

3 CHINA

Huang Xueying

3.1 Introduction

From the set up of the new People Republic of China (thereinafter referred as China) in 1949 to the end of 1970s, China had adopted centrally-plan economy and had almost isolated itself from world economy. Since 1978, the watershed of Chinese society, China has carried out the comprehensive market-oriented economic reforms. The Family Responsibility System and partial liberalization of agricultural prices helped raise agricultural production and rural incomes, especially in the early years of reforms. Liberal policies toward non-state economy and a gradual marketization and decentralization are mainstay of the reforms. As a result, the country's economic performance has been remarkable. The real output has increased at an average rate of 9% per year. The world is seeing substantial improvements in living condition and notable progress in reducing poverty in China. Over 170 million of the 270 million Chinese living in absolute poverty in 1978 were raised above the poverty threshold. At the same time, the economy has become open and integrated with the rest of the world.

Notwithstanding these achievements, China has been still a developing country with per capital GDP about 660 U.S dollars at 1996. About 100 million people remain in absolute poverty, mostly in remote rural areas, but those are increasing in urban areas. Serious economic problems remain. The lack of an effective infrastructure for macroeconomic management is the bottleneck of further development. Thus, the economy has been inclined to "stop-go" cycles of macroeconomic instability, as economic stabilization had to rely invariably on administrative measures that have imposed abrupt and at times excessive restraint on the economy, creating, in turn, countervailing pressures for relaxation. Efforts to restore economic stability usually have been accompanied by a slowdown of reforms. Although Chinese government has successfully pulled down inflation rate from about 24% in 1994 to about 6% (estimated) in 1997 without sacrificing the development, the real GDP growth rate is expected to be around 9% this year, the economy is still structurally flawed. The continuing poor performance of state-own enterprises constrained the implementation of financial policies and hindered the reform of the financial system. Additionally, the weak legal and regulatory framework has impeded the development of competitive markets and a clear delineation of the rights and obligations of market participants. The obstacles posed by these problems for maintaining sustainable growth have become

increasingly evident with each macroeconomic cycle, as have the risks of not dealing with them thoroughly.

Since 1994, Chinese government intended to develop a prudential economic reform to achieve a breakthrough in the transformation to a fully market-based economic system that is consistent with socialism. A new phase of economic reforms began, aiming at tackling the existing problems and establishing “socialist market economy”, in which market forces will play the primary role in resource allocation while public ownership remains the main part of the economy. The strategy calls for fundamental changes in a broad range of important areas. One major theme of the strategy is to build the infrastructure necessary for indirect macroeconomic management, which requires reforms in such areas as the exchange and trade system, central banking and the financial system, the tax system and intergovernmental fiscal relations, and the investment system. The building of a macroeconomic policy infrastructure is intertwined with state-owned enterprises, which is another important focus. The new strategy also includes an agenda to develop fully the legal and regulatory framework. The reform is designated to create a fair and competitive environment for all market participants across the country and to promote closer relationship with world market, so as to lay a solid foundation for the stable and healthy economic development.

This report describes the current macroeconomic situation in China, focusing on the undergoing reform programs. The second part of the paper gives an overview of macroeconomics activity and fiscal position of China. The third part talks about the tax structure and reform. The last part tries to present country’s specific fiscal issues.

3.2 Overview of Macroeconomic Activity and Fiscal Position

3.2.1 Macroeconomic Activity

A. International Environment

A.1 Trade Balance

At the outset of the reform process in 1978, most foreign trades were subject to planning and were carried out through a handful of authorized foreign trade corporations. Since then, as part of the reform process, the trade system gradually liberalized. The Foreign Trade law that became effective on July 11, 1994 has eliminated all remaining mandatory trade planning.

As regards import controls on machinery, electronic equipment and other general commodities, new regulations were implemented to narrow the scope of controls and simplify

import procedures. Open quotas replaced controlling procedures on products in 44 categories, including automobile, motorcycle, computer, air conditioners, grains and rubber. Other commodities were changed to one based on international competitive trends.

Partly because of the reform, from late 1970s, the share of trade in GNP has been threefold increased (from 10% to 35%) and more than doubled of its share in world trade (from 1% to 2%).

Regarding the structure of import and export, China encourages the trade of hi-tech and quality products. From 1980 to 1995, the share of primary products in export and import declined from 50.3% and 34.8% to 14.4% and 18.5% respectively.

A.2 Current Account Balance

Recent years, China can achieve sound current account balance.

