International Dimensions of Income Taxation in China: A Critique*

Kenny Z Lin
Assistant Professor of Accounting
Faculty of Business Administration
Memorial University of Newfoundland, Canada

Abstract

The impact of China’s open-door policy on its economic development is far-reaching. Foreign direct investment (FDI) brought about by this policy has been the driving force behind the country’s economic reforms. The 1994 tax reform, a direct response to the demand of a socialist market economy, achieved initial success, but left much to be desired. An efficient, equal, and neutral tax system is desirable in an ideal tax environment. China’s numerous tax incentives, available only to foreign investment enterprises (FIEs), have become a rising source of tax inequality, and have proved to be costly in terms of revenue foregone. The equity objective has gained momentum as China is under pressure to boost revenues, through further tax reform, to fund the major infrastructure development programme. It is suggested that further tax reforms in China be grounded in the principles of unifying tax laws, equalizing the tax burden, simplifying the tax system, and improving the efficiency of tax collection and administration.

* The author wishes to thank Ian Fraser, Department of Finance and Accounting, Glasgow Caledonian University, for his helpful comments.
Introduction

The open-door policy launched by the Chinese Government in 1979 has transformed China's development strategy from that of an insular "self-reliance" economy to that of a market, "outward-oriented" one. For almost two decades, China's economy has experienced rapid growth, especially in gross domestic product (GDP), foreign trade and foreign direct investment (FDI). Between 1992–1997, China achieved an annual average GDP growth rate of nearly 10 per cent. Per capita gross national product (GNP) increased from US$220 in 1978 to US$733 in 1997. The increasing openness of the Chinese economy, as measured by the ratio of trade to GDP, has been an important contributing factor to its exceptional growth. The trade/GDP ratio rose from 9.1 per cent in 1978 to 36.6 per cent in 1997, enabling the country to improve its trade position from 32nd to 10th in the world (Beijing Review, 1999c). Other than in 1993, the country has experienced a trade surplus each year since 1990 and has accumulated the second largest foreign exchange reserves in the world — US$145 billion by the end of 1998 (State Statistics Bureau, 1999). In terms of FDI, China has been for five consecutive years since 1993 the second largest recipient of FDI after the US. Two hundred of the 500 largest multinational corporations have invested in the country (Beijing Review, 1999b). FDI is of considerable importance to China's export industry, as foreign investment enterprises' (FIEs) accounted for about 41 per cent of the country's total exports in 1997.

As a consequence of the Government having steered the economy away from state ownership and central planning, the value of industrial output from the public sector has shrunk from 77.6 per cent in 1978 to only 25.5 per cent in 1997. Collectively owned enterprises, privately owned enterprises and FIEs contributed, respectively, 38.1 per cent, 17.9 per cent and 18.5 per cent of the country's gross industrial output in the same year (State Statistics Bureau, 1998). The exceptionally high industrial growth rates of the coastal areas, where FIEs are heavily concentrated, for the period 1984 to 1992, relative to the national average of 9.2 per cent, can be explained entirely by their effective use of FDI and exports (Wei, 1993; Ma, 1997).

To cope with the new strategy of opening the country to the outside world and promoting economic reform, China implemented changes to its tax system in 1979 to take account of foreign investment, and undertook further tax reforms in July 1991 and January 1994. The 1994 tax reform has begun to show some success in improving tax collection. Total government revenue grew 18 per cent from 1995 to 1996, yielding a slight increase in the ratio of revenue to GDP for the first time since 1979. The purpose of this paper is to evaluate critically Chinese tax policy towards FIEs operating in China. The paper proceeds as follows. Next, there is a brief description of the pattern of FDI and of the tax structure of the Chinese tax system. This is followed by an evaluation of the effectiveness of tax incentives in attracting foreign investment and an assessment of the justification of existing tax incentives, in the light of tax revenue foregone. The conclusion discusses how the international dimensions of the Chinese tax system might be developed.
Pattern of FDI and Tax Characteristics in China
Trends and Composition of FDI

Since 1979, when foreign investment in China began, the pattern of utilised FDI grew steadily at an average annual rate of 20 per cent between 1985 and 1991 and more sharply at 50 per cent annually between 1992 and 1998. Total cumulative utilised FDI reached US$265 billion by the end of 1998, making China second in the world among recipients of FDI for the those six years. FDI in China is undergoing fundamental structural change in such areas as entry mode, industry selection, project location, investment size, and operational phases (Luo and O’Connor, 1998).

