intangible property, and the sale of immovable property within China. BT is imposed mostly at rates of 3 percent,⁷⁴ 5 percent,⁷⁵ and 5 to 20 percent.⁷⁶

2.3.4. Consumption Tax

The Consumption Tax (CT) is an excise tax levied mainly on manufacturers and importers in addition to the VAT. Exports are usually exempt. Generally, taxable goods are luxury goods – petroleum products (gasoline and diesel), tobacco, liquor, cosmetics, extravagant vehicles, fireworks, firecrackers, tires, and motorcycles.⁷⁷

2.3.5. Individual Income Tax

For Individual Income Tax (IIT), the 1994 reform program standardized the income tax imposed on Chinese citizens and foreigners. The revised Individual Income Tax Law (IITL)⁷⁸ replaced all the previous tax laws for personal income taxation. The tax position of foreigners working in China remained the same

⁷⁴ Art. 2, Business Tax Regulations, and BT Tax Rate Chart, activities in this category include transportation, construction, postal communication, and cultural and athletic activities

⁷⁵ *Id.*, activities in this category include banking, insurance, services, and the transfer of intangible property and immovable property

⁷⁶ *Id.*, activities in this category include entertainment and those determined by the local government

⁷⁷ *Id.*, for example, the tax rates range from 45 percent on top quality cigarettes to 3 percent on non-luxury cars, gasoline and diesel are taxes on an ad valorem basis at the rate of RMB 0.2 per liter for gasoline and RMB 0.1 per liter for diesel

⁷⁸ The Individual Income Tax Law of the P.R.C., (effective as of January 1, 1994, as amended); as of December 31, 2010, the IITL had been amended 5 times since it was firstly promulgated on September 10, 1980

under the revised IITL. The revised IITL has removed inconsistencies, which existed in the previous tax laws applicable to Chinese citizens. It aimed to provide uniform tax treatment for all individuals. One of the most fundamental changes to the IITL is the formal inclusion of the concept of residence and physical presence as the criteria to determine individual income tax liability.

Article 1 of the IIT Law stipulates that the IIT is charged on “the income obtained within or outside China by an individual residing for one year or more in the PRC.” For non-residents and individuals residing in China for less than one year, only Chinese-source income is taxable. Individuals residing in China for one year or more, but less than five years, pay tax on their Chinese-source income and the portion of their foreign-source income that is remitted to China, and those residing in China for over five years pay tax on all their income irrespective of its source. Temporary absences from China are disregarded in counting an individual’s period of stay in the country.

China also adopted a list of categories of income subject to IIT,⁷⁹ namely: (1) wages, salaries, and bonuses from any office or employment; (2) compensation for personal services, e.g., legal, medical, and accounting services; (3) royalties from patent rights, copyrights, the right to use proprietary technology and other rights; (4) dividends and bonuses from investments and interest; (5) income from leasing property; and (6) other kinds of specified income. Moreover, the monthly deduction is RMB800 for wages and salaries, and income in excess of RMB800 is taxed at progressive rates ranging from 5% to 45%. For compensation received from personal services, royalties and income from leasing property: a deduction

⁷⁹ *Id.*, Art. 2

of RMB800 is allowed for expenses if a single payment is less than RMB4,000; and a deduction of 20% is allowed for single payments in excess of RMB4,000. The balance remaining after the deduction is taxed at a flat rate of 20%. Payments in kind or in marketable securities are taxed according to the market price at the time of acquisition.

In addition, Article 4 of the IIT lists various categories of tax exempt income, such as prizes and awards, interest on savings, welfare benefits, insurance indemnities, diplomatic related earnings, and deduction according to international tax treaties.

A highlight of the 1993 amendment to the IIT Law is the appeal procedures for aggrieved taxpayers regarding local tax authorities' decisions. However, although the taxpayer may appeal to higher level tax authorities or the people's court, the tax due must be paid in advance notwithstanding the result of the appeal. Moreover, a stringent tax audit procedure was designed to curb tax evasion with high penalties, and serious tax evasion behaviors will be handled and criminalized by people's court.

2.3.6. Enterprise Income Tax

As discussed in subchapter 2.2, the NPC enacted the FEITL for foreign enterprises and enterprises with foreign investment (FIEs) to replace three pieces of income tax laws relating to foreign enterprises. Although the FIEIT appears to be incomplete, it sent out a vivid signal about China's intention to modernize its tax law system through simplification and consolidation. As discussed, the FIE Income Tax Law provides numerous incentives for FIEs to do business in China

or earn income from China. FIEs are subject to tax on their worldwide income, whereas foreign enterprises are taxable only on their Chinese-source income. Foreign enterprises operating in China through an “establishment” are taxable on the net income derived through the establishment at thirty-three percent. Foreign enterprises without operations in China are taxable only on Chinese-source investment income and capital gains at twenty percent. The FIE Income Tax Law is levied on taxable income, which is the amount of income net of costs, expenses, and losses. The rules for calculating income largely follow internationally accepted accounting principles.

The 1994 reforms did, however, introduce the Provisional Rules for Enterprises Income Tax for domestic enterprises (DEITL), and this consolidation marks an encouraging step along the road to modernization. Prior to the DEITL, there were four separate sets of rules for domestic enterprise income tax purposes.⁸⁰ The DEITL standardized the income tax charged on various types of domestic enterprises and provided a tax treatment for domestic enterprises as closely aligned to the tax treatment of foreign entities as possible. One noticeable change for domestic enterprises was that the tax rate was reduced from 55 per cent to 33 per cent - the same rate applicable to foreign entities under the 1991 Foreign EITL. It is notable that China undertook a remarkable reform aimed at the SOE sector, which contributed more than half of the state’s revenue for the first four decades of the existence of the PRC. On the one hand, the reform reduced the

⁸⁰ *Rules for the State-owned Enterprises Income Tax (Draft)* (enacted in September 1984); *The Collection Methods for the State-owned Enterprise Income Regulatory Tax* (enacted in September 1984); *Provisional Rules for the Collective Enterprise Income Tax* (enacted in April 1985); and *Provisional Rules for the Private Enterprise Income Tax* (enacted in June 1988).

domestic enterprise income tax rate from between 55% and 60% to 33%, the same rate as FIE income tax, in order to lower the burden shouldered by SOE sectors. SOEs were also challenged by BT and other forms of fees such as education surcharges, real estate surcharges and urban expansion fees, among others. Rather, SOE's payments related to tax and other social security benefits in total were not reduced to the same extent.

On the other hand, the central government removed most meaningful preferential policies for SOEs under the central, planned economy. For example, SOEs had to demonstrate commercial performance in order to obtain commercial loans from banks, while previously SOEs could take loans up to quota amounts assigned to them and received little pressure to repay or risk of bankruptcy. Moreover, SOEs had to reengineer their internal management structures to reflect modern corporate governance principles and financial independence. Since many industries occupied by SOEs were copied from the Soviet industrial model, such as machinery, manufacturing, and mining, these corporations faced challenges meeting consumer needs and organizing effective distribution channels after the Chinese government threw them into the market. To deal with this challenge, over 90% of SOEs began their transformation processes by laying off millions of workers, designing early-retirement plans, removing housing stipends and various other benefits programs. This sudden push of SOEs into an immature market aroused many social problems, but it also freed up enormous labor resources to the market for FIEs and private start-ups. Moreover, the revenue-sharing scheme deepened this problem by depriving government support to SOEs from local

budgets. SOEs instead had to survive by themselves, bearing the difficulties of drained financial sources.

2.3.7. Revenue Sharing

Another important aspect of the 1994 tax reform is the establishment of a revenue sharing regime intended to shift the revenue base from the provincial level to the central government, which was suffering an imbalance with provincial government. According to the revenue sharing formula, 100 percent of revenue generated from business tax on the supply of services, 25 percent of revenue from the VAT on the sale of goods, and half of the revenue from enterprise and individual income are allocated to provincial governments.

Given the inconsistent and incoherent accumulation of rules, formulas and processes regarding the revenue split in the 1980s, the 1994 fixed revenue sharing formula, as a non-legislative agreement reached after complex negotiations between central and provincial authorities, was an enforceable scheme to alleviate the central revenue deficiency. Moreover, with regard to the transfer payment system, the central government guaranteed to the provinces that they would receive the same base revenues they had in 1993. This revenue sharing formula, on its surface, appeared quite alluring to provincial government, however, it favored the central government by directing more high-yield and growing tax revenue bases from provincial governments to the center.

2.3.8. Tax Administration

To echo the fixed revenue sharing formula designed in 1994, the tax

administration was adjusted accordingly to accommodate such change for tax assessment and collection. Primarily, provincial tax authorities aimed to firmly control the taxes, e.g., business tax and part of VAT, that were entirely allocated to them. The division of tax administration responsibilities was acceptable to both central and provincial authorities as an enforceable approach to implement the new revenue sharing scheme.

Ultimately, the creation of provincial tax bureaus or branches was achieved by assigning half of the administration's power and structure from provincial offices of the central government's tax branches. The final tax administration structure in the provinces is now comprised of two limbs: the local tax offices under control of provincial governments, and the local branch of central state tax administration. The operation and management of the local tax bureau of a province are supervised by provincial governments, which provide operating funds through a retention formula.

The local branch of the centrally administered SAT mostly serves as a conduit to collect the central government's share. In particular, they are responsible for assessing and collecting enterprise income taxes (FIEs and centrally-owned SOEs), VAT and consumption taxes from all enterprises, and business tax from selected industries such as insurance, banking, railway, and infrastructure, and individual income taxes from non-citizens. The head of the local branch of SAT is appointed jointly by the SAT and the provincial government. On the other hand, the central SAT is generally responsible for administering centrally-owned enterprises, public listed companies and foreign-owned enterprises with a few

prescribed exceptions.

Provincial tax offices, as a result of the revenue sharing formula, pay more attention to taxes that are entirely controlled by them, such as business tax and individual income tax. In addition, they are responsible for assessing and collecting enterprise income tax from provincial and private enterprises.

2.3.9. Summary

Tax law from 1992-2001 experienced rigorous reform to match China's economic development changes in its political climate. In addition to a non-legislative revenue sharing scheme, a relatively modern and equitable tax system has been established in China through turnover taxes (namely, VAT, CT, and BT) generating the major portion of the total tax revenue, and a set of consolidated income tax laws. The reform mostly simplified previous over-classified, ideologically complicated and discriminatory sets of tax laws and regulations. For example, three individual income tax laws targeting taxpayers on citizenship and residence were consolidated into one piece of law with a clear definition of residency and source requirements. Different types of foreign investment-related enterprise income tax regimes were reorganized to formulate a systematic code. Noticeably, the adoption of VAT followed the international trends of putting more focus on the balance between production and consumption. Although the Chinese government suffered complaints from the SOE sector that they were pushed too harshly into market participation, the tax law reform strongly assisted in achieving goals within the SOE reform.

In terms of legislation drafting techniques, almost all tax laws promulgated by the

NPC were sketchy and over elementary in form, and the implementation regulations issued by the State Council were not that helpful in providing further operative guidelines. Circulars, rulings, and notices issued by the MOF and the SAT instead compose the operational body of tax laws and policies, but on an ad hoc basis when unforeseen issues or causal political initiatives pop up. These irregularities in legislation not only failed in structuring a modern tax law system, but also frustrated taxpayers and, at times, officials in implementation.

2.4. Post-WTO Accession

In conjunction with the transition from a central, planned economy to an open, market-oriented economy, China's new tax reform initiatives were designed and formulated by its accession to WTO on December 11, 2001. This celebrated event for both China and the international community presented China with the laborious task of adjusting economic and tax policies to accommodate challenges required by its WTO commitments and general WTO principles. Given the complexities of China's legal, economic and social settings, finance and tax authorities faced a daunting task ahead to cure and restructure tax law system to lodge challenges brought by the WTO membership.

The implications of WTO membership for Chinese tax law reform are extensive. It is not difficult to imagine various aspects of the Chinese tax law system conflicting with general WTO principles, such as principles of nondiscrimination, transparency, uniform and impartial administration, and judicial review, among others. To address this problem, China's commitments include instrumental aspects of tax law reform such as lowering tariffs and removing non-tariff barriers

to encourage foreign trade and investment, removing tax-related export subsidies, and designing tax policies following international standards, and substantive reform proposals to reform its legal system to be more compatible with a market economy and the rule of law.

In contrast to the stepwise consolidation and rough development of tax law reform in the 1990s that characterized the legislation meant to establish a functional tax order for China's new market economy, developments in tax law after China's WTO accession comprised a steady and flexible approach in coordinating international trade and tax norms. There are three major prongs in the reform. The first is a continuation of the consolidation and completion process carried over from the pre-WTO accession tax law aiming to rewrite tax legislation and deepen the revenue sharing scheme. This can be understood as a continuation of the socialist legacy and political-compromise culture. Such continued efforts included releasing an update of accounting standards, adjusting the revenue sharing scheme, and consolidating the enterprise income tax. Second, in order to fulfill its Protocol commitments, China gradually removed its non-compliant tax laws and regulations, especially regulations that provided special treatment for export products. Third, the tax law reform, as part of the comprehensive legal reform in China,⁸¹ gradually began to accommodate the rule of law and WTO principles of transparency, uniformity, impartial administration and judicial review. At first

⁸¹ For more discussion on the Chinese legal traditions, *see infra* Chapter III; *see generally* Randall Peerenboom, *China's Long March Toward Rule of Law*. New York: Cambridge University Press (2002); Stanley B. Lubman, *Bird in a Cage-Legal Reform in China After Mao*. Stanford, Calif.: Stanford University Press (1999); Stanley B. Lubman, *Looking for Law in China*, *Columbia J. of Asian Law* 1 (2006); Hsu, C. Stephen, ed., *Understanding China's Legal System: Essays in Honor of Jerome A. Cohen*. New York: New York University Press (2003); Xin Ren, *Tradition of the Law and Law of the Tradition: Law, State, and Social*. New York, Greenwood Press (1997)

glance, the WTO accession suggests a general framework to guide further tax law reform in China. However, compliance with the commitments made in the Accession Protocol and the desire to build a rule of law will complicate China's future tax reform as well.

2.4.1. Accounting standards

In February 2006, a new version of Accounting Standards for Business Enterprises was adopted by MOF aimed at listed companies and SOEs. The new ASBE, based on the 1992 set of financial and accounting rules for domestic enterprises, mostly referred to the international financial report standards which are widely accepted by developed countries, especially those with major capital markets. Two problems led to the promulgation of these new standards. The first was that the 1992 version of accounting standards was far out of line with and even conflicted with international accounting standards, reflecting the domestic enterprise focus of previous standards. Second, the jagged and unsystematic accounting routines adopted by various SOEs presented huge difficulties for auditors calculating profits and taxable income. Therefore, more stringent requirements on disclosure are included in the new version. It is said that over 90% of SOEs, centrally or provincially-owned, for business expansion and development have kept their own "treasury" which encouraged corrupt and unprofessional retention and use of revenue resources. Moreover, with the boom of China's stock markets and loosened monitoring on "A" share listing by SOEs, scandals of false financial statements and performance reports caused headaches for the securities regulatory commission, and a set of uniform financial and

accounting standards was designed to remedy these problems.

While the new version of ASBE was modeled on international standards, it contains quite a few rules reflecting the ideology of Chinese legislators regarding their fears of exploiting rules and socialist characteristics of market economy. In this sense, the new ASBE is a compromise between international standards and specifically Chinese concerns. For example, the restructuring and adjustment of enterprise debts is relaxed to encourage the use of financial planning and derivatives, related-party disclosure rules remain loose, and there are significant disparities between accounting and tax law treatments of recognition of profits and cost identification. Among the above differences, the relaxation of regulations governing the use of financial planning and derivatives was mostly targeted at improving the vitality and competency of the enterprise surplus, given that SOEs, after the painful restructuring after 1980s, have more financial capacity and knowledge of modern corporate governance practices to compete in the market. However, the loosened disclosure requirements allow SOEs to conduct more related party transactions leaving a huge loophole, which complicates auditing and the enforcement of tax compliance. Moreover, as far as tax practitioners are concerned, the new ASBE created a larger gap between the accounting and tax practice of profit recognition and cost identification, which would burden tax auditing authorities to undergo complicated compliance audit and expertise training. Moreover, the new ASBE also takes care of farming and small, private enterprises by adopting cost rather than market price to determine product values.

2.4.2. A silent transition to a consumption type VAT

After applying a pseudo “trial” VAT to domestic enterprise in the 1980s and adopting a set of VAT laws and regulations of modern sense in the 1994 tax law reform, VAT as a turnover tax has been proclaimed by both Chinese academics and international commentators as an important step toward modernizing and completing the reform of China’s tax system. Since 2007, there has been a heated debate on transforming the current production type VAT to a more neutral and administratively efficient VAT model based on consumption. The academic deliberation mostly centers on allowing a full input tax deductions as is exemplified in the traditional, and more efficient, VAT system as adopted in other market economies. Meanwhile, the opponents to a consumption based VAT, most notably several central SAT officials, believe that such consumption based VAT will hurt revenue in total and create administrative confusion. However, major changes in the VAT arena since 2001 seem to have muted the opposition over revenue concerns.

In 2003 a limited deduction for VAT inputs on capital equipment was allowed by MOF and SAT to revitalize the northeastern rustbelt provinces for eight designated industries, such as oil-drilling, auto manufacturing, metallurgy and down-stream oil chemical production. However, the original initiative was not intended as a tax law reform, rather, it served as an incentive to promote investment in the northeastern region and to quell the unrest of laid-off workers from regional large SOEs. However, an optimistic view would take this change as a case for moving the VAT regime toward a neutral, modern system without

burdening intermediate enterprises with a final VAT. Following the socialist stereotype thinking, this change was phased in by an “incremental amount deduction” that limits the deduction only to the VAT payable in excess of that in previous years. Ironically, this change was delayed in implementation for three months until July 1, 2003 due to the extremely high number of fixed asset purchases undertaken immediately after the policy was announced in early 2003. This program, however, was extended to other regions in 2007 and 2008 to rejuvenate twenty-six old industrial bases in the central region and five industry-rust cities in the Inner Mongolia region. The third round of this program was adopted to promote reconstruction of the three provinces that suffered earthquake disasters in 2008 but carried more preferential input tax deductions on capital assets: enterprises of all industries (with slight exception on military related businesses) were approved to recognize the full amount of input tax on acquisition of fixed assets. However, the policies adopted in the regions affected by the earthquake were more deemed as a revitalizing approach to resurrect shattered public confidence and nurture local investments. Ultimately and more remarkably, the State Council in November 2008 announced that the deduction for VAT input tax on acquisitions of fixed assets would be extended to all industries in a few regions of China beginning in January 2009.

It is too early to assess the fiscal impact that may be brought by such expansive VAT reform for the past eight years, and it is far too soon to guess the next move MOF and SAT will make concerning the input tax deduction, given the pressure from currency reevaluation of RMB, high foreign exchange reserve and the

sweeping financial crisis since 2008. At the very least we can observe that the shifting of the VAT base from production to consumption may direct more revenues from poorer to richer provinces. Such an imbalance can only be resolved through a well-channeled transfer payment regime designed by the government. However, this may necessitate a reformulation of the current 25:75 split of revenues from the VAT to a new ratio to be negotiated by central and provincial governments, or a multi-tier formulation for richer or poorer provinces. In essence, China's VAT reform demands a high learning curve, mature commitments by central and local governments, and caution in the implementation of experiments with shifting the VAT from a production to a consumption tax.

2.4.3. Adjusting the revenue sharing formula

Another significant move made by MOF to the tax system concerned the adjustment to the 1993 arrangement on the share of enterprise and individual income tax revenue between central and provincial governments. According to the revenue sharing formula adopted in 1993, the agreed division between central and provincial government would gradually move from 50:50 to 60:40 leading the central government to take a larger share of the designated revenue base. The change made in 2003 was therefore simply a delayed realization of previously reached formulae. This change has had a larger impact than the central government originally intended. Not only were relative finances of both tiers of government rebalanced, but the central government also sent a strong signal regarding its intention to further restrain the control of the provincial government

over its own revenue. Provincial governments, instead, had to pay more attention to the taxes (e.g. business tax) assigned exclusively to them. This change in part also distorted provincial governments' behavior, causing them to increase their revenue by various other means, including the recent real estate market boom and land transfer fever dominated by provincial and local government actors is an unsurprising result of the rebalancing of tax revenues and the systemic revenue shortage perceived by provincial governments.

2.4.4. Nondiscrimination Principle

The principle of nondiscrimination is central to the WTO umbrella agreements, comprising two important principles: the Most-favored-nation (MFN) and National Treatment (NT) obligations. Under the MFN principle, GATT contracting parties must grant each other treatment as favorable as they give any country in the treatment of their goods (import and export tariffs, duties, and charges).⁸² The NT principle⁸³ prohibits member countries from discriminating between imported and domestically produced products and services. Once import duty is paid, imported goods and services must be treated no less favorably than domestic products and services. This nondiscrimination obligation is applied broadly to cover all internal taxes and charges, and all laws, regulations, and requirements affecting the domestic sale, offering for sale, purchase, distribution or use of a product.

The principle prohibiting tax subsidies is found in the Agreement on Subsidies

⁸² See GATT, Art. I

⁸³ See GATT, Art. III

and Countervailing Measures.⁸⁴ This provision sets out the general prohibition on two types of subsidies, including tax subsidies. The first type of prohibited subsidies covers those made contingent on export performance or, more common, export subsidies. The second type of prohibited subsidies includes import replacement subsidies, which are made contingent on the use of domestic, over imported, goods. Some aspects of the current Chinese tax system may violate the principles of nondiscrimination and prohibition of tax subsidies.⁸⁵ In addition, the WTO system also requires an expanded scope of taxpayer rights and deepened transparency in tax legislation and administration.⁸⁶

Another important aspect of China's tax system that may conflict with WTO principles is the two-track tax system introduced since early 1980s, when China first started modernizing its tax system. The two track system refers to the existence of one set of rules for foreign investment and foreign individuals, and another set of rules for domestic enterprises and Chinese citizens. As previously discussed,⁸⁷ these two tracks were merged and simplified gradually during the reform process in the areas of individual income tax, VAT, and other indirect taxes, including the business tax and consumption tax.

A remarkable merging of the two tracks was undertaken in 2007 when the unified Enterprise Income Tax was promulgated, but there are still some preferential policies offered to foreign enterprises. In particular, (1) tax holidays: a standard

⁸⁴ See SCM Art.III

⁸⁵ See *infra* Chapter V, Subchapters II and III

⁸⁶ See *infra* Chapter VII for details on taxpayers' rights protection

⁸⁷ See *supra* 3 and accompanying texts

five-year holiday⁸⁸ for FIEs engaged in productive activities, which entails a tax exemption for two years and a 50% reduction in the tax rate for the next three years; (2) preferential policies in special economic zones and recently established new zones (e.g., Chongqing Liangjiang and Tianjin Binhai new zones), including extended tax holidays, and lower income tax rates for large foreign investment projects exceeding certain investment values such as USD 10 million or 5 million; (3) reinvestment refunds, whereby FIEs receive 40% refund of tax if they reinvest their profits in China for at least five years, and a full refund is allowed if profits are reinvested for establishing or expanding an export-oriented or technologically advanced enterprise; and (4) reduced rates for export-oriented enterprises,⁸⁹ which are granted a 50% reduction in the applicable tax rate after their tax holidays expire and such reduced rate applies whenever it qualifies as an export-oriented enterprise. In contrast, domestic enterprises do not receive many tax incentives unless they choose investing in waste disposal projects, locating in remote, poverty-stricken or minority ethnic regions, or creating large numbers of new jobs, to name just a few.

Admittedly, China's tax system was redesigned based on WTO principles and related economic policy changes. However, the extent to which it achieves and implements these goals is another question. The unification process evidenced that China catered various principles under WTO and honored the development schemes of Chinese government with flexible tax policies. However, due to

⁸⁸ See Arts. 8-11, FIE Income Tax Law, for certain infrastructure enterprises, the tax holiday is ten years

⁸⁹ An export-oriented enterprise is one for which, on an annual basis, at least 70% of total output value is derived from exportation

limitations in the WTO rules and dispute settlement mechanism, the impact of WTO rules will continue to be relatively modest. Another question is whether China's tax system suffers from problems resulting from a lack of consideration of principles of equity and neutrality. More time is needed under the WTO regime to determine whether WTO principles may cure such deficiency.

III. Framework of the Chinese Tax System

3.1. Sources of the Chinese Tax Laws

An examination of the framework underlying China's tax law system is necessary at this stage. Not surprisingly, many problems arise pursuant to the sources and hierarchy of China's tax law system. In a descending manner, the laws enacted by the National People's Congress (NPC) have the highest authority. The provisional regulations or "regulations" enacted by the State Council, the executive center comprising various ministries, are next in the hierarchy. They are followed by provisional implementation rules issued by the Ministry of Finance (MOF) and State Administration of Taxation (SAT).⁹⁰ Each of these tax laws or provisional rules is usually supplemented by a set of detailed rules, regulations and various circulars, rulings and notices for implementation. The law sets out broad taxation principles whereas the provisional rules and regulations contain specific provisions for implementation of the respective tax issues. Major tax legislation,

⁹⁰ MOF and SAT are entrusted with the authority from the State Council to interpret tax laws and implement tax policies in China, some of which are coordinated with State Custom and State Administration of Industry and Commerce (SAIC)

together with the detailed rules and regulations for implementation, provides the basic regime for the related taxes.

Circulars, rulings and notices issued by various (central, provincial and local) authorities theoretically have the least authority and are a supplement for clarifying specific issues raised by the taxpayers and tax authorities. Although these circulars do not have the force of law, they are often so highly valued by tax authorities that they are deemed to possess the second highest level of authority. Hence these tax circulars are practically binding on taxpayers and authorities. One reason for this phenomenon is that the legislative process for basic tax laws and regulations is time consuming and laborious – the NPC typically assembles only once per year and only the State Council passes regulations on a regular basis. Moreover, the internal legislation process requires MOF and SAT to serve as the drafters and collectors of public opinion about tax laws passed by NPC. Therefore, investors have to resort to local tax offices for explanations of related tax regulations. Tight control on interpretation and enforcement of tax regulations does not exist and circulars may be carried emanate from local tax administrations and inconsistent with those of central government. There is no clear way to establish “unified” measures.

3.2. Basic Factors Affecting China’s Tax Law System in General

Tax law in China is marked heavily by political interference. When China’s tax system is discussed, scholars may initially go to the policy or guidelines enclosed in resolutions of CCP Congress annual plenary session and CCP Central Economic Working Conference. In this case, China’s tax law and policies are a

designated system relying on the social, economic and international settings and norms. In the transition from a central, planned and socialist economy to an open, market-oriented system, mixed with various domestic political and social strife, China's tax law system presents a painful process of evolution mixed with back-and-forth policy turbulence. This section aims to briefly describe the political factors and policy orientations that might have or will continue to impact the tax law system including legislation, administration and judicature in China.

The Chinese government has long used economic and fiscal policies to promote the CCP's political and economic objectives.⁹¹ In addition to the revenue-raising function of taxation,⁹² the government has used the tax regime to achieve objectives beyond revenue allocation.⁹³ In the early 1950s, the CCP class struggle policy and agrarian-land reform induced the imposition of arduous tax burdens on landlords,⁹⁴ with the goal of transferring benefits extracted from land and property to the working class. Moreover, in urban areas, especially large cities, taxation was "a tool to protect and develop socialist and semi-socialist economies and gradually to use, constrain, and transform capitalist industry and commerce."⁹⁵ To this end, an Industrial and Commercial Income Tax" (*Gongshangye Suodeshui*, or ICIT)⁹⁶ was introduced against "capitalist, industrial and commercial businesses" to restrict their capital growth and divert their profits to strengthen the public

⁹¹ See Xu, *supra* 3, at 25-29 and Jiang, *supra* 4, at 601-602

⁹² See Jiang, *supra* 4, at 601

⁹³ *Id.*

⁹⁴ See Wang, *supra* 11 at 67-69, for a discussion of China's Socialist Transformation during the 1950s

⁹⁵ *Id.*

⁹⁶ *Gongshangye Shui Zhanxing Tiaoli* [*Provisional Regulations on Industrial and Commercial Taxes*], adopted by the State Council of Government Administration on January 27, 1950 and promulgated on January 31, 1950, see Li, *supra* 3 and Jiang *supra* 4 at 601

sector, while collective or state-owned enterprises did not have such ICIT liability. Instead, they remitted profits to the state treasury under separate regulations.⁹⁷ At the same time, favorable treatment was given and applied to industries or enterprises that met certain specified political and policy criteria.⁹⁸ Following the same logic, after China adopted the open door policy of economic reform to upgrade technology and attract foreign investment, the Chinese government granted tax holidays and exemption for enterprises engaged in the development and manufacturing of approved new products,⁹⁹ and for public and state-owned enterprises suffering financial hardships.¹⁰⁰ Preferential tax measures were also adopted to assign resources among industries, sectors and even geographical regions,¹⁰¹ especially to state-chosen advantageous areas, although such treatment reduced nominal tax revenues. This policy orientation remains popular based on the economic development needs of different regions.¹⁰²

As China had no modern corporate income tax of its own at the beginning of the openness policy and felt pressure to replicate successful tax practices, the Chinese government looked to other nations for both normative rules and special treatment

⁹⁷ For a detailed review of the history of ICIT, and related tax reforms, see Jiang *supra* 4, at 602, noting that in particular, in 1958, the government raised taxes on the profit of private enterprises by ten to one hundred percent which brought the total income tax rate of private enterprises to as high as sixty-seven percent. Moreover, in the early 1970s, the ICIT adopted a special category named “temporary business” to catch any unregistered or unauthorized business activities, which was further imposed non-state and private businesses a penalty of up to one hundred percent in 1977, despite the scope of the penalty provision broadly covered any individuals and units

⁹⁸ *Id.*, at 603, for example, to implement Mao’s industrial policy of favoring industries over commerce and heavy industries over light industries, a deduction of the ICIT rate ranging from ten to forty percent was offered to SOEs in machinery and military production.

⁹⁹ *Id.*, for farm-related businesses including agricultural machine repair and leasing, small fertilizer and cement producers, newly established enterprises in people’s communes

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

¹⁰² See Xinmin Zhang, *Tax Incentives for the Chong Qing Liang Jiang New Zones*, presented at the PKU-Umich International Tax Conference in October 2010

to induce foreign capital.¹⁰³ In order to maintain competitiveness in international markets and further its open door policy, the Chinese government also appealed to foreign business communities by comparing Chinese tax preferences and incentives against other developing countries.¹⁰⁴ In this way, the Chinese government was influenced by the concepts and practice of using fiscal and tax incentives to attract investments.¹⁰⁵ Chinese authorities also ratified separate tax regimes and incentives to codify differences between FIEs and DEs.¹⁰⁶ Moreover, state tax authorities had to supervise the spending of tax savings.¹⁰⁷

WTO accession, through the application of international norms to the Chinese economy, has tremendously shaped China's tax policy orientation. The Chinese government is both a cautious adopter and a quick learner of international tax practices. One important drive behind China's fast assimilation into international

¹⁰³ See Jiang, *supra* 4, at 605 and accompanying footnotes, reviewing the legislative intents of the first set of tax incentives;

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*, at 606, Jiang summarizes that it is not surprising that foreign investment enterprises were initially limited to export-oriented and technologically advanced investments for the following reasons: (1) taxes are negatively related to net profits and therefore negatively related to the net rate of return, it follows that to increase [foreign direct investment] is to decrease the taxes on foreign investment income; (2) Beijing also prioritized profit maximization considerations in its decision-making to signal that China had become a friendly and willing host for business and investment; (3) Chinese officials were aware that access and opening to China's immense market would be immensely profitable to many overseas investors, but they were also concerned with the domestic problems arising from opening

¹⁰⁶ *Id.*, at 607 and accompanying footnotes. Foreign investors were set apart from tax, finance, and accounting rules governing domestic enterprises, most of which, during the 1980s, still operated according to planned economy principles, for example, (1) different tax regimes also gave Chinese policy makers more room for manipulating the illusion of preferential treatment for foreign investors. As DEs were limited by stern rules and limitations in operation and business scope, any relaxation or flexibility approved for foreign investors from such "standard practice" could be called "preferences;" (2) such preferences hid the fact that DEs received state subsidies as well as market protection; (3) this "trade-off" enhanced the domestic competitiveness of Chinese firms and attracted foreign investments, but twisted the notions of fairness and efficiency in ways that would complicate future SOE reforms. Without favorable tax and fiscal treatment, SOEs might have lost support by competing for funds through costly and lengthy budgeting processes. SOEs were educated to retain a greater share of their revenue for business expansion and investment by depositing retained profit into designated accounts

¹⁰⁷ See *supra* 3, Moser & Zee, at 112-16, discussing that Chinese tax authorities may request an explanation of usage of tax savings and encourage re-investment in the same geographical area

tax practice is its strategic use of external forces to drive internal economic development. China has undertaken more extraordinary, or discriminatory, obligations than other WTO member countries could accept. This is not without its purpose however. China's leaders intended to take advantage of market access commitments and international disciplines imposed by WTO to further strengthen China's competence and competitiveness by transforming the state sector economy. In this sense, almost all major tax law reforms and revisions after WTO accession are directed at further liberalizing China's economy. This is evidenced by the unification of income tax treatment between FIEs and domestic enterprises in 2007, and China's prompt response to complaints filed by US on the export VAT refund through the WTO dispute settlement mechanism.

In summary, looking back at China's tax law reform for the past three decades, China's tax policies have been colored and dominated by the pursuit of economic growth and standard of living improvement. Designed as a planned socialist economy, the government had first to categorize particular areas or types of foreign investment to make the openness policy successful. Then tax and non-tax measures were targeted and adopted to promote such investments. National tax legislation has been augmented by a myriad of particularistic rules designed for targeted foreign investments, "regionally-oriented, industry-specific or ethnically-based".¹⁰⁸

¹⁰⁸See Jiang, *supra* 4, at 607, explaining SEZs and other priority areas were created in coastal regions because they were in the best position to attract foreign business. Overseas Chinese businesses received additional preferential treatment because they were more likely to invest in China

IV. Policy Considerations and the Reform of the Tax Law

China's tax law system experienced extensive and dynamic changes over the past six decades, especially for the last thirty years. The speed of economic development achieved through foreign investment has been paralleled by the development of "preferential" tax policies and incentives. This describes the ultimate goal of China's tax law architecture since the early 1980s. The WTO accession drove China's tax law toward international and multidisciplinary compliance. As a result, advocates on any side of the tax reform debate in China are confronted with ambiguous and even contradictory results. However, there are a few policy orientations worth noting regarding China's efforts to establish a modern tax law system.

4.1. A Capitalist Profit Motive?

China's tax policy is marked by its socialist origins. On this foundation, the country initiated the policy of openness and domestic reform to build socialism with Chinese characteristics¹⁰⁹ and sought foreign capital for the "development of socialist productive forces."¹¹⁰ The development and application of law in China's transition to a market economy therefore bears markers of a strong socialist legacy and reflects the ideology of China's legislators. The Chinese authorities

¹⁰⁹ *Id.*, at 610 and accompanying footnotes, quoting Deng Xiaoping, *Building the Socialism With Chinese Characteristics [Jianshe You Zhongguo Tese De Shehui Zhuyi]*, June 30, 1984, in *Selected Works of Deng Xiaoping*, at 62-64, explaining socialism in terms of developing productive forces); Deng Xiaoping, *Yi Kao Lixiang Er Kao Jilu Caineng Tuanjie Qilai [Unite on the Basis of Idealism and Discipline]*, at 110, explaining that socialism with Chinese characteristics depends on spiritual civilizations, idealism, ethics, morality, culture and discipline

¹¹⁰ See generally, Deng Xiaoping, *Shehui Zhuyi He Shichang Jingji Bu Cunzai Genben Maodun [No Fundamental Contradiction Exists Between the Socialism and Market Economy]*, October 23, 1985, in *Selected Works of Deng Xiaoping*, at 148-50

had to convince themselves and the Chinese people that the use of tax preferences would be beneficial to the country without sacrificing its socialist identity. However, the concept of profit maximization initially did not resonate well domestically when the CCP was dominated by left-wing military leaders.¹¹¹ Under their leadership, the predominant view was that purely profit-motivated investment decisions would jeopardize the China's socialist legacy and long-term development goals by inducing chaotic competition with foreign seizures of domestic market shares and by threatening Chinese domestic industries. At the same time, the fast growing domestic private sector economy troubled the government on finding a mixed means to safeguard SOEs and public sector economy. Therefore, it was conceded that the pursuit of profit by foreign investors, while unavoidable, must therefore be controlled by the state.¹¹² Many even feared that because of preferential treatment, foreign investors might benefit more from the country's opening up than the Chinese themselves.¹¹³

As a result, Chinese government had to formulate a two-track system. It maintained a socialist system for domestic enterprises, i.e., SOEs, and Chinese citizens, and a western-style tax system for foreign-owned enterprises and foreign individuals. Therefore, a bifurcated tax, accounting and financial system was set

¹¹¹ According to Communist thinking, the capitalist idea of profit was offensive because it was related to exploitation and cheating, and profit motivation was synonymous with selfishness and greed

¹¹² See Guanyu Woguo De Duiwai Jingji Guanxi Wenti [*Issues Concerning Our Country's Foreign Economic Relations*], Hong Qi [*Red Flag*], April. 6, 1982, Hongqi Zazhi Bianjibu [Editorial Board, Red Flag Magazine]. The Chinese admitted that their lack of advanced equipment, technology, skilled personnel and management expertise, shortage of funds, and overpopulation were factors unfavorable to Chinese-foreign economic ties. at 2, 3-4, quoted by Jiang *supra* 4 at 611

¹¹³ *Id.*

up to monitor foreign profit-seeking behavior.¹¹⁴ Tax preferences also played a role in controlling foreign investment through information gathering and other monitoring.¹¹⁵ Although the two tracks later merged in the areas of enterprise income tax, individual income tax, VAT, business tax, consumption tax and other indirect taxes, many tax incentives were kept to continue China's efforts in attracting foreign investment and promoting international trade. This two-track system served the goals of economic development and balancing foreign and domestic interests. In this case, the original worries of capitalist transformation seem overwrought. In addition, China's WTO accession bolstered the view that the profit seeking nature of foreign capital will actually contribute to the economic wellbeing of the Chinese economy. Tax policies, in this context, should therefore attempt to enlarge tax revenues and balance development among different regions.

Another notorious example of the "socialist notion" in the turnover tax law area is the perverse dichotomy in which goods are subject to a VAT and services are subject to a business tax. Such artificial distinctions, requiring taxpayers to draw an artificial line in their business activities for different tax compliance purposes, is outdated in China's modern economy in which hybrid supplies are provided

¹¹⁴ *Id.*, Jiang *supra* 4 at 610-611, noting the 1979 EJV Law required EJVs to contribute to a reserve fund and a venture expansion fund from their after-tax profit, before distribution of any profit could be made to venture partners for reinvestment and joint venture expansion. Chinese joint venture partners had to hand over their distributed profits to their superior government department. Certain tax benefits were explicitly tied to reinvestment by foreign investors in China. The profit that foreign investors could actually repatriate represented only a small portion.

¹¹⁵ See Pitman B. Potter, *Foreign Investment Law in the People's Republic of China: Dilemmas of State Control*, China Quarterly, Mar. 1995, at 155, 173 (noting that the Chinese state seeks to strengthen its capacity to obtain information on the financial condition, sales activities and technology base of foreign investment projects" through tax preferences, quoted by Jiang *supra* 4 at 611)

without showing the division of tangible elements and associated services. For example, the sale of computerized hardware supplemented by database infrastructures, for which the value is largely in the intellectual property, may distort such a classification allowing firms to evade a high-rated VAT by characterizing the products as a service item, subject to a lower business tax obligation. A similar example is that in construction, taxpayers and tax authorities may have different views regarding which component of the constructions can be identified as immovable and which as movable properties. The former are subject to business tax and the latter to VAT. Worse yet, for products mixed with goods and accompanying services it is hard find an enforceable formula due to the complexities of transactions. Therefore, two separate methods of keeping records, one for goods and one for services, forces business taxpayers to drop optimal tax planning activities. All of this contributes either to the draining of collectible revenue and tax evasion, or to uncertainty in tax auditing and manipulative discretion in tax administration.

4.2. Economic Efficiency and Tax Equity

Efficiency and equity are basic elements in a well-functioning modern tax law system in a market economy, not to mention compliance with WTO principles.¹¹⁶

¹¹⁶ For a discussion of the tax equity in general, see, e.g., Richard A. Musgrave, *Horizontal Equity, Once More*, 43 Nat'l Tax J. 113, 113 (1990); Deborah M. Weiss, *Tax Incentives Without Inequity*, 41 UCLA L. Rev. 1949, 1955 (1994) (about tax incentives created horizontal inequity); For a discussion of the equity aspect of tax competition, see Reuven S. Avi-Yonah, *Bridging the North/South Divide: International Redistribution and Tax Competition*, 26 Mich. J. Int'l L. 371 (2004); Julie Roin, *Competition and Evasion: Another Perspective on International Tax Competition*, 89 Geo. L. J. 543 (2001). For a critique of the role of Miranda Stewart and Sunita Jogarajan, *The International Monetary Fund and Tax Reform*, British Tax Review (2004) 146-175 (2004); and Miranda Stewart, *Global Trajectories of Tax Reform: The Disclosure of Tax Reform*

Not surprisingly, the Chinese government was aware of the efficiency argument against tax incentives throughout years of tax law reform.¹¹⁷ Allocation of resources advocated in Western tax literature in perfectly competitive markets is presumably not achievable in China.¹¹⁸ However, such market efficiency would imply significant government intervention in China.¹¹⁹ On the other hand, in China, tax policy is meant to achieve higher goals of state and individual ordering that go beyond basic considerations of revenue maximization. In this case, bilateral tax treaties signed by China help the recognition of the concept of tax sparing and double taxation¹²⁰ to allow foreign investors to keep tax preferences they were entitled to under Chinese law.¹²¹ The efficiency argument is particularly important in the current international tax regime as well.¹²²

in Developing and Transition Countries, 44 Harv. Int'l L. J. 134, 140-190 (2003).

¹¹⁷ See Jin Renqing (Minister of Finance of the P.R.C.), *Explanation on Draft Enterprise Income Tax Law*, The full text of the speech in English is <http://www.china-embassy.org/eng/gyzg/t302221.htm>

¹¹⁸ See Jiang *supra* 4, at 611-637, Professor Jiang discussed the cultural factors are part of an important perspective on the reform of tax law in China in the past decades, and provided a policy consideration to understand how Chinese tax reform may evolve even a market economy system did not come into place

¹¹⁹ Economists tend to argue that state intervention in the form of tax subsidies distorts the efficient allocation of resources through price and market mechanisms. For a survey of these views, see Celine Azemar, Rodolphe Desbordes and Jean-Louis Mucchielli, *Do Tax Sparing Agreements Contribute to the Attraction of FDI in Developing Countries?*, <ftp://mse.univ-paris1.fr/pub/mse/cahiers2004/Bla04047.pdf>; James Hines, Jr., *Tax Sparing and Direct Investment in Developing Countries*, Nat'l Bureau Econ. Research Working Paper No. 6728 (1998), <http://www.nber.org/papers/w6728>. see also Jiang *supra* 4, at 638, noting that as tax incentives are intended to affect resource allocation and generate tax collection by deviating from market principles, they are objectionable *per se* according to the most basic tax policy framework. However, "in a world of uncertainty and imperfect information, a world in which most significant policy decisions rest on assumptions and conjectures," taxation is "one of the range of governing instruments at the disposal of government" and can be utilized "to maintain the acceptability and influence of the governing party with important segments of opinion"

¹²⁰ For further research, see Celine Azemar and Andrew Delios, *Fiscal Incentives in Developing Countries and FDI: Tax Sparing Matters* (Apr. 2005), http://www.afse.fr/docs/congres_2005/docs2005/Azemar.pdf

¹²¹ A typical tax sparing credit clause makes specific references to the Chinese legislation that grants the tax reduction or exemption. The tax incentives granted under the FIE Tax (1991) have been considered to be of a substantially similar. Because the new Enterprise Income Tax Law (2007) retains the reductions and exemptions of withholding tax on dividends, interest and

Measuring the 1994 tax system overhaul on indirect taxes for efficiency, none of those three major indirect taxes (VAT, Business Tax and Consumption Tax) achieve the correct relationship between negative externalities and social costs, and tax burdens were mostly placed on firms in the intermediate part of the production chain. The VAT, for example has a general 17 percent VAT for sales of most goods and a 13 percent rate for a select few goods or products. Different from a modern final-consumption-based VAT regime such as a retail sales tax where tax is not collected in intermediate, business-to-business stages of the production chain, China's VAT is refunded or credited for exportation and business-to-business transactions. On the other hand, small businesses are subject to two tax rates – 4 and 6 percent, but they are not entitled to recover VAT on their acquisitions and businesses subject to higher tax rate can only recover the input VAT from inventory, and no input VAT from capital goods is usually refundable. As the most important tax, in terms of revenue contribution, the current production-based cascading VAT induces economic inefficiencies by associating externalities and social costs with longer production chains (with various intermediate stages of inventory and production). Intermediate transactions completed within a single, inefficient, but integrated firm may avoid more costs than those efficient intermediate businesses that need to deal with both

royalties available under the 1991 tax law, it should be clear that the tax sparing credit applies to the new law.

¹²² It is beyond the scope of this thesis to overview the literature on international tax neutralities. For further reference, see Hugh J. Ault & Brian J. Arnold, *Comparative Income Taxation: A Structural Analysis* (Kluwer Law International 2d ed. 2004); Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 Tex. L. Rev. 1301 (1996); Michael Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies*, 54 Tax L. Rev. 261 (2001); Michael Graetz & Itai Grinberg, *Taxing International Portfolio Income*, 56 Tax L. Rev. 537 (2003)

input and output VAT compliance. Therefore, the efficiency rationale fails to justify the shortage of relief from input business tax for small businesses and prejudice against businesses relying heavily on services.

Moreover, the VAT relief provided for exported goods creates another set of inefficiency concerns. China offers a VAT refund to exporters to remove their domestic externalities in terms of tax paid before exported goods leave China with a credit for all tax incurred on inputs during the production of exported goods or a refund of available input taxes. However, this general rule was fragmented into five discretionary rates of refund formulas as enforced by tax authorities, ranging from the highest rate of 17 percent to the lowest – 3 percent. Tax authorities, based on their sole discretion, may apply or selectively distort the application of these various rates to penalize disfavored exports or subsidize industries desirable in the particular industrial reform climate. These adjustable rates and applicable industries may also serve to retool investments across different industries and sectors, which leave ample room for tax authorities to administer the laws inefficiently.

As to the other two types of indirect taxes, the business tax is imposed on all services, whether provided to intermediate businesses or final consumption, and this tax collection practice breeds inefficiency as it creates both externalities on intermediate business and burdens the final consumers. An example is the business tax based on interest payments of bank loans, the most popular, if not the only, way to obtain capital for business development. For enterprises with different types of debt financing needs, especially those privately-held or medium

and small sized businesses, such taxes on bank loan interest payment may lead them to borrow capital from non-bank sources by back-to-back or alternative means without incurring the business tax obligation through the high interest rate charged on loans. This rule will definitely cause external costs for capital and a social cost of unregulated and tainted financing practices. As to the consumption tax, which is imposed on a long list of selected “luxury” goods, it can hardly perform intended redistributive function. Rather it mostly serves as a punitive measure, actualizing political biases with a very weak link to sound tax policy. The consumption tax, with rates ranging from 3 to 45 percent, is at best a policy to balance socioeconomic disparity in China. However it really succeeds only in shifting the purchasing capacity of the growing population of wealthy Chinese to overseas markets for luxury goods.

A focus on tax equity now turns more attention to the Chinese government, which seemed to pay it little or no attention when they first introduced the two-track system. While many other factors may have contributed to the dismal performance of China’s SOEs, disparate tax treatment has been criticized based on irregular development of markets and the weakening of state planning.¹²³ To eliminate these criticisms, in 1985, the State Council revised the progressive income tax schedule for collectively-owned enterprises to reduce their tax burden.¹²⁴ While non-state sectors are thriving, the performance of many SOEs

¹²³ See Wang, *supra* 11 at 166-168, discussing the control of the states are private economy sector has been loosened since the 1980s

¹²⁴ see Zhonghua Renmin Gongheguo Jiti Qiye Suodeshui Zhanxing Tiaoli [*Provisional Regulations of the People's Republic of China on Income Tax of Collective Enterprises*], issued by the State Council on April 11, 1985; See Li, *supra* 3 at 47-49; see Jiang *supra* 4, at 647, noting that after China’s Constitution allowed for privately-owned businesses in 1988, the government

remains dismal.¹²⁵ Differences in tax treatment between the state and non-state sectors were eliminated by the 1994 tax law reform, which unified income tax regulations governing all firms, whether state-owned or not. However, since then the critics have shifted the thrust of their complaints to various tax and non-tax preferences benefiting FIEs, all of which led to the unification of enterprise income tax law in 2007.

Tax incentives create horizontal inequity. After the unification of enterprise income tax law, the debates that equity does not apply to tax preferences have been animated, particularly after China's accession to WTO. Advocates for uniform taxation of FIEs and SOEs usually assume that, although the rules should be changed, the preferential tax policies should be maintained. Although SOEs have eagerly sought tax benefits for themselves arguing with reference to policy concerns,¹²⁶ their equity argument does not require an abandonment of tax preferences *per se*; rather, it simply demands the same tax benefits given to foreign businesses. In reality, however, it is unlikely that existing tax preferences favoring foreign businesses can indiscriminately be applied to domestic enterprises.

Another aspect of tax equity – vertical equity – requires “an appropriate differentiation among unequals.”¹²⁷ Vertical equity is more controversial than horizontal equity to China because the differentiation is made based on “social

applied a favorable thirty-five percent income tax rate to private enterprises, compared with the then fifty-five percent rate for large and medium state-owned enterprises

¹²⁵ See Jiang *supra* 4 at 648, noting critics blame disparate tax treatment for the plight of the state sector. By 1991, large-and medium-sized SOEs paid a higher percentage of their profits as income tax than did the non-state enterprises

¹²⁶ See Wang *supra* 11 at 127-132, discussing SOEs may take the advantage of governmental subsidies

¹²⁷ See Musgrave *supra* 116 at 113, quoted by Jiang *supra* 4 at 651

taste and political debate.”¹²⁸ China once had a revenue-sharing system under which a portion of locally-collected revenues were withheld for the central government. The rest went into a pool to be shared between the central and local governments according to pre-determined formulas or contracts.¹²⁹

The efficiency and equity debate perfectly showcases the inability of China’s tax system to resolve challenges between foreign and domestic interests, coastal and hinterland development and income disparities among various classes. China is now far more open than thirty years ago. The debate is important because it serves to perfect the agenda of domestic economic development and liberalization set by Chinese leaders. The scope of this debate should focus on the future agenda of Chinese economic development, given China’s tradition of treating tax policies as political and social adjustments.

V. China’s Tax Law Reform and Fiscal Decentralization

5.1. Overview

5.1.1. Decentralization in General

A series of fiscal and tax law reforms undertaken in China in the past decades witnessed the enduring, sometimes painful, process of *de facto* fiscal decentralization. Inheriting an established feudal, authoritarian, bureaucratic

¹²⁸ see Paul R. McDaniel and James R. Repetti, *Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange*, 1, Fla. Tax Rev. 607 (1993)

¹²⁹ See Xu, *supra* 3, at 163-169, discussing the effect of revenue sharing between central and local governments; see Jiang *supra* 4, at 651, emphasizing rich or coastal provinces could yield tax revenues because they had a large revenue basis to be shared with the central government, whereas poor or interior provinces had scarce resources as all the revenues collected locally often fell short of local development targets. Governments in poor areas tended to treat tax preferences as abuses and distortions in favor of richer regions

system lasting over two thousand years, the People's Republic took up the imperial tradition of bureaucratic government by maintaining a centralized, planned economy system with Soviet overtones. Tax collection, was run locally but organized and manipulated by the central government. Insufficient financial resources caused by political and economic centralization, vestiges of feudal relationships, and the denial of democratic elections and government accountability collectively contributed to serious corruption, uneven tax burdens, and high prevalence of land annexation in both imperial China and the PRC.

In retrospect, the strategy of prioritizing heavy industries and a state-owned sector was likely inconsistent with China's inherited governmental structure at the beginning of the socialist transformation in the 1950s. The mobilization of capital for resource-intensive industrialization and deficient material accumulation require a planned economy system, and corresponding fiscal system. China's history of distorted prices, highly centralized planned resource allocation, and a micro-management of firms left its financial sector dangerously under-developed and the fiscal system served as the key, if not the only channel, for centralized resource enlistment and allocation.

Some scholars arguably theorized the institutional settings of China's "central-local two track" system in the past three decades as a "market-preserving federalism."¹³⁰ In particular, it emphasized local fiscal incentives created for local economic development and growth by retaining a high degree of local revenue as providing powerful incentives to expand local tax bases through market-friendly

¹³⁰ See generally, Qian Yingyi and Gérard Roland, *Federalism and the Soft Budget Constraint*, *Am. Econ. Rev.*, Vol. 88, No. 5, (1998), Qian Yingyi and Barry Weingast, *China's Transition to Market: Market-Preserving Federalism Chinese Style*, *Journal of Policy Reform*, 1:149-185 (1996)

and development-oriented policies.¹³¹ During periods of socialist industrialization and market formation when capital was scarce, a profoundly centralized fiscal system, such as the “unified revenue and unified expenditure” (*tongshou tongzhi*) model, was sought where the accounting system and financial indexes of SOEs were directly incorporated into and formulated through the fiscal system and all important resources were heavily controlled by the central government. For instance, all budgets were devised and monitored by the central while local governments did not have discretionary power to determine independent budgets.¹³² On the other hand, local governments were not silent in voicing out their “autonomy.” They not only obtained significant autonomy over their own budgetary decision processes, investments, land requisitions and sales, local fees and the like, but they also took on the responsibilities of providing and monitoring public goods and services, such as healthcare, social insurance, education and infrastructure construction. Local governments also relaxed the control of SOEs and TVEs by promoting a market-based system honoring contractual business activities and independent firm operation in the hope to establish a coordinated local system of tax incentives.

Not surprisingly, the intergovernmental game in China followed a cycle of “decentralization leads to disorder; disorder leads to centralization; centralization

¹³¹ *Id.*

¹³² Local governments (at province, prefecture, county level and commune level) did not have independent budgets. As to expenditure assignment, the central government was responsible for national defense, economic development (capital spending, R&D, universities and research institutes), industrial policy, and administration of national institutions such as the judicial system. Responsibilities for delivering day-to-day public administration and social services such as education (except universities), public safety, health care, social security, housing, and other local/urban services was delegated to local governments

leads to stagnation; stagnation leads to decentralization,”¹³³ which was inevitable under the soft-budget constraints vested to local government and SOEs. However, the evolution of the Chinese fiscal and tax system hardly can be portrayed as a “federalism”¹³⁴ which is constitution-oriented, election-based and inter-regional mobility-driven¹³⁵. Consequently, a *de facto* informal and flexible tax framework administered by local government intertwined with central, formal and national tax regime controlled by the central government inevitably came into place contributing to a complex “central-local two track” system.

5.1.2. The Dilemma of the Decentralization Cycle in China’s Planned Economy

The typical problem of State control and centralized scrutinizing caused by information asymmetry emerged shortly after the central planned system was formulated in the early 1950s. Deficiencies of the over-centralized economy inherited by the PRC received close attention from top Chinese leaders,¹³⁶ to whom China’s “territory is so vast,”¹³⁷ and Chinese “population is so large and the conditions are so complex that it is far between to have the initiatives come

¹³³ See Qian and Weingast, *supra* 130 at 152-53

¹³⁴ See generally, Brennan, G. and J.M. Buchanan, *The Power to Tax*, (Cambridge University Press, 1980). In Brennan and Buchanan’s Model, the government is viewed as a monolithic Leviathan to maximize its tax revenue, which should be restrained by the institutional settings of fiscal federalism

¹³⁵ See Ch.M. Tiebout, *A Pure Theory of Local Expenditures*, *Journal of Political Economy* 64 (1956), 416–424, discussing vote by hand vs. vote by feet

¹³⁶ See generally Mao, Zedong *On Ten Important Relationships*, a famous speech published by Mao in 1956

¹³⁷ *Id.*

from both the central and the local authorities than from once source alone.”¹³⁸ Therefore, China “must not follow the example of the Soviet Union in concentrating everything in the hands of the central authorities, shackling the local authorities and denying them the right to independent action.”¹³⁹ In light of the substantial workload required to formulate, administrate, balance, coordinate, and monitor a planned fiscal system in China and establish corresponding intergovernmental arrangements, which only increased as the economy grew larger and more complicated, decentralization of the fiscal function was necessary.¹⁴⁰ As economic development coupled with more infrastructure projects initiated and enlarged the SOE sector, fiscal centralization became increasingly less efficient and competent. Moreover, a highly centralized planned system thwarted promoting SOE incentives as well as discouraged local governments to fully coordinate and foster local industrial projects.

To resolve problems arising from centralized socialist transformation, China initiated the first round of decentralization efforts within the planned economy framework by delegating more powers to local governments immediately after the first five-year plan in 1957¹⁴¹, for example, revenue sharing schemes were fixed for five years and local governments were granted some authority over taxes.

¹³⁸ *Id.*

¹³⁹ *Id.*

¹⁴⁰ See Qian and Weingast, *supra* 130, at 160-161, the number of state owned enterprises(SOEs) subordinated to the central government increased from 2,800 in 1953 to 9,300 in 1957, and the number of items in material allocation under central planning increased from 55 in 1952 to 231 in 1957

¹⁴¹ *Id.*, reviewing the history of decentralization in China, in particular, the policies then covered: (1) delegating nearly all SOEs to local governments such that the share of industrial output by the enterprises subordinated to the central government shrank from 40 percent to 14 percent of the national total; (2) central planning was to change from a national to a provincial basis, with decisions about fixed investment to be made by local governments rather than the central government

However, the decentralization, together with Great Leap Forward, led to the collapse of cross-industry coordination assembled under the planned centralization and inter-regional segmentation pushed local governments to establish an independent, but duplicative, set of industrial systems in the interest of self-sufficiency. As a result, central government revenue heavily shrank from 75 percent to less than 50 percent of the treasury until the end of 1950s.¹⁴²

Expectedly, such radical decentralization efforts run to opposite extreme due to coordination failures. The soft budget constraint faced by local governments and SOEs soon led to excessive investment expansion and inefficient duplication of production among various regions. Recentralization had to begin in 1959 in which all large and medium-sized industrial enterprises were again subordinated back to the central government. However, the centralization again brought about incentive problems and economic stagnation in the 1960s, thus a second wave of decentralization followed in the early 1970s when local governments gained more authority over fixed investment and local revenue. Afterwards, a similar, but less serious investment boom led to yet another round of recentralization in the mid-1970s, coupled with the political strife caused by the Cultural Revolution.

To recap, the separation of administrative responsibilities and adjustment of power division between the central and local governments ultimately only changed the political statuses of regions and reshuffled industries in the resource allocation scheme. However, the heavy-industry-stressed development strategy, the distorted macro-policy environment, controlled resource allocation system and rigid enterprise management institutions were left largely intact. It is easy to see

¹⁴² *Id.*

that the decentralization under a central, planned system was not able to alleviate the inefficiency problem since it could neither improve micro-efficiency through market discipline, nor could it change the heavy industry development strategy inconsistent with China's comparative advantage. Therefore, a cycle of "decentralization leads to disorder; disorder leads to centralization; centralization leads to stagnation; stagnation leads to decentralization" was inevitable under the soft-budget constraints vested to local government and SOEs.

5.1.3. Administrative Decentralization

Although the distorted infrastructures and low efficiency under the planned economy were considered problematic from the first round of decentralization in the 1950s, it was not until the 1978 market economy reforms that fundamental reforms were undertaken. There had been an inherent political logic for the distorted development strategy, centralized resource allocation system and rigid enterprise institutions, with production irregularities and twisted price control. When China's top leaders realized in the late 1970s the production inefficiency of SOEs and People's Communes and lack of stimulus for workers and farmers, the Household Responsibility System became a dominant form of microeconomic organizations in rural areas, and reforms of the Contract Responsibility System (*chengbao zeren zhi*) on SOEs centering on power delegation and profit sharing were initiated. Accordingly, those micro-reforms in rural areas and SOEs were accompanied by a process of administrative and fiscal decentralization, which

was deemed necessary in a large country like China to induce local coordination in market-oriented reforms.

From the administrative perspective, fiscal and tax reform since the early 1980s stimulated a significant increase in local governments' autonomy in local administration and economic management. The autonomy was evidenced by a few decentralization efforts in improving efficiency and justifying fair competition, such as "local state corporatism"¹⁴³, tax incentives for attracting (foreign) investment, removal of barriers on industry entry standards, pledging bank credit for the profitability of local firms, and flexibility in resource allocation. Moreover, rural economies, especially the town and village enterprises (TVEs), and some local SOEs were tentatively released outside the planned framework due to deregulation. For instance, a shift of revenue sources from top-down stripping of profit or cash flow gradually moved to levying taxes on the non-state sector to secure protection of local property rights under an unpredictable centralized setting. Local governments behave as lawmakers when they impose taxes on TVEs and as possessors when they declare residual profits under local control. Another particularly remarkable development is the flexibility of coastal systems in designing local tax incentives in the initial years of the open door policy.¹⁴⁴ Starting from the early 1980s, many regions especially coastal provinces were designated and approved to establish their own foreign trade

¹⁴³ See e.g., Jean Oi, *Fiscal Reform and the Economic Foundations of Local State Corporatism in China*, *World Politics* 45:99-126 (1992) [hereinafter Oi: Fiscal Reform]; Jean Oi, *Rural China Takes Off: Incentives for Reform* Berkeley: University of California Press (1994); Jean Oi, *The Role of the Local States in China's Transitional Economy* *China Quarterly* 144:1132-1149 (1995) (Professor Jean Oi from Stanford is one of the leading political scientists in studying the federalism and central-local government relationships of China.)

¹⁴⁴ See generally Jean Oi, *Fiscal Reform*, *World Politics* 45:99-126 (1992)

corporations with regional opening-up experimentation. Experiments included the “one step ahead” policy, implemented in Guangdong and Fujian provinces, the establishment of four special economic zones (“SEZ”) (Shenzhen, Zhuhai, and Shantou, and Xiamen) in 1980, and the designation of 14 coastal cities as “coastal open cities” (“COC”) in 1984. These areas were privileged to enjoy lower tax rates and a higher share of collected revenues, but perhaps more importantly, they benefited from special institutional and policy arrangements and gained more autonomy over local economic development.

Granting more independent decision-making autonomy to an increased number of local, especially littoral SEZs and COCs, governments is far from describing the whole picture of administrative decentralization. The principle-agent relationship is another deliberation underpinning many scholars’ characterizations¹⁴⁵ of China’s intergovernmental balance. Local government agencies exploited different degrees of flexibilities in implementing central policies given their diversified social, geographical, historical and resource allocation. With balance shifted and separated between central-to-local ownership, local governments were provided with incentives in tax and profit sharing to step up their effort in revenue collection. Meanwhile, inter-regional rivalry compelled local governments to adopt aggressive tax incentives to subsidize their tax bases.¹⁴⁶ A penetrating factor in the administrative decentralization was the delegation, from the early 1980s

¹⁴⁵ See generally Barbara Krug and Hans Hendrischke. (eds.) *China’s Economy in the 21st century: Enterprise and Business Behavior*. London: Edward Elgar (2007); see also Barbara Krug, (ed.) *China’s Rational Entrepreneurs : The Development of the New Private Business Sector*. London: Routledge Press.(2004)

¹⁴⁶ See Barbara Krug, *Introduction: New Opportunities, New Sector, New Firms* in Barbara Krug (ed.) *China’s Rational Entrepreneurs: The Development of the New Private Business Sector*. London: Routledge Press.(2004)

onward, of the operation and management of SOEs to local governments at the provincial, municipal and county levels.¹⁴⁷ Fixed asset investments for local-government-owned-enterprises naturally fell on the shoulders of local government, which had to take primary and final responsibilities as the SOE owners for expenditures covering a wide range of social services like education, healthcare, pension and retirement services. These created a *de facto* coalition of SOEs and local government agencies incentivized to exploit central fiscal and tax policies to maximize local benefits.

5.2. Overview of Fiscal Decentralization

5.2.1. Fiscal Decentralization under Market Economy Development (1978-1993)

Chinese fiscal system also experienced substantial decentralizing process and efforts since adopting the reform and economic reform policies from the late 1970s. The objective of decentralization was designed to substantiate local government responsibilities and autonomy for local economic development and fiscal functioning, while preserving an adequate degree of central fiscal control

¹⁴⁷ See Yingyi Qian and Chenggang Xu, *Why China's Economic Reform Differ: The M-form Hierarchy and Entry/Expansion of the Non-state Sector*, *Economics of Transition* 1(2), pp.135-170 (1993), discussing the overall costs and benefits of U-forms and M-forms in terms of scale economies, incentives, and coordination, and also the implications of these costs and benefits for alternative approaches to reform and further noting that, by 1985, the state-owned industrial enterprises controlled by the center accounted for only 20 percent of the total industrial output at or above the township level, while provincial and municipality governments controlled 45 percent and county governments 35 percent

and appropriate nationwide resource allocation. Meanwhile, decentralization brought unexpected headaches to top Chinese leaders in executing contractual arrangements between the central and local agents, such as drains on revenue, increased central deficits, weakened macroeconomic management and augmented interregional disparities. China's fiscal decentralization efforts in the 1980s and early 1990s involved balancing and delineating intergovernmental contractual relationships in three areas: 1) division of expenditure responsibilities between central and local governments; 2) reformulating the allocation or sharing of revenue resources; and 3) vertical fiscal transfers among various levels of governments.

China's division of expenditure responsibilities between the central¹⁴⁸ and the local¹⁴⁹ governments follows the hierarchy of budgetary agencies, which is roughly consistent with international practices.¹⁵⁰ Accordingly, expenditures of budgetary agencies owned or materially managed by local governments are taken care of by local budgets, whereas the central government only provides subsidies to poor or underdeveloped regions to meet a set of uniform national minimum standards of basic public services and social security. Although the central

¹⁴⁸ Details on such arrangement and formula are the website of the Ministry of Finance of the P.R.C., <http://www.mof.gov.cn>, the center government's expenditure responsibilities include national defense; foreign aid and external relations; capital construction and technical upgrading of centrally owned enterprises and outlays on their new product development; agriculture, forestry, and water conservation at the central level; industrial transportation, and commercial operation of national importance; certain education, culture, health and social services; outlays on centrally obligated price subsidies; geological surveys; and repayment of public debt (last visited on March 15, 2011)

¹⁴⁹ Local expenditure responsibilities include basic construction and technical improvement of locally owned enterprises and their new product development; rural production assistance, agricultural development and water conservation at the local level; urban maintenance and construction; education, health, culture, and social services; social welfare and pensions; administrative expenditures; and a range of price subsidies.

¹⁵⁰ See generally, Ze Zhu and Barbara Krug, *Is China a Leviathan?* ERIM Report Series Research in Management (2005), <https://ep.eur.nl/handle/1765/7175> (last visited on March 15, 2011)

government no longer micromanaged with confusing stipulations for individual local cases, it continued to burden itself with formulating compulsory guidelines monitoring acceptable minimum levels of local expenditure, adjusted by factors such as policy priorities such as disasters relief, price readjustment and government procurement changes.

The revenue-sharing and tax assignment dimension of decentralization was no less dramatic. Starting in the early 1980s, the central-provincial fiscal system shifted from a “unified revenue and unified expenditure” into the “dining in separate kitchens”(*fenzao chifan*) that divided revenue and expenditure responsibilities between the central and the provincial governments.¹⁵¹ To experiment with the transfer of fiscal power from central to local governments, many programs were initiated such as the “fixed overall revenue sharing rate” in Jiangsu Province in 1977, “dividing central, local and central-local share” in Sichuan Province in 1979, and a “fixed lump sum upward remittance” in Guangdong and Fujian Provinces from 1979 to 1983. The central-provincial intergovernmental division experienced some further adjustments including the proportional sharing system in 1982. Moreover, the central government adopted the Contract Responsibility System followed by a “tax-for-profit” (*li gai shui*) in 1983 and 1984. The share of after tax profit or the tax rate was subject to a case-

¹⁵¹ See Qian and Xu, *supra* 147 at 150-155, noting under such a system, (i) some fiscal sources were clearly specified as the central government’s revenue, among these were custom duties and revenue remitted by central-government-owned-enterprises; (ii) other sources such as salt tax, agricultural taxes, and the revenue of local-government-owned-enterprises were defined as the local governments’ revenues. (iii) for the profits of large-scale SOEs under dual leadership by central and local governments, the industrial and commercial taxes (turnover taxes), central government and local government shared them with some fixed proportion. It is obvious that the spirit of the rearrangements in 1980 is to preserve the incentives for the local governments, constraint to the guarantee of the central government’s revenue

by-case annual or bi-annual negotiation with the central government in terms of enterprise size, industry sectors, and various development concerns. In this new arrangement, SOEs, after submitting their contracted quota of profits to the central government, behaved as independent market participants and kept residual profits for wages, investments, and capital investment purposes without State intervention. However, the underperformance of SOEs forced the central government to increase expenditures and bank loans to bail out bankrupt SOEs, while managers of profitable SOEs were suspected of manipulation and asset-stripping through privatization of state assets or transfer of assets to non-state sectors. Therefore, the subsidies for SOEs were much higher than the revenue collected from SOEs. This led the central government to design more schemes to expand the tax base including TVEs, Sino-foreign joint ventures and foreign investments.

As to the fiscal contracting system, or tax farming, the central government negotiated different contracts with each province on revenue remittances to the central treasury, and permitted most provincial governments to retain the bulk of their revenues.¹⁵² However, the contractual arrangements were not strictly honored, enforced, adhered to and were revised repeatedly for some provinces. These breaches of central-local contractual arrangements can be explained.

¹⁵² See Oi: Fiscal Reform, *supra* 143, noting that there were six basic types of sharing schemes in 1988 and they continued through 1993, such as a fixed subsidies from the center (in 14 provinces), fixed quota delivery to the center (in 3 provinces), fixed sharing with the center (in 3 provinces), quota delivery with a pre-specified growth (in 2 provinces), an incremental sharing, and sharing up to a limit with growth adjustment (10 provinces retained a share within a specific percentage of revenue from the previous year and then retain all revenues above that quota)

Although the 1988 fiscal contracting system was extended until the end of 1993 with limited modifications to revenue-sharing ratios and quotas, the central government was unable to find its way to negotiate a satisfactory replacement scheme. First of all, the local budget planning as well as a comprehensive understanding of cross-regional budgets is unpredictable. Second, the information asymmetry based on the principal-agent relationship was dominated by various localities, which may switch part of revenue offline from the sharing arrangement. Under the fiscal contract systems, the local government controlled considerably the actual tax rates and tax bases adopted in practice, although they did not enjoy the legislative authority to design and adjust the statutory tax rates and bases. Local governments offered various types of tax concessions and incentives to enterprises especially foreign investments located and operated in local jurisdictions, and shifted budgetary funds for non-budgetary or extra-budgetary purposes, thus minimizing the tax revenue share to be remitted to the center. Hence, the central government had to take various *ad hoc* measures to demand and manage revenue remittances from local governments, which inevitably had perverse reactions to those measures. Therefore, it was not uncommon for local governments to submit fraudulent reports on, or even conceal, their true revenue capacities when the central government reacted to tighten or revise rules to squeeze or penalize local governments with rapidly growing revenues.

Due to the declining local tax efforts and then on-going SOE reforms, the state financial bases were eroded heavily and the central government proposed to remedy such deficiency. China's budgetary revenue-to-GDP ratio decreased

sharply which caused more government deficits and constrained the central government's flexibility in redistribution as well as its stabilization control. The central government became increasingly concerned about the shrinking revenue-to-GDP ratio,¹⁵³ which fell from an already low 26 percent in 1980 to 13 percent in 1993, and the ratio of central government revenue to total revenue¹⁵⁴ which fell from 41 percent in 1984 to 22 percent in 1993.¹⁵⁵

Another unresolved issue is the vertical fiscal transfers between various layers of administrative hierarchy (central, provincial, prefecture, county and township) in addition to various levels of special economic zones. Although the central and provincial governments may negotiate the share of expenditures and revenue, the negotiation on sub-provincial levels of fiscal transfers was left unlegislated, and the tax rates were contracted without reflecting efficiencies or legislative intent. Diversity of the sub-provincial levels of governments even aggregated the discretionary implementation of national tax legislations and policies. Sub-provincial governments had to negotiate their shares of expenditure and revenue with upper level of governments. Therefore, negotiations between different layers of governments on transfers and reallocation were constant and added considerable burden to tax administration and collection. Moreover, lower levels of government made tentative attempts to maximize discretionary revenue and their tax base but shift expenditure responsibilities upward in order to minimize transfers.

¹⁵³ The government revenue refers to the budgetary revenue

¹⁵⁴ Domestic and foreign debts held by the central government are excluded

¹⁵⁵ See China Statistical Yearbook, National Bureau of Statistics, China (2004)

5.2.2. Recentralization efforts – the 1994 fiscal reform

Echoing the endangered two ratios¹⁵⁶ as well as to strengthen expansion on tax revenue and expenditure policies implementation, in 1994 the central government initiated a fundamental fiscal reform to replace the already disabling fiscal contracting system thus to increase the regulatory share and authority of central revenue and to establish a reformulated fiscal transfer system. The centerpiece of the comprehensive package of fiscal reform in 1994, still in effect today, was the revenue sharing scheme (*fen shui zhi*), under which the sources of revenue were regrouped to include those shared revenues that central and local governments can only collect revenue from designated taxes only. In total 29 taxes have been imposed on income, turnover, property, resources and services, and indirect taxes since then have composed the major revenue source. The revenue sharing scheme (Table 4.1) authorizes the central government to collect the bulk of the tax revenue, and importantly a 75% share of the newly created Value Added Tax (VAT) and other indirect taxes.¹⁵⁷ Local taxes mainly consist of business taxes, personal and enterprises income taxes, and other taxes such as urban construction tax, land use and real estate taxes, and agricultural taxes (abolished in 2004). In addition to VAT, shared revenue sources include securities trading tax and natural resource taxes. The expenditure responsibilities were nominally unchanged with the sub-provincial levels (prefecture, county, and township) bearing the same

¹⁵⁶ *Id.*

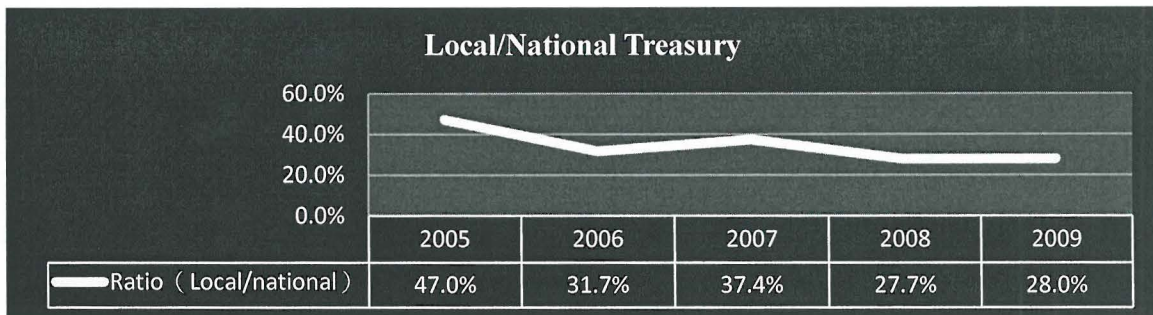
¹⁵⁷ Customs duty, consumption tax collected by customs, income tax on centrally-owned SOE, turnover taxes on railway, banks, and insurance companies, and income tax from financial institutions set up by the headquarters of People's Bank of China, etc.

expenditure responsibilities that were delegated to them through the decentralization in the 1980s. (Table 1)

Table 1. Central-local Taxes Sharing Formula

Shared Taxes	Central	Local
VAT	75%	25%
Enterprise Income Tax	50% (2002)	50% (2002)
	60% (2003)	40% (2003)
Individual Income Tax	50% (2002)	50% (2002)
	60% (2003)	40% (2003)
Stamp Duty	94% of taxes on Security transaction	6%

Along with the reformed tax assignment system, the central government set up strong infrastructural revenue collection agencies called State Tax Bureaus under the supervision of State Administration of Taxation in all provincial, prefecture and city level governments to collect central and shared taxes. The outcome of the revenue sharing system was very remarkable. (Table 2 and Figure 14)



(Figure 14)

Local Revenue/ Total Government Revenue (2005-2009)

Tabl.2 Local Revenue

	Total Governme nt Revenue	Local Revenue	Percentage (Local/Tota l)	Δ (weight)
2005	31649.29	14884.22	47.0%	N/A
2006	38760.2	12297.31	31.7%	-15.3%
2007	51321.78	19168.93	37.4%	5.6%
2008	61330.35	17008.04	27.7%	-9.6%
2009	68518.3	19168.93	28.0%	0.2%

The percentage of total budgetary revenue collected by the central government jumped from 22 percent by the end of 1993 to 61 percent in the share of central government revenue in 2009, more importantly, the central government regained the authority to collect the major part of the VAT, which, alone, accounted for

about 42 percent of total government revenue.

Although the reformulated revenue sharing scheme was carried out with more transparency and stability, many rudiments of old fiscal system remained along with emerging new problems. First, the central government compromised with many provinces especially the affluent, coastal regions that were initially averse to the revenue sharing formula. It was forced to agree that the tax-sharing system would be implemented gradually over a few years and part of the shared revenues would be returned to locals. Second, the central government allowed tax exemptions associated with foreign investment and approved by local governments to remain valid for the first two years after the fiscal reform. SOEs that were previously co-managed by central and provincial governments could continue to receive subsidies for launching large-scale investments and for supporting laid-off workers. In addition, many new issues arose regarding the expenditure burden borne by county and township governments, which together provided the bulk of vital public services such as social security, social welfare, education and health services, particularly after the large-scale SOE restructuring in the mid-1990s. Many of the public services and social security responsibilities that were provided by SOEs fell upon local governments, which were not allocated corresponding capital and human resources to perform those responsibilities. Accordingly, many local governments at county or township levels became nearly insolvent or were in urgent need of redistribution or additional transfers from the center.

Further, a notorious old problem remained unresolved under the revenue sharing scheme – a serious lack of a clear assignment of responsibilities among sub-provincial levels of government, which produced a high degree of concurrent and overlapping expenditures and made it more difficult to identify what levels of sub-provincial government were accountable to deliver particular public services social security. Perpetuating the disadvantaged bureaucratic position lower level county and township governments have always held in China, upper level governments concentrate revenue near the center and delegating expenditure responsibilities to lower level governments. Provincial governments on one hand tend to squeeze larger shares of revenues from sub-provincial levels of governments, and on the other hand, exploit means to request and negotiate more transfers from the center.¹⁵⁸ This two-sided tendency became increasingly apparent after the 1994 fiscal reform.

At the same time, the revenue sharing scheme fiscal reform also promised to achieve a healthy intergovernmental fiscal transfer. Among those transfers or grants, the sharing formula based on the old fiscal contracting system prevailing during 1979-93¹⁵⁹ was still allowed in some regions. In some specific industry lines, such contracting formulas remained unbothered to ensure silky completion of those then on-going construction projects such as water conservancy, electricity power plant and animal husbandry, etc. The second type of transfer is the calculated share returned from the central government to ensure various locality to keep the same revenue capacity that was no less than what it was prior

¹⁵⁸ See Justin Y., Lin, *Decentralization, Deregulation and Economic Transition in China* (Working Paper, CCER, Peking University, 2003) (on file with the author) at page 41

¹⁵⁹ *Id.*

to 1994. Regretfully, the newly designed transfer formulas did not attain the considerations of regional disparity, and worse is that many transfers were made on *ad hoc* basis based on political needs and equalitarian concerns without a scientific or statistic measurement of fiscal capacities and needs. Thirdly, intergovernmental transfers comprised grants for various purposes, such as price subsidies for bulk products, educational organization subsidies, environmental protection missions, natural disaster relief and outlaying poverty-stricken regional development. However, a “transitional fiscal transfer plans” for channeling more transfers from richer coastal areas to poorer hinterland ones by the center was never fully realized.¹⁶⁰

5.3. Impact of Fiscal Decentralization

Fiscal decentralization, characterized by local tax incentives, has played a significant role in upholding state revenue growth and local economic

¹⁶⁰ *Id.*, Lin, at 49. See also, Hu Shudong *The Logic of China's Fiscal System Change in the Past 50 years*. Ph.D. dissertation (2001) (CCER, Peking University), noting that in order to satisfy the needs of coastal provinces that generate much of the revenues, a lump-sum tax rebates to guarantee their pre-1994 income was agreed. In addition, to permit each province to share in the growth of its lost tax base over time, the central government committed to giving back 30 percent of its increased revenue from the newly created value added tax as well as consumption tax each year. The tax rebates, the largest item in overall transfers, are highly correlated with incomes and dis-equalizing in nature. The *earmarked grants*, the second largest item of transfer, have been found to be mildly dis-equalizing because they were dominated by food and other consumer subsidies that favored urban areas. To offset this regressive effect, the government introduced an equalizing (general purpose) transfer to aid poor regions in 1996. They are rule based and rely on variables such as provincial GDP, student-teacher ratios, number of civil servants, and population density. However, these transfers have been under-funded since their inception, accounting for just 2% of total transfers. For example, in 1998 the central government allocated RMB 2.2 billion to equalization transfers, compared to the estimated fiscal gap of RMB 63 billion produced by the formula.

development¹⁶¹ in the past three decades, especially for the development of an impressive and distinctive expansion of non-state sector enterprises, including TVEs and foreign investment. The autonomy of local governments ensured their flexibility in designing local tax incentives to attract foreign investment and structure comprehensive local economic infrastructure. Meanwhile, the troubled intergovernmental fiscal transfer system also stimulated non-state-owned sectors to compete successfully in the market economy. Fiscal decentralization in China, after rounds of ups and downs, deserves credit for promoting rapid economic development.

5.3.1. Private Enterprises

The rise and expansion of TVEs,¹⁶² some of which later developed into successful private enterprises (*minying qiye* or *siying qiye*), were attributed to the administrative and fiscal decentralization since the late 1970s. Local governments actively supported market-oriented, needs-driven, non-state enterprises to expand

¹⁶¹ See generally, Linda Chelan Li, *Centre and Provinces--China 1978-1993: Power as Non-Zero-Sum* (Clarendon Press, Oxford, 2002), noting that, from 1978 to 1993, China's per capita GNP increased in real terms by around 280 percent. National absolute poverty was reduced by more than 50 percent in the first half of the 1980s, dropping from 17.9 percent of the population in 1982 to 6.1 percent in 1984. This downward trend corresponds to the growth of real income and real GNP. China also witnessed an across-board growth both in coastal and inland regions. Indeed, if each China's province were taken as an economy, about 20 out of top 30 growth regions in the world in the period would be provinces in China

¹⁶² See Jiahua Che & Yingyi Qian, *Institutional Environment, Community Government, and Corporate Governance: Understanding China's Township-Village Enterprises*, William Davidson Institute Working Papers Series 59, William Davidson Institute at the University of Michigan (1998), noting the output of TVEs grew more than six-fold in real terms between 1985 and 1997, leading China's rapid industrial and overall growth. By 1993, TVEs already accounted for 36% of the national industrial output, up from 9% in 1978. Within the rural sector, the TVEs accounted for three-quarters of rural industrial output

their revenue bases, enlarge local markets, and increase their labor forces in response to interregional competition, especially after the establishment of Household Responsibility System in rural areas and discharge of agricultural collectivization. Fiscal decentralization gave higher shares of revenue (TVE tax or profits) to local governments as well as discretionary authority to design locally customized incentives for TVEs. The decentralization policies called for local governments to enjoy great autonomy, including independently standardizing pricing strategy, investing self-raised funds, and designing local labor-incentive industries to margin cover capital shortage. More importantly, the autonomy to restructure local enterprises structure and simplified procedures to issue licenses to newly established enterprises,¹⁶³ which led to the golden period of TVE and private enterprises growth. In addition, fiscal decentralization supported a better delimitation of intra-governmental property rights, which provided provincial governments as resident claimant and de facto controller of those previously central-provincial jointly owned SOEs within their jurisdiction. Local governments then stepped in and assumed the entrepreneurial role, which is beneficial to the legislation and implementation of tax incentives and efficient administration.

¹⁶³ See generally Linda Li, *supra* 161, noting that in the planning period, the state planning seriously limited the autonomy of local governments to generate and retain revenues. Localities were required to turn over all or most of their revenues to upper level governments. The surplus retained was also subject to higher-level approval before any use. It is also interesting to mention that the upsurge of TVEs in post-reform period is also closely related to the two waves of decentralization before the reform, which led to the rise of some collective enterprises (such as Commune and Brigade Enterprises in rural areas to emerge outside the state plan before the advent of reform)

5.3.2. Foreign direct investment (FDI)

The fiscal decentralization process also intertwined with China's development strategy by facilitating a gradual, region-by-region, and industry-specific tempo of attracting of foreign capital and technology. Under a centralized authoritarian state based on extensive expenditure decentralization but little revenue decentralization or fiscal transfer, local government officials no doubt focused on local development needs. With vast expanse, large population, huge regional contrasts, outdated industrial infrastructure, and a ridiculous scarcity of trained workers and business professionals, China has, since the late 1970s, needed an enormous infusion of foreign capital and massive amounts imports of modern equipment and technology in order to make an immediate, visible difference in its productivity and standard of living. China's business and fiscal environment, nationally and locally, were not so appealing to foreign investment. However, China's top leaders understood clearly the importance of decentralization as drastic changes had to be achieved by delegating more authority to localities to improve efficiency and productivity nationally or attract foreign capital. Fiscal decentralization was prioritized as a way of giving that authority by allowing locally designed, region-specific tax incentives and flexible tax collection policies. On July 15, 1979, experimental Special Export Zone (*chukou tequ*) proposed by Fujian and Guangdong provinces were approved by the CCP Central Standing Committee to compete for oversea investment, and such zones were later renamed as Special Economic Zones (*jingji tequ* or SEZ) in part to attract funds from

overseas Chinese¹⁶⁴ who were geographically proximate or had a cultural closeness and kinship with the SEZs. Because SEZs served as a breakthrough of opening-up policy, the government secured unprecedented undertakings to make them successful. SEZs and their governments were given exceptional autonomy and extensive powers in areas such as foreign exchange, financial management, and labor and price controls. As a matter of decentralization, SEZs received preferential policies on tax reductions, exemptions and other flexible fiscal privileges to make them more attractive. Early preferential tax treatment of foreign investors in SEZs was governed by the Regulations on Special Economic Zones in Guangdong Province, which, in fact, preceded the 1980 JVITL and later was fine-tuned and improved by the 1984 Tax Reduction and Exemption Regulations by unifying tax treatment for foreign investment projects in all four SEZs and in Hainan Island.