A.3 Exchange System and Exchange Rate

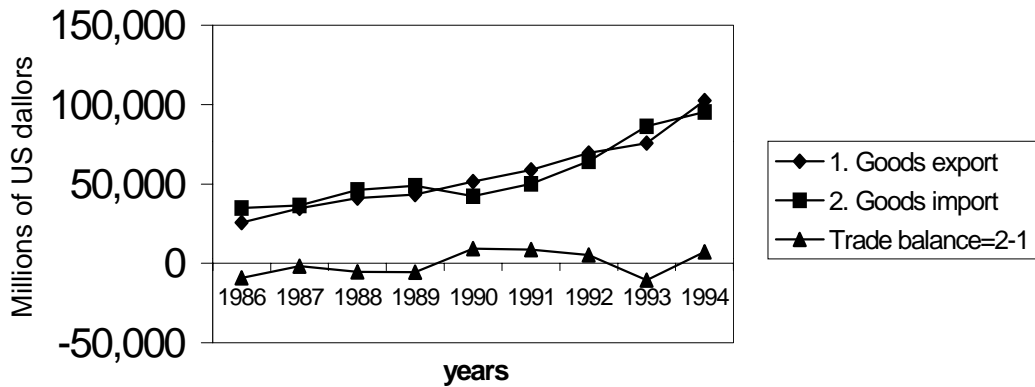
During 1986-1993, China maintained a dual exchange system, with an official rate and an adjustment rate set in the Foreign Exchange Adjustment Centers. A new exchange system was introduced on January 1, 1994, featuring a unified exchange rate that is determined in an inter-bank market. New regulations were introduced for domestic enterprises with liberalized access for trade and trade-related transactions. Enterprises with foreign investment are subject to regulations on foreign exchange balancing requirement.

The unified arrangement is a managed float. At the start of each day's trading, the People's Bank of China (the central bank of China) announces a reference rate based on the average of the buying and selling rates against the US dollar at the close of the previous day's trading. Movement of the renminbi (China's local currency) against US dollar is limited to 0.3% on either side of the reference rate, with the PBC intervening inter-bank market through purchases and sales of foreign exchange.

A.4 Foreign Direct Investment

The most striking feature of China's external capital account has been the sharp rise in foreign direct investment inflows, which grew from virtually nothing at the beginning of the reform to \$30 billion in 1994--almost half of all foreign direct flows to developing countries. The scope of foreign direct flows ranges from manufacture, energy, transportation, entertainment, to real estate development and so forth. Due to the ameliorating investment

Figure 3.1 Trade Balance



Source: Balance of payments statistics, World Bank, 1996.

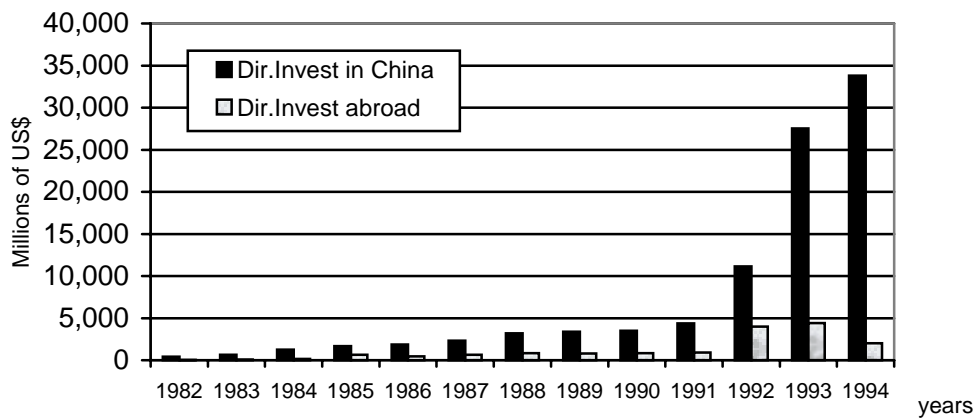
Table 3.1

(Millions of US\$)

| Year | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
|-----------------|--------|--------|--------|--------|-------|---------|-------|-------|
| Current Account | -3,802 | -4,317 | 11,997 | 13,272 | 6,401 | -11,609 | 6,908 | 1,168 |

Source: World Bank: Balance of payments statistics 1996.

Figure 3.2 Foreign direct Investment



Source: Global Development Finance, World bank, 1997.

environment, foreign direct investment expands and rising percentage of the money goes to infrastructure and hi-tech industry.

A.5 Borrowing from Abroad

In 1950s, China borrowed money mainly from previous Soviet Union. But when the cooperative relation between two countries broke up, China stopped borrowing from abroad. In 1979, China again began to borrow money from abroad. The amount has been rising from 3.5 billion to 27.3 billion dollar in 1994(estimate). The foreign debt services ratio is 9.7%.

About one fourth of the deficits were financed by foreign sources, which were used primarily for imports of capital equipment for key construction projects.