China’s strategy in targeting its coastal areas as the engine of the nation’s economic development is reflected in the magnitude of FDI brought into this region. Up to 1997, the coastal areas absorbed about 82 per cent of total FDI. Eighty-seven per cent of the top 500 FIEs (based on sales volume) were located in the coastal regions in 1998 (Beijing Review, 1999b). However, the Government has recently adopted a number of measures to encourage foreign businesses to invest in central and western regions. As the mainly preferred coastal area is gradually becoming more expensive for many investors, FDI is being gradually disseminated to the inland provinces. FDI in the inland provinces accounted for only 6 per cent of the nation’s total FDI in 1990, but this proportion increased to 16 per cent in 1997.

In 1997, about 41.1 per cent of all investment in China came from companies based in Hong Kong. Investment from Japan, Taiwan, the US, Singapore, Korea and the UK was well behind and ranked second to seventh, at 8.3, 6.4, 6.3, 4.9, 4.2, and 3.5 per cent respectively.

Throughout the 1980s, the average contractual value of FDI projects in China was around the US$900,000 mark. This had increased to US$2.4 million per project in 1997. While investors from the US, Japan, Germany and the UK tended to commit to larger investments, the contractual value of projects by Hong Kong investors averaged below US$1 million.

In the 1980s, foreign companies invested primarily in labour-intensive industries. In the 1990s there has been a strategic move toward capital and technology-intensive industries (Luo and O’Connor, 1998). China’s success in recasting its coastal areas as export platforms is reflected in the importance of investment in manufacturing. Nationally the manufacturing sector accounted for 69.8 per cent of FDI in 1997. Real estate was a distant second (22.2 per cent), followed by supply (7.2 per cent), construction (6.1 per cent), transportation and telecommunication services (5.1 per cent), and agriculture (2.8 per cent). Equity joint ventures are the most common mode of entry into the Chinese market and these accounted for 40.6 per cent of total FDI in 1997.

Tax Structure

Between 1979 and 1990, the taxation of income from foreign investment came under one of two laws: the Income Tax Law Concerning Joint Ventures with Chinese and Foreign Investment, or the Income Tax Law Concerning Foreign Enterprises. As a result of the 1991 tax reform, the original two income tax laws concerning foreign investment were consolidated to form a unified enterprise income tax law, in order to mitigate the problems of irregular scope of ap-
plication and lack of equity in tax burden. To enhance the Central Government’s ability to improve its share of tax revenue, China undertook further tax reforms in 1994. The 1994 reform resulted in an all-round restructuring of the pre-existing tax system. With this reform, China moved closer to customary international practice and to the adoption of a more unified and equitable tax regime. The new tax regime lowered the income tax rate on domestic enterprises from an average rate of 55 per cent to 33 per cent, thus allowing domestic enterprises to compete on a more equitable basis with FIEs, which are usually given concessionary tax rates. The original 32 industrial and commercial taxes were reduced to 17, of which 11 apply to FIEs. The major component of the reform was the restructuring of turnover tax. The new turnover tax system, which applies to both Chinese enterprises and FIEs, created a more equitable competitive environment for various types of enterprises.

Table 1 shows six principal taxes under the current Chinese tax regime and the proportion of revenue raised by each tax relative to total tax revenue in 1995.