With a plethora of preferential schemes and overlapping promises, foreign investors in a designated area may claim not only benefits that are available nationwide, but also special treatment offered by regional schemes. On top of nationwide preferential income tax treatments, several SEZ-specific privileges stood out, evidencing the seriousness of China's decentralization efforts.¹⁶⁵

¹⁶⁴ See Jiang, *supra* 4, at 633 and accompanying footnotes, presenting the 1985 Regulations on Preferences to Overseas Chinese Investment created confusion as overseas Chinese investors, no matter where they invested, received more tax benefits than foreign investors even in SEZs, and it was also difficult to distinguish overseas Chinese investment from other foreign investment as many investors were companies, rather than individuals

¹⁶⁵ *Id.*, at 571 and accompanying footnotes, and *see generally* Li, *supra* 1, explaining that all FDI projects in SEZs enjoyed a reduced enterprise income tax rate without distinction between forms of investment and continued using this privilege even after the 1991 unified tax law was promulgated. Moreover, the local governments in SEZs could waive or reduce local income tax. Most significantly, SEZs established precedents for the authorities to create preferences, which helped channel foreign capital and technology into other designated priority areas

China's fiscal decentralization efforts were strengthened after the establishment of SEZs when Chinese leaders decided to encourage almost all coastal areas to accommodate foreign investment and attract foreign capital and technology. Tax incentives ranked high on regional barometers of openness and hospitality to foreign investment. Therefore, efforts to improve investment conditions needed to incorporate preferential tax measures. In May 1984, the central government designated fourteen coastal cities as Coastal Open Cities (*yanhai kaifang chengshi* or COC) and released broader autonomy on local development and foreign investment affairs. In particular, government assigned certain areas within COCs as Economic and Technology Development Zones (*jingji jishu kaifaqu* or ETDZs), which duplicated most of the characteristics of the SEZs together with other preferential policies to target technology-oriented and capital-intensive projects. ETDZs, however, in part evidenced the recentralization efforts of the central government since it retained the final say on matters such as the feasibility of establishing an ETDZ and the exact location and scale of ETDZs¹⁶⁶ Meanwhile, as a regionally based initiative, Old Urban Districts (*lao cheng qu* or OUDs) within COCs were created with limited incentives for foreign investment¹⁶⁷ to

¹⁶⁶ *Id.*, at 573

¹⁶⁷ *Id.*, at 575, and accompanying footnotes, OUD's tax preferential policies were closely applied to another initiative of decentralization – the Coastal Economic Open Regions (*yanhai jingji kaifangqu* or CEORs) that were established to strengthen export sectors as well as reinforce receipts of foreign capital, technology, management skills. The 1984 Tax Reduction and Exemption Regulations has allowed a reduced fifteen percent rate to certain productive EJV, CJV and WFOEs in OUDs. In particular, the enterprises must be technology or know-how intensive, with an investment exceeding U.S. \$30 million and a long investment recovery period, or they must be projects related to energy, transport or port construction. EJV, WFOEs and CJV based in OUDs which are not eligible for the fifteen percent rate receive a twenty percent reduction in their applicable income tax if they fall within one of the following sectors: (1) machinery, manufacturing and electronics; (2) metallurgy, chemical, and building material; (3) light industry, textile, and packaging; (4) medical equipment and pharmaceutical; (5) agriculture,

refuel regional economy. China's leaders also championed the development of those privileged regions and committed their limited available resources to the improvement of related infrastructure.¹⁶⁸ Regional tax incentives made SEZs, ETDZs, OUDs and CEORs outshine the rest of the country but hierarchies were created even among those prioritized regions themselves. SEZs received special attention with the most generous tax benefits to foreign investors due to their pioneering positions and top priority status – a situation, which has remained largely unchanged – since the establishment of the SEZs. The heightened tension had already aroused certain unrest within the CCP leadership itself, so it is no surprise that decentralized efforts and tax benefits available to foreign investment in ETDZs, OUDs and CEORs were capped.¹⁶⁹

The cycle of decentralization and recentralization in terms of tax incentives and fiscal transfers repeated and carried over in the 1990s. Although interrupted by the 1989 democracy movement, the CCP's top leaders realized that any continued unreasonable clench on centralized power would hamper their ability to deliver on promises of material improvements of standards of living. As a result, in addition to those prioritized initiatives, the central government approved further opening and development of the Pudong New District in the City of Shanghai as a showcase for Chinese leaders' commitment to embrace foreign investments by designating a new priority district, and preferential schemes comparable to those

forestry, husbandry, aquatic breeding and processing related to any one of these sectors; or (6) construction

¹⁶⁸ *Id.*, at 575-76

¹⁶⁹ *Id.*, discussing that in fact, China's leaders suspected that to allow the same preferential treatment in non-SEZ prioritized areas would lead to damaging rivalries and distract attention from SEZs

in SEZs were adopted for foreign investment in Pudong¹⁷⁰ followed by the Tianjin Binhai¹⁷¹ and Chongqing Liangjiang¹⁷² new zones. Chinese leaders also adopted a development plan to stimulate economy within unparalleled geographical width. In early 1992, recognizing that urban popular discontent was responsible for the unrest in the spring of 1989, the central authorities placed an increased emphasis on economic development in cities and municipalities to maintain political and social stability. Concerns for stability in border areas called for fast economic growth and both domestic and foreign investments were encouraged through preferential measures.¹⁷³ Decentralization efforts, as evidenced by the establishment and prosperous development of those privileged regions, were largely implemented through tax incentives including tax holidays, exemptions, concessions, and preferential tax rates for reinvestment, among others. Such incentives were also in line with international practices of attracting foreign

¹⁷⁰ See Xinmin Zhang, *supra* 102, the program applies a fifteen percent enterprise income tax rate to FIEs engaged in productive sectors, large infrastructure development projects, construction of airport, port, railway, road, power station, or other energy and communication projects, as well as certain foreign banks, branches, and Chinese-foreign joint banking corporations or finance companies established in Pudong. All FIEs in Pudong are exempt from local enterprise income surcharge until the year 2000

¹⁷¹ *Id.*

¹⁷² *Id.*

¹⁷³ See generally, Moser & Zee, *supra* 3, *China Tax Guide* 105-06 (2d ed. 1993). Jiang, *supra* 4 at 577-580, Curley & Fortunato, *Tax Considerations for Investors in China*, 20 N.C. J. Int'l L. & Com. Reg. 531 (1995); noting that there are other a few types of special economic zones established: in some cities bordering Russia, Mongolia and Vietnam were created as Border Economic Cooperation Zones (*bianjing jingji hezuoque* or BECZs), which were adjusted shortly after the political chaos of former Soviet Union and Eastern European block. The plan offered a preferential income tax rate of twenty-four percent to FIEs incorporated in BECZs. More border cities and towns were later designated as open border cities and permitted to set up their own BECZs. These efforts to stimulate economic growth in urban areas spread to non-coastal cities. Large cities alongside the Yangtze River and in interior provinces were accorded a status similar to that of COCs, with permission to set up their own ETDZs. Various newly designated priority zones and areas mushroomed in coastal regions and urban areas which were given of special status and subsequent preferential measures to accommodate foreign investment in those new designated regions, such as Free Trade Zone (*baoshuiqu*), High and New Technology Industrial Development Zones (*gaoxin jishu chanye kaifaqu*), Taiwan Investment Zones (*taishang touziqu*), and State Tourist and Resort Areas (*guojia lvyou dujiagu*).

capital and keeping profits in the host country. Many Chinese local governments performed even better by setting up assorted auxiliary services such as supply chain management, export control, quality supervision, and other services, all of which were incidental to the successful implementation of tax incentives and fiscal transfers.

5.3.3. Development strategy for the Western Region

China's administrative and fiscal decentralization in the past decades also created increased regional disparity and worsened the poverty situation in certain outlying regions, in spite of the fact that originally tax preferential policies were designed for nationwide economic development. In reality, over eighty percent of foreign but high quality investment for the past three decades was pooled in coastal areas, which account for less than twenty percent of China's territory.¹⁷⁴ The uneven and imbalanced economic development across China was the product of an unsustainable model based on lopsided preferential policies which would eventually cause political instability and social upheaval. In China's Eleventh Five-Year Plan, the CCP proclaimed the Grand Western Region Development (*xibu da kaifa*) that in the first two decades of the twenty-first century, more resources and favors will be transplanted and adopted to the hinterland and

¹⁷⁴ See Sheila Rae, *Time to Go West*, China Brief, (September 2000), <http://www.amchamchina.org/article/3057> (last visited March 15, 2011)

western regions of China.¹⁷⁵ Hinterland provincial governments will enjoy larger degrees of autonomy for attracting investment and substantiating local economies, such as loosened land use approval processes, expanded access to national markets, the ability to nurture agricultural and forestry business, and building up selective industrial infrastructure profiles.¹⁷⁶ Of course, tax preferential policies and incentives, as proven tooling for advancing local development, account for major approaches in development strategy reforms.

It is beyond the scope of this chapter to catalog the pros and cons of reform strategies on western development, however, several serious concerns have arisen in terms of decentralization and poverty alleviation in western regions. First of all, are hinterland provinces capable of handling special tax preferential policies? To date, there has been a serious shortage of practical and meaningful approaches to carry out nationwide reform measures. Moreover, is there any supervision on quality of investment to which tax preferential policy will be applied? As capital investment of various sources flooded into coastal areas, which have experienced hardships in setting up standardized processes of handlings, hinterland provinces emerged as regions where unqualified or unhealthy funds go. More importantly, because the agricultural, forestry and mineral industries dominate hinterland economy, enormous environmental protection and natural deterioration challenge the sustainability of development and land requisition. To this extent, hinterland provinces are alarmed about the prospect of tightening the tax incentive and investment quality supervision of the central government, which in turn may

¹⁷⁵ See Mehmet Ögütçü, *FDI and Importance of the "Go West" Strategy in China's Energy Sector* (2002) <http://www.oecd.org/dataoecd/1/35/2085596.pdf> (last visited March 15, 2011)

¹⁷⁶ See generally in Rae, *supra* 174

jeopardize the decentralization efforts designated for west regions. This dilemma may require decades to work out. Finally and more controversially, coastal areas, facing further centralizing efforts and enlarged fiscal transfers to western regions, are reluctant to transfer capital investment to hinterland provinces.

5.3.4. Harmful Impacts on Economic Growth

The cycle of decentralization is endogenous to China during the process of economic development. Local governments face ruthless political pressure from tight hierarchical personnel arrangements and polytropical fiscal transfer schemes. Worse is that almost all levels of governments in China are economic-growth-driven and over-receptive in nature. Moreover, the promotion and performance evaluation of individual local officials at every level are calculated by a series of economic and social indicators manipulated by the central government, such as annual growth achieved in local GDP, the growth of collected revenue, the revenue contributions made to upper levels of government, output of SOEs and the quantities of foreign investment attracted, etc. as unbreakable economic factors; as well as various but sometime embarrassed societal measures, such as birth control quota, public security maintenance judged by death sentences approved, reducing elementary drop-out rate, elderly care system, and healthcare reform and so on. Successfully completing or exceeding anticipated targets prescribed by central and provincial governments is the *sine qua non* for local officials seeking political promotion or retirement benefits. Meanwhile, to fulfill

economic and social targets, local officials have a tendency to fabricate statistics on economic growth, exaggerate SOEs' growth, and underreport collected revenues. Either image projects, such as more visible highway, outstretched educational institutionalization, and expensive health care facilities, showcase in the local government agenda, or arisen excessive fee charged on farmers or private enterprises, are lavishly, repeatedly increased to meet revenue contribution needs requested by upper level governments.

As discussed above, instead of decentralizing or loosening controls, the central government is eager to centralize fiscal and administrative power. When local governments are deprived of most of their fiscal and administrative autonomy, the best option for the central government is to heavily manipulate local government behavior, directly dictating local management and providing fiscal large transfers. Unfortunately, such fiscal transfers fail to embody central policy intentions. Local governments easily recourse to the further expansion of local bureaucracy and to rent-seeking under the soft budget constraints created by such a transfer mechanism. The fiscal transfers simply create imbalanced initiatives to mobilize resources and failed to meet local development needs.

China's fiscal transfer schemes also include a fairly top-down approach to poverty relief policy implementation, in which tax measures, tax exemption, and intergovernmental transfers play a key role. Fiscal transfers were allocated to various poverty-stricken and underdeveloped areas to nurture economy and maintain lowest tolerable standard of living. A most prevalent complaint submitted by government officials from underdeveloped areas is that they were

not allowed the choice of what activities to do with poverty alleviation investment funds allocated. Rather, they often are forced to participate in duplicative or less-urgent activities even when time, resources, and know-how for undertaking the project is limited. The lack of fieldwork and survey, rule-based formula and transparency in transfer tends to systematically distort local incentives and draw local governments in poor regions into unhealthy competition for more transfers and frame political performance that caters to upper-level officials. Moreover, urbanization and industrialization in developed regions continually contributed to escalation of land values, and forcibly seizure of country land from farmers became pervasive and even up to neck of robbery. Revenue-hungry governments have every incentive to expropriate more agricultural land for urban expansion and commercial leases and make a profit since such land revenues fall into the locally controlled extra-budgets. With faster urbanization and stronger regional competition for outside investments, local governments initiated waves of land requisition leading to roaring high housing price, and distorted promotional hype of establishing unnecessary and duplicative lower-level industrial parks and development zones.

5.4. Challenges raised by fiscal decentralization

5.4.1. Dual Tax Administration Structure

Tax administration in China has a two-track institutionalized structure. The national system governs major tax legislation that prescribes tax bases, (nominal) tax rates, enforceable administrative procedures, the intergovernmental revenue sharing formula, and budgetary planning above the provincial level. On the other hand, the provincial and sub-provincial system mostly deals with local revenue collection, implementation of national tax legislations, designing local (foreign) investment-friendly tax incentives, stipulating local administrative procedures, and detailing local budgetary planning. This dual-track tax administration system creates several challenges for implementation. First, the *transparency* issue – revenue collection and allocation remain mysterious and undisclosed. Many *ad hoc* taxation and stipends are offered without scientific and statistical substantiation. Procedural conflicts on tax administration are not uncommon. Second, the *uniformity* issue – the actual tax rate for economic activities varies across localities when local governments hold ultimate authority in calculating and enforcing actual local rates and fees. One cause is that local tax preferential policies and incentives may distort the legislative purpose of national tax rate stipulation in implementation. In addition, the already worsened regional development disparity aggregates jurisdictional competition for irrational tax administration as to hunting for investment. Third, the *principal-agent* issue – local governments experience constantly-changing financial needs and political agendas in their negotiations with the central government. Finally, the *coordination* issue – can the central government, national auditing and treasury authorities essentially control and coordinate the vastly fragmented two-track

system? How can the Chinese government remedy the ambiguity in local collection of off-budget fees and tax-for-fee at sub-provincial levels? How to streamline sub-provincial budgetary control *ex ante* for a more effective sharing formula? Is it achievable for the central government to supervise and coordinate sub-provincial sharing formula? Regretfully, answers to these questions are thorny to identify, but these unaddressed concerns lighten the direction for further policy orientations.

5.4.2. Extra-budgetary and off-budgetary revenues

Extra-budgetary and off-budgetary revenues are two quasi-taxes collected by local governments to compensate for revenue shortages under the existing tax system. Usually collected in the name of service fees or charges for local administrative activities, these non-tax levies *de facto* contribute inflows to local treasury without being compromised by sharing commands of the central government, and therefore, foster local autonomy. Without legitimate substantiation, extra-budgetary and off-budgetary revenues usually are presented without uniformity and transparency in terms of calculation, base, rate, procedures and statutes of limitation.

Extra-budgetary revenue is the legacy of the socialist planned economy to finance locally nurtured expenditures, and it generally includes 1) locally collected funds and administrative fees, such as road tolls, road maintenance fees, utilities charges, and education fees (partially abolished for the 9-year basic education); 2) local

funds and surtaxes, such as agricultural surtax and education surtax, imposed on income, consumption, turnover or resources bases; 3) a special reserve for SOEs such as depreciation, infrastructure innovation and repair funds (abolished in 1993 and 1997).¹⁷⁷ On the other hand, off-budgetary items are more locally-controlled, self-raised and independent revenues with contributions from local land sales, private enterprises, and charges from various administrative authorities¹⁷⁸.

The outbreak of extra-budgetary and off-budgetary issues has come up with regularity since 2003 when the central government adjusted the revenue sharing formula leaving even lesser shares to local governments. Meanwhile, prompted by self-interested maximization of revenue and expenditures, local governments are forced to hunt for leeway to bolster their financial independence over and above that provided by the small portion of taxes they are allowed to collect. Various proposals have been explored to reinforce local disposable revenues, such as land sales or long-term leases to investors, overcharged service fees, sales of previously state-owned assets, SOE employee benefits buy-outs, investments in local businesses, and mandatory apportioned collection to support local infrastructure construction – all proceeds collected through these means are legitimized as local extra-budgetary and off-budgetary items. In particular, collections from land sales, real estate management, and overcharged

¹⁷⁷ See generally, Richard Eckaus, *Some Consequences of Fiscal Reliance on Extra-budgetary Revenues in China*, *China Economic Review* 14:72-88 (2003); C.P.W. Wong, *Financing Local Government in the People's Republic of China*. Hong Kong: Oxford University Press (1997); Gang Fan, *Market-oriented Economic Reform and the Growth of Off-budget Local Public Finance*. in Brean, D. J. S. (ed.) *Taxation in Modern China*. New York: Routledge Press (1998); Z. Zhu and B. Krug, *China's Emerging Tax Regime: Local Tax Farming and Central Tax Bureaucracy*. in B. Krug and H. Hendrichske. (eds.) *China's Economy in the 21st century: Enterprise and Business Behavior* (London: Edward Elgar, 2007)

¹⁷⁸ See, Richard Eckaus, *Some Consequences of Fiscal Reliance on Extra-budgetary Revenues in China*, *China Economic Review* 14:72-88 (2003) at 76

administrative fees are pillars of local revenues to buttress financial independence and local autonomy. The roaring housing price increase has spread from coastal regions and metropolitan areas to central provinces and second-tier cities since 2004, and local GDP growth has become more rapid as well. This has given local governments the incentive to seek greater control over local assets without interference from the center.

Extra-budgetary and off-budgetary revenues create the same *transparency* and *uniformity* controversies as described above with regard to the decentralization and redistribution process. The lack of administrative procedure, basis calculation, rate stipulation and the ambiguous fiscal status of extra-budgetary and off-budgetary revenues, all challenge the capacity of central and provincial governments in fiscal transfer and uniform coordination of sub-provincial fiscal activities. Local governments find these off-budget levies an advantageous alternative to simple political leverage in their quest to maintain social stability and foster local development. However, considerations of efficiency and fairness are not depicted given short spectrum of local political agenda and deteriorated bureaucracy. Fiscal administration of extra-budgetary and off-budgetary revenues is far from procedural substantiation such as public hearing and *ex post* audit. On the one hand, such proceeds are ideal in terms of local governments' capacity to provide local public goods, social services,¹⁷⁹ nimble reaction to local emergencies, and management of local affairs. On the other hand, over-extraction from local enterprises and taxpayers in the form of extra-budgetary and off-

¹⁷⁹ *Id.*

budgetary revenues may arouse opposition and cause social instability such as rural unrest or protests.¹⁸⁰

5.4.3. Intergovernmental transfer system

As discussed earlier, management of vertical fiscal transfers between a mixture of levels in the administrative hierarchy (central, provincial, prefecture, county and township) in addition to various administrative levels of special economic zones presents another challenge to the central-local two track tax system. Since central and provincial governments may bargain over the share of expenditure and revenue, the total amount and nature of sub-provincial fiscal transfers is left unlegislated and mismanaged. Calculation of basis, rates, and procedural requirements are usually contracted in inefficient ways, contrary to legislative intent and without regard for diverse sub-provincial social and economic needs. Multiplicity of the sub-provincial governments even aggregates the discretionary practice of national tax legislations and fiscal policies.

As long as the upper levels of government farm out lower levels to collect revenue, negotiations between different layers of governments on transfers and reallocation have to be constant. Tax farming imposes considerable logistical burdens on the already complicated two-track tax administration and redistribution procedures. As negotiated formulas are in place, three issues

¹⁸⁰ See generally, Thomas Bernstein and Xiaobo Lv, *Taxation without Representation in Contemporary Rural China* (Cambridge Press 2003); Tsui, K. and Y. Wang, *Between Separate Stoves and a Single Menu: Fiscal Decentralization in China*, *China Quarterly* 177: 71-91 (2004)

prompted in such principal-agent relationship. First, if contractual arrangements in revenue sharing are breached, would upper level of government remedy the revenue deficiency of those farmed lower levels of governments? Usually, As long as a reallocation is invested and operated by the lower level, local governments may request more allocation without any punishment for more subsidies above the fixed agreed amount or based on the *ad hoc* appropriation of local budget surpluses at the end of a fiscal year. Second, lower levels of administrations have the drive to maximize their discretionary revenue and tax base, and therefore, shift expenditure upward to minimize transfers. Third, the fiscal administration of local extra-budgetary and off-budgetary proceeds is opposed by lower level of governments in many aspects. In addition to the lack of systematic way to measure an uncalculated bases and rates, lower levels of governments investigate many ways to evade control from upper levels on genuine local financings, if not discoverable, such as investments in local business and profitable operation of local public services. Given the complicated tax structure and administrative hierarchies, it is safe to highlight the self-conflicting yet evolving feature of China's two-track tax system.

5.5. Summary

China has experienced rounds of fiscal and administrative decentralization dominated by a socialist legacy and alignment of political compromises with a significant consideration for transactional costs and budgetary constraints. First,

the decentralization efforts have been endogenous from the centralized, planned economic system featured by heavy industrialization development strategy to a market economy-oriented revenue sharing scheme with international inputs. Although fiscal decentralization for market-oriented reforms helped strengthen provincial and local autonomy and fostered economic growth, they are plagued by impotent central redistributive power and enlarged interregional inequality. With only a rough system of intergovernmental expenditure responsibility division and egalitarian fiscal transfer scheme, the recentralization since 1994 has significantly impaired local capacity to provide decent public goods and services, and witnessed serious local governance issues such as land-requisition-based local GDP growth and scattered social unrest.

Second, tax farming by the central government on one hand fortifies central revenue and authority by squeezing local revenues with budget constraints and national enforcement agencies; decentralization also harnesses the increased autonomy of local governments in designing local-friendly tax incentives and flexibly carrying on centrally-authorized tax policies on the other hand. The intergovernmental bargaining influences the official tax system. Jurisdictional competition for (foreign) investment and local development creates less efficient and irrational local tax concessions such as over-extended contractual land leases for plant constructions, and introduces a detrimental fiscal culture to boost local GDP by concentrating tax levying on only a few tax bases such as real estate development and land sale. It worth noting that the local autonomy and intergovernmental balance is not a federalism model based on a separation of

powers. Rather, decentralization is a regulatory compromise to align different political and administrative authorities. Since the rural tax was officially repealed in 2004, some local governments in agricultural regions have become increasingly reliant on governmental transfers or certain off-budgetary revenue collections. The drop of part of local tax bases implies not only how the central government can provide sufficient transfers, but also on how to make those transfers without discouraging local resource mobilization and removing the soft budget constraint for local governments. A centralized party-state bureaucratic system inevitably leads to a shortage of local government accountability due to widespread corruption and distorted local tax practices, such as excessive fees or taxes in rural areas and abusive land requisition. In the long run, good governance will be the outcome of a more decentralized administrative and fiscal system that includes a sound inter-governmental transfer arrangement, of wider local political participation and competition under free elections and, ultimately, of stronger capital mobility across regions.

Third, the institutionalization of the central-local two-track tax administration is not uniform across the nation. Diversity or irregularity in local tax administration especially on sub-provincial levels evidences the cooperation between local business and governments over time to architect a framework to evade central control or switch upward more expenditure to serve local economic interests. Moreover, if the central government has to collect localities into its fiscal umbrella, local administrations may lose incentives to provide locally adequate

public goods and services as long as more shares of transfers are assigned from the central rather than for specific local needs.

Fourth, the inflated extra-budgetary and off-budgetary revenues represent local efforts to seize resources outside of the central government's control and to keep larger shares of local revenue for local development. However, the lack of legally established institutions to streamline extra-budgetary and off-budgetary revenues may simply exacerbate interregional economic disparities and rampant corruption. This practice erodes the tax base and there is no institution to enforce administrative efficiency in this area. However, further administrative and fiscal centralization may bring more distortions in local government behavior.

VI. Conclusion

In conclusion, the past six decades of tax law reform in China have developed within the context of enormous economic development, legal reform, a socialist political system, efficiency concerns, tax equity, cultural factors, assimilation to internationally accepted accounting standards, and the fulfillment of WTO principles and international tax norms. This varied context has contributed to the evolution of a modern and internationalized tax system, albeit one with Chinese characteristics.

First, each of the three major phases of tax law reform in China has improved the structure of the Chinese tax law system. Meanwhile, the tax authorities reshuffle

and an ever-growing need for transparent, uniform and impartial tax administration poses vital challenges and opportunities for tax reform.

Second, tax laws in China are designated to promote revenue collection with the hope to enlarge the tax base and improve the standard of living of Chinese citizens within sound enforcement and compliance regimes. At the same time, the concerns of balancing the tax treatment of domestic and foreign enterprises and minimizing interregional disparities imply fundamental dilemmas of tax law administration, enforcement and fiscal transfers.

Third, the fiscal and administrative decentralization prompted a market economy-oriented revenue sharing scheme with international inputs. Tax farming by the central government consolidated central fiscal authority and revenue collection, even as it increased local autonomy by allowing provincial governments to bargain toward an intergovernmental compromise. The central-local two-track tax administration system, however, does not prescribe an institutionalized framework for managing the enlarged extra-budgetary and off-budgetary revenues. The abolishment of rural tax and twisted local GDP development culture add another layer of complexity to fiscal decentralization and transfers. In addition, the large scale of China's economy makes the adoption of fiscal policies which touch on matters of legislation, administration, judicature and internationalization, particularly urgent.

Chapter III

The Rule of Law and Legal Reform in China

I. Introduction

Stepping into the 21st Century, the legal system, in which China's tax law and its reform are embedded, has experienced its most dynamic period of evolution and reform.¹ No other major modern society has endeavored to reconstruct its legal system in such an expansive, novel, and globalized fashion for the past three decades as China.² However, China's unprecedented, ongoing legal³ reform is intertwined with its enormous economic development, and more importantly, burdened by a deep introspective ambivalence on the part of its reformers.

This analysis of the evolution of the Chinese legal system development shall not be ahistorical. In truth, China's contemporary legal system is neither

¹ See generally Benjamin L. Liebman, *The 60th Anniversary of the PRC: A Retrospective on the Chinese Legal System*, 23 Colum. J. Asian L. 1 (2009) [hereinafter Liebman: Retrospective].

² *Id.*

³ See generally Zhongguo Fazhi Gaige Sanshinian [*Thirty Years of China's Legal Reform*] (《中国法治改革三十年》), edited by CPC Central Compilation and Translation Bureau, (中国中央编译局) http://www.cctb.net/zjxz/expertarticle/200912/t20091230_19604.htm (last visited on March 15, 2011)

fundamentally inherited from its imperial tradition nor entirely a western transplant.⁴ Historical eventful turning-points in the 20th Century are critical to evaluating the progress and troubles arising from China's legal reform, and China was not without such critical turning points in the last century.⁵ It endured massive foreign invasion and semi-colonization from the late nineteenth century by western forces, republican democratic revolution, various civil wars and wars against Japanese fascists, Communist revolution⁶ (civil war with the KMT Regime), socialist construction and transformation⁷ in the 1950s, Cultural Revolution, opening to the outside world and consequent globalization, the development of market economy, and accession to the WTO, among other major transformations. Even so, several important elements of China's traditional legal system survived this century-and-a-half of uncommon upheaval and transformation.⁸

China's adoption of a "Socialist Market Economy" in 1992 and "protection of property rights" in 2004 Amendments to the Chinese Constitution signaled a

⁴ see Jianfu Chen, *Chinese Law: Towards an Understanding of Chinese Law, Its Nature and Development* (The Hague: Kluwer Law International, 1999) at 83-85; see also Li Xiuqing, *Yuwaifa de Yinjie ji Falvren de Dandang* [*Transplantation of Extraterritorial Laws and Mission of Chinese Jurists*], presenting that the seventh stage of Chinese legal system development (1970-present) is featured by enormous introduction and transplantation of foreign legal conceptions and international norms, <http://www.sinoss.net/2011/0215/30729.html> (last visited on March 15, 2011)

⁵ See *Id.*, Li, at 8-19; for a discussion of taxation system evolution in the Tsing Dynasty, See generally in Shao-Kwan Chen, *The System of Taxation in China in the Tsing Dynasty, 1644-1911 [1914]*, Cornell University Press (2009)

⁶ See Kathlyn Gay, *Mao Zedong's China* (21st Century Books, 2008), stating that the last three years of the Chinese Civil War (1947-1949) is more commonly known as the War of Liberation

⁷ See generally in Peter J. Boettke, *Why Perestroika Failed: The Politics and Economics of Socialist Transformation* (Routledge, 1993), discussing the impacts and rationales of socialist transformation movements aiming to achieve communism in China and East European countries in the 1940s and 1950s.

⁸ See Randal Peerenboom, *The X-Files: Past and Present Portrayals of China's Alien "Legal System"* (2003) 2 Wash. U. Global Studies L. Rev.37 at 38-39 [hereinafter Peerenboom: X-Files]

breakthrough in China's self-conscious westernization.⁹ The CCP also officially endorsed such notions in its Party Charter.¹⁰ Meanwhile, political slogans such as “performing in accordance with international standards” and “assimilation or harmonization with international practice” materialized in the official propaganda agenda and daily political and legal settings. China's WTO commitments have driven China's immense, if disorganized, legal infrastructure increasingly into compliance with a decidedly non-Marxist international legal order. Celebrating ten years of WTO membership, China has rigorously overhauled its legal system to a postural stability by incorporating both international and domestic norms.

Another important turning point in Chinese legal evolution is the triumph of “*rule of law*”¹¹ (“*fa zhi*” 法治) over “*rule of men*” (“*ren zhi*” 人治).¹² The importance of

⁹ The evolution of China's Constitution has four stages. The first Constitution of the People's Republic of China was promulgated in 1954. After two intervening versions enacted in 1975 and 1978, the current Constitution was promulgated in 1982. There were significant differences between each of these versions, and the 1982 Constitution has subsequently been amended four times since its promulgation

¹⁰ See generally, Mei Ying Gechlik (Veron Hung), *The Chinese Communist Party's Leadership and Judicial Independence* (2003), discussing revision of the CCP Charter and its impact to China's legal system, <http://www.carnegieendowment.org/events/index.cfm?fa=eventDetail&id=650> (last visited on March 15, 2011)

¹¹ See Margaret Jane Radin, *Reconsidering the Rule of Law*, 69 B.U.L. Rev. 781 (1989), at 783-91, presenting the “instrumental” and “substantive” concepts of the rule of law; See also, Robert S. Summers, *A Formal Theory of the Rule of Law*, 6 Ratio Juris 127, 135 (1993), presenting the “formal” and “substantive” concepts of the rule of law; Other theorists have also made distinctions between rule by law and the rule of law, particularly in the context of China. See also generally in Chen, *supra* 4, at 135; Paha L. Heieh, *China's Development of International Economic Law and WTO Legal Capacity Building*, 13 J. Int'l Econ. L. 997 (2010); Eric W. Orts, *The Rule of Law in China*, 34 Vand. J. Transnat'l L. 43 (2001) at 93-98, discussing the difference of rule by law and rule of law. In particular, two conceptions between law and the state should be distinguished to expedite discussion on the rule of law in China: 1) the rule by law, referring to a descriptive, positive, and instrumental view of the relationship, in which law is used to govern by state; 2) the rule of law, a prescriptive, normative, and political view, which refers limited government, procedural justices and equality before law; Cao Jianming, *Speech: WTO and the Rule of Law in China*, 16 Temp. Int'l & Comp. L.J. 379 (2002)

¹² See XIAN FA art 5, (1982) (P.R.C.) (Constitution of the P.R.C.), stipulating that “all state organs, the armed forces, all political parties and public organizations and all enterprises and undertakings must abide by the Constitution and law”. See also Aristotle (384–322 BC): *General*

this development in China cannot be overstated. The CCP's commitment to subject itself to law finally offers domestic reformers and foreign observers the arena, in an authoritarian society, to advocate liberal ideals of limiting the arbitrary use of power, establishment of the rule of law, and possibly dynamic polity reform. The results of the CCP's commitment are not unequivocally celebrated by international or domestic commentators. However, that China's economic development has driven important rule of law reforms is undeniable. Indeed, market economy development has been a crucial stimulus for creating the rule of law in the contemporary Chinese legal system. From Deng's "reform and open door" orientation to its WTO accession in 2001, China has arguably implemented a setting in which "acting according to law" is conceived as the "objective demand of a socialist market economy."¹³ "The economic reform, based on autonomy, equality, credit and honesty, and fair competition, needs to be maintained primarily by legal tools."¹⁴ Primarily, the market economy requires "the establishment of legal rules governing the rights and duties of those carrying out transactions."¹⁵

Introduction Internet Encyclopedia of Philosophy. There are two kinds of rule of person. The first kind is rule of the few persons, examples of which include tyranny and oligarchy. The second kind of rule of person is rule of the many persons, an example of which is the ancient Greek democracies. The common feature of rule of person is the ethos that what pleases the ruler(s) is law. That is, under rule of person, there is no limit to what the rulers (the government) can do and how they do things, <http://www.iep.utm.edu/aristotl/> (last visited on March 15, 2011); Many scholars have chosen to define the rule of law by what it is not, namely, the "rule of men," see, e.g., Teemu Ruskola, *Legal Orientalism*, 101 Mich. L. Rev. 179, 222-23 (2002); Teemu Ruskola, *Law Without Law, or Is "Chinese Law" an Oxymoron?*, 11 Wm. & Mary Bill Rts. J. 655, 655 (2003)

¹³ See Liberman, *supra* 1, at 32, stating that China's legal reforms aim to create a fair system that serves both to further economic development and to address the rights and grievances of those left behind by such development

¹⁴ *Id.*, at 31

¹⁵ See Pitman B. Potter, *The Legal Implications of China's Accession to the WTO*, *The China Quarterly*, at 593 and 602-603.

It is clear that, for the past three decades, Chinese legal system development has focused on absorbing westernized legal norms, modernizing practice, and conforming to the demands of a globalized market-based order. An objective assessment of China's legal reform, at this stage, must acknowledge the successes of China's law reforms in laying the foundation for constructing the rule of law, albeit "with Chinese characteristics."¹⁶ Noticeably, China agreed to initiate sweeping reform measures "designed to implement the WTO market access, national treatment and transparency standards, to protect intellectual property rights, to limit the use of trade-distorting domestic subsidies and to make other changes to bring its legal and regulatory system in line with those of other WTO members."¹⁷ China has put tremendous effort into honoring such commitments. Its efforts have been the subject of debates regarding how China will fulfill its WTO obligations as well as establish "the rule of law" to promote the country's economic growth and liberal democracy.¹⁸

This chapter and the next will attempt to evaluate how the rule of law rhetoric and WTO accession has impacted Chinese legal reform in the past three decades, looking particularly at the post-WTO accession framework, and the major implications of this impact. The Second subchapter begins with a critical but brief

¹⁶ See U.S. Congressional-Executive Commission on China (CECC) Annual Report 2002, at 1, stating that "China has made important strides toward building the structure of a modern legal system", albeit [a] wide gap remains between the law on paper and the law in practice, <http://www.cecc.gov> (last visited March 15, 2011); the same conclusion was also drawn by a few other scholars, see also Jiangyu Wang, *The Rule of Law in China: A Realistic View of the Jurisprudence, the Impact of the WTO, and the Prospects for Future Development*, Sing. J. Legal Stud. 347, at 348, 359.

¹⁷ See United States Trade Representative, *2003 Report to Congress on China's WTO Compliance*, at 3. Available at <http://www.ustr.gov> (words searched: Report 2003) (last visited March 15, 2011)

¹⁸ See generally in Potter *supra* 15. See also Wang, *supra* 16, summarizing a debate between Professors Porter and Don Clarke, at 363-367

overview of rule of law rhetoric developed by western jurists and philosophers, to develop an understanding of the rule of law as a contested concept.¹⁹ Then the third subchapter provides an overview of China's legal reform for the past thirty years is provided focusing on the evolution of the socialist rule of law construct, and how the rule of law concept fits in the socialist legal system with Chinese characteristics. The fourth subchapter concludes and introduces the impacts of WTO accession which will be explored in more detail in chapter IV in terms of China's WTO commitments, WTO principles of transparency, judicial review, and impartial administration.

II. The Western Rule of Law Rhetoric

It is beyond the scope of this thesis to rehash the voluminous debates regarding the evolution and conception of the rule of law.²⁰ Bearing a western origin, the

¹⁹ See Radin *supra* 11, at 783-794

²⁰ *Id.* Western conceptions of the rule of law trace their origins to the writings of Aristotle, Montesquieu, Locke, who emphasized the importance of law in protecting society from the potentially arbitrary and abusive authority of government. See also, Alvaro Santos, *The World Bank's Uses of the "Rule of Law" Promise in Economic Development*, in *The New Law and Development: A Critical Appraisal*, (David Trubek & Alvaro Santos eds., 2006), at 257. The rule of law is viewed as necessary to the market economy and has been promoted in developing and transition economies. The connection between the rule of law, markets, and economic development is based in large part on the work of Friedrich Hayek, Max Weber, and, more broadly, by the work of modernization theorists. Under this theory, efficient markets require the protection of private property and freedom of contract. The rule of law was necessary to ensure the integrity of these rights. Markets, in turn, fuel economic growth which leads gradually, according to modernization theory, to the growth of the middle class and a demand for democracy; see also, William P. Alford, *Exporting "The Pursuit of Happiness,"* 113 Harv. L. Rev. 1677, 1683 (2000) (book review); John K.M. Ohnesorge, *Asia's Legal Systems in the Wake of the Financial Crisis: Can the Rule of Law Carry Any of the Weight?*, in *Neoliberalism and Institutional Reform in East Asia* 64-68 (Meredith Jung-En Woo ed.) [hereinafter Ohnesorge: Asia's Legal Systems], http://www.law.wisc.edu/m/hfwd3/risd_rule_of_law_northeast_asia_proofs.pdf; (last visited on March 15, 2011); see also Friedrich Hayek, *The Road to Serfdom* (1944), formulating the rule of law is largely limited to its instrumental aspect, and focuses on the power of law to limit the actions of government. Rules, "fixed and announced beforehand," allow individuals to foresee

rule of law concept is contested,²¹ at times loosely interpreted,²² and variously described. The definition of the term “rule of law“ has long been the object of heated debate. All of the various interpretations include in the term the protection of a correct balance of rights and powers between individuals and the state.²³ In a state embracing the rule of law, the society is governed by a complete and functioning legal infrastructure which governs relations between private actors and public authorities and among private sectors with the independent judge as enforcer of rules and of privately bargained contracts.²⁴ Further, and perhaps more importantly, the rule of law presumes democracy, liberty and freedom. Like many other philosophical ideals in the West, the concept of rule of law originated in ancient Greece.²⁵ From Plato and Aristotle through the Roman jurists, the medieval natural law thinkers, the neo-Stoics and modern natural law theorists, Montesquieu and the American Founders, the nineteenth-century advocates of the *Rechtsstaat*, and up to contemporary enthusiasts such as Friedrich Hayek and John Rawls, Lon Fuller and Theodore Lowi, champions of the rule of law have

potential coercive intrusions of government authority, which in turn allows individuals to plan their activities and regulate their behaviors accordingly

²¹ See Radin *supra* 11, at 784; see also Randall Peerenboom, *Let One Hundred Flowers Bloom, One Hundred Schools Contend: Debating Rule of Law in China* (2002) 23 Mich. J. Int'l L. 471 at 472-3 [hereinafter Peerenboom: Debating Rule of Law in China]

²² See generally, Lawrence Solum, *Equity and The Rule of Law*, in Ian Shapiro (Ed.) *The Rule of Law: NOMOS XXXVI*. (New York: New York University Press, 1994), noting that the rule of law ... may be more accurate to understand as the ideal of the rule of law as a set of ideals connected more by family resemblance than by a unifying conceptual structure

²³ See generally in Joseph Raz, *The Rule of Law and Its Virtues*, in *This thesisity of Law: Essays on Law and Morality* 210-29 (1979)

²⁴ See John K.M. Ohnesorge “*The Rule of Law, Economic Development, and The Developmental States of Northeast Asia*” in *Law and Economic Development in East and Southeast Asia* 91 (Christoph Antons, ed., 2003) at 93-94 [hereinafter *The Rule of Law and Economic Development*], http://www.law.wisc.edu/m/m2mgg/leiden_rol.pdf (last visited on March 15, 2011)

²⁵ See Radin *supra* 11, stating that Plato and Aristotle instituted the tradition of thinking about rule of law

assumed the desirability or at least the ineliminable reality of extensive legal orders and political rule of human conduct.²⁶

The underlying complexity to define the rule of law is not completely canonical²⁷.

The nineteenth-century British jurist, Albert Venn Dicey, to whom the formulation of the term “the rule of law” may to some extent be credited, elaborated three characteristics of the “the rule or supremacy of law”: absence of arbitrary power on the part of government; ordinary law administered by ordinary tribunals; and general rules of constitutional law resulting from the ordinary law of the land.²⁸ Similarly, in Germany a state of legality is *Rechtsstaat* (literally, a law-based state or a constitutional state), it advocates rule of law, limited government, substantive due process, reasonableness, equal protection, and a full and fair hearing, which is similar to the Anglo-American rule of law and French *Etat De Droit*, where the rule of law restrains the exercise of state power or government power²⁹.

For developing thesis of this chapter, different categories of dichotomies of the Rule of Law conceptions will be briefed in this subchapter, mostly, the instrumental and substantive discussion, the “thin” and “thick” model, and the

²⁶ See generally, Richard Flathman, *Liberalism and the Suspect Enterprise of Political Institutionalization: The Case of the Rule of Law*, in *The Rule of Law* 297, 302 (Ian Shapiro ed., 1994) (discussing Plato’s philosophy of law); see also Ernest J. Weinrib, *The Intelligibility of the Rule of Law*, in *The Rule of Law: Ideal or Ideology*, at 59, 62-63 (arguing that for Plato law was “a matter of convention” and “the rationality of law” depended entirely on the philosophical wisdom and knowledge of the rulers), quoted by Orts, *supra* 20, at 78

²⁷ See Radin, *supra* 11

²⁸ See A.V. Dicey, *Introduction to the Study of the Law of the Constitution* 179-92 (1908)

²⁹ See generally in L. Heuschling, *Etat de droit, Rechtsstaat, Rule of law*, (Paris: Dalloz, 2002), Michael Rosenfeld, *The Rule of Law and the legitimacy of Constitutional Democracy*, 74 S. Cal. L. Rev. 1307-09 (2001), Susan Newman, *Comparing Courts*, Wash. U. Sch. of L. Magazine 8-9 (Spring 2002)

Rule of Law and development rhetoric. The purpose of this discussion is to introduce the discussion of how Rule of Law, which may serve as a model, may impact the legal reform in China. More importantly, the goal is to develop a Rule of Law – Tax Rhetoric, particularly for the reform of China’s Tax Law system.

2.1 The Contested Definition—Instrumental vs. Substantive

Legal theorists have proffered various definitions for the rule of law, among which Lon Fuller³⁰ and John Rawls³¹ represent two of the most important conceptualizations. Fuller articulates an instrumental conception of the rule of law,³² which advocates that the Rule of Law is a prerequisite for any efficacious legal order.³³ Rawls’s conception alternatively is substantive and holds that the Rule of Law embodies tenets of a particular political morality. This distinction, although it is overly simplistic and risky, is the core of our notion of a *contested* Rule of Law.

2.1.1 The Instrumental Conception

Lon Fuller’s instrumental conception advocates the “inner morality of law:” a relative certainty and uniformity in the application, regular and impartial administration of legal rules,³⁴ whereby a legal system is regarded as “the product of a sustained purposive effort” fulfilling certain moral qualities. To this extent,

³⁰ See generally, Lon Fuller, *The Morality of Law* 33-94 (rev.ed.1969)

³¹ See generally, John Rawls, *A Theory of Justice* 235-43 (1971)

³² See Radin *supra* 11 at 792, admitting that her reading of this characterization is oversimplified because Fuller apparently include his formulation other values besides instrumental efficacy

³³ *Id.*

³⁴ See Rawls, *supra* 31, at 235 (1971).

the state may use the institutions of law and the method adopting the enforcement of legal rules as an instrument of policy where any separation or differentiation between the legal system and state is not required. In this regard, Lon Fuller outlined eight elements whereby to measure the Rule of Law, which represent “the morality” that makes law possible: generality;³⁵ notice or publicity;³⁶ prospectivity;³⁷ clarity;³⁸ consistency or non-contradictoriness;³⁹ conformability;⁴⁰ stability;⁴¹ and congruence.⁴²

Fuller’s notion of generality requires that the rules encompass a broader sphere than specific cases, and must be comprehended, subsumed, or covered⁴³. The rest of Fuller’s list, however, can be boiled down to two categories “know-ability” and “perform-ability.”⁴⁴ Western scholars have added ninth and tenth elements, found to be implicit in Fuller’s formulation, that the affected parties must be rational

³⁵ See Radin *supra* 11 at 785, stating that “there must be rules, cognizable separately from (and broader than) specific cases, such that the rules can applied to specific cases, or specific cases that can be seen to fall under or lie within them”. There is, of course, a major debate between Fuller and Hart, among others, concerning whether Hitler’s Nazi regime and other modern tyrannies may properly be described as having “law.” see Orts, *supra* 20, at 255-56, 270-72, discussing differing views of the legality of the Nazi regime. Similarly, one may argue about whether the Cultural Revolution resulted in a complete or only partial breakdown of rule by law. This thesis shares that this debate should be more empirical and historical than conceptual. A regime may rule by law in some areas of life and yet still employ other irregular methods for decisions in a wide array of other important fields. The essential empirical and historical question is to ask about the extent to which rule by law institutions had broken down or were overturned in the most important government decisions, such as the criminal law and the use of lethal force by government officials.

³⁶ See Radin *supra* 11 at 785, stating publicity means that those affected party who are supposed to observe the rules, at least to the extent necessary, are made available to the rules to conform

³⁷ *Id.*, stating that the rules must exist prior in time to guide future actions which may be judged by them

³⁸ *Id.*, stating that the rules at least are sufficiently understandable to affected parties to follow

³⁹ *Id.*, stating that at least to some extent, completely contradictory rules are equivalent to no rule or at least an arbitrary decision between two rules

⁴⁰ *Id.*, stating that The affected parties must be capable of following particular rules

⁴¹ *Id.*, stating that, in some degrees, the rules must not change constantly so that affected parties can follow or orient their actions toward rules

⁴² *Id.*, stating that the explicitly promulgated rules must correspond with the rules enforced in actual practice.

⁴³ *Id.*, at 786-787

⁴⁴ *Id.*

choosers⁴⁵ and suitably motivated by either penal sanctions or by compensation.⁴⁶

Given the gravity of Fuller's formulation, all (eight) elements should be "internal" to law,⁴⁷ meaning that failure to comply with any one of those eight attributes would jeopardize the state's ability to be called a legal system at all.⁴⁸

Fuller's explanation, however complex, does not explicitly raise substantive ideals such as fairness or democracy, autonomy or dignity of persons, nor did he exemplify democratic procedural traditions, like separation of powers or the access to courts and jury trials, all of which are essential to the substantive conception of the Rule of Law.⁴⁹

2.2.2. The Substantive Conception

John Rawls claims that the Rule of Law is formal justice which promotes liberty and fairness. Derived from his seminal definition of a legal system, Rawls believes that Rule of law is necessary for predictability, determinateness, and certainty of legal consequences. More importantly, as exemplified in his Hobbes's Thesis and social cooperation, Rawls states that liberty is required for achieving social justice, which underlies the Rule of Law. However, Rawls's conception is not complete in that it misses, especially with regard to American jurisprudence, commitment to the separation of powers, judicial review and constrained role of judges.⁵⁰

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *See generally*, Fuller, *supra* 30

⁴⁸ *Id.*

⁴⁹ *See* Radin *supra* 11 at 787

⁵⁰ *Id.*, at 788-792

A similar version of distinction is developed by Paul Craig,⁵¹ who accents Rawls's "substantive" conception with his own "formal" notion. Craig's formal conception defines the rule of law as "the manner in which the law was promulgated"⁵² by responsible authorities under a properly authorized guideline. The substantive version conceptualizes that certain substantive rights should be derived from or based on the rule of law, "which are used to distinguish between 'good' laws, which comply with such rights, and 'bad' laws which do not."⁵³

The above discussion, albeit crude and oversimplified, suggests at least broadly that the Rule of Law is a Janus-faced, deeply ambiguous and contested conception⁵⁴. The instrumental version emphasizes the role of a legal system in structuring behaviors, whereas the substantive version necessitates fairness, human dignity, freedom and democracy.⁵⁵ Putting this distinction into a broader social-political context, the instrumental conception is a model of a general and ahistorical nature where government achieves its ends by way of rules. The substantive conception, on the other hand, bears a particular modern ideological heritage which demands the government's ends be the goals of social contract: liberty and justice.⁵⁶

⁵¹ See generally, Paul Craig, *Formal and Substantive Conceptions of the Rule of Law: An Analytical Framework* (1997) P.L.467, cited by Wang *supra* 16 at 350

⁵² See Wang *supra* 16, 351

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ See Radin *supra* 11, at 791-792

⁵⁶ *Id.*

2.2. Rule of Law in Positivism and Natural Law

Denying the inherent or necessary connection between the requirements of law, on the one hand, and ethics or morality on the other, modern legal positivism centers on the “Separation Thesis.”⁵⁷ It suggests that laws are rules made, whether deliberately or unintentionally, by human beings, without questioning what is good, right, or just.⁵⁸ Furthering the views of H.L.A. Hart⁵⁹ -- and influenced by Max Weber -- Joseph Raz supports the distinction between the internal and external points of view of law and rules. Rule of Law, as interpreted by Raz, is a political ideal which a legal system may lack or may possess to a greater or lesser degree.⁶⁰ For instance, although Raz in the end turns towards the substantive conception of the Rule of Law, he proffers a slightly different version of the instrumental conception of the rule of law and Fuller’s eight principles⁶¹. Thus, as

⁵⁷ See H.L.A. Hart, *The Concept of Law*, (2nd ed., Oxford, Clarendon Press, 1994) at 97-101 and 250, which emerged from a set of lectures that Hart began to deliver in 1952, and it is presaged by his Holmes lecture, *Positivism and the Separation of Law and Morals*, putting it simple, the Separation thesis holds that having a legal right to do doesn’t entail having a moral right to do it, and vice versa; having a legal obligation to do something doesn’t entail having a moral right to do it, and vice versa; having a legal justification to do something doesn’t entail having a moral justification, and vice versa; etc. Largely, this thesis understands and draws this notion from Professor Radin’s analysis

⁵⁸ *Id.* See also, Raz, *supra* 23, at 47-50

⁵⁹ See Radin *supra* 11, at 800-801, stating that a distinction between the internal and external points of view of law and rules, close to (and influenced by) Max Weber’s distinction between the sociological and the legal perspectives of law. Professor Radin further states that a distinction between primary and secondary legal rules, where a primary rule governs conduct, such as criminal law and a secondary rule govern the procedural methods by which primary rules are enforced, prosecuted and so on; See generally, Hart, *supra* 57, Hart specifically enumerates three secondary rules including the Rule of Recognition, the rule by which any member of society may check to find out what the primary rules of the society are. In a simple society, Hart states, the recognition rule might only be what is written in a sacred book or what is said by a ruler. Hart viewed the concept of rule of recognition as an evolution from Hans Kelsen’s “Grundnorm”, or “basic norm.”

⁶⁰ See Raz, *supra* 23, at 211

⁶¹ *Id.*, at 214-224 for original discussion by Raz; See also in Ronald Dworkin, *The Practice of Principle: In Defense of a Pragmatist Approach to Legal Theory* (book review), 115 Harv. L. Rev. 1655 (2002); see, Wang, *supra* 16, at 351-352, summarizing legal positivism that law should be prospective, open and clear, stable, that law-making process should be guided by open, stable,

positivism views the law ultimately as a matter of human custom or convention, i.e., the nature of law as a human institution, without touching the substantive value of liberty, justice and fairness, the rule of law in legal positivism is mostly featured as an instrumental conception.

Natural law contests the rivalry legal positivism's notion of law and its relation to morality. It has evolved thousands of years featured great jurists and philosophers⁶² and been cited as a component in landmark legal documents such as the United States Declaration of Independence and the Constitution of the United States. Natural law holds that just laws are immanent in nature and emerge by the natural process of resolving conflicts. More importantly, the content of law cannot be determined except by reference to various moral principles. Influential contemporary natural law jurist Ronald Dworkin, in attacking the legal positivists' model of rules, i.e. the "rule-book conception"⁶³, bifurcated the general category of "standards" into "rules", on the one hand, and "principles, policies and other sorts of standards" that "do not function as rules" on the other.⁶⁴ Dworkin argues that there is a "logical difference" between rules and principles,⁶⁵ and "a rule can

clear and general rules, that judicial independence must be guaranteed, that judicial judgments shall have the final binding force, that the principles of natural justice must be observed, that the power of judicial review on legislation and administrative action is secure, that courts are accessible to citizens, and that the discretion possessed by crime-preventing agencies should not pervert the law

⁶² jurists and philosophers include Aristotle, Thomas Aquinas, Francisco Suárez, Richard Hooker, Thomas Hobbes, Hugo Grotius, Samuel von Pufendorf, John Locke, Francis Hutcheson, Jean Jacques Burlamaqui, and Emmerich de Vattel

⁶³ See Dworkin *supra* 61 at 1660; *see generally*, Ronald Dworkin, *Law's Empire* 209-15 (1986), presenting the relationship between law and rules

⁶⁴ See Ronald Dworkin, *Taking Rights Seriously* 14-80 (1977) at 22, referring to the "rulebook model of community". *See generally* also Radin *supra* 11 at 803-06

⁶⁵ *Id.*, Dworkin, at 26-27

be completely stated with all exceptions, but a principle cannot.”⁶⁶ Moreover, the use of principles determines one right answer to legal questions even though principles lack formal actualization, because in using principles the judge should apply the best interpretation of the entire body of past legal authoritative acts, where that interpretation rests on the best political theory available to explain and justify law as an expertise.⁶⁷ Therefore, the natural law conception of rule of law is essentially the rule of certain rights or values that are inherent in or universally cognizable by virtue of human reason or human nature, and for this instance, conforms more to the substantive conception of the rule of law.

2.3. “Thin vs. Thick” categorization – an over-asserted dichotomy

The “thin” and “thick” categorization of the rule of law is principally championed and explored for the case of China by Professor Randall Peerenboom,⁶⁸ and a school of supportive scholars. The thesis obligates to mention that the thin-thick rule of law model also appeared in Michael Neumann’s treatise almost at the same time as Professor Peerenboom raised the model.⁶⁹ This thesis respectfully submits that, the thin and thick definition of the rule of law is not major but a reinterpretation of Lon Fuller’s theory. Although proponents of thin and thick interpretations of rule of law rhetoric endeavor to label their construct in slightly

⁶⁶ *Id.*, at 25-26, Dworkin presents that legal positivists’ model of rules does not describe what the law is, because law also consists of principles; and that application of rules does not fully document what judges do, because judges also use principles.

⁶⁷ See Radin *supra* 11, at 806

⁶⁸ See Randall Peerenboom: Debating Rule of Law in China, *supra* 21, and Wang, *supra* 11 for detailed description of the thin-thick rule of law model. This thesis notes that wordsmithing does not change the instrumental-substantive bifurcation of the rule of law interpretations

⁶⁹ See generally in Michael Neumann, *The Rule of Law: Politicizing Ethics* (Burlington, T, Ashgate Publishing, 2002) at 3

different or heuristic ways, there is considerable common ground with Lon Fuller's influential account that laws, in particular, a thin rule of law requires laws be general, public, prospective, clear, consistent, capable of being followed, stable, and enforceable,⁷⁰ which are based on Lon Fuller's instrumentalist view.

Analogically, the thin version of the rule of law formulates the rule of law as "a vision of judging that celebrates the systemic virtues of regularity, predictability and certainty over the concern with substantive justice in particular instances: formal rules are the most efficacious and legitimate way to protect substantive values."⁷¹ Therefore, "it is possible for a legal system to comply with the rule of law and still be undemocratic and/or unjust in general ... and in particular instances."⁷² On the other hand, the thick conception is more substantive built up on those basic elements of a thin conception. The "thick" version of the rule of law holds that law is inseparable from moral, (universal) values and politics such as particular economic arrangements, forms of government or conception of human rights, and that "the existence of pre-announced, objectively-knowable and impartially-applied rules must be supplemented by tying such formal virtues to a substantive account of democratic justice."⁷³ Arguably, comparing with the antagonistic opposition between positivism and natural law, the acrimony between "thin" and "formal" is less notable, and, to some extent, such

⁷⁰ See Peerenboom: Debating Rule of Law in China *supra* 21 at 497

⁷¹ See Allan Hutchinson, *The Rule of Law revisited: Democracy and Courts*, in David Dyzenhaus, ed., *Recrafting the Rule of Law: The Limits of Legal Order* 196 (Hart Publishing, 1999) at 199, cited by Wang, *supra* 16

⁷² *Id.*

⁷³ *Id.*

resemblance pictures a parallel intergrowth for the establishment of the rule of law.⁷⁴

A primary merit of the thin and thick categorization is that such definition rests on the model of the rule of law explicated by Fuller and Dicey. The definition, debatably, can be substantiated on two grounds and is encouraged to sustain. First,⁷⁵ the “thin” version focuses on the “instrumental function” or “process nature” of a legal system. Second,⁷⁶ in addition to meaningful restraints on State actors, the inner morality of law pictures that a legal system meeting the requirement of generality,⁷⁷ regularity,⁷⁸ transparency,⁷⁹ consistency,⁸⁰ clarity,⁸¹ acceptability,⁸² and good enforcement,⁸³ among others, are not likely to lead to a moral legal system.⁸⁴ However, there are still barriers in fully addressing the thin and thick conceptions.

The first setback with the thin and thick model is the insurmountable barrier between the thin and thick models which features individual rights and liberty, although the supporters of model argue that the thin model could develop into the

⁷⁴ See Radin *supra* 11, at 792-793, stating that the conception of the rule of law has not changed over generations but scholars usually employ different re-interpretations for their own needs

⁷⁵ See Wang *supra* 16, at 354-358, analyzing the jurisprudence of “thin” and “thick” theories in detail

⁷⁶ *Id.*

⁷⁷ *Id.*, Wang does not create any new conceptions of the rule of law but interpretatively states his explanations of Fuller’s rule of law elements, in particular, laws must not be aimed at a particular person and must treat similarly situated people equally

⁷⁸ *Id.*, stating that laws must be relatively stable

⁷⁹ *Id.*, stating that laws must be made public and readily accessible

⁸⁰ *Id.*, stating that laws must be consistent on the whole

⁸¹ *Id.*, stating that laws must be relatively clear

⁸² *Id.*, stating that laws must be reasonably acceptable to a majority of the populace or people affected (or at least the key groups affected) by the laws

⁸³ *Id.*, stating that laws must be fairly applied and enforced -- the gap between the law on the books and law in practice should be narrow

⁸⁴ *Id.*

thick version. This barrier parallels the wide bifurcation of positivism and natural law in structuring a legal system. Further, too much leeway has been granted the supporters of the thin/thick model in their suggestion that the thin model might develop into the thick.⁸⁵ Even Fuller's work suggests that the rule of law is a "matter of degree."⁸⁶ The thick model, however obscure, was structured to incorporate all elements of the thin model. However, it was also presented as an opposite ideal to which thin model is incapable of being evolved to. If the thin model is defined as similar to Fuller's instrumental conception or Raz's purposive enterprise, the thick model would be difficult to resolve with Rawls's substantive connection between the rule of law and the core value of liberty, justice and fairness, let alone his sense of the American jurisprudence innovation.⁸⁷ Therefore the thin/thick dichotomy is too aggressive theoretically unsustainable and not as sophisticated as Rawls's and Fuller's theories.

Empirically, another obstacle for the thin and thick model overlooks the rule of law as a political theory of limited government. As Hobbes argues, a sovereign state or "Leviathan"⁸⁸ requires, first and foremost, that the rule of law necessitate "a known and authentic legislator" who is "endowed with authority to create obligations." Under the theory of the state, the rule of law "stands as a moral (not

⁸⁵ Professor deLisie in his presentation at the University of Michigan in Fall 2010 stated that the thin and thick model is only a pragmatic manner in structuring a discussion and this model is far from representing a hallmark model, even for the purpose of analyzing China's legal reform (notes on file with the author)

⁸⁶ See Robert P. George, *Reason, Freedom and the Rule of Law: their Significance in the Natural Law Tradition* (2001) 46 Am. J. Juris. 249, at 250

⁸⁷ See generally, Radin *supra* 11

⁸⁸ See generally Thomas Hobbes, *Leviathan 100* (Michael Oakeshott ed., 1973) (1651)

a prudential) relationship⁸⁹, and needs a legal authority that is morally binding on its citizens.⁹⁰ With such an omission in applying its model empirically, the thin and thick model supporters evade the challenge of articulating the rule of law as a political theory, especially on government, the judiciary and legal institutionalization.

Another challenge to the thin and thick model is that, in transition economies, China for example, it does not address the ramifications of the shifting social, political, economic and international setting for its implementation and application. As detailed later as to the rule of law – development rhetoric, a comprehensive evaluation and outside force to the development of the rule of law are indispensable and of pith and moment.

In spite of these theoretical and empirical obstacles and challenges to applying the thin and thick model in defining the rule of law, and its tendency to be too forcefully applied, it still can be accepted as a practical and modern means to describe and analyze a legal system, especially for developing countries. Given the lack of empirical value represented by the thin and thick model, it is far too early to abandon the instrumental and substantive conceptions of the rule of law prescribed by leading theorists. While analyses and reform propositions based on the thick/thin model are still among the most important and realistic proposals for restructuring a legal system, however, assertions propelled by this model

⁸⁹ See Michael Oakeshott, *On History? And Other Essays*, Imprint Academic (January 2004) at 163

⁹⁰ *Id.* at 170-171, cited by Ortiz *supra* 20 at 84-86 and accompanying notes

inevitably involves the connection between instrumental and substantive conceptions.

2.4. The Rule of Law – Development Rhetoric

Over the past few decades, especially after the end of Cold war, the rule of law rhetoric has experienced an impressive revival, not only in western academic discourses, but also in a parallel reinforcement in the international sphere.⁹¹ The prevalence of western civilization, technology, capitalism, and globalization inspired tremendous indigenous demand for law in the non-western world⁹² and developing countries. Among the newly spread disciplines reached by the rule of law, the area of law and development has dramatically escalated and reshaped the traditional rule of law discourse, normatively and practically. For international financial institutions (IFIs) – major drivers of this law and development rule of law rhetoric⁹³ – the rule of law is associated with economic development, modernization and settings of market economy, rather than any rigid legal or political ideal.

This new trend of expanding the conception of rule of law is driven by the development assistance offered by IFIs in a suddenly unipolar world with tactical demands of reforming IFI borrower countries' legal systems.⁹⁴ In particular, IFI client countries should adopt sets of rules that would enshrine the policy

⁹¹ See generally, Ohnesorge: Asia's Legal Systems, *supra* 20; see also, Ohnesorge, The Rule of Law and Economic Development, *supra* 24

⁹² See generally, Li Xiuqing, *supra* 4

⁹⁴ See generally Ohnesorge, *supra* 24, discussing the political movement such as the crash down of Berlin Wall and the Soviet Union fall-down

prescriptions of the Washington Consensus in their legal systems.⁹⁵ The rule of law – development rhetoric envisions both positivist⁹⁶ and formalist suggestions that economic development at times may be prioritized over civil, social, and political development which will predictably follow the sustainable economic development, in particular, deregulation, privatization of state-owned sectors, tight restrictions on bureaucratic discretion, stringent property rights protections, enhanced protections for minority shareholders, *a well-functioning tax system*, and independent judicature, amongst others.⁹⁷

The interpretation of the rule of law rhetoric has changed over time, experiencing an ongoing expansion of its substance. Adopting an instrumental conception of the rule of law as a start, IFI initially demands primarily a functioning legal infrastructure that is capable of enforcing substantive rules.⁹⁸ In 1999, the Comprehensive Development Framework (CDF) proposed by the World Bank envisioned a highly contentious⁹⁹ “all in” notion¹⁰⁰ of legal reform in a client country, requiring that a client country protect “human and property rights,”¹⁰¹ and set up “a comprehensive framework of laws,”¹⁰² reasoning that otherwise, “no

⁹⁵ See generally, Alvaro Santos, *supra* 20

⁹⁶ See Ohnesorge, *supra* 24 at 94

⁹⁷ For detailed analysis, review and critics about the Washington Consensus, See generally, Narcís Serra and Joseph E. Stiglitz, *The Washington Consensus Reconsidered: Towards a New Global Governance (Initiative for Policy Dialogue)* Oxford University Press, USA (2008)

⁹⁸ See Ohnesorge: Asia’s Legal Systems, *supra* 20, at 65

⁹⁹ See Joseph Stiglitz, *Globalization and Its Discontents* (2002) challenging the neoliberal orthodoxy based Washington Consensus and its applicability. See also Kenneth Rogoff presents an extraordinary open letter to respond Stiglitz’s criticism, <http://www.imf.org/external/np/vc/2001/070202.htm>

¹⁰⁰ See John Ohnesorge, *The Rule of Law*, *Annu. Rev. Law Soc. Sci.* 3:99–114 (2007) at 106, quoting the new Comprehensive Development Framework proposed by World Bank President James Wolfensohn on legal reform issues of developing countries

¹⁰¹ *Id.*

¹⁰² *Id.*

equitable development is possible.”¹⁰³ The CDF further demanded that a government ensure “an effective system of property, contract, labor, bankruptcy, commercial codes, personal rights laws and other elements of a *comprehensive* legal system”¹⁰⁴ (emphasis added by the author), which are effectively, impartially and cleanly administered by “a well-functioning, impartial and honest judicial and legal system.”¹⁰⁵ Apparently, this description of the rule of law was too broad in its embrace of liberal values of democracy and justice. Values of democracy, justice, human rights and limited government go over and above an instrumental conception of rule of law,¹⁰⁶ which requires only elements such as know-ability and perform-ability.¹⁰⁷

Echoing criticism and resistance from client countries, the World Bank in 2002 defined conditions of the Rule of Law in its *Initiatives in Legal and Judicial Reform*: “(1) the government itself is bound by the law; (2) all in society are treated equally under the law; (3) the government authorities, including the judiciary, protect the human dignity of its citizens; and (4) justice is accessible for all its citizens.”¹⁰⁸ The rule of law requires transparent legislation, fair laws, predictable enforcement, and accountable governments to maintain order, promote private sector growth, fight poverty, and have legitimacy.¹⁰⁹ Legal and

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ See Radin *supra* 11, at 786

¹⁰⁸ See generally, World Bank *Initiatives in Legal and Judicial Reform* (2002),

[http://siteresources.worldbank.org/BRAZILINPOREXTN/Resources/3817166-](http://siteresources.worldbank.org/BRAZILINPOREXTN/Resources/3817166-1185895645304/4044168-1186409169154/18initiativesFinal.pdf)

[1185895645304/4044168-1186409169154/18initiativesFinal.pdf](http://siteresources.worldbank.org/BRAZILINPOREXTN/Resources/3817166-1185895645304/4044168-1186409169154/18initiativesFinal.pdf) (last visited on March 15, 2011)

¹⁰⁹ *Id.*, at 2

judicial reform is a means to promote the rule of law.”¹¹⁰ We can perceive that, in this definition, the World Bank aims its definition at the approval of human rights activists and dyed-in-the-wool internationalists. Without a doubt, this definition raises the bar for the market economy development model as well as infrastructure reconstruction for borrower countries, which are plagued by its vague, generally articulated standards.

The rule of law rhetoric in the economic development context brings together literatures¹¹¹ theorizing, in various ways, the relationship between legal reform and economic development.¹¹² The scholarship in this area mostly explicates two essentials for a proper rule of law: limiting bureaucratic discretion on economic governance, and promoting freedom of contracts and private property rights protection. Limitation of bureaucratic discretion connotes transparency, predictable administration, and anti-corruption. The second essential element, ensuring freedom of contract and protection of property rights (including intellectual property rights), is the foundation of market economy. In this sense, rule of law rhetoric in the economic development context accords with Raz’s

¹¹⁰ *Id.*, at 3

¹¹¹ Professor John Ohnesorge in the past years has summarized and been a major contributor on the rule of law – economic development rhetoric. For discussion about the rule of law reform dominated by western jurisdictions and IFIs, see also generally in Thomas Carothers, *The Rule of Law Revival*, Foreign Affairs 77-95 (2006), Thomas Carothers, *Promoting the Rule of Law Abroad: In search of Knowledge*, (Washington, DC: Carnegie Endow. Int. Peace, 2006); for discussion of rule of law reform and development in other developing countries, see John Stanley Gillespie, *Transplanting Commercial Law Reform: Developing a “Rule of Law” in Vietnam*, (Ashgate, Burlington VT, 2006), <http://www.ejcl.org/122/review122-1.PDF>, See Paul Gewirtz, *The U.S.-China Rule of Law Initiative*, William Mary Bill Rights J. 11 603-22 (2003); Kathryn Hendley, *Assessing the Rule of Law in Russia*, Cardozo J. Int’l & Comp. L 14 347-91 (2006), http://www.law.wisc.edu/m/zgyzz/russian_style_rol.pdf; Professor Ohnesorge’s works are <http://www.law.wisc.edu/profiles/pubs.php?iEmployeeID=184> (last visited March 15, 2011)

¹¹² *Id.*, Carothers, stating that the law and economic development also suffered from a fall from grace in the 1970s and 1980s, at 22-25

“Rule of Good Law,” but also heeds the Hayekian definition requiring predictability and private economic protections.

The rule of law rhetoric in the economic development is more favored by politicians, who see rule of law reforms as part of a broader strategy to micromanage the social and economic structures of IFI client countries, and thereby to steer reform down a path of development, which caters to IFI policy preferences. According to the ideal formula of IFI rule of law models, economic development “spills over” into areas of sensitive political and legal issues, and uses economic incentives to bring transition countries in line with IFI – especially American – ideals of liberal democracy. The mark of American political and legal ideology in this rhetoric is undeniable. IFIs and international organizations such as the WTO largely concentrate on the competency and autonomy of the judicial and legislative sectors and on promoting administrative proficiency in member states.¹¹³ That these efforts conform to the United State’s understanding of its own political ideals and economic best interests is not a coincidence.

The rule of law rhetoric in the economic development phenomenon exhibits the influence, enforceable upon developing states by developed states through international organizations like IFIs, used to conform developing states’ legal infrastructures to the requirements of the global market economy. Although empirically the development of Northeastern Asian countries has not proven the inevitability of the development of the rule of law, especially in the case of liberal

¹¹³ See generally, Jacques deLisle, *Lex Americana?: United States Legal Assistance, American Legal Models, and Legal Change in the Post-Communist World and Beyond*, 20 U. Pa. J. Int’l Econ. L. 179, 217-18 (1999).

legal values,¹¹⁴ there is still an urgency in these countries to adopt the conceptions of rule of law, in a pragmatic and realistic manner, which cater to their own economic, social and legal needs. As will be discussed below, China's invitation of the rule of law as impacted by its WTO membership, both charms and frustrates domestic and outside commentators, albeit for widely varying reasons.

2.5 Summary

Having discussed major conceptions and arguments of the rule of law rhetoric, bifurcations such as instrumental and substantive, positivism and natural law, the thin and thick model, and the economic development rhetoric, this thesis aims to prepare a reasonable, practical and realistic foundation to evaluate the progress of the China's legal reform in the past three decades. Pushing this goal further, this thesis tentatively submits – on the basis of the foregoing contemporary debates of Rule of Law – a tailored, pragmatic and practical proposal for the tax reform rhetoric under China's current legal infrastructure. This proposed rhetoric is underpinned by instrumental notions of, *inter alia*, generality, clarity, consistency, enforceability, stability and congruence, as well as substantive notions of judicial independence, human rights and the limitation of bureaucratic government.

III. The Establishment of the Socialist Rule of Law with Chinese Characteristics

Chronicling Chinese officials' discussion of China's rule of law conception is essential, given its contested content within a complicated transitory "elite legal

¹¹⁴ See Ohnesorge, *The Rule of Law and Economic Development*, *supra* 20, at 95

culture,”¹¹⁵ and because the Chinese party-state devises and implements the legal reform process. Below, therefore we examine the policies orientations taken by senior politicians and cheered by scholars. In the past thirty years, three stages of legal reform and development have taken place based on Deng’s theory of “socialism with Chinese characteristics” for economic reform.

3.1 Deng’s Legal Theorems

Deng Xiaoping, facing a fragmented polity after the Cultural Revolution, first focused on “institutionalization” (*zhiduhua* 制度化) and “legitimatization” (*fazhuhua* 法制化). In particular, Deng said, “to safeguard people’s democracy” and “to ensure the stability, continuity and full authority of...[the] democratic system and laws”, there must be “laws for people to follow, laws [must] be observed, enforcement must be strict and lawbreakers must be punished.”¹¹⁶ These 16 words¹¹⁷ are still enshrined in the minds of Chinese politicians and academics as pillars of the socialist legal canon as to features of “to modernize the law, to observe the law and act in accordance with law, equity before the law, and to fortify laws as the utmost authority.”¹¹⁸

¹¹⁵ See Pitman Potter, *The Chinese Legal System: Globalization and Local Legal Culture* (Routledge Studies on China in Transition, 2001) at Preface and 115

¹¹⁶ See People’s Daily, *The Communiqué of the Third Plenum of the Eleventh Congress of the Central Committee of CCP* (December 22, 1978)

¹¹⁷ Deng’s legal thoughts center on “there must be laws to go by, the laws must be observed and strictly enforced, and lawbreakers must be prosecuted.” (“有法可依，有法必依，执法必严，违法必究”)

¹¹⁸ See generally, *Research on Deng Xiao Ping’s Ideologies on Rule of Law*, <http://www.yfzs.gov.cn/gb/info/xsll/2006-03/19/1950232785.html> (last visited on March 15, 2011); Chuanguang Jiang Goujian Zhongguo Fazhi Shehui de Zhinan – Deng Xiao Ping Fazhi Sixiang Yanjiu [*Guidelines on Structuring the Rule of Law in China – Research on Deng Xiao Ping’s Ideologies on Rule of Law*], (Anhui University Press, 2000)

Likely reflecting wisdom gained in his personal political tribulations, Deng's goal of "institutionalization" of law focused primarily on circumventing individual arbitrariness, and the "rule of men." His goal of "legitimization" aimed at improving legal awareness (*falü yishi* 法律意识) and equity before law (*falü mian qian renren pingdeng* 法律面前人人平等). Pursuing these goals however, Deng was adamant that in establishing a stable political order, resistant to outside influence, China should also achieve economic development.¹¹⁹

We have to admit that Deng's institutionalization and legitimization ideals come from an ideological standpoint that is radically different from that of traditional rule of law conceptions. His political agenda demands that law, as an institution, simply normalize a set of rules to buttress economic development and eradicate political turmoil of the kind seen during the Cultural Revolution. On the other hand, his legal theorems are constructed to solidify the ruling position of the communists and not to vivify law in a role over and above the party-state. Deng's alternative political interpretation of the rule of law is well evidenced by the One Party rule and his refusal to adopt Americanized separation of powers in the mid-1980s.¹²⁰

¹¹⁹ See generally, Deng Xiao Ping Wen Xuan Di San Juan [*Selected Works of Deng Xiao Ping*], Volume III (2000) In Deng's famous notion that constructing economic development on one hand, and law and socialist value on the other, with equal priority and commitments (*liangshouzhua, liangshou dou yaoying* 两手抓，两手都要硬), Deng again reiterated his concomitant goals to achieve economic development and thwart westernized liberal invasion

¹²⁰ *Id.* at 256, stating that Deng rejected a western mutually constrained system, stating "if excessive emphasis is placed on a mutually limited system, it maybe still cannot solve the problem"

3.2 Jiang's Development of Socialist rule of law

Although initially seen as a “puppet”¹²¹ of Deng, Jiang Zemin made bold strides to develop the socialist rule of law in the 1990s. The term “rule of law,” in fact, did not officially surface until 1997 at the 15th CCP Congress, where it was presented as a part of the new phase of socialist market economy development.¹²² In a 2005 editorial in *Qiu Shi* (Seeking Truth), an official publication of CCP Standing Committee, Jiang proposed the rule of law to “renovate legal and administrative system, improve ‘for the people’ ideology and modernize society to strengthen order and keep away unhealthy influences.”¹²³ In essence, the socialist market economy precipitated the shift away from Deng’s rule by law to Jiang’s new rule of law conception. However, cautioning romanticized expectations of the “socialist rule of law”, Jiang further clarified in an Op-Ed piece for the People’s Daily that his regal goal in developing the rule of law was “upholding and improving political system without copying any westernized models.” Indeed the rule of law was to be “decisive in sustaining the leadership of the party” and the people’s democracy.”¹²⁴ Jiang further bulleted that “administration in accordance with law unifies the Party’s leadership...and

¹²¹ See Edward Friedman, *Jiang Zemin's Successors and China's Growing*, in *China Under Hu Jintao, Opportunities, Dangers and Dilemma*, 97-134 (Cheng, deLisle and Brown, ed., World Scientific, 2006)

¹²² See Cai Dingjian & Wang Chenguang, *China's Journal Toward the Rule of Law* (Koninklijk Brill NV, Leiden, The Netherlands, and Social Sciences Academic Pres, Beijing, 2010) [hereinafter “Cai and Wang”] at 15-16

¹²³ See generally, Jiang Zemin, *Hold High the Great Banner of Deng Xiaoping Theor for all Round Advancement of the Cause of Building Socialist with Chinese characteriscs into the 21st Century – Report Delivered at the 15th National Congress of the Communist Party of China* (*Gaoju Deng Xiao Ping Lilun Weida Qizhi, Ba Jianshe You Zhongguo Tese Shehui Zhuyi Shiye Quanmian tuixiang Ershiyi Shiji*) [江泽民:高举邓小平理论伟大旗帜,把建设有中国特色社会主义事业全面推向二十一世纪—在中国共产党第十五次全国代表大会上的报告], http://news.xinhuanet.com/ziliao/2003-01/20/content_697189.htm (last visited on March 15, 2011)

¹²⁴ *Id.*

ensures the enforcement and implementation of the Party's basic policies... to ensure that the Party at all times play the crucial leading role in controlling the full situation and coordinating all constituents.”¹²⁵

Jiang's rule of law therefore may be read as a cogent recapitulation of Deng's institutionalization and legitimization, for a more modern and globalized Chinese economic and political situation. Jiang's formulation still prioritizes the political agenda of the party-state and un-challengeable position of the One Party sovereign. Westernized or Americanized ideals of separation of powers, judicial independence, the supremacy of law, human rights and multiparty polity are deemed “incompatible” with China's “overall situation” of socialism (“*quanguo daju*” 社会主义全国大局).¹²⁶ The CCP and China's One Party system of rule, during Jiang's era, faced severe challenges and pressures from domestic dissidents and foreign governments and international institutions. Jiang's rule of law was a response to domestic challenges to the party's legitimacy¹²⁷ and foreign condemnations of China's sluggish reform process.¹²⁸ After abandoned the notion of socialist rule by law (*shehui zhuyi fazhi* 社会主义法制) in political reform settings, Jiang further honors the rule of virtue (*yide zhiguo* 以德治国) to

¹²⁵ *Id.* (omissions added by this thesis)

¹²⁶ See People's Daily (overseas version), February 1, 2001

¹²⁷ See Jiang Zemin, “Resolutions in the CCP Central Committee Regarding Important Questions on Promoting Socialist Ethical and Cultural Program,” adopted at the Sixth Session of the 14th CCP Central Committee Congress, October 10, 1996. Jiang warned about the deterioration of moral standards, the practice of worshipping money, seeking pleasure and selfish individualism, the revival of feudal superstitions, pornography, gambling and drug abuse, the production of shoddy and fake goods and fraud in the market place, and rampant corruption, all of which are seriously damaging the work of both Party and government. Furthermore, there is a vacuum in people's faith in socialism and the ideal of honoring the state is weak. He claimed that all these problems must be resolved through the promotion of ethical and cultural moralism. See generally, Cai and Wang, *supra* 122

¹²⁸ See generally CECC 2002 Report, *supra* 16

supplement the rule of law to divert attention pushing on political reform to legal and administrative system reform.

The “Three Represents” (*sange daibiao* 三个代表)¹²⁹ arguably is the most remarkable theorized contribution made by Jiang to the socialism movement. Although Jiang fought hard to insert the “Three Represents” as an amendment to the Preface of Constitution and the Party Charter, together with the “rule of virtue”, it still fails to weld the political legacy and ideological vacuum opinionated by the general constituents. Is the upholding of the “rule of virtue” another resort to justify the inwardly sensitiveness of adopting the westernized conception of rule of law, or to find Chinese ancient root for the rule of law rhetoric to substantiate the legitimacy of the party-state? There is no clear answer to this. However, the academia in China admits that rule of virtue marginalize the debate and introduction of the traditional or western rule of law conception, even the “rule of virtue” proclaims fair competition, creditability, self-respect and cooperation with government.

Although Jiang boldly introduced the “rule of law” discourse into the social, political and legal settings of China, the conception he articulated was to secure the ruling of party-state and maintain the authoritarian status of the CCP, rather than to implement checks on governmental powers. Jiang’s rule of law is therefore, in essence, a reformulation of Deng’s legal theorems that aims to

¹²⁹ See generally Larry Cata Backer, *Chinese Constitutionalism, Sange Daibiao (the “Three Represents”)*, and *the Rule of Law*, 16 *Transnat’l L. & Contemp. Probs.* 29, 33-34 (2006) for a detailed analysis of the rule of law reform and the “Three Represents”

stimulate economic development and evade potential challenges to the part-state legitimacy.

3.3 The Hu-Wen Harmonious Society Undertaking

Chinese President, Hu Jintao, and Premier, Wen Jiabao, are survivors of the first arguably peaceful power transition in modern Chinese history, and its legacy represents the ascension of China's fourth generation of leadership after the Sixteenth CCP Congress held in November 2002. Unlike their predecessors, Hu and Wen have been confronted with myriad domestic political challenges from economic readjustments domestically and constant international calls for economic and political liberalization, to managing the SARS epidemic and an Olympic Games. The leaders, as a result of their WTO obligations in particular, face difficult choices in carrying out their political agenda.

Hu and Wen advocate a "harmonious society" for promoting people's welfare (*minsheng*, 民生) and balancing economic growth with social justice. In this instance, Hu and Wen have plainly inherited the discourse of "socialist rule of law" from Jiang, while concern for social welfare and reducing socioeconomic disparity that have clearly affected their notion of the object of law. Hu and Wen have mostly been "trouble-removers" and have faced complex a domestic political setting after China's over two decades of economic growth and participation in international orders. Cultivating their grass-roots allures, Hu and Wen have concerned themselves and the party more with the plight of low-income citizenry and countryside or agricultural welfares. Extensive corruption,

undisciplined local grandees, enlarged social disparity, a further deteriorated environment, growing breakouts of worker unrest, and social imbalance all contribute to Hu and Wen's policy deviations from their predecessors' focus on economic development, SOE destruction and reform, and international outreaches.

As evidenced by the amendment to China's constitution in 2004, which includes safeguarding human rights and private property rights as a primary focus of the party-state, Hu and Wen have added more "substantive" or "thick" elements to the official undertaking of the rule of law reform in China. It further accents the economic development, WTO obligation fulfillment and the sense that the ruling party-state cannot be preserved without promoting justice and fairness. Substantial as the Constitution's rule of law development looks in its invocation of employing laws as weapons to protect individuals' rights and liberties, citizens' fair share of social wealth and corresponding social status, Hu and Wen mostly purport seeking to achieve a harmonious relationship between GDP growth and social welfare, with the ultimate goals of maintaining social stability and cooling down hatreds towards the highest echelon of wealthy classes (先富阶层). Hu and Wen's political vocabulary does not speak to political harmony or further institutionalized legal structure, nor does its agenda ever manifestly proclaim the rule of law. Thus, it is well recognized that Hu and Wen's focus, albeit using a rule of law discourse, continues to try to secure CCP's rule status and maintain social stability.

It is too early to analyze ideologies on socialist rule of law of Xi Jinping and Li Keqiang, who are supposed to take over the mantle of the Hu-Wen legacy in three years. However, given the perceptions of CCP's steady goal of securing party-state sovereign and traditional focus on GDP growth, a reasonable observation would conclude that in the near future an overhauled upgrade of rule of law reform is not attainable, especially under the decentralized and cliquy factionalism of the inner-party system, which is now under heated debate.

3.4. Summary

In summary, the development of socialist rule of law rhetoric is a paradoxical labor, being receptive to market economy principles and modernizing state and private enterprises on the one hand, while remorselessly preserving an autocratic form of socialism on the other. Such a paradox can only be described as “the socialist rule of law with Chinese Characteristics”, with vague description of “characteristics” and re-interpretative conception of “socialism”. Throughout the three decades of economic reform and social evolution, and three generations of CCP leaderships, China has consistently made overtures toward the goal of setting up the rule of law order. However, ideological barriers still preclude adoption of traditional rule of law conceptions, allowing only for strategic reinterpretations. Minimum thresholds of traditional rule of law: protection of individual rights and building up a “government under rule of law” (*fazhi zhengfu* 法治政府) or “limited government” (*youxian zhengfu* 有限政府), still appear unachievable. The development of socialist rule of law is heavily constrained by serving its political

initiatives of maintaining social stability and securing the one party state. Even bearing a “Chinese characteristic” or “socialism” stamp, which might lay differences at the doorstep of legitimate sovereignty concerns, the legal institution itself can hardly say as being embraced or centered as a modern means to harmonize the society.

Any serious discussion of a viable rule of law rhetoric for use in China must consider its domestic political and social needs to maintain social stability and its demonstrated desire to maintain one party rule, in conjunction with new and complex roles played by China in the international arena. The CCP’s adoption of new political slogans such as “doing things in accordance with international standard” and “assimilation or harmonization with international practice,” compels serious commentators to include in-depth examination of the impact of international organizations, such as the WTO, in their reviews of China’s socialist rule of law rhetoric.

IV. The Implication of Rule of Law Conception to Contemporary China

4.1. Legal Reform in the Past Three Decades

Beginning in the late 1970s with an over-manipulated and shattered Constitution that was essentially a complex assurance of the CCP’s ruling status, established institutions of socialist governance, and a limited number of vaguely worded statutes typically derived from CCP’s class struggle policy pronouncements (*yi jieji touzheng weigang* 以阶级斗争为纲), China has developed an extensive body

of laws, regulations, and other legal enactments.¹³⁰ This accomplishment has only been possible with the parallel development of administrative infrastructure, as well as the establishment of over 400 post-secondary law departments which have graduated over 250,000 students. Professor William Alford's excellent summary ten years ago on the achievements of China's legal system reform might shed some lights on such promising and phenomenal progress¹³¹:

Over the past quarter century, China has been engaged in the most concerted program of legal construction in world history. At the end of the Cultural Revolution, China's modest legal infrastructure lay in near ruin – with but a skeletal body of legislation, a thinly staffed judicial system, and a populace having scant awareness of law... China now has an extensive body of national and sub-national legislation and other legal enactment,

¹³⁰ The literature on China's legal reform in the past three decades is voluminous. *See generally*, *The 60th Anniversary of the PRC: A Retrospective on the Chinese Legal System*, 23 *Colum. J. Asian L.* (2009); *China's Legal System: New Developments, New Challenges, The China Quarterly (Special Issue, September 2007)* (Cambridge University Press) on China's legal reform; For projects related to China's rule of law reform, *See generally*, Gewirtz, *supra* 111; Randall Peerenboom, *Globalization, Path Dependency and the Limits of Law: Administrative Law Reform and Rule of Law in the People's Republic of China*, 19 *Berkeley J. Int'l L.* 161, 198-99 (2001); Fred Bergsten, N. Lardy, B. Gill & D. Mitchell, *The Balance Sheet in 2007 and Beyond*, (Conference held jointly by the Center for Strategic and International Studies and the Peterson Institute for International Economics, Apr. 2007) (suggesting that "China is slowly establishing elements of a 'rule of law' system"), <http://www.chinabalancesheet.org/Documents/05RuleofLaw.pdf>; (last visited on March 15, 2011); Randall Peerenboom, *What Have we Learned about Law and Development? Describing, Predicting, and Assessing Legal Reforms in China*, 27 *Mich. J. Int'l L.* 823, 842 (2006); Randall Peerenboom, *Law and Development of Constitutional Democracy in China: Problem or Paradigm?*, 19 *Colum. J. Asian L.* 185, 187 (2005); Li Buyun, *Ideal and Reality of the Rule of Law in China*, 3 *J. Chinese & Comp. L.* 40-59 (1997); Xianchu Zhang, *Commentary on "Legislating for a Market Economy in China,"* 191 *China Q.* 586, 588 (2007) (citing the Report on Governance and Social Policy of the World Bank Institute, <http://www.worldbank.org/wbi/governance/pubs/govmatters4.htm>. (last visited on March 15, 2011)

¹³¹ *See generally*, Alford, *supra* 20, noting that Chinese officials proudly report the promulgation in the past quarter century of more than 300 laws by NPC and its Standing Committee, more than 700 regulations by the State Council, more than 4,000 regulations by sub-national people's congresses and their standing committees, and more than 24,000 other legal enactments by the ministries arrayed under the State Council and their sub-national counterparts

concentrated on, but not limited to, economic matters, and has joined major international agreements covering trade, the environment, human rights, intellectual property and a host of other issues... The Chinese judicial system now has a nation-wide presence, with specialized chambers to address criminal, civil, economic, administrative and in some instances, intellectual property law questions. Whereas a generation ago, China had fewer than 3,000 lawyers and approximately a dozen law schools, now there are over 125,000 lawyers and hundreds of law schools, with law a very popular subject for university study and well over 150,000 candidates yearly taking the bar exam. Chinese citizens now avail themselves of the formal legal system in an unprecedented manner...¹³²

As noted above, the achievements of the past three decades of formal legal development have been phenomenal. After a few controversial amendments, China has developed an intricate Constitution that sets forth an institutional regime for the protection of, *inter alia*, general economic social and cultural as well as civil and political rights of individuals. The Constitution further establishes the legal functions and statuses of central and local Congresses, courts, and the Procuracy and other key administrative institutions. Basic laws (*ji ben fa* 基本法) promulgated by the NPC Standing Committee implement and fill in the rights and governance system outlined in the Constitution, detailing principles and rules on commercial routines, contracts, civil, criminal and administrative principle and procedure, enterprise, tax, finance, securities, labor, and

¹³² *Id.*

environmental protection, among other areas, many of which are in their fourth or later revisions; and various laws and regulations in areas of investment, corporations, health and safety, construction, intellectual property, and legal profession.¹³³ The Constitution and laws therefore cover almost all major aspects of social, economic and legal life in China. Moreover, China has extended its international presence tremendously, as exemplified by its WTO membership and improved discourse power in IFIs, all of which contributes to and encourages China's legal reform.