B. Domestic Environment

B.1 Economic Growth Rate and Inflation Rate

Since China's market-oriented reforms began at the end of 1970s, real GNP growth has averaged over 9 percent a year, and inflation rate 7.5 percent a year. As the result of imperfect development of macroeconomic stabilization policy tools, the economy has experienced repeated fluctuation, overheating and inflation in 1985-86, 1988-89 and 1992-96 (main reasons for the fluctuation are stated in Introduction of this paper).

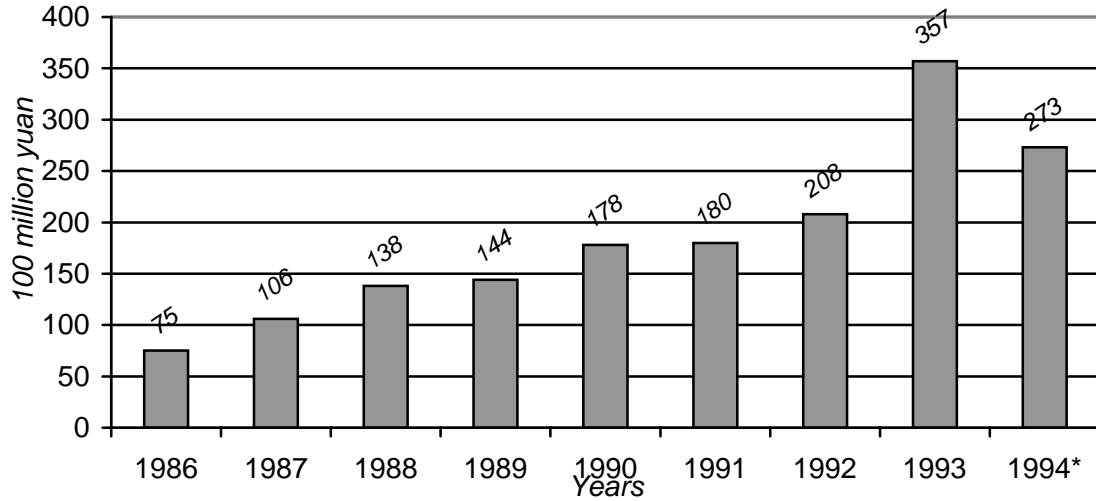
B.2 Consumption

Total consumption has soared strikingly. In 1995, public consumption and resident consumption are about 12 times and 11 times more than that in 1980, respectively. Especially in 1990s, average annual growth rate of total consumption is 25.2%.

Average residence consumption (nominal) in 1993 is 9.44 times of that in 1978, with that of rural residence 7.88 times and urban 9.77 times. In 1994, average residence consumption of urban residence is 3.64 times as much as that of rural residence, larger than the 2.93 in 1978, implying a wider gap of living condition between rural and urban area. Although the real average growth rate for the 15 years is 7.4%, unfortunately, the average consumption level in China is still quite low.

B.3 Investment

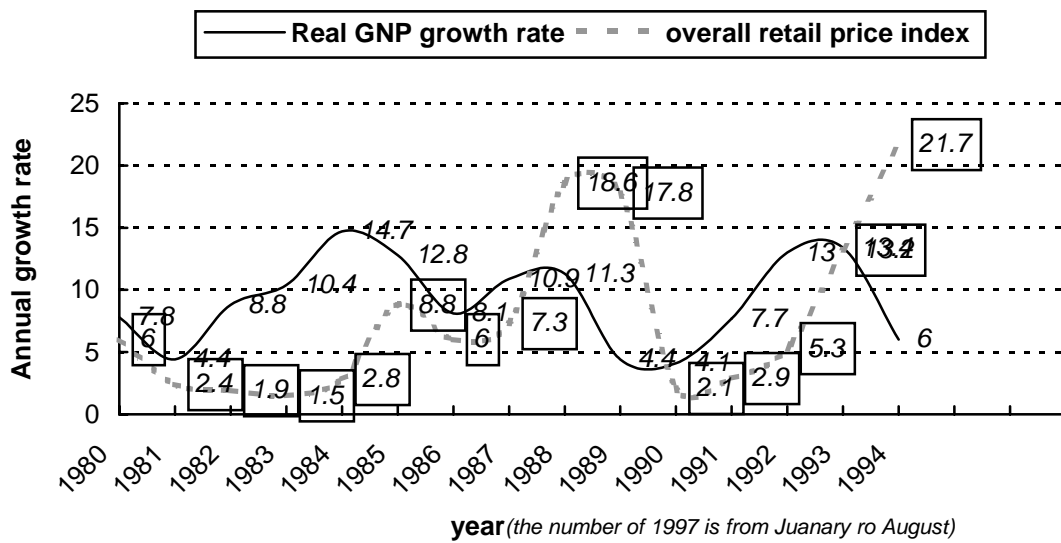
Figure 3.3 Borrowing from Abroad



Source: China Yearbook 1994.