Table 1: China’s Tax Structure and Tax Revenue in 1995

<table>
<thead>
<tr>
<th>Types of Tax</th>
<th>Revenue (Billion RMB)</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Turnover tax: VAT</td>
<td>264.03</td>
<td>43.43</td>
</tr>
<tr>
<td>Consumption tax</td>
<td>55.32</td>
<td>9.10</td>
</tr>
<tr>
<td>Business tax</td>
<td>86.90</td>
<td>14.29</td>
</tr>
<tr>
<td>Enterprise income tax</td>
<td>82.02</td>
<td>13.49</td>
</tr>
<tr>
<td>Individual income tax</td>
<td>13.14</td>
<td>2.16</td>
</tr>
<tr>
<td>Other taxes</td>
<td>106.60</td>
<td>17.53</td>
</tr>
<tr>
<td>Total</td>
<td>608.01</td>
<td>100.00</td>
</tr>
</tbody>
</table>

(Source: Economic Daily, March 2, 1996. Figures do not include customs duties and tariffs)

Turnover tax, which includes value-added tax (VAT), consumption tax and business tax, accounted for 66.8 per cent of total tax revenue in 1995. In terms of the share of turnover tax in total tax revenue, China surpasses the levels of most other countries. VAT applies to all manufacturing, wholesale, and retail enterprises, regardless of the form of ownership. For most products the VAT rate is 17 per cent and tax is collected based on the products’ origin, unlike the consumption-based VAT applied in many western countries. VAT is the single largest source of government revenue. Consumption tax applies to a small number of consumer goods, such as alcohol and tobacco. Business tax of 3 to 5 per cent is applied to services other than retail and wholesale. Enterprise income tax is calculated at a uniform rate of 33 per cent and is applied to all types of enterprises whether they are domestic, foreign-owned, or joint venture.
enterprises. A uniform individual income tax is applied to Chinese nationals and foreigners, but with different monthly exemption allowances, RMB800 for Chinese and RMB4,000 (approximately US$500) for foreigners. A progressive rate of 5 to 45 per cent is applied to income from wages and salaries. The share of income taxes in total tax revenue is considerably less than the average in market-based economies where income taxes (particularly personal income tax) play a much more important role in raising revenue and in redistributing social resources. It has been suggested that China should move from a turnover tax to an income tax base in the future (Cheung, 1998). State enterprises were the biggest contributors of total tax revenue in 1995 (71.1 per cent), followed by collective enterprises (17.2 per cent), private enterprises (6.1 per cent) and FIEs (5.6 per cent). The 1994 reform, to some extent, strengthened the Central Government's fiscal power to use tax as an economic lever. The share of Central Government revenue in total Government revenue increased from 33 per cent in 1993 to 57 per cent in 1994 (Ma, 1997). It is worth noting that although as a result of the reform, domestic enterprises and FIEs are now taxed at the same rate, there are still separate rules for taxing domestic businesses and FIEs. Moreover, FIEs still enjoy tax holidays and incentive tax rates which are not available to domestic enterprises.

China adopts the residence principle in combination with the source principle in determining the scope of charge of taxable income. Consequently, as all FIEs have their headquarters in China, they are treated as domestic enterprises and are taxed on their world-wide income with a foreign tax credit. Foreign entities with no permanent establishment in China are subject to Chinese tax only on income from sources in China.

Evaluation of Tax Incentive Schemes in China

Since 1979 China has brought in a series of tax incentives in the form of tax exemptions and reductions in order to stimulate foreign investment. Tax incentives to encourage foreign investment are mainly embodied in enterprise income tax. The majority of these incentives fall into the following three categories. Firstly, there are reduced tax rates in defined areas and for defined industries. For example, a 15 per cent income tax rate is applied to foreign investors located in special economic zones, or engaged in harbour and wharf construction. Secondly, there are preferential policies available to foreign investors establishing export-oriented or technologically advanced enterprises and for transferring advanced technology. For example, technologically advanced enterprises may enjoy a 50 per cent reduction of income tax for an additional three years following the expiry of the usual tax holiday. Thirdly and finally, there are preferential policies to encourage foreign investors to retain their earnings for reinvestment in the country. For example, foreign investors who reinvest in China to establish or expand export-oriented or technologically advanced enterprises scheduled to operate for no less than five years are eligible for a refund available of the full amount of the income tax paid in respect of the profit reinvested.