Notwithstanding the above accomplishments and ongoing legal reform, there are still debates on how to reform China's legal system, and even suspicions on whether China owns a separate and institutionalized legal system or if there exists a "Chinese legal system" at all. A notably opinionated view along these lines holds that Chinese historical, social, and political settings are so fractured and inhomogeneous from modern western legal system, that meaningful transplantation or adoption of western legal ideals, e.g. a western polity, to China is fantasy.¹³⁴ This view, although analytically it bears the merits of an in-depth understanding of Chinese legal settings, showcases a certain deficiency in historical materialism on which it theorized western legal tradition, and

¹³³ See generally, *China's Efforts and Achievements in Promoting the Rule of Law*, Information Office of the State Council of the People's Republic of China (February 2008), stating that China's promulgation efforts have also been coupled with unprecedented undertakings in training, nominating and placing required personnel for the legal project. Moreover, China citizens are increasingly engaging themselves in safeguarding rights and receiving basic legal assistance. The awareness of Chinese citizen to understand, accept, and employ law has been improved and more rooted in the population including farmers of more than 1 billion

¹³⁴ See Donald Clark, *Puzzling Observation in Chinese Law: When is a Riddle Just a Mistake?* in C. Stephen Hsu, Ed., *Understanding China's Legal System: Essays in Honor of Jerome A. Cohen* (New York: New York University Press, 2003) at 93

exaggerates the difference between the legal systems. First, the danger of this view is to isolate western legal ideals in a self-congratulatory manner as a system without referential needs from other legal systems. Second, legal reform in China has, since its imperial era, been shaped by western legal norms. Republican era China's laws were an almost direct translation of western norms.¹³⁵ Moreover, China's contemporary legal reform also presents a strong absorption of westernize legal ideas. Third, the impact of participation in the international legal sphere cannot be understated. Finally, it causes illusion that supporters of this view neglect international and domestic efforts to build a more accepted and functioning Chinese legal system.

4.2. Rule of Law vs. Rule by law

It is essential now to revisit and appraise two conceptions of the possible relationship between law and the state: rule *by* law and rule *of* law. These two notions, although they are somewhat unsophisticated for the purposes of complete normative comparison, outline basic sets of prerequisites for modern economic development and legal infrastructures, especially in transitory and emerging economies: an independent judiciary; and limited bureaucratic discretion and administration. Both of these constructs assume away a third possibility of rule by

¹³⁵ See generally, Tay-sheng Wang, *Legal Reform in Taiwan under Japanese Colonial Rule, 1895-1945: The Reception of Western Law* (University of Washington Press, 2000)

definition – the rule of men¹³⁶ and both are particularly appropriate to the discussion of various aspects of China’s legal reform¹³⁷.

Rule by law as a term in this thesis primarily refers to the instrumental aspect of law: descriptive, positive, and thin. Rule of law as a term, given various interpretations and for the purpose of comparing with the rule by law, represents a prescriptive, normative, thick and political view that includes, but is not limited to, separation of powers, fairness and justice, judicial review and embracing liberty and freedom.¹³⁸ Given the substantial impacts that these two conceptions have had on Chinese legal reform, it is necessary to briefly describe the difference between these two terms.

Rule by law does not require separation of between the legal infrastructure and the state. In this sense, rule by law aims at implementation of generally prescribed, known, consistent, and enforceable rules by the state government over human conduct.¹³⁹ Value in this system is placed on uniformity, impartiality and predictability¹⁴⁰ in application, which invites the regularity and consistency in a legal system independent of spontaneous political and social interference. Of

¹³⁶ See Yufan Hao, *From Rule of Men to Rule of Law: An Unintended Consequences of Corruption in China in the 1990s*, 8 J. Contemp. China.(1999); See also Cai and Wang, *supra* 122 at 1-50

¹³⁷ See Albert Chen, *Toward a Legal Enlightenment: Discussion in Contemporary China on the Rule of Law*, 17 UCLA Pac. Basin L.J. at 135

¹³⁸ See Radin, *infra* 11, at 783-91, discussing the “instrumental” and “substantive” concepts of law; see also, Robert Summers, *supra* 11, at 127, 135, briefing the “formal” and “substantive” concepts of the rule of law. For discussions in Chinese, see generally, Zhu Haigen, *From Rule by Law to Rule of Law (Cong Fazhi Dao Fazhi*, 2008), <http://www.chinacourt.org/html/article/200812/19/336712.shtml> (last visited on March 15, 2011); Cheng Liaoyuan, *From Rule by Law to Rule of Law (Cong Fazhi Dao Fazhi)* (China Law Press, 1999)

¹³⁹ See Radin, *supra* 11, at 785-786 and accompanying text.

¹⁴⁰ See generally, Maimon Schwarzschild, *Keeping it Private* (2007), stating that legal stability and predictability are a fundamental part of “what people mean by the Rule of Law”

course, the minimum requirement is that there is a set up codified rules available for administration and application. So, enforcement of rules can be merely realized by legal staffs of a state's administrative and judicial apparatuses. Rule by law is often criticized, because even an authoritarian legal system or a legal system depraving human rights may qualify such relatively strict instrumental and positivist thresholds.¹⁴¹

Rule by law is most similar to Fuller's eight fundamental characteristics instrumental conception.¹⁴² Meanwhile, formalist theorists also hearken back to Fuller,¹⁴³ who also claims that formalism lies in the concept of decision making according to law.¹⁴⁴ In this sense, a formalist view of rule by law centers on using the promulgation and enforcement of law as a method of ruling.¹⁴⁵ Rule by law, in terms of enforcement, envisions a method whereby legal rules are enforced as a part of governance. However, rule by law as instrumental, descriptive and positive, does not embrace fully the "inner morality" or values as preferred by Fuller.¹⁴⁶

Rule of law, on the contrary, incorporates a normative and political theory of the relationship between the state and law. In this sense, rule of law primarily refers to a set of substantive and prescriptive values and political theories of limited government, independent judiciary, how laws are used and how governmental discretion is constrained by law. Rule of law, as discussed in the economic development literature, has expanded to include almost all characteristics of

¹⁴¹ *Id.*

¹⁴² *See generally*, Fuller *supra* 30

¹⁴³ *See* Summers, *supra* 11, at 135 (1993)

¹⁴⁴ *See* Frederick Schauer, *Formalism*, 97, Yale L.J. 509-510 (1988)

¹⁴⁵ *Id. see also* Radin *supra* 11 at 796

¹⁴⁶ *See* Fuller *supra* 30 at 42-44, 96-97; *see also* Radin *Supra* 11 at 795-96

“good law” or “good governance.” In this sense, the rule of law embraces a constitutional structure in which government behavior is subject to review by independent legal process, and possibly, limitations and punishment, i.e., government officials are monitored by judicial review. Therefore, a well-functioning judicial system including court, police, judges, qualified legal professionals, and a set of normative procedures is required for the rule of law in the economic development literature. Although Fuller’s eight characteristics of rule of law may also be broadly reinterpreted in a substantive and prescriptive way,¹⁴⁷ other interpretations of rule of law cannot be missed. Among others, Raz argues that “judicial judgments shall have the final binding force”, “the power of judicial review on legislation and administrative action is secure”, and “courts are accessible to citizens, and that the discretion possessed by crime-preventing agencies should not pervert the law.”¹⁴⁸ Therefore, rule of law in Raz’s conception, requires at least a judicial and legal infrastructure independent, at least to some extent, of administrative interference.

In summary, in the context of Chinese legal reform, the development of rule of law conception has been inextricably intertwined with polity evolution in China. Following the Republic of China in adopting a westernized model, China’s legal reform in the past three decades gradually developed into a mixed yet promising socialist rule of law catering to the needs of a globalized market economy. From the beginning of China’s contemporary legal reform, there has been consensus to

¹⁴⁷ See William P. Alford, *A Second Great Wall?: China’s Post-Cultural Revolution Project of Legal Construction*, 11 *Cultural Dynamics*, 203-205, describing the forces encouraging an attitude of “instrumental approaches to legality” in China, [hereinafter Alford: *A Second Great Wall*]

¹⁴⁸ See Radin 11 at 788-789

pursue the rule of law or rule by law rather than rule of men to circumvent individual arbitrariness and personality cult. Moreover, given the heated debates on which model of rule of law that China should undertake, the instrumental characteristics of rule of law and a realistic understanding of China's political, economic, social and international settings are commensurably essential. Furthermore, rule by law and rule of law bifurcation on one hand shows the China's promise to developing a law based market economy, and present arduous commitments to China in developing a rule of law order on the other. Situating an instrumental, descriptive and positive conception of rule of law as bottom line, reasonable efforts to promote a normative and substantive conception of rule of law would for sure escalate China's legal reform conforming to universally accepted values and ideals of human rights protection, limited government, functioning independent judiciary and impartial administration by bureaucratic discretions. The analysis of this chapter shows that, putting aside the prioritization on which rule of law model that China should embrace and adopt (assuming there is one), the formal aspects of Chinese legal reform including its deficiencies and problem need be identified and appraised. Needless to say, China's greatly increased international commitments have made its need for domestic legal reform more urgent.

4.3. Incompetency of China's legal system

Chinese legal reform accomplishments deserve quality deliberations¹⁴⁹ but so do various undertakings in which China's legal system continues to fall short of expectations – either romanticized or widely accepted – of a modern, rule of law state. In a substantive sense, China has substantially failed to protect legitimate rights of all citizens, leaving groups such as rural seniors, unattended children, migrant laborers, laid-off SOE workers, natural disaster victims, minority nationals, and notoriously trafficked women, just name a few, without effective legal recourse. The judiciary branch woefully is not privileged to be sufficiently independent from the CCP and political authority, nor are its judges uniformly competent or autonomous in their embrace of the rule of law and impartial political ideals. Corruption, on both national and local levels and involving almost all corners of economic and social fields, plagues the legal system abrasively. Environmental protection protocols and low carbon guidelines are distorted in application and encumber meaningful calculations in fighting pollution and deterioration of ecological balance; administrative branch of government, though improved under the new Information Disclosure Law in 2009, is still characterized by its low efficiency, overstaffing, overlapping hierarchies of command, and opacity. Although the legislative process has expanded to include public hearings and opinion collection from a broader spectrum of interests, it remains largely a top-down routine, typically falling short of implementing

¹⁴⁹ See generally, Liebman: *Retrospective*, *supra* 1

formally provided opportunities for quality input from academics and popularized comments by citizens, especially low-income constituencies.

Law enforcement, still manifests violence, dissonance, staffing shortages, procedural confusion,¹⁵⁰ case nature misidentification, local protectionism and retarded response mechanisms. The emergence of countless prison management scandals has increased doubts about the competence of the penal system to uphold the rights of accused and convicted individuals.¹⁵¹ While China has accomplished the *formal* articulation of a reformed socialist legal system, even the theoretical and instrumental foundation articulated is not without problems. Indeed, one need not hunt far to find limitations and vulnerability inherent even in the formal laws.

Even China's Constitution¹⁵² has been the target of academic and public criticism. Although China's Constitution has put forward panoply of basic rights of citizens, some of which are not even explicitly stated in those of developed countries, the difference between a constitution on the book and an enforceable document in practice is so massive that western scholars and politicians have lost their faith in a "qualified constitutionalism."¹⁵³ China's Constitution is not subject to litigation

¹⁵⁰ For example, see *Cross-Provincial Detainment by Hubei Tongcheng Police Bureau* [Hubei Tongcheng Jingfang Kuasheng Zhuaren] May 30, 2009, Southern Weekend, <http://news.sina.com.cn/c/sd/2009-05-30/160517915790.shtml> (last visited on March 15, 2011)

¹⁵¹ For example, the development of a popular lexicon deriving from these incidents, including terms such as "peekaboo" (duomaomao), "soy sauce shopping" (dajiangyou), "pushing-up" (fuwocheng), etc., which showcase the hazy and helpless mindsets of citizens

¹⁵² See generally, Marc Rosenberg, *The Chinese Legal System Made Easy: A Survey of the Structure of Government, Creation of Legislation, and the Judicial System under the Constitution and Major Statutes of the People's Republic of China*, 9 U. Miami Int'l & Comp. L. Rev. (2001). The precise role of the Constitution in Chinese law is subject to debate; Michael William Dowdle, *Of Parliaments, Pragmatism, and the Dynamics of Constitutional Development: The Curious Case of China*, 35 N.Y.U. J. Int'l L. & Pol. (2002).

¹⁵³ *Id.*, See also generally, Louis Henkin, *Constitutionalism, Democracy, and Foreign Affairs* (Columbia University Press, 1990), interpreting constitutionalism as comprising the following elements: (1) government according to the constitution; (2) separation of power; (3) sovereignty of

nor is it designed to serve as reference in judging cases – it is a nonjusticiable document. Constitutionalism, in western traditional interpretations, means an institution that denies the preeminence of the legislature but recognizes liberalism and the realization of human rights and human nature. China’s Constitution,¹⁵⁴ by comparison, is relatively incapable of constraining the government’s or authorities’ power or determining cases. Another defect ascribed to China’s Constitution is its amendments lack solid legal grounding; rather, those amendments are enshrined as signifying the political supremacy of individual leaders. China’s new 1982 Constitution has been amended four times over the past thirty years. Except a few canonical amendments such as introducing the notion of a private sector economy, market economy and the conception of rule of law, amendments are frequently just juggling with terms in ways that suggest political manipulation rather than legal reform is their impetus. For example, the forceful insertion of the “Three Represents” into the 2004 Amendment did not even receive the supportive votes in the NPC Parliament that seemed a foregone conclusion. It is well noted that such unscrupulous political interference has heavily trampled on the stability and authority of China’s Constitution, which are minimum requirements of modern Constitutionalism.

Considerable doubts about legislative upgrade of the Chinese legal system exist as well. This old charge points to vagueness and obfuscation with regard to which

the people and democratic government; (4) constitutional review; (5) independent judiciary; (6) limited government subject to a bill of individual rights; (7) controlling the police; (8) civilian control of the military; and (9) no state power, or very limited and strictly circumscribed state power, to suspend the operation of some parts of, or the entire, constitution

¹⁵⁴ See Marc Rosenberg, *supra* 152 at 225-226, arguing that China’s Constitution is an aspirational document lacking any binding legal force

units of government, administrative organs or local authorities are appropriately entitled to interpret and enforce any given cluster of laws and on what basis.¹⁵⁵ Ambiguity chronically consists in implementing standards and guidelines to categorize various sources of laws, such as basic and other laws passed by the NPC, regulations promulgated by state agencies by delegation or authorization, and the enormous volume of interpretive notices and circulars enacted by non-judicial administrative organs, to speak nothing of provincial and local decrees and regulations.

Putting it simply, abstractions in legal language and inherent confusion within Chinese legal system exacerbate the concerns aroused by of the inability to define legal obligations and authoritative boundaries of administrations. Various administrative agencies have failed to architect, annotate, and execute laws and regulations promulgated by themselves, which are free of “riddle quizzing,” deliberations and external reviews, particularly at times when unqualified, obtrusive administrators intrude to churn out rules designed in part to super-ordinate their political symbol rather than serving underlying legislative initiatives.¹⁵⁶ Moreover, Chinese legislative process is filled with stochastic inputs that represent political motives and crisis interventions. It proceeds without a formulated agenda to fill in legislation gaps, nor does it have an early-warning or prefiguring process to identify fields of promulgation – many unplanned regulations and laws are made on *ad hoc* basis – that lead to delayed remedies. The Chinese legal system clearly needs an “ombudsperson,” system or

¹⁵⁵ See Alford: A Second Great Wall, *supra* 147 at 196

¹⁵⁶ *Id.*

coordination of networks that might help eradicate inadequacy or local protective regulations of decentralized legislative process.¹⁵⁷

Finally, the case or precedent record system has not been officially substantiated throughout even the top judiciary reforms. As a so-called “civil law” system bearing a former Soviet Union heritage,¹⁵⁸ Chinese courts are unpredictable in creating or referring to precedents for adjudication or dispute settlement. This attribute is no longer attributable to China’s civil law origins, but rather, the judiciary’s lack of autonomy and confidence has prevented its embrace of the precedents approach. Another censorable criticism of the Chinese judiciary is the inconsistent qualification of judges and legal staff, which are crucial in realizing the “predictabilities” of applying the “promulgated” regulations, an indispensable characteristic for the rule of law conception. Such irregularity is inevitably more evident when China’s local courts hear cases featuring international norms and foreign litigants, especially where, for example, the WTO dispute settlement mechanism adopts a jurisdictional system in which case law and precedents matter.

¹⁵⁷ See He Weifang, *Three Supremes, Who is the Most Supreme?* [Sange Zhishang Shui Zhishang?], http://blog.sina.com.cn/s/blog_488663200100atga.html (last visited on March 15, 2011)

¹⁵⁸ This understanding is strengthened by Professor Whitmore Gray from the University of Michigan Law School. Professor Gray noted that China in many aspects followed Soviet Union’s model for codification of important laws and such heritage still plays a huge part in jurisprudential research settings (discussion notes on file with the author) See also Walter Gellhorn, *China’s Quest for Legal Modernity*, 1 J. Chinese L. 1, 6 (1987), observing that China has relied heavily upon Soviet Union for content of law, and training of judges, lawyers and legal staffs; for discussions in Chinese, See generally, He Qinhua, *Reexaminations of China’s Transplantation of Soviet Union Legal System* (Guanyu Xinzhongguo Yizhi Sulian Sifa Zhidu de Fansi, 2008), <http://www.china-review.com/sao.asp?id=2836> (last visited on March 15, 2011)

4.4. Summary

The above plaudits and criticisms convincingly expose true facets of Chinese legal reform, although the academic coverage has been much broader than it is necessary for this thesis to examine. A balanced observer must admit the significant strides China has taken, by reaping and absorbing advantages of western liberal legality, in terms of its perceived capacity to buttress economic growth, engage in the international legal order, upgrade existing legislation, and reform its judiciary. On the other hand, given China's current authoritarian ruling regime, too many social, political, historical troubles have thwarted and will continue disturb China's legal reform process, making it fall short of meeting certain instrumental requirements of the "rule of law" or creating a paradoxically variant socialist rule of law system that heavily deviates from the original initiatives of legal reform.

V. Prospects and Implications for China's Socialist Rule of Law

5.1. Is There a Necessity to Locate a Rule of Law Model for China?

One inescapable attribute squeezed into debates on China's legal reform is to fantasize and mold a rule of law conception. This thought deserves further consideration. Such approach is quite common in literature authored by western jurists and theorists in the hope of creating and insinuating such a rule of law model into the Chinese legal system. This methodological setting is not without merits, but it risks ossifying a biased standard in mind in advance before making quality evaluation. Drawing from the discussion and sources above, there are a

number of categorizations of the rule of law model in general and formulations for China's legal system in specific. For example, the instrumental and substantive definitions, positivism and natural law ideals, the bifurcated thin and thick models, views of futility in application or radical proponents of overhaul reconstruction, all advocate different approaches to developing the rule of law. This thesis submits that the priority of conceptualizing a perfect model of rule of law for the whole legal system is not practical for China's current stage of development or the current state of its legal system. Rather, a few recommendations shall be made against retooling the Chinese legal system.

Democracy is still sensitive, but not untouchable, in China. Mostly, it depends on how Chinese top politicians and reformers conceive of it. In the context of contemporary Chinese political system and social orders, China does not enjoy the luxury of the historical, religious, and philosophical traditions from whence western or American models of democracy organically arose. In this sense, we need a probing discussion of the relationship between democracy and the rule of law, especially in the Chinese context. A normative conception of Chinese rule of law should therefore be confined to an independent judicial and legal system, while democracy has to be viewed from a historical and developmental perspective. On the other hand, we should note that no single contemporary western polity or society perfectly meets all criteria of their liberal rule of law conception.¹⁵⁹ The rule of law as a political and democratic theory should not be subject to exaggeration and abuse, and requires careful deliberation. After all,

¹⁵⁹ See Radin *supra* 11 at 787

empirically and conceptually, a full-scale Chinese conversion to a western style of polity and democracy may not translate into a stable political and economic order,¹⁶⁰ on which the establishment and development of rule of law is conditioned. It is difficult to substantiate that a democratic government might rather invite social turmoil and political chaos than fail to implement certain political ideals or romanticized legal conceptions, so this thesis will limit its focus on legal and judicial reform independent of democracy.

An often neglected or misunderstood feature about China's rule of law reform is that such reform has strong inner political, economic and social drives and support from top glitterati, growing middle class and broader constituencies (farmers and low-income groups). The modern post-information society, characterized by information advancement over, the internet renders many old tropes about China outdated and unwelcome to its citizens. Establishing the rule of law means real business to China. Developmental goals such as limited government, regularity of laws, transparency in procedures and administration, and perform-ability of laws, are what generations of Chinese elites pursue and fight for. Drawing from the above, this thesis proposes the following submissions, some of which are shared by domestic policy makers and foreign commentators, for upgrading the rule of law reform in China in general.

¹⁶⁰ See John Stanley Gillespie, *supra* 111, discussing the impact of rule of law reform in Vietnam; See generally, Ohnersorge, *Asian Legal System, supra* 24, noting that IFI-dominated legal reforms in Taiwan, Thailand, Indonesia, South Korea, Japan, Latin American nations have various problems such as social stability

5.2. Prospects for Chinese Legal Reform

First and foremost, securing the independence of legal system as an institution, even in a relatively self-sufficient manner, is the foundation for transformation to the rule of law. Political barriers in China are evidently against reaching the autonomy of the legal system. “Political science” and “law” conceptions (*zhengfa* 政法) have never been officially separated in governmental reform agenda. One notorious example of this lack of separation is that the “politics and law committee” (*zhengfawei* 政法委) controlled by the CCP is the highest authority in the legal and judicial system administration. Professor Stanley Lubman observes that Chinese legal system alone hardly has never enjoyed the same autonomy as its western counterparts,¹⁶¹ thus he expresses mixed pessimism towards the future of China’s rule of law reform. However, Chinese scholars find greater hope¹⁶² in their observation of the CCP’s loosened control as over legal functions like legislation, adjudication, and the procuracy while it pursues priorities of deepening economic development. This thesis shares such optimism regarding the development of autonomy and independence of an institutionalized legal system for two reasons. First, reform over the past three decades has promoted a legal

¹⁶¹ See generally, Stanley Lubman, *Introduction: The Future of Chinese Law*, 141 *China Q.* 1, 14 (1995), noting that “a number of factors clouding the future of Chinese law reform, in particular the continual intervention by political interests, growing weakness of the Chinese apparatus of state’ and declining power of the central government over the rest of the country”; quoted in Professor Donald C. Clarke, *Introduction: The Chinese Legal System Since 1995: Steady Development and Striking Continuities*, 191 *China Q.* 555, 556 (2007)

¹⁶² See Pei Minxin, *Creeping Democratization in China*, 6 *J. Democracy* 65, at 66 (1995); A prominent Chinese law scholar, Professor Ma Huaide (the Vice-President of the China University of Political Science and Law) notes that CCP has made receptive efforts in promoting legal reform even the extent is subject to debate, see Ma Huaide, *Kaohe Fazhi GDP, Tuijin Yifa Xingzheng [Revaluation of the Rule of Law GDP, Promoting Administration in Accordance with Law]* (2011), <http://theory.people.com.cn/GB/14323193.html> (last visited on March 15, 2011)

culture of seeking remedies through legal process rather than personal favor or connections, and such legal culture in turn sets political inference in the spotlight and fosters judicial independence. Second, disputes arising from foreign investment and international trade arena have lined up judicial procedural settings which are not easily subject to political manipulations. In this sense, the Chinese legal system as an independent infrastructure promises considerable reform opportunities.

Second, transparency and public accountability are the catalysts for promoting the publicity of laws, judicial decisions and administrative process. As Fuller notes, the “publicity” characteristic of the rule of law characterizes that “those who are expected to obey the rules must be able to find out what the rules are.”¹⁶³ Chinese laws and administrative regulations are at times not available to interested parties or are subject to unclear processes of interpretation. Citizens sometimes are short of access to information about legislative updates or trial hearings. For many years the Chinese government launched rounds of “law dissemination campaigns” (*pufa yundong* 普法运动) and received sound responses in the initial reform years, but most of such campaigns ended up being mere formalities. The failure of these law dissemination campaigns may have resulted from the somewhat propagandistic method of dissemination itself, but another important account is that the surfeit of laws, regulations, notices, and circulars promulgated by various authorities create confusion thus leading to a public aversion to new laws. Public accountability, on the other hand, requires public disclosure of legal information

¹⁶³ See generally, Radin *supra* 11 and Fuller *supra* 30

and procedures. Non-enforcement of bargained over contracts among individuals, private and state enterprises often traps and hurts good will market participants. Another annoying trap for foreign businesses is the government procurement process associated with confusing administrative procedures. “Black box” practice, backstage operation, affiliated trading and secret deals are popular and have plagued the legal system in China for a long time. Transparency, in this sense, as a normative requirement for transforming to the rule of law, demands public disclosure and accessibility of important legal information.

The third prerequisite goes to the independence of the judicature system and the autonomy of legal professionals in particular. Judges in China, especially those presiding in lower courts face various unjustified influences from many sources. Local courts usually are underpaid, understaffed, and undervalued. In this sense, the natural justice requirement of the rule of law values that “judges must be impartial and independent” and “trials must be fair, open, and not prejudiced by public clamor.” However, local judges at times have to yield to local interests and reach imperfect legal reasoning and decisions. Given China lacks a historical litigation culture, such surrender by local courts and judges may deteriorate what remaining trust that litigants credit to them. Lawyers, on the other hand, suffer similar hardships in performing professional roles in practice. They have to rely on judges to benefit their clients and concede to the order of bar association which is controlled by the “politics and law” committee, let alone the top authority in law firms is the CCP branch but not the partner board. As normative elements of the rule of law in addition to know-ability and perform-ability, lawyers (on behalf

their clients) must “be rational choosers”, and “be suitably motivated, perhaps by penal sanctions or opportunities for reward.”¹⁶⁴ Therefore, rationality, legal sophistication and impartiality must be established in China to conform the rule of law basics.

Finally, a brief submission about the more sensitive role of human rights in China’s rule of law development: As discussed earlier, the human rights package embraces a long, if not exhaustive, list of to-dos for structuring a socialist rule of law rhetoric. The Chinese government claims that it acknowledges and respects meaningful, universally accepted human rights and values, but caveats that cultural, economic, historical and social settings must be considered together to honor basic human rights. Probably due to both political withering and ideological rigidity, the expansion of civil rights and liberties is often said to endanger and impede China’s economic development. However, this thought fails to identify a balanced and healthy relationship among economic development, human rights, and related substantive norms of the rule of law. Human rights can be interpreted in various ways, but at a minimum level – for example, a citizen’s ability to contribute to and benefit from the economic behaviors she chooses – a citizen has the right to know into which area her taxes go and how they are distributed. Flexible and strategic interpretations of human rights can therefore be a boon to efficient administration and contract enforcement protection. Therefore, for the purpose of this thesis, a list of pragmatic and proactive taxpayers’ rights walks a middle ground on the issue of human rights, which might be both morally

¹⁶⁴ See Radin *supra* 11 at 787-88

defensible and politically viable. Criticisms of China's protections of human rights without consideration of both morality *and* the political viability of such protections may not help promote the rule of law in China; rather, they might worsen or endanger its nascent system of basic human rights.

VI. Summary

This chapter summarizes the theoretical debates on conceptions of the rule of law, the evolution of the Chinese socialist rule of law rhetoric, and progress that Chinese legal reform has made to date. One goal has been examination of the, often paradoxical, forces exerted on China's rule of law development by its historical roots, ideological interferences, economic development, and dynamic reformers in the past thirty years. True, this young system suffers infrastructural deficiency, domestic political intrusion, understaffing, and difficult demands from the outside world. On the other hand, it has already embraced many traditional rule of law characteristics, albeit in a somewhat unique socialist rearticulation, respectfully acknowledging universal basic human rights, improving room for scholastic submissions and debates, and more importantly, inviting foreign observation and attempting compliance with international norms.

This chapter has further sought to show that an institutionalized Chinese legal system does exist in both a normative and an instrumental sense, despite valid critiques, which must be respected and accommodated. Solutions and upgrades are essential to tackle technical misidentification, and implementation (*zhixing* 执

行)¹⁶⁵ and enforcement have priorities in nursing difficulties arising at all times. For policymakers and entrepreneurial leaders in the West, perhaps especially in the United States, an objective assessment of China's historical, political and social traditions is necessary for targeted, objective and meaningful promotion of China's rule of law reform.

¹⁶⁵ Professor Jacques deLisle, in his speech at the University of Michigan, specifically mentioned the difficulty in law enforcement, i.e. *zhixingnan* (执行难). For similar and detailed discussions, see generally, Cai and Wang, *supra* 122, Huang Yanzhong, *Is the Chinese State Apparatus Being Revamped?*; in *China Under Hu Jintao* (in Cheng, deLisle and Brown), *supra* 2 at 49-52, discussing the divergence between the law promulgation and enforcement

Chapter IV

WTO Accession and its Implications for the Rule of Law Reform in China

I. Introduction

A close examination of China's legal reform for the past ten years reveals that it has been heavily shaped by China's accession to the World Trade Organization (WTO).¹ Although China has implemented Deng's "Reform and Open Door" paradigm since the late 1970s, China's WTO membership has wrought equally influential dynamic changes in social, economic and regulatory areas in a much shorter time. While China's commitments in its accession agreement (the "Protocol")² primarily involve in liberalizing its trade, foreign investment, tax and dispute resolution laws, the impacts exerted by WTO go well beyond the economic and trade regimes by requiring transparency, uniformity and impartiality of its domestic governance and legal system.

¹ See generally, Nicholas R. Lardy, *Integrating China into the Global Economy* (Washington, D.C.: Brookings Institution Press, 2002) [hereinafter Lardy: *Integrating China*]

² Protocol on the Accession of the People's Republic of China, WT/L/432 (10 November 2001) (the Protocol), which incorporates by reference selected paragraphs of Report of the Working Party on the Accession of China, WT/MIN(01)/3 (10 November 2001) (WPR). The texts of the Protocol and WPR are <http://www.worldtradelaw.net/misc/ChinaAccessionProtocol.pdf> (last visited on March 15, 2011)

The Protocol is China's first treaty adopted containing explicit provisions against discrimination, and the WTO is the first international economic organization to which China has acceded to supervisory and adjudicative oversight. As evidenced by commitments enclosed in Protocol, China gave extraordinary concessions in its accession to WTO in terms of intensifying economic reform, improving administrative efficiency, training qualified agents, localizing international norms, and removing trade barriers. In this sense, WTO accession is considered a milestone for its domestic reform agenda wherein China, for the first time, openly incorporated foreign minimum requirements and international norms into its legal reform project. China accepted much higher accession standards than any other member country to date. The underlying rationale is that Chinese top leaders take advantage of external forces and international norms to further develop its economy and upgrade institutionalization of its system to keep China as a whole competitive and sustainable in fostering development. This is particularly true given China's endeavor to overhaul its legal system in preparation for and compliance with the accession. During the three years prior to formal accession, the Chinese government abolished and revised thousands of laws and regulations that were in conflict with WTO principles, meanwhile, investing tremendous resources and tireless efforts to promulgate new WTO-compliant laws and ensure local synchronization of WTO practices. More importantly, WTO principles such as transparency, consistency and trade promotion were introduced to and employed by the Chinese public in their daily lives. "Gearing to WTO norms and integration into international markets" (*yu shimao he guojia shichang jiegui* 与世

贸和国际市场接轨) was among the most popular phrases in the common vocabulary at the end of the twentieth century in China. All these social, cultural, regulatory and institutional overhauls stimulated by the general public's receptivity and WTO membership have contributed astoundingly to further development of China's economic and legal reform.

China has been a beneficiary, albeit not without some bitterness, of its accession to WTO. In the last 30 years the rate of Chinese economic growth has been miraculous, averaging 9.3% growth in GDP per annum, while the GDP growth since accession to the WTO has averaged 9.7% with GDP reaching approximately \$5.08 trillion by 2010. From 2001 to 2010, China's foreign trade increased nearly six times.³ At the same time, China's post-accession development has witnessed serious issues arising like increased disparities in rural and urban livelihoods, fluctuating trade scale,⁴ increasing domestic needs, stock market bubbles and shock, an increasingly dissatisfied migrant labor force, overexpansion of infrastructure construction, environmental degradation and shortages of natural resources. Although the Chinese government has downplayed its role gradually as both market economy regulator and participant, vigilant observation shows that it has tightened monitoring measures to ensure a steady and stable development.

³ The total value of China's imports and exports was approximately \$509.5 billion in 2001 and \$2,900 billion in 2010, respectively. For a detailed data analysis, see *infra* Chapter I

⁴ China's exportation volume was severely hacked by the SARS in 2003 and the financial crisis in 2008. See generally, Wayne M. Morrison, *China and the Global Financial Crisis: Implications for the United States*, Congressional Research Service, June 3, 2009, discussing the impact of financial crisis on Sino-US trade balances, <http://www.fas.org/sgp/crs/row/RS22984.pdf>, (last visited on March 15, 2011); Tung Chen-yuan, *SARS Impact on China's Economy*, Taipei Times, July 05, 2003, p. 8, presenting that the heaviest impact SARS had on the Chinese economy was on demand, or, to be more specific, on consumption

Chinese government realistically has prepared for the political, economic and social costs of its international obligations. It even has outlined a tentative reform agenda before putting signatories on the Protocol. The abolition of the notorious agricultural tax, the overhaul of pension and social security system, better promotion of regional equality in economic development, a nationwide educational program to familiarize talented actors with WTO rules, and pre-designed anti-monopoly and anti-money-laundering legislations, all evidence China's preparatory works and political precautions. China's institutionalized reform has a longer list of international pursuits and domestic ambitions which increased its participation in the international legal order and created new domestic legal reform targets as a result of its WTO commitments. While it is certain that full compliance with WTO norms will improve China's legal system; evasion of its WTO responsibilities, intentionally or recklessly, is not entirely unlikely given the significant extra obligations China agreed to and the experiences of other member states after their accession. In this sense, the chapter aims to brief China's WTO commitments on market access and domestic adoption of WTO rule of conduct.

China's integration into the globalized trade system arouses heightened complaints on national treatment and fair competition from both foreign and domestic enterprises. One charge against the Chinese government is that it engages in protectionism, economic nationalism and constrained profits transfer in favor of domestic state and private enterprises in order to compete with foreign capitalist rivals. On the other hand, perceptions of foreign capital invasion and hot

money manipulation have required the Chinese government to cool down indigenous anger. For the context of Chinese legal reform, certain areas of legal reform may be accelerated and concentrated, but disciplines of the international business norms should be prioritized essentially for a healthy economic setting. In a political instance, the accession to WTO helps Chinese government remove stubborn obstacles on its domestic reform agenda, while it induces other sets of unforeseen impediments to deepen a deliberate development regime.

Focusing on China's fulfillment of and uncertainty associated with WTO commitments, this chapter firstly briefs obligations conditioned in the Protocol, then summarizes their ramifications on Chinese legal system, in particular, foreign trade and investment, constitutional order⁵, domestic governance, judicature, WTO dispute practices, and more importantly, the final subchapter summarizes impacts that WTO possibly injects into the rule of law reform and related profound domestic policy orientations.

II. Overview of China's WTO Commitments

The WTO represents a self-regulatory global trading system for promoting international trade and breaking down barriers to the trade of goods and services, cross-border investments, and controversial intellectual property protection. In this sense, two major areas under WTO jurisdiction are market access and

⁵ The constitutional function of the world trading system is commonly understood. See generally Frider Roessler, *The Constitutional function of the multilateral trade order*, in *Essays on the Legal Structure, Functions & Limits of the World Trade Order* (London: Cameron May, 2000), at 109-53. See generally, *Ten Benefits of the WTO trading system*, [http:// www.wto.org](http://www.wto.org) (last visited on March 15, 2011)

international principles of conduct for member countries. Market access is subject to negotiation while WTO principles of conduct bear consistency and uniformity applicable to all member countries. By periodically reviewing trade policies, the WTO dispute settlement mechanism is essential to implementing WTO jurisdictional guidelines, such as notification requirements, and enforcement of binding rulings and trade sanctions to avoid trade wars or retaliations. China as a WTO member Country will have to comply with both the market access and WTO principles requirements.⁶

As discussed earlier, China's commitments in terms of market access are unprecedented. In certain sectors the commitments are much more extensive than those highly developed countries,⁷ and China agreed not to adopt many special treatment provisions granted to other developing countries. The depth and scope of those commitments enclosed in Protocol are tremendous for China as a developing country. In particular, the Protocol subjects all tariffs to unusually low statutory rates, and sets up an aggressive agenda for foreign access to sensitive service sectors such as telecommunication, banking, natural resources, and distribution, etc. This remarkable level of trade liberalization is further intensified by China's accession to special rule obligations – its so called “WTO-plus” and “WTO-minus” obligations.⁸ In this sense, “WTO-plus” obligations in particular

⁶ See generally, Cass, Williams and Barker, *China and the World Trading System: Entering the New Millennium*, Cambridge Press (2003)

⁷ See Aadiya Mattoo, *China's Accession to the WTO: the Service Dimension*, J. of Int'l Econ. L., Vol. 6, No. 2, (2003), at 299 and 302-04

⁸ See generally, Julia Ya Qin, *WTO-plus Obligations and Their Implementations for the WTO Legal System – An Appraisal of the China Accession Protocol*, Journal of World Trade, Vol. 37, No. 3 (2003), at 483-533 [hereinafter Qin: WTO-plus Obligations] (Professor Julia Qin from the

raise issues about the condition of China's market economy, foreign investment and domestic governance, while the "WTO-minus" provisions order discriminatory measures against Chinese exports. These "WTO-minus" obligations allow an importing member to lower WTO standards in applying trade remedies (antidumping, anti-subsidy and safeguard measures) against Chinese exported products. Although some "WTO-minus" rules are restrained with phase-out dates, all "WTO-plus" obligations are permanent.⁹

A special transition review mechanism ("TRM") was specially designed to monitor China's compliance with its extensive WTO commitments. Under this review mechanism, for the first eight years of accession, annual review of China's performance is conducted to evaluate China's policy changes and economic settings. In addition, at the end of the tenth year of accession, a final review is due to summarize China's over-all performance and compliance. No other WTO member Country has acceded to such a strict watch by the WTO and international community. Furthermore, all the market access and rule obligations are subject to compulsory jurisdiction and possibly binding sanction of the WTO dispute settlement mechanism.

To summarize, China's undertakings of WTO obligations and principles are tremendous and unprecedented. Undoubtedly, these market access and WTO principles obligations have powered China's market economy development to achieve greater compliance with international standards, yet they have done so at

Wayne State University Law School is one of the topmost contributors in reviewing the China's accession to the WTO and commitments enclosed in the Protocol)

⁹ *Id.* at 496

the cost of explicitly discriminatory terms and unequal treatments.¹⁰ This swift liberalization by way of international legal commitments has brought dynamic yet astringent changes and reform to China's legal system on the whole, and in a few areas of law in particular.

III. Impact of WTO Accession on the China's Legal System

WTO's jurisdictional outreach presents many unique challenges to the Chinese legal system. An underlying question is whether the WTO agreements are self-executing, since the Chinese Constitution does not define the legal status and applicability of international treaties, nor does it prescribe meaningful procedures as to directly adopting compulsory jurisdiction of treaty obligations.¹¹ Such a "muddled account" is not unintentional. One reason is that the accession negotiation timeline was too tight for China to calculate a comprehensive system of domestic execution of such a large number of obligations enclosed in Protocol. Another reason is that top Chinese political leaders, using external forces to transform the state economy, simply wanted to foster and impinge a consensus

¹⁰ Leftists in CCP specifically characterized the accession to the WTO as the New Eight Power Allied Force, which was one of the stigmas in the latest Chinese history; see *China Should be a Utility Infielder upon Accession to the WTO* (*Zhongguo Jiaru Shimao Ying Nenggong Shanshou*) (《中国加入世贸应能攻善守》), <http://www.gdyjzx.gov.cn/xxhw/99.files/wto05/05.htm> (last visited on March 15, 2011)

¹¹ See Bing Ling, *Is China's Accession to the WTO Legally Valid?* (2002), <http://bingling.page.tl/>. Professor Ling of the Chinese University of Hong Kong argues persuasively that the ratification procedure was defective – the validity of China's accession, in spite of any procedural defects, seems unquestionable as a matter of international law under Articles 45 and 46 of the Vienna Convention on the Law of Treaties; although the National People's Congress Standing Committee granted a before-the-fact authorization (on August 25, 2000, long before the accession protocol had taken its final form and been signed by the Chinese government's representative), not an after-the-fact ratification; Professor Donald Clarke shares the same concerns, see Donald Clarke, *China's Legal System and the WTO: Prospects for Compliance* http://docs.law.gwu.edu/facweb/dclarke/pubs/wto_china.pdf (last visited on March 15, 2011)

that all international agreements obligations must be endorsed and implemented through domestic legislation.

3.1. Market Economy

On a basic level, the “market economy” commitment requires all parties including the Chinese government, state and private sectors, and foreign investors to participate market activities equally. For instance, the prices of goods and services are result of fair competition and calculated choices. “WTO-plus” obligations to China also demand that prior state-controlled import-export business sectors must open to foreign investors within three years of accession¹², and that SOEs have to carry out its own commercial decisions without any administrative and political interference.

These “market economy” related obligations are also of constitutional importance. A milestone development in this connection is the fourth amendment to the 1982 Chinese Constitution which embraces two major symbolic additions: “the State respects and preserves human rights” and “citizen’s lawful private property is inviolable.” With strong suspicions, legal scholars and political theorists still believe that these constitutional amendments evidence an ideological inclination to deepen China’s legal reform. One example is the enactment of the Property Law in 2007 which details operational guidelines and rules for protecting various ownership forms. In this sense, the Property law stipulates the equal status of state

¹² Such overwhelming market access has a few exceptions, especially in those “prohibited industries” contained in the Catalog

and private property in terms of decision making, corporate governance and minority shareholder protection.¹³

Moreover, securing the acknowledgement of the “market economy” designation challenges and discomfits the Chinese government and state economy sector. The government has to transform from a state regulator and property owner to a market participant and an authority constrained by law. This undertaking commits the Chinese government itself into a globalized system. The liberation of trading rights and state interference of commercial activities are among top complaints from other WTO member countries. Therefore, the Chinese government has to behave in a “market economy” manner to serve China’s membership in the WTO, and as a result, to subscribe itself to a multilateral and balanced setting of uniformity and fairness.

3.2. Dispute Settlement and China’s WTO capacity building

The jurisdictional significance of binding decisions and sanction against noncompliance of WTO commitments has placed the Chinese government under an unprecedented external judicial enforcement system. The dispute settlement mechanism at the same time calls for China to develop its capacity to participate in modern legal order and litigate before international tribunals. The accession has immediately prompted governmental and scholarly interest in studying the WTO

¹³ See generally, Andrew L. Stoler, *Treatment of China as a Non-Market Economy: Implications for Anti-dumping and Countervailing Measures and Impact on Chinese Company Operations in the WTO Framework*, presented at the Shanghai WTO Affairs Consultation Center (December 2003), discussing how the market economy system may influence investment decisions, <http://www.iit.adelaide.edu.au/docs/Shanghai%20Speech.pdf> (last visited on March 15, 2011)

system and the domestic ramifications its dispute settlement mechanism. During the first few years after the accession, the international community seemed to be flexible and patient waiting for China to honor its commitments, however, due to rapidly growing trade deficits with China, partners like the U.S. and EU have more aggressively used the WTO judicial framework to influence China.

Since the US filed the first WTO case in 2004 against China regarding the exemption of VAT rebates for domestically produced semiconductor products, as of June 2010, five countries – US, EU, Canada, Guatemala and Mexico – have initiated 18 complaints against China, 11 of which were filed by joint complainants. The growing number of complaints filed against China has mostly resulted from the trade deficits western countries have with China and the beginning of China's commitments in the services sector at the end 2006. Moreover, internal politics and financial crises in 2008 intensified the pressure faced by US and EU to initiate actions against China.

China has not, by any means, been exclusively a respondent before the WTO dispute settlement board. Since China filed its first WTO complaint in 2007, China has initiated seven complaints, all of which were against the US and EU. These complaints brought to the WTO mostly concerned the designation of non-market economy treatment of anti-dumping and safeguard regulations that China resented. In addition, China, as a co-complainant, has joined other member countries in filing 67 cases as a third party. All these litigation efforts evidence that China is gradually withdrawing its passive mindset by participating

international disputes and inserting its own role with singular voice. However, China has been very diplomatic in resolving trade crises with its trading partners,¹⁴ and has taken meaningful steps in cooperation with domestic enterprises in resolving disputes before cases are brought up against China in formal procedure since the settlement process is resource intensive and time consuming.¹⁵

Overall, the dispute settlement mechanism of the WTO has helped China in honoring its commitments by privileging its trading partners with opportunities to challenge the incomplete implementation of commitments. It also arms China to safeguard its exports to sustain economic development and to avoid harmful invasion of foreign trade routines over Chinese domestic enterprises. China has implemented WTO education campaigns to promote anticipation of possible WTO related disputes on the local and regional level. Given China's growing experience as a complainant, third-party complainant and respondent in WTO disputes, it is meaningful to theorize about the more assertive roles China may play in defending its economic and political interests before the WTO.¹⁶

¹⁴ See Julia Ya Qin, *The Impact of WTO Accession on the Chinese Legal System: Trade, Investment and Beyond* 189 *The China Quarterly* (Special Issue, September 2007) (Cambridge University Press) at 739, http://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=625173 (last visited on March 15, 2011)

¹⁵ See Pasha L. Hsieh, *China's Development on International Economic Law and WTO Legal Capacity Building*, 13 *J. Int'l Econ. L.* 997, [hereinafter Hsieh, *China's WTO Capacity Building*] at 1010

¹⁶ *Id.*, at 1017, discussing that China's passive mindset has been slightly changed to take a more assertive role in defending its interests

3.3. Foreign Investment Law

WTO accession has brought tremendous expansion of FDI of all sources and contributed unprecedented increase of foreign trade surplus to China.¹⁷ Since WTO accession, China's foreign trade has increased about three times which nearly two thirds were derived from imports and exports by foreign invested enterprises (FIEs).¹⁸ China's market access commitments in service sectors, preferential treatment of foreign capital and administrative efficiency improvement all foster foreign investment flows into China. However, ten years after China's accession, there has been a trend of tightened government interference and control, beginning after the "accession honeymoon," as discussed below.

3.3.1. National Treatment

WTO accession gives China a quite different set of requirements for national treatment, some of which are "WTO-plus" obligations beyond the scope of WTO national treatment provisions. In particular, the national treatment rules in the Protocol demand that China give foreign investors market access in the services sector, the right to engage in the import-export business, and favorable conditions concerning foreign investors' operations and production. These favorable

¹⁷ See generally in Qin: Impact of WTO Accession, *supra* 14 at 735-738, from which this sentence is mostly drawn

¹⁸ See *infra* Chapter I for data analysis

conditions have powered a huge influx of foreign investment entering into various fields of the Chinese economy since accession.¹⁹

Ironically, compliance with the national treatment provisions has created an interesting battle initiated by Chinese domestic enterprises claiming their rights and market status are too disadvantaged and engulfed thus losing their reasonable share in the market. According to national treatment and most favored nation provisions, China is directed only to provide foreign interests “no less favorable” treatment than those offered to domestic interests. This requirement, however, does not substantiate Chinese public misunderstanding of national treatment that foreign interests must be taken care with preferential treatment.

The complaint from Chinese domestic interests is not surprising, especially given that China, during the twenty years prior to accession, adopted remarkably different policies towards foreign and domestic, and state-owned and private enterprises.²⁰ Foreign and state-owned enterprises are too privileged in terms of income tax rate, resource allocation, and operational assistance, and there have been public calls to remove foreign preferential policies and to create a fair competition environment for all enterprises, especially private enterprises.²¹ The promulgation of the new Enterprise Income Tax Law passed in 2007 presents an

¹⁹ See Qin *supra* 8 at 492-96, discussing the details of WTO-plus obligations that China has agreed to take. This thesis benefits from Professor Qin’s analysis on understanding of WTO’s impact on China’s legal reform, especially as to SOEs subsidies and detailed documentations of China’s WTO accession

²⁰ *Id.*, at 490

²¹ See Qin *supra* 14 at 740-741

example of such efforts at unifying different policies toward foreign and domestic enterprises.

3.3.2. Tightened Control Associated with Protectionism

WTO accession commitments on market access to a broader scope of industries, removal of trade barriers and reduction of tariffs to a low level have created other issues commonly associated with fair competition between foreign and domestic enterprises in China. Following the WTO accession, foreign investors increasingly steered their investment towards acquiring local Chinese companies. An increasing number of mergers and acquisitions conducted by foreign companies heightened China's government's and general public's concerns that its industries might be dominated, or even controlled, by foreign companies. At the same time, there has been an intensified aversion grown among China's domestic enterprises that foreign investors have benefitted from too many preferential policies for the past three decades, and that now they are cornered into very disadvantaged positions in the market. All those worries arose when many local name-brands were acquired by foreign interests, and some of those acquisitions were completed at considerably discounted prices. Domestic enterprises complain that such foreign investment inappropriately seized valuable state owned assets and transferred profits overseas without providing promised technology transfers and human capital development. These domestic interests blame the shortsightedness of government policy in allowing these foreign acquisitions.

Cautiously, Chinese government adopted a few regulations and guidelines to circumvent mergers and acquisitions by foreign investments in sensitive sectors. For this instance, MOFCOM may investigate and deny²² the foreign acquisition of domestic enterprises after national security review. Furthermore, responding to concerns on protecting domestic enterprises from “foreign capital invasion,” the Chinese government has accelerated the promulgation of China’s first Anti-Monopoly Law passed in March 2007 (together with the Unified Enterprise Income Tax Law), which induces arrears from foreign investors of being targeted as monopoly practice. Moreover, with China’s attraction on foreign investment, Chinese government has upgraded its national strategy focusing on the quality rather than quantity of foreign investment²³, and diverting more attention to high-end, technology-based, research-orientated and environmentally friendly foreign investments.²⁴

It might be over assertive to claim Chinese government’s tightened supervision on mergers and acquisitions evidence nationalism against foreign investment. There are still overwhelming needs for foreign capital in the hinterlands of China²⁵. China’s economic scale, pressure on appreciation of Chinese currency, shortage of measure to watch capital mobility, and so forth, are legitimate arrows in China’s quiver of responses to charges of nationalism or protectionism. Given the pressure on China’s government to push back against market access, WTO

²² See Guanyu Waiguo Touzizhe Binggou Jingnei Qiye de Guiding [*Provisions on Mergers and Acquisitions of Domestic Enterprise by Foreign Investors*], jointly issued by MOFCOM and five other state ministries, effective as of September 6, 2006

²³ See Liyong Waizi “Shiyiwu” Guihua [*The 11th Five-Year Plan for Utilizing Foreign Investment*], issued by the National Development and Reform Commission of the P.R.C, November 2006

²⁴ *Id.*

²⁵ As evidenced by Chong Qing Liangjiang and Tian Jin TEDA SEZs

commitments of market access to various industries remain an important source of monitoring, and incentive to China's compliance and reform progress.

3.3.3. Eliminating Performance Requirements

China has adopted unprecedented commitments on eliminating performance requirements. Under the Agreement on Trade Related Investment Measures (TRIMs), China must eliminate certain performance requirements or supervisory measures against foreign investments. Those performance requirements usually include foreign exchange controls, export performance controls, and import substitution, all of which restrict free trade and limit capital mobility. Further, China agreed in the Protocol not to condition foreign investment on "performance requirements of any kind," including "the transfer of technology" and "the conduct of research and development in China," going significantly over and above the TRIMs requirements.²⁶

To honor these remarkable commitments, the Chinese government has abolished, revised and promulgated various foreign investment related laws and regulations.²⁷ One vivid example is that previous compulsory requirement on technology transfer is removed from approval of foreign investment planning and operation except with regard to certain prohibited and restricted technologies prescribed. However, the Chinese government maintains a cautious strategy by gradually eliminating certain performance requirements for specific industries. For example, all tax benefits and other incentives offered to foreign enterprises

²⁶ See Qin *supra* 14 at 732-33

²⁷ See Potter, *supra* 1 at 597-598

were upheld until 2010, and in 2007 the Environmental Protection Administration required foreign investments in chemical products and petroleum drilling to be environmentally friendly and supported by sound research and development controls.

3.3.4. Entry Restriction

It is worth emphasizing that China made extensive market access commitments in services. According to the national treatment principle and the General Agreement on Trade in Services (GATS), once a member country pledges commitments in a particular service sector, it will have to guarantee national treatment to all foreign investments, subject only to negotiated service schedules based on GATS. After WTO accession, the Chinese government has substantially revised the Industry Guidance Catalogue for Foreign Investment (the Catalogue), which outlines specific requirements and the scope of industries in which foreign enterprises may invest. According to the latest 2007 Catalogue effective as of December 1, 2007, the number of encouraged industries increases to 351 from 257 in the 2004 Catalogue, aiming to control resources exploitation, lower energy consumption and upgrade industries and monitor real estate investment. For the other three industry categories, i.e. permitted, restricted and prohibited categories, the adjustments were designed to convert more permitted category industries to encouraged category industries, and ease the barrier between restricted and permitted categories. For example, in September 2010, Chinese government solicited revision proposals from foreign investors to further its endeavors to open

as many industries as possible while balancing its hinterland development policies.²⁸

As per the Protocol, China has agreed to open nine out of twelve service sectors according to GATS provisions. The market access commitments cover crucial areas such as distribution, construction, transportation, banking and telecommunications. One important aspect of China's implementation of its commitments is the opening of the banking service sector – foreign banks can now operate fully in Chinese territory without any geographical, client base and ownership strings. This is remarkable given the tight controls imposed on the banking sector by Chinese government since 1979.²⁹ However, the future of this bold policy is unclear especially when all four major state-owned commercial banks have completed their public offerings in overseas stock markets.

3.4. Trade Law Regime

China's foreign trade law regime has been overhauled and liberalized after WTO accession. Important legislation concerning foreign trade such as the Foreign Trade Law (2004), the Custom Law (2001), trade remedy regulations,³⁰ intellectual property protection, administrative procedures and rules, has been reviewed, evaluated and revised to make the foreign trade sector WTO-

²⁸ See generally, Waishang Touzi Chanye Zhidao Mulu [*Industry Guidance Catalogue for Foreign Investment (2007)*] 《外商投资产业指导目录(2007年修订)》, released by MOFCOM effective as of October 31, 2007, http://www.hb.xinhuanet.com/zhuanti/2008-04/10/content_12931826.htm (last visited on March 15, 2011)

²⁹ See generally, Peng Yuanyuan, *The Challenges of WTO Entry to China's Banking Industry*, <http://faculty.washington.edu/karyiu/confer/beijing06/papers/peng.pdf> (last visited on March 15, 2011)

³⁰ See Qin *supra* 14 at 727

compliant.³¹ In addition, the Chinese government has liberalized control over importation by substantially reducing tariffs and non-tariff barriers and opening broader service sectors. As discussed above, although protectionism may arise in the course of trade regime liberalization, China's foreign trade regime, as a system, is institutionally capable of ensuring compliance with accession commitments and WTO principles.

China has been rigorously compliant with its commitments to lower its tariffs to statutory binding rates and remove non-tariff barriers such as quotas and licenses to attainably minimum level. State trading especially state procurement through commercial means should be transparent and the scope of state trading is subject to review by MOFCOM. Notification requirements by WTO also demands timely updates of any adjustments or changes made to the list of state trading in the Protocol.

China has been aggressive in responding to charges on trade remedies initiated by other member countries.³² For example, China has implemented revised anti-dumping and anti-subsidy measures and a new safeguard regulation, promulgated in 2001, all of which follow the WTO standards but lack certain operational details. The key reason is that the U.S., EU, and certain other countries designate China as a non-market economy, and such designation allows those countries to abuse anti-dumping measures against Chinese producers or imported products

³¹ See generally, TPR Report, Appendix, Table A.II.2. For updates and changes of China's trade regulations, visit MOFCOM official website <http://www.mofcom.gov.cn>. (last visited on March 15, 2011)

³² See Hsieh *supra* 15 at 1030-31 and Table A1, summarizing that China became the third largest antidumping user after India and the United States according to the WTO Anti-dumping Statistics

from China. It is likely true that some anti-dumping measures imposed on China were purely a product of internal political interests rather than in the spirit of promoting free trade. Moreover, the Protocol stipulates that designation of China as a non-market economy may persist until December 2016 for anti-dumping purposes, and permanently for anti-subsidy purposes. The Protocol further permits an importing member Country to categorize China separately for safeguard measures. All these discriminatory measures have aroused China's export practices especially after China has realized lowering tariffs and removal of non-tariff barriers.

Another branch of laws affected by WTO accession is foreign trade laws and regulations. For example, China, in 2004, replaced a ten-year old foreign trade law with a WTO compliant one. The new Foreign Trade Law switches the pre-WTO approval system to a registration system removing tedious procedures for most forms of foreign investment by agreeing to issue registration within five days if stipulated procedures are followed. As to technical standards applicable to specific areas of economic sectors, such as those in healthcare, chemical and technology fields, China has revised most relevant laws to assure a legitimate objective and impartial and non-discriminatory implementation. However, since many industries fall into restrict or prohibited categories of the Catalogue, China has gradually taken more cautious procedures and tightened import and export controls in safeguarding technical interests of domestic enterprises. One example is that in 2007, China promulgated new rules regarding importation of certain

metalwork scrape such as copper and lead, for which traders from the US and EU submitted their complaints to local import authorities and customs.³³

Last but not least, the foreign trade regime gives great attention to the protection of intellectual property according to requirements of Trade-Related Aspects of Intellectual Property Rights (TRIPS). Inadequate protections for intellectual property has been a complaint in China for many years due to the rampant violation of IP rights and China's weak enforcement against infringers. TRIPS designs a wide-ranging set of detailed regulations for its member countries to take action, including a comprehensive list of minimum requirements for civil, criminal and administrative procedures and undertaking to be inserted into the domestic legal system. Without a doubt, China has made great efforts and achieved quite remarkable circumvention against IP rights violations. However, China's IP rights protection remains one of the most troubling factors for foreign investors in carrying out commercial activities and in refraining Chinese domestic competitors from reverse engineering or "fortifying" (*shanzhai* 山寨) their innovations and products.

The Chinese government, in this regard, has made amendments to almost all laws and regulations concerning IP, including but not limited to, crimes of IP violation in the Criminal Code (1997), the Trademark Law (2001), the Copyright Law (2001), computer software protection measures (2001), lay-out designs of

³³ See generally Qin *supra* 14, providing a summary of major foreign trade related laws and regulations since China's WTO accession

integrated circuits protection regulations (2001), and the Patent Law (2000).³⁴ Overall, China has been fundamentally WTO-compliant in IP rights protection although its efforts are still a cause for grumbles by trade partners who find them incomplete and ineffective. The US's opinion to this extent resulted in an official complaint filed with the WTO in April 2007.³⁵

3.5. WTO's Normative Impacts

WTO accession not only brings specific legislative revisions in an "instrumental" sense in almost all major areas of economic arena, but it also sets out significant normative challenges to the Chinese legislative and institutional systems. China has gradually accepted the basic values and obligations of WTO membership, such as *transparency, uniformity and impartiality* and *judicial review* and incorporated them into the legal system, in which the tax law reform is embedded. There has been remarkable progress made in terms of introducing WTO related commitments to academic debates and public awareness. WTO principles have stepped into the daily lives of Chinese people in commercial and political settings. Chinese scholars have also given support to WTO principles of promoting and enforcing constitutionally significant ideas such as property rights, as the

³⁴ See generally, Omario Kanji, *Paper Dragon: Inadequate Protection of Intellectual Property Rights in China*, 27 Mich. J. Int'l L. 1261, 1270 (2006); Aaron Schwabach, *Intellectual Property Piracy: Perception and Reality in China, the United States, and Elsewhere*, 2 J. Int'l Media & Ent. L. 65 (2008); Joseph A. Massey, *The Emperor is Far Away: China's Enforcement of Intellectual Property Rights Protection 1986-2006*, 7 Chi. J. Int'l L. 231, 235 (2006); Donald Harris, *The Honeymoon is Over: The US-China WTO Intellectual Property Complaint*, 32 Fordham Int'l L.J. 96

³⁵ See generally, *WTO: China-Measures Affecting the Protection and Enforcement of Intellectual Property Rights*, DS 362 (April 16, 2007), charging that China's criminal law does not provide appropriate criminal punishments for IP violations, and the denial of copyright protection under the censorship review is not compliant with TRIPS

foundations of a market economy.³⁶ Such discussion was largely inconceivable before accession. The normative implications of WTO accession for the Chinese legal system are thus political, philosophical and institutional.

3.5.1. Transparency

The transparency commitment in China's Protocol is a quite comprehensive rule of law requirement. The concept of transparency is central to the WTO agreements as well as to the construction of the rule of law. According to GATT Article X, GATS Article III³⁷ and TRIPS Article 63, laws, regulations, judicial decisions and administrative decisions in connection with trade of a member country should be made public before their implementation and enforcement, and any change in such laws should be notified to the WTO. In the Protocol, China has agreed to undertake extra transparency obligations that are stricter than regular transparency requirements. Admittedly, public disclosure and the availability of legal decisions promote the rationality as well as the legitimacy of the rule of law.³⁸ It is also important in order for citizens and foreign investors to

³⁶ See generally, Frieder Roessler, *Diverging Domestic Policies and Multilateral Trade Integration*, in *Fair Trade and Harmonization: Prerequisites for Free Trade?* Vol. 2: *Legal Analysis* 22-27 (Jagdish Bhagwati & Robert E. Hudec eds., 1996), Roessler is an ex-GATT Legal Advisor (United States--Measures on Alcoholic and Malt Beverages and United States--Taxes on Automobiles cases)

³⁷ *Id.* Roessler wrote that the central issue considered by dispute settlement panels in determining whether two products are "like products" for purposes of Article III "is whether the product categories under which they fall have been distinguished with the intent and effect of affording protection." see also, Frieder Roessler, *Should Principles of Competition Policy be Incorporated into WTO Law Through Non-Violation Complaints?*, 2 J. Int'l Econ. L. 413, 421 (1999).

³⁸ See Lon Fuller, *The Morality of Law* 33-94 (rev.ed.1969) at 49-51 and 79-81, discussing the need for "promulgation" and "constancy of law through time"

be informed of the “rules of the game” and to enable investors to get reliable advice.³⁹

Although the definition and scope of “transparency” is subject to debate, the Protocol provides clear and operational guidelines on the “transparency” requirement for China⁴⁰:

- 1) China shall make public all relevant laws, regulations and other measures before they are implemented or enforced; China will only enforce those laws that are published and made readily available to other WTO members, individuals and enterprises;
- 2) China shall establish or designate an official journal dedicated to the publication of all relevant laws which should be made readily available to the public;
- 3) After publication of laws in such a journal, China shall provide a reasonable period for comments to be made to the appropriate authorities before such measures are implemented;
- 4) China shall establish or designate an entry point where the published laws can be obtained and requests from the public can be replied to in an authoritative way.

³⁹ See generally, James Zimmerman, *China Law Deskbook: A Legal Guide for Foreign-Invested Enterprises* (2004); see also Donald Clarke, *Power and Politics in the Chinese Court System: The Enforcement of Civil Judgment*, 10 Colum. J. Asia L. 1 (1996) at 82, discussing various factors that drive judicial decisions without robust basis of statute, regulation, or even policy.

⁴⁰ See Protocol, *supra* 2 Part I. para. 2. (c) on details of transparency requirements

Features of “transparency” include fair notice and hearing provisions, public promulgation of legislation, and the availability of the legal information necessary to meet reasonable expectations for a person to find out what the law is and to behave in accordance with it.⁴¹ Foreign investors continually complain of the unfairness of being plagued by inaccessible internal or unpublished regulations (*neibu guizhang* 内部规章), which discourage investment and trouble business operations. Moreover, many ministerial rulings and regulations, internal or public, are hard to track and record when issued given their *ad hoc* nature. Following China’s commitment to transparency, most trade-related legislation is classified and edited by a central publishing authority, i.e., the MOFCOM. However, some local regulations are still hard for investors and courts to locate and rely upon, in spite of the fact that the issuing authorities give those regulations binding force. In addition to certain encouraging progress on transparency made since accession, such as the publication of “Gazette of the MOFTEC of the PRC,” annual publication of collections of new law, and electronic databases of administrative laws and regulations available to the public, the Chinese government has promulgated a series of laws and regulations to facilitate implementation of the transparency requirement, such as the Legislation Law’s (2000) requirement of appropriate forms of public hearing and comments collection, and the Law on Administrative Permission’s (2003) prohibition of using unpublished documents as a basis for denying or granting administrative licenses.

⁴¹ See Fuller, *supra* 38 at 63-65 and 81-91, discussing the clarity of laws and congruence between official action and declared rules

In summary, China's implementation of the transparency requirement is remarkable but incomplete given the large number of laws and regulations promulgated every year and complex details of local procedural filing. Transparency concerns still trouble foreign investors in making commercial and operational decisions. However, observers should have an optimistic perspective regarding the prospect of further improvements to transparency in legislation, administration and procedural compliance.

3.5.2. Uniform and Impartial Administration of Laws

China agreed in the Protocol to apply and administer all WTO-related laws, regulations, and other measures in a "uniform, impartial and reasonable manner."⁴² Actually, the major legal challenges confronting China's WTO accession lie in its application and enforcement of the law (执行力度),⁴³ which presumes the existence of enforcement institutions with clear lines of authority and the capacity to render neutral decisions according to the law.⁴⁴ The Protocol seeks to apply WTO agreements to the entire territory of the PRC, including all the areas in the complex political map such as border trade regions, minority autonomous areas and various special economic and development zones, among others. The Protocol further demands the administration "in a uniform, impartial and reasonable manner" at both central and sub-national levels with a reporting

⁴² See Protocol, *supra* 2, Part I, para. 2. (a);

⁴³ *Id.*, Part I, para.2(a)-2

⁴⁴ *Id.*

system where noncompliance of this requirement in trade regime is brought to attention.⁴⁵

In reality, compliance with the uniform administration commitment mostly depends on the political determination of central and local governments to implement it. Therefore, it is premature to evaluate and examine to which extent the uniform administration is carried out on the local level, in that China today is plagued by distorted local protectionism and the failures of its decentralization strategy. The Chinese central government should stress the importance of uniform administration to local governments, since WTO agreements permit a petitioner country to submit complaints on breaches of uniformity and impartiality requirements at a local level.

3.6. Judicial Review⁴⁶

An independent, effective and true judicial authority is essential to compliance with China's WTO commitments. The Protocol mandates the establishment of tribunal, contact points and procedures for the prompt review of all administrative actions relating to the implementation of the laws, regulations, judicial decisions, and administrative rulings of general application referred to in the WTO rules. Meanwhile, the tribunals must be independent of administrative organs and thus are required to be "impartial and independent of the agency entrusted with administrative enforcement and shall not have any substantial interest in the

⁴⁵ *Id.*

⁴⁶ *See* Article X, 3(b) of GATT, stipulating that member countries should establish a judicial review infrastructure

outcome of the matter.”⁴⁷ The tribunals may be administrative or judicial, however, right to appeal must be granted if the case is originally submitted for an administrative review following due process.

Effective judicial review is comprised of four essential pillars: a capable court system, a group of judges with reliability and proficiency, judicial review empowered by law, and full judicial independence⁴⁸. Although China’s judicial system has been subjected to significant criticism with regard to its independence and competency, positive trends suggest that the situation is gradually improving. In addition to the Legislation Law (2000), and the Law on Administrative Permissions (2003), the Supreme People’s Court of China issued three judicial interpretations to detail the scope and standards for judicial review of WTO-related cases, for example, the SPC authorizes courts at the intermediate or higher level to take the initial review of international cases to ensure impartial and uniform judgment and avoid unexpected external influence on judgments.

Overall, it is not realistic to expect China to set up a judicial review system similar to the western or American routines, however, the judicial review requirements under WTO agreements give a strong push to modernize China’s judicial system to ensure impartiality and uniformity in administration, and to foster judicial independence and the quality of its judges. It also subjects the government to a limited scope of judicial review if possible to avoid administrative discretion. Therefore, it is reasonable to expect the judicial-review-

⁴⁷ See Protocol, *supra* 2 Part I, para. 2(d)

⁴⁸ *Id.*

related reforms will be embraced, especially in areas such as tax law, as a means to perfect the functioning of the legal system.

IV. The Impact of WTO Accession on Rule of Law Development in China

WTO accession has brought comprehensive changes to the political, economic, legal and international settings for the ongoing development of the rule of law in China. As summarized above in this chapter, WTO accession politically is viewed as a forceful external incentive to implement and promote domestic institutional reform and shut down opposition to reform. Substantive characteristics of rule of law, such as transparency, uniformity, impartiality, judicial review and procedural justice, which once were hard to implement due to ideological barriers, have been forcibly incorporated into Chinese legal reform through the adoption and strict implementation of similar WTO principles. Moreover, China has made remarkable progress in institutional reforms to comply with its WTO commitments – it has abolished, revised and promulgated almost 3,000 national and local laws and regulations. Normatively, WTO accession has promoted the rule of law awareness and fostered education on WTO principles and rules. Any conscious commentator would acknowledge the influential impacts on the rule of law development in China encouraged by the WTO and its dispute settlement mechanism.

Moreover, WTO accession has strengthened China's efforts in promoting judicial independence, even over and above its Protocol commitments, advancing judicial review of administrative discretion on both national and local levels. Promising

signs such as using case as precedent and rigorous pursuit to safeguard national interests through the WTO dispute settlement mechanism also boost China's favorable implementation of national treatment and most favored national principles. Another significant lesson learnt from China's role and participation in WTO capacity building is China's gradual adoption of traditional rule of law requirements such as due process, predictability, and the supremacy of law in governance.

The impacts of WTO accession on the rule of law development in China, however debated, have been profound. The force of WTO principles and rules is sharp and straightforward in conforming China to both instrumental and substantive conceptions of the rule of law: legal institutions, transparency, uniformity, impartiality, judicial independence, limited government, and a culture seasoned with "common law" routines of case precedent and judicial review. Although such impacts should not be exaggerated or over-romanticized, it is meaningful to incorporate these positive implications into studies of specific sectors of Chinese legal reform. This thesis will do so in developing a practical and suggestive rule of law – tax law reform rhetoric particularly for China's post-accession legal reform.

Chapter V

WTO and China's Tax Law Reform – Tax Legislation Reform

I. Introduction

As one of the newest members of the WTO, China is unique in a number of aspects as the largest developing economy and communist regime. The accession to the WTO marks China's commitment to further opening up to the globalized regime and its priority of embracing a market economy as a more dynamic economic growth engine. This aspiration was evident in the global financial crisis of 2008. The trajectory of China's economic development in the past three decades has shown its WTO accession as to be profound influencing its rule of law development and judicial reform with remarkable progresses.¹

Literature regarding the implications of WTO accession for China's economic and legal reform is voluminous,² but opinions vary widely across the

¹ See generally, *MOFTEC China International Trade White Paper*, released on August 31, 2000

² See Cass, Williams and Barker, *China and the World Trading System: Entering the New Millennium*, Cambridge Press (2003); Aadiya Mattoo, *China's Accession to the WTO: the Service Dimension*, J. of Int'l Econ. L., Vol. 6, No. 2, (2003), at 299-339 and 302-04; Julia Ya Qin, *WTO-plus Obligations and Their Implementations for the WTO Legal System – An Appraisal of the China Accession Protocol*, Journal of World Trade, Vol. 37, No. 3 (2003), at 483-533; *China Under Hu Jintao, Opportunities, Dangers and Dilemma*, 97-134 (Cheng,

literature. Some discussions fantasize that the WTO's influence will result in a complete overhaul of the Chinese legal system to conform to a rule of law construct or western ideals of multi-party democracy. Some are more instrumentally oriented, focusing on changes of finely textured details in specific areas of law such as transplanting banking regulations or environmental protection measures. The same mixed discourse applies to China's tax laws. Moreover, the traditional distinction between trade law and tax law is vague under multilateral trading agreements such as the WTO or NAFTA. Meanwhile, China's tax legislation is administrative in nature – the line between tax administration or tax legislation is somewhat blurred in China. This chapter submits that the Chinese tax law reform embodies the WTO principles in a visible but constrained manner, however the normative value of those WTO is applicable to China's tax reforms as well – it richly applies to China's tax legislation, which is embedded in its tax administration. Two points should be made about the Chinese tax legislation framework. First, starting from the pre-WTO massive regulatory clean-up, tax legislation reform was focused in trade related areas, such as lowering tariffs or non-tariff barriers, turnover tax reformulation, income tax compliance updates, and transplantation of international tax practices. Without doubt, this aspect of tax legislation is popular for scholars concentrating on WTO or trade related areas. Although certain tax legislation updates have proven not to be ideal and have been subject to frequent change, tax laws generally remain stable and enforceable. Second, modern tax policies should be adopted in a more vibrant

deLisle and Brown, ed., World Scientific, 2006); Cai Dingjian & Wang Chenguang, *China's Journal Toward the Rule of Law* (Koninklijk Brill NV, Leiden, The Netherlands, and Social Sciences Academic Pres, Beijing, 2010) [hereinafter "Cai and Wang"] at 439-495

way. For example, advanced pricing agreements for curbing tax evasion should be employed or actual enterprise tax payment should be lowered. It is without merit or political substantiation to take cautious steps in transplanting modern tax conceptions. However, experimental trials in appropriate localities or industry lines are a more reasonable means of honing these transplants. Given China's marvelous expansion in revenue collection over the past three decades, the time is ripe to introduce reform measures on certain types of taxes.³ Another dissonance in tax legislation is the irregular orientation of tax administrative documents. Some scholars argue that tax administrative rulings, notices or directives are true "legislation,"⁴ however, the administrative nature of China's tax system and centralization efforts somewhat validate the enforcement of tax legislation given China's nascent tax judicature system.

This chapter discusses the tax legislation sector, which is intertwined with tax administration. Subchapter II reviews the impacts of the accession to WTO on the tax system in general, its principles and the dispute settlement procedures associated with tax law areas. Subchapter III discusses the tax legislation updates since China's accession to the WTO, including enterprise income tax, individual income tax and turnover tax. Subchapter IV summarizes tax legislation from the perspectives of administration and compliance.

China's dual status as the largest developing country with an inheritance of centralized economy and communist sovereign underlies commentators' worries about China's market economy orientation. This dualism partially explains China's acceptance of supervisory and adjudicative oversight from

³ See Warrick Smith, *World Development Report 2005: A Better Investment Climate for Everyone*, World Bank at 95-171, discussing potential new tax legislations in China

⁴ See generally, Perry Keller, *Sources of Order in Chinese Law*, Am. J. of Comp. L. 42:4, 711-759 (1994)

the WTO by acceding to WTO-plus obligations. Taking WTO's demands into account, in many aspects, the tax laws system manifests extraordinary concessions in terms of intensifying legislative updates, improving administrative efficiency, reforming compliance practice, localizing international norms, and removing trade barriers.

II. Overview of WTO Principles Affecting the Tax Laws System

The WTO institutionalizes a unified structure for international trade, and the significance thereof is renowned and profound.⁵ The WTO agreements is an umbrella agreement with four annexes and a series of agreements⁶ including the GATT and the General Agreement on Trade in Services (GATS),⁷ and covenants which contain the substantive obligations of member countries. Two important principles are dominant in the WTO agreements: the non-discrimination principle and the principle against trading subsidies, in particular, the following rules are usually considered as primarily affecting the domestic tax policies of WTO member countries.

⁵ See John Jackson, Preface, in Cass *supra* 2, at 16-18

⁶ For an introduction and overview of the WTO framework and international trade regime, see generally, Michael Trebilcock, Robert Howse, and Antonia Eliason, *The Regulation of International Trade*, (Routledge; 2nd Ed., 1999)

⁷ See GATT, Article I, para. 1, the Most-Favored-Nation Treatment reads as "with respect to customs duties and charges of any kind imposed on or in connection with importation or exportation or imposed on the international transfer of payments for imports or exports, and with respect to the method of levying such duties and charges, and with respect to all rules and formalities in connection with importation and exportation, and with respect to all matters referred to in paragraphs 2 and 4 of Article III, any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties"
http://www.wto.org/english/docs_e/legal_e/gatt47_01_e.htm (last visited on March 15, 2011)

- The General Agreement on Tariffs and Trade 1994 (Annex 1A) incorporated the rules of the GATT 1947. Mostly, these rules cover customs duties and procedures, and, to a narrower extent, to indirect taxes. The objective of the GATT is to liberalize trade within WTO member countries by non-discrimination principle and the reduction of barriers.
- The Agreement on Subsidies and Countervailing Measures (SCM Agreement) is one of the 12 agreements that further detail or clarify the GATT 1994. In particular, the SCM Agreement elaborates the obligations of member countries associated with subsidies and designs a comprehensive code regarding the application of countervailing duties.
- The Understanding on Rules and Procedures Governing the Settlement of Disputes, which is also known as the “Dispute Settlement Understanding” (DSU), sets forth the procedural requirements for dispute resolution under the WTO and establishes the Dispute Settlement Body to administer the procedures.

2.1. The non-discrimination Principle

The non-discrimination principle consists of two specific rules: the most-favored-national (MFN) and national treatment principles. Under the MFN principle, in particular, products and services provided by member countries must be treated alike.⁸ Under the national treatment principle, once import

⁸ *Id.*, GATT, Article III, National Treatment on Internal Taxation and Regulation

duties have been paid, imported goods and services must be treated no less favorably than domestic products and services.⁹

The national treatment principle demands that member countries not impose internal taxes or adopt other measures to protect domestic production.¹⁰ Obviously, this principle principally affects indirect taxes including excise taxes, VAT, and sales taxes imposed on imported goods. These types of taxes may not exceed those imposed on similar domestic products or be applied in a protective manner to domestic production.

2.2.Principle against Export Subsidies

Subsidies have been debated for a long time as a trade issue where they enable domestic producers to compete unfairly in international (foreign) markets. For example, export subsidies have been distorted in many ways especially for agricultural products. Article XVI of the GATT 1994 forbids export subsidies other than those for primary products and provides for consultations if such subsidies are applied by seriously damaging the interests of other member countries.¹¹

The SCM Agreement, on the other hand, stipulates explicit rules and guidelines on subsidies. The SCM Article 1 defines “subsidy” as a “financial contribution by a government or any public body within the territory of a member...whereby... government revenue that is otherwise due is foregone or

⁹ *Id.*, GATT, Arts. II.1 and III.2

¹⁰ *Id.*, GATT Article XVI, Subsidies

¹¹ *See* SCM Article 1, Definition of A Subsidy

not collected... and a benefit is thereby conferred.”¹² Therefore, tax reductions, exemptions and refunds are clearly “subsidies” according to the SCM Agreement.¹³ Furthermore, the SCM Agreement classifies subsidies as prohibited subsidies, actionable subsidies, and non-actionable subsidies. Specifically:

- Article 3.1 of the SCM Agreement provides that, with the exception of agricultural products, prohibited subsidies are “(a) subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance; (b) subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods.” A prohibited subsidy must be specific. Article 2 of the SCM Agreement defines that a subsidy is specific to an enterprise or a group of enterprises or industries if access to it is limited to certain enterprises or to certain enterprises within a designated geographical region;
- Actionable subsidies are those that cause injury to the domestic industry of another member country, nullify or impair the benefits of the GATT 1994, or cause serious prejudice to the interests of another member country; and
- Subsidies are non-actionable if they are given for certain purposes that are recognized as legitimate, such as regional aid, environmental protection, or (within certain limits) the promotion of research and development.¹⁴

¹² See Illustrative (e), SCM Annex I, Illustrative List of Export Subsidies “The full or partial exemption remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises”

¹³ See generally, Yariv Brauner, *USA Report*, in *The WTO and Direct Taxation* (Michael Lang, ed.), Kluwer Law International (2005)

¹⁴ *Id.*

Obviously, the meaning of “Contingent” is subject to meticulous interpretation. The Appellate Body expatiated on this word in the recent US FSC case, explaining it to mean “conditional” or “dependent for its existence on something else”:

In other words, the grant to the subsidy must be conditional or dependent upon export performance. Footnote 4 of the SCM Agreement, attached to Article 3.1(a), describes the relationship of contingency by stating that the grant of a subsidy must be “tied to” export performance. Article 3.1(a) further provides that such export contingency may be the “sole” condition governing the grant of a prohibited subsidy or it may be “one of several other conditions”.

The contingency upon export performance may be in law or in fact. The Appellate Body interpreted “contingency in law” in Para. 112 as follows:

A subsidy is contingent “in law” upon export performance when the existence of that condition can be demonstrated on the basis of the very words of the relevant legislation, regulation or other legal instrument constituting the measure... For a subsidy to be *de jure* export contingent, the underlying legal instrument does not always have to provide *expressis verbis* that the subsidy is available only upon fulfillment of the condition of export performance. Such conditionality can also be derived by necessary implication from the words actually used in the measure.¹⁵

¹⁵ *Id.*, summarizing that the most important segment of trio was ruled upon by the AB in February 2000 that the FSC (foreign subsidiary of U.S. corporations) regime constituted a prohibited subsidy under Art.3(1)(a) of the SCM Agreement. The FSC regime, enacted in 1984, replaced the Domestic International Sales Corporation (DISC) regime which provided indefinite deferral to a portion of such corporations’ export earnings. The DISC provisions were immediately attacked by the European Commission, and in 1976 ruled as contradictory

Furthermore, the SCM Agreement incorporates a specific “illustrative list” of measures into the definition of prohibited subsidies, including some tax related measures: “the full or partial exemption, remission, or deferral specifically related to exports, of direct taxes...”¹⁶ This item is explained in footnote 59, which provides that: (1) if appropriate interest is collected on deferred revenue, the deferral does not constitute an exports subsidy; (2) the arms’ length standard applies to this analysis, and it implies that deviation from this standard may indicate a subsidy; (3) measures to avoid double-taxation of foreign sourced income are exempted from scrutiny as a subsidy.

According to footnote 4 of the SCM Agreement, the standard for determining whether subsidies are in fact contingent upon export performance is met when the facts demonstrate that the granting of a subsidy, without being made legally contingent upon export performance, is in fact tied to actual or

to the U.S. obligations under Article XVI (4) of the GATT 1947. At the same time, the U.S. challenged some of the European territorial income tax system. The panel disapproved of these too, but in 1981 the GATT council cleared these in a decision that served as a *de facto* roadmap for the FSC legislation as part of the U.S. Tax Reform Act of 1984. The FSC regime followed the same purposes of the DISC regime, attempting to adjust it to the council decision’s language that permitted non-taxation of extraterritorial income. However, it still exempted a portion of export related corporation’s foreign source income from U.S. tax that would have otherwise applied in contrast to the normal U.S. policy of worldwide income taxation. In November 1997, European Commission initiated the challenge against this second regime, followed by an official request filed on July 1, 1998 to the dispute settlement panel, based on violations under Arts., 1.1, 3.1(a) and the SCM illustrative list. The Panel issued a final report against the U.S. in October 8, 1999, finding that the FSC constituted an export subsidy inconsistent with the SCM Agreement. The U.S. appeal was rejected on February 24, 2000. In response, the U.S. designed a third regime – the ETI regime, which as designed to be in compliance with decision, but achieve similar consequences to the FSC regime. It purported to incorporate to the U.S. worldwide income system, territorial aspects, which had been ruled compliant with the GATT. The EU promptly responded, arguing that ETI did not comply with FSC ruling and panel was established and reported against the U.S. on August 20, 2001. The U.S. appealed and was rejected on all grounds by the Appellate Body on January, 14, 2002. The U.S. conceded then this battle, but Congress has not yet succeeded in repealing the ETI regime, which prompted EU retaliation as of March 1, 2004. Probably the most important aspect of this final ruling is its firm support of the logic that each country has a baseline normative tax system that could be established as a benchmark for an inquiry into a specific measure that is suspected as tax subsidy, and a deviation from such benchmark would indicate, technically, that a tax would be “otherwise due.”

¹⁶ See SCM Annex I, Illustrative List of Export Subsidies

anticipated exportation or export earnings.¹⁷ In this regard, a number of China's tax incentives may constitute discriminatory measures or prohibited export subsidies. There is little doubt, such tax incentives are subject to discretionary review under the WTO agreements or may be challenged by other member countries, which will lead to actions before the dispute resolution body.

2.3.The dispute settlement process under the WTO

While the GATT 1994 and other multilateral trade agreements are important for their substantive provisions on international trade, the agreements ultimately rely on the dispute settlement process to regulate compliance.¹⁸

Member countries are entitled to safeguard their interests by following the dispute settling mechanism to ensure compliance with WTO agreements.

According to the DSU, only the legitimate government of member countries has standings under the procedure, and no individuals or organizations are able to file related requests even when their interests are affected by the resolution of the dispute. The DSU disallows member countries from unilaterally

¹⁷ See SCM Art. 15, Determination of Injury; for export performance related details, see SCM Art. 15.5, stipulating that it must be demonstrated that the subsidized imports are, through the effects of subsidies, causing injury within the meaning of this Agreement. The demonstration of a causal relationship between the subsidized imports and the injury to the domestic industry shall be based on an examination of all relevant evidence before the authorities. The authorities shall also examine any known factors other than the subsidized imports which at the same time are injuring the domestic industry, and the injuries caused by these other factors must not be attributed to the subsidized imports. Factors which may be relevant in this respect include, *inter alia*, the volumes and prices of non-subsidized imports of the product in question, contraction in demand or changes in the patterns of consumption, trade restrictive practices of and competition between the foreign and domestic producers, developments in technology and the export performance and productivity of the domestic industry

¹⁸ See John Jackson, *supra* 1 at 15

determining the liability, designing corrective measures, or judging whether their benefits are impaired or nullified under the WTO agreements.