*1994 is estimate number

Figure 3.4



Source: China statistical yearbook and Chinses authority.

Table 3.2

| Item | Value (nominal) (unit: one hundred million yuan) | | | | | Average annual growth rate % | | |
|----------------------|---|-------|--------|--------|--------|---------------------------------|---------------|---------------|
| | 1980 | 1985 | 1990 | 1994 | 1995 | 1981-1 991 | 1986-1 991 | 1991-1 995 |
| Total consumption | 2,976 | 5,773 | 11,365 | 27,216 | 34,962 | 17.9 | 19.7 | 25.2 |
| Resident Consumption | 2,317 | 4,589 | 9,113 | 21,230 | 27,839 | 18 | 19.8 | 25 |
| Public Consumption | 659 | 1,184 | 2,252 | 5,986 | 7,123 | 17.2 | 19.7 | 25.9 |

Source: National economic statistics 1995.

Table 3.3 Average Residence Consumption (nominal)

| Item ¥ year | (yuan) | | | | | |
|-----------------------|--------|------|------|------|------|------|
| | 1978 | 1980 | 1985 | 1990 | 1993 | 1994 |
| Residence consumption | 184 | 236 | 437 | 803 | 1331 | 1737 |
| Rural residence | 138 | 178 | 347 | 571 | 855 | 1087 |
| Urban residence | 405 | 496 | 802 | 1686 | 3027 | 3956 |

Source: National economy statistics 1995.

Table 3.4 Total Investment in Fixed Assets

| Item | (100 million yuan) | | | | |
|----------------------------|--------------------|---------|---------|----------|----------|
| | 1980 | 1985 | 1990 | 1994 | 1995 |
| Investment in Fixed Assets | 910.9 | 2,543.2 | 4,517.6 | 17,042.9 | 20,019.3 |

Source: Principal Indicators and development speed of national economy and social development 1996.

The recurring macroeconomic cycles in China during the past 15 years have been largely attributed to the excessive outlays on fixed investment by state-owned enterprises and local governments. The share of fixed investment in GNP rose from about 20% in 1980 to a peak of about 32% in 1987-88 but fell to 25% in 1991 under the “rectification program”, when investment projects were drastically cut back. With the acceleration of reforms and the associated boom in fixed investment, the share of fixed investment in GNP increased sharply in 1992 and rose to almost 38% in 1993.

As the reforms underwent, the central authorities’ direct control over the investment process was gradually eroded. The percentage of fixed investment financed by state units declined from 81 in 1980 to 54 in 1995.

B.4 Employment

At the end of 1995, the population of China was about 1.2 billion and 70% of them are rural residents. Annually average population growth rate from 1991-1995 was 1.2%. Most people are concentrated in the east and central parts of China because of the favorable climate and arable lands, while in the northwest and southwest parts residents are sparsely scattered.

The ratio of male economic activity participants (thereinafter referred as EAP) to working age population (Table 3.5) has not changed much from 1975 to 1994, but that of female has raised from 53% to 72.9%, which implies that female plays a more active and important role in social life.

More than 70% of Chinese EAP are involved in agricultural activity.

Regarding employment, as Soe reform proceeds, unemployment has inevitably increased. To tackle this problem, government has launched “re-employment” projects and set up various types of vocational schools. At same time, government encourages the prosperity of other economic sectors and service industries. Since late 1970s, the components of employment have diversified from mainly employees of state-owned enterprises’ to that of various newly emerging economic sectors such as foreign investment enterprises, joint-stock enterprises, and individual businesses.

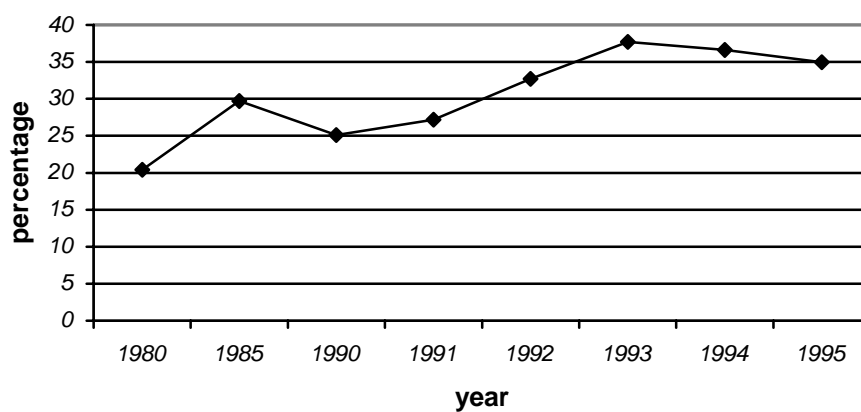
3.2.2 Fiscal position

A. Government expenditure

Government expenditure has grown rapidly, especially in 1990s. The reasons are:

- a) More expenditure on agriculture, public security, public welfare, education, etc.