Following a successful experiment in some selected provinces, China replaced profit remittance by domestic enterprises with tax payment throughout the country in October 1984. In the period between 1985 and 1996, China's tax revenues grew at an average annual rate of 12 per cent. However, tax revenue fell, relative to GNP, from 22.7 per cent in 1985 to 11.2 per cent in 1997. Non-state enterprises accounted for 74.5
per cent of industrial output in 1997, but they contributed only about 30 per cent of total state revenue. The major reasons for the consistent decline in the tax revenue/GNP ratio include the numerous before-tax privileges available to FIEs and significant tax avoidance and evasion by enterprises (Zhang, 1994; Sender, 1994; Liu and Wang, 1996).

China's current income tax system has a number of deficiencies. The most important one is perhaps the erosion of the enterprise income tax base as a result of widespread tax incentives. A recent estimate (Zhang, 1994) indicates that the government has reduced its tax base by RMB1,500 billion and tax revenue by RMB500 billion (approximately US$60 billion) as a direct result of tax holidays offered to FIEs. When other tax incentives are taken into account, total tax revenues forgone could be as much as RMB1,000 billion (approximately US$120 billion). While it is not easy to determine whether the revenue sacrifice is justified in terms of future benefits to the economy, a survey of 1,000 multinational companies suggested that tax benefits are not considered a determining factor in choosing China as the most favorable country for investment (Shum, 1995). Factors such as political stability, geographic features, resource conditions, labour costs, GDP growth, market prospects and infrastructure are more relevant to investment decisions (OECD, 1990; Broadman and Sun, 1997).

Foreign investors have indicated that large market size and low labour costs are amongst the major determinants in their decision whether or not to invest in China (Marr, 1997) and that inadequate legal structures, insufficient infrastructure support and inefficient government services are the major concerns (Bank of East Asia, 1996). This is consistent with the results of surveys in developing and developed countries to the effect that tax benefits play a relatively minor role in the formation of new businesses (e.g. Shah and Toye, 1978; Lim, 1983). It appears, therefore, that removing tax incentives would have an insignificant effect on the flow of FDI into China.

A further deficiency in the Chinese enterprise income tax system is that tax incentives are subject to serious tax avoidance and evasion which have added greatly to their revenue cost. Tax officials estimate that about 50, 70, 80, and 90 per cent of state-owned enterprises, collectively-owned enterprises, FIEs and private enterprises respectively manage to avoid paying taxes to some extent (Zhang, 1994). Law enforcement bodies nationwide punished more than 6.47 million tax evaders and other related offenders between 1993 and 1997 (Xindeco Business Information Company, 1998). The largest tax evasion since the founding of the PRC, which came to light in 1997, involved the use of false VAT bills to offset RMB724 million (approximately US$86 million) of tax payments (Beijing Review, 1999a). Tax authorities believe that they were denied RMB100 billion (approximately US$17 billion) in tax revenues during 1992, or about 30 per cent of the total Government revenue (Sender, 1994). Between 1991 and 1995, the Chinese tax authorities uncovered cases of tax evasion by FIEs worth some US$50 million (International Centre for Commercial Law, 1998). The tax avoidance strategies adopted by FIEs include transfer pricing through transfers of tangible or intangible properties and the provision of funds and services; establishment of counterfeit Sino-foreign joint ventures to enjoy preferential tax treatment; use of thin capitalisation to take advantage of interest deductions; and rollover of businesses to enjoy continuous tax holidays (e.g. Lin, 1990; Zhang, 1994).
The potential revenue losses from transfer pricing are high. In the late 1980s, when the periods of tax exemption granted to many FIEs gradually expired, more than half of FIEs claimed operating losses (Zhang, 1994). This percentage further increased to between 60 and 70 per cent in 1996. Chinese officials alleged that foreign investors used transfer pricing mechanisms to shift profits out of the country. Zhang (1994) compared the import and export prices of 557 commodities for both domestic and foreign enterprises in 1990. He found that for the same or similar commodity, the import price paid by FIEs in China is much higher than that paid by domestic enterprises, and the export price charged by FIEs is much lower than that charged by domestic enterprises. He estimated that this has resulted in a tax revenue loss of US$3 billion in 1990. Chan and Chow (1997) also found evidence of FIEs transferring profits out of China by over-pricing their imports, but failed to find that FIEs shift profits out of China by under-pricing their exports. It is normal practice for multinational companies to transfer profits from high-tax jurisdictions to low-tax jurisdictions. Given that China has a lower enterprise income tax rate than most developed countries, and that the existing tax incentives in China further reduce the effective tax rate, it is surprising to find that foreign investors still use transfer pricing as a major mechanism for tax avoidance. These results suggest that the primary purpose of transfer pricing by multinational corporations is not to avoid the already relatively low tax burden in China, but to accelerate recovery of their investment so as to maximise global profit and minimise local operational risk.