According to the DSU, the settlement of a dispute begins with a request for consultations, which takes, at most, 60 days. If a dispute is not resolved through consultations, the complaining party may request a three-person panel to adjudicate the case. The panel's decision may be appealed by the parties to the WTO Appellate Body, a permanent institution established by the Dispute Settlement Body. The appeal is limited to the issues of law in the panel's report and the legal interpretations issued by the panel. If a panel or the Appellate Body concludes that a measure is inconsistent with WTO agreements, it will recommend that the country that lost the case bring the measure into conformity with the agreement, and it may suggest ways for doing so. If the recommendations are not implemented within a reasonable period of time, the Dispute Settlement Body can authorize the suspension of concessions or other obligations to implement its rulings.¹⁹ In cases of prolonged non-compliance, Dispute Settlement Body may also authorize the winning party or the plaintiff member to impose trade sanctions against the defendant member country. For instance, the DSU procedures and operations may be understood by a primary and most developed dispute – the development of DISC/FSC/ETI saga, which comprises three consecutive and closely related cases brought by the European Union against U.S.²⁰ The saga of U.S. and European fights over U.S. domestic income tax policies help us draw two conclusions: firstly, WTO agreements, as multilateral trading agreements, influence legislation and enforcement of domestic policies as

¹⁹ See generally, Michael Trebilcock & Robert Howse, *supra* 6

²⁰ See generally, Brauner, *supra* 13

enforced by the dispute settlement process; secondly, the terms of WTO agreements are not incorporated automatically. For instance, it was not well-equipped to deal with income taxes based on the widespread use of elections of deductions in income tax system at member countries.²¹

III. Overview of the impacts of WTO Principles on China's tax laws system

China's tax law system is not isolated. Rather, it functions as part of a legal system intertwining with other sectors of law. The objective of this subchapter is to brief the impact of WTO agreements on China's tax governance order, which can be viewed from two angles: a public law perspective and a private sector perspective, focused on due process and judicial protections. This thesis tentatively addresses the first set of fundamental but key questions, such as: "is WTO law binding on China?"; "does it form a legitimate component of the Chinese legal system, and if so, to what extent?" and "is it supreme over other parts of Chinese law, including China's tax law system?". Answering these questions in the affirmative, this thesis later turns to a more practical question:²² "Will the Chinese judicature system resolve inconsistencies in the administration of tax laws?" It further considers how the Chinese tax judicature system might meaningfully resolve tax related disputes". This chapter attempts to connect these two perspectives by discussing how the tax legislation system may fulfill the requirements of WTO membership.

²¹ *Id.*

²² *See infra* Chapter VI

3.1. The binding effects of WTO agreements on the tax law system

When elaborating the influence of WTO agreements on China's tax governance, the *first* question concerns the binding effect of WTO agreements. The answer rests mainly in a well known principle of, "*pacta sunt servanda*" ("treaties must be abided by"), and China is bound by the international treaties it concludes, including WTO agreements. As a result, the binding nature of WTO agreements requires that any inconsistent acts against the WTO agreements may expose China to the WTO dispute settlement process. Such process usually includes consultations, requests for the establishment of a panel, panel decision within established deadlines, possibility of appeal, and a final Appellate Body decision within established deadlines. Such dispute settle processes may bring in binding recommendations from the Dispute Settlement Body (DSB) for readjusting domestic policies to ensure WTO compliance.

The *second* question is to which extent the WTO agreements bind China with regard to its tax order. In practice, there are two main ways to apply international treaties. One is the transformational -- to revise domestic law in order to comply with the treaty. The other is direct application, requiring no change to domestic law. Some countries adopt the mixed approach depending on the nature of the treaty. However, the Constitution of China is not clear as

to how to apply international treaties in China.²³ It seems it is neither against direct nor transformational application.²⁴

Taking one step further, the *third* question deals with the possible direct effect of WTO provisions regardless of the approaches of adopting WTO principles – this is particularly evident in the Chinese tax context. This question shifts the challenges entirely to the tax legislation and related tax judicature system by which the private sector may seek to relief. Therefore, tax legislation has to identify and incorporate the possible direct effect of treaty articles to assure provisions at issue are sufficiently clear and precise for administrative interpretation or judiciary application.

Being mindful of three questions above, impacts of the WTO agreements on China's tax law system necessitate two lines of inquiry: firstly, under the WTO general principles which affect China's legal reform in general, such as transparency, impartial and uniform administration, and judicial review, what are the *direct* implications of WTO accession? Second, what does China need to do to accommodate those implications? Apparently, these two queries should be addressed by the tax legislation reform at the first place.

²³ See Bing Ling, *Is China's Accession to the WTO Legally Valid?* (2002) <http://bingling.page.tl/> (last visited on March 15, 2011), arguing that the ratification procedure was defective – the validity of China's accession, in spite of any procedural defects, seems unquestionable as a matter of international law under Articles 45 and 46 of the Vienna Convention on the Law of Treaties; although the National People's Congress Standing Committee granted a before-the-fact authorization but not an after-the-fact ratification;

²⁴ *Id.*

3.2. Implication of the WTO agreements to China's tax laws reform in General

The essential function of the WTO has been described as providing a means to “resolve conflicts of interest *within, not between, nations.*”²⁵ “[A] more vivid analogy, along these same lines, characterizes the WTO as a “mast to which governments can tie themselves to escape the siren-like calls of various pressure groups.”²⁶ Equally illustrative is the impetus derived from the WTO on China's rule of law construct. Undertakings of WTO accession, in addition to trade liberalization commitments, impose a special commitment that aims to promote transparency, predictability and fairness.²⁷ This includes, in particular, obligations on the public availability of trade-related laws, including tax legislation, uniform administration of the laws where tax administration and related procedural consistency are concerned, and the establishment of an independent and impartial system for reviewing administrative decisions – the tax judiciary reform.

3.2.1. Transparency

Transparency is a crucial, basic WTO principle, which requires that all WTO members publish and administer, in a uniform, impartial and reasonable

²⁵ See Friender Roessler, *The Constitutional Function of the Multilateral Trade Order*, in *Essays on the Legal Structure, Function and Limits of the WTO*, 109 (Meinhard Hilf & Ernst-Ulrich eds., 2000) (emphasis added)

²⁶ See Friender Roessler, *The Scope, Limits and Function of the GATT Legal System*, 8 *World Econ.* 289-98 (1985).

²⁷ See generally, Jianming Cao, *WTO and the Rule of Law in China* 16 *Temp. Int'l & Comp. L.J.* at 379

manner, all of its laws, administrative regulations and foreign trade policies. Its main function is to prevent and eliminate any discriminatory treatment by members through unpublished laws, regulations and other measures or barriers, and to monitor the implementation of WTO agreements by all the members. The transparency requirement applies to the tax laws context in a singular way. In the Protocol,²⁸ China agreed that not only would WTO-related law, regulations and other measures that are published and readily available to other WTO members be made public, but also that drafts of all such documents should be provided beforehand for comments prior to official release and implementation²⁹. China must also establish or designate an official journal for the publication of WTO-related rules, regulations, and other measures and to make copies of the journal readily available.³⁰ Moreover, China agreed to designate an enquiry point where all WTO-related information may be obtained.

As to tax laws reform, since 1990, China has gradually published all of its laws, regulations, and policies related to tax administration and public finance management.³¹ Still, its efforts fall short of transparency requirements during the process of policy and law development and opinion collection before final promulgation. Usually, the SAT or the MOF does not disclose “internal” or

²⁸ China's accession terms are contained in the *WTO Report of the Working Party on the Accession of China*, *supra* 2, and in World Trade Organization, *Accession of the People's Republic of China*, WT/L/432 (Nov. 10, 2001)

²⁹ Currently, according to the Law of Legislation, all legislations at basic law level or above are found beforehand or soon after official release, typically in the gazette of Ministry of Commerce that issue the legislation and sometimes in the national daily newspaper.

³⁰ See Karen Halverson Cross, *China's WTO Accession: Economic, Legal, and Political Implications*, B. C. Int'l & Comp. L. Rev. Vol. 27, No. 2 (2004), at 349, SSRN: <http://ssrn.com/abstract=1082546>(last visited on March 15, 2011)

³¹ The publication usually is referred to as the “Blue Book” for tax professionals. Originally being edited into a one-volume collection, nowadays it is mostly edited as two-volume or three-volume collection of selective tax ruling, notices, directives or regulations, part of which is accompanied with an official translation in English

“sensitive” documents. Ironically, sometimes foreign scholars even receive legislative documents earlier than local critics.³² A robust example of the importance of transparency in cases where China does submit draft laws for public commentary is the intense debates cross-fired to determine the exact threshold for the new individual income tax deduction³³ before it was signed into enactment on January 1, 2006.³⁴ Despite the efforts China has made in the past decade, many new problems have arisen from its blurred hierarchy of legislative power. The clearest example is that, in the case of certain tax policies, no disclosure was made beforehand to enterprises and no information on implementation details was exchanged afterwards. Foreign investors may not become aware of the new policy or amendments to laws until they are faced with a particular problem in actual management and daily operation. Furthermore, there is an amorphous category of tax administrative documents referred to as rulings (*guizhang* or *banfa*) notices (*tongzhi*) and directives (*zhishi* or *wenjian*) that are released jointly or separately by the SAT, the MOF, and provincial tax authorities. Although the use of those administrative directives has decreased gradually due to various complaints it never disappears. As a result, there exists reckless or manipulative inconsistency or irregularities in the implementation of tax laws and policies in different localities. To preemptively restrict legislative actions in this regard, the SAT imposed stricter rulemaking procedures on the issuance of generally

³² See *infra* Chapter VIII, noting that Professor Karla Simon even published a law review article commenting China’s Charity Code before most of scholars knew about the draft which was never published in any media in China

³³ See *China to Raise Deductible Income Rate for IIT to RMB3,000*, *China Briefing*, March 7, 2011, noting that the threshold has been a good example of manipulating IIT but also showing progress in legislative opinion collection and public hearing, <http://www.china-briefing.com/news/2011/03/07/china-to-allow-more-income-deduction-for-iit.html> (last visited on March 15, 2011)

³⁴ *Id.*

applicable rules by tax agencies or those tax-related regulations by releasing the Administrative Measures for Formulating Normative Documents in Taxation.³⁵ However, the implementation of the “New Measures for Normative Documents” remains unclear.

An additional obstacle in honoring the transparency requirement is that, other than tax authorities, various administrative apparatuses at different hierarchical levels issue overlapping and less formal notices, supplemental circulars, and interpretative opinions affecting taxpayers’ behavior and creating nuances.³⁶ Following the guideline that administration in accordance with the rule of law, China’s Legislation Law demands the publication of all legislation including the NPC-level basic laws and amendments, administrative regulations, local and regional regulations, ministerial rules and local level rules.³⁷ Only a few normative documents or circulars are exempted from the requirement. Of course, to fulfill requirements of WTO as a multilateral trading system, China may “undertake only those laws, regulations, and other measures pertaining to or affecting trade in goods, services, TRIPs, or the control of foreign exchange that are published and readily available to other members, individuals, and enterprises, shall be enforced.³⁸” In addition, China is obliged to make available to WTO members, upon request, all laws, regulations, and other measures pertaining to or

³⁵SAT Decree No. 20, published Feb. 10, 2010, effective Jul. 1, 2010, [hereinafter “New Measures for Normative Documents”] 《税收规范性文件制定管理办法》, 国家税务总局令第20号(2010)

³⁶ An example is a notice issued by the State Administration of Industry and Commerce on redefining the status of Permanent Establishment, which arouses disputes on its tax treatment and international tax implications.

³⁷ See e.g., *Regulations for Registration and Management of Representative Offices of Foreign Enterprises*, effective as of March 1, 2011, issued by the State Administration of Industry and Commerce (《外国企业常驻代表机构登记管理条例》)

³⁸ See Halverson, *supra* 30, at 351

affecting trade in goods, services, TRIPs, or the control of foreign exchange before such measure are implemented or enforced. In emergency situations, laws, regulations, and other measures shall be made available at the latest when they are implemented or enforced.³⁹ However, given the meticulous reach of tax legislations, it is always hard and impractical to pick out specific tax terms stipulated in widely scattered administrative regulations.

Another practical obstacle to compliance with China's tax laws is that they are not easily accessible. Although the protocol specifically requires China to publish an official journal and establish a single enquiry point for WTO-related materials under paragraph 2(C) of the Protocol,⁴⁰ accurate and reliable information on tax legislation is often not provided to individuals and enterprises. Even the official website of the SAT or the MOF, which is supposed to be most authoritative hub on China's tax laws, does not provide all major tax related laws and regulations, let alone various administrative rulings, notices and directives.⁴¹

An additional note is that secrecy and lack of transparency in the tax legislation system are not merely accidental. Rather, they stem from China's

³⁹ *Id.*, at 352

⁴⁰ Article X of the GATT 1994 stipulates that laws, regulations, policies, and decisions, including judicial decisions, pertaining to foreign trade "shall be published promptly in such manner as to enable governments and traders to become acquainted with them. *See China to Open Official WTO Website*, XINHUA NEWS AGENCY, Sept. 12, 2002, LEXIS, News Library, Xinhua File. TRIPs also prescribes that laws and regulations, and final judicial decisions and administrative rulings of general applications, made effective by a member pertaining to the availability, scope, acquisition, enforcement, and protection shall be published by each member; see Halverson, *supra* 30 at 350-352, establishing an official WTO website could greatly facilitate the ability of outsiders to gather legal information. The website at least purports to make current information regarding the WTO accessible to the public, provides links to China's WTO-related laws and regulations, and allows visitors to ask question

⁴¹ For instance, for the first 6 months of 2010, around 310 "SAT Correspondences" were issued, of which only 53 are currently publicly available; 64 "SAT Issuances" were adopted but only 36 are currently publicly available from the SAT official website <http://www.chinatax.gov.cn> (last visited on March 15, 2011)

basic hierarchical organization structure. China's tax governance is essentially administrative. Most tax laws and regulations, national or local, would be better characterized as commands running down a bureaucratic hierarchy from superiors to subordinates. If laws and regulations are alien to the administrative hierarchy, it is not surprising that those laws are subject to ineffective implementation. The result is that tax laws and regulations passed by legislative bodies are rarely very meaningful without administrative articulation and implementation.

3.2.2. Uniform and impartial administration of tax laws and regulations

As required by Article X of the GATT 1994, China agreed, in the Protocol, to apply and administer all WTO-related laws, regulations, and other measures in a "uniform, impartial and reasonable manner."⁴² Scholars of Chinese law express a mix of skepticism⁴³ and optimism⁴⁴ regarding the possibility of China's fulfillment to this obligation, which demands enforcement institution with clear lines of authority and the capacity to render neutral decisions.⁴⁵ However, as this requirement applies to the tax context, there are several problems that might jeopardize the neutrality and predictability of their administration.⁴⁶

⁴² See the Protocol, Part. I, Para. 2(A)(2).

⁴³ See generally Halverson, *supra* 30

⁴⁴ See generally Cao, *supra* 27

⁴⁵ See Halverson *supra* 30 at 352

⁴⁶ *Id.*, at 353

First, Chinese tax legislation usually tends to fall into one of two extremes. Those drafted in vague terms or in direction by “political guidelines or spirit,” and those drafted with too many details applicable only to specific issues. Both extremes are lacking in jurisprudential value.⁴⁷ Those undefined, policy-orientated, broadly worded tax laws and regulations create a mixed authority and provoke discretionary decision-making on the part of local tax authorities interpreting their specific meaning.⁴⁸ This is particularly problematic, because many local tax authorities are incompetent to exercise this discretionary capacity. Second, tax authorities as lawmaking institutions usually are short of modern legislation techniques.⁴⁹ This results in a proliferation of overlapping, repetitive, ambiguous or contradictory laws at various hierarchical levels. Finally, various extra-legal factors impede the neutral and just implementation of tax laws. Those factors include political intervention, corruption of local tax officials, social stability concerns, imbalanced development strategies, minority unity, and the traditional Chinese notion of *guanxi* or influence peddling.

Moreover, China has been criticized for local protectionism that manifests in certain localities through legislation and enforcement of tax regulations and rules associated with unfair implementation and treatment. For example, China’s tax system suffers from discriminatory measures such as actual higher tax rates, refusal to issue tax registration licenses, overly strict administration against non-local products or services. It is clear that

⁴⁷ See Lubman, *supra* 1 at 147, describing the techniques that characterize Chinese legislative drafting, including “the use of general principles, vagueness and ambiguity, undefined terms, broadly worded discretion, omissions and general catch-all phrases”

⁴⁸ See Halverson *supra* 30 at 352

⁴⁹ *Id.*, at 354

unless local protectionism is destroyed, the national market as a whole will be impeded and trade disputes will arise. Meanwhile, it should be noted that the NPC, its Standing Committee and State Council have power to annul the administrative regulations that contradict the Constitution, laws and major regulations promulgated by legislative bodies in a higher hierarchy. This is in line with China's agreement to improve the uniform administration echoing the requirement under the Article X of GATT 1994.⁵⁰

A few other aspects of China's tax law system militate against its impartial and predictable administration. First, except a few nationwide basic laws or regulations issued by the NPC, the MOF and the SAT on tax, many areas of the tax law or administrative regulations are not covered or promulgated, although some are available in vague or tentative terms. For example, the discussion centered on gift and estate tax has been kept for over a decade, however, there are no rules in this area. Courts or tax authorities have to resort to general provisions in the Civil Law Code or Contract Law to resolve disputes arising in this connection. Second, the tax authorities are comprised of officials of varying qualifications. Ironically, jobs in tax administration are viewed as safe, career positions. Job security is not premised on increasing sophistication of one's capacity to implement new tax provisions. So, there is no guarantee that the implementation and interpretation of tax laws will be consistent across localities. Third, China's economic structure and policies favoring coastal areas further undermine uniformity and predictability. When local officials' promotions and political sponsorship are staked on local

⁵⁰ See Jianfu Chen, *Chinese Law: Towards an Understanding of Chinese Law, Its Nature and Development*, at 107-109 (1999).

economic performance, it is without doubt that ill-defined, ambiguous and contradictory tax laws and regulations are implemented for local benefit, which causes inconsistency and unpredictability. Notably, the administration of tax laws and regulations in special economic zones are in general illustrative of the above summary. Through the end of 2008, over 7,000 special economic zones have been set up in China since 1979, of which nearly 300 zones are of national level and the rest is of provincial or local level. The rapid increase of special economic zones caused irregularity and insufficiency to tax legislation and administration. Moreover, a considerable portion of local rulings, notices and directives (either published or non-published), are in conflict with laws and regulations from the central government. Meanwhile, the task force for tax administration is in short supply and a significant portion of available tax professionals do not possess adequate training and qualification to secure impartiality and independence. An additional note is that not all special economic zones have an independent judiciary for determining administrative cases, which in turn exacerbates irregularity and the manipulation of tax related disputes.

3.2.3. Review of Administrative Decisions

One difficulty that plagues the Chinese legal system is the inability to provide, on a consistent basis, truly independent judicial review of administrative actions.⁵¹ Tax administration is not an exception to this dilemma. According to

⁵¹ See *infra* Chapter VI on details about tax judiciary reform discussions. This section briefly reviews the overall picture of the administrative system that may concern tax legislation and judiciary.

Article X of GATT 1994, Article VI of GATS and other related WTO agreements, China has committed itself to establishing and maintaining “impartial and independent tribunals, contact points and procedures” for the prompt review of all administrative actions relating to the implementation of the laws, regulations, judicial decisions and administrative rulings of general application referred to in the WTO transparency rules.⁵² Article II (d) of the GATT 1994 requires that review procedures be included with the opportunity for appeal, without penalty, by individuals or enterprises affected by any administrative action subject to review. If the initial right of appeal is to an administrative body, there shall in all cases be the opportunity to choose to appeal the decision to a judicial body. Notice of the decision on appeal shall be given to the appellant and the reasons for such decision shall be provided in writing. The appellant shall also be informed of any right to further appeal.⁵³

This thesis notes that China has made remarkable progress in creating a national jurisprudence examination and reforming its judiciary institutions. The Supreme People’s Court (“SPC”), during the process of constructing the rule of law as incorporated in Chinese Constitution, has served as a dominant

⁵² China’s official press is replete with examples of officials announcing the importance of transparency and rule of law in light of the country’s WTO obligations. *See, e.g., Timetable Set for China’s Entry to WTO*, XINHUA NEWS AGENCY, Nov. 3, 2001 (trade minister quoted as saying that the “most important” change resulting from China’s WTO entry will be improving transparency of laws); Meng Yan, *Legislative Efforts Benefit WTO Accession*, CHINA DAILY, Jan. 7, 2002 (NPC representative observes that “transparency and public participation” have recently been emphasized during the NPC’s legislative process after China’s WTO entry); Shao Zongwei, *Judicial Rules to Comply with WTO*, CHINA DAILY, Feb. 26, 2002 (senior prosecutor pledges that China’s procuracy will incorporate WTO principles of “openness, integrity and transparency”).

⁵³ See Protocol, *supra* 2 pt. I, para. 2(D)(2). The Protocol also requires that the relevant tribunal provide written notice of the decision on appeal, including the reasons for such decision; *see also* Working Party Report, *supra* 2 para.78, requiring that the tribunals responsible for judicial review be “impartial and independent of the agency entrusted with administrative enforcement” and have no “substantial” interest in the outcome

intervening force in judicial review reform.⁵⁴ In view of the powerful bureaucracy and political interference in China, however, a key issue is what degree of independence China's judges exert with regard to their delegated authority to review and correct administrative decisions, let alone the incomplete or absent tribunals in several important economic areas such as tax, international trade and bankruptcy.

Although in some aspects China's judiciary system may fall short of expectations or the commitment listed in its Protocol, the efforts and progress demonstrate a capable framework in place that comports with the Protocol's obligation for reviewing administrative decisions with tribunals for appeal. In addition to judicial review of WTO-related laws and administrative

⁵⁴ See Halverson, *supra* 30 at 360-363, summarizing that SPC's authority to promote judicial independence is circumscribed both by the supremacy of the CPC and by specific statutory limitations on its authority to interpret law. Constraints undermining the judiciary independence include political influence and the continued involvement of CPC, lower status of judges *vis-a-vis* administrators, financial interests in court decisions at the local level (i.e., the interconnectedness of local government and the private sector), dependence on local government to enforce judgments, the hold-backs of *guanxi*, and outright corruption. Crucially, funding of courts at the local level is supported by local revenues. More generally, the weakening authority of the CCP, along with the growing importance of wealth as a measure of success, has left a moral vacuum, which exacerbates corruption and complicates efforts to promote neutral and objective decision-making. These factors will operate impeding effective implementation of China's WTO obligations, in particular, the commitment on judicial review of administrative decisions. Significantly, the SPC has emphasized China's WTO transparency-related obligations as a means to promote judicial independence in cases affecting international trade. However, The SPC's authority to promote judicial independence is circumscribed both by the supremacy of CPC and by specific statutory limitations on its authority to interpret law. The requirement of the rule of law encompasses not only transparency but also judicial independence and the notion that no person, including a government official, is above the law. Even Beijing has expressed a commitment to promoting judicial independence in a narrow sense of the phrase –WTO-related cases (including review of administrative acts) should be determined on the basis of international obligations – as opposed to being influenced by *guanxi*, corruption, incompetence of professionalism or political inference at the local level, it is unrealistic that such change will expand courts' power or authority *vis-a-vis* the CPC or certain administrative apparatus; for more discussion on the SPC, See generally, *China's Legal Reforms* (Stanley Lubman ed., 1996) (containing papers by various authors); *The Limits of the Rule of Law in China* (Karen G. Turner et al. eds., 2000) (containing papers by various authors addressing rule of law related issues in China); Stanley B. Lubman, *Bird in a Cage: Legal Reform in China After Mao* (1999); Pitman Potter, *The Chinese Legal System: Globalization and Local Legal Culture* (2001); Randall Peerenboom, *Globalization, Path Dependency and the Limits of the Law: Administrative Law Reform and Rule of Law in the People's Republic of China*, 19 Berkeley J. Int'l L. 1 (2001)

decisions,⁵⁵ there are a number of other channels that are worth highlighting for the review of administrative actions, including tax administrative decisions. First, Chinese law provides an *internal but extra-judicial* supervisory authority for reconsideration system of administrative decision-making, which is conducted from within the administration.⁵⁶ An evident limitation to this review, is its lack of independence. Usually, such a supervisory or reconsideration system serves political concerns of keeping potential conflicts of interests within the administrative system. Second, incomplete though it may be, the 1996 Administrative Punishment Law (“APL”) outlines basic elements of a comprehensive law or an administrative punishment code, which imposes procedural requirements on administrative agencies.⁵⁷ The APL was developed to remove arbitrariness and overlapping exertions of jurisdiction in the imposition of an administrative “penalty” *per se*. The APL is distinctive in its incorporating procedural safeguards, including replacing inappropriate administrative clerks, establishing a right to know and the right to a hearing a certain cases.⁵⁸ Third, as it applies to tax litigation, limited judicial review of “concrete” tax administrative cases is available. However, influences imposed on judges by tax authorities may distort its judgment by favoring tax authorities. China’s tax judicature does not embody the “common law” principles of *stare decisis* to handle judicial review. Although the 1989

⁵⁵ See Protocol, *supra* note 2, pt.1 para 2.

⁵⁶ *Id.*

⁵⁷ See generally The Administrative Reconsideration Law of the P.R.C.; Administrative Supervision Law of the P.R.C. (1997); Administrative Penalties Law of the P.R.C. (1996) [hereinafter APL]; State Compensation Law of the P.R.C. (1994); Administrative Litigation Law of the P.R.C. (1989) [hereinafter ALL].

⁵⁸ See Chen *supra* 50 at 139-151. Noting that the right to hearing applies when “serious” penalties are at stake. In addition, the APL provides that (i) penalties may only be imposed and enforced by authorities that are specifically authorized to do so (Article15), (ii) a penalty may not be based on rules contained in internal, or unpublished, documents (Article4), and (iv) no administrative body may impose fines for the same offense twice (Article24), quoted by Halverson *supra* 30 at 365

Administrative Litigation Law (ALL) enriched China's judicial review system by allowing suits against administrations,⁵⁹ some drawbacks are associated with the narrowly designated ALL – namely, judicial review is limited to specific or concrete acts of the government such as imposing a fine or invoking a license. However, courts are not permitted to review abstract administrative actions, including for example the appropriateness or reasonableness of local tax administrative rulings or guidelines.⁶⁰

Generally, judicial review of tax administrative cases involves similar efforts and difficulties as discussed above, but also has a few specific problems. First, tax administrative cases suffer from a high withdrawal rate. Foreign investors or individuals are typically not privileged to updates on consistent-changing local tax laws, regulations, and court procedures. Even though they are afforded representation by lawyers, a calculated cost-effective analysis may prevent them to do so and taxpayers are disincentivized from using it. Second, in contrast with civil or criminal law areas, judges in China are short of competency and expertise in handling administrative tax cases. More tax specialists are employed by tax authorities but fewer serve as judges for tax cases. It is not surprising that courts may seek suggestions from tax administration to determine tax cases, which in turn causes conflict of interests. Third, local courts lack financial independence and usually they are entirely funded by local revenue. As a result, judges are more cautious and unwilling to rule against the local tax administration or large local SOEs which may threaten their financial needs. This concern has been described as a “growing

⁵⁹ See Wang Hanbin, *Explanation of the (Draft) Administrative Litigation Law of the PRC, Delivered at the 2nd Session of the Seventh NPC* (Mar. 28, 1989), translated in 3 CHINESE LAW AND GOVERNMENT 35, 35-36 (1991), quoted by Chen, *supra* 50 at 147

⁶⁰ See Chen *supra* 50, at 155

tumor” for China’s tax judicature reform. While other areas of the law are affected, the lack of judicial independence affects tax cases specifically. Finally, overlapping and contradictory local tax laws and incentives put judges in the position of relying on uncertain legal sources – sometimes a vacancy of related laws or regulations.

To this end, the active role of SPC for fulfilling WTO obligations and promoting tax judiciary competence may be extended to the proposal of establishing a Chinese tax court system. SPC, as the most important and active interpretation authority in China, functions both as a tribunal and as supervisor of an *imaginary* tax court system.⁶¹ The desirable tax court system structure is to adopt a circuit tax courts framework exercising both original (conditioned first instance) and appellate jurisdiction, sitting permanently in six to eight regions covering the entire Chinese territory, and reporting to the SPC Tax Tribunal based in Beijing. The designated High Tax Tribunal is an SPC subsidiary and should have ultimate appellate jurisdiction over tax cases appealed from circuit tax courts and provincial high courts, and perform tax court system administration or management. The transitory, costly and overhauling midlist “spin-off” structure should be denounced based on tax policy routines.

3.2.4. Summary

China’s tax governance is essentially administrative. The binding effect of the WTO agreements on the tax governance can be summarized by three WTO principles: transparency, impartial and uniform administration, and judicial review.

⁶¹ See *infra* Chapter VI

The transparency principle implies three separate issues. The process of tax legislation as to policy orientation and opinion collection before the final promulgation mostly is not open to public. Inconsistency and irregularity in the implementation of tax laws and policies in different localities create further ambiguity. Although the SAT imposed stricter rulemaking procedures on the issuance of generally applicable rules by tax agencies or those tax-related regulations by releasing the “New Measures for Normative Documents,” the implementation of which remains unclear. Moreover, other than tax authorities, various administrative apparatus at different hierarchical levels issue overlapping and less formal notices, supplemental circulars. Secrecy and the lack of transparency in the tax legislation system partially stem from its basic hierarchical organizational structure.

Uniform and impartial administration requirements raise the bar high for China’s tax system especially for its tax legislation. China is required to apply and administer all WTO-related laws, regulations, and other measures in a “uniform, impartial and reasonable manner” to accord with neutrality and predictability requirements. However, tax authorities are usually vested with incompetent capacity to administer ill-designed tax laws: those drafted in vague terms or in direction by “political guidelines or spirit,” and those drafted with too many details applicable only to specific issues. Tax authorities as lawmaking institutions usually are short of modern legislation techniques, and this leads to a proliferation of overlapping, repetitive, ambiguous or contradictory tax laws at various hierarchical levels. Various extra-legal factors also impede the neutral and righteous implementation of tax laws, such as political intervention, corruption of local tax officials, and local

protectionism. In addition to the marginal qualification of tax officials, China's favorable economic policies towards coastal areas undermine uniformity and predictability. When local economic performance is combined with economic pressure, ill-defined, ambiguous and contradictory tax laws and regulations are implemented for local benefit which induces disparity and unpredictability.

The judicial review requirement creates specific issues in the Chinese tax context. A key issue is to what extent China's judges can independently execute their delegated authority to review and correct administrative decisions. Although certain extra-judicial means, such as administrative supervision or reconsideration, may be used to resolve adverse tax decisions made against taxpayers, tax administrative cases suffer from a high withdrawal rate due to unfamiliarity with tax laws and court procedure as well as a calculated cost-effective analysis. Judges hearing tax cases lack competency and expertise. Their financial dependence on local revenue drives courts to be more cautious and unwilling to rule against local tax administration or large local SOEs, which control their monetary allocations. Meanwhile, overlapping and contradictive local tax laws and incentives present judges with an unfavorable situation of facing vacancy or ambiguities of related laws or regulations. Although the debate regarding the tax court system is popular, the system, as imagined, is not in a position to replace the rest of the judiciary reform.⁶²

⁶² *Id.*

3.3. WTO's impacts on the Chinese tax law system – a normative perspective

China's tax reform is one of the most important components to bringing China into compliance with obligations enclosed in the Protocol and related WTO principles. China's tax law system is not isolated from macroeconomic and political constraints. Many of China's tax policies, laws, regulations and procedures have higher reform priority than other areas of law. The objectives of China's tax policies are to raise revenue and stimulate the economy by encouraging exports and foreign direct investment. However, less emphasis was put on tax equity and neutrality. In contrast with counterparts in Western tax jurisdictions, China's tax law system is plagued by the lack of impartial administration and judicial review. Although some outdated tax legislation was reformed before the accession to WTO, coupled with the unfinished business of establishing an institutional tax governance structure for liberating trade and capital mobility, a few areas in China's tax law remain necessary steps to accord with China's obligations the WTO accession. This section introduces necessary tax legislation updates based on two closely related WTO principles – the national treatment and most-favored-nation (MFN) principles.

3.3.1. The national treatment principle

Article III (1) of the GATT stipulates the equalization of foreign with domestic products in the field of internal taxes and charges, as well as legal provisions. Although the definition of "product" is not found in GATT, it is reasonable to consider a product to be tangible and moveable. This general

rule is further explained by Article III (2) of the GATT, the first sentence of which states that “the products of territory of any contracting party imported into the territory of any other contracting party shall not be subject, *directly* or *indirectly*, to internal taxes or other internal charges of any kind in excess of those applied, *directly* or *indirectly*,⁶³ to like domestic products” (emphasis added by the author).⁶⁴ Identical products are not required, but “likeness” is sufficient. Moreover, as the GATT Analytical Index states, a situation falling under the scope of Article III (2) of the GATT has to fulfill two requirements: first, it must be a competition situation; second, there must be a directly competitive or substitutable product which has not been similarly taxed. Another crucial feature is that Article III of the GATT prohibits discrimination of not only a *de jure*, but also a *de facto* nature – in any case, the measure must be protective. Mere marginal differences are subject to the *de minimis* principle and, therefore, do not prove a violation.⁶⁵ Although scholars debate whether or not Article III (2) of the GATT applies to direct taxation,⁶⁶ one cannot deny the Appellate Body’s decisions in the FSC/ETI case, which recognize the applicability of Article III (4) of the GATT to direct taxation.⁶⁷ In summary, tax measures of a WTO member country have to meet the requirement of national treatment under Article III of the GATT as long as the tax under consideration is levied on the profits arising from import transactions. Additionally, if tax measures protect domestic products exclusively, such measure may violate Article III of the GATT.

⁶³ See Article III (2) of the GATT

⁶⁴ See Brauner, *supra* 13 at 143

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ *Id.*

Whereas the GATT regulates trade in goods, the GATS is applicable to the trade in services. Article XVII of the GATS sets forth the principle of national treatment for the trade in services:⁶⁸ “[E]ach member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favorable than that it accords to its own like services and service suppliers”. Moreover, there are exceptions to this rule provided that the difference in treatment is aimed at ensuring the equitable or effective imposition or collection of direct taxes or the measure falls in scope of international agreements relating to the avoidance of double taxation.⁶⁹

China’s tax measures, especially those associated with foreign investments, have to comply with national treatment principle under Article III of the GATT and Article XVII of the GATS. To violate Article III of the GATT, the taxation of importing enterprises must be disadvantageous. This may include those sources which are not taxed in the comparable domestic situation, which are taxed at different or higher tax rates, which are denied or offered lower deductions and so on. After a painful process of negotiation and opinion collection, China has made quite good pointed tax legislation progress. For example, the following pre-WTO measures promulgated in various tax laws on the nation level were removed or adjusted based on recent updates including the 2008 new Enterprise Income Tax Law.

⁶⁸ See GATS Article XVIII(1)

⁶⁹ See Brauner, *supra* 13 at 143-145

- Income tax reduction for export-oriented enterprises: Article 75 of the Rules of Foreign Enterprise Income Tax Law (FEITL)⁷⁰ provides that: after the application of a regular tax holiday, an enterprise exporting more than 70 percent of its sales is eligible for a 50 percent income tax reduction, but the reduced tax rate cannot be less than 10 percent. Although this measure is designated to benefit foreign investment, other WTO members may treat it as an export-subsidy measure;
- VAT and Income Tax Incentives for buying domestically made equipment: to encourage the use of locally made equipment specified in a qualifying list, VAT tax refund and income tax credits are granted to those who take advantage of this policy. For this instance, domestic enterprises (DEs) and foreign invested enterprises (FIEs) are allowed for an income tax credit equal to 40 percent of the purchase price of domestically made equipment. Such credit can be used to offset the incremental portion of the enterprises' current income tax liability over the preceding year. Unused income tax credits can be carried over for five years (seven years for FIEs eligible for a tax holiday). Purchasers may also depreciate the equipment based on the original purchase price and can receive a full VAT refund for tax paid on the equipment. This policy, obviously, could be viewed as discriminatory against manufacturers using imported equipment. Moreover, its application to DEs and FIEs could be considered inconsistent;⁷¹

⁷⁰ the FEITL was replaced by the new Enterprise Income Tax Law which became effective from January 1, 2008

⁷¹ See generally, Alan Tsoi, *China Goes for Equality*, International Tax Review (July 2001)

- Income tax exemptions for domestic enterprises: a two-track enterprise tax system⁷² was introduced in the early 1980s. It included a Western-style tax system for FIES and another system for DEs. Several incentives, however, are available only to DEs to encourage the growth of specific industrial sectors. First, income derived from domestic research institutes for transfers of research results, technology training, consultation, and services are exempt from enterprise income tax. Second, DEs in agricultural production, fisheries, forestry, and husbandry will receive a general income tax exemption. However, FIEs engaged in the same industries will receive only a five-year tax holiday. Third, A two-year, tax free holiday, from the date of an entity's establishment, is provided for firms engaged in law, accountancy, auditing, technology, taxation, information consulting, transportation, shipping and communication. A one-year tax holiday is offered to enterprises engaged in the travel sector, restaurants, storage, education, and healthcare. However, only FIEs located in special economic zones that have registered capital of at least \$ 5 million are entitled to a three-year tax holiday. Again, this income tax exemption arrangement puts DEs and FIEs in different position;
- VAT incentives for Domestic Enterprises: various VAT reductions and exemptions have been granted to DEs under special scenarios. First, DEs that utilize waste gas, waste water and solid waste as major production inputs. Second, newly established enterprises in remote regions, poverty-stricken regions or regions with ethnic groups. Third,

⁷² The two-track enterprise income tax system was removed by the new Enterprise Income Tax Law in 2008

enterprise that receive income from transferring technologies or from related services such as technology consultancy or training. Fourth, enterprises that suffer from disasters and Acts of God. Fifth, newly established TVEs that create a significant number of new jobs. New jobs contribute over 60 percent of task force. Finally, enterprises that sell self-developed software effectively pay VAT at a 6 percent by refunding a portion of the tax paid already. All the above VAT incentives, among others, may induce national treatment issues when FIEs find themselves in a disadvantageous position due to higher VAT burden;

- Deductibility of Management Fees: China's tax authorities have not dealt favorably with inter-company charges and cost sharing arrangements, which are a common practice of multinationals. In fact, FIEs are not allowed to deduct management fees. However, DEs are allowed to deduct (by conditional approval) management fees paid to parent companies and affiliated companies. Obviously, FIEs may view such deduction measure as distorting operation process and putting them into a competitive disadvantageous position;
- Tax consolidation: FIEs with multiple entities in China are not encouraged to file consolidated returns, but DEs may act differently, especially domestic banks, insurance companies, airlines and power companies. This consolidation practice is under review following national treatment principle;
- Depreciation: DEs are granted a salvage value of up to 5 percent of the original fixed-asset costs, however, FIEs cannot set the salvage value

below 10 percent of cost, unless the tax authorities approve so. Therefore, when compared to domestic counterparts, FIEs must keep 5 percent more of fixed asset cost in the balance sheet, as opposed to claiming that amount as a current tax deduction.

- Individual income tax: although WTO principles deal solely with the trading of goods and services, the current system of individual income tax has experienced a few rounds of review under the national treatment principle. The monthly deduction for individual taxpayers has been increased from RMB 800 to RMB 1,600, and is expected to be raised further. The RMB 4,800 monthly deduction for foreign individuals remains valid based on a RMB3,200 adjustment. There are a number of other scenarios that Chinese nationals and foreigners are treated differently, but it is beyond the scope of this.

In summary, implications of the national treatment principle to China's tax law system probably are not as profound as observers may expect, however, certain inconsistencies with this principle exist even after a few major tax legislative pieces came into place in the past decade. However, certain irregular treatments for Chinese domestic enterprises exist with merits, mostly because foreign investments rarely get into certain industry lines such as the low-profit-margin but environmentally friendly waste recycling business dominated by domestic enterprises. With more emphasis put on the "green technology" industry by the Chinese government, this treatment may change as more foreign capitals are interested in entering into the environment protection business. Overall, although in many ways the Chinese tax system

has been reformulated and to certain extent has been successful after the accession to the WTO, the benchmark has to be upheld that the national treatment principle by large serves to restrict, not to enlarge the state's taxing power.

3.3.2. The most-favored-nation (MFN) Principle

The most-favored-nation (MFN) principle is embodied in Article I of the GATT that each country is obliged to accord immediately and unconditionally “any advantage, favor, privilege or immunity granted by any contracting party to any product originating in or destined for any other country... to the like product originating in or destined for the territories of all other contracting parties.”⁷³ Moreover, this applies “with respect to customs duties and charges of any kind imposed on or in connection with importation or exportation or imposed on the international transfer of payments for imports or exports, and with respect to the method of levying such duties and charges, and with respect to all rules and formalities in connection with importation and exportation, and with respect to all matters referred to in Articles III (2) and III (4).”⁷⁴ Although GATT provisions apply the MFN treatment to specific issues only,⁷⁵ the terms “advantage, favor, privilege or immunity” are not defined precisely, but they are interpreted broadly. An additional requirement is that the benefit is granted immediately or unconditionally rather than gradually but

⁷³ See Article I, GATT

⁷⁴ *Id.*

⁷⁵ See Brauner, *supra* 13 at 156

it may be partially granted. If this requirement is fulfilled, the same benefit should be offered to other member countries.

Article II of the GATS, like Article I of the GATT, contains a MFN clause for trades of services. It states that “each Member shall accord immediately and unconditionally to services and service suppliers of any other Member treatment *no less favorable* than that it accords *to like services and services suppliers* of any other country” (emphasis added by the author).⁷⁶ The term service includes any kind of services and the production, distribution, marketing, sale and delivery of services.⁷⁷ It has to be mentioned that services in the form of a “commercial presence” also include direct investment and, therefore, also include a freedom of establishment, either in form of a branch, or by purchase of shares in an existing enterprises. In reference to the determination of which treatment is more favorable it is forbidden to resort to the national treatment provisions of Article XVII of the GATS or Article III of the GATT. Because of the different wording, it cannot be concluded that the contracting parties had a common meaning in mind. However, the Appellate Body recognizes similarities between the MFN clauses of Article II of the GATS and Article I of the GATT. Both provisions prohibit a *de jure* as well as a *de facto* discrimination.

Under the MFN principle, China is *not* prohibited from offering its trading partners *more favorable* tax treatment than that provided to domestic enterprises. For example, China could approve more tax incentives to FIEs with investment in specific geographical areas. As a matter of compliance,

⁷⁶ *Id.*, at 159

⁷⁷ *Id.*

China needs to review not only rules violating WTO principles but also those provide preferential treatment based on capital resources of enterprises. On the other hand, when more and new business activities emerge after accession to the WTO, both FIEs and DEs must be aware of updated tax and financial implications caused by modifications of tax laws and regulations. To honor the commitments in the Protocol, the following pre-WTO measures in practice were removed or adjusted based on the mass pre-WTO legislation clean-up and recent tax legislative updates.

- Significant tariff reduction: According to U.S – China Market Access Agreement, the tariff rate is subject to significant reduction based on China’s actual accession date. Although China has been reducing tariff rates since its accession to WTO the current average tariff rate for imports to China is around 12-15 percent which is substantially higher than the average of developed countries – 3.8 percent – and even developing countries, which is 10-11 percent. Some imported items are still running on a quota or import-permit system. In particular, i) for agricultural products, China already has a lowered its average tariff rate on U.S. agricultural products from 31 percent to roughly 14 percent by January 2004; foreign producers have already begun using newly created tariff-rate quotas; ii) for industrial products, China has cut its tariff rate to around 10 percent. Foreign companies are able to market, sell and distribute industrial goods freely and role of previous import and export agencies is fading harshly; iii) regarding automobiles, since mid-2006 China has

reduced its tariff from the original rate of 80-100 percent to 25 percent. Tariffs on auto parts reduced to 10 percent already.

- Foreign banks or financial institutions: according to the market-access commitment in the Protocol, China has acknowledged full market access (no geographic and customer restrictions) to foreign banks or financial institutions after end 2006, i.e., five years after the WTO accession. As foreign banks are granted substantially the same rights as Chinese banks, the reforms in tax law in this connection should be closely watched under the MFN principle;
- Reinvestment refund: a tax refund is available if an FIE reinvests the profits derived from China for at least five years. The standard refund rate is 40 percent. A full refund is allowed if the profits are reinvested for establishing or expanding an export-oriented or technologically advanced enterprise. Although debates had been made over whether this incentive should be refined, Chinese tax authorities believe in its control over it with a tightened approval processes for technologically advanced enterprise;
- Tax treatment on dividends: dividends paid by FIEs are not subject to withholding tax, and foreign nationals (corporate and individual) can receive dividends tax-free. Domestic enterprises are allowed to offset income tax based on attributable shares of the tax paid by the invested enterprise on the dividends. However, the tax credit may not be fully utilized if the applicable tax rate of the investors is lower than that of the invested enterprisers. Unlike foreign individual investors, dividends received from FIEs by Chinese individual investors are subject to income tax. This requirement is under review for amendment.

- Bad debt: FIEs may claim a bad debt deduction for debts outstanding for more than two years and only financial institutions can establish bad debt reserves. Moreover, if an enterprise does not establish a reserve in books, it can deduct a bad debt only if the debt has been outstanding for more than three years. In contrast, domestic enterprises can claim a bad debt reserve and a bad debt deduction on an *ad hoc* basis. Although China has adopted an updated set of accounting rules, the bad debt extrudes the different treatment over books and details of accounting practice. Therefore, Chinese tax authorities will have to detail such differentiation under the MFN;
- Surtaxes and Surcharges: DEs usually are required to pay a city maintenance and construction surtax at rates varying based on enterprises' locations (e.g. 7 percent for urban area and 1 percent for town or other areas) and a 3 percent education surcharge is imposed on the same tax base additionally. However, FIEs are exempt from the above surtax and surcharges which means domestic enterprises effectively pay 10 percent more of turnover tax than their FIE counterparts. Certain surcharges nowadays are applicable to FIEs as well.

Overall, China has made tremendous efforts through tax legislation to identify and reform inconsistencies with MFN principles in the tax context even the definitions of many key words or commonly accepted practice under the MFN principle are subject to broad interpretation. A mix of different tax treatments towards FIEs and DEs are caused by two main factors. First, the economic structure and development priorities invite flexible treatments towards specific industry lines or preferential tax treatments. To a substantial extent, foreign

interests are treated more favorably than domestic interests. Tax preferential measures are direct and enforceable in driving the free trade of products and services without discrimination. Second, arising complaints from foreign investors are about the non-transparent government procurement process associated with negotiation and protectionism. To foreign investors, a “Black box” practice may imply preferential tax treatments that are not available to them in negotiated procedures with competition bidding for government contracts. Although the government’s practice to nurture domestic interests is common to many WTO member countries, the tax implications of the government procurement process are not given enough attention according to the MFN principle of eliminating barriers to facilitate the mobility of goods and services among member countries.

3.4. Implications for the Tax Administration System

The foremost effect of WTO accession for China’s tax administration reform has been completed through an important piece of tax legislation. An amended The Law of Administration of the Levy and Collection Tax of PRC (the “Tax Collection Law” or “TCL”) was passed in April 2001, in response to the requirements of WTO accession. The Tax Collection Law marks a major step in China’s tax legislation for conforming to WTO requirements. It articulates the rules for the administration of tax collection, stipulates various taxpayers’ rights, identifies clear standards for tax collection at both the national and local levels, and establishes penalties for various violations of tax collection. More importantly, the Tax Collection Law sets forth clear rules for combating

inconsistency in tax collection that have long plagued the certainty and reliance of tax administration. It also improves transparency to assure investors of predictable tax consequences of specific transactions.

Without doubt, establishing clear-cut standards for tax collection is prioritized by Chinese tax authorities to fight against local protectionism and corruption that drains revenue and distorts competition. The Tax Collection Law, along with its implementation regulations, largely prohibits cross-regional barriers and to certain extent combats tax evasion. It also helps consolidate domestic industries to improve competitiveness and operating efficiency. However, two major problems are unresolved. First, even the TCL stipulates various taxpayers' rights, the degree that tax administrations honor protection thereof remains uncertain. Rather, the TCL internalizes tax disputes within the tax administration system itself and to improve the internal management in the hope of monitoring the decentralization efforts of local tax bureaus. Second,⁷⁸ the tax administration is not matched with a full-bodied tax judicature system in reaching impartial judgment on tax cases increase. Issues such as irregular judgment of similar tax controversies, shortage of tax expertise of judges hearing tax cases, and intervention from various authorities all impede the uniformity and impartiality of tax administration, let alone the vacancy of a tribunal designated exclusively for tax cases. Tax judicature reform, again, constitutes a break-through point against which Chinese tax authorities need to testify its commitment under WTO.

⁷⁸ See *infra* Chapter VI

3.5. Summary

China's tax law system is not isolated; rather, it intertwines with other sectors of law. China's tax governance is essentially administrative. This subchapter has outlined the normative impacts of the WTO agreement on China's tax governance order from the tax legislation perspective in the hope to bridge the WTO principles and the tax administration system in terms of fulfilling the requirements raised thereof. Tax legislation also contributes to improving tax administration and protection of taxpayers' rights through the Tax Collection Law, which sets forth clear rules for combating inconsistency in tax collection and promoting transparency to assure predictable tax consequences of transactional behaviors. In addition, it requires an improved tax judiciary system to review tax administrative decisions and legislative actions.

The binding effect of the WTO agreements on the tax governance could be addressed with attention paid to three WTO principles: transparency, impartial and uniform administration, and judicial review.

The transparency principle implicates three ongoing issues in China's legal reform: (1) secrecy and lack of transparency in the tax legislation system partially stem from China's basic hierarchical organization structure. The process of tax legislation as to policy orientation and opinion collection should be open to public before final promulgation; (2) although the SAT released the "New Measures for Normative Documents", reckless or manipulative inconsistency or irregularities in local tax legislations in different localities still create ambiguity; (3) intervention from other administrative agents at

different hierarchical levels also complicates tax legislation reform by issuing overlapping and less formal notices and supplemental circulars.

The uniform and impartial administration raises the bar high for China's tax system, and especially for the tax legislation. Tax authorities usually suffer from incompetent discretionary capacity to administer ill-designed tax laws. Modern legislation techniques somewhat are missing in local tax legislation which lead to a proliferation of overlapping, repetitive, ambiguous and contradictory tax laws at various hierarchical levels. Various extra-legal factors impede the neutral and just implementation of tax laws, including political intervention, corruption of local tax officials, and local protectionism. China's favorable economic policies toward coastal areas bring in unbalanced uniformity and predictability. Given the political stakes put on local economic performance, many ill-defined, ambiguous and contradictory tax laws and regulations are enforced for local benefit, which causes inconsistency and unpredictability.

The judicial review requirement creates specific issues in the Chinese tax context. A key issue is the extent to which China's judges can exert independence in their delegated authority to review and correct tax administrative decisions.

This subchapter further discusses implications of the national treatment and the most-favored-nation principles. First, certain inconsistency against the national treatment principle is diagnosed even after a few major tax legislative pieces came into place in the past decade. However, the inconsistent treatment of Chinese domestic enterprises may have its merits. The benchmark is that

the national treatment principle by and large serves to restrict, not enlarging to enlarge the state's tax power. Second, overall, China has made tremendous efforts through tax legislation in accordance with the MFN principle even the definitions of many key words or commonly accepted practices thereunder are subject to broad interpretation. Two inferences are made based on a mix of different tax treatments towards FIEs and DEs: (1) the economic structure and development priorities invite flexible treatment toward specific industry lines or preferential tax treatments. Tax preferential measures are direct and enforceable in driving free trade of products and services without discrimination; (2) arising complaints from foreign investors on the non-transparent government procurement process may imply preferential tax treatments that are not available to foreign investors in negotiated procedures with competition bidding for government contracts. The tax implications of the government procurement process are not given enough attention according to the MFN principle of eliminating barrier to facilitate the mobility of goods and services among member countries.

Based on the normative general binding impacts of WTO's principles on the tax governance order, the next subchapter provides an overview of progress made as to specific areas of tax laws after China's accession to the WTO.

IV. Implications to the tax legislation reform – a formal perspective

Contemporary tax governance discourses require a balance of formal and normative perspectives. In particular, a dynamic between focusing on specific

areas of tax legislation as unique entities in the tax mix firmament, and a substantiation to the values of WTO principles under the globalized context for liberating trade and capital mobility. As discussed in subchapters above, for the Chinese tax legislation reform, the normative implications of the WTO accession enjoy some salutary effects. Accession requires a more sophisticated understanding of WTO agreements, draws focus to the substance of China's current tax system, and accentuates the interrelationship of China's tax governance structure and taxpayers' rights. Paradoxically, an over-emphasis or vague transplant of WTO principles may make tax reform somewhat less relevant than the specific legislation that gives them meaning in the Chinese context. Many of the proposals offered based on WTO principles are not practical for China's taxpayers or its tax administration, but, rather, could be manipulated to reach political or local empowerment. Indeed, many of values embodied in WTO principles are the same as those that make up a rule of law order. However, when stepping into details of tax laws reform in China, much of the intellectual application for WTO principles converges with the promulgation and enforcement of tax laws. This subchapter, therefore, discusses a few formal implications of WTO principles to specific areas of tax laws to evidence the progress and problems associated with tax legislation reform.

4.1.Implications for the turnover tax system

4.1.1. Value-added Tax (VAT)

Perhaps the most significant impact of China's accession to the WTO for foreign investors will be the opening of many industries previously closed to foreign investments, such as pharmaceuticals, high-end chemicals, banking and minerals. A key implication of WTO principles is the reform of turnover tax system, of which VAT is the most important turnover tax type. By definition, VAT is imposed on the importation and sales of goods, and provision of processing, repair, and replacement services. Currently, China has a production-type of VAT under which input VAT tax paid on the purchase of fixed assets cannot be used to offset output VAT on sales. As a feature of production-type of VAT, the non-creditable VAT on fixed asset investment played a role in reducing capital investment. Moreover, production-type of VAT regime favors low-tech, labor-intensive industries and penalize high-tech, capital-intensive industries that employ a large amount of fixed assets. Inevitably, a production-type of VAT reverses the original objective of promoting capital-intensive, high-value-added industries. As a result, China's tax authorities should value the impact and merits of allowing the recovery of input VAT incurred on fixed assets, especially in those industries closed to foreigners, to yield more profound economic benefits under WTO principles.

The second issue with VAT reform is the expansion of VAT basis. Chinese tax authorities have had discussed this topic even before the WTO accession. The idea is to include certain service industries that are currently subject to

business tax into the scope of VAT, such as finance, construction, communication, transportation, hotels, and restaurants. Proponents claim that those service industries, which attract most of the foreign investment after China's accession to WTO, thus expanding the scope of VAT to high-margin industries, will help generate more tax revenues. However, this thesis suggests two caveats to this basic notion. First, expanding VAT base will further complicate the current multifaceted VAT regime – it currently lacks methods to incorporate business tax items into the VAT. Second, in practice, the VAT is a state tax while the business tax is a local tax. Pending on current VAT-share formula, such expansion will reduce local revenues and require a readjustment of the share formula. The likely result is that this proposal will be rejected or manipulated by local authorities.

Another implication of VAT reform is a change in the percentage of VAT refund to exported products. According to international practices, exported goods are entitled to full refund of VAT. However, export VAT refund in China is calculated at rates ranging from 5 percent to 17 percent. Only certain exports related to machinery and equipment, electrical items and electronics, transportation equipment, instruments, and clothing are currently enjoying the full refund rate, but VAT on most other exported goods is still not subject to full refund. Obviously, such practice of partial export VAT refund disadvantages and weakens the competitiveness in certain industry lines. To this end, this thesis shares the position that the VAT refund mechanism should consider incorporating an actual-payment system for three reasons. First, there is a consensus among many tax officials and scholars that a consumption-type VAT should be supplemented to the current production-type VAT regime. The

actual-payment system helps avoid the underlying difference between the two types of VAT. Second, the actual-payment system is unresponsive to the difference among industries, which saves the burden of differentiating industries and simplifying the collection system; third, for China to attract foreign investments, the actual-payment system, especially if it is associated with consumption-based VAT, is more acceptable and accommodating to general international practice on VAT refund of other WTO members.

In addition to the proposals of incorporating the production-based VAT with a consumption-based VAT and restructuring the export rebate mechanism, with respect to VAT taxpayers, the definition of “small scale” taxpayers should be reconsidered. “Small scale” taxpayers in China are posited awkwardly due to the conflict of credit and deduction during the transactions with their counterparts – “regular” taxpayers.⁷⁹ The services sector dominated by disadvantaged small-scale taxpayers represents a higher and growing proportion of China’s fast GDP growth. Actually, small scale taxpayers account for much of local economy growth, increased employment opportunities and resourceful utilization of capital. Revenue from the services sector is essential to China’s dynamic economic growth. As the small-scale taxpayer find hard to issue VAT invoices, output VAT cannot be offset against input VAT and the tax base for small-scale taxpayers is the VAT exclusive sales value.⁸⁰

⁷⁹ See Article 2, Provisional Regulation of VAT of the P.R.C., stipulating that small-scale taxpayers engaged in selling goods or taxable services shall use a simplified method for calculating the tax payable

⁸⁰ The VAT exemption and refund policy also applies to goods exported for contracted engineering projects and repair and maintenance services. However, as stipulated by a Circular issued by SAT on 24 March 2005 (*Guoshuihan* [2005] No. 248), export enterprises exporting products purchased from small-scale taxpayers must present a VAT invoice to

Due to China's labor-intensive advantage and enlarged market opened under WTO, refining the status and management of small-scale taxpayers has to be in line with similar rules of other WTO member countries.⁸¹ For instance, small-scale taxpayers would benefit from tax simplification of VAT, and the importance of small-scale taxpayers must be valued by tax administration in revenue collection given the potential tax bases.

Therefore, one issue here is to redefine the status of small-scale taxpayers to crystallize the tax bases. Then, considerable tax administrative resources for VAT collection should be assigned to design an appropriate framework to control the number of small-scale VAT taxpayers, and to transform them to regular or ordinary VAT taxpayers. That being said, the following questions should be considered in future VAT legislation, although approaches to resolve them are in debate: (1) which kind of a "single tax" might be designed for small-scale taxpayer; (2) if there is a need to eliminate the "small-scale" taxpayer category, what are the meaningful and practical standards to classify small-scale and ordinary or regular VAT taxpayers or any particular social and political ramifications; (3) does tax administration overestimate the tax evasion channeled through small scale taxpayers; and (4) is there any alternative to address the small scale taxpayers within the current VAT structure or an overhaul is necessary. All of these concerns complicate the post-WTO tax legislation reform as to VAT.

obtain a VAT refund. In such cases, the small-scale taxpayer can request the tax authorities to issue a VAT invoice for products sold to export enterprises

⁸¹ Public perception of small businesses has been changed radically over the last decades in China. During the first 15 years of China's opening economy, small businesses were perceived as marginal to the mainstream of economic activity, and were typically cast as habitual tax avoiders and evaders

4.1.2. Consumption Tax

As an excise tax, the Chinese consumption tax is a means for the government to influence consumer spending behavior in terms of tax equity. Since the consumption tax was introduced in 1994, many commodities then categorized as “luxury” now are considered basics of daily urban life, including automobiles, cosmetic products, wine, and authentic Louis Vuitton handbags. Hence, an enlarged, open market under the WTO regime and increased citizens’ purchasing power would drive Chinese tax authorities to redefine the subjects and tax rates of consumption tax – many then “luxury” now “basic needs” goods should be excluded from the consumption tax basis. On the other hand, the scope of consumption tax basis should include certain “luxurious” services such as high-yield personal banking services or recreation activities. Moreover, this thesis submits that to nurture domestic interests, tax authorities should also consider imposing a reasonable consumption tax rate on certain goods that are currently not produced locally or, even those products can be produced locally, but the standards of domestic products might not reach those imported ones. This may help enrich the market by saturation of both domestic and foreign products.

4.1.3. Business Tax

Business tax is imposed on provisions of services and transfers of immovable and intangible assets in China. As Business tax and VAT are mutually exclusive, a reform to VAT will inevitably lead to reduction of scope of

business tax. For those important domestic service industries that will be opened to foreign investors following China's accession to WTO, the tax authorities should consider imposing an even lower business tax rate on insurance and financial industries to drive the growth into a true "market" with healthy competition and easy entrance. However, the timing is not ripe to combine the business tax with the VAT. One important reason is that the VAT is a state tax under a central-local sharing formula, but the business tax is collected by local tax bureaus. Such combination may induce a readjustment of the sharing formula between central and local governments. Given the potential of reduced local revenues, very likely such combination will be rejected or manipulated by localities.

4.2. Implications for Enterprise Income Tax

The implications of China's accession to the WTO on the income tax regime centers on two major WTO non-discriminatory principles: the national treatment and most-favored-nation principles. The current Chinese income tax law framework derives from the tax system overhaul conducted in 1994. One of the foremost income tax legislation reforms is the enactment of the new Enterprise Income Tax Law effective as of January 1, 2008. The new Enterprise Income Tax Law (the "2008 EIT Law") actually is one of a series of updated legislative efforts catering to principles of the WTO and the rule of law order. Other major legislations include the new Corporation Law (2006), the Anti-Money-Laundering Law (2007), and the Anti-Monopoly Law (2008),

all of which were engineered and devised to follow an international practice in related areas.

The 2008 EIT Law unified a bifurcated enterprise income tax treatment in force since 1994. Prior to 2008, China enterprise income tax law system consists of two parallel sections which regulate income tax on Chinese-invested enterprises (DEs) and income tax on enterprises with foreign investment and foreign enterprises (FIEs), respectively. Undoubtedly, China's two-track structured income tax law system has provided an easy platform for enhancing China's economic stability, safeguarding national economic advantages, and coordinating between DEs and FIEs. However, with China's WTO accession and the need to expand revenue collection, drawbacks of a dual-track income tax become readily apparent. In addition to various complaint from foreign investors on confusing treatment of different types of corporate entities, intensified administration on tax collection, frequent tax evasion, and compliance with WTO's national treatment rule all contribute to the urgency of the China's need for the newly promulgated the 2008 EIT Law.

4.2.1. The pre-2008 bifurcated enterprise income tax treatment

The bifurcated enterprise income tax system for DEs and FIEs is historically rooted and well established in China.⁸² Briefly, the track of DE income tax system evolved through the painful process of SOEs reform and a changed the balance between state-owned and private sectors in terms of economy scale and revenue contribution. The development of the FIE income tax law system

⁸² See *supra* Chapter II.

mirrors China's tax preferential policies embracing foreign investment and international coordination. However, tax collection deficiency and global trade bring the drawbacks of China's dualism in its enterprise income tax law system to the fore in enforcement and administration. The following are major problems in the old "dual track" enterprise income tax system that led to the promulgation of the 2008 EIT Law.

4.2.1.1. The costly dividing criteria of DE affecting tax efficiency

Based on China's hierarchical tax administration structure, the 1994 enterprise income tax regime classified DEs into two groups with regard to income tax: those directly subordinate to the central government, and those to local governments. Accordingly, DE's income tax liabilities are controlled some by the central and some by local governments. Characterized by the discord and rigidity of a traditional command economy, such a tax-sharing structure lead to a distorted relationship between various tax authorities on partitioning revenue collection, and impeded an appropriate fiscal structure. A deep-rooted administrative loophole is that every level of tax authority aims to control the direct administration and collection of the income tax. Some SOEs are privileged to enjoy particular incentives conditioned on types of enterprises and this leads to designated preference and unfairness. Since the revenue partitioning and administrative hierarchy make the tax collection and tax law enforcement come under various levels of administration, the costs of tax collection are increased and uncertain. Worse is that the competent level of the

state treasury to collect a given tax is unclear and enterprises are bedeviled by cross collection and administration at will.

4.2.1.2.III-designed tax collection and administration system

The DEs enterprise income tax collection and administration are full of misapprehension and confusion. First, tax collection implementation has historically been subject to distortion. The old Provisional Regulations for Enterprise Income Tax provided that enterprises with independent books and accounting should pay taxes locally, yet it also provided that the sectors of railroad, civil aviation, postal service and banking should be collected on an industry basis. This mixed industry and hierarchical collection approaches added another double-layer to the dual track system, especially when many restricted markets were opened after the WTO accession. Second, irregular tax collection activities lead to inconsistency in administration and weaken the controlling role of tax authorities.⁸³ Third, although theoretically state and local tax authorities carry out uniform measures for the income tax collections, a parallel structure was set up to apply separate rules.

4.2.1.3. Taxable income vs. accounting income

Under the Accounting Standards for Business Enterprises (ASBE) promulgated by the MOF in 1992, a set of accounting rules specifies the

⁸³ for Chinese-invested enterprises, to which the authority of collection and administration of the income tax on the non-state-owned ones is allocated to the local tax authorities, whereas the income tax on the state-owned enterprises, nominally collected and administrated by tax authorities, is actually controlled by different levels of administrative organs.

categories and differences between taxable income and accounting income. However, the gap therein makes it more difficult for tax authorities and taxpayers, especially DEs, in practice.⁸⁴ A prime example of this is the lack of a uniform standard for the deduction of salary and donation, depreciation, tax auditing, bad-debt clearance and conflicts between provisional rules and local policies applied to the state-owned enterprises.

4.2.1.4. Narrowly defined enterprises income tax incentives

Despite the purpose of attracting foreign capitals with advanced technologies and developing infrastructure of bottleneck industries, the old FIE income tax incentives do not live up to national treatment and MFN standards. First, the industry lines of foreign investments are too narrow. The overall quality of foreign investment is relatively concentrated on labor-intensive nature instead of technology-focused or capital-intensive orientation. Second, the disparity and imbalance in economic development aggravate the loopholes in enforcing tax incentives. The preferential policy has evolved into an uneven FIE income tax policy. From special economic zones, to coastal economic development zones, and further to hinterland regions, the tax rates become progressively uneven. Such tax rate structure inevitably creates unfair competition and further worsens preferential policy shopping.

⁸⁴ The Provisional Regulations for Enterprise Income Tax and the Income Tax Law Concerning FIEs and Foreign Enterprises have both stipulated that when, applying to its own accounting method, the accounting income of a taxpayer is not agreeable to the applicable provisions of tax law, the income tax shall be determined by the applicable provisions. However, there are some practical concerns in implementing such general provisions

4.2.1.5. Irregular tax rates applied

The tax rate is the core of tax legislation in terms of simplicity, enforcement, transparency and fairness. The old two-track enterprise income tax system imposes the same tax rate for DEs and FIEs – a nominal rate of 33%. However, due to various exemptions, stipulated tax holidays, and local tax incentives, the actual tax rate for FIE income is substantially lower than that of DEs. It is estimated that FIEs were actually charged at rates ranging from 17% to 27%. This difference aroused complaints from DEs about their disadvantaged position in market competition and reinvestment. Moreover, quite often domestic capital takes a “detour” overseas to be coated as foreign capital to enjoy tax preferential policies, which leads to draining of revenue and complicated tax administration. Considering the international trend of lowering corporate tax rate, a uniform tax rate applying to both DEs and FIEs was highly pledged by domestic interests.

4.2.1.6. Summary

As noted, the pre-2008 income tax law system complicated preferential tax treatments on enterprises of different ownership or capital sources, in different regions, and on different industries and productions lines.⁸⁵ As a result, enterprise income tax reform in large part centered on the unification of the bifurcation tax treatments for DEs and FIEs. First, the tax efficiency consideration drove the removal of irregular administrative activities

⁸⁵ See, Jinyan Li, *The Rise and Fall of Chinese Tax Incentives and Implications for International Tax Debates*, 8 Fla. Tax Rev. 669, at 675

associated therewith. Vertically, the structure of revenue partitioning between the central and local on DEs income tax was not well formulated. Horizontally, even at the same hierarchical level, two separate systems for DEs and FIEs created nuances in tax collection practice. Second, the difference between the actual income tax rates for DEs and FIEs was with highly disparate. A uniform tax rate, regardless of capital sources or ownership, is necessary. Third, the accounting standards imposed by ASBE and modernization of SOE reform require similar tax treatment for DEs and FIEs such as deduction, appreciation, and booking practices. Fourth, complaints from DEs were partially based on the national treatment principle, with which they sought to remedy their disadvantaged position in market share and competition.⁸⁶

The promulgation of the 2008 EIT Law also conditioned on the WTO principles. The unification of enterprise income tax treatment would help create fair competition and investment conditions. In light of commitments made in the Protocol, tax preferential policies should be adjusted for assurance and supervision with transparency and uniform administration, especially for regions or industry lines that are badly in need of FDI. The tax authorities should continue benefiting FIEs in an encouraging but careful way, for the purpose of complying with the national treatment and MFN principles. Certain innovation in enterprise tax laws should be incorporated following international practice – attention should be paid to balance exacerbation of disparity which might create political sensitivity in China.

⁸⁶ *Id.*, at 676-682

4.2.2. The 2008 EIT Law

Given the challenges raised by the bifurcated tax treatments and deficiencies in tax administration, the 2008 EIT Law incorporates both corrective measures and modern corporate tax conceptions. In terms of tax rate, taxpayer categorization, taxable income determination, tax credit, tax preference, tax evasion, and tax administration, the 2008 EIT Law provides a better income tax framework with an emphasis on international tax.

4.2.2.1. An improved unified tax rate?

The tax rate⁸⁷ is essential to revenue collection and central to the dynamic balancing taxpayers and the state in terms of private property rights. Enterprise income tax rate is even more evident or decisive in regulating taxpayers' transactional or planning behaviors. Therefore, the design of an enterprise tax structure reflects the status of overall economic development and rule of law considerations. According to the 2008 EIT Law, the statutory tax rate for regular enterprise taxpayers is stipulated as 25%, a tax rate of 20% for small-scale enterprises and 15% for state-sponsored high-tech enterprises.

It is well noted that the uniform 25% rate is a compromised number after evaluating various factors. First and foremost, the 25% rate reflects the effective or actual tax rate applicable to FIEs under pre-2008 tax treatment – no extra burden is created considering the tax preferential treatments

⁸⁷ See Reuven Avi-Yonah, *Corporate and International Tax Reform: Long-, Medium-, and Short Term Proposals*, <http://law.bepress.com/umichlwps/olin/art106>, discussing the global trend on corporate tax rate reduction (last visited on March 15, 2011)

grandfathered under the old FIE tax treatment. Moreover, the tax burden of DEs is reduced to an acceptable level for carrying on business and generating reinvestments. Second, although the 25% rate is higher than that of Hong Kong (16.5%-17.5%), it is quite competitive comparing with statutory rates at peer neighboring tax jurisdictions such as Japan (20%), South Korea (27.5%), Vietnam (28%) and Malaysia (28%) as well as statutory rates adopted by developed tax jurisdictions in U.S. (35%), France (33.3%), Germany (25%), U.K. (30%), Italy (33%). This comparative advantage was highly valued in the legislative opinion collection process for two causes: (1) the rate should allow the Chinese market to remain competitive and attractive to FDI; and (2) it shall not substantially jeopardize the scale of national revenue collection. Third, from the perspective of tax collection and administration, the uniform 25% rate facilitates compliance and cross-regional consolidation of tax liabilities.

However, the benefit of a uniform tax rate should not be exaggerated. It is too early to claim such a uniform rate will improve tax equity and efficiency in a modern sense. Ultimately a uniform statutory rate only prevents tax inequality or cures deficiency. The inefficient partitioning formula between the central and local government still exists. The effective tax rates for DEs and FIEs in large extent are still different – the 2008 EIT somewhat only helps narrow the divergence. Moreover, although the nominal tax rate drops by 8 percent from 33% to 25%, this decreased rate is only reflective of existing effective tax rate in practice. From a microeconomics point of view, the tax burden is not, in fact, lowered as much as the rate change shows. From the revenue collection perspective, given the limited fiscal contribution made by the enterprise

income tax sector, a lowered uniform tax rate with expanded taxpayer base does not substantiate tax authorities' position that extra-intensified compliance control should be implemented for revenue collection.

4.2.2.2. Clearer categorization of enterprise taxpayers

The 2008 EIT Law classifies taxpayers as “resident” and “non-resident”⁸⁸ taxpayers in accordance with international standards of “place of incorporation” and “effective management.” The outmoded categorization based on sources of capital, i.e., the two-track DE and FIE bifurcation,⁸⁹ was repudiated to expand the scope of taxpayers to include all units and organizations⁹⁰ with business operation and income in China – but individual proprietorships and partnerships are excluded. Overall, this clearer categorization is wise for three reasons.

First, the Marxist ideological delineation of “socialist ownership by all people” still plagues the tax system. The line between socialist collective or commune ownership and “private ownership” is blurred given the overall economic situation and establishment of modern corporate governance structures comprising publicly held corporations and shareholders. Sticking with stereotype classification would only perplex tax administration and impede tax collection. In this sense, the revised classification based on commercial

⁸⁸ See Art. II, The EIT Law of the P.R.C.

⁸⁹ *Id.*, Art. I, stipulating that the taxpayer for enterprise income tax is “any enterprise except for individual proprietorship and partnership, and other organizations which has income.”

⁹⁰ See *infra* Chapter VIII, noting whether the organization should include non-profit organization is still in debate. Different from the U.S., which has the UBIT, the tax treatment of income generated by nonprofit organizations is not clear

profitability and business entity is a forced move rather than voluntary progress. Second, the exclusion of individual proprietorships and partnerships from the EIT application looks like a cautious makeshift. One probable reason is that China does not have a modern piece of comprehensive tax legislation for either individual proprietorships or partnerships. The other reason is that the EIT compliance system is not able to synchronize individual income tax to consolidate income generated by individual proprietorships and partnerships. Third, the classification of “resident” and “non-resident” enterprises is a perfect example of borrowing concepts from the individual income tax context. The advantage of this approach is that it simplifies tax administration based on standards of “place of incorporation” and “effective management”. In this sense, this classification embodies an improvement in tax equity solely for tax collection purposes and in tax efficiency by identifying and administering presence of commercial benefits.

4.2.2.3. Coordination of standards for taxable income and accounting income

Progress made by the 2008 EIT Law includes a better coordinated taxable income calculation from the ASBE perspective. For the first time, the 2008 EIT Law stipulates that taxable income in each taxable year is derived by deducting non-taxable income, exempted income, various deductions and remaining sum from covering losses in the previous year from the total income. The non-taxable income and exempted income actually are tax accounting concepts attaining more economic sense for tax auditing purposes. The 2008 EIT Law also unifies standards for deduction calculation in determining

taxable income.⁹¹ For instance, *reasonable* expenses actually incurred in production, management and other relevant business activities, such as costs, expenses, taxes, losses, and other miscellaneous expenses, can be deducted in calculating taxable income. In this sense, tax equity is better realized by honoring the principles of the ability to pay and accrual basis.

4.2.2.4. *A more centralized framework of tax incentives for investment*

Tax preferential policies stipulated in the 2008 EIT Law reveal considerable controversy over whether those incentives are effective or desirable,⁹² i.e., for which incentives that the Chinese government would take the loss the revenue as a tradeoff.⁹³ In the 2008 EIT Law, different modes of amending previous tax incentives co-exist – some old preferential policies are kept,⁹⁴ expanded,⁹⁵ modified⁹⁶ or even voided.⁹⁷ A careful reading of tax incentives would

⁹¹ See Article VIII, The EIT Law of the P.R.C. (2008)

⁹² See generally in David Holland and Richard J. Vann, in Victor Thuronyi ed. *Tax Law Design and Drafting*, 986-1020

⁹³ See generally in Alex Easson, *Tax Incentives for Foreign Direct Investment*, BIFD 266 (July 2001)

⁹⁴ See Art. 27, the EIT Law of the P.R.C. (2008), stipulating that for tax preferences for investment on agriculture, forestry, husbandry and fishery industries, and public infrastructure, and Article 28(1) provides that tax preference is still reserved for small-sized enterprises with meager profit

⁹⁵ Articles 31 and 34, the EIT Law of the P.R.C. (2008), eliminating the regional tax preference limitation confining to high-tech industries the low tax preference of 15%, adds tax preference for venture investment, expands investment tax credit applicable from environment protection equipment and water conservation facilities to equipment of environmental protection, water and energy conservation and safe production etc.

⁹⁶ Articles 30(1) the EIT Law of the P.R.C. (2008), changes direct tax preferences into indirect tax preferences, such as wage paid for disabled people by labor service enterprise, welfare enterprise; Article 33 provides that income earned by products in conformity with industrial policy produced by resource comprehensive utilization enterprise, Article 30(1) allows research and development fees to be added up and deducted, and Article 30 permits accelerating depreciation, or shorten depreciation time of fixed asset in the enterprise

⁹⁷ Some old preferential tax policies were repudiated, such as the preferential policy providing periodic tax reduction or exemption to newly-established production-oriented foreign-invested

disclose that the central government is strongly favored with a controlling position in designing tax incentives. Incentive legislation policy power, once delegated to regional tax authorities, was centralized to integrate industry-oriented or region-preferred schemes. The merits of this development are three fold. First, it strengthens a nationwide tax incentive scheme to ensure a balanced and improved development framework for various industries. For example, the 2008 EIT Law prioritizes environmentally friendly and high tech sectors. Second, centralized control helps circumvent local protectionism and cross-region tax incentive shopping by foreign investors, which may lead to interregional development disparity. Third, an integrated incentive framework is advantageous to simplifying the tax administration, and more importantly, to increasing efficiency in revenue collection.

4.2.2.5. Development in international tax – tax credits and anti-avoidance system

The 2008 EIT Law incorporates the long-awaited international tax credit system.⁹⁸ Briefly, for income originated offshore which has already been charged tax in the source country, the tax paid should be deducted from tax liabilities in China, if the deductible amount is lower than that of tax calculated under Chinese tax laws. The tax credit system marks one of very few developments in the international aspects of Chinese tax legislation in

enterprises or to enterprises after the transitional period ends, and preferential policy which levies only half the tax on export-oriented foreign-invested enterprises. For details, see Jianwen Liu, *Eight Innovations of the New EIT Law*, http://www.cftl.cn/show.asp?c_id=550&a_id=6948 (last visited on March 15, 2011)

⁹⁸ See Articles 23 and 24, the EIT Law of the P.R.C. (2008)

recent years. Undoubtedly, it constructively avoids international double taxation and advances principles of tax equity.

Another march that the 2008 EIT Law advances is the insertion of anti-avoidance measures.⁹⁹ Three prongs of consideration prompted the validation. First, after 30 years of accommodating FDI, thin capitalization and profits transfer after exploitation of tax incentives by foreign investors endanger the revenue collection at various fronts. In addition, increased capital mobility incentivizes exploiting tax havens for round-tripping which acerbates the draining of collectable tax payment. As a shared practice, tax avoidance measures are adopted to safeguard revenue sources. In this connection, the 2008 EIT Law catches up with international routines. Second, the arm's length principle is established for transfer pricing and advanced pricing agreement practices. This is an encouraging move made in the 2008 EIT Law for modernizing tax administration. Since many multinationals treat the China market as indispensable for global profitability, the growing commercial expansion requires China's tax administration to master basic tax rationales to guarantee safe tax sovereign and revenue collection – the adoption of the arm's length principle provides a perfect example. Third, a few modern corporate law elements are embraced in the 2008 EIT Law. Tax treatments for closely-held corporations are detailed as to tax payments consolidation and compliance. One reason for this change is that irregular tax planning activities exploit the loopholes in cross-region tax administrative coordination. The other reason falls on the expertise and competence shortage suffered by local

⁹⁹ See generally, Section IV "Special Tax Payment Adjustment", the EIT Law of the P.R.C. (2008)

tax officials. A nationwide EIT law would leverage more discretion in handling complicated corporate structure issues.

4.2.2.6. *Increased support for tax administrative discretion*

Under the 2008 EIT Law, administration is in line with the classification of taxpayers based on “place of incorporation” and “effective management” principles.¹⁰⁰ The old enterprise income tax system evidenced a deficiency in this connection. Two lines of tax administrative discretion are evident. First, the consolidation of tax payment is administered more collectively. Taxpayers are not required to consolidate books of branches, representative offices, and subsidiaries to reach a final tax payment. Meanwhile, the headquarters may serve as the liaison point to fulfill tax liabilities. Second, the 2008 EIT Law honors the principle of non-retroactivity in administration, i.e., tax incentives would be grandfathered for taxpayers which have enjoyed tax incentives based on the old enterprise income tax system. Therefore, the solution of *old enterprises old way, new enterprises new way* should be enforced for FIEs concerning preferential tax treatments. According to Article 57 of the 2008 EIT Law, an enterprise established before the promulgation of the new law,

¹⁰⁰ See Articles 3(2) and 3(3), the EIT Law of the P.R.C. (2008), if a non-resident enterprise obtains income, the office or the site where the income occurs is considered as place of tax payment. If the non-resident enterprise has two or more than two offices or sites in China, the main office or site shall be chosen to pay enterprise income tax; if a non-resident enterprise acquires income, the place of the withholding agent is considered as the place of tax payment. As for headquarters and branches, if a resident enterprise set up business establishment of non-corporate status, enterprise income taxes of the headquarters and branch should be added up and calculated on a consolidated basis

which enjoyed a preferential tax rate according to the old tax law or tax regulations, then it will enjoy a 5-year grace period.¹⁰¹

4.2.2.7. Summary

Overall, the 2008 EIT Law is a hopeful piece upgrading the tax legislation and administration system in China. It not only is in line with the WTO principles and international tax practice on transparency, improved administration, and non-discrimination, but also helps establishing important elements of the rule of law order in terms of consistency, non-retroactivity and clear-cut obligation. Given the rich modern tax concepts embodied therein, it showcases improved legislative techniques in the tax context in terms of a unified tax rate, clearer categorization of taxpayers, synchronization with ASBE standards, tax credit and anti-avoidance measures.

It is continually significant to mention that it still aims for revenue collection and internalizing administrative discrepancies. The 2008 EIT Law is not without limitations under the revenue-sharing formula between the central and local governments. The consolidation of tax payments and compliance still suffers from a shortage of detailed rules on approval and tax auditing

¹⁰¹ See Article 57, the EIT Law of the P.R.C. (2008), enterprise which enjoys periodic reduction and exemption of income tax can continue to enjoy the preferential treatment after the implementation of the Law. But if the enterprise did not enjoy preferential treatment because of non-profitability, the preferential period will be calculated from the year of enforcement of the Law. High-tech enterprise which needs key support of the State in regions of economic cooperation and technology exchange with foreign countries, and in regions with special policy as prescribed by State Council, can enjoy transitional preferential treatment of the transitional nature. Other enterprises whose establishments are encouraged by the State, can enjoy tax reduction and exemption preferences according to regulations prescribed by State Council

procedures. The arm's-length principle adopted for transfer pricing and advance payment agreement is not often initiated or applied for domestic cross-region tax planning. Meanwhile, a centralized control on tax incentives promulgation may over-tailor a non-applicable nationwide administration practice. All these problems will emerge coupled with incompetency in tax administration.

4.3. Individual income tax (IIT)

Over the past three decades of economic development and livelihood improvement, although the IIT legislation has been amended five times,¹⁰² the current IIT Law¹⁰³ remains nascent and incomplete. Generally, the Chinese IIT adopts tax jurisdictions based on “residence” and “source” principles – a tax resident¹⁰⁴ is liable to the IIT on her worldwide income whereas a nonresident is liable for her Chinese-source income. Given the turnover tax dominant tax governance structure, IIT either for revenue contribution or as the main tool of redistribution suffers from less attention. Introduced firstly in 1980¹⁰⁵ for imposing an income tax to foreign individuals employed in China, the IIT is

¹⁰² Five amendments were made in 1993, 1999, 2005, and 2007 (twice), *see* SAT official website: <http://www.chinatax.gov.cn> (last visited on March 15, 2011)

¹⁰³ Individual Income Tax Law of the People's Republic of China, adopted by the 4th Session of the Standing Committee of the 8th National People's Congress on October 31, 1993, and promulgated by the president on the same date. Implementing Regulations for the Individual Income Tax Law of the People's Republic of China, issued by the State Council on January 29, 1994

¹⁰⁴ This thesis uses the term “individual” referring to as a “physical person” or “natural person”

¹⁰⁵ The Individual Income Tax Law of the People's Republic of China was enacted by the 3rd Session of the 5th National People's Congress and promulgated September 10, 1980. Detailed Rules and Regulations for the Implementation of the Individual Income Tax Law of the People's Republic of China were approved December 10, 1980, by the State Council and promulgated December 14, 1980, by the Ministry of Finance

more symbolic than fiscal to the international community that the Chinese tax context is compatible with the market economy and conducive to international investment. Mostly, Revenue collection contributed by the IIT was not significant enough and the IIT bases were too narrow to actually influence redistribution. Although it increased eight-fold from 1980 to 2010 as a percentage of total tax revenue,¹⁰⁶ the IIT does not perform as a meaningful tool of redistribution like its counterparts in western tax jurisdictions. On the other hand, although revenue contributed by IIT is insignificant comparing with turnover taxes,¹⁰⁷ the amount of IIT revenue increased rapidly.

Since China's accession to the WTO, however, the fiscal and redistribution functions of IIT have become more evident and recognized. There are three prongs of causes. First, for the past decade, the enlarged income disparities among taxpayers have greatly exacerbated the tension between the wealthy and the low-income groups in both urban and rural regions.¹⁰⁸ Second, with private property rights established in the Constitution and the stringent IIT compliance requirements, the awareness of individual taxpayers' rights focuses more on the equity and efficiency of IIT. The requirements of compulsory withholding and voluntary tax compliance for high-income taxpayers lead to questioning on redistribution function of IIT when larger share of their income are

¹⁰⁶ In 1980, revenue contribution by IIT is approximately CNY 0.1 million, accounting for less than 1 percent of total tax revenue; in 2010, approximately CNY653 billion, accounting for more than 8 percent of total tax revenue, State Administration of Taxation, Tax Statistics. <http://www.chinatax.gov.cn> (last visited on April. 10, 2011).

¹⁰⁷ For example, the combination of revenue from VAT, Business Tax and Consumption Tax accounts for approximately over 62% of total tax revenue in 2010. <http://202.108.90.130/n8136506/n8136593/n8137633/n8138832/10637226.html> (last visited on March 15, 2011)

¹⁰⁸ See generally, People's Daily: Disparity of Income Worsens the "Disadvantaged Mindset" of Citizens (November 11, 2010), (人民日报:收入差距加大致国民“弱势心理”蔓延), http://news.xinhuanet.com/politics/2010-11/11/c_12760474.htm (last visited on March 15, 2011)

taxed.¹⁰⁹ Third, tax administrative deficiencies in IIT collection dishonor the tax credit and international coordination. Although various bi-lateral tax treaties have been contracted to avoid double taxation, given the increased cross-border mobility of labor and capital, IIT collection actually complicates the tax administration in favor of tax authorities. Having noted the above, the IIT legislation itself is left far behind from reform.

The Chinese IIT mostly is a scheduler and largely gross-basis taxation. Its collection usually is completed by direct source withholding from the source for easy calculation and administrative control. In this sense, tax authorities, in large measure, rely on employers to complete IIT collection. However, the Chinese IIT system suffers from the lack of tax equity and efficiency which arouse media attention and popular protest against current IIT Law.

First, based on the principle of “ability to pay,” the IIT fails to meet vertical equity with a progressive tax rate schedule, i.e., higher income is charged with higher tax. Taxable individual income is not measured on an annual, comprehensive basis; rather, IIT calculation adopts a scheduler basis and is determined monthly or for each payment. Joint-filing is not allowed in China – a taxpayer’s household income is not valued and no relief is given familial obligations, such as child-care, education, and medical expenses.

Second, in terms of horizontal equity, i.e., same tax liability for taxpayers with the same dollar, under the current Chinese IIT Law, only employment income, such as salary, dividends and service charges, and certain business income are

¹⁰⁹ See generally, Chang’an Li, The Poor’s Contribution Outshines the Wealthy? CHINA SOCIETY PERIODICAL 2005 (30) (李长安：中国个税：穷人贡献大于富人？中国社会导刊) (2005)

subject to the high progressive IIT tax rates schedule. Income from other sources is not taxable at the same rate or even not subject to tax. Because quite large portion of personal income is obtained from self-employment, capital investment or even “black-box” sources by those high-income earners, the IIT sources are short of control. Moreover, IIT for foreigners and Chinese citizens are calculated under different formulas and deduction arrangements which create nuances in tax administration.

Third, tax efficiency is heavily impaired by the current IIT Law. As to the collection system structure, China does not have an IIT return filing system available. Although the SAT stipulates that individual taxpayers with annual income of RMB120,000 must file an IIT return, the administration of this filing regime is weak. The IIT system lends itself to manipulation by well-designed tax planning activities or specific arrangements to avoid tax. The administrative efficiency is distorted by the draining of IIT revenue and leaves opportunities for corruption of bribing partial IIT payment.