Figure 3.5 Ratio of Fixed Investment to GNP



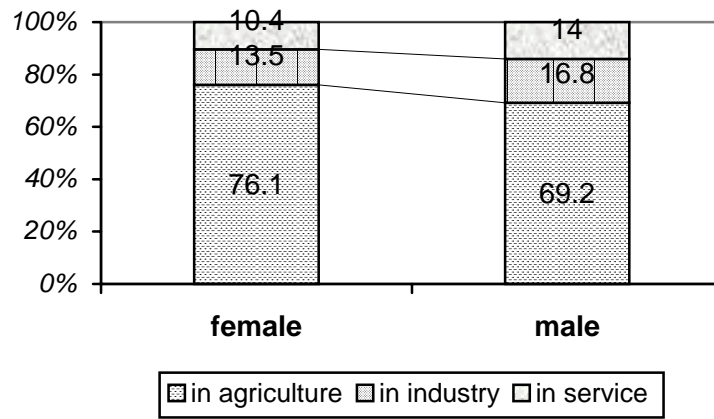
Source: China Statistical Yearbook 1994, Principal Indicators and Develop Speed of National Economy and Social Development 1996.

Table 3.5 Ratio of EAP to Working Age Population (%)

| Sex / year | 1975 | 1985 | 1994 |
|------------|------|------|------|
| Male | 83.7 | 86.2 | 84.9 |
| Female | 53 | 70.1 | 72.9 |

Source: Key Indicators of Developing Asian and Pacific Countries (ADB 1996).

Figure 3.6 Breakdown of EAP



Source: Key Indicators of Developing Asian and Pacific Countries (ADB 1996).

Figure 3.7



The unemployment rate in rural area is not available.

Source: Principal indicators and develop speed of national economy and social development 1996.

- b) Wage reform in government
- c) entities. Over staffing in government.
- d) Failure of tightly controlling some government entities' expenditure and existence of violation of financial regulations.

B. Aggregate tax revenue:

From 1985 to 1994, tax revenue has risen only about threefold, much more sluggish than economic growth, although various kinds of tax credits such as those for export and for enterprises with foreign investment and foreign enterprises, are partly responsible for it.

3.3 Tax Structure and Reform

3.3.1 Tax Reform in 1994

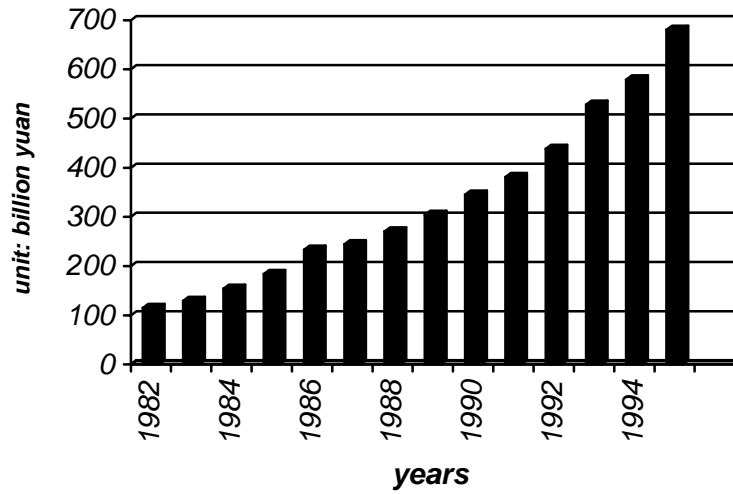
The profound and comprehensive tax reform in 1994 was a transition of Chinese tax system. In order to facilitate the formation of socialist market economy system, to smooth the fiscal relation between central and local government, to foster the continuous, rapid and healthy development of national economy, China launched a comprehensive tax reform which is an important part of 1994's fiscal reforms. The tax reforms were aimed at *unifying the tax code, equalizing the tax burden, simplifying the tax system, increasing revenue buoyancy, and building up a sound tax-sharing system*. A theme of the reforms is to integrate domestic markets and create level playing field for domestic and, eventually, foreign enterprises. Except those for enterprises with foreign investment, most tax preferences were abolished. After the reform, the tax types are reduced from original 38 to 25.

A. Tax-sharing System

From January 1, 1994, the original complex contract-based intergovernmental revenue system was replaced by a transparent delineation of revenue sources for the central and local governments. The new intergovernmental revenue system assigns the bulk of two major taxes -- VAT and excise tax -- to the central government and thus raises the central government's share of revenue from 38 percent to 60 percent. Greater resources at the disposal of the central government will provide wider scope to implement national priorities, including the reduction of regional fiscal disparities through grants.