Another problem with incentives is the complexity these incentives introduce into the tax system. This arises from the requirement for precise legislation to allow taxpayers accurately to predict whether they qualify for the provisions and from the difficulty of implementing the provisions by the tax authorities. Tax planning in China is not easy, as the interpretation of planning information is subject to great deal of uncertainty (Fu, 1999). The wilful offer of tax concessions and exemptions by different localities for foreign investment makes tax planning even more difficult (Lin, 1999). Lack of precise legislation leading to inconsistent interpretation and frequent change of the provisions is an example of tax complexity (OECD, 1995). This complexity imposes costs not only on taxpayers, but also on the tax authorities. The need to carry out audits and assessments of incentives diverts resources from other competing tasks that deserve more attention and provides an extra challenge to the authorities with the shortage of suitably qualified auditors.

Discussions and Future Perspectives

The 1994 tax reform has only been partially completed. The enterprise income tax regime for both foreign and domestic enterprises has been aligned only in terms of the income tax rate. Major differences still exist with respect to the availability of tax favours and the deductibility of expenses for income tax. Although the effects of tax incentives on FDI are difficult to predict, their negative impact on tax neutrality is quite clear. By putting domestic enterprises at an unfair disadvantage, the preferential tax treatment of FIEs has become a rising source of tax inequality. It causes inequitable tax burdens on domestic enterprises and leads to unbalanced regional economic development in the country. Under the equity principle, China should integrate preferential income tax policies for domestic and foreign-funded enterprises to allow them to compete on a similar footing. It is worth
noting, however, that some transitional arrangements may be necessary to ensure a smooth transfer from the old tax regime to the new one.

FDI in China is highly concentrated geographically, and its sectoral distribution is highly uneven. To help narrow regional disparities and to implement national industrial policy, China should emphasise economic sectors over geographical location. As long as enterprises engage in industries that are encouraged by the State, tax preferences should be applied to all businesses regardless of their location and capital source. However, although the existing preferential tax policies currently enjoyed by FIEs are gradually diminishing, it is still necessary for China to retain some forms of preference so as to direct foreign investment to those projects which are urgently needed and which require capital and technology which domestic enterprises are presently unable to supply.

The Chinese Government is under pressure to boost its tax revenue and eliminate its fiscal deficit by 2000. It has been widely accepted that the possibility of increasing tax revenue without having high tax rates or creating new taxes lies fundamentally in preventing and curbing non-compliance, a task that is the responsibility of the tax administration (Bird, 1992). It is therefore essential to improve the tax administration to enable it to collect more taxes. The World Bank also urged China to improve its tax administration (China Tax Review, 1996). To move towards a world trend of more efficient tax collection and administration, China should speed up the implementation of a self-assessment and self-filing system. In light of an insufficient tax workforce, the introduction of self-assessment and subsequent establishment of social tax agents may help ensure the assessment mechanism and bridge the gap between the tax authorities and the taxpayers in terms of tax collection and administration.