Overall, China’s IIT system contains biased and oversimplified rules with insufficient tax administration. Surprisingly, other than playing a symbolic game of increasing the IIT deduction threshold a few times, there are weak political pressures and reform proposals calling for a more neutral and efficient IIT law system. Meanwhile, the deficiency in IIT administration demands transparency and impartial administration with predictability. Almost no individual taxpayer would seek judicial review to challenge controversial IIT collection. Returning to a jurisprudential analysis, the IIT legislation should be reexamined to better realize the efficiency and redistributive functions of IIT. For example, in terms of consistency, each of five

amendments would waste tremendous legislative resources. The IIT Law should play a more proactive role in redistributing social wealth and resolve tensions caused by income disparity.

4.3.1. Drawbacks

China's IIT Law has been quite passive in taking care of issues popping up from time to time. Therefore, it is plagued by many issues such as monitoring high income taxpayers, IIT thresholds, measures to increase taxpayer awareness, and inconsistency with international practice. Drawbacks of the IIT regime are summarized as below.

4.3.1.1. Inadequate scheduler arrangement

China adopts a scheduler system and a flat rate to facilitate IIT withholding at source. Income from employment is subject to a progressive rate schedule ranging from 5 percent to 45 percent, while itemized income such as royalties, interest, dividends, bonuses, lease of property, transfer of property and like kind income that is not paid for the labor, is subject to a flat rate of 20 percent. However, individual taxpayers' income portfolios have become much more enriched than in the early 1980's when the scheduler system was designed. Flourishing capital investment and private wealth aggregation make people rely less on income from employment. In this sense, the current IIT scheduler system does not honor the "ability to pay" and "tax equity" principles by leaving a great gap to locate legitimate bases for revenue collection – the

direct withholding at sources cannot remedy the loophole or create tax evasions through unethical accounting practice. On the other hand, taxpayers generally do not file a tax return to report tax liability unless they receive income from multiple sources or tax is not withheld by the payer. This leaves a large portion of income unreported and untaxed. Given the shortage of tax compliance culture in China, the scope of the IIT system is no longer compatible with diversified and expanded income composition.

4.3.1.2. Ill-proportioned structure of tax rate

A progressive IIT tax rates schedule is widely recognized as an international practice.¹¹⁰ Usually, income that cannot be itemized should be taxed at differentiated proportioned rates. In contrast with reforms adopted in western tax jurisdictions which support lower IIT tax rates, reduction of the number of grade of tax rates and widening tax base, China's IIT tax rate schedule remain highly progressive with the highest bracket as 45%. Three corrections should be made to the current IIT tax rate schedule. First, the classification of progressive rates applied to income in excess of threshold amount is too complicated. In addition to IIT imposed on sole proprietorship and partnerships, this classification complicates collection with a four-category rate structure, which is even further differentiated. Second, there are too many brackets of progressive rates on non-itemized income such as salary, and the marginal rate between grades is unreasonably high. Third, the standards of

¹¹⁰ See generally, Victor Thuronyi, *Tax Law Design and Drafting*, IMF, Preface, noting the U.S. and other OECD countries adopting a progressive IIT gradually since the late 1980s

establishing progressive rates are incoherent between different brackets of tax rates. For example, no statistical study substantiates a RMB20,000 difference for the tax rates from 25% to 35% within 3 brackets. This imposes an unnecessary tax burden and complicates the IIT calculation, especially for income from remuneration for personal service and intellectual property (e.g. royalty);

4.3.1.3. Illogical design of expense deductions

Another common complaint against China's IIT is the frustration as to unclear rules on expense deductions. Briefly, there are two measures of deduction under the Chinese IIT Law: quota deduction and rate deduction. Income from wages and salaries shall be on quota deduction, while the concession for intellectual property, the remuneration for personal service and like kind services shall be taxed by combining quota deduction and rate deduction. In practice, the deduction measures complicate tax liability determination by overlooking actual burden on the taxpayers. The diversified portfolio of personal income through education, housing and social security makes it difficult to apply a reasonable expense deduction schedule to accommodate various aspects of economic well-being. On the other hand, the monthly deductible amount for income from wages and salaries remains symbolic although it has been amended quite a few times. Such revision is not without its merits considering the inflation and social wealth redistribution. However,

it manifests a shortage of legislative techniques on deciding deduction measures.

4.3.1.4. IIT collection and administration:

Source withholding (and remitting) and filing (reporting) tax returns are two major ways realizing tax collection. However, voluntary tax return filing only applies to high income earners. Due to the incompleteness in tax return filing computerization, deficiency in tax audit and inspection, and weak synchronization of enterprise income tax with IIT, a modern collection and administration system is not available in China. This deficiency might be a good thing for many high income earners given the lack of tax compliance culture in China. However, in a long run, the weak administration of IIT would jeopardize revenue collection and exacerbate wealth disparity. First, the process of tax return filing is not standardized. No practical and integrated tax filing rules and compliance standards is available, nor individual income reporting, self-assessment tools and investigation system are established. Second, due to voluminous cash transactions in practice pushed by the loose banking transactional control, tax authorities are confronted with the dilemma of choosing between weak monitoring of high income groups and setting up a check system of all taxpayers. Third, the method of withholding and remitting tax is not comprehensive. Although it is stipulated that the enterprises (units) or persons must withhold and remit taxes and make special notes for the future audit, there are no systematic and feasible measures to assure or improve fulfillment of this obligation and, pertinent tax laws become a dead letter.

4.3.2. Reform proposals

The reform of individual income tax laws should focus on tax equity and efficiency principles with efforts to improve neutrality and transparency. The legislation reform of Chinese IIT Law should be overwhelming. Priorities should be given to broadening tax base, adjusting preferential policies and fighting against tax evasion. In light of the WTO principles of transparency, uniform and impartial administration, China's commitment in Protocol, as well as basic elements enclosed in a rule of law order, the following measures should be emphasized if a new IIT Law is in expectation.

4.3.2.1. Refining the scheduler system

Transition to a comprehensively classified income tax system is necessary for Chinese IIT system. Income tax is usually imposed by “definitional structure” (scheduler or global) based on the concept of income (accretion, source or thrust concept).¹¹¹ Among three major kinds of income taxation systems: item-categorized income tax system, comprehensive income tax system and comprehensive item-categorized income tax system,¹¹² the third should be adopted in the Chinese IIT system.¹¹³ The rational is simple: the item-

¹¹¹ See Victor Thuronyi *Comparative Tax* (Kluwer Press, 2003) at 233

¹¹² The standpoint of item-categorized income tax system is that income of different nature is taxed differently for the convenience of controlling tax administration and saving cost of collection. Yet it is suspected to discord the principle of levying tax on ability-to-pay. Although the comprehensive income tax system meets the principle of levying tax based on the actual paying ability of taxpayers, the collection process would be very complicated and may lead to unforeseeable tax evasion.

¹¹³ Historically, the 1980 Individual Income Tax Law of China, first income tax law of China's opening economy, once took advantages of such comprehensive item-categorized

categorized tax system, though easy to implement, does not pay proper attention to the taxpayer's actual paying ability, and the comprehensive income tax system. The comprehensive item-categorized income tax system combines advantages of the above two systems, i.e. regrouping wages, salaries, income from contracted or subcontracted operation of enterprises or institutions, income from lease of property, and income from transfer of property into a comprehensive income, at progressive rates after a reasonable expense deduction. As to income from other sources, a proportional tax rate should remain applicable.

4.3.2.2. Introducing the family-taxpayer practice

The principles of transparency and tax equity demand the treatment of individuals and families as taxpayers.¹¹⁴ In terms of equity and efficiency, treating the family as a taxpayer is a rather proper way to tax incomes from other sources than labor, including interest, dividend, bonuses, concession fees and so on. The source of the withholding would overlook various factors that might potentially impact the tax burden when only an individual is treated as a taxpayer. On the other hand, in terms of improving the deduction measures, many reasonable deductions will be grouped together to justify household income before paying tax. This practice has the U.S. system as precedent to follow. In terms of efficiency, treating an individual as the taxpayer may influence her investment choices, while treating a family, the basic unit of the

income tax system. Yet the 1987 Provisional Regulations on Individual Regulatory Income Tax used item-categorized income tax system and later the amended Individual Income Tax Law kept item-categorized income tax system.

¹¹⁴ Treating an individual or a family as a taxpayer mainly depends on the purpose of individual income tax at a particular time

society, as a taxpayer helps ensure that revenue collection will not be encumbered by considerations of expenses. In terms of social wealth redistribution, treating a family as a taxpayer somewhat increases mobility of capital and increase labor force. The thesis submits that the IIT compliance system reform should prioritize expenses deduction for seniors and children. Moreover, under the current social intensity from unemployed college graduate and laid-off workers, treating a family as a taxpayer will comfort low-income families and mitigate disturbance arising from the unemployment.

4.3.2.3. Broadening the IIT bases

Broadened tax bases lead to enlarged tax revenues. Given the large population in China, IIT tax bases should be given a dominant role in running the IIT system. Although the SAT provides various measures to solidify tax bases, consideration should be given to the following goals. (1) The scope of itemized income should be expanded to include personal gains from various forms of investments. For example, earnings of stock trading from overseas stock exchanges and private mineral production should be included; (2) Expense deductions against some categories of income, such as income from contracted services or real estate leasing operation should be voided or decreased; (3) Preferential deduction measures applicable to foreign individual taxpayers should be given to Chinese taxpayers for the same categories of income. Moreover, lowering tax rate and reducing the number of grade of tax rate must be taken into account. Current Chinese IIT Law imposes a 9-scale tax rate schedule which is against its legislative intent of simplifying tax laws.

Income from personal services and employment income are taxed at different tax rates which is inconsistent with the tax equity principle.

Another issue is about the synchronization of corporate and shareholder tax liabilities. However, this double taxation scenario is not fully attained by Chinese legislators. Similarly, individual proprietorships and partnerships are not separated from individual taxpayer IIT treatment. For example, sole proprietorships' income derived from public sector infrastructures are only subject to a 5-scale tax rate comparing with the 9-scale IIT rate structure. Therefore, the enlarged self-employed sector may exploit advantages of this discrepancy promulgated 25 years ago to evade tax liability. Meanwhile, the partnership tax law is not in place.

4.3.2.4. Normalization of the expense deduction

Deduction for the purposes of IIT is covered by a comprehensive set of measures. Reasonable expenses, the livelihood standards, marital status, and social settings should be put together based on the “ability to pay” principle. In this sense, the deduction system is a symbol of tax mix quality for living and investments. Although the SAT and local tax authorities have released various provisional rules and circulars on deduction categorization and timing limits, the Chinese IIT legislation is expected to formulate the following aspects: (1) the same income may mean different costs to different taxpayers. Therefore, the deduction method should be used uniformly in view of the imbalance of development; (2) a properly differentiated deduction index should be adapted to reduce income disparities; (3) China's one-child policy for the past thirty

years has forced the fourth and fifth generations of Chinese to face unprecedented pressure of supporting three families by a couple. Although China is in the process of establishing a pension system as well as social security mechanism to accommodate and prevent future restlessness, expense deduction should be awarded to families supporting seniors and children. In this sense, the expense deduction stipulated in the individual income tax should be flexible; (4) inflation, exchange rate variance, purchasing power, cost of living and labor mobility should also be considered in localizing deduction measures. (5) A unification of deduction measures for Chinese and foreign individuals should be considered following WTO principles of liberating trades and capital mobility.

4.3.2.5.Improving IIT compliance and administration

The current IIT administration of combining source withholding and an auxiliary tax declaration should be improved in the IIT legislation. This thesis submits that current source withholding measures should be maintained in consideration of administrative efficiency. However, the scope of tax declaration should be prioritized to a simplified annual return filing and encouragements to synchronize *annual* tax credit and non-withheld taxable income. Given the lack of tax compliance culture and manipulated booking practice, tax credit should be considered on an annual basis. Therefore, individual taxpayers have incentives to consolidate expenses to lower tax liability or to get refund. This is in line with compliance practice in many tax jurisdictions. Gradually, the IIT should consider transforming source

withholding to self declaration for specific categories of taxpayers, but the digitization of compliance system must enable this measure.

A system of tax audits should be incorporated, and the U.S. provides a good precedent in handling related issues such as solidifying tax bases and avoiding tax evasion. This thesis submits that, if confidentiality or privacy is sensitive to individual taxpayers, a system of Individual Economic Identity Cards (IEID), even on an annual basis, would help tracking income tax for both Chinese and foreign individuals. Meanwhile, measures such as credit card monitoring, individual account checks, and a real-name banking deposit system will enhance the transparency and help administration.

4.3.3. Summary

The list above is far from complete. The reform of IIT legislation under China's WTO accession cannot be simplified as a few unifications or adding corrective administration approaches. Rather, a comprehensive study should be involved for the restructuring and streamlining of IIT legislation system in general. The IIT functions for revenue contribution and social wealth redistribution must be valued based on considerations such as taxpayers' right awareness, acerbated income disparities, enterprise income tax synchronization, individual proprietorships and partnerships, personal gains from various forms of capital investments, and out-of-control underground gains. On the other hand, international investors are concerned with IIT more because it is the most tangible and visible sign of robustness in a country's tax system. Equally important is the question of how to incorporate basic

requirements of the rule of law on legislation such as generality, regularity, transparency, consistency, clarity, acceptability and enforceability, among others, into the forthcoming IIT legislation reform. Only after fulfilling these instrumental requirements can the IIT legislation reform better embody WTO principles of transparency, uniform administration and judicial review for taxpayers' rights protection. Meanwhile, flexible approaches should be taken in building up a computerized IIT compliance system and administration embracing both source withholding and self tax declaration.

4.4. Case analysis -- WTO Constraints on China's Tax Law Reform

4.4.1. The Semiconductor Case against China

Export tax rebate (exemption) is a major concern for most foreign enterprises in China because the policies and declaration procedures affect the cash flows of enterprises in the country. On the other hand, policies on export tax rebates are practically complex in terms of resulting in different export methods and tax rebate declaration processes, leading to differing tax rebate amounts and affecting profitability. Foreign enterprises may legally use appropriate tactics to get more tax rebates over a short period of time.¹¹⁵

¹¹⁵ Therefore, choosing an experienced tax consultant and get valuable advice at an early stage has become an important success factor for most foreign enterprises. In view of the fact that the relevant policies are changing frequently, and that officers from tax authorities may hold different opinions over regulations thus giving different interpretations, this is an area that needs careful analysis and attention

Export tax rebate refers to rebate of the taxes, including the VAT, business tax, and special consumption tax, that are incurred during the processes of domestic production and circulation for exported products – the purpose of export tax rebate is to encourage exportation which composes large portion of China's GDP growth and foreign currency reserve. For foreign-invested enterprises in China, such rebate usually refers to VAT rebates only, based on current stipulations of zero rate of consumption tax for FIEs. An understanding of relevant VAT policies and legislative background is a must to appropriately take the advantage of Chinese export tax rebate policies.

4.4.2. Factual background

Reform of China's VAT legislation has a major point of contention between the U.S. and China in the past years, especially involving the semiconductor industries. On March 18, 2004, U.S. (together with Semiconductor Industry Association) filed a complaint with the WTO claiming that China's VAT treatment of integrated circuits (semiconductors) was discriminatory against foreign semiconductor manufacturers and designers and, therefore, in breach of the national treatment principle. This was the first complaint against China since China's accession to the WTO and has been regarded as an experiment to test China's ability to respond as a WTO member. These complaints eventually escalated into a trade policy dispute between the U.S. and China governments, which reached a negotiation together in Geneva on July 14, 2004. China agreed to stop certifying new semiconductor products and

manufacturers for the VAT refunds and to stop providing the refunds to the current beneficiaries by April 1, 2005. China also promised to terminate the tax refund for semiconductors that are designed locally, produced abroad and then imported into China. In turn, U.S. withdrew its complaint to the WTO. However, whether the same result would come out of the WTO Dispute Settlement Body (DSB) itself is uncertain.

An additional factual point is that the Chinese government provides a rebate of the VAT burden in excess of 3% for certain semiconductors manufactured within China, while it imposes the full 17% VAT on imported semiconductors. Although there is an argument that such VAT rebate constitutes a subsidy to domestic semiconductor industries, and was exempted from application of the national treatment requirement prescribed under GATT Article III, issues also come up for China's tax authorities as to what really constitute subsidies as interpreted under the WTO agreements.

4.4.3. Analysis

A subsidy under the SCM Agreement should fulfill two requirements. First, it must represent a cost to government and a benefit to the recipient. Second, it must be specific and applicable to a specific industry, a group of enterprises, or even an individual enterprise. There seems to be no issue that the VAT rebate program meets these two criteria. By definition, the VAT rebate is construed as a "direct transfer of funds" in accordance with Article I(1)(a)(i) of the SCM Agreement, and it is for a specific industry which will receive

benefits under this rebate program. However, being a subsidy is not necessarily illegal under the SCM Agreement, which categorizes subsidies into three categories: prohibited (Article III), actionable (Article V), and non-actionable (Article VIII). As per Article VIII(2)(a) of the SCM Agreement, a non-actionable subsidy mostly refers to certain types of assistance for research activities conducted by firms or higher education entities on a contract basis. Apparently, the factual background of the export VAT rebate does not fall into the non-actionable subsidy category. Moreover, Article VIII ceased to be effective by December 31, 1999 due its conflicting provisions with other SCM Agreement articles such as Article XXXI. Therefore, prohibited subsidies and actionable subsidies are the only two categories left for analysis.

According to SCM Agreement, a subsidy is prohibited if it is 1) either contingent (in law or in fact, solely or partially) upon export performance or 2) contingent (solely or partially) upon the use of domestic over imported goods. For the first factor, Article III(1)(a) of the SCM Agreement explicitly states that subsidies contingent on export can be either *de facto* or *de jure*. For VAT rebate, although one of its goals is to increase exportation, no tax regulation particularly requires that export performance is indispensable for obtaining such rebate. China authorities, therefore, can easily show such a VAT rebate is not contingent upon any export performance. Additionally, the plaintiff bears the burden of proof to establish such contingency, but the chance of substantiation is slim. Another contingency to support prohibited subsidy is under Article III(1)(b) of SCM Agreement which is about encouraging the use of domestic goods over imported ones. China's rebate program is advantageous to China's domestic importers that import semiconductor parts

designed in China. The issue then is left on whether the VAT rebate is contingent on the procurement of domestic design services over life services from foreign countries. China, therefore, can easily save the VAT rebate program from being deemed prohibited.

As to the third and last category of subsidy, actionable subsidy under Articles V and VII of the SCM Agreement composes the last weapon for protesting China's VAT rebate program. The SCM Agreement tolerates an actionable subsidy unless it creates an "adverse effect" for the interests of other WTO member countries. In a meticulous way, Article V of SCM Agreement enumerates the types of adverse effects: (a) injury to the domestic industry of another Member; (b) nullification or impairment of benefits accruing directly or indirectly to other Members under the 1994 GATT in particular the benefits of concessions bound under Article II of GATT 1994; or (c) serious prejudice to the interests of another Member. As to first type of adverse effect, in order for any complaining country to assure a domestic industry injury, an investigation following Article XI of the SCM Agreement should be conducted to access the level of injury. For the second type of adverse effect, it would be a "robust" nullification or impairment of benefits if more details and cases of WTO requirement were examined.

Lastly, serious prejudice as the last type of adverse effect should be put together with Article VI of the SCM Agreement, which lists a number of scenarios where serious prejudice occurs and situations where serious prejudice does not apply. The challenging party must prove any of the four

effects according to Article VI(3) of the SCM Agreement.¹¹⁶ Based on factual background of China's export VAT rebate program, without any robust substantiation, the WTO judiciary body will not approve the request of filing the VAT rebate as an actionable subsidy.

4.4.4. Summary

Based on analysis above on China's VAT rebate program, the substantiation of subsidy that emphasized by numerous WTO treaty provisions and precedents is not easy. However, the Complaint filed by the U.S. showed that, even if China may discharge itself from a dispute before the WTO tribunals on substantive and procedural grounds, the risk of improperly reforming VAT system and practice is that it would fail to comply with WTO rules. Under the big WTO "umbrella", the narrow consideration of domestic interests may bring tremendous challenges. This also raises the need for better legislative techniques in designing VAT or other tax legislations. The legislative intent has to embody or address standardized practices under WTO agreements.

¹¹⁶ Article VI (3) of the SCM Agreement includes (a) the effect of displacing or impeding the imports of a like product of another Member into the market of the subsidizing Member; (b) the effect of displacing or impeding the exports of a like product of another Member into a third country market; (c) the effect of a significant price undercutting by the subsidized product as compared with the price of a like product of another Member in the same market or significant price suppression, price depression or lost sales in the same market; or (d) the effect of any increase in the world market share of the subsidizing Member in a particular subsidized primary product or commodity as compared to its average share during the previous three year period and where this increase follows a consistent trend over a period when subsidies have been granted

4.5. Limitations of the WTO's Constraints

As a multilateral trading regime, the WTO's impacts on domestic tax policies is constrained in many aspects, which are found in the interpretation of WTO rules, rules affecting taxation, the dispute settlement process, and the enforcement mechanism. Returning to a jurisprudential analysis, WTO rules are designed to liberate trade and capital mobility, but not to influence the tax system specifically. Other than WTO rules affecting tax laws, China has sovereignty to determine its tax legislation and structural reforms on each type of tax. Even for tax subsidies, the WTO principles do not seem to prohibit China from using them.

The first limitation of WTO's constraints comes from the approach of treaty or WTO rules interpretation. According to Articles 31 and 32 of the Vienna Convention on the Law of Treaties, three major approaches to treaty interpretation are pointed out: subjective or intentions, textual, and teleological methods. However, Vienna Convention rules essentially emphasize the *objectively ascertained* intention of the parties as *manifested in the text of the agreement*, i.e. the expressed intent rather than the subjective intent of the parties.¹¹⁷ To this end, impacts of WTO rules are limited to the non-teleological interpretation in applying to the tax regime.

Second, application means limitation. WTO rules affecting taxation traditionally focus on domestic tax obstacles to trade in goods and trade-

¹¹⁷ See Michael Lennard, *Navigating by the Stars: Interpreting the WTO Agreements*, 5 J. of Int'l Econ. L. (2002) at 17-19.

distorting subsidies.¹¹⁸ As discussed earlier in this chapter, three prongs of WTO provisions are relevant in the tax area. The first is the non-discrimination principles prescribed in Articles I and III GATT which includes the most-favored-nation principle¹¹⁹ and the national treatment principle.¹²⁰ The second is the widely defined prohibited or actionable subsidies under Article XVI GATT and the SCM Agreement, including tax incentives. The third is based on GATS. All measures that may affect services or service suppliers may therefore apply to income taxes.¹²¹

Taxes that do not implicate the WTO rules above are imposable by Chinese tax legislations. For example, if a VAT export rebate is less than or equal to the VAT levied on business inputs, the rebate is not a prohibited export subsidy. Theoretically, as long as the export rebate rates are below the nominal VAT rates, China may elect to allow a full VAT rebate for exports without violating WTO rules while stimulating exports.

Third, the enforcement of WTO appellate decisions has limitations due to the nature of the multilateral regime – specifically the problem of sovereignty.¹²² Mostly, the execution of WTO principles depends on domestic policies and bilateral agreements. Usually, enforcement is more likely to happen or lead to settlement when the economic venture is tremendous, e.g., the US FSC/ETI

¹¹⁸ See generally Servaas van Thiel, *General Report*, in M. Lang, ed., *WTO and Direct Taxation*, Linde Publishing Inc. (2005) at page 13-48

¹¹⁹ *Id.*, noting the MFN principle prohibits higher internal taxes or more burdensome regulation on products imported than on similar imports from other members

¹²⁰ *Id.*, the national treatment principle prohibits higher internal taxes or more burdensome regulation on products imported on similar domestic products

¹²¹ *Id.*, at 25-28, noting, in particular, it applies to services that are supplied by means of cross border establishment in the form of a branch or a subsidiary (mode 3) or by means of the cross-border movement of economically active professionals (mode 4)

¹²² See Reuven Avi-Yonah, *The WTO, Export Subsidies, and Tax Competition*, in Lang Ed., p115-131, *supra* 13, at 130

case (over USD 4 billion per annum) or the political stakes are high, e.g. the Sino-U.S. semiconductor case. Actually, the impact on domestic policy usually causes retaliation which is against the intent of WTO Agreements.

The fourth limitation goes to transparency for two reasons. First, the WTO arguably is “non-transparent” and lacks “democratic legitimacy”.¹²³ Second, the transparency requirement scattered in various provisions of the WTO Agreements may require the accessibility and publish of all tax legislations, but the extent of transparency is somewhat subject to negotiation.

4.6. Summary

This subchapter discusses the impacts of WTO accession to China’s tax legislation system from a formal perspective. In particular, rules and principles of WTO Agreements call for China’s turnover tax, enterprise income tax and individual income tax legislation and reform to incorporate non-discrimination principles and the transparency requirement. However, a careful review of tax legislations in China reveals that some basic elements of the instrumentalist concept of the rule of law are missed. This is specifically evident in the IIT legislation reform. Meanwhile, even though the 2008 EIT Law in many aspects embodies modern tax concepts, it remains unclear how to realize both tax equity and efficiency by balancing central and local tax authorities.

¹²³ See generally in Robert Green, *Anti-legalistic Approaches to resolving Disputes Between Governments: A Comparison of International Tax and Trade Regime*, 23 Yale J., Int’l L. 79 (1998)

Another aspect of Chinese tax legislative reform is setting up a tax administration system with efficiency.

Although WTO's principles and rules impose constraints such as the adoption of export subsidies and enforcement of AB decisions, as long as a member country may provide same economic benefit by manipulating domestic tax policies, WTO regime is weak in pushing tax legislative reforms. Lessons learnt from the US FSC/ETI and Sino-US semiconductor case exemplify the inherent weakness or distorted tax rule-making.

V. Conclusion – Tax Incentive Policies under the WTO Regime

Following the accession to the WTO and legal system reform, the tax legislation reform has endured a painful process. From the 1994 tax system overhaul in incorporating WTO principles, the tax legislation has experienced simplification, unification, and the revenue sharing scheme. Because tax legislations mostly attempt to encourage FDI with provisions such as tax holidays, rate reduction, export subsidy, reinvestment encouragement, exemption of the withholding tax, and accelerated depreciation, the structure of tax legislation is imbalanced from the very beginning in a way that harms tax equity and efficiency. For example, the dual-track enterprise income tax system frustrated both DEs and FIEs. The design of IIT Law does not manifest revenue contribution and social wealth redistribution as it should be. Even though turnover tax dominates tax revenue in China, the structure of VAT and

Business Tax is still plagued by a few fundamental issues such as the transition to a consumption type VAT.

China's tax legislation reform is further complicated by rules and principles under WTO Agreements and the rule of law order. In particular, rules and principles of WTO Agreements call for China's turnover tax, enterprise income tax and individual income tax legislation and reform to incorporate non-discrimination principles and the transparency requirement. However, a careful review of tax legislation in China reveals that some basic elements of the instrumentalist concept of the rule of law are missing. This is specifically evident in the IIT legislation reform. Review of tax incentives to ensure transparency and proper judicial review is also imperative. Even the 2008 EIT Law in many aspects embodies modern tax concepts, it remains unclear how to realize both tax equity and efficiency by balancing central and local tax authorities. Another aspect of Chinese tax legislative reform is setting up a tax administration system with efficiency.

Although the WTO's principles and rules impose constraints such as on the adoption of export subsidies and enforcement of AB decisions, as long as all member countries are provided the same economic benefit by manipulating domestic tax policies, WTO regime is not without limitations in pushing forward tax legislative reforms. Lessons learnt from the US FSC/ETI and Sino-US semiconductor case exemplify the inherent weakness in tax rule-making.

As proposed by Avi-Yonah, answers to fine-tune China's tax legislation system might be found in an international tax arena through a multilateral solution. Essential is that the fundamental goals of taxation and WTO

principles should be achieved in terms of revenue collection, social wealth redistribution, transparency, uniform and impartial administration, and judicial review. Equally important is to incorporate elements of the rule of law order as well as to integrate China's tax legislation with an international perspective of facilitating development and institutionalization of the tax system.

Chapter VI

Tax Judicature System Reform – An Identity Loss

I. Introduction

The reform of Chinese tax judicature system has been a complicated undertaking, which China's tax administration, its Chinese general judiciary, and its taxpayers have endured in equal measure.¹²⁴ "China's tax judicature must account for China's social and economic development situation before introducing pragmatic reform proposals,"¹²⁵ and China should develop "a long-term goal of establishing a Chinese tax judicature system, in particular, a tax court system."¹²⁶ Moreover, given the current overhaul the Chinese administrative legal system, the tax judicature reform in China has garnered unprecedented attention from both tax authorities and Chinese taxpayers. In general, the tax judicature structure incorporates two layers: a dispute settlement mechanism for disputes between tax authorities and taxpayers as to

¹²⁴ See *infra* Chapter VII, for detailed discussion on China's taxpayers' right protection

¹²⁵ See Xu Shanda, *Zhongguo Shuiquan Yanjiu [China Tax Jurisdiction Research]*, (China Taxation Press, 2004) Preface

¹²⁶ The establishment of the Chinese tax court is heatedly debated among Chinese tax scholars and tax administrators. See *e.g.*, Liu Jianwen, Chairman of China's Tax Law Society, in the evaluation conference of the World Bank project on China Tax Law Reform proposed the potential of setting up the Chinese tax court system (notes on file with the author)

an assessment of tax; and, if a settlement is not achieved, a cause of action in a Chinese court to appeal the administrative decision. Different from a common law system such as the United States, tax controversies in China are mostly litigated as administrative cases, supplemented by civil and criminal proceedings as necessary.¹²⁷ Given the small number of tax lawsuits in China, however, the tax judicature reform is usually one-sided. Chinese tax authorities dominate related reform proposals, while taxpayers are relatively innocuous in advocating for the protection of their rights. Meanwhile, there is a legitimate need to advance the reform in terms of fulfilling the WTO principles, to which China has committed itself, in a manner consistent with its socialist rule of law construct.

China's tax judicature system, like China's judiciary in general, is permeated with controversies and deficiencies. Just as procedures for rights protections against administrative agencies mean less in light of China's problems with administrative impartiality, judicial review, and a system of elaborated rights, remedies, and procedures for taxpayers are of little use to China's taxpayers when there is no independent, impartial and competent judiciary. However, the reality is that the independence of the Chinese tax judiciary is inextricably linked to that of its formal courts. The independence of China's judiciary has been notoriously plagued by the judges' insecurity of tenure as well as the judiciary's own traditions of knowledge, integrity, and expertise and the law of contempt. Therefore, for China's tax judicature properly to exercise its jurisdiction requires that it have at least three interrelated features: technical

¹²⁷ Due to space limitations, this chapter focuses on administrative tax lawsuits. For discussions on criminal and civil aspects of tax lawsuits, *see generally supra* 2. This thesis also shares Professor Wei Xiong's concern that the reform for Chinese tax judicature is not highly prioritized by tax administrations

competence, commitment to the rule of law, and finally, institutionalized independence to embrace domestic causes and international demands such as WTO principles. Regretfully, none of these three features is unequivocally present or identifiable.

As to China's tax judiciary reform, this Chapter considers the following questions: (1) what is the procedure for administrative and judicial appeals and how likely is it to process a reasonable case? (2) Is all or a portion of the tax to be paid pending appeal, and if so, how secure is the taxpayer in obtaining relief from this requirement? (3) Is there any realistic need to establish a judicial tribunal for tax cases specifically, and if so, why and in which format? (4) Is the appeal process undermined by corruption? Subchapter II introduces general policy concerns and rationales for improving the tax judiciary system, especially under the requirements of the rule of law. Subchapter III offers a brief description of the evolution of the tax court system in the United States. The goal is to summarize considerations for structuring a tax judiciary system from tax authorities' and taxpayers' perspectives. Subchapter IV reviews the *status quo* of China's tax judiciary system, and summarizes an interesting debate by Chinese tax scholars on tax judiciary reforms, such as whether a tax court should be introduced and by which institution. Subchapter V further contributes several proposals for reform for China's tax judiciary reform. Subchapter VI concludes.

II. Rationales for structuring the tax judicature system

2.1. The application of basic principles of administrative law

An established modern tax system in a socially just society embraces tax policies of efficiency, equity, transparency, simplicity and administrability¹²⁸ in terms of both substantive and procedural law. Revenue collection by a government and the extensive reach of the tax laws into taxpayers' actions necessitate a sound system of tax administration. In this sense, the tax judicature system presupposes dynamics between the tax administration and taxpayers. Tribunals thus must be available to taxpayers in the hope to resolve potential discrepancies in administrative assessment of taxes due or conflicting analyses of the tax laws. Therefore, many basic principles such as the principle of legality under China's administrative law more generally apply to the tax context.

One example is the principle of fairness or public trust which underpins a functional tax administration. The tax authorities are restricted from exploiting unreasonable advantages in their interactions with taxpayers. This principle concerns the horizontal equity of the tax system. Taxpayers comparatively are a group of disadvantaged citizens, which do not anticipate direct conflict with the government. Entrusted with administering a fair and impartial system, tax authorities should perform in a logical and jurisprudential manner and be bound by judicial interpretations of the tax law. A taxpayer should receive

¹²⁸ See Government Accountability Office, Publ'n No. GAO-05-1009 SP, *Understanding the Tax Reform Debate: Background, Criteria & Questions* (2005), <http://www.gao.gov/new.items/d051009sp.pdf> (last visited on March 15, 2011)

prompt notice of any action conducted by tax authorities concerning her and have guaranteed access to prescribed procedures in litigation.

The principle of the ability to pay requires and expects tax legislators to account for taxpayers' means and relative ability to support government operation. In this sense, this principle is based on the vertical equity of a tax system, i.e., those with a greater ability to pay should pay a larger amount. The enforcement of the tax laws is not supposed to overtake or interfere with the exclusivity and ownership of individual property rights. The principle of the ability to pay also requires appreciation of taxpayers' compliance costs, because voluntary self-reporting is so often one-sidedly persuaded by tax authorities for the purpose of reducing tax collection costs. Similar to the principle of ability to pay is the principle of proportionality, which enshrines protections of taxpayers against excessive tax obligations.

Another principle centers on taxpayers' reliance on tax authorities' administrative application and interpretation of the tax laws. If tax authorities erroneously interpret legislative intent or inaccurately administer related tax laws, and taxpayers rely on such rulings or decisions, it is without question that taxpayers should be free of charges for wrongful tax behaviors. Returning to a jurisprudential analysis, the principle of nonretroactivity shares the same reasoning of efficiency: tax consequences of taxpayers' behaviors should be predictable based on available knowledge. To this end, changes in the tax laws should be updated publicly and consistently in a timely manner. The principle of nonretroactivity also contributes to cost-efficient tax collection – when tax disputes arise, tax authorities are obligated to substantiate their administrative decisions and thus have to avoid abuses of discretion, which generate

compliance costs. This also helps reduce the likelihood of creating disputes thus minimizing tax litigation.

An additional adaptive principle of administration law is that the reconsideration and appeal should be subject to fair hearing or due process. There are a number of rationales supporting the protection of due process. First, a fair hearing requires that the judge or a member of the administrative tribunal is neither personally or professionally prejudiced nor biased in conducting prescribed proceedings. In the tax law context, the independence of the tribunal from the larger tax authority in the reconsideration or review of administrative decisions is vital to protecting taxpayers' property rights and the efficiency of State revenue collection. Second, due process supports the right to legal representation by a qualified agent, usually, a lawyer. However, given the special nature of tax return filing and tax payment calculation, a CPA or a certified tax agent can replace a lawyer representing taxpayers before tribunals. Third, due process implies procedural equality, whereby both taxpayers and tax authorities have legitimate standing to represent and argue their cases. A palpable implication for taxpayers is the right to information, i.e., evidence and clear procedural rules, for understanding a tax administrative decision, because the dominant authority of tax administrative bureaus might otherwise unduly dominate the taxpayer in a grievance process. Tax authorities must comply with procedural requirements without interference with the independence of judicial review.

Finally, an administrative system should safeguard the right to review and appeal, either by administrative or judicial recourse. A taxpayer needs this right as a last resort to receive a final decision to avoid circumvent any undue

interference in her property rights, especially outside of any intervention from the tax authorities. Administrative laws often involve the more banal operations of civil affairs, such as healthcare and education, and disputes therefrom are relatively straightforward and clear-cut. In the tax law context however, the right to review or appeal entails complexities – in particular, does the taxpayer need to prepay the tax due prior to commencing litigation? The answer varies in different jurisdictions,¹²⁹ but Chinese tax laws control this requirement as legal regimentations.

Overall, tax judicature is intertwined with tax administration, which falls in the general administrative law framework. As a result, major drawbacks of an administrative law system manifest in the tax law contexts discussed above. For China's tax judicature, this feature is even more evident, because China's system inherits the imperial tradition of the over-reaching arm of administration. Taxpayers' inheritance in this context is a cultural history of obedience. This deeply-rooted cultural orientation dictates pragmatism over ideology in the judicature reform design.

2.2. Judicial review and the rule of law

China's tax judicature system is an indispensable component of the state's judicial review framework. Judicial review is doctrinal and imperative in modern legal systems and requires that legislative and executive proceedings or decisions be subject to review, and possible invalidation, by an independent judiciary. Tribunals with judicial review power should invalidate state actions

¹²⁹ See Victor Thuronyi, *Comparative Tax* (Kluwer Law International, 2003) at 215-218

that violate a higher authority, such as a written constitution or prescribed procedures. Usually, judicial review exemplifies the separation of powers in a modern governmental system but is subject to various interpretations based on variations in the hierarchy of government structures. The procedure and scope of judicial review is also a case-by-case adaption based on different social, economic, political and legal settings.

Regarding judicial review, A. V. Dicey emphasized three aspects in phrasing the rule of law:¹³⁰ (1) no one can be punished or made to suffer except for a breach of law proved in an ordinary court; (2) ... [e]veryone (including government agencies) is equal before the law regardless of social, economic, or political status; and (3) the rule of law includes the results of judicial decisions determining the rights of private persons.¹³¹

Joseph Raz shares Dicey's last notion and further contends that the rule of law entails minimizing the danger of the exercise of discretionary power in an arbitrary manner. In particular, Raz details that, (1) laws should be prospective rather than retroactive; (2) laws (and interpretations thereof) should be stable and not changed so frequently as to prevent one from being guided by them (principle of consistency); (3) rules and procedures for making laws must be clear (right to know); (4) the independence of the judiciary must be guaranteed; (5) the right to fair hearing must also be guaranteed; (6) the judicial review power of an independent tribunal; (7) the courts should be accessible and (8) the law enforcement and crime prevention should not be discretionary.¹³² Raz

¹³⁰ See generally, Albert Dicey, *An Introduction to the Study of the Law of the Constitution* (1885)

¹³¹ See S. A. Palekar, *Comparative Politics and Government* at 64-65 (PHI Learning 2009)

¹³² See Joseph Raz, *The Rule of Law and It's Virtue*, *The Law Quarterly Review*, volume 93, at 195 (1977), reprinted by Keith Culver, *Readings in the Philosophy of Law*, at 13 (Broadview Press, 1999).

further presents that judicial review should not be “confused with democracy, justice, equality (before the law or otherwise), human rights of any kind or respect for persons or for the dignity of man”.¹³³

As China strives to build up a socialist rule of law order, its tax judiciary system must be incorporated and upgraded. But there should not be any over-romanticized expectation that the tax judiciary reform can proceed ahead or outside of the general judicial framework that is also full of flaws and discrepancies and in need of reform. The tax context has its singularities, so do other areas of law. The tax judiciary reform, therefore, should proceed in a pragmatic fashion without dominating judicial reform in any sense.

2.3. Development of a market economy

China’s ongoing efforts to structure a socialist market economy system and the rule of law order create an abiding need for an improved judicial system in general and an improved tax judiciary system specifically. As remnants of the planned economy fade, transactional routines and corporate management structures become progressively complicated and tax is implicated from the planning to the wrapping-up. The market economy construct requires a functional tax judiciary system embracing a set of standards and principles to regulate taxpayers’ behavior as well as an independent, fair, and efficient tribunal system to enforce those standards. An underlying driver in this context is the shifting identity to the market participant in China. The roles of government agencies, enterprises, and individuals are not restricted by their

¹³³ *Id.*, at 195-97

stereotypes as administrators, SOEs, and low-income constituencies, respectively. Rather, a balanced dynamic is expected to operate for the revenue collection and redistribution of social wealth. Tax judiciary system, in turn, provides standardized protection to enforce this undertaking with substantive and procedural components.

2.4. Pressure from the tax legislation reform

The development of the Chinese judicial system is colored by political demands, or as a tradeoff, by interference from the party-state. It seems naïve to describe how democratization of Chinese politics develops over the past three decades, but at least comparing to the Cultural Revolution and the planned economy era, remarkable progress has been witnessed. Meanwhile, the dispute resolution system has lagged far behind the progress of legislation reform in terms of structuring an authoritative framework catering to diversified economic concerns and social needs. Echoing the overwhelming tax legislation reform in the past three decades, a tax dispute resolution system remains oversimplified and has therefore not caught up to tax legislation yet. New legislation in tax related areas poses unprecedented challenges to China's tax judiciary system. Tax issues usually are intertwined with other economic matters, for example, banking, foreign trade and investment, which incorporate international elements as well as SOEs reform pressures.¹³⁴ Many localities at the same time promulgate local rulings, notices and directives based on local self-interests. Therefore, inappropriate handling of tax dispute

¹³⁴ See Chunlin Zhang, *Revisiting China's SOE Reform Strategy* (World Bank, 2009), <http://www.hongfan.org.cn/file/upload/2009/11/02/1257972368.pdf> (last visited on March 15, 2011)

resolution would spread unwelcoming implications to areas other than tax fields. The complexity of transactional behaviors rarely finds simplicity in the tax field, whereas it is on better footing in other areas of economic law. Therefore, tax legislation as to the growingly complicated economic transactions and diversified interests calls for *ex post* application of law by a robust tax judicature to compose an organized tax law framework as part of the whole legal system.

2.5. Taxpayers' rights protection awareness¹³⁵

The awareness of taxpayers' rights has fashioned China's tax law reform in the past decade. Vocabularies such as the principle of legality and "no representation, no tax" were introduced to substantiate a latest wave of taxpayer consciousness movement to challenge the rights protection *status quo* in China. A fair and efficient tax judicature system is one of the most popular reform areas raised by taxpayers. China has been called the most miserable Asian country in terms of taxes,¹³⁶ and this issue is particularly important because the increase of Chinese tax revenue has been greater than its GDP growth in the past decade. Coupled with the inflation, rising housing prices, and high CPI experienced by Chinese taxpayers who are burdened by various forms of direct or indirect taxes, a reform of the tax system has naturally become a top priority for many Chinese citizens. Compliance requirements encourage taxpayers to examine the public benefits they receive compared

¹³⁵ See *infra* Chapter VII

¹³⁶ See *China ranks the second in Forbes Tax Misery Index* and accompanying discussions at <http://forum.globaltimes.cn/forum/showthread.php?t=10043> (September 2009) (last visited on March 15, 2011); see also e.g., *The Forbes Tax Misery Index 2009*, <http://pdf.forbes.com/media/pdfs/TaxMisery.pdf> (last visited on March 15, 2011)

with the level of tax they pay, and inevitably seek rights protection against contribution without payback. Accordingly, the public's perception of the Tax Court may also affect its perception of the tax system as a whole, and thereby affect tax compliance.¹³⁷ For instance, a pragmatic and proactive approach to taxpayers' rights promotion is essential to construct a well-established, taxpayer-friendly tax judicature system which is politically viable and helpful to human rights protection.

2.6. A catch-up to international routines

The convergence of cross-border tax administration, enforcement, and cooperation has entailed two impacts on the tax judicature reform push in China. First, foreign investors, which have experienced better-structured rights protection from their home tax jurisdictions, have legitimate expectation and needs to receive similar procedural justice from Chinese tribunals, especially its tax authorities. Second, there is a consensus that a robust tax judicature system creates a strong competitive advantage in the international market. The WTO exemplifies a robust multilateral regime embracing capital mobility and free trade, as well as prevention against discretionary interference from tax authorities. Rights exercised by taxpayers demand that an accommodation of international protection standards be incorporated into China's tax law system to safeguard revenue collection and to fuel economic development.

¹³⁷ See generally, Tom Tyler, *Why People Obey the Law* (1990), arguing that procedural fairness is critical in maintaining the legitimacy of authority, and that legitimacy affects self-reported compliance with laws

2.7. Summary

Chinese tax judicature reform is substantiated by various legitimate drives. The administrative law system reform expects tax authorities' discretion to be efficiently limited by a functional judicial review process. Taxpayers' awareness creates pressure to find a more taxpayer-friendly and just judiciary for rights protection. At the same time, legislation in the tax area is overwhelming, over-meticulous and more all-rounded, and thus adds to the need for an upgraded judicature system for the proper enforcement of new laws. More importantly, the market economy and the rule of law order urge the tax judicature to accommodate diversified economic interests and social needs in a fair, impartial, accessible, efficient and clear-cut manner. Pressures from international interests such as the WTO raise the bar for Chinese tax judicature reform. In addition, a tax judicature system contributes necessary competitive advantages to China's overall economy for seeking foreign investment and improving revenue collection.

III. Takeaways from the U.S. experience

A typical question for the Chinese tax judicature reform is which model it should follow, however, there are no right or wrong answers to this query, and there is no perfect model for all tax jurisdictions. The tax judicature system is so varied due to diversified economic, social and cultural of each state, and there are substantial differences in review or appeal procedures in terms of the administrative and judicial systems that take tax cases. This subchapter

tentatively draws on the U.S. experience, in particular, its tax court system. The goal is not to offer detailed structural proposals but to illustrate appropriate considerations or standards that should be reflected on in designing an upgrade of Chinese tax judicature reform.

3.1. The evolution of the U.S. Tax Court system¹³⁸

3.1.1. The current tax judicature system

The current tax judicature system in the U.S. mainly has two prongs: the federal system and the tax court system.¹³⁹ As to the federal system,¹⁴⁰ disputes between a taxpayer and the IRS regarding the amount of tax payment due or a decision on the tax consequences of a transaction can be tried in the

¹³⁸ Section 3.1. was written based on a careful reading and review of description of U.S. Tax Court history and procedures presented in voluminous writings and critics. *See e.g.*, David Laro, *The Evolution of the Tax Court as an Independent Tribunal*, U. Ill. L. Rev. (1995); W. Patrick Cantrell, *Federal Tax Procedure for Attorneys* (2008) ABA General Practice, Solo & Small Firm Division; Christopher M. Peitruszkiewicz, *Conflating Standards of Review in the Tax Court: A Lesson in Ambiguity*, 44 Hous. L. Rev. (2008); Danshera Cords, *Administration law and Judicial Review of Tax Collection Decisions*, 52 St. Louis U. L. J. 429 (2008); Leandra Lederman, *Equity and the Article I Court: Is the Tax Court's Exercise of Equitable Powers Constitutional*, 5 Fla. Tax Rev. 357 (2001); Leo P. Martinez, *The Summons Power and tax Court Discovery: A Different Perspective*, 13 Va. Tax Rev. 731 (1994); Leandra Lederman, *Tax Appeal: A Proposal to Make the United States Tax Court More Judicial*, 85 Wash. U. L. Rev. 1195 (2008); Andre L. Smith, *Differential Review of Tax Court Decisions of Law: Promoting Expertise, Uniformity, and Impartiality*, 58 Tax Law. 361 (2005); Harold Dubroff, *The United States Tax Court: An Historical Analysis, Part III: The Revenue Act of 1926 – Improving the Board of Tax Appeals*, 40 Alb. L. Rev. (1976), reprinted in Harold A. Dubroff, *The United States Tax Court: An Historical Analysis* at 113 (1979), Camilla E. Watson, *Tax Procedure And Tax Fraud in a Nutshell* (Nutshell Series) (Thomson West, 3rd Ed., 2006)

¹³⁹ *See generally id.*, there are four different trial-level courts hear federal civil tax cases in the United States: the U.S. Tax Court, U.S. district courts, the U.S. Court of Federal Claims, and U.S. bankruptcy courts. Professor Douglas Kahn also noted that the U.S. bankruptcy courts usually do not put too much focus on tax cases unless the bankruptcy cases are closely involved in tax factors. By a large margin, most tax cases are filed in the Tax Court, but the thoughtful advocate planning tax litigation carefully considers all available options

¹⁴⁰ *See* Leandra Lederman, *Tax Appeal: A Proposal to Make the United States Tax Court More Judicial*, 85 Wash. U. L. Rev. 1195 (2008), at 1198, presenting that management of federal courts is decentralized so that each court is largely self-governing, federal courts are served and overseen by centralized bodies, including the United States Judicial Conference and the Administrative Office of U.S. Courts (AOUSC)

federal system. Taxpayers may elect to pay their taxes and file a refund request in the United States District Court for the district in which they reside or in the U.S. Court of Federal Claims.¹⁴¹ Appeals of the district court decision then can be filed to the circuit court of appeals governing that district. If the Court of Federal Claims presides over a tax controversy, appeals are to the Court of Appeals for the Federal Circuit. It is noted that tax payment usually should be paid in full in the first hand before filing a case in the federal system. Federal courts referred to here are all Article III (of the U.S. Constitution) courts.¹⁴²

Alternatively, if the taxpayer chooses to litigate the controversy before paying in full, i.e., in a pre-assessment proceeding, she usually prefers a re-determination by the Tax Court.¹⁴³ A Tax Court decision may be appealed either in the court of appeals in the circuit where the taxpayer resides or the principal place of the taxpayer's business, at the time she filed her petition to the United States Tax Court (Tax Court). All cases may, as a final matter after grant of *certiorari*, be heard by the Supreme Court.¹⁴⁴ The Tax Court resolves the overwhelming majority of all tax controversies, but after the financial crisis the U.S. Bankruptcy Court has become a more common forum for tax cases as well.

3.1.2. The U.S. Tax Court system

The United States Tax Court represents the type of court that only hears

¹⁴¹ See generally Watson (Nutshell), *supra* 15

¹⁴² See Lederman *supra* 17 at 1198-99

¹⁴³ I.R.C. §6213(a)

¹⁴⁴ I.R.C. §7482(a)(1)

disputes between taxpayers and the government agencies, i.e., the IRS. Although a choice of forum is available to a U.S. taxpayer as discussed above, it is more hypothetical than real because the Tax Court is the only tribunal that allows taxpayers not to first pay the amount in dispute, and approximately ninety-five percent of litigated federal tax cases are filed in Tax Court.¹⁴⁵

According to the holdings in *Pollock v. Farmers' Loan & Trust Co.*¹⁴⁶ and the Sixteenth Amendment,¹⁴⁷ in 1924, the Congress created the Board of Tax Appeals, which was later renamed as the Tax Court of the United States, to provide a tribunal for challenging tax deficiencies decided by the Bureau of Internal Revenue, the predecessor of the IRS. The Board of Tax Appeals was designated as “an independent agency in the executive branch of the Government.”¹⁴⁸ Findings of fact by the Board of Tax Appeals were “prima facie evidence of the facts therein stated.”¹⁴⁹ Appeals of decisions of the Board of Tax Appeals were firstly limited to the federal district courts, but later

¹⁴⁵ Professor Douglas Kahn noted that there have been various reasons that created the current dispute resolution system for tax cases, and many historical accident led to the evolution of the U.S. tax judiciary system. Moreover, Prof. Kahn noted that in many occasions the filing requirement and strategies for tax cases may depend on specific cases or litigation skills. The author thanks Professor Doug Kahn's comments; see Laro, *supra* 15, at 17-18

¹⁴⁶ See *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429, 583 (1895), *aff'd on reh'g*, 158 U.S. 601 (1895), the Supreme Court determined that taxes on income from property were unconstitutional as direct taxes that were not levied apportionately

¹⁴⁷ On February 25, 1913, the Sixteenth Amendment was ratified by the necessary three-quarters of the states, reversing *Pollock* and making unapportioned federal income taxes constitutional. See Carlos E. Gonzales, *The Logic of Legal Conflict: The Perplexing Combination of Formalism and Anti-Formalism in Adjudication of Conflicting Legal Norms*, 80 *Or. L. Rev.* 447, 449 n.105 (2001) (“The ratification of the Sixteenth Amendment was the direct consequence of the Supreme Court's 1895 decision in *Pollock*, holding Congress's attempt to tax incomes uniformly throughout the United States unconstitutional.”), see also Peitruszkiewicz, *supra* 15, footnote 12

¹⁴⁸ The author submits that this initial status of the U.S. Tax Court has plenary informative reference value to China's tax judiciary reform. See *id.*, Peitruszkiewicz at 1342-43 (quoting Leo P. Martinez, *The Summons Power and Tax Court Discovery: A Different Perspective*, 13 *Va. Tax Rev.* 731, 743-44 (1994) (contending that the Board of Tax Appeals was created for three reasons: “(1) to establish a pre-assessment forum for hearing tax controversies, (2) to create an adjudicating body which would be independent from the Internal Revenue Bureau's collection function, and (3) to initiate a forum which would increase efficiency and streamline judicial procedure for the growing number of tax cases”)

¹⁴⁹ *Id.*

expanded to the various circuit courts of appeal. The circuit courts may modify or reverse a decision of the Board of Tax Appeals only “if the decision of the Board is not in accordance with the law.”¹⁵⁰

In 1969, the “United States Tax Court” took its current name and was reclassified as a legislative court under Article I of the U.S. Constitution. The Tax Court is granted jurisdiction to adjudicate specific income, excess profits, estate, and gift tax disputes prior to payment of taxes by a taxpayer.¹⁵¹ The Tax Court is a “court of record”¹⁵² or a “court of law”¹⁵³ in that it engages in purely judicial functions. However, the Congress has left the Tax Court out of the administrative framework to which most federal courts belong. As a result, it is “neither fish nor fowl.”¹⁵⁴ It is neither an agency nor a member of the judicial branch of government. Thus, the Tax Court is not served by the AOUSC or otherwise subject to the Judicial Code. Because it is not an agency, it is not subject to the Freedom of Information Act (FOIA) or the agency provisions of the Administrative Procedure Act (APA).¹⁵⁵

The Tax Court is based in Washington, D.C., though it conducts trials in cities nationwide. All of the Tax Court’s cases involve disputes between taxpayers and the IRS.¹⁵⁶ The Tax Court’s core jurisdiction involves IRS assertions that the taxpayer understated the correct tax liability, resulting in a tax “deficiency.”¹⁵⁷ Generally, “pretrial procedure before the Tax Court is similar

¹⁵⁰ See generally Laro, *supra* 15

¹⁵¹ *Id.*

¹⁵² I.R.C. § 7441

¹⁵³ See *Freytag v. Comm’r*, 501 U.S. 868, 889-91 (1991)

¹⁵⁴ See Lederman, *supra* 17, at 1199-1200

¹⁵⁵ *Id.*

¹⁵⁶ See generally Laro, *supra* 15

¹⁵⁷ For the definition of “deficiency”, see I.R.C. § 6211

to that applicable in most trial courts,”¹⁵⁸ i.e., the taxpayer files a petition, and the IRS must file an answer. “Discovery is available in Tax Court, though its use is more limited than in the district courts, and the parties are required to stipulate to the facts of the case to the fullest extent possible.”¹⁵⁹

By statute, Tax Court trials are bench trials. Nineteen judges serve in the Tax Court for a fifteen-year term.¹⁶⁰ The Tax Court judges are “appointed by the President, by and with the advice and consent of the Senate,”¹⁶¹ and they come from an array of backgrounds.¹⁶² Judges may be elected as senior status.¹⁶³ In addition, the Chief Judge has the power to appoint Special Trial Judges (STJs), who are somewhat analogous to magistrate judges, though they are employees at will.¹⁶⁴ STJs are permitted to hear any Tax Court case involving amount less than \$50,000, i.e., mostly the “small tax cases,”¹⁶⁵ which are cases with limited amounts in dispute, are decided under an informal procedure.¹⁶⁶

For Chinese tax judicature reform, the U.S. Tax Court’s evolution is quite informative from a legal historical perspective. Starting its tenure as an agency with doubts about its independence, the development of the U.S. Tax Court experienced a number of unsuccessful efforts to become an Article III court. With authorized expansion of its jurisdiction by the Congress, it ultimately

¹⁵⁸ See generally Joseph Cook & Harold Dubroff, *The United States Tax Court: An Historical Analysis, Part V: Pretrial procedure*, 40 Alb. L. Rev. 639-41(1976), reprinted in Harold A. Dubroff, *The United States Tax Court: An Historical Analysis*, 113 (1979).

¹⁵⁹ See Lederman, *supra* 17, at 1200; see also generally Watson, *supra* 15

¹⁶⁰ See generally, Thomas Greenaway, *Choice of Forum in Federal Civil Tax Litigation*, 62 Tax Law, at 313

¹⁶¹ I.R.C. §7443(b)

¹⁶² for background of judges, senior judges and special trial judges, see U.S. Tax Court, Judges, <http://www.ustaxcourt.gov> (last visited on March 15, 2011)

¹⁶³ I.R.C. §7447

¹⁶⁴ For role played by STJ, see http://www.ustaxcourt.gov/rules/title_xviii.pdf. (last visited on March 15, 2011)

¹⁶⁵ I.R.C. §7443

¹⁶⁶ I.R.C. §7663. The author respectfully notes that description about STJ is quite similar in most literatures available, and is primary based on I.R.C. §§7443 and 7663, see generally *supra* 15

became an Article I court. Yet, the Tax Court retains vestigial attributes of an administrative tribunal, and it continues to face “allegations of bias in its decision making”,¹⁶⁷ as challenged by legal critics.

3.2.Considerations for structuring a tax court system

The factors outlined below are selected in the hope of providing a reference to the Chinese tax judiciary reform, in particular, the tax administrative reconsideration procedures and the tax court construct in the future. When considering how the U.S. Tax Court system emerges as the major tribunal for taxpayers’ suits, there are a number of reasons that provide much to do about judicial review and independence, which is particularly significant for any tax system including China. One perspective – focusing on the taxpayers, not the tax administration or IRS – is the deliberation on choice of forum in advocating taxpayers’ rights or cost-efficiency concerns. Another problem, also from the taxpayers’ perspective, is on how to handle increasing complex cases in the tax context. In this sense, it is imperative to formulate necessary considerations that taxpayers, as the petitioner against IRS, may put forth invoking the tax court jurisdiction. Otherwise, tax court is of no jurisdictional value or structural contribution in the judiciary system.

3.2.1. Discretion of the Tax Court

The statute of limitations on assessment is suspended when a case is pending

¹⁶⁷ See generally Lederman, *supra* 17. Professor Lederman has been quite critical in reviewing the status of tax court and suggests a reform proposal to include the Tax Court under management of AOUSC

at the Tax Court.¹⁶⁸ Usually, due to the workload and complexities of the cases, the IRS sometimes does not come to all issues in its examination. The jurisdiction of the Tax Court covers reviewing all items in the taxable period at issue in a deficiency case, so the amount of deficiency may increase before making a final decision.¹⁶⁹ However, the Tax Court usually considers whether an increased deficiency jeopardizes a taxpayer's financial interests and IRS's capacity to take more burdens of proof.¹⁷⁰

3.2.2. Timeline¹⁷¹

Similar to the statute of limitation, timing is a foremost jurisdictional issue that both tax authorities and taxpayers attain. A taxpayer may take time to locate available tax-optimal methods in filing a suit while the IRS has to figure out a reasonable time for revenue collection. Failure to petition at the Tax Court in a timely fashion after the issuance of the notice of deficiency may foreclose the taxpayer's options. Passing the 90-day unextendable deadline¹⁷² will inevitably invite a motion to dismiss from the IRS Office of Chief Counsel, which usually will be granted by the Tax Court. For a refund request of overpaid tax, a taxpayer must file an administrative claim within three years of filing a return or within two years of payment, whichever comes later.¹⁷³ Then a refund suit may be filed within six months after the claim is filed and ending

¹⁶⁸ I.R.C. §6503(a)(1)

¹⁶⁹ See generally W. Patrick Cantrell, *supra* 15

¹⁷⁰ *Id.*

¹⁷¹ *Id.*

¹⁷² The deadline is 150 days if the notice is addressed to a person outside the United States

¹⁷³ I.R.C. §6511(a)

two years after the denial of the claim by the IRS.¹⁷⁴ Usually, the statute of limitations begins running when the IRS denies the claim.

3.2.3. Complexity of the case

Another factor in evaluating the role played by the Tax Court is the complexity of the case. Usually, straightforward claims filed require less coordination between taxpayers and the IRS, but complex cases often encourage settlement before the Tax Court makes final determination. The virtue of settlement is significant – as long as revenue collection is realized in a cost-efficient way – as the IRS usually views complex cases as a bother rather than a bonus.¹⁷⁵

3.2.4. Cost-efficiency

The Tax Court does not require a full payment of taxes due before filing a suit against IRS's assessments, but full payment of tax liabilities is necessary for filing refund claims before a district court or the Court of Federal Claims.¹⁷⁶ The financial ability to pay a potential assessment if the Tax Court makes a final decision is a key factor in the taxpayer's calculus before filing a petition. Having this in mind, a taxpayer should weigh her financial capacities and the potential costs with the merits of the case and market interest rates as

¹⁷⁴ I.R.C. §6532(a)

¹⁷⁵ See generally Cantrell, *supra* 15

¹⁷⁶ See *Greenaway*, *supra* 15, at 311, 318, noting that the “full payment” rule also applies to estate and gift tax refund suits but not to refund suits litigated in bankruptcy

compared to underpayment and overpayment rates.¹⁷⁷

3.2.5. Discovery¹⁷⁸

A key element in the U.S. discovery process is the taxpayers' right to confidentiality. Business secrets and corporate operation privacy are particularly sensitive to petitioners when filing a tax claim. Taking this a concern, the Tax Court may encourage mutual consulting and collaboration between the IRS and taxpayers in the discovery process for stipulating a reasonable judgment before the case is made to public. However, depositions are rarely taken in the Tax Court except in complex cases where the parties depart. Discovery practice in refund litigation at the district courts is more formalized than discovery in Tax Court, and deposition practice is common in refund litigation.

3.2.6. Settlement

Adjudicating a settlement between a taxpayer and the Office of Appeals of the IRS is an important part of tax judges' daily routine. Unless the IRS Chief Counsel purposefully designates a case or an issue within a case for litigation, a taxpayer may opt to settle with the Office of Appeals. Moreover, any refund or credit greater than \$2 million, whether triggered by an accepted administrative claim, an overpayment in the Tax Court, or refund litigation, is

¹⁷⁷ *Id.*, quoting *GE v. United States*, 103 A.F.T.R. 2d 2009-858, presenting the importance of overall consideration of financial capacity and merits of the case, especially under the financial crisis settings

¹⁷⁸ See generally Cantrell, *supra* 15

subject to review by the Joint Committee on Taxation at the Tax Court.¹⁷⁹

3.2.7. Trial

Tax Court judges mostly make final determinations based on stipulated facts: either the case is adjudicated by a Tax Court judge, or the case is submitted for decision fully stipulated under Rule 122.¹⁸⁰ Is a trial the most efficient way in resolving a dispute? The answer varies. As long as a trial is necessary for the benefits of the taxpayer and the IRS, yes. Complex cases often lead to either a settlement or on motion, however. The Tax Court does not have a jury trial but the litigation in district court is before a jury.

Trials in the Tax Court are relatively short, even summary judgment is often used. Given the Tax Court's emphasis on stipulation, most Tax Court judges have little patience for laborious trials where trial counsel attempt, through testimony or unstipulated exhibits, to introduce evidence susceptible to stipulation.

Proceedings in the Tax Court are conducted under the Tax Court Rules, while the trial of the "Small Tax Case" ("S-Cases") where the amount in dispute is less than \$50,000 has specific procedures.¹⁸¹ The advantages of "S-Cases," as they are colloquially known, are several: more choices as to the place of the trial, less discovery, and relatively informal procedural and evidentiary

¹⁷⁹ I.R.C. §6405(a)

¹⁸⁰ See generally Honorable Theodore Tannenwald, Jr., Tax Court Trials: An Updated View from the Bench, 47 Tax Law 587 (1994) as quoted in footnote 112 by Greenaway, *supra* 15

¹⁸¹ I.R.C. §7463

standards at trial.¹⁸²

3.2.8. Appeals

Appeal is probably the last resort for the taxpayer or the IRS, but it happens often. A key factor for appeal is how the case is adjudicated by the Tax Court, and under which controlling precedent or in stipulation. However, the right to appeal has to be given to either party to guarantee procedural justice.

3.3. Summary

The above description of the U.S. tax judiciary system obviously is oversimplified and selectively tailored. It is not the goal of this thesis to furnish a critical review of the U.S. tax judicial construct. However, all factors have to be put together as reference in submitting a proposal catering to potential reform needs of China's tax judiciary system. Taxpayers and the tax authorities share similar concerns, such as discretion of the court, timeline, cost-efficiency, complexity of the issue, settlement potential, trial and appeals. And these issues should be considered under the general framework of the judicial system, overall financial capacities of taxpayers and social policy needs. Again, there is no uniform model that can be globally applied in tax judiciary reform. Rather, a few commonly acceptable factors should be considered in designing a reform.

¹⁸² See generally Tax Ct. R. 174(b)

IV. A triple whammy – prospects of Chinese tax judicature reform

Improvements of the Chinese tax judicature system in the past three decades have been characterized by irregular adaption of the general administrative procedures in the tax context, a lack of thoughtful attention to taxpayers, and obstinate interference from political and administrative actors. The tax dispute resolution has taken on problematic deficiencies similar to those of the general administrative judicature framework into which it is embedded. Therefore, the Chinese tax judicature reform falls into two areas: the peculiarities of the tax system and the upgrade of the overall Chinese judiciary. Due to space limitations, this subchapter focuses on the flaws in and debates over the current tax judicature. It considers the second prong, i.e., the competence, autonomy and independence of the Chinese judiciary in general, much more briefly. After all, it is continually important to note the substantial differences in the procedures in terms of administrative and judicial bodies that hear tax cases in different systems.

4.1.A system full of peculiarities

The tax dispute resolution system in China looks similar to many other established frameworks: taxpayers have the right to appeal an adverse decision of the tax administrations. Since tax authorities are party to a dispute, approaches that are often adopted in civil disputes such as negotiation, mediation, and arbitration rarely are applicable. Chinese tax disputes are therefore mostly administrative in nature. Tax disputes generally fall into two

categories based on their resolution methods: tax administrative reconsideration and tax administrative litigation. The former is usually conducted by the tax authority one level up within the administrative hierarchy, and the latter is governed by the jurisdiction of the Chinese administrative court. Criticism of the Chinese tax judiciary often fastens on the following aspects.

4.1.1. A pre-trial tax administrative reconsideration

Tax litigation on collection of tax is occasioned by a required pre-trial tax administrative reconsideration. In general, an aggrieved taxpayer who refuses to accept an official administrative decision has a straightforward choice of forum: filing an application for an administrative reconsideration, or invoking a lawsuit directly with an administration court seeking relief such as the repudiation or adjustment of the administrative decision.¹⁸³ Sharply different from administrative litigation in other areas of law, before initiating a tax dispute arising from the *tax collection*, a taxpayer is required to file an application for an administrative reconsideration. Only when a taxpayer refuses to accept the administrative reconsideration can she file a law suit. However, it is noted that for disputes based on punishments, asset secured measures, or mandatory enforcement by the tax administration, a taxpayer has forum selection options similar to other administrative cases, i.e., either filing

¹⁸³ See Articles 37 and 38, Zhonghua Renmin Gongheguo Xingzheng Susong Fa [*The Administrative Procedure Law of the People's Republic of China*] 中华人民共和国行政诉讼法 (effective as of October 1, 1990)

an application for an administrative reconsideration or directly filing a lawsuit with the court.¹⁸⁴

This conditional afflicting procedure of a pre-trial reconsideration is not without merits. First, from the administrative efficiency perspective, the implementation and enforcement of the tax laws fluctuates in different localities. Externalities resulting from varied competence and understanding of the tax laws render a tax administrative reconsideration efficient by filtering out obviously erroneous tax decisions and easily settled controversies. In addition, this should limit the number of frivolous tax suits. Second, from an enforcement perspective, the reconsideration is usually made by a tax authority of the next level in the administrative hierarchy. This internalization of tax disputes serve taxpayers interests in terms of ensuring the tax expertise of the decision-making body. Reconsideration normally results in a settlement between tax authorities and taxpayers; therefore, the enforcement of a reconsideration decision is clear-cut. Third, based on the doctrine of equitable recoupment, the pre-trail reconsideration can better guarantee revenue collection, which dominates tax authorities' behavior. Bad taxpayers may take advantage of a court dispute process to drag the payment process out longer and avoid paying taxes on time. An administrative reconsideration, in this sense, drives taxpayers to fulfill compliance without hindering the pace of collection.

In spite of these perceived merits of the Chinese system however, its many drawbacks overwhelm its benefits. A primary concern is whether tax authorities' discretion is too expansive to avoid arbitrary administration. In

¹⁸⁴ See Article 15, *the Rules for Tax Administrative Reconsideration of the P.R.C. (Trial Implementation)* [hereinafter "Tax Administrative Reconsideration Rules"], as amended effective as of May 1, 2004

reality, other than restrictions on the physical freedom of a taxpayer, Chinese tax authorities probably have jurisdiction governing almost all aspects of taxpayers' activities: registration, administration, audit, investigation, collection, imposing penalties, asset secured measures, enforcement, and reconsideration. According to a Chinese judge, the reconsideration may be viewed as an expansion rather than a control on tax authorities' discretion.¹⁸⁵ Furthermore, the independence of the agent making reconsideration decision is subject to serious doubt. The extensive relationship between lower and higher level tax authorities may impair objective measurement and the trust given by taxpayers. Sometimes, this dualism drives the reconsideration unit to act as a "coordinator" rather an "administrative magistrate". In addition, the jurisdiction of reconsideration units at different localities may conclude different tax decisions on the same issue. This raises a jurisprudential question: is there any need to establish a national "appeal" reconsideration unit? How to correlate the tax administration and the court taking tax cases? Last but not least, returning to a jurisprudential analysis, tax disputes involving the other types of tax administrative decisions such as punishments, asset secured measures, or mandatory enforcement are not conditioned with this pre-trial tax administrative reconsideration. If the unwritten speculation that a tax administrative reconsideration is imposed mostly for revenue collection purposes turns out true, the stake of imposing an additional barrier to taxpayers on seeking legitimate relief is against constitutional protection of

¹⁸⁵ See Wang Song, *Nashui ren quanli baohu shijiao xiao de shuishou sifa gaige* [*The Tax Judicial Reform from the Point of View of Protection of Taxpayers' Rights*] (王松, 《纳税人权利保护视角下的税收私法改革》 (2006)), *Tax Judicial Reform Proceeding*, pp74-77, at 77. Wang Song is a judge from the He'nan Provincial High Court and is in charge of tax disputes in China

taxpayers' property rights. The legislation of this due process pre-trial requirement would therefore be a matter of fierce debate.

4.1.2. The full payment rule

By statute, a taxpayer must first pay or remit tax payments, surcharges, and late fees (if applicable) due or provide a guarantee of payment before filing an application for the tax administrative reconsideration or a lawsuit.¹⁸⁶ This full payment rule has been vehemently criticized by judges and scholars in China. First, the criticism is based on the principles of equity and ability to pay. Cases that could be accepted for an administrative reconsideration encompass a wide variety of issues. The unilateral jurisdictional acts conducted by tax authorities include the identification of the taxpayer, subject of tax, applicable tax rate, tax deduction, tax exemption, tax refund, tax basis calculation, tax jurisdiction, timing, and tax collection method. In this sense, tax authorities can single-handedly use any of those factors to substantiate the issuance of an initial tax decision. Tax authorities may over-assess the tax liability borne by taxpayers. If a taxpayer fails to pay an over-estimated assessment due to limited financial capacity, she may never go through the due process to file claims and seek relief. And tax authorities cannot rule out the possibility of making erroneous decisions. Therefore, the full payment requirement jeopardizes taxpayers'

¹⁸⁶ See *Law concerning The Administration of Tax Collection of the P.R.C.* (hereinafter Tax Collection Law), effective as of May 1, 2001; see Article 88(1) of the Tax Collection Law provides that "if any tax dispute between the tax authority and a taxpayer, withholding agent or tax payment guarantor occurs, the taxpayer, withholding agent or tax payment guarantor must first pay or remit the taxes and the late fee in accordance with the decision on tax payment made by the tax authority, or provide corresponding guaranty, and then after may, apply for an administrative reconsideration in accordance with the law. If they object to the decision made after the administrative reconsideration, they may bring a suit in the people's court in accordance with the law"

legitimate rights to plead, appeal and gain legal relief. Meanwhile, if two taxpayers have similar cases but one petitioner withdraws the case due to financial incapacity, the equality of taxpayers cannot be realized in the tax system, and taxpayers' rights protection becomes inequitable.

Second, from the point of view of the principle of proportionality, the full payment rule adds the burden of proof on the taxpayers' side, and this worsens the already imbalanced bargaining position between taxpayers and tax authorities. An excuse that tax authorities in assessing tax liabilities is that taxpayers hide authentic book and corporate records in a tax audit or investigation which leads to a wrongful determination. This defense, however, does not remove the burden of proof from the tax authority side in reaching a reasonably adjudicated assessment. Equally misleading is that tax authorities may manipulate an over-estimated tax liability as a measure to "squeeze" taxpayers for tax payments. Aside from charges of selective and corrupt tax audits, this approach clearly violates the principle of proportionality of tax liabilities.

Third, the full payment rule is an improper inference of the variance doctrine, which is applied to circumscribe refund suit jurisdiction. It is important to mention that the full payment rule adopted in China deals with disputes relating to collection of tax *only*. But the variance doctrine prevents a taxpayer from presenting claims in a *refund* suit that substantially vary from the legal theoretical and factual bases set forth in the tax collection claims presented to tax authorities. Given the charge by tax authorities that taxpayers may conceal authentic tax-related information, as long as a taxpayer does not file a refund

claim, it lacks the jurisprudential basis to subject a taxpayer to a quasi-penal tax payment.

Is this condition of full payment exclusively applicable to unfortunate Chinese taxpayers only? Absolutely not. In the U.S., the Tax Court and bankruptcy courts usually are prepayment forums, as the statutes and case law demand full payment of tax liabilities before a district court or the Court of Federal Claims may take jurisdiction over a refund suit.¹⁸⁷ The “full payment” rule also applies to estate and gift tax refund suits but not to refund suits litigated in bankruptcy.¹⁸⁸ *However*, the key difference must be identified here – a full payment of tax assessment is required only if a taxpayer files a refund suit. The reasoning is quite straightforward – a taxpayer cannot get a refund without paying it first. As to China’s full payment requirement for disputes arising from tax collection, other than fiscal policy considerations of guaranteed revenue collection, there is no basis in law or policy for such a provision.

4.1.3. Competence of judges adjudicating tax disputes

When a tax dispute is filed at a court, the expertise and competence of the judge hearing tax case is of great significance. Competence of judges in adjudicating tax disputes refers to their “technical expertise...in evaluating factually and legally complex disputes.”¹⁸⁹ Following the dishonorable

¹⁸⁷ See, e.g., 28 U.S.C. § 1346(a)(1) (2006); see also *Flora v. United States*, 362 U.S. 145 (1960).

¹⁸⁸ See Greenaway *supra* 15, at 317-18

¹⁸⁹ See Nicolas C. Howson, *Judicial Independence and The Company Law in the Shanghai Courts* (in *Judicial independence in China: Lessons for Global Rule of Law Promotion* (R. Peerenboom, Ed.), Cambridge University Press, PP 134-153) at 137

tradition of low professionalism in the Chinese judiciary, judges that specialize in corporate, securities, or tax laws are hard to find, especially in hinterland or less developed provinces. This is not surprising. Although China has made unprecedented efforts to build the competence of its judiciary, such as recruiting graduates from university law schools, requiring the passage of the Jurisprudence Exam and the promulgation of the “Judge Law”, the competence of judges still undermines the Chinese judiciary. This deficiency is even particularly salient in the tax judicature system.

First, the training of tax law expertise in university law schools has been weak or rudimentary. Law graduates majoring in tax usually prefer working in the fiscal or tax sectors. Second, as the talent pool is so concentrated in the tax authorities, given the close connections between courts and administrations, judges are not willing or particularly incentivized to develop tax expertise. Rather, they take tax authorities’ opinions as authoritative guidelines or instructions. This in turn damages taxpayers’ interests unilaterally. Third, due to the prerequisite tax administrative reconsideration, judges are not given enough opportunities to adjudicate tax cases, most of which are filtered by tax authorities. In this sense, the judgment of tax disputes may remain somewhat unsophisticated, since the tax administration is unlikely to challenge itself by encouraging taxpayers to file tax lawsuits in courts. Tax cases usually are filed at the lowest-tier court in the system, at which complex cases are neither anticipated nor common. Finally, the number of tax cases of first instance filed has been consistently low. For example, for the years 2002, 2003, and 2004, the number of tax cases of first instance accepted nationwide was 1496, 803,

and 1032,¹⁹⁰ respectively. The complexities of cases also diverge. Without a significant number of cases available to adjudicate, the judges cannot build their competence in this area.

4.1.4. Summary

Chinese tax disputes are administrative in nature, and they include two avenues: tax administrative reconsideration and tax administrative litigation. However, the tax judiciary system is plagued by several systemic flaws, in practice. The requirement of pre-trial tax administrative reconsideration renders tax authorities' discretion too expansive to avoid arbitrary administration. The full payment requirement for disputes arising from tax collection is poorly justified from the perspective of justice and efficiency and receives vehement criticism from both judges and scholars. Moreover, due to limited number of less complex tax cases accepted by the administrative court, the competence of judges in tax laws has not markedly improved, nor has robust application of the doctrine of *stare decisis*. All these defects, coupled with tax authorities' adamant efforts to increase revenue collection, call for an upgrade of the Chinese tax judiciary reform.

¹⁹⁰ See generally, China Statistics Yearbook (2002-2004)

4.2. An interesting debate – the Chinese tax court

To many commentators' surprise, the proposal to set up the Chinese tax court system was first raised in the mid-1980s.¹⁹¹ However, different from the U.S., China's tax judiciary system still does not contain a court that hears tax cases only. But the debate on whether China should establish a tax court and follow which model has gone on for the past decade between and among tax academia and judges from the administrative courts that hear tax cases.¹⁹² In general, there are three distinguishable views regarding establishing the tax court in China: (1) an opposition, which suggests it is too early to set up a tax court given the current political and legal situation in China; (2) a supportive position that a tax court system should emerge to further the tax judiciary reform; and (3) a middle path, somewhat vaguely defined, that a special tax tribunal within the current court system for tax disputes, similar to the *questions perpetuae* for criminal cases, would be best. Based on less than 30 available articles and conference papers on the tax judiciary reform written in Chinese, this section aims to summarize those major positions on this topic and offer a few observations on the flaws of China's general judiciary system, which are manifested in the tax context.

¹⁹¹ The author, when attending Review Conference of World Bank 4th Phase Project – China's Tax Law Reform held in Beijing in May 2005, remembers that then SAT Vice-Governor Xu, Shanda mentioned that the proposal of setting up a Chinese tax court was raised in an IMF report in the mid 1980s

¹⁹² Professor Douglas Kahn from the University of Michigan Law School noted that there are at least two concerns to be considered prior to setting up a tax court system: first, the uniformity of judgment and how to select a panel of judges for tax cases; second, the tax court system may require a separate court of appeals for tax cases as necessary (notes on file with the author); *See generally* in the Proceedings of International Conference on "Harmonious Society and Tax Judicial Reform in China", Peking Univ., May 2006 (hereinafter "Tax Judicial Reform Proceeding")

4.2.1. Open-minded oppositionist's view

Opposition to the establishment of a tax court system of any type is based on the following arguments.¹⁹³

4.2.1.1. The current tax judiciary functions well

China's current tax judiciary system operates well in meeting taxpayers' needs for challenging adverse tax assessments by employing tax administrative reconsideration and tax litigation. True, there are flaws in policy orientations, legislation, and enforcement in tax governance, but overall the system does not materially dampen taxpayers' rights. Therefore, specific amendment of problematic rules, such as the full-payment requirement as discussed above, is preferable to the overhaul of the judiciary system entirely.¹⁹⁴

4.2.1.2. Very limited caseload of tax disputes

¹⁹³ There are two major groups of oppositionists: 1) judges presiding or supervising tax disputes in practice. *See Wang supra* 62 and 2) tax scholars who have firsthand experience in legislation and practice, *see e.g.*, Xiong Wei, *Zhongguo you Biyao Jianli Shuiwu Fayuan ma [Does China need Tax Courts Right Now?]* 熊伟, 《中国有必要建立税务法院吗?》 *Tax Judicial Reform Proceeding*, pp178-185. Xiong is a professor of tax law from Wuhan University, China.

¹⁹⁴ *Id.*, Wang at 77

The caseload of tax disputes brought to the lowest-level courts is too limited,¹⁹⁵ *inter alia*, tax disputes can be appropriately handled and adjudicated by judges on board already, and “the urgency of establishing a court dealing with tax disputes only is nebulous.”¹⁹⁶ However, such small caseload of tax disputes deserves deliberations before concluding that taxpayers are satisfied with tax administration.

- Consistent commercial operation: consistent business operation in the same tax jurisdiction demands the enterprise taxpayers keep a sociable and secure relationship with tax authorities without initiating conflicts through tax disputes, which may invite revenges from tax authorities;
- Judicial autonomy and independence: taxpayers usually distrust the autonomy and independence of a court in adjudicating tax disputes against the tax authority defendant. “Many cases are simply not accepted due to public or internal bureaucratic direction or precisely because of the case’s political coloration, or even if initially accepted, such cases are not subject to adjudication again for fear of bumping up against extralegal power.”¹⁹⁷ In particular, 1) the tax expertise of judges hearing tax cases sometimes is guided by tax authorities’ technical support, so the judgment of a tax dispute may be distorted against taxpayers’ rights;¹⁹⁸ 2) the relationship of court and tax administration is intertwined. The connection of the two falls along two axes: the budget and spending of local court is supported by local

¹⁹⁵ *Id. see also* Xiong, at 179

¹⁹⁶ *See* Xiong *supra* 70 at 176-77, presenting that from 1998 to 2004, the overall tax caseload accepted at the first phase decreased from 2,069 to 1,032

¹⁹⁷ *See* Howson *supra* 66 at 138, summarizing his understanding and watch on case acceptance or dismissal in China’s court

¹⁹⁸ *See* Wang *supra* 62 at 77

fiscal revenue, and local People's Congress is responsible for rejecting or approving court administrative budgets.¹⁹⁹ The court, for the sake of local revenue collection and interests of itself, may reach unfavorable decisions against taxpayers. Meanwhile, local judges, especially the chief judges of the adjudication committees and judges in key tribunals, are appointed or at least approved by the local peoples' congress.²⁰⁰ This bureaucratic undertaking might compose an important factor in adjudicating a tax dispute. Another source of political influence comes from the fact that the People's Congress exercises stipulated "individual case supervision". According to the Supervision Law passed in 2007, local People's Congress may supervise courts by investigating specific issues, appointing and dismissing judicial officials. In practice, the supervision may lead to indirect intervention to the adjudication process.

- The expansive discretionary power of tax authorities: according to the Tax Collection Law, tax authorities are entitled to impose a penalty ranging from 50 percent to 5 times of tax assessment due for behaviors such as tax evasion or improper handling of unsecured assets.²⁰¹ Such a

¹⁹⁹ See Xiong *supra* 70 at 180

²⁰⁰ See generally Zhonghua Renmin Gongheguo Xingzheng Jiancha Fa [*The Law on Administrative Supervision of the P.R.C.*] [hereinafter Supervision Law of the PRC] 《中华人民共和国行政监察法》, effective as of May 9, 1997, as amended on June 25, 2010

²⁰¹ See e.g., Article 63 of the Tax Collection Law, stipulating that [f]or a taxpayer who evades taxes, the tax authority shall pursue the payment of the taxes unpaid or underpaid, the late fee, and impose a fine with the amount from 50% to five times of the taxes unpaid or underpaid; Article 64 of the Tax Collection Law, "Where a taxpayer does not file tax returns, or does not pay or underpays the taxes payable, the tax authority shall pursue the payment of the taxes unpaid or underpaid and the late fee, and impose a fine with the amount from 50% to five times of the taxes unpaid or underpaid."

Article 65 of the Tax Collection Law, "where a taxpayer fails to pay the taxes payable, or hinders the tax authority from pursuing the payment of the taxes unpaid by means of transferring or concealing the properties, the tax authority shall pursue the payment of the taxes unpaid and the late fee, and impose a fine with the amount from 50% to five times of the

wide range of discretion inevitably leads to potential corruptions and unethical collection routines. Moreover, tax authorities may violate the principle of legality because to a large extent tax collection is based on administrative quota or budgetary order but not on legitimate calculation of tax liability.²⁰²

- The full-payment rule: by statute, a taxpayer must first pay or remit tax payment, surcharge, and late fees (if applicable) due or provide guarantee in the first place before filing an application for the tax administrative reconsideration or a law suit.²⁰³ This rule bars financially incapable taxpayers from exercising the right to access to seek relief through administrative or judicial tribunals.

As noted by oppositionists, the caseload of tax disputes does not warrant the establishment of a separate tribunal to accept and adjudicate tax cases only. Seeking relief through tax litigation is even an inefficient approach disliked by taxpayers; rather, settlement usually is reached at the tax administrative reconsideration stage. The flaws of the judicial system manifest in the tax judicature operation as well, such as its lack of independence and autonomy. Moreover, this thesis seconds oppositionist' notion on the demand-supply logic between tax cases and establishment of the tax court. In this sense, it is clear that setting up a tax court does not necessarily encourage filing of tax

taxes unpaid; if such acts constitute an offence, criminal liabilities shall be investigated in accordance with the law.”

Article 68 of the Tax Collection Law, “where a taxpayer or withholding agent which has been ordered by the tax authority to pay, within a prescribed time limit, the amount of taxes which should be paid or remitted but have not been paid or have been underpaid within the time limit, fails to pay the amount of taxes within the time limit, the tax authority may, in addition to pursuing the payment of the amount of taxes the taxpayer or withholding agent has failed to pay or underpaid by the mandatory measures as prescribed in Article 40 of this Law, impose a fine of 50% or more of the amount of taxes which have not been paid or underpaid but not more than five times of the said amount.”

²⁰² See Xiong *supra* 70 at 181

²⁰³ See Article 88(1) Tax Collection Law of the P.R.C.

disputes, rather, tax cases should prompt the institutionalization of the tax court system.²⁰⁴

4.2.1.3. *The nebulous architect of the proposed tax court system*

Another argument put forward by those opposing a tax court is that no practical architect is available for the tax court system. The establishment of the tax court, they argue, is more theoretical than practical. According to oppositionists, the tax court system would be complicated by the following factors.

- The supervision of the tax court: both supporters and oppositionists agree that tax authorities or the SAT must be kept from supervising the tax court. Therefore, the Supreme People's Court of China should supervise the operation and management of the tax court, but no details have been provided regarding how this would work;²⁰⁵
- The setting of the tax court: if the tax court is part of the judiciary system, is it a separate sub-system paralleling the current structure with four tiers of court hierarchy, or just a tribunal paralleling administrative, civil and criminal tribunals? Is it necessary to have tax tribunals in all levels of court?²⁰⁶ If it has a principal office location, are tax court judges able to sit "at any place within China" and travel

²⁰⁴ See Xiong *supra* at 183. The demand-supply logic centers on one of the divergence between oppositionists and supporters

²⁰⁵ *Id.*, at 182

²⁰⁶ *Id.*

nationwide to conduct trials in various designated cities, as is U.S. practice?²⁰⁷ How to appeal a tax court decision?

- Competency of tax court judges: given the specialty of tax laws, judges have expertise in the tax laws, and are tasked to “apply that expertise in a manner to ensure that taxpayers are assessed only what they owe, and no more.”²⁰⁸ The same rationale applies to future judges of Chinese tax court as well. Therefore, aside from general requirements under China’s Judge Law, how to select, appoint, manage, train, evaluate and compensate qualified judges is unclear. How, for example, can China guarantee the tax expertise, rotation, and tenure of judges? Will the tax court recruit judges from “the pool of tax officials”²⁰⁹ or from elsewhere?
- Right to representation: a consistent supply of lawyers litigating tax cases is a vital component of U.S. Tax Court operation. China, however, does not have this luxury. Even as the number of qualified lawyers in China has increased 800 fold over the past thirty years reaching over 200,000 by the end of 2010,²¹⁰ there remains an urgent need for qualified and well-trained tax practitioners, and there will for the foreseeable future.²¹¹ Therefore, is it necessary to entitle CPAs and CTAs the representation under the tax court jurisdiction? How to standardize the tax professionalism?