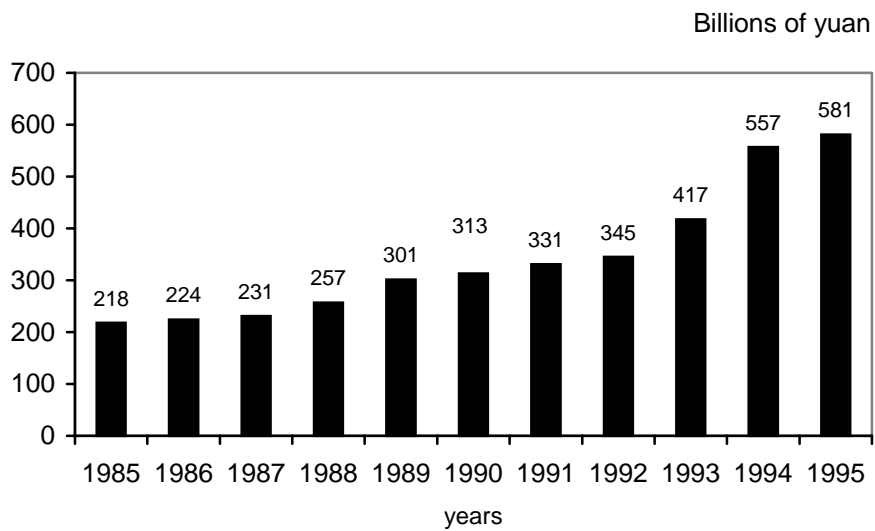
- a) *The central government* is assigned revenue from the excise tax; customs duties; VAT on

Figure 3.8 Government Expenditure



Source: International financial statistics yearbook 1996.

Figure 3.9 Tax Revenue 1985-1995



Source: Tax authorities.

imports; the enterprise income tax on centrally owned state-owned enterprises, local banks, banks with foreign investment, and non bank financial institutes; the business tax, income tax and city maintenance and construction tax on railways, national banks and insurance companies.

- b) *The local governments* are assigned revenue from the business tax, city maintenance and construction tax (excluding that assigned to the central government, as indicated above), the enterprise income tax on all enterprises that are not centrally owned (that is, locally state-owned enterprises, collectives, joint ventures, and private enterprises); the individual income tax; the city and town land use taxes; the fix assets investment orientation regulation tax; the land value added tax; the house property tax; the vehicle and vessel usage tax; the vehicle and vessel usage license plate tax; the stamp tax; the slaughter tax; the agriculture tax; the animal husbandry tax; cultivated land usage tax; deed tax.
- c) *Sharing tax*: besides what mentioned above, 75 percent of VAT belongs to central government and 25 percent of VAT belongs to local governments; most resource tax belongs to local governments except the ocean petroleum tax.

B. Structure Reform of Tax Administration

Under the State Administration of Taxation (SAT)-the headquarter of all tax administrations, locally located tax administrations across the country are split into two parts, namely, National Tax Service (NTS) and Local Tax Service (LTS). So far, the levels of NTS and LTS are corresponding to that of local governments.

- a) The NTS is responsible for administration and collection of most central and shared taxes, that is: VAT and the excise tax except those on imports, the enterprise income tax on central state-owned enterprises, local banks, banks with foreign investment, and non bank financial institutes; the business tax, income tax and city maintenance and construction tax on railways, national banks and insurance companies; enterprise income tax and resource tax for ocean petroleum enterprises; the income tax for enterprises with foreign investment and foreign enterprises; education surcharge and all fines surcharged with these taxes.
- b) The LTS is in charge for administrating and collecting local taxes for local governments. Local taxes includes: the business tax, city maintenance and construction tax (excluding that collected by NTS, as indicated above), the enterprise income tax (except those collected by NTS, as indicated above); the individual income tax; the city and town land use taxes; the fix assets investment orientation regulation tax; the land value added tax; the house property tax; the vehicle and vessel usage tax; the vehicle and vessel usage license plate tax; the stamp tax; the slaughter tax; education surcharge and all fines surcharged with these taxes.

- c) The Customs are responsible for the administration and collection of customs duties, excises tax and VAT on imports.
- d) The agriculture tax; the animal husbandry tax; cultivated land usage tax; deed tax are collected by Financial Bureau.