To this end, a number of measures are necessary. First, the public’s awareness of tax obligations must be raised continuously through such means as media advertisements, publications, workshops and school curriculum enrichment. It is exceedingly difficult to administer any tax if every hand is raised against it. Taxpayer education therefore is an urgent task and will have a profound influence on the voluntary compliance of the entire population (Bird, 1992). Second, rigorous tax inspection procedures must be established and tougher enforcement procedures and penalty provisions must be put in place. Although this would put greater pressure on taxpayers, a rigorous tax inspection system and enforced tax environment can only be good for those interested in the long-term development of their businesses in China. It would mean pricing evaders out of the market, making competition fairer and easier. Third, strict tax reporting requirements for transfer pricing must be reinforced. Indeed, the recent requirement that all FIEs in China conducting transactions with overseas associates must report the size and amount of related party transactions is in line with the transfer pricing reporting requirements found in US tax legislation (Horwath International, 1999b). Finally, a computerised administration and monitoring system should be established. The Chinese tax authorities are still poorly equipped with the technical resources needed to oversee an increasing number of multinationals manipulating transfer pricing for tax avoidance. Indeed, setting up specialised inspection on the basis of self-declaration and a computerised network should be one of the key administrative dimensions of further tax reform in China (Chinese Business World, 1997).
Endnotes

1. FIEs include equity joint ventures, contractual joint ventures and wholly foreign owned enterprises.

2. Since 1995 the Chinese Government has taken a number of measures to direct investment to preferred sectors or regions through industrial policies. One of the recent efforts was a State Council circular issued in August 1996, which increases the right of the inland provinces to authorise foreign investment to US$30 million from the previous US$10 million ceiling. The Government also stipulated that at least 60 per cent of loans from international financial institutions and foreign governments should be used in central and western areas of the PRC.

3. These are: enterprise income tax, individual income tax, VAT, consumption tax, business tax, real property gains tax, resource tax, stamp duty, animal slaughter tax, urban land and house tax, and vehicle and vessel license plate tax.

4. In general, FIEs enjoy a 100 per cent tax exemption for the first two profit-making years and a 50 per cent exemption for the next three profit-making years.

5. It was reported that preferential tax treatment in the 44 Development Zones in the country will be completely phased out by 2003 (Horwath International, 1999a). It can be expected that the five Special Economic Zones will also have their tax holidays phased out; however, there is currently no indication as to when this may occur.

6. For example, FIEs engaged in technology and knowledge intensive projects and infrastructure projects (e.g. agriculture, energy, communication and transportation, and harbour and wharf constructions) enjoy a reduced income tax rate of 15 per cent. Royalties from the transfer of advanced technologies at favourable terms are exempt from withholding tax. Capital assets imported by foreign-funded projects involved in areas encouraged by the State are exempt from import duty and VAT.

7. Among the taxes that the Government collected, individual income tax accounted for most losses by volume. The tax authorities estimate that every year about RMB15 billion of individual income tax has gone uncollected, due to the public’s ignorance of the tax laws, ineffective checks and controls on people’s incomes, and lack of enforcement mechanisms (Chinese Business World, 1997). An investigation in six cities showed that over 60 per cent of the population did not know the tax threshold level.

8. The State Administration of Taxation carried out a nationwide inspection campaign from June to September 1998 to crack down on tax evasion (KPMG China Alert, 1998). China is considering setting up a special policy force for tax collection as part of its efforts to reinforce the taxation sector (CRI Special, 1999).

9. In developed countries, computers are being widely used for consultation, registration, invoice management, collection, inspection and all other aspects of tax administration. In addition, tax authorities usually link their computer systems with the banks. Personal
deposits must be held under a real name, making it difficult to conceal personal income.

References