²⁰⁷ I.R.C§ 7445

²⁰⁸ For more detail, see <http://www.court.com/article/view/united-states-tax-court> , (last visited on March 15, 2011)

²⁰⁹ See Xiong *supra* 70, at 182

²¹⁰ For a summary of development of Chinese legal profession for the past 30 years, see generally <http://china.findlaw.cn/law/506581/viewspace-22221> (in Chinese) (last visited on March 15, 2011)

²¹¹ See Li Jiyou, *Three Restrictions against the Development of the Tax Planning Practice* (Tax Judicature Reform Proceedings, 2006) at 522

4.2.1.4. Summary

As noted, those opposed to the establishment of a tax court treat the idea as impracticable under the current political and judicial situation in China. The establishment of the tax court system may lead to an overhaul of the overall judicial system and reform²¹² including the civil and criminal court systems. In addition, the idea of a tax court system needs approval from the NPC Standing Committee.²¹³ However, it is important to mention that any major judiciary reform originates from social and political needs.²¹⁴

4.2.2. Supporters' over-romanticized view

Supporters of establishment of the Chinese tax court system are hardly a minority in the Chinese tax academia.²¹⁵ Their substantiation for the tax court stands on three basic propositions: (1) taxpayers rights would be better secured by the tax court system; (2) the tax court system helps realize judicial independence and autonomy; and (3) the tax court system would make more consistent the current tax adjudication practice, which suffers from inconsistency nationwide. However, proposals supporting tax court construct

²¹² See Xiong *supra* 70, at 178

²¹³ See Article 29, Zhongguo Renmin Fayuan Zuzhi Fa [*The People's Court Organization Law of the People's Republic of China*] 《人民法院组织法》, effective as of May 1, 1979, as amended on October 31, 2006

²¹⁴ *Id.*

²¹⁵ Among all articles and conference papers reviewed on tax judicature reform compiled in the Tax Judicial Reform Proceeding, 10 out 28 articles support the establishment of a tax court system, 13 oppose and 5 prefer a midlist view of setting a tax tribunal in the existing court system

remain more hypothetical than realistic. In responding to the challenges of skeptics, the following arguments are raised.²¹⁶

4.2.2.1. Proposed organizational structure of the tax court system

According to supporters, the setting or organization structure of the tax court should follow current geographic economic essentials and development prospect rather than sticking with current nationwide administrative hierarchy. In this sense, tax jurisdiction nationwide will be divided into five or six regional tax jurisdictions. The tax court should be headquartered in Beijing under the direct supervision of the People's Supreme Court, and be structured in three tiers handling two levels of adjudications: the first trial and an appeal. Within each regional tax jurisdiction, tax court judges may travel to different sites to adjudicate tax disputes.

4.2.2.2. Enlarged scope of cases accepted

In addition to regular tax assessment or enforcement decisions, supporters boldly suggest expanding the scope of tax judicial review to cover local tax rulings and notices that are released by lowest hierarchy of tax bureaus. This proposal is extraordinary. By statute, Chinese administrative courts should dismiss petitions asking courts to overrule administrative actions with

²¹⁶ See Zhu Daqi and He Xiayang, *Lun Woguo Shuiwu Fayuan de Sheli [About Establishing the Tax Court System in China]*, Vol. 21, No. 3 pp17-22 *Contemporary Law Review*, May 2007 [hereinafter Zhu and He] 朱大旗、何遐祥,《论我国税务法院的设立》当代法学第21卷第三期. The author notes that supporters are cautious in safeguarding their positions in terms of the speculative proposals they have. Zhu and He probably contribute one of persuasive pieces in this connection. Zhu is a professor of tax law from People's University of China

generally binding force,²¹⁷ such as binding administrative regulations or rulings passed by administrative organs that are authorized or delegated by the legislature. Therefore, subjecting local tax rulings to dispute in courts would add to tax judicature reform an unintended shift in established legal hierarchies.

This proposal is nevertheless supported in two ways. First, corruption and irregular tax administrative acts usually are based on unsophisticated or otherwise perverse local tax rulings. Even with nationwide or provincial guidelines, local tax bureaus may twist policies for unstated rationales. Those supporting the establishment of tax courts point out that this sort of administrative arbitrariness leads to a large portion of controversies or disputes.²¹⁸ Second, complaints about uncontrolled, expansive and manipulative local tax policies are harsh. Aside from regular revenue collection, equally important is political pressure to increase local GDP for personnel promotion and inflate resources in developing local economy. Therefore, local-specific tax rulings are employed to “squeeze” as much tax payment as possible and reallocate financial burdens to taxpayers. To this end, distorted tax administration and uncontrolled or manipulative local tax rulings are supposed to be regulated by the envisioned tax court system.

²¹⁷ See generally Zhonghua Renmin Gongheguo Xingzheng Susong Fa [*Administrative Litigation Procedure Law of the People's Republic of China*] (effective as of October 1, 1990).[hereinafter “the Administrative Litigation Procedure Law”] 《中华人民共和国行政诉讼法》. In particular, Article 2 of the Administrative Litigation Procedure Law proscribes “If a citizen, a legal person or any other organization considers that his or its lawful rights and interests have been infringed upon by a specific administrative act of an administrative organ or its personnel, he or it shall have the right to bring a suit before a people’s court in accordance with this Law.” However, Article 12 (1) the Administrative Litigation Procedure Law provides that “The people’s courts shall not accept suits brought by citizens, legal persons or other organizations against administrative rules and regulations, regulations, or decisions and orders with general binding force formulated and announced by administrative organs”

²¹⁸ See Zhu and He supra 93 at 20

4.2.2.3. Small Tax Cases

Another concept proposed is the definition of small tax cases, which is pretty in line with the U.S. Tax Court handlings. As noted above, special procedures on trial of the “Small Tax Case” in the U.S. cover disputes for less than \$50,000.²¹⁹ Usually, the trial of “S-Cases” entails less discovery and relatively informal procedural and evidentiary standards.²²⁰ Regrettably, supporters discuss this point very briefly.

4.2.2.4. Reduction of intervention by administrative reconsideration

According to supporters, the procedural advantage of tax administrative reconsideration is over-emphasized and thus should be abolished. In this respect, supporters’ position is more aggressive and clear-cut while the opposition still have pragmatic ideas of keeping the administrative reconsideration mechanism as a filter to remove externalities caused by disputed tax assessment.

4.2.2.5. Summary

A key dividing line between supporters and oppositionists is whether the tax court system invites tax disputes or not. Supporters are more optimistic while those who oppose it are not. Paradoxically, there is no right or wrong answer

²¹⁹ I.R.C. §7463

²²⁰ See Tax Ct. R. 174(b)

to this question. Although supporters propose a different mechanism for reform, the two groups share similar criticisms. First, the full-payment rule for seeking administrative or judicial relief should be abolished. Second, the tax administrative reconsideration is not appropriate. Third, taxpayers need more realistic protection of their rights. In this sense, conflicting views of two groups display like a fair charge but are not incompatible.

4.2.3. A midlist view

An intermediate position between the opposition and supporters proposes inserting a tax tribunal into the current court system, parallel to China's civil, criminal and administration tribunals. The tax tribunal would, by definition, hear tax cases only and sits in each hierarchy of the court system, i.e., from the Supreme People's Court to lowest-level People's Court.²²¹ However, there are many complications to this plan despite its merits.²²²

First, how could China structure the appeals of lower tax court judgments? Would they go to an upper level of the tax court, an upper level administrative court, or would either suffice? This question is left largely unanswered. Second, a waste of judicial resource such as judges, administrative forces and operational spending is inevitable if the tax tribunal appears in every court on each level. After all, the need to set up a tax tribunal is not clear at each level of the courts given the limited, irregular, and widely dispersed tax caseload. Third, although setting up a tax tribunal in the current court system does not need approval from the NPC Standing Committee, but it is unlikely that a

²²¹ See Xiong *supra* 70, at 183 (quoting Zhai Jiguang, who is an adamant supporter of the middle ground)

²²² See Zhu and He *supra* 93, at 17

nationwide tax tribunal system would escape the scrutiny of the Supreme People's Court, which is heavily colored by issues of institutional independence. In this sense, the intermediate proposal seems to avoid shortcomings in the arguments of supporters and the opposition. However, it invites harsher challenges on eradicating the dilemma of its transitory nature and has its own issues of impracticality. To this end, the tax tribunal proposition somewhat suffers from illiberality of twisting the *Confucian gold rule of mean* for reforming the tax judicature construct in allowance towards catering to both supporters and oppositionists. As a result, ultimately this middle path has some theoretical merit, but little present pragmatic value.

4.2.4. Summary

As noted above, three factions of thoughts co-exist in proposing agenda of establishing the hypothetical Chinese tax court system, and each has its merits. Equally important is that they share similar reform proposals such as the removal of the pre-trial administrative reconsideration mechanism and abolishment of the full-payment rule. Overall, the opposition prefers a mild but pointed plea without inviting an overhaul of the current system. The supporters, on the other hand, are more aggressive or optimistic in seeing the tax court as a rare opportunity to reform both the judicial system and tax administration. A middle path approach is attractive at first glance, because it seems to avoid obvious problems in each of the other two positions. But its transitory nature and over-conformism misidentify a few key considerations in construct a compromise constrained by impracticality. Again, there is no clear

answer to the speculative pursuit of tax judiciary reform. The establishment of the tax court system ultimately seems a proxy for political and social policy²²³ debates rather a solemn pursuit on the Chinese legal reform agenda.²²⁴

4.3. A legitimate need of tax administration

China's tax judiciary reform is a three-front battle, as it must orient itself simultaneously toward tax administration, the general judicial system, and China's taxpayers. In China, tax law remains heavily reliant on tax administration. The enforcement and reconsideration of adverse decision of the tax administrations are inherently hierarchical. Subordinate tax officials' position in the tax administrative hierarchy determines for them the simplest, most direct, or most cost-efficient manner to seek relief. Therefore, tax administrative reconsideration is historically rooted in China's general administration framework. China does not have a court hearing tax cases only; rather, the administration tribunal within the People's Court system is the only available channel to seek judicial remedies. The taxpayers' position is disadvantaged given the dominance and authority of tax administrations. In spite of various prescribed rights, taxpayers are hindered in filing tax disputes against tax authorities in terms of procedure, financial capacity and political pressure. Therefore, the tax judiciary reform is determined by these three pillars. Due to the limited space, the prospects of tax judicial review will be introduced in the following two sessions, and the taxpayers' right protection is

²²³ See generally Xiong *supra* 70

²²⁴ See Zhaodong Jiang, *The Administrative Use of Law in China: The Baori Golf Club Tax Case*, 12 Colum. J. Asian L. 191, at 193-95

detailed later in this thesis.

4.3.1. Irregularity in local tax administration

Tax administration must accommodate both national guidelines and local interests and needs. Even though tax laws and regulations promulgated by NPC, the State Council, or the tax administrative apparatus²²⁵ are applicable nationwide, various local tax rulings, notices, and directives give effect to and define the content of these laws in practice.²²⁶ This local particularism is amplified by the local need to deal with new issues that have not been considered by the SAT or MOF.²²⁷ These local tax documents jurisprudentially are “entitled to respect” to the extent they “have the power to persuade”.²²⁸ First, not all local tax documents accurately convey the administration intent enclosed in superiors’ order or instructions. Local self-interest and discrepancies in understanding cause uneven enforcement of same legislation. Local tax administrations are also understaffed, underpaid, and undervalued. The tax administration embodies a reverse triangle hierarchical structure in terms of staff forces and enforcement of tax policies thereof. Today, over 1,000 officials work at the SAT in Beijing, hundreds of tax officials on the provincial level, over a hundred on the city level while only less than a hundred at the basic or county level. Given the fact that over 2,000

²²⁶ See generally two circulars issued by the Ministry of Finance: (86) Cai Shui Zhi No. 143, and (86) Cai Shui Wai Zi, No. 170. Government ministries, such as, the Ministry of Finance, and departments, such as the State Administration of Taxation, may issue orders or directives and promulgate rules within their respective ministerial or departmental jurisdictions

²²⁷ See Article 90, *Zhonghua Renmin Gongheguo xian fa* [“XIAN FA”] [the Constitution of the P.R.C. (1982).] Ministerial pronouncements refer to directives and rules issued in the name of government ministries or departments, such as the SAT and the MOF

²²⁸ See generally, *Del Commercial properties Inc. v. Comm’r.*, 251 F.3d 210, 214 (D.C. Cir. 2001), *cert. denied*, 122 S. Ct. 903 (2002)

rulings, notices and legislative interpretations form the law which must be applied by basic tax bureaus, local tax officials are short of expertise, time and uniformity in their enforcement.²²⁹ The over-expansive discretion of local tax bureaus may induce these underpaid tax officials to manipulate tax assessment to solicit unreasonable remuneration or bribes by trading tax assessment for unlawful personal gains. These irregular tax administrative actions all contribute to adverse tax enforcement or decisions.

4.3.2. Concerns regarding tax administrative reconsideration

Expertise and independence are two of the foremost issues involved in the critique of the administrative reconsideration mechanism. Tax expertise at the superior level usually is stronger than its subordinate tax officials. However, given the extensive scope of discretion entertained by the tax authorities in general, it is dubious that superior tax official may reach an overall just consideration in reviewing the controversy filed. For example, for tax collection only, determination of issues such as identification of the taxpayer, subject of tax, applicable tax rate, tax deduction, tax exemption, tax refund, tax bases calculation, tax jurisdiction, timing, and tax collection method are all unilaterally controlled by tax authorities. In this sense, any single item may again be reviewed against taxpayers. Moreover, the expertise of tax officials is constrained by the shortage of up-to-date training to identify legitimate tax planning activities. Often, decisions on tax evasion made by local tax official

²²⁹ See Xiao Zhumei, *Shuishou Sifa Piruan de Zhengzhuang, Bingyin ji Zhenzhi Fang'an* [*The Manifestation, Causes and Countermeasures of Judicature Weakening in Taxation*] 肖竹梅《税收司法疲软的症状、病因及诊治方案》, *Tax Judicial Reform Proceeding*, pp87-91, at 89

manifest a crude understanding or ignorance of justifiable enterprise tax planning methods.²³⁰

The independence of the tax administrative reconsideration unit faces distrust from taxpayers. Usually, local tax officials take internal reporting channels to seek their superiors' understanding and support even before they decide special tax issues. Taxpayers are given little room for argument and this dualism renders the reconsideration only a formal process rather than an independent review as anticipated. Records of such hierarchical internal communication such as reports, requests, instructions and directives largely kept from public circulation. To this end, taxpayers, when facing an adverse enforcement decision, often deem it more cost-efficient or administratively safer to seek settlement with either the tax administrative reconsideration unit or its subordinate officials. Political pressure and local GDP development needs also compose critical roles in reaching reconsideration decisions.²³¹

4.3.3. Advance rulings

There is always ambiguity in the application of tax law to specific transactions. Even the SAT and the MOF publish voluminous notices, ruling, guidelines and directives on dealing with tax issues arising from specific scenarios or transactions. Chinese tax laws in general remain inherently ambiguous and incomplete. In line with modern tax administrative practice, taxpayers especially those involved in foreign investments may desire to consult the tax consequences of a proposed transaction so that controversial issues may be

²³⁰ The author, when practicing tax law in China, remembers that a district local tax bureau in Beijing erroneously issued a penalty notice based on unsubstantiated legal reasoning

²³¹ See Xiong *supra* 70, at 183

avoided or negotiated beforehand. Tax authorities may advise generally but such “unofficial” opinions usually are not legally grounded or reliable, nor may they be raised in proceedings against the tax authority if controversy arises. Therefore, the practice of advance ruling is preferred by taxpayers wishing to obtain legally binding instructions from tax authorities. This practice is increasingly common in the U.S. and many OECD countries, which formally recognize the binding effect thereof.

Chinese tax administration, however, has been fairly conservative in employing the practice of advance ruling until recently. In limited circumstances, Chinese tax authorities may approve advance rulings upon application by taxpayers, but the scope of applicable transactions is quite narrow.²³² A few recent cases adopting advance rulings sort out pricing agreements for cross-border transfers of goods and services among subsidiaries of multinational companies which have a large commercial presence in China.²³³ Advance rulings may create procedural peculiarities such as applications to two or more tax jurisdictions²³⁴ and careful tax planning to avoid pricing discrepancies. Due to technical and procedural formalities, the

²³² See generally Guanlian Qiyejian Yewu Wanglai Yuyue Dingjia Shishi Xize (Shixing) [*Rules for Advance Ruling of Closely-held Enterprise Transactions (Trial Implementation)*] (guoshuifa) No. 118, 2004, issued by the SAT 《关联企业间业务往来预约定价实施规则(试行)》(国税发[2004]118号), see also Guanlian Qiye Wanglai Shuiwu Guanli Guicheng [*Guidelines on Tax management of Closely-held Enterprises Transactions*] (guoshuifa) No. 59, 1998, published by the SAT 国家税务总局《关联企业业务往来税务管理规程》[国税发(1998)59号], prescribing that upon application, tax authorities may approve advance ruling on a case-by-case basis”

²³³ From 1998 and 2008, there are at least 6 advance rulings are negotiated between the SAT and multinationals, such as the Walmart ruling in 2007 and the Toshiba ruling in 2005. See Zhongmei Dacheng Shouli Shuangbian Yuyue Dingjia Xieyi [*The First Advanced Ruling Concluded by China, U.S. and Walmart*] 中美达成首例双边预约定价协议, <http://news.cnnb.com.cn/system/2007/01/12/005235319.shtml> (in Chinese) (last visited on March 15, 2011)

²³⁴ *Id.*, Walmart submitted dual application to the IRS in the U.S. and the SAT in China; Toshiba submitted applications to Japan, the SAT in China and at least two local tax jurisdiction in China

application and approval of advance ruling usually drag a long time ranging from six months to a year. The term of the advance ruling usually is two to four years and is extendable up to five years.

Advance ruling is an increasingly accepted practice in China, usually conducted between taxpayers and the SAT. However, the use of advance ruling in China is still primitive and sometimes the SAT may refuse to even consider issuing a ruling on a case-by-case basis. Rarely there is any advance ruling approved by provincial or local tax authorities, because local tax officials are largely risk-averse and usually fail to match professional tax advisors in terms of tax expertise and tax planning tactics. In this connection, tax authorities should be more open in embracing and reviewing advance ruling from local enterprises or at least offer written opinions prior to transactional activities in the hope to avoid potential tax controversies.

4.3.4. Summary

Today, the tax administration is the most important part in structuring modernization of China's tax system. Despite some progress, efforts at its reform have failed in several ways. First, the irregular enforcement of tax laws and regulations applicable nationwide creates discrepancies which invite tax dispute. Moreover, provincial and local tax bureaus are entitled with too much discretion in handling tax collection and dealing with taxpayers. Second, the expertise and independence of tax authorities is subject to challenge and improvement in many ways. The dualism of superior and subordinate tax officials may make taxpayers' rightful claims futile and impractical. Records

of such hierarchical internal communication such as reports, requests, instructions and directives have mostly been kept out of public availability. Therefore, taxpayers' right to know is severely discounted by tax authorities' persuasion to accept settlement. Third, China's tax administration is resourceful in preventing tax controversies. The issue is how adamantly and flexibly it wants to honor taxpayers' legitimate requests. Advance ruling, in this sense, exemplifies one of the cost-efficient approaches available to China's tax administration.

4.4. Judicial review through the lens of tax judicature

Dicey defines the rule of law in terms of judicial review that requires that²³⁵ only an ordinary court can punish law breakers and equality must be guaranteed regardless of social, economic, or political status in terms of substance and procedure.²³⁶ Raz further details that uniformity, independence, transparency and procedural justice should be established in the judicial review system to effectuate the rule of law. Meanwhile, an independent, effective and true judicial authority is essential to compliance with China's WTO commitments. The Protocol mandates the establishment of tribunal, contact points and procedures for the prompt review of all administrative actions relating to the implementation of the laws, regulations, judicial decisions, and administrative rulings of general application referred to in the WTO rules. Obviously, the tribunals must be independent of administrative organs and thus are required to be "impartial and independent of the agency

²³⁵ See generally Dicey, *supra* 7

²³⁶ See generally Palekar, *supra* 8

entrusted with administrative enforcement and shall not have any substantial interest in the outcome of the matter.”²³⁷The tribunals may be administrative or judicial, however, right to appeal must be granted if the case is originally submitted for an administrative review following due process.

The tax judiciary system is vital to China’s general judicial framework. As noted above, judicial review of tax administrative discretion is doctrinal. Tribunals hearing tax cases with judicial review power should examine tax authorities’ actions that are incompatible with constitution, written tax laws and regulations, and related procedures. Meanwhile, the tax judiciary system is a key component of modern tax governance. As China does not have a strong institutionalized separation of powers, the tax judiciary reform implicates changes in the relationship between courts and the administrative structures created by and for China’s one-party state. There should be a realistic expectation of the role that can be played by the tax judiciary in this context. The tax context has its peculiarities. This section would take tax judiciary as an example to briefly analyze flaws embedded in China’s general judicial review structure, and submit proposals for its reform. Again, it is continually important to mention that the procedure and scope of judicial review is a case-by-case undertaking by each country based on different social, economic, political and legal settings.

The past three decades have witnessed an improvement of China’s judicial structure in many ways. It remains to be seen whether such progress will entail broader application. However, many scholars still keep a skeptical, albeit optimistic, view of China’s judicial review mechanism. Among the reasons

²³⁷ See *Accession of the People's Republic of China*, WT/L/432 (Nov. 10, 2001), Part I, para. 2(d), <http://www.uschina.org> (last visited on March 15, 2011)

given by these academics for their skepticism, the following particularly implicate China's tax judicature reform which has a longstanding emphasis on stipulation and enforcement. China's judicial review system suffers from non-uniformity, political intervention, impartiality, deficiency of expertise, and narrowed scope of caseload. Non-uniformity in the tax judicature system is a consistently recognized problem. Political interference is notorious. Impartiality primarily refers to the dynamics among taxpayers, tax administration and judicial tribunals. Tax expertise demands deliberation in terms of the complexity and caseload of tax disputes and even more so when a proposal for summary judgment is posted. Overall speaking, discussing flaws specifically associated with the tax peculiarities is crucial. Equally contributive for this thesis is to introduce proposed thoughts that should be considered for improving competency and legitimacy of the system.

4.4.1. Uniformity

As noted, the consistently asymmetrical enforcement of local tax bureaus prolongs the problem of non-uniform enforcement of tax laws nationwide in China. The same rational applies to local courts hearing tax disputes. In theory, tax laws should subject all taxpayers to equal treatment. Because tax adjudication falls to whichever local administrative tribunal has jurisdiction, there is an opportunity to have divergent applications of the same tax laws governing similar issues. The principle of equality requires that courts nationwide adjudicate similarly situated people on analogous basis. Otherwise, the tax administration would be arbitrary in and abusive of entitled discretions.

Moreover, given the cross-region or even cross-border mobility of capital and labor as well as simultaneously conducted commercial operations, for the same taxpayer, a selection of different tax jurisdictions, i.e., the administration courts, may invite quite different judgments for the similar tax dispute at issue. This mess may be interpreted as either bad or good. It is bad in that it may create tax jurisdiction shopping which may be manipulated as an incentive to attract outside investments. It is good in that it may promote vigorous competition of expertise or adjudication techniques among judges on a shared bothersome tax issue for the benefit of taxpayers or the tax administration. If the good aspect turns out valid, any appeals in this connection then have opportunity to get into uniformity.

Is national uniformity on adjudicating similar tax issues a possibility? Yes. Two types of efforts can bring this about. First, a top-down approach is employable by the People's Supreme Court or the SAT to release a uniform official standing on the issue, and a tax scholar may serve as *ex officio* endorsing the reasoning. Second, a spill-over process is taken by the taxpayer to bring in an acceptable judgment to other tax jurisdictions might promote consensus among all jurisdictions involved. The need for uniformity may also promote the development of a national tax court with exclusive jurisdiction, which, if established, could render better uniformity.

4.4.2. Political intervention into judicial independence

Obstruction by political influences is an acknowledged complication for judicial independence reform in China. Courts hearing tax cases are no

exception to this affliction. For example, one of most recent political impositions on judicial independence has resulted from the “Three Supremes”, which holds that the undertaking of the Party, the interests of the people, and the Constitution and laws (in the order as originally stipulated) must all be given the utmost consideration in law enforcement and adjudication.²³⁸ But the “Three Supreme” actually makes only the “Party Supreme”²³⁹ insofar as “the Party’s exclusive supervision over the court system must be guaranteed.”²⁴⁰ In addition, commentators raise the following charges as to political intervention into judicial independence in China.

- The expenditure and budgetary line of local judicial tribunals and compensation of local court judges are funded by local governments or authorities in sectors concerned. This is particularly noteworthy because local tax bureaus or public finance bureaus are directly responsible for disbursing funds to local courts. It is very likely local tax bureau tool its “treasury” role in influencing adjudication of tax disputes where the local tax bureaus is the defendant. The local tax bureau may even hold a better position than other administrative apparatuses in persuading local tribunals to award the winning to the local bureaus.

²³⁸ See Hu Jintao’s Speech at the National Conference on procuratorial, judicial and public security work (December 26, 2007) 《胡锦涛在全国政法工作会议的发言》 (in Chinese)

²³⁹ See He Weifang, Sange Zhishang Shui Zhishang [*Three Supremes, Who is the Most Supreme?*] 贺卫方 《三个至上”谁至上?》, http://blog.sina.com.cn/s/blog_488663200100atga.html (in Chinese) (last visited on March 15, 2011)

²⁴⁰ See generally, *Deepening the Theoretical Research on the “Three Supreme” Guideline 进一步深化“三个至上”指导思想的理论研究*, <http://www.chinacourt.org/html/article/200906/26/362750.shtml> (in Chinese)(last visited on March 15, 2011)

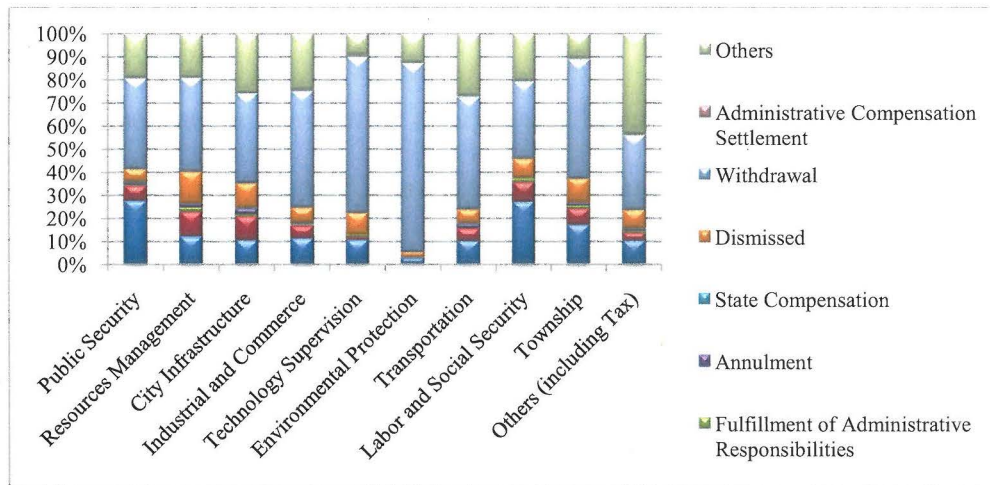
- The judges of local judicial tribunals are appointed by the local People's congress at the same hierarchy, which forces the courts to subject judicial review to the desires of the local political organ;
- The adjudication or case handling of local judicial tribunals is subject to supervision of the local People's congress at the same hierarchy. As per the China Supervision Law, the areas of supervision include (1) reviewing annual and specialized work reports submitted by courts; (2) investigating the enforcement of laws and regulations; (3) filing and reviewing judicial interpretations and other normative legal documents; (4) questioning judicial personnel about relevant cases; (5) investigating specific issues; and (6) appointing and removing judicial officials. Therefore, almost all elements of judicial independence are supervised or monitored by the local People's Congress, which is under the direct leadership of the Party-state.
- Returning to political economy studies, tax policies sometimes represent or reflect social or political policy orientations, directly or indirectly. Therefore, the adjudication of tax issues may relate to promotion or public signal on specific public policy issues. The constraints from general political and social settings cannot be understated for tax judicature.

4.4.3. Impartiality

As noted above, there is always ambiguity in the application of tax law to specific transactions, and Chinese tax laws in general remain inherently

ambiguous and incomplete. This invites deliberation of tax laws by both tax authorities and courts hearing tax disputes. Therefore, it is of high legitimate significance to examine whether the tax judicature system can honor impartiality in adjudicating tax disputes between taxpayers and the tax administration. This part aims to briefly review the current system and suggest proposals for its reform.

Administrative tribunals adjudicate tax cases prejudicially. Empirical evidence clearly confirms that tax administration wins more often than the taxpayer. Numbers discover that impartiality is nearly nonexistent given the sharp disparity as shown below. In 2009, out of all administrative cases at the first phase from the “Other Cases” category which includes tax disputes, cases in favor of the defendant administrative body, i.e., cases “affirmed,” “invalidated,” “fulfillment of administrative responsibilities,” and “dismissed,” account for over 25% and cases “settled” account for 20%; while cases in favor of petitioner. The “annulled” and “awarded administrative compensation” cases only compose less than 2% of the total caseload. This empirical simple empirical observation at least shows the scarcity of impartiality in the tax judicature system. There are a number of causes of the evident pro-administration bias in the Chinese tax judicature system.



(Figure 15)

Source: China Law Statistics Yearbook (2009)

4.4.3.1. Legitimate reasons for disparity

- The burden of proof and the merits of tax disputes may somehow proffer better litigation leverage to tax administration. Generally, the burden of proof as to tax cases at the administrative tribunals falls on the tax administration. The tax administration may present better evidence to persuade judges to favor its position, while taxpayers usually manifest deficiency in submitting evidence to prove tax authorities' errors. Chinese tax laws and regulations are quite straightforward, and not as intricate as those in western jurisdictions. The issues of tax cases are sometimes without merit. Rather, they may arise out of a misunderstanding of the law, poor advice from an associate, the stubbornness of a corporate management, or simple obstinacy by the taxpayer. Some taxpayers are either unable to pay or simply want to take the chance of litigating to reduce tax liability if at

all possible.

- Experience matters. With a larger and better trained staff, the tax administration usually is more experienced in litigating tax disputes, while a single taxpayer may have limited tax knowledge or unfamiliarity with the administration tribunal. Even though a taxpayer might consult a lawyer the cost-efficiency concern of fighting the local tax bureau may prevent her doing so. Even if the taxpayer wins in the first trial, the tax administration usually chooses to appeal and often still has good chance to win the case. Having said the above, how the administration tribunal applies the tax laws is still a factor in weighing experience.
- The discretionary strength of the Chinese tax administration may persuade the administrative tribunal judges to accept the government's position in many ways. As to tax collection cases, tax authorities' unilateral administrative construction embodies a wide range such as the subject of tax, applicable tax rate, tax deduction, tax exemption, tax refund, tax bases calculation, statute of limitation, and tax collection method. Any single act derived from this long list howsoever may arm the tax administration to use equitable judicial doctrines for its own favor.

4.4.3.2. Judicial Independence

The obvious lack of judicial independence in many cases may make a taxpayer skeptical of benefit of pursuing a claim. Aside from the political intervention

in the financial security of local judges as noted above, local administrative tribunal judges are inclined to coordinate a settlement rather than releasing a one-sided judgment. This is a tacit and ever-present manifestation of the desire to promote social harmony and keep a healthy relationship between the government and taxpayers. Meanwhile, the political hierarchy sometimes drives local judges to have the mentality that the government and judiciary are on the same team, in opposition to taxpayers. Local judges may also have a mentality to enforce tax administrative decisions for local benefits, given the contribution of tax revenues to local GDP growth.

4.4.4. A deficiency of expertise

Another burden impairing the autonomy and independence of judicial system is the deficient expertise of judges.²⁴¹ This problem is particularly applicable in the tax judiciary context. Since the state's power to tax fundamentally limits the scope of taxpayers' private property rights, tax expertise employed in adjudication for interpreting and substantiating this power must be competent and proficient. In terms of judicial autonomy, tax adjudicators' expertise guarantees the just legitimacy and functionality of China's judicial system. As to judicial independence, tax expertise would empower adjudicators with neutral and decisive judgments and restrict the tax administration from interfering with the administration of justice. Moreover, tax expertise of local tribunal judges has been criticized and somewhat

²⁴¹ See generally, Donald C. Clarke, *Introduction: The Chinese Legal System Since 1995: Steady Development and Striking Continuities*, 191 *China Q.* 555, 556 (2007), discussing the expertise of judges impedes further development of the Chinese legal reform

doubted by both taxpayers and tax administration. There are a few factors contributing to this deficiency.

First, usually local judges are not trained in the specialty of tax. Rather, when tax disputes are filed, the tribunal appoints a judge who is familiar with the transaction where tax issues arise. A judge presiding a tax dispute may be appointed just because she is more acquiescent with the tax administration or the taxpayer. This is sharply different from the U.S. practice where judges at the Tax Court are chosen from among former IRS employees and veterans of tax private practice.

Second, most tax experts are employed by the tax administration. Since the talent pool is so concentrated, given the bureaucratic connection between courts and the tax administration, judges are willing to seek advice from experts within the administration – a major conflict of interest in the minds of many observers of the system. Taxpayers question the autonomy of local tax judges in terms of influence from tax authorities. Often, judges hearing tax cases take tax authorities' opinions as authoritative guidelines or instructions.

Third, the continual tax training of local tribunal judges is not significant. Rather, since tax disputes mostly are filtered through the tax administrative reconsideration mechanism, tax disputes before courts are of one of two types: simple issues with answers identifiable without much judicial deliberation, and vexing issues that are beyond the expertise of local tribunal judges. When adjudicating cases in the second category, judges have no choice but to seek expert opinions, which is not wrong by itself, but creates a conflict of interest when the expert is from tax authority. Moreover, the caseload of tax disputes is limited. Such shortage even gives judges less exposure to cutting edge tax

issues. For example, very few judicial staffs may be capable of articulating a working knowledge as to tax avoidance, tax evasion or tax planning.

In summary, deficiency of tax expertise in local judiciary leads to an impairment to tax judicature. The autonomy of tax adjudicators is weakened by the tax administration and its own incompetency. Moreover, an independent opinion on tax a tax dispute can be unattainable due to tax administration's dominant position in interpreting the tax laws. Regretful is that this deficiency is unlikely to change in the near future given the prescribed pre-trial administrative consideration for tax disputes.

4.4.5. Narrowed scope of caseload

The scope of judicial review in China is arguably narrow. In China, general rules made by administrative agencies are not excluded from judicial review, such as local administrative rulings, notices, and directives. This means that, even if a local tax notice or enforcement procedure is based on a distorted understanding of superior administrative orders, taxpayers have nothing to do unless upper level of tax authorities repudiate it by way of an internal order. This is particularly sensitive to taxpayers as it often results in the unjust taking of their property. Moreover, taxpayers' right to know is limited with regard to access to forthcoming local rules, which would help taxpayers proactively conduct tax planning and corporate management.

Further, too many local administrative rulings, notices, and directives under guidelines and instructions flood into the judiciary. This propensity toward complexity and uncertainty in the implementation of the law is partly caused

by the lack of a mechanism for judicial review. The extensive local administrative documents on one hand dilute administrative efficiency, and create irregular local actions on the other. Local administrative tribunals may be distracted by relatively meritless cases. To this end, there should be a “quality control” mechanism to identify legitimate cases, concerning specific administrative acts, for judicial review. Not all administrative adverse decisions should be unconditionally allowed to be submitted for litigation even for those which have completed the administrative reconsideration procedure. Although criticism about pre-trial tax administrative reconsideration is widely shared, there are fewer consensuses about the value of the “filtering” function. The outstanding issue is about how to control the administrative reconsideration but not the pre-trial procedure itself.

4.4.6. Summary

This subchapter briefly reviews flaws of tax judiciary system and, to a limited extent, drawbacks in the general judicial review system in China. There are a few factors attached to China’s tax judiciary deficiencies. First is non-uniformity. Distorted understanding and peculiarities of the tax laws and the influence of local interests create non-uniform adjudication of tax disputes. Cross-jurisdiction irregularity in judgment may be brought against the same taxpayer and lead to jurisdiction shopping. However, national uniformity might be achievable under the supervision of the Supreme People’s Court and the SAT. Second is about political intervention entailed in supervision from local People’s Congress, local tax authorities, and general political and social

policy arrangements. Third refers to the impartiality in terms of the flawed disparity in favor of tax administration in the adjudication practice. A few factors contribute to such disparity such as burden of proof, merits of tax cases, litigation experience and techniques, and over-expansive discretion enjoyed by the tax administration. Fourth involves in the tax expertise of local tribunal judges. Deficiency of tax expertise is caused by weak training, shortages of cases, irregularities in the caseload, and the dominance of expertise concentrated within the tax administration. Finally, the arguably narrow scope of judicial review in the tax context is another potential focus for reform. The scope should include abstract administrative acts such as local tax rulings, notices and directives, *if* they clearly violate laws of higher authority. Further, tax disputes derived from overly extensive local tax administration acts should not be unconditionally filed. The “case-merit control” should be incorporated but not limited to an upgraded pre-trial tax administrative reconsideration “filter”.

4.5. The Taxpayers’ rights perspective

The third and last cornerstone of a robust tax judiciary framework deals with taxpayers’ rights protection.²⁴² In any modern tax government, taxpayers have the right to appeal an adverse decision of the tax administrations. Tax judiciary in turn delivers just decisions by performing a judicial review of tax authorities’ discretions and protecting taxpayers’ private property from unfounded extraction. China has a legitimate need to develop a set of rules for

²⁴² See *infra* Chapter VII for details on the protection of taxpayers’ rights protection in China. This section only presents a brief introduction of the topic

promoting taxpayers' rights, the awareness of which emerge in a meaningful and pragmatic manner for bettering outcomes of economic behavior and social policy implementation. Taxpayers' rights primarily are divided into primary and the secondary rights. Meanwhile, almost all deficiencies and drawbacks of human rights protection and the tax law system fall into the taxpayers' rights area. The constitutional enrichment of primary taxpayers' rights is weak because of a misunderstanding of how to situate taxpayers to claim or interpret primary legal rights. Secondary taxpayers' rights are supposed to be enriched with enough clear-cut rules in detailing taxpayers' administrative and legislative rights, but China's current framework fails to contribute those details in a satisfying manner. Although the Tax Collection Law, the Proclamation and relevant administrative procedural laws facilitate, to some extent, clarification and expansion of rights available to taxpayers at first glance, those stipulated rights remain short of jurisprudential significance and practical value, showing the necessity to identify each category of taxpayers' rights with enough details.

As to China's tax judicature reform, the most substantive rights are taxpayers' right to know, right to plead, right to a fair hearing and right to appeal. The right to know guarantees predictability of tax consequences after a taxpayer learns details of applicable tax laws and regulations. Right to plead refers to tax authorities' responsibility to explain details and evidence for reaching an adverse decision against a taxpayer. Right to a fair hearing requires an occasion where taxpayers and tax authorities can present arguments during a pre-trial process. Usually, this happens when an administrative reconsideration is filed. Right to appeal is the last resort that a Chinese taxpayer may rely on;

however, it in quite many cases it leads to a settlement between the taxpayer and tax authorities. To this end, the issue centers on the realization of taxpayer's protections but not those found solely in legal documents.

Being mindful about frustrations of taxpayers' rights protection, it might be over-cynical to understate the progress and merit of rights protection reforms in China's tax context. Overall, China's tax mix still provides a formulated, yet promising, framework to facilitate access to available legal remedies, both administrative and judicial, for taxpayers. In particular, the administrative lawsuits filed by taxpayers attain more respects and identification, although such awareness is discounted by the "non-contentious" or "settlement" culture in China.

In line with tax judicature reform, the protection of taxpayers' rights serves as a key element substantiating China's construct of the rule of law order and fulfillment of WTO principles. Both the tax judicature and the taxpayers' rights provisions should embrace a *fair, transparent, certain, consistent, equitable, effective, and clear* tax law for the sake of promoting the rule of law order. The WTO principles require similar inculcation, into China's tax judicature, of principles of *transparency, uniformity and impartiality and judicial review*.

4.6.Summary

This subchapter focuses on the *status quo* and flaws of China's current tax judicature, and to a much less extent, reviews the general Chinese judiciary framework in terms of the competence, autonomy and independence through

the lens of tax judicature. Mostly, the tax judicature system suffers from flaws and particularities penetrated from both the tax context and China's general judicial framework.

The first section suggests that the Chinese tax judicature system includes two components: the tax administrative reconsideration and tax administrative litigation. In particular, a few obvious flaws are discussed: (1) the condition of the pre-trial tax administrative reconsideration; (2) the full payment requirement for disputes arising from tax collection which receives vehemently criticism from both judges and scholars; (3) the deficiency of competence for judges hearing tax cases. All these flaws, coupled with adamant efforts to increase revenue collection, call for an upgrade of the Chinese tax judicature reform.

The second section reviews an interesting debate among Chinese tax scholars as to the establishment of a tax court system. Arguments from three factions: an opposition, supporters, and a middle path, are reviewed. (1) *The opposition* treats this goal as impracticable under the current political and judicial settings in China. They are skeptical of what they believe to be a requirement in the plan of a complete overhaul of the entire judicial system and reform. Major arguments include that the current system generally functions well and only needs adjustment, an enforceable model is not available, and any major judicial reform must come from and be oriented toward actual social and political needs. (2) Supporters optimistically believe that a tax court system invites tax disputes. Paradoxically, both supporters and oppositionists share similar criticisms of the full-payment rule and the pre-trial tax administrative reconsideration. A supporters' key point is that taxpayers need deliberations

and more realistic protection of their rights through a tax court system. (3) The intermediate view seems to strike an attractive compromise between the two polar opposite positions at the first glance, but its transitory, costly and overhauling nature and over-conformism misidentify a few key aspects of a basic court system.

The third section reviews China's tax administration for a better construct of the tax judiciary system. A few flaws are identified. (1) The irregular local enforcement of tax laws creates discrepancies which invite tax disputes. Local tax administrations are entitled with overly expansive discretion in handling tax collection and dealing with taxpayers. (2) The expertise and independence of tax authorities are subject to challenge and improvement. The dualism of superior and subordinate tax officials may make taxpayers' claim futile and impractical. Taxpayers' right to know is severely discounted by tax authorities' persuasion to accept settlement. (3) China's tax administration is resourceful in preventing tax controversies. The issue is how adamant and flexible it wants to honor taxpayers' legitimate requests. Advance ruling exemplifies one of the cost-efficient approaches available to tax administrations.

The fourth section briefly reviews flaws in the general judicial review system in China through the lens of the tax judiciary system. (1) Non-uniformity: distorted understanding and peculiarities of the tax laws and locality self-interests create non-uniform adjudication of tax disputes. Cross-jurisdiction irregularity in judgment may be brought against the same taxpayer and lead to jurisdiction shopping. (2) Political intervention: mostly, pressures from three factors, including local People's Congress, local tax authorities, and general political and social policy orientations, impair the tax judiciary system. (3)

Impartiality: there is always an empirically-proven, flawed disparity in favor of tax administration in adjudication practice. A few factors contribute to such disparity such as burden of proof, merits of tax cases, litigation experience and techniques, and over-expansive discretion enjoyed by the tax administration.

(4) Tax expertise: the deficiency in tax expertise is caused by weakened training, shortage of caseload, and dominance of expertise concentrated within the tax administration. (5)The narrow scope of judicial review: this flaw has two prongs: the scope should include abstract administrative acts such as local tax rulings, notices and directives, and tax disputes derived from uncontrolled, over-meticulous and voluminous local tax administration acts should not be unconditionally filed. The “case-merit control” should be incorporated but not limited to the pre-trial tax administrative reconsideration “filter”.

The fifth and last section briefly discusses the role of taxpayers’ rights in reform the tax judicature system. Mostly, taxpayers’ rights should accord to a rule of law order inviting a *fair, transparent, certain, consistent, equitable, effective, and clear* manner within the tax law context. WTO principles similarly require an inculcation of principles of *transparency, uniformity and impartiality* and *judicial review* into the Chinese tax system.

V. Submission of proposals for China’s tax judicature reform

5.1. Two Prongs of tax judicature reform

The tax judicature reform in China has two major prospects.

First, in light of the peculiar situation of the Chinese tax system in its legal and institutional framework, the role of tax judicature should not be exaggerated in regard to its potential for overhauling or extending to the whole tax law field. Rather, the progress of judicature reform itself should be integrated into the system piecemeal. Another key point is that taxation involves a balance among extraction of taxpayers' private property, tax collection, and social wealth distribution. Judicial review of tax administrative discretions should give consideration to both the exigencies of tax collection and the protection taxpayer rights. Any bias toward one of these elements impairs the other. Therefore, uniformity of decisions, tax expertise in the judicature and restriction of rights exploitation should be pursued with equal vigor.

Second, the penetration of flaws and established settings of China's general judiciary framework into the tax laws arena must be carefully examined and evaluated. Proposals for tax judicature reform should feature the judiciary system in an efficient way. Fantasies about using the tax judicature reform to fabricate a whole new judiciary system or expecting an immediate overhaul of China's judicial reform will prove futile and rootless. Therefore, proposals should be tailored realistically and pragmatically, with regard to their benefit to administrative efficiency and rights protection.

It is essential that tax judicature reform, in line with upgrades of the tax legislature, administration and taxpayer's rights protection, must be grounded in the rule of law order embracing a *fair, transparent, certain, consistent, equitable, effective, and clear* judicature. Meanwhile, it should also incorporate WTO principles of *transparency, uniformity and impartiality, and judicial review*. Those principles might not be directly translated into due

process enclosed in the tax judicature undertakings, but the jurisprudential value reflected in the general judiciary framework must be incorporated. Based on these notions, this thesis would submit the following proposals in the order of tentative feasibility and significance.

5.2.Repudiation of the full-payment rule

This thesis shares the position that China should eliminate the full-payment rule.²⁴³ By statute, a taxpayer must first pay or remit tax payments, surcharges, and late fees (if applicable) due or provide guarantee in the first place before filing an application for the tax administrative reconsideration or a law suit.²⁴⁴ As discussed, this rule should be abolished for the following reasons. The full-payment rule bars financially incapable taxpayers from exercising the right to seek relief through administrative or judicial tribunals. The full-payment rule is not in line with principles of equity and ability to pay. Based on the principle of proportionality, it is suspected to add the burden of proof on the taxpayers' side, and this worsens the already imbalanced bargaining position prejudicing taxpayers.

5.3. Summary judgment for small tax cases

Summary judgment is increasingly encouraged by the Supreme People's Court,²⁴⁵ especially for the adjudication of administration cases.²⁴⁶ However,

²⁴³ See *infra* section 4.1.2. for analysis and accompanying footnotes

²⁴⁴ See Article 88(1) of the Tax Collection Law

²⁴⁵ See Zuigao Renmin Fayuan Guanyu Kaizhan Xingzheng Susong Jianyi Chengxu Shidian Gongzuo de Tongzhi [*SPC Notice on Experimental Work on Advancing Summary Judgment*

this rigorous effort has not been extended to the tax field yet. The past three years have seen an increase in the number of administrative cases decided on summary judgment. Most of that growth has come in rulings in the industrial and commercial areas. The tax judicature system should take this unprecedented opportunity to include summary judgment in its reform agenda. Moreover, the U.S. Tax Court practice shares the same trend of increasing use of summary judgment for tax collection due process suits.

Summary judgment of tax cases should be offered to collection due process lawsuits. In particular, taxpayers should be entitled to elect a “*small tax case*” procedure, which would allow for summary judgment, if the amount in dispute is less than a prescribed value, say RMB 100,000. If the tax administration is not comfortable with losing discretion, the summary judgment could even be limited to such small tax cases.

Adopting summary judgment for small tax cases has two advantages. (1) Keeping the current pre-trial tax administrative reconsideration procedure unchanged, if a taxpayer has a qualifying tax collection case, she may check the box for a summary judgment. This adds efficiency for all three parties involved: the taxpayer; the tax administration; and the tribunal. (2) The summary judgment process provides unparalleled opportunities to train judges in the tax field. The caseload in this area is larger and issues are more straightforward. Further, this training process also prepares judges to staff a tax court, should it ever be created in China. Summary judgment also enjoys

for Administration Lawsuits] (SPC No. 446, 2010) 《最高人民法院关于开展行政诉讼简易程序试点工作的通知》(法〔2010〕446号)

http://www.chinacourt.org/flwk/show.php?file_id=146359 (last visited on March 15, 2011)

²⁴⁶ Hainan Province started the experimental work on summary judgment in April 2010 and received very good feedbacks from both judges and petitioners, <http://www.cpd.com.cn/n1695/n3569/c1406229/content.html> (last visited on March 15, 2011)

several other advantages: lower burden of proof, less discovery practice, relatively cooperative procedural standards at trial. To this end, the settings of “*small tax case*” procedure, i.e., summary judgment, creates a win-win situation. Also, the summary judgment helps reinforcing the longstanding emphasis on stipulation and informal cooperation.

5.4. Cautious restructuring of the tax administrative reconsideration

The thesis cautiously agrees, with those who oppose the creation of a tax court, that improving the structure of the pre-trial tax administrative reconsideration mechanism is more feasible.²⁴⁷ It shares an opinion with the opposition to the tax court that realistic reforms must be pursued first. It may be too brusque to abolish this pre-trial reconsideration procedure. Further, such reconsideration does have value in “filtering” meritless cases or plainly dogmatic application of laws. Finally, it might be feasible to set up a separate “internal tribunal” unit within the tax administrative framework to perform the reconsideration. However, this “internal tribunal” can be best made possible by political drives, but not for the sake of administrative efficiency.²⁴⁸

5.5. Building up tax expertise

Promotion of tax expertise in judges is straightforward. It requires selecting junior judges with strong tax training and specifically assigning them more tax cases, and expanding the current pool of judges with tax expertise by hiring

²⁴⁷ See *infra* section 4.1.2. and accompanying footnotes

²⁴⁸ See Xiong *supra* 70, at 184

experienced tax experts from the tax administration. This could create conflicts of interests, but the risk is worth it. Also, hiring tax scholars with adjudication experience for expert opinions on an *ad hoc* basis is quite feasible given that the authority of tax judges can be established with tax scholarship, which is a key factor in the Chinese court practice.

5.6. Subject general administrative actions to judicial review

Following the WTO principle of judicial review, discretionary actions made by administrative authorities are subject to judicial review in WTO member countries. These discretionary actions generally include abstract administrative acts, such as promulgation or enforcement of locally-tailored tax rulings, notices or directives. Under Chinese law, even they clearly violate or are not in line with laws of higher authority, such abstract tax administrative acts would escape from judicial review.²⁴⁹ The best a taxpayer can do is to report such discrepancies but have to wait for a superior administrative order which sounds nebulous in practice. A clear proposal is to subject certain illegitimate local tax rulings, notices or directives to judicial review by the administrative tribunal of the same hierarchical level. In particular, a county's (the lowest administrative hierarchy) tax rulings should be subject to review by the basic administrative tribunal in the same jurisdiction (the lowest tribunal available). At the moment, this judicial review has to be kept at the lowest level of the administrative hierarchy in selected localities for two reasons: (1) the potential of creating administrative turmoil there is slim; and (2) selected localities

²⁴⁹ See generally *The Administrative Procedure Law of the People's Republic of China*, (effective as of October 1, 1990). 中华人民共和国行政诉讼法

should at least include coastal economic development zones where better services and tax officials are available for preventing contingencies.²⁵⁰

5.7. Tax Court

Seconding the views of those opposed to the establishment of a tax court, this thesis does not advocate establishing such a tax court system at this stage or in the foreseeable future, nor does it concur with the middle path of inserting a “transitory” tax tribunal within the current court system. It makes two reform suggestions along these lines.

5.7.1. The Structure of tax court system

Even if a tax court system were to be adopted, the desirable structure would be a circuit tax court exercising both original and appellate jurisdiction. Original jurisdiction would make it a court of first instance, but it would exclude those summary judgment cases in which the amount in dispute was less than, say, RMB 100,000. The circuit tax court should sit permanently in six to eight regions covering nationwide territory and report to the SPC Tax Tribunal based in Beijing. The designated High Tax Tribunal is an SPC subsidiary, paralleling peer criminal or civil tribunals. It should have the ultimate appellate jurisdiction over tax cases appealed at circuit tax courts and

²⁵⁰ In the field studies at local tax bureaus at Waigaoqiao Free Trade Zone in Shanghai, this proposal was even praised by tax officials who believe, unofficially, such judicial review will help them concentrate on interpretations rather than promulgation (notes on file with the author)

provincial high courts and responsibility for tax court system administration or management.

5.7.2. Policy orientations and tradition

The intermediate view described above should be denounced as well. First, aside from shortcomings as noted above,²⁵¹ the eventual goal of the middle path is still adopting a tax court system, but doing so as a spin-off of the current system. Given the complications brought in by the midlist structure such as inserting a tribunal to each level of court at every locality, its transitory, costly and overhauling feature and its impracticality render it infeasible. Second, an established but unwritten routine for tax law or judicial reform in the past three decades mostly follows a pattern of reaching finalization through experience of experimental work in selected localities, but rarely took the detour of transient proposal. Again, this thesis shares with oppositionists' view that the establishment of a tax court system is a decision based on political needs and social pressure.

5.8. Summary

This subchapter submits a few proposals for China's tax judiciary reform. Mostly, the proposals remain based on the following theoretical analysis: (1) the tax context has its particularities. Tax judiciary's role therefore should not be exaggerated in overhauling or extending to the whole tax law field. (2)

²⁵¹ See *infra* Section 4.2.3. and accompanying footnotes for detailed discussions.

Flaws and established settings of China's judicial framework translated into the tax law context must be carefully examined and evaluated.(3) the tax judicature should ground itself on the rule of law order emphasizing a *fair, transparent, certain, consistent, equitable, effective, and clear* system. (4) The WTO principles of *transparency, uniformity and impartiality* and *judicial review* should be fulfilled utmost extent possible with a set of niceties and convenient courses of action, even those principles might not directly apply to the tax context.

The following proposals are raised in this subchapter. (1) The full-payment rule should be abolished. For an adverse tax collection decision, a taxpayer does not need to pay the assessed payment or provide guarantee at the first place before filing an application for a tax administrative reconsideration. (2) A summary judgment procedure should be established for small tax cases as a tax collection due course procedure. The summary judgment generally enjoys several advantages: keeping the current reconsideration procedure untouched, promoting tax expertise of judges, lower burden of proof, less discovery practice, relatively cooperative procedural standards at trial. (3) A better scheme should be designed for the tax administrative reconsideration mechanism, but the structure must be calculated and designed. (4) Tax expertise can be strengthened by teaming up more experienced personnel with those who specialize in tax. (5) At the lowest level of the local bureaucratic hierarchy, abstract administrative acts should be subject to judicial review. This reform could be implemented, at first, in a few coastal localities which have better tax talents. (6) If a tax court should be established, the desirable structure is to adopt a circuit tax courts framework with all courts exercising

both original and appellate jurisdiction and sitting permanently in six to eight regions covering a nationwide territory and reporting to the SPC Tax Tribunal based in Beijing. The designated High Tax Tribunal is an SPC subsidiary and should have the ultimate appellate jurisdiction over tax cases appealed at circuit tax courts and provincial high courts, and perform tax court system administration or management.

VI. Conclusion

The Chinese tax judicature involves three fundamental actors and perspectives: tax administration, the general Chinese judiciary, and taxpayers. Tax judicature reform is not an isolated undertaking. It calls for considerations from various related contexts. China's tax law framework has its peculiarities. The role of tax judicature, as a key component, should not be prolonged for overhauling the whole tax law arena. Flaws and established settings of China's judiciary framework translated into the tax judicature must be carefully examined and evaluated. Any over-romantized tax judicature reform proposals must be proactively reviewed in the context of the general judicial situation in China. Under China's socialist legal system, the tax judicature should ground itself honoring a rule of law order emphasizing a *fair, transparent, certain, consistent, equitable, effective, and clear* framework. Meanwhile, the WTO principles of *transparency, uniformity and impartiality and judicial review* should be incorporated to the utmost extent possible. Overall, "China's tax

judicature should reflect its social and economic development situation before introducing pragmatic reform proposals.”²⁵²

First, the administrative law system reform expects to submit tax authorities’ discretion for a functional and productive judicial review process. Taxpayers’ awareness raises the request to find a more taxpayer-friendly and just tax judicial setting for rights protection. Overwhelming but irregular local legislations efforts in the tax areas create inconsistency. The goal of uniform, impartial, and transparent tax administration encourages the assimilation of an upgraded reform of the tax judicature system. More importantly, the market economy and the rule of law order urge the tax judicature to accommodate diversified economic interests and social needs in a fair, impartial, accessible, efficient and clear-cut manner. Pressures from international interests derived from the WTO principles raise the bar for Chinese tax judicature reform according to transferable practice from other tax jurisdictions. In addition, a tax judicature system contributes competitive advantages to Chinese economy by keeping and encouraging foreign investments and improving revenue collection.

To this end, the precedent and experience of other established tax judicature systems are of high reference value. It would be foolish to suggest the direct transfer of techniques from the discussion of the U.S. Tax Court particularities. Rather, certain relevant factors in the U.S. system might cater to pragmatic reform needs in China’s tax judicature system. Roughly, like many other tax judicature systems, U.S. taxpayers and the IRS share similar concerns, such as the discretion of the court, the litigation timeline, cost-efficiency, complexity

²⁵² See generally Xu *supra* 2

of the issue, settlement potentials, trial, and appeals. These factors must be measured under the general framework of U.S. judicial system based on separation of powers, overall financial settings, and social and fiscal policy needs. Again, there is no uniform, globally applicable model that could be applied widely in any tax judiciary system. The most informative takeaways should be those commonly accepted factors for tax judiciary reform.

Second, the *status quo* and flaws of China's current tax judiciary might be used as a reference for understanding the general Chinese judiciary framework in terms of the competence, autonomy and independence. The tax judiciary system suffers from flaws and particularities coming from both the tax context and China's general judicial framework. China's tax judiciary system has two components: the tax administrative reconsideration and tax administrative litigation. In particular, a few identified flaws include the pre-trial tax administrative reconsideration, the full payment rule for tax collection due process, and the deficiency of judicial competence in hearing tax cases. All these flaws are aspects of national efforts to increase revenue collection.

There has been a heated debate among Chinese tax academia on the establishment of a tax court system. Arguments from each of three factions – those who oppose and those who support a tax court, as well as an intermediate position – are not without merits. This thesis shares more common ground with the opposition, finding that this goal is impracticable under China's current political and judicial situation and that any major judicial reform must be oriented to social and political needs. A key difference between oppositionists and supporters is whether a tax court system in China creates tax disputes. After all, the current tax judiciary system generally

functions well and *no* realistic tax court system model has been meaningfully proposed. Paradoxically, both supporters and oppositionists share similar criticisms on the full-payment rule and the pre-trial tax administrative. A major contribution that supporters make is that taxpayers need deliberations and more realistic protection of their rights through a tax court system. The least acceptable is the midlist view which looks attractive at the first glance. But the transitory, costly and overhauling nature embodied in midlist-ism and over-conformism misidentifies a few key considerations in both Chinese court construct and its reference to the U.S. Tax Court system.

China's tax system primarily is administrative in nature. Therefore, a few flaws in the tax administration system directly influence the underrating of tax judiciary system. For example, tax disputes may arise when irregular local enforcement of tax laws creates discrepancies. Local tax administrations are entitled with too-expansive discretion in handling tax collection and dealing with taxpayers. Meanwhile, many scholars question the expertise and independence of tax authorities. The dualism of superior and subordinate tax officials may pose taxpayers' claim futile and impractical. Equally noteworthy is that tax administration is so resourceful that settlement becomes a preferred approach in removing tax controversies. Flaws and discrepancies in the general judicial review system in China also penetrate to the tax judiciary system. Some identifiable flaws are non-uniformity, political intervention, impartiality, shortage of tax expertise, and the narrow scope of judicial review. As to the tax judiciary, a "case-merit control" should be incorporated but not limited to the pre-trial tax administrative reconsideration "filter".

Moreover, taxpayers' rights should be guaranteed in structuring the tax judicature reform. Mostly, taxpayers' right should accord to a rule of law order inviting a *fair, transparent, certain, consistent, equitable, effective, and clear* manner within the tax law context. The WTO principles attach similar assimilation into tax judicature in terms of honoring the *transparency, uniformity and impartiality* and *judicial review* principles with a full set of details and convenient courses of action.

Third, this thesis contributes a few proposals for China's tax judicature reform based on above-noted theoretical analysis: the particularities in China's tax context, flaws and established settings of China's judiciary framework, the rule of law order construct, and the WTO principles fulfillment.

Proposals tentatively submitted include: (1) the abolition of the full-payment rule. (2) Establishment of a summary judgment procedure for small tax cases as a tax collection due process procedure. (3) The calculated adjustment, but not the abolition, of the pretrial tax administrative reconsideration mechanism. (4) Strengthening the tax expertise of the courts by teaming up more experienced personnel with those who specialize in tax. (5) At the lowest bureaucratic level, making abstract administrative acts subject to judicial review. This reform could start as an experiment in a few coastal localities with better tax talents. (6) If there is a tax court system established, the adoption of a circuit tax courts framework in which courts exercise both original and appellate jurisdiction, sitting permanently in six to eight regions covering nationwide territory and reporting to the SPC Tax Tribunal based in Beijing. The designated High Tax Tribunal is an SPC subsidiary and should have the ultimate appellate jurisdiction over tax cases appealed at circuit tax

courts and provincial high courts, and perform tax court system administration or management.

Overall, the tax judiciary reform in China should consider both the idea of permanence and that of flexibility. It must balance the dynamic between tax administration, the general judicial framework, and taxpayers' rights. As law supports the government's political authority as well as the power of the legal system, the principles and tenets of tax judiciary system should be enshrined in a jurisprudential manner, honoring the rule of law order. With hopes to deepen the reform, this chapter concludes with a quote from an official excerpt proclaimed by the Communist Party for the judicial system reform in China.²⁵³

Our goal is to improve the allocation of judicial powers and responsibilities; standardize judicial activities, establish a fair, efficient, and authoritative socialist judicial system, ensure that court and procuratorates exercise their powers and carry out responsibilities fairly, independently, and according to law; strengthen the corps of political-legal workers; and strictly and fairly enforce the law in a civilized manner.

²⁵³ See Hu Jintao zai Zhongguo Gongchandang Di Shiqici Quanguo Daibiao Dahui shang de Baogao [*Hu Jintao's Report to the Seventeenth CCP Congress*], October 24, 2007, (《胡锦涛在中国共产党第十七次全国代表大会上的报告》)(in Chinese)

Chapter VII

Taxpayers' Rights Protection – An Under-Delivered Promise

I. Introduction

The awareness of taxpayers' rights has influenced China's tax law reform in the past decade.¹ The understanding that "political rights involve political duties...[a]mong them is certainly the duty to pay taxes"² substantiates the latest development in the taxpayers' movement to challenge the rights protection *status quo* in China. As China has been called the most miserable Asian country in terms of tax³, this issue is particularly important, because the increase of Chinese tax revenue has been greater than its GDP growth in the past decade.⁴ Coupled with an inflationary currency and high CPI, this fact has driven tax payers to demand reform. Taxes are imposed by law, and as a result

¹ See Xu Shanda, *Zhongguo Shuiquan Yanjiu [China Tax Jurisdiction Research]*, (China Taxation Press, 2004) Preface

² See Edwin R. A. Seligman, *Essay in Taxation* (10th ed. 1931), at 111. Seligman is an early contributor in advancing formation of international tax standards and principles was cherished by his involvement in the earliest transnational collaboration on coordination in international tax matters. This is not to suggest that no other literature articulates these ideas, but only to point to an early piece of analysis as one source of such a perspective

³ See "China ranks the second in *Forbes Tax Misery Index*" and accompanying discussions at <http://forum.globaltimes.cn/forum/showthread.php?t=10043> (last visited on March 15, 2011); see also, *The Forbes Tax Misery Index 2009*, <http://pdf.forbes.com/media/pdfs/TaxMisery.pdf> (last visited on March 15, 2011)

⁴ For more details on China's GDP development, see *supra* Chapter I

they compose an indispensable element of China's legal framework. Moreover, enlarged tax basis has caused taxpayers to examine the public benefits they receive compared with the level of tax they pay, and inevitably seek rights protection against unreciprocated taxation.

Meanwhile, Chinese government's official endorsements of universal values and generally accepted human rights principles⁵ advance the debate on reframing China's legal and social settings.⁶ However, traditional tax policy discourse⁷ lacks a framework for exploring whether or how taxpayers' rights paradigm may guide and impact China's pursuit of sensitive human rights protection goals that would help promote social order and an international image as a country in which individual rights and freedoms are fully realized. This Chapter argues that taxpayers' right protection could be an avenue to dealing directly with the problems of social welfare and economic inequality in China. For instance, a list of pragmatic and proactive taxpayers' rights promotes human rights protection, which is both morally defensible and politically viable.

The concept of taxpayers' rights is not isolated from general legal and social environment. It is generally defined to limit the state power to promulgate,

⁵ Hu Jintao, China's President, in concluding the Convention for Sino-Japan Strategic Beneficial Relationship, on May 7, 2008, posited that universal value is a mutual understanding of international community and China would embrace such notion in fostering human rights protection with Chinese characteristics, *see generally* Zhongri Guanyu Quanmian Tuijin Zhanlue Huhui Guanxi de Lianhe Shengming [*Declaration for the promotion of Sino-Japan Strategic Beneficial Relationship*], May 7, 2008, 胡锦涛《中日关于全面推进战略互惠关系的联合声明》2008年5月7日; *See, e.g.*, Shi-kun Li, Chuyi Jiazhi Shehui Zhuyi Hexin Jiazhi he Pushi Jiazhi [*Thinking About Value, Socialist Core Value and Universal Value*], Journal of Beijing Union University (Humanities and Social Sciences) (2009-04), In Chinese

⁶ *See generally* *Id.*, Li

⁷ *See, e.g.*, Jian Fan, Lun Shuishou Zhengguan Zhong de Wei Nashuren Fuwu [*Serving Taxpayers in Tax Administrative Collection*], (Taxation Research, 1998-04), in Chinese (范坚:《论税收征管中的"为纳税人服务"》,《税务研究》1998年第4期)

administer and enforce the tax laws and to bindingly obligate uniformity, transparency and procedural justice. The rule of law in this sense warrants taxpayers' reliance on rights protection.⁸ On an international level, the protection of taxpayer rights has received widespread attention and legislations of various sources define and defend taxpayers' rights. Many tax administrations and international organizations have promulgated bills, declarations and manuals specifically designed for the protection of taxpayer rights.⁹ The competitive advantage provided by taxpayer rights protection in international markets further ensures against interference to taxpayers' rights, and the WTO exemplifies a robust multilateral regime embracing capital mobility and free trade. Rights exercised by taxpayers demand that protection standards on par with international standards be incorporated into China's tax law system to safeguard both revenue collection and fuel economic development.

This Chapter reviews China's taxpayer's rights framework and proposes reform guidelines for enforceable taxpayers' rights protection under China's rule of law conception and in accord with WTO principles. Subchapter II describes the rationale for taxpayers' rights¹⁰ based on the relationship between taxation and the state. The discussion grounds on a theory of the state, which holds that legal rights are meaningless unless they are accessible

⁸ See generally G.S. Cooper (ed.) *Tax Avoidance and the Rule of Law* (Amsterdam, IBFD and ATRF, 1997) for an early review of rule of law and taxpayers' rights

⁹ For example, U.S. passed the "Declaration of Taxpayer Rights" in 1988 (and amended in 1996); Canada passed the "Declaration of Taxpayer Rights" in 1985, and OECD constituted a Model Tax Convention for its member countries

¹⁰ It is beyond the scope of this thesis to document voluminous literatures on the origin, definition and interpretation, see generally, C. Wellman, "Concepts of Rights" in L.C. Becker and C.B. Becker (eds), *Encyclopedia of ethics, Duty and Obligations Vols 1 and 2* (New York, Garland Publishing Inc., 1992)

and enforceable.¹¹ It therefore posits that taxpayers' rights are primarily part of civil and political rights, concerned with harmonizing taxpayers' rights against and duties to the state. It also posits that broader human rights protection can be achieved following the construction of a set of meaningful taxpayer's rights. Subchapter III critically assesses the taxpayers' right structure in China, in terms of constitutional interpretation, primary rights and secondary rights available for Chinese taxpayers. Subchapter IV identifies how the conception of rule of law and the WTO principles affect the reform of taxpayers' rights. It also contributes a proposed guideline with high practical significance.¹²

II. The Rationale for Chinese taxpayers' rights protection

Discussion of taxpayers' rights has been limited and did not carry much weight until recently in China¹³. A conscientious search of constitutional sources for taxpayers' rights embarrassedly shows that, other than a prescribed duty to pay tax under Article 56 of the Chinese Constitutional, there are no explicit protections or statements about the normative relationship between state and taxpayer. Only a few vague constitutional rights are even indirectly associated with the basic framework for safeguarding individual rights as to tax administration, collection, and enforcement. Given the notorious futility of Chinese Constitutional Law in practice, the constitutional conception of

¹¹ See OECD, *Taxpayers' Rights and Obligations: A Survey of the Legal Situation in OECD Countries* (Paris, OECD, 1990), discussing the accessible legal rights available to taxpayers in OECD members

¹² A list of taxpayers' rights is listed based on the summary of interviews conducted by the author from 2005 to 2008. The author presents this order as a proposal of practical value and an outcome of his long-stretched attention in Chinese taxpayers' rights. The interviewees are 12 experienced tax collection officials working on first-front tax services from 12 local / municipal tax authorities across China

¹³ This chapter submits respectfully that the seemingly voluminous literature (in Chinese) about taxpayers' rights is of ambiguity and utilitarianism

taxpayers' rights is not a useful avenue for challenging the State's power to tax.

The Chinese tax system however, in its attempt to incorporate international market standards and empower taxpayers and its situation in a broader campaign to improve public service in China, it is an important and fertile area for rights protection reform in the Chinese legal system. The official notion of "small government, big society," endlessly government corruption scandals, and the steady growth of the civil service corps have driven Chinese taxpayers to question the distribution and handling of their tax payments. The rising expectations of individual liberty nowadays further propel Chinese taxpayers to demand reciprocity from the state for the taxes they pay. This Subchapter sets out the rationale underlying why a timely articulation of Chinese taxpayers' rights is essential especially in the context of socialist rule of law construct, human rights protection and the fulfillment of WTO principles.

2.1. Taxation, the state and rights

Theoretically, taxation is usually viewed as a restriction on fundamental individual property rights.¹⁴ Taxpayers make tax payments according to laws¹⁵ in the hopes of receiving quality benefits returned to them by the state. Tax, therefore, essentially envisions a balancing of necessary state fiscal and administrative power and individual rights. Articulation of individual property

¹⁴ See Liam Murphy and Thomas Nagel, *The Myth of Ownership: Taxes and Justice* (New York, Oxford University Press, 2002) at 6

¹⁵ See *supra* Chapter III of this thesis for discussions on Rule of Law and accompanying footnotes on divergent views on origin of law

rights presumes basic individual liberty and an established legal framework ensuring exclusivity and ownership.¹⁶ State power to levy tax must recognize individual property rights¹⁷ as part of a citizen's natural entitlement and the basis for social welfare accumulation.¹⁸ The origin of taxation¹⁹ is fundamental to theories of the state,²⁰ and therefore can be justified as a check on individual liberty²¹ or essential to the finance, operation, and growth of the public order²² and to uphold economic development.²³ However, China's tax system, founded on a Marxist public ownership ideology, traditionally has paid little respect to individual property rights and framed the tax law as collecting financial sources for the redistribution of social wealth.²⁴

Although legal reasoning developed by influential jurists and theorists²⁵ can be equally applied to the tax law,²⁶ tax scholars' focus has been centered

¹⁶ The author submits that different definitions of rights and duties provide various understanding of taxation

¹⁷ See Murphy and Nagel, *supra* 14, at 42-45, discussing Consequentialist and Deontological theories

¹⁸ *Id.*, at 44

¹⁹ See David Bentley, *Taxpayers' Rights: Theory, Origin and Implementation* (Kluwer Law International, 2007), at 3-5

²⁰ For a general discussion on the theory of the state, see generally Robert L. Carneiro, *A Theory of the Origin of the State*, New Series, Vol. 169, No. 3947 (Aug. 21, 1970), American Association for the Advancement of Science, at 733-738, see also, Hazard, Geoffrey C. Jr., *General Theory of State-Court Jurisdiction*, 1965 Sup. Ct. Rev. 241 (1965)

²¹ See John Finnis, *Natural Law and Natural Rights* (Oxford, Clarendon Press, 1980), at 155, 276-277, positing a type of common good that is not fundamental, but which allows members of a community to collaborate to attain reasonable objectives supported by a legal system that is specific, not arbitrary and maintains reciprocity between subjects of the system and its lawful authorities; See also Murphy and Nagel, *supra* 14 at 42-45 for a discussion on the deontological theory

²² See Murphy and Nagel, *supra* 14 at 8

²³ *Id.*, at 43, see also generally Reuven Avi-Yonah and Joel Slemrod, *(How) Should Trade Agreements Deal with Income Tax Issues?* (September 2001). Michigan Law and Economics Research Paper No. 01-008. Available at SSRN: <http://ssrn.com/abstract=285345> or doi:10.2139/ssrn.285345 (last visited on March 15, 2011)

²⁴ The definition of taxation is interpreted quietly differently based on various understanding of individual rights, see generally, R. Nozick, *Anarchy, State and Utopia* (New York, Basic Books, 1974), emphasizing that taxation as necessary to uphold the state's pursuit of goals but limited as far as possible based on its direct interference with the basic concept of maximizing individual choice; see also A.P. d'Entreves, *Natural Law* (London, Hutchinson University Library, 1967), Chap VI, viewing taxation as a means of distributing important social goods and has a wider role. See Bentley, *supra* 19 at 14 for summaries of both examples

²⁵ See *infra* Chapter III of this thesis, Rule of Law and accompanying footnotes

primarily on framing a robust tax legislative, administrative, and judicial structure for the purpose of raising revenue and distributing social goods efficiently and fairly.²⁷ Rarely, however, have they focused on taxpayers' rights. This is apparent in the 1200-page two-volume treatise authored by Victor Thuronyi on tax law design, in which only *two* pages are spent listing impracticable taxpayers' individual rights,²⁸ showing little interest in contemplating or detailing their substance. Not surprisingly, the voluminous literature on international tax and multilateral tax collaboration published in the last several decades shares the same lacuna,²⁹ and such exclusion also extends to procedural rights and arrangements especially pertinent to taxpayers.

The development of taxpayers' rights and obligations formulation has evocative merits. Essentially, the conception of taxpayers' rights suggests two lines of inquiry: capturing the dynamic relationship between tax authorities and taxpayers with enumerated rights expressed in law,³⁰ and encouraging taxpayers' compliance with tax law,³¹ especially in the globalization era with increased capital movement and free trade.³² On the tax administration level, the taxpayer-oriented client service approach is a major recent improvement in

²⁶ *Id.*, re-interpretation as legal theories are presented including tax theory due to conflicting values and social orders. Radin specifically raises that theories developed on a case-by-case interpretation

²⁷ See Victor Thuronyi, *Tax Law Design and Drafting* (IMF, 1996), at 110

²⁸ *Id.*, at 111-12

²⁹ *Id.*

³⁰ See A. Sawyer, *A Comparison of New Zealand Taxpayers' Rights with Selected Civil Law and Common Law Countries – Have New Zealand Taxpayers been “Short-Changed?”* (1999) 32 *Vanderbilt J. of Trans'n'l L.*, 1346-47; see also generally, Philip Baker and Anne-Mieke Groenhagen, *The Protection of Taxpayers' Rights – An International Codification* (London, European Financial Forum, 2001); see M. McLennan, *The Principles and Concepts in the Development of the Taxpayers Charter* (2003), 32 *Australian Tax Review*, 22

³¹ See Thuronyi *supra* 27; see also generally Benley (ed.) *Taxpayers' Rights: An International Perspective* (Gold Coast, Revenue Law Journal, 1998)

³² See generally Valerie Braithwaite (ed.), *Taxing Democracy: Understanding Tax Avoidance and Evasion* (Aldershot, Ashgate Publishing Ltd., 2003).

the direction of taxpayer rights protection. Tax authorities have shifted from a controlling or coercive position to that of a friendly collection service provider. Although it is entitled with state power to collect taxes, the tax administration has begun positioning itself almost as an interface between taxpayers and the state. This encouraging transformation may partially be attributed to increasing cross-border transfer of capital and taxpayer-friendly policies provided by many developing countries, which face harsh challenges for keeping their tax base when so much of it is predicated on large capital exportation. Similarly, because of the direct economic advantage received from their services to foreign investors, tax authorities, especially those in developing countries, have inner motivations to consistently maintain quality services for taxpayers to keep and attract investments from the outside.

From the point of view of compliance, voluntary fulfillment of obligation to pay tax due is rewardingly encouraged. An obvious drive is the enlarged social welfare scale and high density of economic activities, which are beyond traditional capacity of tax authorities to monitor closely of taxpayers' behaviors. Coupled with enforceable criminal sanctions, taxpayers' obligations to pay taxes are generally interpreted broadly to circumvent calculated evasion and noncompliance. Voluntary compliance is a cost-efficient strategy to carry on business and maximize investment profits. Further, in the international marketplace, the convergence of global taxpayer treatments restrains tax-avoidance-shopping investment behaviors to a minimum without the potential for manipulation by any state actor. Given the limited room to explore evasion possibilities, taxpayers have a rational interest in monitoring the scope of their rights and the extent of protection therefrom.

As a result, taxpayers' rights are alternatively strengthened by compliance together with the dynamic relationship built between the tax authorities (state) and taxpayers.

Overall, taxpayers' rights require a valid recognition of individual property rights and their obligations to the state. The state's power to tax cannot be arbitrarily enforced. It is also critically important to emphasize democracy and the rule of law in a social and legal order in order to ensure tax laws are not subject to arbitrary enforcement. The conception of taxpayers' rights firstly has to accept a set of generally accepted, accessible and enforceable individual liberties. For instance, taxpayer's rights in originally derive from a framework human rights, but they embrace influences from a broader scope of political and civil rights.

2.2. A practical recourse to human rights protection

The conception of taxpayers' rights attaches to and presumes a basic framework of human rights including individual property rights. A legal order without recognition of universally accepted human rights and values likely would render taxpayers' right futile and rootless. At the same time, a robust system of taxpayers' rights to a large extent advances and translates into realization of human rights protection. This Chapter assumes a positivist view of the rule of recognition but not of the inherent nature³³ of rules, and further

³³ See H.L.A. Hart, *The Concept of Law* (2nd ed., Oxford, Clarendon Press 1994) at 250-251

puts front a presumption that there is a “common”³⁴ set of universal human rights standards that nations can pledge, although the formulation, clarity and content of those western-dominated standards are subject to debate and selective customization by signatories to international human rights treaties. This assumption also calls for prerequisites of an able legal order that can accommodate the accessibility and enforceability of those universally accepted standards.

This positivist assumption for taxpayers’ rights has merit and is not groundless. The “universal nature of the rights and freedoms” is an acknowledged consensus³⁵ and is “beyond question,”³⁶ and such universality and some freedoms are “fundamental.”³⁷ Cultural traditions, religious preference, political ideologies and diversified customs are also valued in supporting such universality: “all human rights are universal, indivisible and interdependent and interrelated.”³⁸ Meanwhile, “universal human rights emerge with sufficient flexibility to respect and protect cultural diversity and integrity. The flexibility of human rights to be relevant to diverse cultures is facilitated by the establishment of minimum standards and the incorporation of cultural rights,”³⁹ but “cultural consideration in no way diminishes States’ human rights obligations.”⁴⁰ In this connection, recognition of rules composes the

³⁴ See *Preamble of the Universal Declaration of Human Rights (UDHR)*, adopted on December 10, 1948 by the General Assembly of the United Nations proclaims it as a “common standard of achievement for all peoples and all nations”.

<http://www.un.org/en/documents/udhr/index.shtml> (last visited on March 15, 2011)

³⁵ *Id.*

³⁶ *Id.*, Article 1; see also Diana Ayton-Shenker, *The Challenge of Human Rights and Cultural Diversity*, United Nations Background Note, quoting Vienna Declaration and Program of Action, <http://www.un.org/rights/dpi1627e.htm> (last visited on March 15, 2011)

³⁷ *Id.*, see also Article 5 of the Vienna Declaration and Program of Action

³⁸ See Articles 1 and 2 *Preamble of the Universal Declaration of Human Rights (UDHR)*, adopted on December 10, 1948

³⁹ *Id.*

⁴⁰ *Id.*

rational for adopting a set of universally accepted rules with the understanding of cultural, religious and social diversities.

Inherited from the minimum standards of human rights, recognition of taxpayers' rights at least can be interpreted with universality and flexibility. Analogically, a set of rules embracing basic taxpayers' rights should be established and commonly accepted. For instance, there is no need to create a new set of rights specifically for taxpayers, rather, many rules are in place already and need only be customized to the tax context. To a state that has needs to design and reform taxpayers' rights system, many technically well-designed taxpayers charters and models are available to adapt to specific legal, cultural, political and economic settings. On the other hand, taxpayers' rights as political and civil rights are less debatable, and more importantly, less sensitive or disturbing to states than human rights. Therefore, threats caused by the codification and enforcement of minimum taxpayers' rights would be unlikely to jeopardize revenue collectability of states.

Approaching human rights through the lens of taxpayers' rights supports a focus on fairness in social policies. For example, taxpayers' rights would denounce an order which tends to "distribute tax burdens towards more economically vulnerable groups."⁴¹ This approach also brings in efficiency aspects in evaluating of a given social policy by considering the potential costs of taxpayers. The reciprocal dynamic derived from the balance between taxpayers' rights and the government is quite informative or crucial to human rights protection, especially for developing countries where the status of

⁴¹ See Allison Christians, *Fair Taxation as a Basic Human Right*, 9 Int'l. R. Const. 211 (2009) at 22

taxpayers is generally more favorably treated than citizens with general claim of basic human rights. Philosophically, an established, accessible, and enforceable set of taxpayers' rights facilitates the realization of basic human rights. Even though the tax context is limited in nature, a social and legal order without adequate taxpayers' rights protection can hardly be a society embracing basic universally accepted human rights standards. Fulfillment of taxpayers' rights easily may spill-over to other areas of laws, all of which contribute to a bettered protection of human rights. Ultimately, taxpayers' rights might lead to a reconsideration of the relationship between individuals and state, the way we debate what fairness requires and with respect to whom, and the way we balance fairness against efficiency and other tax policy goals⁴².

2.3. A pragmatic demand for tax law reform in China

The subject of taxpayers' rights has progressively shaped public and academic discussion of tax law reform in China. The official agenda of China's legal construct also generates the need for taxpayers' rights protection to fuel economic development and to help achieve a harmonious society. Growing awareness of individual property and social rights cultivate taxpayers with concern on the fair redistribution of social wealth and enthusiasm in public affairs participation. An emerging service-orient and client-friendly culture in daily economic activities, on the other hand, compels authorities, including the tax administration, to refine their manners in properly handling constituency

⁴² *Id.*

and state dynamics. Meanwhile, an increasingly complicated tax system and systematized international influences shift the concentration of intensifying investment to modernizing a well-rounded full-service tax system, in which taxpayers' rights are indispensable and of significance.

China's legal development over the past three decades has, in many ways, shaped the motivation and needs for safeguarding taxpayers' rights. A primary driver is the conception of inviolable individual property rights incorporated into the Amendment to China's Constitution, enshrining a clear-cut private property establishment but conceptually obscuring its borders with the previously dominant public ownership model. The full-bodied legal development in major arenas of economic activities promotes quality market participation in the hope to create a social order based on libertarianism and citizenry. Anger over corruption and erosion of individual rights together with wealth disparities suggest growing expectations for the quality, fairness, and transparency of government services. Exposure to western lifestyles and the availability of information from the internet and international relationships also foster the awareness and pursuit of individual liberty in China. All these vigorous searches contribute to a forceful push for taxpayers to demand respect and safeguards of their rights.

The imbalanced structure of the Chinese tax law reform for the past three decades by itself also spawns desires for taxpayers' rights. Large portions of tax policies oriented mostly toward attracting and catering to foreign investments, and a capably managed tax regime has been formed at least as to governing tax matters of foreign and domestic enterprises. An improved turnover tax system was also formulated to channel capital mobility and

redistribution of social goods, but such indirect-tax-dominant system cuts do not engage the contact between the state and actual consumers who take the final burden of tax payments. Tax administration, on the other hand, based on computerization upgrades and the dual-track central-local structure, has produced steady trends of tax audit and evasion reduction with criminal sanctions and encouraging voluntary compliance. Returning to jurisprudential analysis, however, systematic measures to secure taxpayers' rights have been neglected, if not intentionally avoided. Adopting taxpayers' rights is discounted in legislation and very few efforts are aimed at integrating taxpayers' rights into the tax system. Procedural rights available to or specifically designed for taxpayers, similarly, are subordinated or loosely attached to the existing nascent administrative or civil procedural reforms. For individual or enterprise taxpayers, a framework of rights for administrative reconsideration composes a burden dealing with tax authorities. Meanwhile, political pressures of improving GDPs and preserving investments entail tax authorities especially local officials to develop a set of taxpayers' rights, at least on paper, to show their friendly gestures to taxpayers. For instance, it continues to be important to reveal irregularities of tax administration in practice across regions and sub-provincial localities.

Taxpayers' calls for rights can be attributed to an extraction of emerging litigant culture deposited in commercial activities and formed over thirty years of economic complexities – taxpayers are not collectively “non-contentious” anymore. The inefficient dispute resolution scheme in practice fails to safeguard legitimate pursuits of taxpayers, which creates a mindset of victimism and an aversion to authorities including tax administration and

judiciary incompetence. In this sense, taxpayers as revenue contributors gradually build up a determination to challenge and litigate against tax authorities following procedures. Information available according to the Information Disclosure Regulation (effective as of May 1, 2008) and various local regulations of the same nature encourage and invite taxpayers to inquiry tax administrations as to budgetary arrangement and revenue distribution. However, the lack of enforceable taxpayers' rights renders such legitimate concerns futile. In this connection, out of unpredictable benefits, taxpayers have strong inclination to safeguard a set of rights for their own sake.

A key drive underlying taxpayers' rights development originates from principles of the rule of law and compliance with international obligations, including China's WTO obligations. In constructing the socialist rule of law order, taxpayers' rights nimbly accommodate basic elements of the rule of law in terms of demanding for notice or publicity, prospectivity, clarity, conformability, stability, and congruence. The rule of law order requires that taxpayers' rights be procedurally just and an existing legal framework to make those rights accessible and enforceable, in certain extent in connection with morality and social etiquettes exercised by tax officials. International organizations such as the WTO and international treaties on human rights protection demand transparency, uniformity and neutrality in tax administration on one hand, and prompt acceptance a set of well-accepted taxpayers' rights on the other. Foreign investors, experiencing established taxpayers' rights regime in developed tax systems, are reluctant to further invest after tax preferential policies have been exploited. In this sense, taxpayers' rights serve as a measure of comfort and assurance to keep and

foster investments. Foreign enterprise taxpayers, are among those active boosters in China for institutionalizing an organized taxpayers' rights framework.

Overall, institutionalization of taxpayers' rights enjoys a systematic powerful drives from taxpayers themselves, tax administration, general legal settings and international influence, all of which are intertwined with human rights protection and the rule of law order. The rationale for legitimizing a set of taxpayers' rights in China is, in part, to compensate the shortage of tax administrative efficiency. It also promotes a dynamic balance between the taxpayers and the state, vertically with due process and horizontally with fairness norms. China, facing a growing revenue base and a more complex administrative structure, needs a set of taxpayers' rights to fill in legislative gaps and to remedy the potential erosion of tax bases.