C. *Tax reforms in indirect taxes and direct taxes*

| Coverage of old indirect taxes | Coverage of new indirect taxes |
|---|--|
| ❖ Product tax <ul style="list-style-type: none"> • Imports and manufacture: <ul style="list-style-type: none"> ▪ agriculture ▪ liquor ▪ tobacco ▪ chemical goods ▪ electrical goods ▪ rubber • purchases of agricultural goods | ❖ Abolished |
| ❖ Old VAT (only for domestic taxpayers) | ❖ New VAT (both for domestic taxpayers and taxpayers with foreign investment) |
| • Import and manufacture of products not covered by product tax | • Import and manufacture of almost all goods |
| | • process, repairs and replacement |
| | • trade |
| ❖ Old business tax | ❖ New business tax |
| • Trade | New VAT |
| • Process, repairs and replacement | New VAT |
| • Transportation and communication | • Unchanged |
| • Culture and entertainment | • Unchanged |
| • Construction and installation services | • Unchanged |
| • Other services | • Unchanged |
| | • Transfer of intangible assets |
| | • Sales of buildings |
| ❖ Consolidated industrial and commercial tax | ❖ Abolished |
| | ❖ Consumption tax Import and manufacture luxurious goods |

Under the old indirect tax system, the products tax, VAT and business tax were applied to taxpayers with domestic investment, while the consolidated industrial and commercial tax was applied to enterprises with foreign investment. Under new tax system, indirect taxes are unified and applied equally to all taxpayers.

3.3.2 Contents of Main Taxes

A. VAT

Value-added tax is levied in accordance with the Provisional Regulations of the People's Republic of China on Value-added Tax which came into effect from January 1, 1994.

A.1 Taxpayer

All units and individuals engaged in the sales of goods, provision of processing, repairs and replacement services, and imports are the taxpayers of VAT.

A.2 Tax Base

- a) The tax payable shall be the balance of output tax for the period after deducting the input tax for the period. The formula for computing the tax payable is as follows:

Tax payable = Output tax payable for the period – Input tax for the period

If the output tax for the period is less than and insufficient to offset against the excess input tax for the period can be carried forward to following periods.

- b) Output tax = Sales amount x Tax rate

Sales amount shall be the total consideration and all other charges receivable from the purchasers by the taxpayer selling taxable goods and services, excluding the output tax collected.

The sales amount shall be computed in Reminbi. The sales amount of the taxpayer settled in foreign currencies shall be converted into Reminbi according to the exchange rate prevailing in the foreign exchange market.

A.3 Tax Rate

- a) For taxpayers selling or importing goods, providing processing, repairs and replacement services, other than those stipulated in items (b) and (c), the tax rate shall be 17%.
- b) For taxpayers selling or importing the following goods, the tax rate shall be 13%.
- i. Food grains, edible vegetable oils;
 - ii. Social facilities;
 - iii. Books, newspapers, magazines;
 - iv. Feeds, chemical fertilizers; agricultural chemicals, agricultural machinery and

covering plastic film for farming;

- v. Others goods as regulated by the State Councils.

For taxpayers exporting goods, the tax rate shall be 0%, except those stipulated by the State Council.

A.4 Creditable input VAT shall be restricted to the amount of VAT payable as indicated on the Special VAT Invoices obtained from the sellers or the tax payment receipts obtained from the customs offices.

The creditable input tax for the purchasing tax-exempted agricultural products is calculated based on a deemed deduction rate at 10% on the actual purchasing price.

Where taxpayers purchasing goods or taxable services have not obtained and kept the VAT credit documents in accordance with the regulations, or the VAT payable and other relevant items in accordance with the regulations are not indicated on the VAT credit document, no input tax shall be credited against the output tax.

A.5 Input tax on the following items shall not be credited against the output tax

- a) Fixed assets purchased;
- b) Goods purchased or taxable services used for non-taxable items;
- c) Goods purchased or taxable services used for tax exempt items;
- d) Goods purchased or taxable services used for group welfare or personal consumption
- e) Abnormal losses of goods purchased;
- f) Goods purchased or taxable services consumed in the production of work-in-progress or finished goods which suffer abnormal losses.

A.6 *The following items shall be exempt from VAT*

- a) Self-produced agricultural products sold by agricultural producers;
- b) Contraceptive medicines and devices; antique books;
- c) Importation of materials and equipment directly used in scientific research, experiment and education; and from foreign governments and international organizations as assistance free of charge.
- d) Equipment and machinery required to be imported by organizations for the disabled for special use or those under contract processing, contract assembly and compensation trade.
- e) Sale of goods which have been used by the sellers.

A.7 For taxpayers importing goods, the formulas for computing the tax payable are as follows

Tax payable = composite price x tax rate

Composite price = customs dutiable value + custom duty +consumption tax

No tax will be credited.

A.8 Small-scale taxpayers engaged in selling goods or taxable services shall use a simplified method for calculating the tax payable. The formula for calculating the tax payable is as follows

Tax payable = sales amount x leviable rate

No input tax shall be creditable.