III. Taxpayer's rights protection in China

This subchapter aims to critically review China's legislations and *status quo* of taxpayers' rights. It firstly classifies taxpayers' rights as primary constitutional and administrative rights and secondary administrative rights. Based on a brief appraisal of available rights to Chinese taxpayers, the probable causes for deficiencies are analyzed and summarized in the hope of furnishing credible reform guidelines. Discussion of the impact of the rule of law order and the WTO principles follows.

China, in line with its Constitution and embrace of the socialist rule of law order, showed reasonable efforts for the protection of taxpayers' rights in the

past three decades. Partially designed as a responsive gesture for WTO accession, an amended Law of Administration of the Levy and Collection Tax of PRC (the “Tax Collection Law” or “TCL”) was passed in April 2001 based on a previously nascent draft promulgated in September 1992. The Tax Collection Law, on one hand, enhances the means of tax law enforcement and serves as a guideline for tax collection procedures, and on the other delineates the relationship between taxpayers and tax authorities in terms of taxpayers’ rights. Many obscure descriptions of taxpayers’ rights in the earlier version were clarified and abolished in the 2001 Tax Collection Law such as the right to confidentiality, the right to give statement and appeal, the right to relief and compensation. However, several generally accepted taxpayers’ rights were stipulated evasively or too sketchily especially those associated with procedural arrangements.

A recent interesting and informative document on taxpayers’ rights is the Proclamation on the Rights and Obligations of Taxpayers, released by the SAT in December 2009 (hereinafter referred to as the “Proclamation”). This first systematic attempt by the SAT summarizes taxpayers’ rights and obligations prescribed in the Tax Collection Law with detailed explanations on enforcement and simple case illustrations. However, the Proclamation did not receive the favorable reception from taxpayers and even from Chinese tax administration body itself, which it anticipated. Taxpayers remain suspicious of the tax administration and taxpayers’ rights are regarded as “traps” in exchange of formidable taxpayers’ duties stipulated in the Proclamation. This dilemma is particularly evident as SAT issued many follow-up notices or

administrative rulings to integrate the Proclamation into its official propaganda.

3.1. An overview of the classification of taxpayers' rights

A careful reading of taxpayers' rights protection in the U.S.⁴³ and in OECD countries⁴⁴ would conclude a long list various rights available to taxpayers under different criteria. For simplicity's sake, two major types of rights are identified, which can further be classified into different categories based on their enforceability⁴⁵. Addressing the vertical relationship between the state and taxpayers, the first type deals with interaction between tax authorities and taxpayers in terms of administration, collection, and enforcement with fairness and efficiency, and envisions the anticipation of protection predicated upon legitimate compliance. The second type of rights comprises a balance of dynamics between the taxpayers and the tax laws in terms of compliance, operation and application.⁴⁶ This second type of rights in substance is enforced by administrative and legislative mechanisms for the fundamental operation of tax laws.⁴⁷

⁴³ See U.S. Taxpayer Bill of Rights (amended in 1996)

<http://www.irs.gov/advocate/article/0,,id=98206,00.html> (last visited on March 15, 2011)

⁴⁴ See generally, *Taxpayers' Rights and Obligations: A Survey of the Legal Situation in OECD Countries* (OECD, 1990); see also Minoru Nakazato and J. Mark Ramseyer, *Tax Law, Hiroshi Kaneko, and the Transformation of Japanese Jurisprudence*, 58 Am. J. Comp. L. 721 2010, for a discussion of Japanese taxpayers' rights; D. Albregtse and H.P.A.M. van Arendonk (eds), *Taxpayer Protection in the European Union* (Kluwer Law International, 1998)

⁴⁵ The author submits that there are many criteria to classify rights which can be broken down into meticulous categories. There is no right or wrong, better or worse, classification of rights as different barometers is applied In this connection, for an ably detailed summary of classification of taxpayer's rights, see generally Bentley *supra* 19 Chapters 4 and 6

⁴⁶ See Bentley *supra* 19 at 186-89, arguing that a third type of rights but drops it as administrative in nature

⁴⁷ As evidenced by the next two paragraphs, the author obligates to posit that this thesis adopts a sharply different analytical method of taxpayers' rights that David Bentley employs in "Taxpayers' Rights: Theory, Origin and Implementation" (Kluwer Law International, 2007).

Revisiting a brief jurisprudential analysis as conceptualized by legal positivist H.L.A. Hart, a further distinction between primary and secondary legal rights has considerable merits if it appropriately applies to the taxpayers' rights context. According to Hart, a primary rule or right governs conduct while a secondary rule or right deals with the procedural methods by which primary rules are enforced, operated, prosecuted and so on⁴⁸. Hart specifically enumerated three secondary rules which have particular reference value for analyses of taxpayers' rights.⁴⁹ First, the rule of recognition, the rule by which any member of society may check to find out what the primary rules of the society are. As stated by Hart, the recognized rule might only be what is written in a sacred book or what is said by a ruler. Second, the rule of change, the rule by which existing primary rules might be created, altered or deleted. Third, the rule of adjudication, the rule by which the society might determine when a rule has been broken and prescribe a remedy. In conjunction with two prescribed types of taxpayers' rights: primary and secondary, Hart's enumeration proffers practical guidelines on classifying taxpayers' rights to an extra categorization, and the similar approach also applies to other major areas of law as well.

Accordingly, a further classification deserves consideration for a meaningful examination of main the categories of taxpayers' rights therein. First, the primary legal rights generally center on processes of tax law making, such as validity of the imposition of a tax and certain constitutional limitations. This category covers rights promulgated by legislatures, administrative agencies

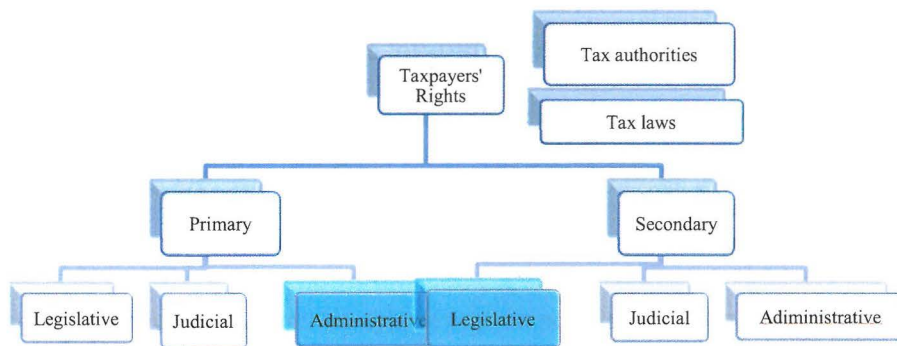
Bentley mostly tailors classification of taxpayers' rights for his ambition of designing a worldwide acceptable model. This thesis aims as simple as laying a positivist background to review the deficiency of taxpayer's rights protection in China.

⁴⁸ See H.L.A. Hart, *supra* 33, at 251-52

⁴⁹ *Id.*

and those interpreted through case law by the judiciary. However, due to the historical constraints on drafting of Constitutions, primary rights may appear in either in express or implied terms. In countries such as the U.K. without a Constitution, the description of taxpayers' rights is different.

The secondary level of taxpayers' rights includes enforceable rights focusing on specific operations of the tax law such as its administration, collection, enforcement procedures, and includes Hart's rules of recognition, change and adjudication, respectively. In daily operation of the tax law, secondary rights are those rights that taxpayers are more familiar with and practice, such as rights for confidentiality, rights of being informed of latest tax regulations, and rights to request an impartial hearing or initiating dispute against tax authorities. Secondary rights also prescribe special procedures and processes available to taxpayers such as individual requests for deductions or advanced rulings negotiated with tax authorities. Secondary rights sometimes are stipulated in administrative regulations, and are similar to primary administrative rights – although the issues that these two categories cover may be similar, but the nature of the rights is different. Having said the above, there are also administrative rights that do not belong to any of the categories above, because they are not rights *per se* and often arise in the form of social etiquette, performance standards or other “soft” expectations. (Figure 16)



3.2. An overview of Chinese taxpayer's rights – primary legal rights

Since primary legal rights are usually the measure of the validity of the tax law, Constitutions, if available, are supposed to provide the strongest protection of enforceable primary taxpayer's rights. China's Constitution, however, only stipulates, in Article 56, taxpayers' duty to pay tax due according to law. There is no expressed language of taxpayers' rights or any exact description of tax *per se* except those generally prescribed citizenry rights, which may be applied to taxpayers.⁵⁰ Given the public finance and legal situation in China, this thesis shares the regrets and vehement criticism of these omissions of taxpayers' rights in China's Constitution,⁵¹ but it suggests, after reviewing available Chinese tax scholarship, that such a lacuna is arguably tolerable, and the necessity of amending China's Constitution for inserting the taxpayers' right language should be considered by both constitutional legislatures and tax academia.

⁵⁰ See generally, Chapter II, Fundamental Rights and Duties of Citizens, Constitution of People's Republic of China [XIAN FA (1982)(P.R.C.), as amended]

⁵¹ See, e.g., Weiguang Li, Gonggong Caizheng de Xianzheng Siwei – Gonggong Caizheng Jingshen Quanshi [*Public Finance and Constitutionalism: An Interpretation of Public Finance Spirit*], in Strategy and Management (*zhanlue yu Guanli*) 2002-3 李炜光: 公共财政的宪政思维——公共财政精神诠释《战略与管理》2002年第3期
<http://www.xschina.org/show.php?id=848> (last visited on March 15, 2011)

Constitutions are diversified in overdrives and magnitude to which they provide for taxpayers' rights. Some Constitutions stipulate express and implied taxpayers' rights, but some fail to do so.⁵² In countries that are prominent for tax collection not being a major source of state revenue, such as some middle-eastern countries, which rely on petroleum trading, rarely would enquiring tax scholars bicker the significance of relevant literally provisions on taxpayers' rights available in those relevant Constitutions. But this does not mean that taxpayers' rights are not protected in those countries. Some Constitutions do not contain elaborated expression of taxpayers' rights at all, but may have meaningful implied rights available to taxpayers. For example, Sweden's Constitution only has a prohibition against retroactive effects of tax statutes.⁵³ The United Kingdom does not even have a formal Constitution, but British taxpayers enjoy quite commendable protection of their rights. Consequently, for some critics of the omission of taxpayers' rights in China's Constitution, there is a need for a certain broadening of scope from the Constitutions of the United States and Germany in the process of looking for a viable transplant provision.

One important question to be considered is whether the lack of an explicit taxpayers' rights provision in China's Constitution violates the principle of legality⁵⁴ as to Chinese taxpayers' rights. The principle of legality⁵⁵ as to taxpayers' rights is more constitutionally interpretative than literally

⁵² See Thuronyi, *Comparative Tax Law*, at 48-49

⁵³ See Anders Hultqvist, *Taxpayers' Rights in Sweden*, Revenue Law Journal: Vol. 7: Issue. 1, Article 4 (1997), <http://epublications.bond.edu.au/rlj/vol7/iss1/4> (last visited on March 15, 2011); see also generally, Sawyer *supra* 30

⁵⁴ It is beyond of this thesis to review the discussion on the principle of legality but quite a few Chinese tax scholars and economists evidently display conflicting understanding in this connection.

⁵⁵ See generally in Thuronyi, *supra* 52, discussing major tax families and their comparative advantages

descriptive. A few Chinese tax scholars embrace Hart's positivist view that any member of society may search for what the primary rights through the Constitution, but exclude another aspect of same positivism that the recognition rule might only be what is written in a sacred book or what is said by a ruler⁵⁶ on the other. However, a narrowly defined or manipulatively applied principle of legality by itself does not substantiate the notion that taxpayers' rights in China are without constitutional legality. Neither does the omission of an explicit provision for taxpayers' rights in China's Constitution necessarily impair constitutional protection of Chinese taxpayers' rights. Philosophically, the idealized provision for taxpayers' rights, if inserted in China's Constitution, does not necessarily initiate taxpayers' rights but somehow would discount the essentialism which is fully-embodied in the positivist view of taxpayers' rights protection. In this sense, this thesis argues that a more sophisticated discussion of the principle of constitutional legality should prioritize its application to the topic of taxpayers' rights as primary legal rights.⁵⁷

Approaching human rights through the lens of taxpayers' rights also complicates the insertion of an explicit provision into China's Constitution. A set of fundamental human rights, bearing selectively interpretable universality and flexibility, is endorsed literally in Chapter II of the China's Constitution, and provides the foundation for enforcing taxpayers' rights in the specific tax context. Taxpayers' rights cannot escape from the general circumstance of

⁵⁶ See generally Li *supra* 51; see also Weiguang Li, Lun Gonggong Caizheng de Shiming [*The Historical Role of Public Finance*], Public Finance Research 2002-3 and 2002-4 (李炜光《论公共财政的历史使命》,《财政研究》2002年3、4期)(in Chinese)

⁵⁷ See generally Thuronyi, *supra* 52; see also, Jianfu Chen, *Chinese Law: Towards an Understanding of Chinese Law, Its Nature and Development* (The Hague: Kluwer Law International, 1999)

human rights protection. As long as those fundamental human rights, at least as arguably shown on paper, are subject to flexible adaption to the tax context, the legislature in providing specific provisions for taxpayers' rights might weaken the minimum protections provided by general human rights norms. After all, there is no special category such as bankers' rights or farmers' rights, and taxpayers' as a term philosophically may lower the minimum standard of treatment or weaken the enforceability of what are actually general human rights norms. Meanwhile, opponents of such provisions argue that worldwide human rights treaties such as the UDHR and Vienna Convention do not automatically endorse a worldwide acceptable set of taxpayers' rights. This is unlikely what supporters of the taxpayers' rights provision hope to dispute given the diversified customization tailored by various subscribers of some international treaties.

Returning to the taxpayers' duty to pay taxes due as stipulated in Article 56, a seemingly straightforward argument raised by supporters of a taxpayers' rights provision is the "symbiotic" mutuality of rights and duties – a duty must have a concomitant right to accord with the principle of legality.⁵⁸ This oversimplified reasoning is of little value in jurisprudential analysis. Legal positivism does not support duty recognition, and duties can be unilaterally prescribed by laws without proffering any rights. A careful reading of much Chinese tax scholarship shows that supporters of this reasoning are not a minority.

⁵⁸ See Shaoying Cheng, *Lun Zhongguo Nashuren Quanli Baohu [Analysis of Chinese Taxpayers' Rights Protection]*, arguing that a duty must have a concomitant right and therefore the Chinese Constitution should contain taxpayers' rights, <http://www.efl.org/Article/ShowArticle.asp?ArticleID=240> (last visited on March 15, 2011)(in Chinese)

The problems of statutory drafting may further complicate notions of incorporating such an express provision for taxpayers' rights into China's Constitution. Chinese tax scholarship usually stops at the point of urging such a provision without extending to thoughts on how to draft it. This welshing displays a lack of legislative drafting studies and may prejudicially be attributed to a flap in studies over taxpayer's rights. This thesis submits that, at the current stage of legal setting, the statutory drafting of an insertable Constitutional provision about taxpayers' rights is hard to achieve, if not impossible. First, definitions of "taxpayer" and "rights" are controversial and not subject to consensus. China's tax system relies in large part on the indirect or turnover tax regime, so the nominal taxpayers are not identical to citizens who actually bear the burden of paying tax, which makes the scope of "taxpayers" vague. An expansively generalized term of "taxpayer" may not be advantageous for legislators to accept. The definition of "rights" itself creates further sensitivity and invites selective interpretation, and the definition of "taxpayers' rights" remains difficult to make explicit. Second, China's Constitution already has a whole chapter on fundamental rights and duties, singling out a "taxpayers' right" might be redundant or create confusion as to its relative status to these fundamental rights. If the legislative intent of prescribing "a duty to pay tax due" in Article 56 could be explained by the dominant ideology of putting national interests over everything else, the legislative purpose for defining taxpayer's rights, as the counterpart of taxpayers' duties, is therefore analogically hard to search for its ideological roots. Third, linguistically the exact wording "safeguarding taxpayers' interests" is complicated to translate. Wordings in Chinese such as

“guarantee” (*baozhang*) and “protection” (*baohu*) are employed interchangeably, if not confusedly, and create nuances. For a legislative bill with Constitutional significance, a provision as to taxpayer’s rights has to be made clear.

Finally, a review of the four amendments made to China’s Constitution so far since 1982 shows that constitutional revisions are usually colored by highly political strains or subject to political manipulation. The establishment of socialist rule of law order, market economy setting and protection of private property may in some senses enjoy jurisprudential proclaims, but a conscious reader of other inserted terminologies may confess strong underlying ideological influence therein.⁵⁹ Amending the constitution for the sake of an explicit provision for taxpayers’ rights would require a significant social and political constituency. Further, such proposed amendment would entail an overhaul in the legal and public finance schemes as well. However, this thesis suggests for these reasons that a taxpayers’ rights provision will be unprocurable in the foreseeable future.

To summarize, taxpayers’ rights on the level of primary legal rights, i.e. as formulated in an explicit provision, in China’s Constitution is not attainable. This thesis shares the notion that taxpayers’ rights can be read into China’s Constitution⁶⁰ under the positivist view, and agrees that the omission of an explicit provision arguably tolerable. The approach of employing an amendment to China’s Constitution to insert a taxpayers’ right provision is not of much practical value or jurisprudential meaning at the current stage.

⁵⁹ See Larry Cata Backer, *Chinese Constitutionalism, Sange Daibiao (the “Three Represents”), and the Rule of Law*, 16 *Transnat’l L. & Contemp. Probs.* 29, 33-34 (2006) for a detailed analysis of the rule of law reform and the “Three Represents”

⁶⁰ See generally Li *supra* 51

3.3. An overview of Chinese taxpayer's rights – secondary legal rights

Secondary legal rights in the tax context, i.e., secondary taxpayers' rights, compose the main body of modern taxpayers' rights system in international practice. Modern tax systems stipulate secondary taxpayers' rights dealing with the taxpayer's dynamics with the operation of the tax laws in terms of administration, collection, adjudication, as well as procedural justice and budgetary planning. Secondary taxpayers' rights in practice integrate the administrative, judicial and legislative branches to construct an enabling tax jurisdiction. Secondary taxpayers' rights can be located in major tax laws and administrative regulations. Those rights on one hand presume a foundation in primary rights and an established legal order to enforce them. They further expand the interpretation of general human rights. Administrative agencies by and large dominate the daily implementation of secondary taxpayers' rights through orders, notices, proclamations and interpretative notes, and sometimes may overlap with enforcing administrative primary rights concerning constitutional protection, if any. Statutory protection is often arranged to fit in a general procedural framework to ensure a fair and impartial decision making process avoiding prejudice against individual taxpayers.

Secondary taxpayers' rights in China features the above-mentioned routine, i.e., a system of secondary legal rights, administrative rights and the principles of good conduct of tax authorities, but they are not without limitations. Particularly, for the operation of the Constitution and the Tax Collection Law, SAT and MOF as tax administrative bodies promulgate statutory regulations

and guidelines on secondary taxpayers' rights in almost all aspects. Processes involving the operation of Chinese tax laws are integrated into the general framework of civil, criminal and administrative procedural requirements, on both central and local levels. Meanwhile, China's secondary taxpayers' rights system is young, and a few general frustrations in China's rights protection regime are visible in the tax context as well. It is also important to mention a few drawbacks specific to secondary rights in the Chinese tax context.

3.3.1. The 2001 Tax Collection Law

The 2001 Tax Collection Law⁶¹ (TCL) enacted on the eve of China's accession to the WTO, in the hope of enhancing tax law enforcement and catering to international expectations, represented the one and only of four pieces of legislation eventually passed by the NPC exclusively managing tax related issues by then.⁶² It aims to serve and guide the operation of the tax laws in general, and tax collection, administration, and protection of taxpayers' rights in particular. Previously opaque but imperative taxpayers' rights are enumerated in a categorized, albeit loosened and irregular, structure carding in the laws, which provides for the right to confidentiality, the right to give statements and to appeal, and the right to relief and compensation, among others. In conjunction with a set of detailed implementing rules (the TCL

⁶¹ See Xiaoyu Guo, *Shuishou Zhengshou Guanlifa Xiuding Gongzuo Yi Quanmian Qidong* [*The Revision and Amendment of TCL Started*] November 20, 2010, *Legal Daily* (郭晓宇, 税收征收管理法修订工作已全面启动)(*法治日报* 2010年11月20日)(in Chinese)

⁶² The other three pieces of tax legislation is the Agricultural Tax Regulation (abolished in 2004), The Individual Income Tax Law (revised three times in the 1990s') and the FIE Income Tax (replaced by the new FIE Income Tax Law as of January 1, 2008)

Implementation Rules),⁶³ the Tax Collection Law, for the first time, enriches the Chinese tax system by grafting its operation with China's Criminal Law by imposing administrative penalties and criminal sanctions of accuracies in the hope to rationalize dynamics between taxpayers and the tax laws.

A cautious reading of the Tax Collection Law and its implementation details would reveal Chinese taxpayers' rights designed as the following:

- Rights to confidentiality (TCL Article 5): information subject to confidentiality primarily includes legal trade secrets (bank account, production/operation and corporate finance) and valid personal data (property and marital status) of taxpayers and withholding agencies;
- Right to choose suitable means of tax return filing upon prior approvals (Article 30 of the TCL Implementation Rules);
- Right to apply for extension of tax payment due (TCL Article 31): this privilege is usually given if hardships such as bankruptcy or financial insolvency cause a tax payment due not to be paid on time. In practice, however, enterprise taxpayers mostly would choose a late penalty rather than going through a unpredictable process of application;
- Right to request refund of overpaid tax (TCL Article 51): the merits derived from this right are significant in terms of privileging taxpayers to review tax returns done and submitting tax authorities to make a

⁶³ See generally *Zhonghua Renmin Gongheguo Shuishou Zhengshou Guanlifa Shishi Xize* [*The Detailed Rules for The Implementation of the Law of The People's Republic of China To Administer The Levying and Collection of Taxes*], effective as of October 15, 2002 (《中华人民共和国税收征收管理法实施细则》)

way to accept taxpayers' feedbacks. Although tax authorities must refund the overpaid tax within a reasonable time, in practice, tax authorities usually prefer offsetting the forthcoming tax liability for the next year rather than getting a check from state treasury;

- Right to apply for deduction or exemption of tax payment due: the application of this right is primarily for encouraging enterprise taxpayers with foreign investment to keep after-tax profits in the same local tax jurisdiction.
- Right to apply for preservation measures upon tax payment or tax enforcement: the implementation details of this right deserve consideration because those details are scattered throughout the TCL and the TCL Implementation Rules, and also because this right is not specifically singled out for taxpayers to initiate. This right mostly serves as part of the safe cradle to cure potential mistakes made by tax authorities', if any;
- Right to request State compensation (TCL Article 43): this right, back in 2001 when firstly initiated, was not novel. It is derived from China's State Compensation Law rather than a specific tax right;
- Right to pursue liability for defaults in the tax law enforcement: this right is stipulated in the *Pursuit of Liability for Law Enforcement Defaults in Tax Collection (Trial Implementation)*. However, conscious taxpayers would find a friendlier way to handle filthy undertakings of tax officials, if any;
- Right to request a hearing, appeal or make statements: (TCL Article 8): this right is nothing but an applicable split of the generalized right

to appeal in the tax context under China's Administrative Penalty Law (Article 6). Taxpayers are not different from other citizens in employing this right;

- Right to use the challenge system against some tax enforcement personnel: this is another application of generalized procedural rights based on the withdrawal system in the tax context;
- Right to use a tax administrative reconsideration or review: this is an application of generalized administrative procedural rights in the tax context. But the Tax Collection Law stipulates a set of minimum requirements for employing this right, such as the thresholds of penalty, determination of the respondent tax authority, and specific tax-wise procedures;
- Right to initiate administrative proceedings: this right is also an application of generalized right to institute administrative proceedings in the tax context. Taxpayers are treated the same as regular petitioners.
- Right to claim reward for exposing tax evasion or illegal enforcement: the value of this policy is dubious although it is supplemented by a set of detailed notes in exercising this right.

As outlined above, taxpayers' rights stipulated in or advocated by the TCL and relevant implementation details are less rich in than expected in reality. For example, the right to request rewards for reporting tax violation is counterproductive to the spirit of impartial administration and is a violation of the principle of transparency in administration. The economic logic underlying

this measure is groundless as it takes the advantage of to-be-paid revenue as an incentive. The TCL does not clarify the necessary qualifications of a reporter, which in turn may arouse confusion or distrust in daily handlings. Even assuming such a reward is sustainable, detailed rules on how to classify contributions are available, it is unclear whether the reward should be determined according to the amount of tax evasion, the social impact of the case, the scale of the tax liability, or other criteria. More importantly, tax authorities may abuse the information provided by anonymous reporters in interfering reportee's business operation with a catch-all "economic crimes" statement. The lack of implementing rules in this connection is also not in line with the spirit of the deepening transparency as set out in the general provisions of the TCL.

Three lessons can be derived the stipulation of taxpayers' rights under TCL. First, some rights especially those associated with administrative procedures are not particularly tailored for the tax context and are at best derived from existing generalized rights available to citizens and reiterated in the tax context. Second, a few important rights, even with implementation details, need further procedural substantiation, such as the right to confidentiality, the right to know, and right to request rewards for reporting tax evasions. Third, limitations imposed on implementation of some rights may dishearten tax authorities to cooperate rights claims initiated by taxpayers. For example, the scheme and procedure to claim refund of overpaid tax usually take recourse of offsetting rather than immediate bank transfer. Moreover, the right to claim a reward for exposing tax evasion requires identification of the reporter, and this practice subjects reporting individuals to revenge by suspected violators. To

this end, the Tax Collection Law, although it makes advances in taxpayers' rights protection, frustrates the ultimate purpose of giving qualified play of taxpayers' rights protections.

3.3.2. The Proclamations of Taxpayers' Rights and Obligations

The most recent document on administrative taxpayers' rights is the Proclamation on the Rights and Obligations of Taxpayers (hereinafter referred to as "the Proclamation") released by the SAT in December 2009, which is further decoded by the "Interpretation of Proclamation" published by the SAT to celebrate the anniversary of releasing the Proclamation.⁶⁴ This move is inspiringly informative, and without question this Proclamation mostly serves to broaden tax bases and augment revenue collection, marginalizing the dynamics between taxpayers and the tax laws as a side effect. It is the first time that SAT has purposefully clarified and sorted out the scattered provisions concerning the rights and obligations of taxpayers contained in a number of different laws. In this sense, The Proclamation hardly can be viewed as an expansion or enrichment of meaningful rights, rather, it only represents a synopsis of the totality of taxpayers' rights that already have been prescribed in the TCL Implementation Details, the State Compensation Law, China's Administrative Procedural Law, and relevant laws and administrative regulations in taxation.

⁶⁴See Shuiwu Zongju Fabu Nashui ren Quanli yu Yiwu Gonggao Jiedu [*SAT Released Interpretation of the Proclamation on the Rights and Duties of Taxpayers*] (税务总局发布《〈纳税人权利与义务公告〉解读》), http://www.gov.cn/gzdt/2011-01/19/content_1788395.htm (last visited on March 15, 2011)

3.3.2.1. Taxpayers' rights

The Proclamation and its official interpretation stipulate that taxpayers are entitled to 14 rights in fulfilling tax liabilities (in the order as prescribed):

- Rights to know: taxpayers have right to get informed of available tax legislations and regulations that are directly applicable in the tax context;
- Rights of confidentiality: confidential information of taxpayers and withholding agencies are subject to protection which is limited only to legal information or data without interfering with legitimate administrative investigation;
- Rights to supervise tax law enforcement: this policy arms taxpayers to report or expose illegal or inappropriate tax enforcement behaviors by tax officials;
- Right to choose suitable means of tax return filing upon prior approvals in accordance with Article 30 of the TCL Implementation Rules;
- Right to request extensions in tax return filing;
- Right to request extension for paying tax due;
- Right to request refund of overpaid tax;
- Right to enjoy tax preferential measures: usually those measures refer to deductions, exemptions or other special tax treatments;
- Right to engage representation of an agent (CPAs or attorneys) to handle tax matters;

- Right to make statements and plead: this right empowers taxpayers to make pleading or explanation in front of tax authorities before any formal administrative procedures are taken;
- Right to refuse investigation: If tax investigation certificate or notice is not exhibited or presented, taxpayers may refuse to any form of investigation of tax related matters such as searches of their enterprise books, financial records or bank accounts.
- Right to seek legal remedy: taxpayers are entitled to have accessible and available resources to initiate administrative reconsideration, file an administrative suit and claim State compensation if their legitimate rights are infringed or violated.
- Right to request a hearing: in the case where penalties are determined by tax authorities, taxpayers may request a hearing on causes, decision-making process and amount of penalty after receiving the notice of penalty imposition;
- Right to obtain receipt of tax payments made: taxpayers are entitled to receive legal proof or receipt of tax payment made for corporate booking, evidence for administrative reconsideration or claiming credits for withheld taxes.

A careful comparison between the enumeration of taxpayers' rights stipulated in the TCL and the Proclamation reveals a few appealing observations. First, the Proclamation mostly summarizes and details stipulated taxpayers' rights contained in various provisions relating to tax matters, but does not expand the scope of the taxpayers protections. In this sense, the *status quo* of under-

protected taxpayers' rights remains unaffected systematically. Secondly, the Proclamation selectively attenuates or evades discussing a few taxpayers' rights prescribed in the TCL, such as the right to challenge administrative enforcement. Third, the Proclamation elaborates in detail regarding how to realize taxpayers' administrative procedural rights, which is a pleasant sign for commentators. However, the timing of the release of the Proclamation in December 2009 makes it unclear whether it was promulgated for the sake of taxpayers, as a part of the general administrative reform undergone during the same period of time, or both. There has been a strong move to upgrade and reform the administrative sector since early 2009.⁶⁵ Rights available for taxpayers such as to challenge tax authorities or to monitor behaviors of tax officials, after all, may signal a much stronger message of rectifying internal management of tax authority itself but putting it in the name of protecting taxpayers. If this speculation is validated, the underlying significance of the provisions for taxpayers' protection by the SAT would be highly discounted. Fourth, taxpayers' rights prescribed in the Proclamation and the Tax Collection Law are still sketchy as compared with the Taxpayers' Manual in the U.S. or the taxpayers' protection laws in Europe. Finally, the "Interpretation of the Proclamation" contains a number of case analyses to introduce the rights available to taxpayers. However, those case illustrations appear to create a misunderstanding that taxpayers' rights are confined to those illustrated only, and this limitation fails to resolve the shortage of implementation guidelines in a systematic manner.

⁶⁵ See Zou Keyuan, *Administrative Reform and Rule of Law in China*, discussing the administrative law reform in China after the WTO accession, <http://rauli.cbs.dk/index.php/cjas/article/viewDownloadInterstitial/814/829> (last visited on March 15, 2011)

3.3.2.2. Taxpayers' obligations

In line with taxpayers' duty to pay tax due as stipulated in China's Constitution, the Proclamation, not surprisingly, stipulates 10 obligations that taxpayers have to earnestly fulfill as a condition to enjoy stipulated rights. They include (listed in the order they are prescribed):

- obligation of fulfilling registration as a taxpayer: this obligation obviously targets enterprise taxpayers that are reluctant to file registration in a timely manner;
- obligation of establishing, and safekeeping of account books and relevant documents and issuing, employing, acquiring and safekeeping invoices: this obligation is quite a challenge to small-sized enterprises or private enterprises that have less needs to establish a fantasized full-bodies corporate accounting practice;
- obligation of adopting financial accounting rules and accounting software: this requirement, similarly, lacks general applicability to small-sized or private enterprises in terms of operational scale and financial capacity;
- Obligation of installing and utilizing tax control devices (software): the author submits that this obligation represents a central, and surprisingly harsh reason behind the Proclamation. This obligation is the center and basis for eliminating tax evasion and enjoying available taxpayers' rights;

- obligation of declaring tax liabilities timely and faithfully;
- obligation of paying taxes in a timely manner;
- Obligation of withholding and collecting tax on an agent basis: this obligation invites a mutual monitoring scheme among taxpayers and is a direct undertaking by tax authorities to expand their administrative jurisdiction.
- obligation of accepting tax investigations;
- Obligation of providing information in a timely manner: this obligation looks quite straightforward but embodies a set of problems. First, the scope of the information is not defined and this gives tax authorities uncontrolled discretion in setting the boundaries of the information; Second, the type of information in the “Interpretation of Proclamation” provides unclear guidelines for application; Third, the wording “in a timely manner” confuses taxpayers;
- Obligations of reporting other tax-related information: a few concerns arise with regard to this obligation. First, the scope of tax-related information as prescribed is too broad and even includes certain confidential information such as trade secrets or individual data that are not appropriate to disclose such as merger and acquisition details, secured transactions and bankruptcy. In this sense, the balance of exercising the right to confidentiality and this obligation is hard to achieve. Second, tax authorities’ usage of tax-related information is not subject to control and monitoring by taxpayers. The management of information might be of concerns to taxpayers. Finally, looking at the illustration in the “Interpretation of the Proclamation,” even if

certain tax-related information provided to tax authorities is sensitive enough from the point of view of taxation, tax authorities may have limited discretion to transfer such information to other non-tax authorities.

As summarized above, significant obligatory requirements for Chinese taxpayers and narrowly-interpreted rights are present in the same document, but show different rule-making rationales. First, obligations stipulated in the Proclamation are calculated and over-expansive. They are likely to hamper the compliance of taxpayers, who view them as cost-inefficient burdens rather than reasonable duties. Second, taxpayers' obligations mostly were described in general terms until the Proclamation detailed them. The effect of stipulating those obligations may inhibit the ongoing process of rapprochement between Chinese taxpayers and administrators. Third, certain obligations are not applicable to all taxpayers, rather, they are derived from particularistic administrative deficiencies that are not generalizable throughout China or across taxpayer groups. For instance, the behaviors of enterprise taxpayers are constrained while less discussion is given to individual taxpayers. Indeed many of these measures are procedural and have been articulated elsewhere, making their specific adaptation to the tax context here redundant. Finally, taxpayers' obligations by themselves are limited to the tax context, therefore, how taxpayers may fulfill the obligations is in large part based on tax authorities' discretion. If the obligation is concerned with tax officials, the value of accepting the obligation is not guaranteed. Taking the obligation to

accept investigation as an example, taxpayers may find it difficult to protect their rights while submitting to the overbearing requirements of tax officials.

3.3.2.3. Summary

The merits of the Proclamation cannot be understated. It facilitates taxpayers' apprehension of rights in paying tax liabilities, facilitating their capability to protect their own interests. It further notifies taxpayers of corresponding obligations to comply with relevant tax procedures and payment obligations, facilitating and incentivizing full compliance in the system. It also helps to standardize tax administration, administrative enforcement, and a service-oriented culture to enhance the dynamics between taxpayers and the tax laws. However, the Proclamation frustrates taxpayers in many respects as well. First, the legislative status and enforceability of the Proclamation is a concern. It is only an administrative document released by the SAT, not in a regular form of regulation, ruling, or notice which has interpretative authority in tax administration. In this sense, the Proclamation serves as an explanation or a report, and is not enforceable itself. Second, the burden brought by stipulated obligations is too overwhelming to taxpayers. Third, the Proclamation stipulates many obligations that are associated with operation of tax authorities. However, such operational details are not available to taxpayers and thus subject to manipulative interpretation by tax authorities. Fourth, the Proclamation is drafted with an unbalanced initiative, putting too much focus on enterprise taxpayers, substantive details, administration, and less focus on

meaningful rules as to individual taxpayers, procedural requirements, adjudication, and tax audits.

3.3.3. Other tax-related laws and regulations

Secondary taxpayers' rights are also found in many other tax-related laws and regulations. In particular, better-prescribed individual rights are offered in the Individual Income Tax Law and its implementation regulations. A major hotspot of tax reform in China is how to promote supervision of individual tax filing and withholding for those taxpayers with higher annual income. Without a doubt, the reform of individual taxpayers' rights deserves more attention to watch. The Golden Taxation Project guidelines on computerization of enterprise tax and indirect tax filing provide detailed rights related to tax audit, record keeping and corporate booking. Centrally-owned SOEs usually may have privileges in negotiating with tax authorities on specific filing procedures and audit routines. It is repeatedly important to mention the undergoing reform of administrative law system in which many procedural rights of taxpayers are embedded. For instance, the State Compensation Law outlines procedures and requirements for claiming tax authorities' liability. The administrative reconsideration procedures are also under revision. Meanwhile, various notices and rulings have been released on compliance of taxpayer's obligations as well.

3.4. Summary

This subchapter explores the classification of rights in the hope to analyze the Chinese taxpayers' rights system: primary legal rights, secondary legal rights, administrative rights and the principles of good conduct of tax authorities. Those rights are offered in a variety of tax-related laws and regulations. Paradoxically, taxpayers' rights are expanding simultaneously with the expanding economy scale and a larger tax enforcement force. Following the positivist rule of recognition, both legislative and administrative rights should be available for the protection of taxpayers.

The discussion of Chinese taxpayers' rights shows the necessity to identify each category of taxpayers' rights with enough details. Chinese tax authorities should feel the insufficiency of setting up a hasty comprehensive framework of tax without considering taxpayers' rights and obligations. The connection between the general administrative law framework and the tax law context should be better defined to determine whether an application of specific provisions in the tax context is appropriate or not. This comprehensive approach should include both legal and administrative rights, looking extensively at all factors that may affect taxpayers.

Taxpayers' rights deal with dynamics between taxpayers and the operation of the tax laws. Chinese taxpayers' rights, in this connection, are limited by the inherent deficiency of the general tax framework. This is particularly evidenced by the discrepancy in the internal management of tax authorities. Moreover, because secondary legal rights, administrative rights and the principles of good conduct of tax authorities are put altogether in the Tax

Collection Law and the Proclamation, the protection of each right is not guaranteed with enough singularity and attention, and the divorce among those rules should be surfaced.

IV. Supranational Taxpayers' Rights for the Rule of Law construct

In line with the supranational undertaking for the protection of basic human rights, taxpayers' rights have evolved with similar goals and compose part of the global convergence of legal rules. Chinese taxpayers' rights protection, in the context of the rule of law construct, has striven to incorporate both supranational influences and rule of law elements. The scope of the term "supranational," for the purposes of this thesis includes: (1) international treaties that China has given direct domestic enforceability; and (2) obligations the Chinese government has transplanted into its domestic legal system by way of legislation and adjudication. The recognition of taxpayers' rights, in this sense, embodies basic elements of the rule of law and the WTO principles that the Chinese government has striven to uphold.

4.1. Taxpayers' rights protection from the rule of law construct

Returning to the debate of the contested conception of the rule of law, primary legal rights are fundamental to the operation of the legal system in general, and can be customized to the tax context in particular. There are three basic questions central to the definition of the rule of law and its requirements for

China's tax law reform. First, what is a valid rule? Answers to this question must consider the principle of legality and basic elements required for the validity of a rule. Second, what is a good rule? This question implicates notions of morality, and presumes an established social and legal order. How should we enforce valid, meaningful, good rules. Answers to this question have included notions of democracy and a limited government. Primary taxpayers' rights, in this connection, should be interpreted on the basis of the makings of valid rules incorporating basic elements; and secondary rights, should be set up and built in the legislative and administrative framework to employ better implementation of tax laws, both substantive and procedural.

The validity of rules elaborating taxpayers' rights is measured according to the same jurisprudential rationale as rights protection in other areas of the law. Dicey elaborated three characteristics of the "the rule or supremacy of law": absence of arbitrary power on the part of government; ordinary law administered by ordinary tribunals; and general rules of constitutional law resulting from the ordinary law of the land.⁶⁶ In this connection, Dicey's thoughts are germane to the design and making of taxpayers' rights. Taxpayer's rights presume the absence of interference from the arbitrary power of tax authorities. Taxpayers' rights should fit into the general administrative and judicial procedures. Most importantly, primary taxpayers' rights implicating the principles of legality are part of the constitutional law.

Taking Dicey's thoughts further, Lon Fuller's instrumental conception of the rule of law advocates an adaptation of details and interpretations for taxpayers' rights. To realize the "inner morality of law", taxpayers' rights

⁶⁶ See A.V. Dicey, *Introduction to the Study of the Law of the Constitution* 179-92 (1908)

without a doubt demand a relative certainty and uniformity in their application, regular and impartial administration,⁶⁷ whereby the tax system is hopefully regarded as “the product of a sustained purposive effort” fulfilling certain moral qualities⁶⁸. To this extent, the tax legislature and administrative authorities may use the institutions of tax laws and the method adopting the enforcement of taxpayer’ rights as an instrument of tax policy in terms of separation or dynamics between the tax laws and taxpayers. For instance, Fuller outlined eight elements whereby to measure the rule of law, which include “the inner morality” that makes taxpayers rights protection meaningful and practical: generality; notice or publicity; prospectivity; clarity; consistency or non-contradictoriness; conformability; stability; and congruence.⁶⁹

Failures to adhere to Fuller’s elements would render the tax laws incomplete thus constrain the protection of taxpayers’ rights futile. Translating those elements into the tax laws would formulate a better reference to the rules of Chinese taxpayers’ rights protection. For instance, taxpayers’ rights under the rule of law order should incorporate the following the rights at minimum.

- Tax must be imposed by law (taxpayer’s rights following the principle of legality)
- Tax law must be published (taxpayer’s right to know)
- Tax law must not be retroactive (the tax consequence of a transaction is legally predictable in the Chinese tax laws)
- Tax law must be applicable, fair, certain, understandable, and non-contradictory (taxpayers’ right to know the certainty, transparency,

⁶⁷ See John Rawls, *A Theory of Justice* 235 (1971)

⁶⁸ *Id.*, at 107-09

⁶⁹ See Margaret Jane Radin, *Reconsidering the Rule of Law*, 69 B.U.L. Rev. 781 (1989), at 785-787

clarity and details of the tax laws , and taxpayers are able to obey the Chinese tax-related laws and regulations);

- Tax law must be consistent (the change, reform, or upgrade of Chinese tax laws and regulations must not undermine prescribed taxpayers' rights)
- Taxpayers must not pay more than the correct amount of tax or be subject to double taxation (tax laws must be certain and transparent based on the principle of proportionality)
- Taxpayers should be treated equally (tax laws must be fair, non-discriminatory and equitable in treating all types of taxpayers irrespective of source of capital, ownership and or wealth of an individual)
- Taxpayers should have rights to access of information, privacy, secrecy, and confidentiality (tax laws must be fair in promoting economic activities)
- Taxpayers should have access to procedural protections and redress from judicial tribunals (tax laws should be fair to realize procedural rights and justice):
 - o An independent tribunal (either administrative or judicial)
 - o A fair and public hearing to a tax case and promulgation of tax laws;
 - o A fair trial
 - o Right of representation by a qualified agent, CPA or attorney
 - o Receiving judgment in a timely manner
 - o Right to appeal and plead

- Right to administrative remedies or State Compensation

Returning to a jurisprudential analysis based on a rule of law order, taxpayers' primary and secondary rights should be contained in various provisions with procedural protections. Each right, if established, should be supported by subsidiary rules, administrative enforcement, and judicial protections. Chinese taxpayers, given the guarantee of a rule of law system, should enjoy these supports. In this connection, Chinese legislative, judicial and administrative authorities should theme taxpayers' rights in a fair, transparent, certain, consistent, equitable, effective, and clear protection within the framework of the tax laws.

4.2. Supranational taxpayers' rights

Taxpayers' rights are not exclusively derived from taxpayer's home jurisdiction. Signatory states are obligated to translate rules and principles from international treaties including trade treaties and human rights treaties to their domestic legal and administrative systems. Meanwhile, taxpayers may invoke the rules and precedents from treaties directly in safeguarding their interests without bothering with transplanted rules, but to which extent a domestic court interprets, accepts, and applies such rules and is an issue of whether the treaty is self-executing. For example, the Constitution of the United States may possibly incorporate a ratified treaty into its domestic legal

system. Some other common law systems may require an enabling process either through legislation or case interpretation to complete such ratification⁷⁰. In connection with taxpayers' rights, multilateral trading regimes of which China is a member state, in particular, the WTO, should compose a major forum to advance the protection of taxpayers. There are three ways in which taxpayers may seek to use this pressure. First, they may appeal to the language of international human rights treaties, to which China is a signatory country. Second, they may look to multilateral or bilateral tax treaties that China has contracted. Finally, they might consult international and multilateral trading regimes, of which China is a member state, such as the WTO. As there is not an international comprehensive framework of tax law or taxpayers' rights protections,⁷¹ taxpayers may have to selectively combine these approaches to maximize their protection.

4.2.1. Inference from human rights treaties

As to taxpayers' rights protection based on human rights treaties or conventions, this pursuit is very immature given China's general framework of human rights protection. True, the conception of taxpayers' rights attaches to and presumes a basic framework of human rights including individual property rights. But, China's legal order or political promise has not matured to an extent of fully recognizing or accepting universally accepted human

⁷⁰ See Malcolm N. Shaw, *International Law* (3rd ed., Cambridge, Cambridge University Press, 1995), at 114 and 223, for example, France and Germany require an enabling legislation if treaty provision demands domestic adaption

⁷¹ See generally Ehab Farah, *Mandatory Arbitration of International Tax Disputes: A Solution in Search of a Problem*, 9 Fla. Tax Rev. 703 (2009)

rights and values. This awkward situation renders taxpayers' rights without legal foundation. From a jurisprudential perspective, taxpayers' rights are generally considered separate from the framework of human rights protection, because taxpayers' rights demand a fair and consistent procedural protection while human rights are compounded with variably changing interpretation and acceptance.

4.2.2. Limited protection from tax treaties

Bilateral or multilateral tax treaties might in theory have a profound impact on the realization of taxpayers' rights, but in practice they focus almost exclusively on double taxation avoidance and international cooperation to circumvent tax evasion between countries. In this sense, the pragmatic value of bilateral or multilateral tax treaties is constrained by their focus and legislative intent. Normatively, tax treaties are designed to safeguard state interests in maintaining a stable tax base. Although in fact certain benefits are stipulated in tax treaties for taxpayers, such protection conforms more to the practice of cross-border cooperation but does not substantiate an architecture for taxpayers' rights. To a large extent, tax treaties provide a framework for tax laws to be fair and effective, not for substantiating too many detailed privileges. To this end, bilateral tax treaties or multilateral tax arrangements are one-sided mechanisms for managing the international extension of taxpayers' rights.

4.2.3. Impacts from the WTO on taxpayers' protection

Returning to the WTO principles, taxpayers of signatory states may be pleased by a cautious expansion of rights in trading and transactional activities, which compose the mainstream basis of taxpayers' right claims. Given the limited impact of international human rights treaties and bilateral tax agreements, China's substantial incorporation of principles prerequisite to WTO membership, such as *transparency, uniformity and impartiality* and *judicial review*, has significantly increased the protection of taxpayers' rights in accord with international standards.

First, the concept of transparency is central to the WTO agreements as well as to the construction of the rule of law. The transparency commitment in China's Protocol is substantive. The adaption of transparency principles encompasses almost all aspects of taxpayers' rights protection. For primary taxpayers' rights governing the relationship between taxpayers and the state, transparency in general requires that all laws must be published and applied, and taxpayers have legitimate access to courts. Taxpayers' rights in this sense should be accessible, and be consistently found in primary legal sources as the Constitution and charters. Such primary rights should be guaranteed by independent and impartial tribunals, available public hearings, fair trials, and rights to representation.

Secondary taxpayers' rights, in conjunction with the principle of transparency, are more important in terms of establishing a complete set of substantive rules, but they are expressed differently from primary rights. Secondary taxpayers' rights should advocate taxpayers' rights with more precision, clarity, and enforceability in terms of their promulgation and application. Taxpayers

should be able to predict the tax consequence of specific trading and transactional activities. To this end, the tax laws should not be imposed retroactively. On the other hand, to fulfill the transparency requirement, taxpayers are entitled the right to privacy, confidentiality, and secrecy in themselves and, at the same time, access to information about laws and regulations.

The transparency principle for taxpayers' rights is evident in efforts to comply with the national treatment provisions under the WTO. Specifically tax rules should not discriminate, and there should be equality before tax laws. According to national treatment provisions, China is required only to provide foreign taxpayers "no less favorable" treatment than those offered to domestic interests. Foreign enterprises have legitimate grounds to request non-discriminatory treatment as a taxpayer, and to anticipate in advance the consequence in terms of frustrating local protectionism.

Second, the WTO principle of uniformity and impartiality in administration is particularly decisive to the protection of Chinese taxpayers' rights. China agreed in the Protocol to apply and administer all laws, regulations, and other measures in a uniform, impartial and reasonable manner. Actually, a major challenge confronting China's protection of taxpayers centers on enforcement of the tax laws, which presumes impartial tax authorities and qualified tax officials staff with clear lines of authority and the capacity to submit neutral decisions on taxpayers' pursuits. In reality, uniformity in the substance and application of the tax laws relies heavily on the commitment and fortitude of tax authorities.

The concern of uniformity and impartiality in tax administration has plagued Chinese tax authorities in many ways. Unprofessional or inappropriate tax enforcement tops this list. Taxpayers often are quite frustrated by unexpected enforcement or tax audits conducted by tax officials, especially where those activities impose harassment or interference with daily operation. Similarly, the irregular quality of services provided by tax authorities creates further frustration. In coastal or otherwise more developed economic areas, this discomfort is not evident. However, in emergent economic regions and hinterland areas, requesting legitimate tax services often proves to be an ordeal. Taxpayers are therefore disincentivized to deal with tax authorities. Another common affliction in Chinese tax administration is corruption, which manifests in many ways such as holdup tax collection of closely-related taxpayers, delaying in replying individual tax service request, setting up barriers in tax filing and soliciting bribes.

A highlighted problem for the uniformity and impartiality in taxpayer's protection centers on administrative procedural compliance. According to the TCL and procedural rights prescribed in generally applicable Administrative Procedure Law and Administrative Reconsideration Law, taxpayers are concerned with how to effectively file an administrative claim within the tax framework, which is a prerequisite to file an administrative lawsuit. Although current laws offer public hearings, the right to representation, and the rights to a timely judgment and pleading, taxpayers are insecure about whether their reasonable claims will result in just rewards or simple vengeance from the tax authority on the ground that they are troublemakers. Meanwhile, taxpayers are required to pay the full amount of tax payment, whether correct or not, before

they can file an administrative claim. In this sense, the stake of fulfilling administrative rights for Chinese taxpayers is too high, and the limitation on discretionary judgment by tax authorities is too low.

Third, China's Accession Protocol to the WTO mandates the establishment of tribunals, contact points, and procedures for the prompt review of all administrative actions relating to the implementation of the laws, regulations, judicial decisions, and administrative rulings of general application referred to in the WTO rules. As the judicial review principle under the WTO applies to taxpayers' rights protection, a Chinese court hearing tax cases or taxpayers' requests must be independent of Chinese tax authorities and shall not have any substantial interest in the outcome of the tax matters. Tribunals hearing taxpayers' rights claims may be administrative or judicial, however, the right to appeal must be granted if taxpayers originally submit the case for an administrative review following due process.

Tax laws in China formally offer a comprehensive set of measures for administrative and judicial review available to taxpayers. Taxpayers, as citizens, are able to enforce their legitimate rights in challenging administrative decisions, including those made by tax authorities. Chinese taxpayers mostly are able to file administrative lawsuits only against administrative decisions. Two concerns are worthy of attention in this regard. First, there is a concern that tax administrative lawsuits are procedurally flawed and subject to more general problems with administrative and judicial trials in general, such as administrative reconsideration procedures and petitioners' rights in administrative lawsuits. The other problem is specific to the tax context where taxpayers are positioned in a particular position: the

dilemma of revenue contribution of taxpayers and the limitation on tax administrations.

A reading of the Proclamation reveals that taxpayers are not fully aware the means to seek legal remedies or those rights associated therewith. Here, a discrepancy between the awareness as a taxpayer and awareness of effective taxpayers' right protection involves. This divergence manifests both the weakness of legal protections of taxpayers' rights through judicial review and a deeper concern about taxpayers' ignorance of their protections in this regard. Judicial review of tax administrative decisions in this way may be little more than a propaganda mechanism to safeguard the authority of tax administration rather than promotion of taxpayers' rights. Regarding China's judicial review, The WTO principle of judicial review, in its focus on regularity and the use of mechanisms such as precedent requires a movement away from the current state of affairs in which administrative and judicial reasoning and decision-making is inconsistent and poorly reasoned across jurisdictions.

4.2.4. A proposal from tax administration's perspective

Returning to the structure of taxpayers' rights, a jurisprudential analysis based on requirements of the rule of law order and WTO principles would help this thesis to submit a sensible proposal for an improvable awareness of protection for Chinese taxpayers. Outlined below is a summary of surveyed taxpayers'

rights from local tax administration perspective, in the order of their anticipated practical value:⁷²

- *Notice*: taxpayers should have the right to be informed of a tax assessment, a decision on adjudicated payment due.⁷³ Tax payment amount is the foremost concern for Chinese taxpayers, a better knowledge of such amount will help taxpayers evaluate which remedy they may prefer, or just make the payment as a cost-efficient calculation;
- *Explanation*: Chinese taxpayers in general are rational individuals and enterprises with good standings. An assessment, therefore, should be substantiated by a reasonable, timely and accommodating explanations made by tax authorities or courts. Such explanation is expected to be delivered in a friendly way under a professional setting;
- *Rational audits*: investigation or audits by tax authorities are not averted by Chinese taxpayers in general. However, such audits should not interfere with ordinary financial order of an enterprise taxpayer, and tax officials should not harass taxpayers with unfounded informal or random audits that impede operation of taxpayers;

⁷² This order is a summary of interviews conducted by the author from 2005 to 2008. The author presents this order as a proposal of practical value and an outcome of his long-stretched attention in Chinese taxpayers' rights. The interviewees are 12 experienced tax collection officials working on first-front tax services from 12 local / municipal tax authorities across China: Eastern China (Shanghai (2 branches: Puxi and Waigaoqiao), Southern China (Shenzhen (2 branches: Luohu and Nanshan)), Guangzhou, and Hangzhou), Northern China (Beijing (2 branches: Chaoyang and Haidian) and Ji'nan), Western China (Chengdu), and Central China (Zhengzhou (2 branches: Jinshui and EDZ)). Interview notes are on file with the author for reference

⁷³ See I.R.C. §6331(d)(3) for a similar but more detailed description applicable to US taxpayers

- *Hearing and recording*: Chinese taxpayers are entitled to hold a hearing in front of tax authorities from which they can present evidence or explanation of specific tax behaviors. In this sense, an effective interaction between taxpayers and tax officials is appreciated before reaching adjudication. Tax authorities should honor a request for a hearing in a professional and considerate way. Meanwhile, taxpayers should be firmly entitled to receive a record of meeting minutes and hearing deposition as the basis for their understanding or evidence for any prospective lawsuits;
- *Confidentiality*: Chinese taxpayers are sensitive about their reputation and trading or business secrets. Tax authorities should prioritize protection of taxpayers' confidential business information without sacrificing a reasonable investigation;
- *Discovery*: Chinese taxpayers expect to be more active and voluntary in seeking and understanding evidence that tax authorities will employ in adjudicating their cases. A clear perception of the government's substantiation in adjudicating somehow predicts possible attitudes or behaviors that taxpayers may initiate – acceptance, aversion, or appeal;
- *Appeal*: Chinese taxpayers dislike filing appeals, because they want to maintain a friendly, professional or mutually beneficial relationship with tax authorities and appeal in nature is not cost-efficient. True, a comprehensive set of administrative lawsuit procedures are available to them in China, but appeal is the last resort that taxpayers want to pursue. Taxpayers hope to maintain an orderly operation but dislike any appeal that may interfere with their well-being;

- *Counsel:* Chinese taxpayers are risk-averse but profit-driven. Even they prefer professional counseling or representation from CPAs, attorneys, or other qualified agents, as they are not typically in a position to recognize and exploit benefits through such representation unless they have to. It is an unwritten rule in China that many retired tax officials or closely-related friends/relatives of tax officials take advantage of such representation. The taxpayer as a rational actor has the pressure to save representation charges and litigation costs.
- *Fair trials:* if cases develop into administrative lawsuits against tax authorities, what the taxpayer will want most is a fair trial with a timely delivered decision and transparency. Because this is the last resort taxpayers may rely on, any discrepancy that hurts taxpayers' confidence in China's judicial system is usually magnified. If this frustration is set up or spread, at the end of day, the overall local economic setting is the most regrettable victim at least.

Although the taxpayers' rights outlined above are derived from the angle of reforms to be implemented by the tax authorities, they are reasonable and practical. First, tax authorities believe that these rights are what taxpayers want in daily operation, and that taxpayers are more likely to honor their responsibility to cooperate in a system that affords them those protections. Second, tax authorities, especially those first-front tax officials, believe that they can implement those rights in a professional and enforceable way. Therefore, the dynamics for a mutually beneficial interaction between

taxpayers and tax authorities can be largely achieved through the implementation of taxpayers' protections in tax laws.

To further substantiate the merits of the outlines above, two examples are informative. First, the right to applying for relief under the TCL upon tax payment preservation measures is open to discussion. It is possible that if tax authorities adopt tax payment preservation measure prior to the scheduled tax payment period where a taxpayer engaged in production or business operation is not involved in an act of tax evasion. Meanwhile, there is no detailed implemental guideline on how tax authorities could employ this measure. Transparency is severely needed to execute this measure.

Second, the right to pursue liability for acts committed in the process of law enforcement by tax authorities also offers an interesting question. The *Pursuit of Liability for Law Enforcement Defaults in Tax Collection Procedures (Trial Implementation)*, promulgated by the SAT provides that taxpayers have the right to pursue liability for defaults by tax officers in law enforcement. This measure is more than welcome. However, the problem of lacking detailed implementing rules arises. In theory this right looks substantial and sophisticated, but in practice it is virtually a dead letter as so few details exist in law to facilitate and guided its application. As a result, this right is neither appreciated by taxpayers nor realistically assists tax officials in remedying their wrongful enforcement handlings.

Beyond proposed rights, the construct of the rule of law order and acceptance of the WTO principles direct China's taxpayers' rights protection to embracing basic rights consciousness and assimilating international routines. The influence, substantively and procedurally, is palpable in terms of China's

reforms to promote a service-oriented tax administration and well-grounded judicial review establishment. For example, Fuller's instrumental conception of the rule of law provides comprehensive theoretical support for designing the scope and details of taxpayers' rights. With this theoretical framework in mind, Chinese legislative, judicial and administrative authorities should establish taxpayers' rights in the form of *fair, transparent, certain, consistent, equitable, effective, and clear* protections within the framework of the tax laws. Meanwhile, WTO principles attach international force in shaping and rectifying the administration and adjudication of Chinese taxpayers' rights. Protection measures honoring *transparency, uniformity and impartiality* and *judicial review* principles embody a full set of details and practical guidelines. For example, the uniformity and impartiality in tax administration, if broadly realized, would even advance protection of taxpayers' rights. A well functioning judicial review mechanism might also root out preventable taxpayers' lawsuits. Moreover, since foreign enterprise taxpayers expect to receive qualified tax services and non-discriminatory treatment from Chinese tax authorities as a baseline, this influence also enjoys far-reaching spill-over benefits to domestic enterprise and individual taxpayers. Therefore, a key contribution credited to the WTO principles is the growing appreciation of taxpayers by tax authorities. Such a respect from administrative organs is not common in China and has high realistic value.

V. Concluding remarks

The discussion of this Chapter has two prongs. First, it contributes a review of the *status quo* of China's taxpayer's rights framework. In this connection, taxpayers' rights are based on a dynamic interaction between the State, the tax system, and taxpayers. Second, it examines China's mechanisms for enforcing taxpayers' rights under the rule of law conception and WTO principles and proposes reform proposals⁷⁴ thereafter.

This Chapter contributes an analysis that the concept and protection of taxpayers' rights presumes a generalized enabling framework of human rights. At the same time, approaching human rights through the lens of taxpayers' rights supports a focus on fairness in social policy orientations, and considers efficiency in evaluating social policy by considering the potential obligation against taxpayers. Ultimately, human rights protections might be better served if a set of taxpayers' rights tended to uphold a professional institutional order that balances state interests and taxpayers' necessities. In this connection, the situation of China's taxpayers is awkward: the human rights framework is not fully incorporated in China's legal system, and the tax law system itself is in the nascent stages of its development.

Furthermore, China has a legitimate need to develop a set of rules for establishing and protecting taxpayers' rights, the awareness of which facilitates economic, behavioral, and social policy implementation. An examination of the primary and secondary taxpayers' rights in China reveals that almost all deficiencies and drawbacks of human rights protection and the

⁷⁴ See *supra* Section 4.2.4. of this chapter

tax laws system fall under the taxpayers' rights category. This discovery is not surprising. The constitutional fortification of primary taxpayers' rights is weak due to an absence of the term "taxpayers' rights," but also, and to a much greater extent because of a discontentedly misunderstanding of how to situate taxpayers to claim or articulate their primary legal rights. Secondary taxpayers' rights are supposed to be enriched with enough clear-cut rules in detailing taxpayers' administrative and legislative rights, while China's current framework fails contributing those details, rather, somehow it misidentifies the roles played by administrative primary rights and secondary legal rights. The result is that an amalgamation of laws, rulings, and notices is displayed out-of-order, and there lacks a systematic certainty of the intended system for the protection of taxpayer's rights. Although the TCL, the Proclamation, and other relevant administrative procedural laws facilitate, to some extent, in clarifying and expanding rights available to taxpayers at the first glance, those stipulated rights remain short of jurisprudential significance and practical value, showing the necessity to identify each category of taxpayers' rights with enough details.

Being mindful of deficiency in taxpayers' rights protection in China, it is excessive to understate or neglect the progress and merits as to rights protection regime in China's tax context. Overall, China's tax system still provides a formulated, yet promising, framework to channel available legal remedies, both administrative and judicial, for taxpayers. From the TCL and the Proclamation, continuous efforts and attention are paid by China's tax authorities to advancing taxpayers' awareness and recognition of their rights. In particular, the administrative lawsuits filed by taxpayers attain more

respects and identification, although such awareness is discounted by the “non-contentious” or “settlement-preferred” culture in China. This chapter also acknowledges the frustration due to the paucity of resources in modulating related research, since many questions of this topic left unaddressed in full extent or some questions are just not answerable given current development stage of the tax legislation reform.

Meanwhile, the protection of taxpayers’ rights is a key element substantiating China’s construct of the rule of law order and fulfillment of WTO principles. Chinese taxpayers’ rights should be written and applied in a *fair, transparent, certain, consistent, equitable, effective, and clear* manner within the framework of the tax laws. Meanwhile, the WTO principles inject international market standards and vitality into the process of designing and implementing Chinese taxpayers’ rights in terms of administration and adjudication. China’s tax laws should embody and honor the *transparency, uniformity and impartiality* and *judicial review* principles that are at the heart of their WTO commitments.

Last but not least, having examined deficiencies, based on the positivist view in jurisprudence for taxpayers *per se*, the construct of the rule of law order and the WTO principles, this thesis submits a summary proposal for improving China’s taxpayers’ rights protection. This proposal should attempts to balance theoretical goals and practical significance, and largely is underpinned by considerations from both tax authorities’ and taxpayers’ perspectives. In this sense, it is not a reordering or rearrangement of existing prescribed rights, rather, it is submitted as reflective of and applicable to daily practice.

Chapter VIII

Tax Treatments of Nonprofit Organizations – A Comparative Study

I. Introduction

This chapter contributes a comparative study of the tax treatments for the nonprofit sector in the U.S. and China for three reasons. First, the development of China's nonprofit sector¹ has been tremendous in the past two decades, but few comprehensive studies have been initiated on reforming China's nonprofit tax system – the crucial component that binds nonprofit sector as a partner of the state. Echoing China's success in economic growth in the past decades, literature on Chinese tax typically focuses on tax incentives for foreign direct investment and tax policies catering to economic development. Second, collaterally, the rule of law development in the past decade has motivated new scholarship regarding the modernizing of China's charity sector with an “all-in” charity code² or cultivating expansive grassroots NGOs. These idealistic

¹ See generally, Evelyn Brody, Institutional Dissonance in the Nonprofit Sector”, 41 Vill. L. Rev. 433-440 (1996), discussing that the third sector often uses the terms “charity” and “nonprofit” interchangeably; see also generally D.B. Reobertson *Should Churches be Taxes?* 40-68 and Chapters II, III and IV(1968). The same problem exists in the limited research as to the definition or literal description of “cishan” or “gongyi”, i.e., “charity” in China

² See generally “China's Draft Charity Law is in shape”
http://www.china.com.cn/news/gongyi/2010-08/02/content_20620246_2.htm (last visited on March 15, 2011)

studies, however, suffer from a lack of focus on the tax treatment for the nonprofit sector and a consequently unrealistic understanding of the legal and political settings in which Chinese NGOs operate. Third, this analysis has commercial implications. China's integration into the WTO and the global trade system has been met with complaints about national treatment and fair competition from both foreign and domestic enterprises. A key issue arising is the gradual downplaying and elimination of preferential tax treatment of foreign investment in China.³ However, there is no materially meaningful tax law regarding the nascent NGO sector. No thought has been given to the economic and fiscal potential of NGOs as foreign investment vehicles. Aiming to address concerns above through a comparative study,⁴ this chapter proceeds cautiously along two distinct tracks.

³ See generally Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 Harv. L. Rev. 1573 (2000), presenting the relationship between tax incentives and revenue; Professor Avi-Yonah examines the increased use of tax incentives as weapons in the international competition to attract investment. Professor Avi-Yonah argues that the establishment of tax havens allows large amounts of capital to go untaxed, depriving both developed and developing countries of revenue and forcing them to rely on forms of taxation less progressive than the income tax. Professor Avi-Yonah contends that both economic efficiency and equity among individuals and among nations support limits on international tax competition, and he presents a proposal that accommodates the competing concern for democratic states' ability to set their tax rates independently. He proposes the coordinated imposition of withholding taxes on international portfolio investment, with the goal of ensuring that all income may be taxed in the investor's home jurisdiction. Professor Avi-Yonah also proposes that multinational corporations be taxed initially in the jurisdictions where their goods and services are consumed. Professor Avi-Yonah outlines that, both developed and developing nations would be able to preserve the progressivity of the income tax and to broaden and stabilize their tax bases in time to stave off the fiscal threat to the welfare state

⁴ The literature on comparative tax and federalism is voluminous. See Reuven Avi-Yonah, *Preface to Comparative Fiscal Federalism: Comparing the European Court of Justice and the US Supreme Court's Tax Jurisprudence*, by R.S. Avi-Yonah, J. R. Hines Jr. and M. Lang, co-editors, xvii-xviii. EUCOTAX Series on European Taxation, 14. Alphen aan den Rijn (The Netherlands: Kluwer Law International, 2007); Michael A. Livingston, *From Milan to Mumbai, Changing in Tel Aviv: Reflections on Progressive Taxation and "Progressive" Politics in a Globalized but Still Local World*, 54 AM. J. COMP. L. 555 (2006), Professor Livingston is one of the topmost contributors of the comparative tax literature and has conducted extensive research; see also Victor Thuronyi, *Comparative Tax Law*, (Kluwer Law International (2004)) for a detailed account of comparative tax methodologies and comparison of tax systems of over 20 countries

First, modern tax studies are debated predominantly in Western terms such as progressivity, equity and efficiency, but the scarcity of decent comparative legal tax scholarship fails to generate a “lively debate on comparative tax works and their methodologies,”⁵ in general. Meanwhile, “a shortage of paradigmatic discourse in comparative tax invites the simultaneous existence of bluntly conflicting arguments, taking parallel courses, yet never engaging each other.”⁶ Although some frameworks of comparative tax studies have been proposed,⁷ there are more theoretical than practical.⁸ One pragmatic concern with these frameworks is that only very limited areas of tax are forcefully analyzable by tax comparativists. This embarrassment is particularly challenging to scholars in the Chinese tax context who want to exploit the “tax transplant” methodology.⁹ In this connection, this thesis contributes that a comparative tax study relating to China might be better achieved by focusing on a “tax law sub-discipline” rather than on a specific tax concept. One reason is that a tax concept, usually a transplanted vocabulary of western origin, is too narrow to substantiate a patulous, meaningful, productive comparative analysis. The other reason is that specific tax provisions are contingent on their contexts and not easily extrapolated to

⁵ See Carlo Garbarino, *An Evolutionary Approach to Comparative Taxation: Methods, and Agenda for Research*, 57 AM. J. COMP. L. 677, 684 (2009) (“[t]here are three aspects related to the peculiar nature of taxation that make comparative research particularly difficult: rapid legislative change; the complexity of tax systems; and the heterogeneity of local tax concepts”); see also, Omri Y. Marian, *The Discursive Failure in Comparative Tax Law*, 58 AM. J. COMP. L., <http://ssrn.com/abstract=1404323>, at 1 (arguing that there have been several efforts at defining a theoretical framework for comparative taxation, but these efforts have been “largely ignored by everybody except their own authors” leading to an ongoing “non-discourse” that characterizes the field) (last visited on March 15, 2011)

⁶ *Id.*, Omri at 1

⁷ *Id.*

⁸ *Id.*

⁹ See Jinyan Li, *Tax Transplants and Local Culture: A Comparative Study of the Chinese and Canadian GAAR, Theoretical Inquiries in Law*: Vol. 11: No. 2, Article 8. (2010) arguing the issues arising as to comparing a westernized conceptions, <http://www.bepress.com/til/default/vol11/iss2/art8> (last visited on March 15, 2011)

others. For example, an international tax concept at the maximum can only throw in scrappy value to other major tax areas such as turnover tax or income tax.¹⁰

Second, the specific cultural, social, political, and legal roots and contexts of a tax governance framework usually are much less discussed or are even purposefully ignored by tax comparativists. This “snooping” methodology unavoidably provokes abundant “contemptuousness” and skeptics from orthodox tax scholarship against tax comparative studies. A tax study ultimately has to pay attention to the general cultural, social, political and legal contexts in which a tax system is embedded. Otherwise, a comparative study may easily turn into descriptive, mechanical and perfunctory analysis. The practical and scholastic significance of comparative tax studies can hardly be achieved by a limited comparison of the technical elements of a tax concept and no more. The “big-picture” perspective nonetheless must be employed to conduct a comparative study as to the Chinese tax context. The same rationale applies to studies of the impact of both the rule of law development and China’s assimilation to the WTO system, as well. Therefore, this thesis also focuses on the role of philanthropic culture in its comparison between the U.S. and Chinese tax systems.

The development of China’s nonprofit sector¹¹ has been marvelous, especially after recent natural disasters,¹² the 2008 Beijing Olympic Games, and various

¹⁰ *Id.*

¹¹ See Brody *supra* 1 at 436-37, discussing that the third sector often uses the terms “charity” and “nonprofit” interchangeably. See also generally D.B. Reobertson *supra* 1

¹² See China Daily, August 18, 2010, listing recent natural disasters that involving high casualty and economic loss including the 2010 South China floods & Yushu Earthquake, Sichuan Earthquake in May 2008, the southern China snowstorm crisis in early 2008, etc.

latest celebrities' donation scandals¹³. Regulatory deficiency in the treatment of nonprofit organizations has alarmed China's failure to maintain its rich tradition of state-centered social provision and the exacerbation of economic disparities between rural and urban citizens. Surges of grassroots NGO activity, millions of affectionate "netizens" during the natural disasters, and faithful volunteers for the Olympic and Paralympics Games also resonate the malfunctioned administration and messed allocation of charitable resources. Meanwhile, the Chinese government has seriously identified the indispensable role played by the nonprofit sector in alleviating the bureaucracy, downsizing government, stimulating wealth mobility, reducing regional inequality, and, ultimately, promoting a harmonious society.

The current Chinese legal framework fails to establish an enabling and operative nonprofit sector. Mostly, the state fails to regulate it through a potent tax system, creating various tax preferences and ensuring no abuse of those preferences occurs. Even it had been suggested that a comprehensive charity law should be enacted, the existing charity tax laws and regulations sojourn discordant, anachronistic and inoperative. Worse is that certain bureaucratic management and unprofessional administration have jeopardized the incentives and confidence on reforming the nonprofit sector.

The United States system on tax treatment of nonprofit organizations has been a well established and sought-after model for decades. It is regarded as particularly appropriate for emerging NGO sections in worldwide. This thesis proffers special emphasis on China's tax reform for the charity sector which has expanded as a result of remarkable economic growth and legal system

¹³ See "Zhang Ziyi began to address quick scandal"
http://www.hollywoodreporter.com/hr/content_display/world/news/e3i4fe3d67e44c8b3addc7a3a9589c41c58 (last visited on March 15, 2011)

reform. Although there is no single pattern fitting in various global needs, the U.S. model provides quite established principles of federalism, fiscal incentives and economic adaptability which make it a powerful system. This thesis compares current nonprofit tax rules in China and U.S. in practice, and highlights suggestions that may benefit charity tax law reform in China.

Following this introduction, subchapter II presents a brief overview of China's current charity laws and regulations, the historical development of charity tax laws and those in practice, especially on charitable tax exemptions. Subchapter III outlines a number of institutional and theoretical backgrounds of the current U.S. charity tax exemption systems. Subchapter IV highlights the institutional and practical similarities and differences between the China and U.S. systems. Subchapter V concludes with major findings by commenting on potential nonprofit tax law reform in China.

II. Overview and Background of Nonprofit Laws in China

2.1 Historical Development

China runs according to a complex party-state system in a struggle within itself to find its way to modernize the nonprofit sector. In 1950, China adopted its first law¹⁴ to manage societal organizations; however, pre-reform (pre-1978) social organizations were government operated non-governmental organizations ("GONGOs") and are not "true" NGOs based on the western

¹⁴ See Shehui Zuzhi Zhuce Zanzing Tiaoli [*The Provisional Rules on Social Organization Management*], the first law governing social organizations "Provisional Procedures on the Registration of Social Organizations", and it remained effective until 1989

definition. Those GONGOs¹⁵ were established and absorbed into the party-state system as part of government branches. Leaders of those organizations are either current or retired senior government officials and their staffs enjoy the same benefits and privileges of government officials. Apparently, GONGOs are exempt from registration and administration requirements which are required of China's NGOs.

The 1980s' saw the development of a plethora of various forms of NGOs surging from economic reform and the "open-up policy." In response to liberalization in economic development and the state-owned enterprises ("SOE") modernization reforms, the state realized its shortage of capacity and resources to provide all necessary social services to function a rapidly reforming society. In the 1990's, the central government proposed a "small government, big society" policy, transferring part of service responsibilities that had come from the government to private or nonprofit sectors. Following the party-state tradition, private and nonprofit sectors have been consistently been treated as auxiliary and subordinate agents of the state in bridging the gap between state and the people, especially in areas like poverty relief, elementary education support, aging population welfare and environment protection. Although the first authentic civil society organizations debuted in somewhat embarrassed way in the early 1980s, they have since shown remarkable potential to outshine the government as a major platform of raising critique and promoting social welfare and justice. However, in sensitive areas like human rights, political reform, religion and freedom of speech, the government territorially maintained an iron grip in controlling related

¹⁵ Mostly, those organizations are semi-government entities, such as "the Chinese Communist Youth League", "the China Writers' Association", "the All-China Workers' Union", and "the All-China Women's Federation"

activities and did not allow private sector or nonprofit sector to step into this realm.

In the second half the 1980s, the government was confronted with a clear and sweeping demonstration of democratic movements coupled with a rudimentary and obsolete system of NGO management. In particular, the year of 1989 witnessed a speedy promulgation of the new Regulation on Registration and Management of Social Organization. Not surprisingly, tightened measures, such as dual management system, approval and management of supervisory unit and membership requirements, all have been established since 1989, and the scale of the NGO sector has risen and fallen according to rounds of re-registration hurdles.

Notwithstanding the fluctuating¹⁶ numbers of registered NGOs, legislation has been unexpectedly friendly to the nonprofit sector in general. Coupled with the establishment of specific government branch to manage societal organizations,¹⁷ the Article 35 of the 1982 Constitution recognizes the right to freedom of association, and the General Principles of Civil Law (“GPCL”) categorized social organizations together with government organs and public institutions that are different from commercial enterprises. This tolerance continued for over 15 years and led to the 1998 promulgation of two important pieces of legislation, most importantly the 2004 Foundation Regulation, which even permits entry of foreign foundations.¹⁸ However, quantification of

¹⁶ See MA, Qiusha, *The Governance of NGOs in China since 1978: How Much Autonomy?* 31 Nonprofit & Voluntary Sector Q. 305-306 (2002); see also *Qu Di Fei Fa Min Jian Zu Zhi Zan Xing Ban Fa* [Provisional Rules Banning Illegal NGOs] (promulgated by the Ministry of Civil Affairs, effective as of April 10, 2010), targeting mostly at Falungong and other qigong movements

¹⁷ For details of the nonprofit organizations management and government apparatus, <http://cszh.mca.gov.cn/> (last visited on March 15, 2011)

¹⁸ see *infra* Subchapter III

growth of the nonprofit sector in China has been always difficult. A majority of NGOs remain unregistered, or registered as for-profit entities' to evade arduous administrative proceedings, and many even dissolve before any formal registration procedure is taken.

2.2. Summary of Current Laws and Regulations

In China, NGOs¹⁹ are classified into three major categories: social organizations (SOs or *shehui tuanti*), private non-enterprise units (PNEUs or *minban feiqiye danwei*), and foundations (*jijinhui*), according to three important NGO legislations: the Regulations on Registration and Management of Social Organizations (hereinafter “SO Regulation” or “*Shehui Tuanti Dengji Guanli Tiaoli*”); the Provisional Regulations on Registration and Management of Private Non-Enterprise Units (hereinafter “PNEU Regulation” or “*Minban Feiqiye Dengji Guanli Zanxing Tiaoli*”); and the Regulation for the Management of Foundation (hereinafter “Foundation Regulation”, or *Jijinhui Guanli Tiaoli*). In particular, Chinese citizens may incorporate, manage, and participate in SOs and PNEUs, while a foreign citizen can only act as the legal representatives of a foundation.²⁰

¹⁹ See Ma *supra* 16, the term civil society organizations (“CSOs”) is *Minjian* (民间) or popular organizations. It is also interchangeably be referred as NGOs. See Na La, Zhongguo Caogen NGO de Wenzhe Xianzhuang yu Wenti, [*Analysis and Problems on the Development of Grassroots NGOs in China*] [hereinafter “Na La”] 娜拉: 《中国草根 NGO 的问责现状与问题》, discussing the literal meanings of NGO, CSO, NPO, SO and Foundation (in Chinese), <http://www.nporuc.org/html/achievements/20090907/167.html> (last visited on March 15, 2011)

²⁰ See Art. 24, Regulations on Management of Foundations [*Ji Jin Hui Guan Li Tiao Li*] (promulgated by the State Council, March 8 2004, effective June 1, 2004) [hereinafter “the 2004 Foundation Regulation”], http://news.xinhuanet.com/zhengfu/2004-03/18/content_1372870.htm (last visited on March 15, 2011)

The Bureau of Administration of NGOs (*Minjian Zuzhi Guanliju*) within the Ministry of Civil Affairs (“MCA”) (previously the Department of Social Organizations or “*Shetuan Si*”) is the primary official agency in charge of nonprofit organization and is responsible for the registration and filings, detailing implementation rulings and interpretation of laws and regulations in the nonprofit sector. Likewise, other government agencies join in regulating NGOs in certain areas. Under appropriate delegation of authority, the SAT and the MOF issues regulations and rulings on the tax-deductibility of donations, tax exemptions or preferences, and internal governance;²¹ the State Administration for Industry and Commerce (SAIC) coordinates non-public fund-raising foundations and certain for-profit activities conducted by NGOs; and the Ministry of Public Security may police NGOs for certain criminal disobedience.²² In addition, local MCA and other administrative branches promulgate various region- or industry-specific rules and regulations to manage NGOs²³.

2.2.1. Social Organizations

2.2.1.1. Dual management requirement

²¹ See Art. 29, Regulations on Registration and Management of Social Organizations [*She Hui Tuan Ti Deng Ji Guang Li Tiao Li*] (promulgated by the State Council, October 25, 1998, effective September 25, 1998) [hereinafter “SO Regulation”], http://www.cnca.gov.cn/rjwbgs/ztxx/dgzfbz/4570_4.shtml (last visited on March 15, 2011)

²² *Id.*, Art. 35

²³ Beijing is considered to be the most conservative in NGO registration and management due to its political sensitivity, while other provinces such as Yunnan and Guangdong take a relatively more liberal approach toward NGO management

The SO and PNEU Regulations and the Foundation Regulations all require a dual management structure. Each type of organization, before it files registration at the national or local level office of MCA, must first seek a professional supervisory unit (“*Yewu Zhuguan Danwei*”) to review (“*Shen Cha*”) and approve (“*pi zhun*”) such registration, and then monitor NGO’s operation, governance and finances etc after its establishment.²⁴ Although any government agency at the national, provincial, or city level, or any certified GONGO,²⁵ can act as an NGO sponsor, NGOs, especially grassroots NGOs, do not have much luxury to select appropriate supervisory sponsors.²⁶ In reality, many SOs remain unregistered or even underground barely because the potential supervisory units deny such sponsorship or the NGO’s proposed major purposes and activities do not fall within sponsor’s scope of duties,²⁷ and any operative unregistered SOs risk criminal liability.²⁸ Therefore,

²⁴ See Arts. 6-9, 27-28, Provisional Regulations on Registration and Management of Private Non-Enterprise Units [*Min Ban Fei Qi Ye Dan Wei Deng Ji Guan Li Zan Xing Tiao Li*] (promulgated by the State Council and effective as of September 25, 1998) [hereinafter “PNEU Regulation”], http://www.ha.xinhuanet.com/fuwu/kejiao/2004-03/29/content_1869912.htm (last visited on March 15, 2011)

²⁵ See Art. 6 SO Regulation

²⁶ See generally Na La, *supra* 19; see also, He and Ashley *Opening One Eye and Closing the Other: The Legal and Regulatory Environment for “Grassroots” NGOs in China*, 26 B.U. Int’l J. 29 (2008) [hereinafter “He and Ashley”]. In practice, the dual management requirement has proved to be the most difficult hurdle for grassroots NGOs to surmount in gaining legal status. In order to secure the support of a government supervisory agency, the founders of an NGO must cultivate personal relationships with government officials to develop trust and connections. From a government agency’s perspective, acting as a sponsor to a grassroots NGO creates many new duties, responsibilities, and political risks, but reaps few benefits. The extreme difficulty of finding a government sponsor is widely considered to be the major reason why over 90% of NGOs in China are either underground and unregistered or registered as commercial enterprises

²⁷ See Art. 6 SO Regulation Art. 6

²⁸ See Art. 35 SO Regulation, stipulating that an unregistered NGO operating in the name of an SO could be subject not only to civil, but also to criminal liability. According to Article 54 of the Law on Public Security Administrative Punishments, a person convicted under this provision could be subject to up to 15 days in prison and a fine of up to 1,000 RMB. Given that many NGOs across China are not officially registered, this provision could be viewed as an axe always hanging over their heads

granting approval by supervisory units is utterly discretionary,²⁹ and there is no standard filing paperwork requirement on obtaining sponsorship by an SO,³⁰ and therefore potential government supervisory sponsors may ostensibly stretch the approval process³¹ or demand unnecessary paperwork maliciously. The dual management requirement creates several layers of problems reflective of historical fears of uncontrolled social movements. First, it does not offer Chinese citizens reasonably accessible venues to the constitutionally protected freedom of association to form all kinds of associations.³² The nature of the supervisory units usually dominates the scope of the activities to be conducted by the application organizations. Although scholars feel powerless to advocate for this precious right, the complaint of the lack of right to association has been, somewhat controversially, published in various periodicals of academic pursuit.³³ Second, the dual management structure inhibits the dynamic development of responsive associations for emergency situations.³⁴ This drawback was particularly evident during the time of emergent natural disasters. Many volunteers had to establish *ad hoc* NGOs to conduct relief activities and they were not even able to find supervisory units within a tight timeframe. Third, it prohibits NGOs from engaging in activities

²⁹ See generally Ge Yunsong, *On the Establishment of Social Organization under Chinese Law*, 2 Int'l J. of Not-for-Profit L. (2000), http://www.icnl.org/knowledge/ijnl/vol2iss3/art_2.htm (last visited on March 15, 2011); see also generally, He and Ashley *supra* 26, discussing a case study of establishment of an eye care center

³⁰ See generally, *Id.*, Ge

³¹ *Id.*

³² See Karla Simon *Regulation of Civil Society in China*, 32 Fordham Int'l L. J. 964. Professor Karla Simon is a major contributor in the field of non-for-profit organization studies. [hereinafter "Simon"]

³³ *Id.*, discussing that scholars complain about not being to form appropriate organizations for academic studies

³⁴ *Id.*

across multiple sectors³⁵. Usually, a supervisory unit is risk averse and thus prefers approving NGO sponsorship within its scope of assigned responsibilities and very reluctantly oversees NGOs that carry out unfamiliar activities, for example, a healthcare supervisory unit usually would refuse supervising NGOs in the education area. Therefore, NGOs have to be singularly focused and are not flexible to receive donations from diversified sources. Fourth, government agencies may set up an SO as a vehicle during government reshuffles to retain their redundant staffs or retirees.³⁶ Fifth, government agencies also often set up GONGOs to raise external sources of funding³⁷ and to disqualify private applicant organizations.

2.2.1.2. Constraints on repeated and cross-regional subsidiaries

A derivative of the dual management requirement is the “non-repetition” constraint. In particular, the supervisory unit or MCA may deny the registration of an NGO if “in the same administrative area there is already a social organization active in the *same* or *similar* area of work.”³⁸ The non-repetition provision stipulates that in a particular area of activity, such as elementary education, only one SO in service is allowed to operate in a given geographical region (city, provincial, or national)³⁹ although the definition of

³⁵ See generally Na La *supra* 19

³⁶ *Id.*

³⁷ See e.g. Simon *supra* 32 and He and Ashley *supra* 26

³⁸ See generally Ge, *supra* 29, citing The Interpretation of the Regulation on the Registration and management of Social Organization and the Interim Regulations on the Regulation and Management of Private Non-enterprise Units 36 (The Dep’t of Politics and Law of the State Council & The Bureau of Admin. of Non-governmental Orgs. of the Ministry of Civil Affairs eds., 1999)

³⁹ See He & Ashley, *supra* 26, at 44-45, noting an example that, if there is already a national AIDS NGO, a similar organization could register only at the provincial or city level. This limitation reflects the Party’s corporatist view of the state-society relationship, considering

“area of activity” is quite discretionary. It is well argued that the non-repetition requirement has the merit of avoiding too many organizations “developing without planning,” and possibly potential “malicious competition” among nonprofit organizations.⁴⁰

A further ramification of the non-repetition constraint is that an SO has to be real name identification member-based and therefore often subjects its members to political surveillance.⁴¹ In addition, the SO Regulations prohibit cross-regional branching.⁴² For instance, the administrative hierarchy of the supervisory unit delineates the geographical application within which an SO can operate. If an SO wishes to reach out its registered geographic region and branch a subsidiary or representative office elsewhere, it has to obtain an approval in advance from its own supervisory sponsor and even the permission of local MCA in the desired subsidiary location which oversees similar areas of activities.⁴³ Literally, national SOs cannot establish branches in different provinces although they are merely permitted to conduct activities across the country.⁴⁴ Moreover, SO subsidiaries cannot set up second-tier subsidiaries and an SO legal representative (*fa ding dai biao ren*) must not at the same time act as a legal representative for another SO.⁴⁵

SOs’ purpose to be to serve as a bridge between the state and society by representing the interests of various constituent groups--for example, those with AIDS or, more traditionally, women or the disabled--at a given administrative level

⁴⁰ See generally Ge *supra* 29

⁴¹ See generally SO Regulation *supra* 21

⁴² *Id.*

⁴³ For instance, a city-level SO can branch within the city, but cannot conduct activities outside of its registered city. If an SO wishes to conduct activities in multiple cities of the same province, it has to seek a provincial-level government sponsor and register at that level. And if an NGO wants to conduct activities in cities outside its home province, to apply the language of the regulation literally, the NGO would have to seek a ministerial-level sponsor and register a national NGO to legally carry out its mission

⁴⁴ See Arts. 12 and 13, SO Regulation *supra* 21

⁴⁵ *Id.* Arts.14 and 19

The non-repetition constraints coupled with branching prohibitions prevent locally-registered NGOs to conduct activities across China, and suppress networking and resource sharing among SOs. Moreover, an SO must not endanger or conflict with the interests and safety of the state and the unity of all ethnicities, and must not violate the state interests, public interests, or public morals.⁴⁶ Those constraints again reinforce the deeply rooted fear against mass political movements that may threaten the party-state.⁴⁷

2.2.1.3. Exempted Organizations

Some organizations are exempted from the registration requirement according to Article 3 of the 1998 SO Regulation. These organizations include those that participate in political consultative meetings, such as the Chinese Communist Party-sanctioned eight political parties and nine other associations including the All-China Federation of Industry and Commerce, the Communist Youth League, and the All-China Women's Federation. Other exempted organizations include 14 well-known GONGOs, such as the China Writers' Association, the Song Qingling Foundation, and the Red Cross Society of China,⁴⁸ just to name a few. These GONGOs are usually considered to have the same status as administrative branches and are often viewed as part of the government bureaucracy.

⁴⁶ *Id.* Art. 4

⁴⁷ See Na La, *supra* 19, Chapters III and IV, discussing that the highly restrictive provisions against pluralism, branching, and networking are based on government concerns over an SO becoming a rival power and thus threatening the reign of the Chinese Communist Party. For instance, national-level NGOs are presumably not able to register at all and usually the most closely monitored and controlled by the central government

⁴⁸ a complete list of these exempted GONGOs is <http://www.mca.gov.cn> (last visited on March 15, 2011)

What is more interesting is the third clause of Article 3, which states that any organization that is set up by a government entity or a GONGO and that conducts its activities within such entity is exempted from registration. In practice, many NGOs exploit this provision and struggle to gain semi-legal status by attaching themselves to a governmental or semi-governmental entity that holds more liberal attitudes toward NGOs. Higher educational institutions are a common example of such liberal entities that shelter and sponsor grassroots NGOs⁴⁹ and nonprofit organizations of a research and academic nature.

The legal status of a GONGO is a precious resource. Some GONGOs find it in their financial interest to offer shelter to grassroots NGOs in exchange for membership fees and management dues. The sheltered NGOs are thus exempted from registration. Sometimes, GONGOs may even formally sponsor NGOs with a second-tier SO status by acting as their supervisory units and allowing them to register with the MCA or its local bureau. A nonprofit organization may take advantage of such an affiliation with and supervision under GONGOs and gain legitimacy and important governmental connections, though often at a high financial stake. For example, one GONGO under the MCA sponsors a nonprofit organization and charges them annual membership fees as high as RMB 200,000 (U.S.\$ 25,900).⁵⁰

⁴⁹ See e.g. Jude Howell, *New Directions in Civil Society: Organizing Around Marginalized Interests*, In *Governance in China*, 143, 155-65 (Jude Howell ed., 2004)

⁵⁰ See He and Ashley, *supra* 26 at 46

2.2.2. Private Non-Enterprise Unit

The Private Non-Enterprise Unit (PNEU) form, first created by the 1998 Provisional Regulations on Registration and Management of Private Non-Enterprise Units (PNEU Regulation), is a special NGO category in the Chinese context. By definition, a PNEU is a privately-run noncommercial unit, and its main purpose is to provide social services,⁵¹ mainly in the fields of education, public health, technology, and sports. These facilities historically have been almost entirely owned and operated by the state. Ever since the economic reforms starting in the late 1970s, private institutions have gradually proliferated and replaced government agencies in running related organizations and PNEUs thus emerged into the picture. The 1998 PNEU Regulation formally recognized the legal status of these then state-operated now privately-run entities and granted them nonprofit status. In practice, a majority of PNEUs are *for-profit* entities in the areas of education and healthcare. The PNEU sector has grown very rapidly since the promulgation of the PNEU Regulation. As of December 31, 2006, a total of 159,000 PNEUs have been registered⁵², accounting for about 46% of all registered NGOs in China, and roughly half of these PNEUs are private schools.⁵³

Many key provisions of the 1998 PNEU Regulations mirror those in the SO Regulation, such as the dual management system, non-repetition within the

⁵¹ See PNEU Regulation, Arts 1 and 2

⁵² See Sun Weilin, Head of National Bureau of NGO Management, *Zai Quan Guo Min Jian Zu Zhi Guan Li Gong Zuo Shi Pin Hui Shang De Jiang Hua* [*Speech at the National NGO Management Conference*] (January 31, 2007), <http://www.mca.gov.cn> (last visited on March 15, 2011)

⁵³ See Zhao Yong, *Min Ban Fei Qi Ye Dan Wei You Guan Fa Lu Wen Ti Zhi Si Kao* [*Thoughts on the Legal Issues of PNEUs*], in *Zhong Guo Fei Ying Li Zu Zhi Fa Lu Mo Shi Lun Wen Ji* [*Collected Essays on the Legal Models of Chinese NPOs*], 220 (2005) (in Chinese)

same administrative region constraint⁵⁴, and not surprisingly, similar broad and vague languages subject to discretionary interpretation by the state police power.⁵⁵ One additional constraint imposed on PNEU is that a PNEU may not set up branches even within its registered administrative region.⁵⁶ Difficult to substantiate as it is, this provision envisions the disadvantaged position of state-run noncommercial organizations (e.g. schools and hospitals) in competition against PNEUs.

Traditionally, PNEUs aim to provide social services and thus are less politically sensitive to the government. PNEUs are even encouraged and fostered as stated in a recent MCA work report,⁵⁷ and adopted by grassroots NGOs as a good vehicle to obtain the nonprofit status and the legitimacy attached thereto. Noticeably, the PNEU Regulation casts out sincere efforts by the government to fashion a tiered-management structure for NGOs and diversify NGO categories.

2.2.3. Foundations

The 2004 Foundation Regulations marked a major step for China's NGO legal framework. Noticeably, for the first time, a foreign NGO, other than a chamber of commerce,⁵⁸ could legally establish its presence in China as a nonprofit entity,⁵⁹ and a foreign citizen, subject to a three-month residency requirement for certain key management personnel, was able to incorporate

⁵⁴ See PNEU Regulations, Arts. 5, 8, and 13

⁵⁵ See SO Regulations Arts. 4 and 35

⁵⁶ See SO Regulations Arts. 4, 13, and 27

⁵⁷ See generally Sun, *supra* 52

⁵⁸ See Wai Guo Shang Hui Guan Li Zan Zing Gui Ding [*Provisional Regulations on Management of Foreign Chambers of Commerce*] (promulgated by the State Council, June 14, 1989, effective July 1, 1989)

⁵⁹ See 2004 Foundation Regulation Arts. 6, 13, and 14

and participate in domestic private foundations.⁶⁰ Foreign foundations are not allowed to raise funds inside China.⁶¹

Superior to the 1998 SO Regulation and PNEU Regulation, the 2004 Foundation Regulation features some modern NGO prerequisites and standards – in particular, management appointments, internal governance, donation and financial management. Not surprisingly, the Foundation Regulations disappointed observers by keeping the dual management,⁶² and a provincial level of government sponsor is required, which is more restraining than the SO and PNEU regulations.

2.2.3.1. Categories of Foundations and Capital Requirements

The Foundation Regulation elaborates separate treatment for domestic foundations and for representative offices of foreign foundations.⁶³ A domestic foundation is further classified geographically as a national foundation and a regional (provincial) foundation, and also classified either as a private or public foundation based on the sources of its funds and donations.⁶⁴ A national foundation, the representative office of a foreign foundation, or any foundation whose legal representative is not a mainland Chinese citizen has to register with the MCA and secure the backing of a ministerial-level government supervising agency or a sponsor recognized by the State Council.⁶⁵

⁶⁰ *Id.*, Art. 24

⁶¹ *Id.*, Art. 25

⁶² *Id.*, Art. 7

⁶³ *Id.*, Art. 13

⁶⁴ *Id.*, Art. 8; *see also* Na La, *supra* 19, Chapter III

⁶⁵ *Id.*, Art. 7. In particular, a foreign citizen may serve as a legal representative or Chairman of the Board for a domestic private foundation, though it is yet to be seen whether this will be allowed in practice. At a minimum, foreign citizens or citizens from Hong Kong, Macau, or

The minimum capital threshold to set up a private foundation is RMB 2.0 million (about \$295,000),⁶⁶ RMB 8 million (about \$1.18 million) for a national foundation, and RMB 4 million (about \$590,000) for a regional foundation.⁶⁷ Local MCAs may at their discretion impose higher initial capital requirements. The initial capital is presumably kept on book and thus cannot be used for programming activities.

2.2.3.2. Constraints on Cross-Regional Subsidiaries and Standards for Internal Governance

A foundation may set up branches upon approval of the MCA or its provincial branch, and the civil affairs bureaus have the discretion to deny the application.⁶⁸ The 2004 Foundation Regulation requires particular internal governance requirements,⁶⁹ such as the board of directors formation,⁷⁰ appointment of a supervisory official,⁷¹ and a legal representative.⁷² Moreover, the Foundation Regulation also elaborates financial management standards,

Taiwan can assume important management positions of a foundation and thus potentially control its operations in significant ways

⁶⁶ *Id.*, Art. 8

⁶⁷ *Id.*

⁶⁸ *Id.*, Art. 12

⁶⁹ The SO and PNEU Regulations, in contrast, have almost none.

⁷⁰ See 2004 Foundation Regulation Art. 20, stipulating that the board must have between 5 and 25 members, 2) for private foundations established using the assets of a private individual, no more than a third of board members may be close relatives of that individual, and for other foundations, close relatives may not serve simultaneously as directors 3) no more than a third of a foundation's board members may receive financial compensation from the foundation

⁷¹ *Id.*, Art. 22, providing that the official cannot be a member of the board, a close relative of a board member, or on the financial staff of the foundation

⁷² *Id.*, Art. 23, providing that the legal representative of the foundation may not concurrently represent any other organization and a public or private foundation's legal representative should be a citizen of mainland China if the foundation's original funds are of domestic Chinese origin

such as annual expenditure restraints,⁷³ and capped management compensation and capped overhead fees.⁷⁴

2.2.4. Unregistered NGOs

The taxing registration requirement, especially the difficulty of searching for a “supervisory or administration unit,” encourages the establishment of many *de facto* NGOs including grassroots NGOs in China that do not seek registration. In fact, the unregistered NGOs that operate openly and legally may well outnumber registered ones.⁷⁵ As mentioned above, a social organization can operate as an internal organization of another enterprise and social organization without registration.⁷⁶ Some *de facto* social organizations incorporate themselves as corporations and are treated the same way as a normal commercial enterprise. If the NGO can demonstrate its nonprofit nature to the local governmental and tax authorities, even though it is hard to prove, there might be some flexible and compromised accommodation can be reached between NGOs and local MCA and SAT.

Many NGOs especially grassroots NGOs simply do not exist as legal entities because they never seek registration. However, some of these NGOs operate

⁷³ *Id.*, Art. 29, stipulating that the amount of money spent annually by public foundations on public benefit activities must not be less than 70% of the previous year's income, and private foundations' annual expenditure must not be less than 8% of the surplus from the previous year

⁷⁴ *Id.*, a foundation may not allocate more than 10% of its total expenditure to cover staff wages and benefits and other overhead costs.

⁷⁵ This thesis excludes secret, underground organizations that operate illegally for discussion for two reasons: (1) the numbers are not collectable or verifiable in any official means; (2) illegally operated underground organizations are loosely associated and sometimes at best are motivated gatherings for spiritual pursuit

⁷⁶ Often, those organizations reach beyond the scope of serving the affiliated enterprise or organization. For example, in many universities, the affiliated social organizations are also serving the society in general and the government will often just turn a blind eye to these types of activities

openly (acknowledged by some governmental entities and officials) and are generally accepted in the community. Since Chinese tradition favors a tradition of connection (*guan xi*) and flexibility in resolving problems when the official process is burdensome and costly, well connected unregistered NGOs will likely continue playing an important role and leading to many administrative discrepancies and uncertainties.

2.3. Tax treatment of Chinese NGOs

China does not have a comprehensive tax code governing various NGO forms. Charitable tax exemptions from major Chinese taxes are mostly based on the “nonprofit” conception⁷⁷ which is prescribed and interpreted by scattered provisions within the various tax laws and regulations, the China Trust Law (on charitable trust) and the Public Benefit Donation Law which is the only law passed by the National People’s Congress governing NGOs.⁷⁸

2.3.1. Tax Treatment of Charitable Donations

As noted above, rules about income tax treatment of donations scatters in various laws and regulation as shown below.

⁷⁷ See 2004 Foundation Regulations Art. 2; SO Regulation, Art. 2; PNEU Regulation, Art. 2

⁷⁸ See generally in Leon Irish, Jin Dongsheng & Karla Simon, *China’s Tax Rules for Not-for-profit Orgs.* 12-16 (2004), and in practice, registration with the MCA or its local branch in one of the three recognized NGO forms guarantees exemption, even the local bureau of industry and commerce may consider NGOs as for-profit commercial enterprises on a case-by-case basis and apply normal business tax rates

Date of Enactment	Legislation	Description
January 28, 1994	Article 24 Regulations for the Implementation of the Individual Income Tax Law of the PRC	“Individual income donated to educational and other public welfare undertakings” refers to the donation by individuals of their income to educational and other public welfare undertakings, and to areas suffering from serious natural disasters or poverty, through social organizations or government agencies in the People's Republic of China. That part of the amount of donations which <i>does not exceed 30 percent of the amount of taxable income</i> declared by the taxpayer may be deducted from his amount of taxable income
February 4, 1994	Article 6(4) Provisional Regulations of the PRC Enterprise Income Tax	Donations for community benefits and charitable donations by a Taxpayer in a year are deductible up to <i>3% of the Taxable Income</i>
September 1, 1999	Articles 24 and 25, Chapter IV Preferential Measures, PBDL	Article 24 When donating property for public welfare undertakings according to the provisions of this Law, corporations and other enterprises may be given preferential treatment in enterprise income tax according to the provisions of laws and administrative regulations. Article 25 When donating property for public welfare undertakings according to the provisions of this Law, Natural persons, individual businesses of industry and commerce may be given preferential treatment in individual income tax according to the provisions of laws and administrative regulations.
July 12, 2000	Joint Notice on Income Tax Treatment of Donation by Enterprises to the Red Cross (SAT and MOF)	Donations made to non-profit social organizations and state apparatus (such as the Red Cross) by enterprises, social organizations and individuals should be fully deducted from taxable income
March 8, 2001	Joint Notice on Income Tax Policies as to Perfecting Experimental Works for Urban Social Securities System (SAT and MOF)	Charitable donations made to charitable organizations, foundations, or non-profit social organizations by enterprises, social organizations and individuals should be fully deducted from taxable income

September 22, 2003	Joint Notice on Income Tax Deduction as to Donations to Five Foundations Including the China Health Vehicle Project (SAT and MOF)	Charitable donations made to China Health Vehicle Foundation, Sunzhifang Economic Science Foundation, China Charity Foundation, China Legal Aid Foundation and China Justice-Upholding Foundations by enterprises, social organizations and individuals should be fully deducted from taxable income
February 5, 2004	Article 8, Joint Notice on Education related Tax Policy (SAT and MOF)	Donations made to the educational institutions by taxpayers through non-profit organization and state apparatus in China should be fully deducted from taxable income
March 16, 2007	Article 9, Enterprise Income Tax Law	In relation to the expenses from charitable donations incurred by Enterprises, the portion within 12% of the total annual profit may be deducted from the taxable income.

(Table 3)

Individuals and corporations can deduct their charitable contributions with some constraints in China. For individuals, “personal contributions to educational and other undertakings for public welfare shall be deducted from the taxable income in accordance with the relevant regulations by the State Council.”⁷⁹ The regulations thereunder define donations as “donations by individual[s] of their income to educational and other undertakings of public welfare, and to areas suffering from serious natural disasters or poverty, through social organizations or government agencies in the People’s Republic of China.”⁸⁰ The regulations further limit the deduction to 30 percent of taxable income.⁸¹

According to the recent unified Enterprise Income Tax Law, which took effect on January 1, 2008 and unifies the treatments between foreign and domestic enterprises, enterprises are allowed to deduct up to 12 percent of taxable

⁷⁹ See *The Individual Income Tax Law of the P.R.C.*, Art. 6

⁸⁰ See *The Regulations for the Implementation of the Individual Income Tax Law of the P.R.C.*, Art. 24

⁸¹ *Id.*

income for contributions to causes for “public benefits and social welfare.”⁸² As stipulated in the Provisional Rules and Regulations thereunder, causes for public benefits and social welfare are defined in almost the same way as the Regulations for the Implementation of the Individual Income Tax Law. The EIT Law explicitly states that donations directly to individual donees are *not* deductible. As of July 2006, the MOF and SAT had only approved tax deductions for donors to sixty-two organizations,⁸³ most of which are GONCOs. Donations to these twenty-six organizations are fully deductible, but for the other thirty-six organizations, individual donors can deduct up to 30% of taxable income, and corporate donors up to 12% under the recently revised Enterprise Income Tax Law, which increases the permissible charitable contribution deduction for both domestic and foreign companies corporate donors from 3% to 12%.⁸⁴

The Chinese tax laws and regulations require that for charitable contributions to be tax-deductible, they must meet both a specific “cause” requirement and an organizational prerequisite, i.e., to be tax deductible, such contributions have to cater certain causes as well as to pledge (through) certain organizations. However, there is serious doubt about how important a role the tax benefit consideration plays in individuals’ or corporations’ donation considerations.⁸⁵ First and foremost, the MOF and SAT stipulate only a few organizations that are eligible for receiving tax deductible charitable

⁸² See *Enterprise Income Tax Law of the P.R.C.*, Art. 9, (promulgated by the National People’s Congress, March 16, 2007, effective January 1 2008) [hereinafter the EIT Law of the P.R.C.]

⁸³ See Ci Shan Juan Zeng You Hui Zheng Ce [*Preferential Policy for Charitable Donations*], <http://www.juanzhu.gov.cn> (last visited on March 15, 2011)

⁸⁴ See the EIT Law of the P.R.C., Art. 9

⁸⁵ See generally, Chinese Taxation Institute, *Report on Tax Policy Studies for Promoting Domestic Needs* [*Guanyu Jinyibu Kuoda Neixu de Shuishou Zhengce Yanjiu Baogao*], 中国税务学会《关于进一步扩大内需的税收政策研究报告》

<http://www.chinatax.gov.cn/n480462/n7921376/n7921576/n7921766/n7921902/8800885.html> (last visited on March 15, 2011)

contributions. Donations made to non-certified NGOs are not tax deductible. Second, due to the high volume of donative activities in times of emergency, eligible organizations might have insufficient human and resources to collect and manage donations. Third, the infrastructure linking individual income tax reporting and charitable deductions is weak.⁸⁶ Finally, the complicated administrative procedure may thwart taxpayers to claim such deduction, the nominal value of which is insignificant in most cases.

In addition, although recent natural disasters in China have stimulated a round of personal charitable donations, such economic endowments remain infrequent in China for various reasons. First, the feeling of distrust still occupies minds of individual donors regarding the likelihood of a reasonable and fair allocation of charitable donations. Second, the absence of an estate or gift tax in China reduces the motivation for making donations. Third, the government adopts an unsympathetic controlling practice toward unregistered NGOs, which mostly are underground churches, religious groups and elderly care centers. Finally, corruption by government officials overwhelmingly impairs their capacity to request further donations.

According to the PBDL, qualified public welfare organizations are allowed to receive public welfare donations under the following conditions:⁸⁷ i) activities carried out by social bodies and individuals to provide disaster relief, aid for the poor, and giving support and assistance to the physically disabled; ii) educational, scientific, cultural, public health, and sports undertakings; iii) construction of environmental protection facilities and public utilities in

⁸⁶ *see supra* Chapter V on tax legislation

⁸⁷ *See* Zhonghua Renmin Gongheguo Gong Yi Shi Ye Juan Zen Fa [*Public Welfare Donation Law*] Art. 3 (effective as of September 1, 1999), <http://www.gqb.gov.cn/node2/node3/node5/node9/userobject7ai1270.html> (last visited on March 15, 2011)

society; and iv) other public and welfare undertakings in society that aim to promote social development and progress.

Noticeably, the donations have to be made to certified public welfare social organizations and public welfare private non-enterprise units under the Public Welfare Donations Law. Therefore, the importance of achieving registration with the MCA as a gateway to receive various benefits is foremost over other considerations in establishing an NGO. The 2001 Trust Law provides for the first time some promising support to the establishment of a public (charitable) trust (with certain limitations). In particular, the purpose of trusts for charity and public interests should include poverty relief, emergency relief, assistance to the disabled, development of education, science and technology, culture, and sports, medicine and health welfare, and environmental protection. However, the establishment of a public trust and trustee appointments for a public trust are all subject to the approval and oversight of MCAs.⁸⁸

As part of friendly legislations to the NGO sector,⁸⁹ in January 2007, the MOF and SAT jointly have released encouraging measures and rulings for promoting tax exemption and deductibility. “All public benefit social organizations or foundations established upon approval of the civil affairs

⁸⁸ See Zhonghua Renmin Gongheguo Xin Tuo Fa [The Trust Law of the PRC], Arts. 62, 64, 65, 67, and 70, which stipulate that public trusts shall establish a trust supervisor. The trust supervisor is prescribed by the trust documents or appointed by the public welfare authorities if there is no such prescription in the trust documents. The trust supervisor has the right to file an action or establish other legal activities in his own name for the benefit of the beneficiary. The duties of the trustee of a public trust have been enhanced. The trustee must make a report about the disposition of the trust business and the status of the trust assets at least once a year. If the public trust expires, the trustee must report the cause and date of the expiration to the public welfare authorities within 15 days of the occurrence of the event forming the reason for expiration of the trust

⁸⁹ See generally Simon *supra* 32, noting that a comprehensive Charity Law is under discussion and is intended to address multiple aspects of the regulation of charities in China, including tax deductibility of donations. The MCA and MOF have sought broad input on the law, a draft of which was circulated for comment in September 2006. See also, *Int'l Ctr. for Civ. Soc'y Law, Comments on the Draft Charity Law for the PRC*, 5, *Int'l J. Civ. Soc'y L.* 12, (2007) [Hereinafter the Simon: Comments]

administrative department” would be eligible to receive tax-deductible donations, subject to a review conducted by MOF and SAT and is designed to confirm the organization's public benefit nature.⁹⁰ Therefore, the category of organizations eligible for charitable tax exemption or deduction expanded to include charities such as aging people care centers, ethnic minority education programs, and health care centers for the treatment of specific diseases.⁹¹ Moreover, in 2008 the MCA upgraded its operations dealing with charity statistics and other charity activities from a semi-independent “bureau” to a Ministry Department.⁹²

A further reading of charitable tax exemption laws and regulations reveals that passive investment income (interest and dividends earned on investments) of NGOs is still subject to tax.⁹³ Investment income has always been one of the major sources of revenue for all NGOs, especially for NGOs in the U.S. However, interest income realized by Chinese foundations, which are established with a high permanent capital requirement, will mostly end up being subject to EIT in the course of an NGO’s operation and existence.⁹⁴ Therefore, the fragile availability of NGO revenue resources again will be hijacked, resulting in actual reductions in charitable finances and low capital mobility. Although this problem has not emerged severely within the SO and

⁹⁰ See “Guan Yu Gong Yi Jiu Ji Xing Juan Zeng Shui Qian Kou Chu Zheng Ce Ji Xiang Guan Guan Li Wen Ti De Tong Zhi” [*Notice Concerning Policy and Related Questions on the Pre-Tax Deduction of Public Benefit Relief Donations*] (promulgated by the MOF and SAT jointly and effective on January 8, 2007) [hereinafter “the 2007 Notice”]

⁹¹ See *Ci Shan Juan Zeng You Hui Zheng Ce Hui Bian* [Collection of Preferential Policy for Charitable Donations], <http://www.juanzhu.gov.cn> (last visited on March 15, 2011)

⁹² See generally *China Adds Government Department for Charity Activities*, People’s Daily Online September 11, 2008, stating that, in China, such escalation of administrative hierarchy means a lot in terms of management authority, resources allocation and enforceability of NGO administrative regulations

⁹³ See *infra* Subchapter IV

⁹⁴ See, e.g., Biqiang Wang, *A Taxing Time for China’s Non-profits*, The Economic Observer Online February 19, 2008

PNEU sectors, a responsive ruling from the SAT should likely remove their fears in this connection.⁹⁵

2.3.2. Procedural reform for charitable tax exemptions

Messy and sometimes opaque procedural practices are not foreign to the tax law field in China, and charitable tax exemption is not an exception in this regard. In the 2007 MOF and SAT joint ruling, a procedural scheme is provided but is too advanced to fully implement comparing with existing tax administrative capacities. Still, smaller sized and more independent charities all expect to see an easier fundraising. It may also challenge the domination of fundraising by the large government related charities such as GONGOs and the municipal charity foundations.

According to the 2007 Ruling, tax deductible donations may be made to all public “welfare social associations or foundations established upon approval of the department of civil affairs of the State Council.”⁹⁶ Apparently, this welcoming gesture of the government comforts donors in many ways, especially when deductions are permissible for donations made to pass-through organizations⁹⁷. Given the enormous economic interests such as commissions or management fees available in pass-through organizations, such procedures for qualifying the organizations that are permitted to receive tax deductible contributions are unlikely to be implemented in the near future.

Furthermore, to qualify as a public welfare organization enjoying deductible

⁹⁵ See generally Simon, *supra* 32, raising that the SAT has taken this issue under advisement and may soon release new policies with regard to tax exemption of revenues earned on funds held by CSOs. A change to reflect the recommendation in the Tax Report would be welcome.

⁹⁶ See 2007 Notice, *supra* 90

⁹⁷ For example, the All-China Charity Federation and the China Red Cross Society

contributions, a confirmation letter from appropriate level of tax authorities is required.⁹⁸ To obtain such recognition letters, an application should be filed enclosing evidence that the organization, *inter alia*, is non-profit, is established and managed consistently with the law, may not distribute any surplus upon dissolution or termination,⁹⁹ may not engage in business activities unrelated to its public welfare purposes, has an oversight body that is not “aimed at making private profits,” has an internal financial and accounting management, and a charter.¹⁰⁰

The 2007 Ruling also stipulates instructions on handling donations and communicating with its donors. Those instructions include that 1) no donor may participate in the asset distributions or take ownership to such assets; 2) organizations eligible for donation-based pre-tax deductions shall use public welfare relief for specific purposes;¹⁰¹ and 3) a special voucher for public welfare relief donations must be used.¹⁰² The 2007 Ruling also prescribes procedures to be followed by donors to claim deductions on their tax returns. For instance, the donor must submit the certification by the authorities of the donee organization; the original receipt received from the donee organization; and other materials as required to be submitted.

Many scholars¹⁰³ have expressed deep interests and completed extensive work

⁹⁸ See 2007 Notice, *supra* 90

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ For example, education, civil affairs, other public welfare undertakings, or for the districts that suffer from natural disasters or the poverty-stricken districts. Moreover, the non-profit public welfare social associations and foundations, as well as the people's governments at or above the county level and their departments”

¹⁰² The organizations must “separately use the vouchers for public welfare relief donations as uniformly printed under supervision of the central or provincial public finance department according to the financial affiliation, and affix their respective special financial seals; and shall issue receipts if any individual asks for it for his donations.”

¹⁰³ See generally Rebecca Lee *Modernizing Charity Law in China*, 18 Pac. Rim L. & Pol’y J. 347

toward the promulgation of a comprehensive charity law, which aims to embrace all valid factors involving nonprofit organizations. For instance, the draft Charity Law provides that current tax laws and regulations fail to detail the approaches by which nonprofit organizations obtain licenses to engage in public fundraising. Article 24, Paragraph 2 of the draft Charity Law¹⁰⁴ states that only organizations with a “[c]ertificate of the certification for charitable organizations” may engage in fundraising activities from the general public (*shehui gongzhong*). This does not apply “if laws or administrative regulations provide otherwise.” Limiting public fund raising in this manner gives the MCA control over the organizations that raise money from the public. This should generally be seen as an important consumer protection, and thus it would be important to enact similar rules in the final Charity Law.¹⁰⁵

As criticized by Professor Simon, the various other rules with respect to permits for fundraising in the draft Charity Law (Articles 26-27) and the rules with respect to public fund raising (Article 28) are, however, not detailed enough to protect the public at the present time.¹⁰⁶ While Articles 26 and 27 of the draft outline the licensing procedure: “certified charitable organizations” must apply at the MCA offices of the people's governments above the county level, there is no clarity as to what information will be required for a license, etc. In addition, it is important to note that in times of natural disaster, the need for a license may inhibit some fundraising--this may prove to be problematic if there are no organizations that have sufficient public trust to collect and disburse the massive funds needed in cases like the one presented by the Sichuan Earthquake. It will be important to put the Charity Law in place

¹⁰⁴ See generally Simon Comments, *supra* 89

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

quickly so as to allow more independent nonprofit organizations to obtain charity status and fundraising licenses.¹⁰⁷

III. Institutional and theoretical background of the current U.S. federal NGO tax exemption system

The U.S. federal law of tax-exempt organization derives its authority from the taxation powers of congress, and related tax provisions are codified in the Internal Revenue Code (the “IRC”). In general, a charitable organization is defined as the one that “pays no tax on its income and whose donors derive a tax benefit as a result of their donations.”¹⁰⁸ The U.S. system adopts a classification method that lists objective standards for qualifying organizations exempt from Federal income tax.

3.1. The Exemption

The current language on NGO tax exemption appeared first in section 501(c)(3) of 1954 IRC. The charitable income tax exemption refers to the statutory relief from the obligation of certain nonprofit entities to pay income tax. Pursuant to IRC section 501(c)(3), such relief is automatically offered to entities that are granted tax-exempt charitable status upon application and approval. A variety of non-charity entities are also entitled to income tax exemption.¹⁰⁹ Moreover, charitable nonprofit organizations, unlike practically

¹⁰⁷ *Id.*

¹⁰⁸ See Besty Buchalter Adler, *Rules of the Road* (1999), at 3

¹⁰⁹ Other forms include social welfare organizations, labor organizations, business leagues and social clubs

all other tax-exempt nonprofit organizations, are the only tax-exempt nonprofit organizations that are also eligible to receive charitable donations from the public entitling the donor to federal income tax benefits. The IRC provides that individuals and corporations that donate money or property to charitable entities may be entitled to receive a tax savings when computing their own tax liability. The potential savings can be quite significant depending on the amount of the donation, the type of property donated, the income of the donor, and the type of charity to which the donation is given. This ability to receive tax deductible donations from the public is the key federal tax law distinction between charities and other tax-exempt nonprofit organizations.¹¹⁰

An interested nonprofit corporation should file an application with the IRS to obtain the tax-exempt charitable status. Not surprisingly, such complex paperwork demands accurate and ample information concerning organizational structure, principal activities, financial assets, expected and past revenue streams, internal policies, and much more. The IRS evaluates the information provided to determine if such proposed activities and organizational structure are deemed “charitable.” Noticeably, the IRS, subject to later judicial review, has sole discretion as to whether to grant or deny the applicant tax-exempt charitable status based if the information provided on the organization's forms do not adequately comply with the law. The IRS may even revoke the “charitable” status if the charitable entity does not operate in compliance with federal law. Accordingly, a charity must often also update annual information reports to the IRS about its operative activities after initial filings.

¹¹⁰ I.R.C. Section 501(c)(3)

These extensive requirements on obtaining and maintaining tax-exempt charitable status are only a few of the many aspects of the charitable tax exemption including, but not limited to, not paying federal income tax. Under the requirement of filing specific forms to obtain the tax-exempt status, the forms required for tax-exempt charitable status are much more complicated than those required of other tax-exempt nonprofit organizations. Such added complexity is mostly due to the additional financial impact on tax revenues because charities are also eligible to receive tax deductible donations from the public.¹¹¹ The IRS, by granting an organization tax-exempt charitable status, not only saves the organization from the requirement to pay federal income tax, but also communicates assurances to potential donors that donations will be used for charitable purposes.

3.2. Theories of Charitable Exemption

Traditional theories of the charitable tax exemption are principally based on concepts of economic efficiency. These efficiency-based theories explain the charitable tax exemption as either a subsidy by government for public goods, a necessary result of using net income to define tax liability, or a means of compensating charities for capital constraints. Other efficiency-based theories contend that the charitable tax exemption is either a payment for an entity's ability to garner donations or a means of compensating charities for the risk

¹¹¹ See David Brennen, *A Diversity Theory of Charitable Tax Exemption – Beyond Efficiency, Through Critical Race Theory, Toward Diversity*, 4 Pitt. Tax Rev. 1. (2006) at 3-5, discussing that the added complexity could be related to something that has nothing to do with dollars, or perhaps the added complexity has something to do with the nature of charities in a market society, and the reason charities are eligible to receive tax deductible contributions is that they are required to use these monies for charitable purposes, as opposed to mutual benefit purposes as is the case with other tax-exempt nonprofit organizations

they assume in providing public goods. Each of these economic theories for the charitable tax exemption has its strengths and its weaknesses. They are also useful in sculpting the contours of the charitable tax exemption. However, these traditional theories lack significant non-economic considerations, which, ultimately, make them incomplete. This explanatory deficiency also means that these efficiency theories cannot fully guide us in sculpting the contours of charitable tax exemption law.¹¹²

3.2.1. The traditional Public Benefit Subsidy Theory

The public benefit subsidy theory views the charitable tax exemption as an approach whereby the government pays organizations consistently engaged in providing public goods. In other words, charitable tax exemption is offered essentially to “pay” or “compensate” private entities that supply public goods and services as noted in *Bob Jones University v. United States*.¹¹³ The theory fundamentally assumes that the government subsidizes certain “goods” or “services” that it either cannot or will not supply on its own due to various constraints, such as constitutional constraints as to religion and political constraints as to campaign support. Another assumption underlies this theory is that government, under neutral principles, can determine what constitutes a public good or service for purposes of the charitable tax exemption. Therefore,

¹¹² See Rob Atkinson, *Theories of the Federal Income Tax Exemption for Charities: Thesis, Antithesis and Syntheses*, in P. Bator et al. *The Tax Treatment of NGOs*, 253-283

¹¹³ See Brennen, *supra* 111 at 6-8, arguing that charitable exemptions are justified on the basis that the exempt entity confers a public benefit—a benefit which the society or the community may not itself choose or be able to provide, or which supplements and advances the work of public institutions already supported by tax revenues. History buttresses logic to make clear that, to warrant exemption under § 501(c)(3), an institution must fall within a category specified in that section and must demonstrably serve and be in harmony with the public interest. The institution's purpose must not be so at odds with the common community conscience as to undermine any public benefit that might otherwise be conferred

the government somehow takes exemption as a form of financial support for charities on what they produce.

The traditional subsidy theory alone does not fully validate the charitable tax exemption. One problem with the theory is that it fails to justify why governmental financial support for charities has to be a tax exemption rather than a direct grant or privileged access to resources. Meanwhile, this theory does not identify a coherent protocol as to what goods and services are for the public benefit. For this instance, although the neutral market principles might drive the process of deciding what benefits the public,¹¹⁴ the “neutral” efficiency principle alone does not substantiate a basis for understanding how a public benefit is determined.

3.2.2. The Base-Defining Theory

By pointing out the insufficiency of the public benefit subsidy theory, Boris Bittker and George Rahdert proposed the base-defining theory, which essentially states that charities (and many other nonprofit organizations) are not suitable targets of the income tax and thus should be exempt from income tax. Specifically, Bittker and Rahdert argue on the economic aspects of the exemption:

. . . [Charities] should be wholly exempted
from income taxation, because [(1)] they do not
realize “income” in the ordinary sense of that

¹¹⁴ *Id.*, Brennen presents that, in *Bob Jones University*, a private university was identified in the charitable tax exemption statute as a public benefit-education, yet the Court held that the education in that case was not entitled to exemption due to the presence of invidious racial discrimination. Brennen further argues that efficiency analysis alone does not provide a rationalization for this aspect of charitable tax exemption

term and because, [(2)] even if they did, there is no satisfactory way to fit the tax rate to the ability of the beneficiaries to pay.¹¹⁵

The base-defining theory explains that measuring the income of a charity is a conceptually difficult, if not impossible, task.¹¹⁶ Since one common Congressional exclusion from income is gifts, money or property given with “detached and disinterested generosity” is not usually treated as taxable income. In checking the sources of a charity's typical revenues such as interest on endowment, funds, membership dues, and gifts/donations, Bittker and Rahdert summarized that, with the exception of interest on endowment funds, charities simply do not realize revenues in of the type that constitute taxable income. According to Bittker and Rahdert, membership dues, gifts, and donations to the charity preferably would be categorized as excludable gifts from members or donors. Moreover, the charitable entity itself behaves as a mere conduit for passing the economic enrichment, which may be viewed as excludable gifts to the charity's beneficiaries.

Another intricacy entails counting deductible expenses incurred in acquiring revenue. Bittker and Rahdert identified charitable expenditures as potentially including items such as staff salaries and medical welfare programs for indigents. Firstly, considering a deductible expense as an “ordinary and necessary expense incurred in carrying on a trade or business” activity is self-contradictory because this treats mission-focused charitable activity as a “trade or business”. Further, even if the definition of “business” includes providing

¹¹⁵ See generally, Bittker & Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 Yale L.J. 299 (1976)

¹¹⁶ *Id.*, measuring an entity's income by a determination of the entity's gross income in excess of expenses incurred in acquiring the income. Gross income is generally any economic enrichment that is not excluded from income by Congress

charitable benefits, since ultimately all revenues are committed to charitable purposes leaving no revenue to insiders as profits, a charity would essentially have no tax liability.¹¹⁷ Moreover, treating the expense as eligible for the charitable contribution deduction is arguably unrealistic since either structural impediments in the statute authorizing the charitable deduction or the necessary zeroing out of income prohibit such deduction.

Another concern underlying the base-defining theory concerns the appropriate tax rate to apply to charities. According to Bittker and Rahdert, tax rates implicate conceptions of efficiency related to either the “benefit” or “ability to pay” theories of taxation.¹¹⁸ Difficulty in identifying beneficiaries necessarily causes an inefficient tax on income. Moreover, charity beneficiaries might not be able to spot the exact charitable gifts as excludable gifts and make tax payment. There is simply no way of design a proper tax rate if charities were to be subject to the income tax.

Although the base-defining theory centers on an economic explanation¹¹⁹ of the charitable tax exemption, it fails to address a few non-economic aspects aside from the elimination of a financial obligation, such as justice and fairness in resource allocation and opportunities for societal enhancement and

¹¹⁷ *Id.*, net income-save for some instances of multi-year accumulations for specific purposes-would always equal zero, resulting in no tax liability.

¹¹⁸ *Id.*, arguing that a charity's income should be imputed to its beneficiaries for rate determination purposes since it is most likely the beneficiary who would bear the burden of any tax on the charity's income. The problem, Bittker and Rahdert explain, is that the beneficiaries are usually unknown at the time the income is received and, thus, it is nearly impossible to determine an appropriate income tax rate. Even if the entity were taxed as a surrogate for the beneficiaries

¹¹⁹ See Brennen *supra* 111 at 12-15, presenting that, throughout their base-defining theory, Bittker and Rahdert explain that, even if the federal income tax were to apply to a charity's income, it is quite likely that no tax revenue would result. However, Evelyn Brody explains quite well in her sovereignty theory of charitable tax exemption: While most observers have described tax exemption as a subsidy, a zero rate of tax differs qualitatively, not just quantitatively, from a one-percent rate of tax. Tax exemption maintains an independent distance between charities and the state. Similarly, exemption differs in an important political way from an equivalent system of direct grants, *see also generally* Brody, *supra* 1

betterment. More precisely, Bittker and Rahdert's thesis fails to fully address a few issues including the difference between a zero or near-zero tax liability and a tax exemption, political activities and lobbying, the definition of "charitable," and private foundation rules.¹²⁰

3.2.3. The Capital Formation Subsidy Theory

In response to the base-defining theory, Professor Henry Hansmann proposed his capital formation subsidy theory on charitable tax exemption.¹²¹ Professor Hansmann explains that the rationale for the charitable tax exemption concerns the access of charities to capital markets.¹²² Professor Hansmann argues that the tax exemption compensates charities for the lack of access to capital markets, and such "capital subsidy" promotes "efficiency especially for industries where nonprofit firms serve consumers better than their for-profit counterparts." If markets operate at optimal efficiency, and if nonprofit organizations are the most efficient producers of "contract failure" goods and services, nonprofit organizations should be subsidized to grow and expand as a societal unit.

A key to Professor Hansmann's capital subsidy theory is the notion of contract failure which "derives from the inability of some or most consumers to make accurate judgments concerning the quality, quantity, or price of services

¹²⁰ *Id.*, presenting that Bittker and Rahdert's base-defining theory uses a similar type of non base-defining (non-economic) analysis to fully account for the educational exemption for museums, colleges, and orchestras

¹²¹ See H. Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 Yale L.J. 54 (1981)

¹²² *Id.*, Professor Hansmann explains: [T]he best justification for the exemption is that it helps to compensate for the constraints on capital formation that nonprofit organizations commonly face, and that such compensation can serve a useful purpose, at least for those classes of nonprofit organizations that operate in industries in which, for various reasons, nonprofit firms are likely to serve consumers better than would profit-seeking firms

provided by alternative producers.” Professor Hansmann typically used the American Red Cross¹²³ to exemplify contract failure in that nonprofit firms are more efficient than for-profit firms in circumstances of contract failure.¹²⁴

Professor Hansmann explains that constraints on the ability of nonprofit organizations to obtain capital make their income tax exemption appropriate. With the three major sources of funding for nonprofit organizations being debt, donations, and retained earnings, unlike for-profit firms, charities do not have access to equity capital and cannot issue shares. Nonprofit organizations also simply fail to obtain appropriate debt capital due to high bankruptcy rates and operative risks involving loans. Notably, donations are also problematic due to their uncertainties and insecurities. Therefore, nonprofit organizations roughly should rely entirely on retained earnings to operate and develop. Professor Hansmann further argues that the exemption is necessarily based on the lack of access to capital and contract failure experienced by nonprofit organizations. Similar to the base-defining theory, the capital formation subsidy theory fails to articulate a few issues that have no necessary connection to economic efficiency, such as exemption to commercial nonprofit organizations¹²⁵ that produce simple standardized services, and the assertion that nonprofit hospitals should not be eligible for tax exemption.¹²⁶

¹²³ See generally Brennen, *supra* 111, arguing that, Professor Hansmann thinks nonprofit firms are more efficient than for-profit firms in providing certain types of contract failure services because of the nondistribution constraint. Consumers are not as concerned with nonprofit firms as they would be with for-profit firms about donations being diverted to shareholders because nonprofit firms do not have shareholders

¹²⁴ *Id.*, at 19-21

¹²⁵ *Id.*, Brennen points that Professor Hansmann's view is the statement that “[t]here would obviously be little point . . . in granting the exemption to a nonprofit hardware store.” Further, Professor Hansmann misses that even a hardware store might provide the type of benefit, under certain circumstances, that society wants, needs, or otherwise values

¹²⁶ *Id.*, Brennen further argues that Professor Hansmann's articulated reason for this assertion is the lack of contract failure or need for capital evident in the hospital industry. It is important to realize-and this is a point that Professor Hansmann and many others miss-that the value

3.2.4. Donative Theory

The donative theory of tax exemption was developed by Mark Hall and John Colombo. Under this theory, tax exemption is considered a subsidy, which is justified where neither the government nor the private market effectively provide a service that is demanded by a significant number (but not a majority) of citizens. In order for the government to assume a duty, there must generally be majority support. In the absence of such support, the needs of significant sector of society may go unmet. A tax exemption thus provides a way for the government to subsidize important services without the necessity of majority support or the ability to control the organizations providing the services. Voters will support tax subsidies for services provided by minority-supported organizations in which they have no interest because they, in turn, receive tax subsidies for services provided by other minority-supported organizations in which they do have an interest.

Hall and Colombo use donations as a proxy for public support. If an organization receives enough public support, the organization can be said to be doing something that is important to a significant segment of society, which is not being done by the government or the private sector. As such, the organization is entitled to tax exemption. The use of donations as a measure of

inherent in a particular form of charitable organization may not be readily apparent by means of traditional efficiency analysis. Brennen also refers to Professor Jill Horwitz's empirical research concerning hospitals. Professor Horwitz concludes that—despite the myriad of calls for ending tax exemption for hospitals that do not serve the poor—empirical research shows that tax-exempt nonprofit hospitals provide societal benefits that for-profit hospitals simply do not provide. The special benefits of nonprofit, as compared to for-profit and government hospitals include the provision of “more profitable services than government hospitals and more unprofitable services than for-profit hospitals.” Brennen posits that though Professor Horwitz does not conclude that these unique benefits of tax exempt nonprofit hospitals are caused by tax exemption, she does acknowledge that this connection has not been disproven

exemption-worthiness separates traditional nonprofit organizations from for-profit institutions, which may also benefit society but which do not receive donations.

3.2.5. Summary

As the rationales underlying the tax exemption described above reveal, there is no generally accepted theory explaining the existence of tax exemption. Scholars have different rationales in explaining tax exemption for nonprofit entities. When a state designs nonprofit tax exemption laws and policies, it is inevitable to include all possible theoretical reasoning for more open and inclusive discussions and hearing. It is notable that those theories do not explain the rationales for giving tax deductions for charitable contributions made to nonprofit entities.

3.3. Overview of financial incentives in the NGO Sector

Central to the NGO tax exemption system is the incentive under IRC section 170 – the tax deduction for charitable contributions. Sections 501(c)(3) and 170 of IRC stipulate an objective formula with measurable standards for exemption and deductibility, and 28 categories of nonprofit organizations are eligible for exemptions from federal income tax. However, only those that qualify under section 501(c)(3) are entitled for the “most favored” treatment per se. While charitable organizations enjoy the generous tax benefits, they are, at the same time, subject to the most stringent monitoring.

A quantitative measurement of public support is to label a public benefit or “charitable” organization based on the extent and type of public support it receives. Section 501(c)(3) classifies public support organizations into “public charities” and “private foundations”. Public charities are further categorized into three types: donative charities under section 509(a)(1); service provider charities under 509(a)(2); and supporting organizations under 509(a)(3). Each type of public charity has its respective tax treatment based on the extent and nature of their public support. A donative charity must raise at least one-third of its total eligible revenues from a combination of gifts, grants and contracts from the public sector. A service provider charity must raise at least one-third from a combination of revenues derived from fees, admission sales, and revenues from the sale of related products, as well as from public gifts and grants. A supporting organization need not raise funds from the public because of its unique affiliation with another publically supported charity.

A charitable organization has to pass the “organized” and “operated” tests under section 501(c)(3), and certain objective standards are applied in this connection. A nonprofit organization is recognized as exempt if it is organized for a recognized exempt purpose and is operated in service of such exempt purpose. Since subjectivity and discretion plays an insignificant role in these determinations, the analysis and test procedures are ascertainable and standardized. Any organization soliciting exemption should affirmatively seek recognition of its exempt status from the IRS. On the other hand, IRS merely performs the role of applying and recognizing exemptions according to the objective standards.

IV. The Charitable Tax-exemption System in Practice – a Further Comparison

After briefly evaluating fundamental features of China and U.S. NGO tax treatment systems, some important provisions in both systems are worthy of detailed comparison. This subchapter explores the details of the differences between the U.S. and Chinese systems. Again, this comparison is selectively oversimplified to embrace concepts that are interpreted differently in the U.S. and Chinese tax contexts. Therefore, the goal is to exemplify in which settings those terms are introduced or interpreted rather than focusing on the technical meaning of elements involved therein.

4.1. Formation and Registration

4.1.1. U.S.

In the U.S., the organization must be “organized” for an exempt purpose. The IRS has no discretion to approve or deny exempt status based on subjective factors, provided the applicant organization can demonstrate that it has been properly formed under state law and that its charter contains the appropriate language required by Federal Law. The process is straightforward and predictable. The applicant organization submits an “Application for Recognition of Exempt Status under Section 501(c)(3)” (IRS Form 1023) supported by a conformed copy of the Articles of Incorporation, corporate

bylaws, various financial schedules and a narrative describing current and planned activities programs and contemplated fundraising strategies. An applicant organization will satisfy quite easily the organizational tests if the governing documents articulate the organization's exempt purpose.

4.1.2. China

In China, every law student studying NGO laws knows about the difficulty of establishing and registering an NGO. As discussed in Part II above, there are several issues central to the registration and application of NGOs China.

4.1.2.1. Dual Management

The dual management requirement forces many NGOs to remain unregistered or even operate subversively because the potential supervisory agencies probably will refuse to oversee applicant organizations. Worse is that there may be even no appropriate supervisory agency willing to take on such a role.¹²⁷ Although slackness to perform supervision may result in a judicial review, obtaining approval for registration from government branches or GONGOs that are sought as sponsoring organizations does not appear to require them to act at all – the granting of permission is entirely discretionary on the part of supervisory agencies. Additionally, even a tentatively complete

¹²⁷ See generally Simon *supra* 32, suggesting only those SOs that choose to be and are defined as charity organizations, would be subject to strict scrutiny under the drafted Charity Law. If this were to be done, the new Charity Law would contain the provisions to accomplish the type of organizational integrity and the institutional oversight necessary for organizations operating for public benefit

list of required documents for submission to obtain supervisory sponsorship by an appropriate entity does not exist. This is but one of the reasons potential supervisory sponsors can ostensibly prolong the application process by imposing unreasonable paperwork requests.

In this manner, the dual management requirement offers the government the ability to manipulate the number of organizations that can be registered in a given territory. Moreover, the Ministry of Civil Affairs may deny registration if “in the same administrative area there is already a social organization active in the same (*xiang tong*) or similar (*xiang si*) area of work, there is no need for a new organization to be established.” On the one hand, this provision helps to create an orderly situation that avoids organizations with duplicated purposes, and to eliminate malicious competition for limited social resources. On the other, however, a this also allows the government, if it wants to control certain area of social services, to establish an NGO beforehand or during the application process so as to rule out the possibility of the registration of a real NGO applicant seeking to do the same work.

The dual management system should be revoked, not only to remove barriers to establish NGOs, but also to realize the fundamental freedom of association as stipulated in China’s 1982 Constitution Law. Advantages of removing the dual management structure are obvious. Many temporarily formed NGOs have made great impacts during early stages of natural disaster relief and rescue activities. The government has been intentionally silent and permissive of those activities conducted by unregistered NGOs, and it has thereby *de facto* eliminated unnecessary administrative barriers. Arguably, a revised provision as to dual management is more desirable allowing special or emergent

formation of NGOs. This solution has also been implemented well in other countries such as Japan.¹²⁸

4.2.1.2. High Endowment Requirement for Foundations

The 2004 Foundation Regulation provides two different types of foundations: private foundations (formed by individuals or private businesses) and public-fundraising foundations. The former kind of foundation is intended to encourage affluent individuals and moneyed corporations to form their own foundations to carry out charitable activities. There has clearly been a positive response in that regard, as the giving statistics from 2007 and press reports regarding new foundations indicate.¹²⁹ Public fund-raising foundations in practice are mostly institutions organized nationally and staffed throughout the country by the party-state itself.¹³⁰ For instance, a public benefit purpose is required for a public fund-raising foundation, and additional review as to formation and registration of such fund-raising foundations is validated and expected in the application process.

Admittedly, the requirement that foundations have to maintain high endowments or capital reserves needs further deliberation. As illustrated in

¹²⁸ *Id.*, drawing an interesting comparison between the China and Japan NGO management system similarly preserving the fundamental freedom of association, which the Chinese constitution guarantees the Chinese people. Only those SOs that choose to be and are defined as charity organizations, would be subject to strict scrutiny under the new Charity Law. If this were to be done, the new Charity Law would contain the provisions to accomplish the type of organizational integrity and the institutional oversight necessary for organizations operating for public benefit.

¹²⁹ *Id.*

¹³⁰ *Id.*, Simon further argues that the regulations appear to permit the Ministry of Civil Affairs to act as the registering and oversight agency with regard to large national private foundations, and the experience of the Narada Foundation offers proof that MCA will assume this role. The language of the regulations also opens the possibility that as a practical matter MCA may not necessarily enforce the dual management requirement of the 2004 regulations with regard to smaller foundations when it chooses not to

Part II, a national private foundation is expected to keep at least two million RMB yuan as a permanent endowment; a local private foundation that does not engage in fund-raising is expected to invest at least two million RMB yuan as permanent endowment. As to public fund-raising foundations, a local one should invest at least four million yuan (U.S.\$58,400) as permanent endowment, and a national one should invest at least eight million yuan (U.S.\$116,800). Notwithstanding the legislation goal of nurturing solid and well-standing foundations, these thresholds are somewhat haughty and may thwart enthuse of interested parties to form and develop fund-raising foundations.

4.2. Recognized Exempt Purpose and Definition of Charity

4.2.1. U.S.

There are seven purposes listed in the U.S. law as recognized exempt purposes¹³¹ under IRC section 501(c)(3) which are inclusive and intentionally broad. Among the seven purposes, treasury regulations mostly interpret three purposes comprehensively: charitable, educational, and scientific purposes. In the meantime, the U.S. system has adopted extensive flexibility in interpreting the other four purposes according to social realities and economic

¹³¹ I.R.C. Section 501(c)(3) stipulates “Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.”

development initiatives.¹³² As a result, the U.S. system has bolstered the nonprofit sector by enabling creativity, such as through joint ventures between the enterprise and government to serve both the investment capital needs and encourage continued commitment to public benefit.¹³³ As to the educational and scientific areas, the Treasury has expanded the original tax treatment by providing a mechanism for accommodating distance learning technologies and unconventional classrooms along with interactive internet activities.

4.2.2. China

The exempt purpose determination usually depends on the definition and coherency of the term “charity” in China. A careful reading of current laws and regulations will reveal several different definitions of “charity.” In practice, the adoption of the conception “public benefit” to define charitable organization is widely accepted by many jurisdictions. For example, the English Charities Act 2006 clarifies the definition of “charity” by emphasizing that public benefit be created.¹³⁴

The definition of charity also appears to differ from that of “public welfare” for public welfare trusts (*gongyi xintuo*) stipulated in the Trust Law, while the “public benefit” terminology used in the 2004 Foundation Regulation and the

¹³² See GCM 36993 (1977), providing that innovative enterprises qualify under section 501(c)(3) for passing the organization test as long as they 1) lessen burdens of government, 2) promote community welfare by lessening neighborhood tensions, 3) eliminate prejudice and discrimination and 4) defend human and civil rights served by law or 5) combat community deterioration and juvenile delinquency.

¹³³ See Rev. Rul. 98-15, 1998-12, I.R.B. 6.; see also *Redlands Surgical Services v. Commissioner*, 242 F. 3rd 904 (9th Cir. 2001), both of which determined that a nonprofit hospital and a for-profit healthcare company could form an LLC to benefit both parties, on the conditions that the nonprofit serve as the general partner and that the exempt purpose drive the enterprise. Furthermore, the LLC’s board would be required to reflect the majority interest of the exempt organization and retain its control over the nonprofit hospital.

¹³⁴ See generally *supra* 19

tax rules defines charity with broader scope. *Gong yi* is the term used in almost all of these legal documents. It is defined in Article 60 of the Trust Law in the context of “public welfare trusts” and in Article 3 of the Public Welfare Donation Law in the context of “public welfare undertakings” (*gongyi shiye*). The Foundation Regulations include no definition of “public welfare,” but refer to the term public welfare institutions (*gong yi shiye*) in Article 2 to define foundations. And the language in the new tax rules with regard to entities qualifying to receive donations is that they must use the money “for education, civil affairs, other public welfare undertakings, or for the districts that suffer from natural disasters or the poverty-stricken districts.” In fact, the word for “charity” (*cishan*)¹³⁵ has only been used one time, at the time of this writing, in Chinese laws and regulations. In Article 10, Paragraph 2 of the PWDL, there is a reference to the regulations of social organizations being established “with the principal aim of developing charities.”

According to Professor Karla Simon, the definition of “charity” in the draft Charity Law incorporates certain enumerated purposes in Article 3 of the PWDL:¹³⁶

- Emergency and crisis relief for regions, individuals and groups in difficulty;
- Relief for disadvantaged people;
- Education, health, science, culture, sports for social benefit; and,
- Promotion of urban and rural community development and environment.

In addition to the above specifically enumerated categories, Article 3,

¹³⁵ *Id.*, stating that there has been some consideration in the Chinese literature of whether the meaning of the two terms is actually the same or different.

¹³⁶ See Simon *supra* 32 at 946

Paragraph 5 also includes the term “other charitable activities,” which provides for future development of the concept of charity.

Therefore, an expansive definition of “charity” should be considered and adopted. As Lee proposed, a charity should be regarded as an eligible charity so long as it: 1) is organized and operated exclusively for public benefit purposes by engaging in public welfare activities (including emergency relief, relief for the poor, education, health and social benefit, promotion of community development, etc.); 2) contains restraints on distribution of profits, dividends, or assets to its members (non-distribution constraints) and 3) is required to spend its remaining assets on charitable purposes after its termination.

4.3. Requirement of Operation for an Exempt Purpose

4.3.1. U.S.

The operational test in the U.S. system views the organization’s financial and program activities as indicators of its operations, and such review is monitored on an annual basis.¹³⁷ Usually, the IRS will wait and see how newly formed and approved nonprofit organizations operate and behave by issuing a provisional “advance ruling” for a four year period, in which the organization can demonstrate its operations in a more concrete manner. At the end of the four-year period, the IRS assesses the organization’s level of public support and makes a final determination as to exempt status.

¹³⁷ See Brennen *supra* 111, at 6-8

Admittedly, the operational test has been quite flexible over decades of development and practice. It recognizes the importance of monetary resources for the nonprofit organizations. Mostly, it enables the organization to charge fees for services and general dues and non-dues-based revenues without compromising its exempt status.

An exempt organization needs to file an annual information return (Form 990) to the IRS if it receives more than \$25,000 in annual revenues and is not a church. The Form 990 asks pointed questions about the organization's program, activities, contributions, grants, compensation and administrative expenses. Moreover, the U.S. system recently improved accountability of exempt organizations by posting all related available information online to promote visibility and exposure. Undoubtedly, this practice makes ensures the exempt organizations continue to operate in the interest of their initial exempt purpose.

4.3.2. China

Monitoring the operation of nonprofit organizations in China presents one of the crucial problems in the development of nonprofit sector. It is not even clear he extent to which currently registered nonprofit organizations of all three types need to go through administrative applications and oversight processes in order to become "verified charities" or the exact benefits if they get verified.

A primary problem is determining institutionally which government organ is the overseeing authority as to the activities of nonprofit organizations. Given

the dual management requirement for nonprofit organizations, it appears that an additional layer of supervisory authority is necessary, however burdensome this might be. It has been suggested that a new agency should be created to oversee all the aspects of institutional development, transparency and accountability (reporting requirements) without involving a sponsoring organization in the formation process.

Unlike the IRS in the U.S. system, the Chinese MCA and SAT are most likely to involve the verification process of all nonprofit organizations, however, due to the intergovernmental conflicts and staffing problems, nonprofit organizations are not able to cost-efficiently manage the administrative reporting procedures to two departments, especially for deciding the exempt status. As evidenced in the 2007 Ruling, there are very weak links between MCA accreditation and SAT approval of tax exempt status. Therefore, scholars have proposed a separate “Public Benefit Commission” to supervise the charitable status of all nonprofit organizations. However, due to the infrastructure complexities in the party-state China, this proposal is too ideal to implement.

In addition, due to the blurred boundaries among the three types of nonprofit organization in China, a uniform reporting form like the U.S. Form 990 is neither wise nor feasible. On the other hand, if each form of nonprofit organizations has its own reporting scheme, the administrative costs will limit the government’s ability to adopt further monitoring and verification procedures.

Finally, many nonprofit organizations in China may even want to register as a commercial enterprise to carry on its exempt purpose. This is especially true

of a few foundations set up by foreign individuals or international philanthropic organizations. These foundations still benefit from taxpayer friendly provisions to enjoy tax holidays while avoiding arduous NGO registration and operative process.

4.4. Prohibition of Private Inurement

4.4.1. U.S.

The IRS historically took a zero tolerance policy for personal benefits inuring to any person with influence over the decision-making affairs of a charitable organization. The IRS had to revoke the exempt status after it found a violation of this rule. However, to balance the IRS and charitable community, the Congress added a new provision IRC Section 4958, i.e. the Intermediate Sanction clause, to the IRC. The Intermediate Sanctions focused on “excess benefit transactions” by disqualified persons and legislated a two-tier excise tax designed to punish the wrongdoer while spring the charity. Under this rule, it is unjust enrichment transactions and their perpetrators that are sanctioned, but not the charitable organizations.

By adopting the Intermediate Sanctions, the U.S. scheme again exhibited its flexibility in balancing interests and competing tensions. Congress admits that most charitable organizations behave properly; the Intermediate Sanctions creates a safe harbor for the majority of nonprofit organizations and their volunteers, staff and directors. Under Section 4958, an organization is compliant with section 501(3)(c) if it i) maintains proper records, ii) obtains comparability data regarding compensation arrangements and iii) has a

conflict of interests policy.

4.4.2. China

The nonprofit sector has been infected with accountability issues since the every outset. In particular, the efficient and responsible use of the funds is now a public concern. A challenging accountability problem relates to corruption. China's notorious corruption makes it less certain that charitable donations reach the hands of those most in need and that no personal interests of management personnel are involved. Widespread fears of corruption or misappropriation of donated funds even stop the general public to donate or switch to foreign nonprofit organizations which presumably have less accountability issues.

A frustrating observation as to China's nonprofit organizational scheme is that the values of accountability, transparency, and performance evaluation are so downplayed in practice. Not surprisingly, the bad practice of non-observance and lax implementation is displayed here. Article 21 of the Public Welfare Donations Law provides for the donor's right to access information about the use and management of the donations. The Foundations Regulations have similar provisions. All current laws contain regulations on submissions of annual reports to the relevant administrative authority. However, only the Foundation Regulations contain a duty of disclosure of information, requiring foundations to make the relevant annual reports public through media channels to provide for public enforcement of accountability. Thus, compared to information disclosure requirements of for-profit listed companies, disclosure

requirements for charitable organizations are still very primitive and under-developed.

The misalignment of interests and information provides charity management with great decision-making discretion. In order to prevent abuses, appropriate checks and balances must be put in place to protect charity assets and ensure the accountability of persons who control them. Appropriate use of checks and balances to improve governance would be beneficial to the charitable sector as a whole. Well-governed charitable organizations are more likely to enjoy greater public confidence, which is critical for fund-raising. Conversely, ineffective charitable governance may reduce the ability of the charitable organizations to carry out their missions.¹³⁸

Another aspect deserving attention is that internal government and financial management remains under-regulated. For example, Article 15 of the Social Organizations Regulations requires that a social organization set out the qualifications, powers, and duties of its members. However, the Regulations give little additional guidance. For example, the Regulations do provide that the highest authority rests with the members, but does not specify the scope of their authority. The Regulations should clearly delineate the powers and authorities that members can exercise at their meetings, including the power to amend the organization's constitution, appoint or remove directors, and dissolve the organization. The Regulations should also include procedures for

¹³⁸ See Simon *supra* 32, suggesting that ninety-nine percent of corporations in China did not engage in any form of charitable donations. While this may be explained partly by the fact that any concept of corporate social responsibility is still embryonic among Chinese corporations, it also partly reflects the lack of efficiency and accountability, and in turn, the lack of public confidence in the charitable sector

calling meetings and passing resolutions.¹³⁹

Regarding the duty of loyalty, only the Foundation Regulations prohibit a director and the director's associates from engaging in “self-dealing” with their foundation. This approach must be amended so that all senior officers and board members of a charitable organization are subject to duties of care and diligence, as well as a fiduciary duty of loyalty that prohibits them from having actual or potential conflicts of interest. Guidelines on how to deal with board conflicts would help the management understand its responsibilities. At the same time, because a voluntary board of trustees usually governs charitable organizations, the law should provide that they may be relieved of personal liability for breaches of certain duties if the court believes they acted honestly and reasonably or in “good faith.”

4.5. Political Activity and Support by NGOs

4.5.1. U.S.

Although the U.S. tax exempt scheme has evolved showing flexibility and tolerance to various economic needs and social services, the ban against political action remains absolute. This prohibition insures the separation of fiscal policy and political interests, thereby protecting the integrity and the independence of the nonprofit sector. Direct or grassroots lobbying is

¹³⁹ See generally *supra* 103, stating that good governance starts with the ability to recruit and retain an effective governing board. This requires clear rules on the procedures for the appointment and removal of directors, the qualifications and number of directors, the duration of their appointments, and the terms of remuneration. The Regulations should also specify the duties and the potential liabilities of the board. While all laws currently governing the main types of charitable organizations prohibit misappropriation of the organization's funds, they fail to stipulate any duty of care for directors respecting their management duties

permitted so long as it not substantial. The IRC section 501(h)'s "election" provides a mechanism by which an organization can elect to exceed specific amounts of lobbying activity in exchange for voluntarily submitting to an excise tax tied to its lobbying expenditures.

4.5.2. China

Political and lobbying activities are rare for and foreign to the nonprofit sector in China. The party-state China almost prohibits nongovernment entities to be involved in any potentially harmful activities or association to the communist reign. For instance, the government itself intentionally forms certain semi-governmental NGOs to perform social services that are not appropriate for the party-state to carry over. Fine examples of those semi-governmental NGOs are Chinese Writers' Association, All-China Workers Union and All-China Women Federation, and usually government officials are appointed to serve in leading or management roles in those organizations, some NGOs even have a branch of the party as a monitoring organ to supervise related activities. Therefore, some scholars argue that certain activities are politically sensitive, but piercing the veil would reveal that those semi-government NGOs be real government organs and political activities are almost never conducted without being controlled by the government.

This situation reflects historical concerns about the potential of NGOs to foment political dissent. The distrust of NGOs still limits the access to the constitutional right of freedom of association, and also stalls the development of NGOs as a responsive and flexible sector to supplement government

services.

4.6. NGO Asset Management upon Dissolution, Termination and Liquidation

4.6.1. U.S.

The U.S. scheme requires that charitable assets remain within the charitable sector. An exempt organization may not dissolve, terminate or liquidate without insuring that assets remaining after paying outstanding liabilities remain within the charitable sector. The board of directors of a dissolving organization may select an appropriate charitable recipient with a similar mission; however, under no circumstance can those assets be diverted to non-charitable recipients or for no-charitable purpose. This rule was tested repeatedly in the 1990's when nonprofit organizations, usually community healthcare institutions, merged with for-profit hospital chains. As a result, foundations were set up to administer charitable assets after closing, and this situation prompted various states' Attorneys General to implement protocols to govern such transactions and to seek court approval for the allocation of the assets before the transaction was completed.¹⁴⁰

¹⁴⁰ This thesis shares Professor Douglas Kahn's concerns that unrelated business tax (UBT), which has been established in the U.S. for decades, has not receive enough attention from the Chinese tax authorities. Moreover, the current tax legislature is not evident in monitoring the business activities of NGOs.

4.6.2. China

The treatment of dissolved or liquidated NGOs is a deep loophole in China's NGO legislation. Provisions on termination and liquidation of three forms of NGOs in China are scattered over various laws and regulations, and most of them are hard to implement or lack specific guidance in practice. For example, Chapter 6 of the Trust Law stipulates the definition, creation, and termination of a trust. However, there are no delineated rules on how to treat the assets after paying all liabilities. Moreover, as discussed in Part II¹⁴¹, the 2007 Ruling by MOF and SAT stipulates that exempt organizations "may not distribute any surplus upon dissolution or termination," but this requirement is vague. Typically, the 2007 Ruling does not establish any detailed procedures to handle assets after dissolution and termination.

4.7. Tax Culture

4.7.1. U.S.

The divergence between the nonprofit tax exemption in practice in the U.S. and China can be attributed to the significant distinctions in the tax cultures of the two countries. First, the U.S. tax exemption scheme evolved through a long process, by balancing social needs and economic development, as well as bridging the gap between the Congress, the IRS, and the nonprofit sector. In China, the first law dealing with a rudimentary form of nonprofit organizations

¹⁴¹ See *supra* 90

of modern conception was only adopted in 1989, after the party-state system was shocked by the democratic movement and surges of grassroots social movement. The development of nonprofit tax exemption scheme in China has been a long painful process, even there are quite many transplantable values and principles underlying modern tax law, such as, rule of law, the ideology of freedom of association and cohesive legal infrastructure. While the SAT and MCA have conducted quite good preparations by inviting leading scholars and legislation consultants to design the charity law and related lessons from other countries, the gap between the law on paper (which has been transplanted from the West) and the law in action (which is defined by local conditions) is still huge.

Moreover, the U.S. scheme is created in a federalist system, which has two sovereign governments – state and national – each has its own authority on the nonprofit sector. China, in contrast, is a party-state system that one central government has formal authority over administrative subdivisions that promulgate and implement the law. This creates the low efficiency in China in carrying out and designing detailed rules for specific questions, let alone the huge disparity as to the development level among different localities in China. In addition to an established system of financial incentives including tax exemption and tax deduction, U.S. history has created a culture of giving and philanthropic activities, especially those associated with church and healthcare institutions, which are protected by the constitutional right of freedom of religion.

4.7.2. China

These factors are currently deficient in China. The Chinese style of tax law drafting makes it difficult for nonprofit organizations to engage in the charity sector and related tax planning common in the U.S. To begin with, the text of the law is unclear in many respects, such as the definition of charity, the regulations on internal governance, the registration process, judicial review, and administrative processes. While the U.S. scheme mostly rests on sections 501(c)(3) and 170, the IRS has promulgated various regulations, rulings, and notices to guide the practice, and case law also makes up a substantial part of the content of the existing scheme. In China, however, the situation is almost the opposite of the U.S. scheme. The scattered regulations as to tax exemptions and tax deduction are vague and subject to too much discretionary review of MCA and SAT. The “opaque” nature of tax legislation also fails taxpayers in following the laws and drives applicant organizations into lengthy process of application and registration.

Another important point is that the general public in China has a long tradition of philanthropic and charitable giving. However, the distrust or fears for unreasonable usage and corruption do inhibit charitable giving even after more functional tax laws and regulations are promulgated in the future. This concern in return leads to the formation of many grassroots or underground NGOs, which sometimes again deepen the insecurities of donors of their charitable giving or donations.

V. Conclusion – An egg vs. an orange

This chapter contributes the comparisons of the tax exemption schemes in U.S. and China in three folds of consideration. First, given the tremendous development of China's nonprofit sector, not many comprehensive studies have been completed on reforms thereof. The tax treatment of nonprofit organizations, as the crucial component to construct a nonprofit sector, is unsophisticated and short of practical significance. Echoing China's success in economic growth in the past decades, literature on Chinese tax typically focuses on tax incentives for foreign direct investment and tax policies catering to economic development. This shortage shows the prejudice against the nascent nonprofit sector as a partner of the state. Second, under the rule of law construct in the past decade, some scholars suggest China might modernize its nonprofit sector through an "all-in" charity code or unrealistically cultivate expansive grassroots NGOs. The study of the nonprofit sector has to embody a down-to-earth understanding of China's legal and political settings. Third, commercial implications of the nonprofit sector invite studies of its tax treatment. Given China's integration into the WTO and heightened complaints over national treatment and fair competition, a key issue arising is that the profitability of foreign investment shrinks as the tax preferential treatment is gradually discounted. The profitable potential of nonprofit organizations as foreign investment vehicles may induce inappropriate tax planning activities. Therefore, it is never too late to develop a tax framework for the nonprofit sector.

The expansion of the nonprofit sector in the past decades has resulted in many

problems with its tax framework. Doubting the suggestion of promulgating a comprehensive charity law, this thesis does not suggest any unrealistic idea of transplanting all valid and enabling values under the U.S. tax exemption system to China. The prime incentive for the tax deduction has not been solidly rooted in the general public. There is a lack of stimulating push for the tax authorities and MCA to adopt a systematic responsive reform measures. However, some positive reforms especially on the tax exemption and tax deduction in the nonprofit sector are more implementable and manageable. A comparison of tax treatment in U.S. and China on nonprofit sector would reveal the following observations.

First, the public benefit or charity purpose of nonprofit organizations has not been coherently defined. This confusion predictably inhibits the development of the nonprofit sector by stalling interested corporate and individual donors to take exemption and tax deduction.

Second, China has not set up an enforceable fiscal incentive system to promote charitable donations. The administrative procedure of obtaining a tax exempt certificate is arduous and discourages donors from donating or causes them to abandon obtaining the certificate, which worsens the efforts to modernize the scheme.

Third, there are still burdensome requirements for the application and registration of nonprofit organizations, such as dual management, high threshold of capital endowment for foundations and prohibition on cross-region development;

Fourth, the administration and supervision on the internal management, human and resource, and financial and accounting management of nonprofit

organizations are very weak. China's complex administrative system for the nonprofit sector, including the MCA, MOF and SAT, is bad at managing fund raising, appropriate usage of donations, and profiteering from donations. Corruption has also been a major concern of the general public discouraging them from making donations.

Fifth, the determination of tax-exempt status and review of such status is *ad hoc* and different from locality to locality. Such irregularities on one hand invite unethical manipulation of tax preferential policies, and create resistance to making donations through locally available venues.

U.S. tax system for the nonprofit sector arguably embraces maturity, objectivity, flexibility and accountability. Evolving throughout the course U.S. history, the U.S. scheme relies solidly on regulatory authority, government authority checks and balances, and confidence in the rugged individualism of American democracy. The qualification requirement to enjoy benefit of tax exemption is objective and subjects to minimum level of discretionary review. Meanwhile, as an outcome-based set of measures, it enables the nonprofit sector to adapt to new economic development and strike a continuous balance between external regulation and internal government.

From a jurisprudential perspective, in the Chinese tax context two cautions are methodologically identified. First, the scarcity of decent comparative legal tax scholarship in general does not support quality comparison. A shortage of paradigmatic discourse shows the simultaneous existence of bluntly conflicting arguments, parallel courses, and irregularities in analysis. Although some comparative tax frameworks have been proposed or compiled, their value to the Chinese tax context is not evident. For this reason, this thesis

argues that a comparative tax study relating to China might be better achieved by focusing on a full “tax law sub-discipline” rather than on a specific tax concept. One reason is that a western-originated tax concept might be too narrow to meaningfully inform a Chinese policy orientation. The other reason is that it lacks generality necessary to apply it to other subsidiaries of tax law. Second, the tax cultural traditions and social, political and legal settings of a systematic tax governance framework should be included in tax comparativists’ theorizations. A tax study ultimately has to be conducted from a “big-picture” perspective in which a tax system is embedded. Otherwise, a comparative study may easily turn into descriptive, mechanical and perfunctory analysis. The practical and scholastic significance of comparative tax studies can hardly be achieved by a limited comparison falling on the technical elements of a tax concept. This “big-picture” perspective is also in line with the rationale applicable to both the rule of law construct and assimilation to the WTO system. This thesis therefore tentatively incorporates tax culture into its considerations to compare primary elements of nonprofit tax schemes of U.S. and China. It argues that a comprehensive tax transplant effort of valued ideas and practices, whilst bold and uncomfortable for the recipient country at the beginning, is what China needs to build a robust nonprofit sector.

CHAPTER IX

SUMMARY AND CONCLUSION

This thesis aims to prepare a reasonable, handy and realistic foundation with which to evaluate the progress of the Chinese tax law reform. Pushing this goal further, this thesis tentatively submits – on the basis of debates on the rule of law and understanding of the WTO principles applicable to China – a tailored, pragmatic and practical set of proposals for the tax reform under China’s current legal infrastructure. The proposals are underpinned by instrumental notions of the rule of law rhetoric, *inter alia*, generality, clarity, consistency, enforceability, stability, congruence, and substantive notions of judicial independence, human rights and the limitations of bureaucratic government with regard to the nonprofit sector.

In terms of background, this thesis submits that economic globalization has been realized not only through supranational legal regimes such as the WTO, but through reforms to regulatory regimes and national laws advocated by international institutions. These reforms have furthered deliberate policy choices to liberalize trade and capital mobility, deregulate markets, increase commercial participation, and eliminate cross-border transactional barriers. Moreover, the

post-World War II development strategy of many developing or transitional economies has included a special role for tax policy. All types of taxes, particularly trade related taxes, are legitimate tools of the state in monitoring the development process. Today, **tax reforms** mainly aim to establish a diverse mix of taxes that will encourage savings and capital investment in open market economies, since development priorities have shifted from promoting self-sufficiency and subsidizing domestic industry to encouraging export-led growth and improving global market participation. Legal system reforms typically involve transplanting legal theories and institutions across borders. Tax governance, with its focus on institutional reform and (re)construction, has been a focal point to facilitate legal system construct. This thesis also engages a short empirical survey before discussing relevant theories, principles and analyses and raising reform proposals on specific tax law topics. Such statistical analysis aids understanding of the rationales that the overall circumstances of social and political settings, economy size, position in global trading, international voicing power, national treasury scale, and composition of tax revenue call for a set of quality proposals in the Chinese tax context.

As tax reform has been a crucial component of economic development initiatives and structural adjustment programs for developing countries, it usually focus on universal development goals including a single-rate, broad-based VAT to replace older-style sales taxes, a low-rate, broad-based corporate and personal income tax, tax neutrality, and the reduction or eventual elimination of tariffs. Moreover, the WTO distinguishes its role by *indirectly* interfering in domestic tax law reforms

under the aegis of protecting free trade in domestic tax systems. The General Agreement on Tariffs and Trade (GATT) underlying all WTO activities includes the key principles of *non-discrimination* and *liberalization* of trade. The non-discrimination obligation is comprised of the Most-favored-nation (MFN) principle,¹ which demands that trade concessions granted to any country be extended equally to all other WTO members, and the National Treatment (NT) principle,² which requires that no internal tax, charge, law, regulation or other measure should discriminate between domestic and foreign suppliers.

A decade after China formally became the 143rd member of the WTO on December 11, 2001, the WTO's technical assistance has been more than plugging up loopholes or to crafting an implementation structure; rather, it aims to imbue tax reforms with broader legal theories and structures conducive to international trade. This thesis believes that an overview of China's rule of law order and post-WTO legal reform is necessary for a discussion of the tax system reform. In particular, the establishment of a "socialist rule of law order" and commitments by the government to act "in accordance with law" have been incorporated as amendments into China's Constitution. Consideration is also given to contested rhetorical conceptions of the rule of law. Debates between instrumental and substantive, positivist and natural law, and thin and thick models of the rule of law, as well as the economic development rhetoric discussed *ad infinitum* in the literature are all reviewed.

¹ See *General Agreement on Tariffs And Trade*, Oct. 30, 1947, Art. I, 61 Stat. A-11, T.I.A.S. 1700, 55 U.N.T.S. 194.

² *Id.*, Art. III

This thesis suggests that the need to conceptualize a “rule of law-Chinese tax laws reform *rhetoric* is too grand and too premature to undertake. First, the development of a socialist rule of law is a paradox, being receptive to market economy principles and modernizing state and private enterprise governance on the one hand, while unabashedly preserving an autocratic form of socialism on the other. Such a paradox can only be described as “the socialist rule of law with Chinese Characteristics.” Second, the tax law reform, which contains elements of traditional conceptions of the rule of law, cannot be understood independently from China’s social, political, economic and legal inheritances. Different from Western jurisdictions with liberal democratic frameworks, under China’s quasi-socialist, soft authoritarian system, the social-political evolution influences the theory and interpretations of the rule of law in many ways as to China’s tax reform.

This thesis argues that China’s accession into the WTO has been a double-edged sword. A close examination of China’s accession commitments reveals that effective economic reform and trade liberalization call for substantiations from a matching legal infrastructure reform. This is particularly evident in the Chinese tax law context. WTO principles and the rule of law requirements must be introduced and evaluated together in tax law reform proposals. WTO principles of transparency, uniform and impartial administration, judicial review match the instrumentalist’s rule of law elements of consistency, generality, predictability, enforceability, stability and congruence, and the substantive rule of law

framework's requirements of democracy, limited government, accountable administrative decision-making, and judicial independence.

This thesis further presents that China's tax law system is administrative in nature but this characterization is complicated by legislative and judicial functions in the tax law. In this sense, the tax law reform benefits from as well as is circumvented by the post-WTO legal reform. The accession to WTO bounds China calling for transparency, consistency, simplicity and certainty in terms of tax legislations at both national and local levels. The hierarchical tax administration structure should not impede enforcement of tax laws. Uniform and impartial administration of tax regulations at various local levels should be eliminated or reduced to a level acceptable to guarantee well-grounded tax administrative decisions and facilitate tax judicature independence. Given the growing awareness of taxpayers' rights, tax authorities should not dwell at the stereotype "monitor" position proclaiming obligation to pay tax, rather, a workable system of protections should be established and honored. Moreover, the tax treatment of the nonprofits sector as the third sector of the society should be formulated and enforced. This thesis contributes a few findings after examining the *status quo* of China's current tax law system.

As to tax legislation, *Chapter V* concludes that the tax legislation reform has endured a painful process of simplification, unification and the revenue sharing scheme. Tax legislation started as FDI driven and incentive-focused, and so the structure of tax legislation was imbalanced from the very beginning without honoring tax equity and efficiency. Meanwhile, China's tax legislation reform is

complicated under WTO Agreements and the rule of law order. In particular, rules and principles of WTO Agreements call for China's turnover tax, enterprise income tax and individual income tax legislation and reform to incorporate non-discrimination principles and the transparency requirement. *Chapter V* further shares and agrees with Avi-Yonah's proposal that, answers to fine-tune China's tax legislation system might be found in an international tax arena through a multilateral solution. It is essential that the fundamental goals of taxation and WTO principles should be achieved in terms of revenue collection, social wealth redistribution, transparency, uniform and impartial administration, and judicial review. Equally important is to incorporate elements of the rule of law order as well as to integrate China's tax legislation with an international perspective of facilitating development and institutionalization of the tax system.

As to tax judicature, *Chapter VI* concludes that the tax judicature reform in China should consider both the idea of permanence and that of flexibility. It must balance the dynamic between tax administration, the general judiciary framework, and taxpayers' rights. As law supports the government's political authority as well as the power of the legal system, the principles and tenets of the tax judicature system should be enshrined in a jurisprudential manner, honoring the rule of law order.

Chapter VI also submits the a few proposals for China's tax judicature reform: (1) the full-payment rule should be abolished. For an adverse tax collection decision, a taxpayer does not need to pay the assessed payment or provide guarantee at the first place before filing an application for a tax administrative reconsideration. (2)

This thesis contributes the novel notion that a summary judgment procedure should be established for small tax cases as a tax collection procedure. (3) China should design a better scheme for administrative reconsideration, but the structure must be calculated and designed. (4) Tax expertise can be strengthened by teaming up more experienced personnel with specialty in tax. (5) At county or lowest hierarchical government levels, abstract administrative acts should be subject to judicial review, and this reform may start as experimental at a few coastal localities with better tax talents. (6) Echoing the debates regarding the imaginary Chinese tax court system, this chapter submits a tentative proposal. The desirable structure is to adopt a circuit tax courts framework exercising both original (conditioned first instance) and appellate jurisdiction sitting permanently in six to eight regions covering nationwide territory and reporting to the SPC Tax Tribunal based in Beijing. The designated High Tax Tribunal should be an SPC subsidiary and should have the ultimate appellate jurisdiction over tax cases appealed at circuit tax courts and provincial high courts, and perform tax court system administration or management. Meanwhile, the transitory, costly and overhauling midlist “spin-off” structure should be denounced based on tax policy routines.

As to taxpayers’ rights, *Chapter VII* evidences that Chinese taxpayers’ rights are limited by the inherent deficiencies in the general tax framework. This is particularly manifested by the discrepancy in the internal management of tax authorities. Moreover, because secondary legal rights, administrative rights and the principles of good conduct of tax authorities are put together in the Tax Collection Law and the Proclamation, the protection of each right is not

guaranteed with enough singularity and attention, and the separation of those rules and its impact should be considered.

Chapter VII summarizes that, China's tax system overall still provides a problematic, yet promising, framework to channel available legal remedies, administrative and judicial, for taxpayers. This thesis further supports the protection of taxpayers' rights centers as a key element substantiating China's construct of the rule of law order and fulfillment of WTO principles. Chinese taxpayers' rights should theme with a *fair, transparent, certain, consistent, equitable, effective, and clear* manner within the framework of the tax laws. Meanwhile, the WTO principles attach assimilation into international taxpayers' rights routine and vitality in designing and rectifying Chinese taxpayers' rights in terms of administration and adjudication. China's tax laws should embody and honor the *transparency, uniformity and impartiality* and *judicial review* principles with a full set of niceties and convenient courses of action in taxpayers' protection. *Chapter VII* concludes a summarized proposal for refining China's taxpayers' rights protection, based on the positivist view in jurisprudence for taxpayers, the rule of law order, and WTO principles. This proposal balances practical significance and largely is underpinned by points of consensus among tax authorities and taxpayers alike. In this sense, it is not a reordering or rearrangement of existing prescribed rights, rather, it is submitted being reflective of daily practice.

As to NGO tax treatment and comparative tax, Chapter VIII identifies two methodological notions as to comparative law in the Chinese tax context. First,

the scarcity of decent comparative legal tax scholarship in general does not support quality comparison. A shortage of paradigmatic discourse shows the simultaneous existence of bluntly conflicting arguments, parallel courses, and irregularities in analysis. Although some comparative tax frameworks have been proposed or compiled, their value to the Chinese tax context is not evident. For this reason, this thesis argues that a comparative tax study relating to China might be better achieved by focusing on a full “tax law sub-discipline” rather than on a specific tax concept. One reason is that a western-originated tax concept might be too narrow to meaningfully inform a Chinese policy orientation. The other reason is that it lacks generality necessary to apply it to other subsidiaries of tax law.

Second, the tax cultural traditions and social, political and legal settings of a systematic tax governance framework should be included in tax comparativists’ theorizations. A tax study ultimately has to be conducted from a “big-picture” perspective in which a tax system is embedded. Otherwise, a comparative study may easily turn into descriptive, mechanical and perfunctory analysis. The practical and scholastic significance of comparative tax studies can hardly be achieved by a limited comparison falling on the technical elements of a tax concept. This “big-picture” perspective is also in line with the rationale applicable to both the rule of law construct and assimilation to the WTO system. This thesis therefore tentatively incorporates tax culture into its considerations to compare primary elements of nonprofit tax schemes of U.S. and China. It argues that a comprehensive tax transplant effort of valued ideas and practices, whilst bold and

uncomfortable for the recipient country at the beginning, is what China needs to build a robust nonprofit sector.

Putting the comparative tax as to tax treatment of the NGO sector, *Chapter VIII* contributes the comparisons of the tax exemption schemes in U.S. and China in three folds of consideration. First, not many comprehensive studies have been completed on reforms thereof. The tax treatment of nonprofit organizations, as the crucial component to construct a nonprofit sector, is unsophisticated and short of practical significance. Second, under the rule of law construct in the past decade, some scholars suggest China might modernize its nonprofit sector through an “all-in” charity code or unrealistically cultivate expansive grassroots NGOs. The study of the nonprofit sector has to embody a realistic understanding of China’ legal and political settings. Third, commercial implications of the nonprofit sector invite studies of its tax treatment. Given China’s integration into the WTO and heightened complaints over national treatment and fair competition, a key issue arising is that the profitability of foreign investment shrinks as the tax preferential treatment is gradually discounted. The profitable potential of nonprofit organizations as foreign investment vehicles may induce inappropriate tax planning activities. *Chapter VIII* provides the following observations as to the comparison of tax treatment in U.S. and China on nonprofit sector. *First*, the public benefit or charity purpose of nonprofit organizations has not been coherently defined. *Second*, China has not set up an enforceable fiscal incentive system to promote charitable donations. *Third*, there are still burdensome requirements for the application and registration of nonprofit organizations, such

as dual management, high threshold of capital endowment for foundations and prohibition on cross-region development; *Fourth*, the administration and supervision on the internal management, human and resource, and financial and accounting management of nonprofit organizations are very weak. *Fifth*, the determination of tax-exempt status and review of such status is *ad hoc* and different from locality to locality. Such irregularities on one hand invite unethical manipulation of tax preferential policies, and create resistance to making donations through locally available venues.

In summary, this thesis intends to put forth a reasonable, practical and realistic foundation to evaluate the prospects and progress of the Chinese tax law reform on the basis of debates on the rule of law and understanding of the WTO principles applicable to China. This thesis also contributes a tailored, pragmatic and practical set of proposals for the tax reform under China's current legal infrastructure and China's goal of setting up a socialist rule of law order. For quite many Chinese tax topics such as NGO tax treatment, taxpayers' rights and tax judicature reform, it is a first step that calls for further theoretical and empirical research for emerging economies in general and for China in particular.