The rate levied in the small-scale taxpayers shall be 6%.

A.9 VAT Payment

Most taxpayers adopt one month as tax period and shall report and pay tax within ten days following the end of the period.

B. Consumption Tax

Consumption tax is levied in accordance with the Provisional Regulation of the People's Republic of China on Consumption Tax.

B.1 Taxpayer

All units and individuals engaged in the production, sub-contracting for processing or the importation of consumers' goods prescribed by the Provisional regulations on consumption tax, are taxpayers of consumption tax.

B.2 Tax Payable

The consumption tax is levied on the top of the VAT.

Tax payable = Sales amount x Tax rate (or Tax amount per unit)

Sales amount shall be the total consideration and other charges receivable from the purchaser for the taxable consumers' goods sold by the taxpayer, including freight, insurance and import duty, except VAT.

B.3 Tax able items and tax rates(tax amount)

| Taxable items | | Tax unit | Tax rate /Amount |
|--|---|---|------------------|
| I. Tobacco | i. Grade A cigarettes | | 45% |
| | i. Grade b cigarettes | | 40% |
| | iii. Cigars | | 40% |
| | iv. Cut tobacco | | 30% |
| II. Alcoholic and alcohol | i. white spirits made from cereal | | 25% |
| | ii. white spirits made from potatoes | | 15% |
| | iii. yellow spirits | ton | 240 yuan |
| | iv. beer | ton | 220yuan |
| | v. other alcoholic drinks | | 10% |
| | vi. alcohol | | 5% |
| III. Cosmetics | | | 30% |
| IV. Skin-care and hair-care products | | | 17% |
| V. Precious jewelry and precious jade and stones | | | 10% |
| VI. Firecrackers and fireworks | | | 15% |
| VII. Gasoline | | litre | 0.2 yuan |
| VIII. Diesel oil | | litre | 0.1yuan |
| IX. Motor vehicle tyres | | | 10% |
| X. Motorcycles | | | 10% |
| XI. Motor cars | i. sedan: | <ul style="list-style-type: none"> ▪ those with a cylinder capacity (i.e.emission capacity) of more than 2200ml (including 2200ml) ▪ those with a cylinder capacity of between 1000-2200 ml(including 1000ml) ▪ those with a cylinder capacity of less than 1000ml | ▪ 8% |
| | | | ▪ 5% |
| | | | ▪ 3% |
| | ii. cross-country vehicles (four-wheel drive) | <ul style="list-style-type: none"> ▪ those with a cylinder capacity of more than 2400ml (including 2400ml) ▪ those with a cylinder capacity of less than 2400ml | ▪ 5% |
| | | | ▪ 3% |
| | iii. minibuses and vans (less than 22 seats) | <ul style="list-style-type: none"> ▪ those with a cylinder capacity of more than 2000ml (including 2000ml) ▪ those with a cylinder capacity of less than 2000ml | ▪ 5% |
| | | | ▪ 3% |

C. Business Tax

Business tax is levied in accordance with the Provisional Regulation of the People’s Republic of China on Business Tax.

C.1 Taxpayer

All units and individuals engaged in the provision of services, the transfer of intangible assets or the sale of immovable properties are the taxpayers of the business tax.

C.2 Tax base

The business tax is levied on services not covered by the VAT, including transportation and communications, banking and insurance, posts and telecommunications, culture and entertainment, hotels and restaurants, transfers of intangible assets, and immovable properties.

- Tax payable = Turnover x tax rate
- The turnover shall be the total consideration and all other changes receivable from the buyers for the provision of taxable services, transfer of intangible assets or sales of immovable properties by the taxpayers.

C.3 Tax rate

| Type | Tax rate |
|---|---|
| 1. communication and transportation 2. construction 3. postal and telecommunications 4. culture and sports | 3% |
| 1. finance and insurance 2. servicing 3. transfer of intangible assets 4. real estate sales | 5% |
| Entertainment | 5%-20% shall be determined by each provincial government within the range |

C.4 Tax payment

Business tax must be paid by the taxpayer (or withholding agent) to the tax authorities where the taxable service is provided or, in the case of transportation companies and the transfer of intangible property, where the taxpayer's establishment is located.

Taxes have to be declared every 5, 10, or 15 days ,every month, or on the basis of transactions, depending on the volume of turnover. Payment is due within 5-10 days following the end of the payment period.

Enterprise Income Tax

D.1 Taxpayer:

According to Provisional Regulations of the People's Republic of China on Enterprise Income Tax (1993), all enterprises, other than enterprises with foreign investment and foreign enterprises, within the People's Republic of China, shall pay enterprise income tax on income derived from production and business operations and other incomes.

Income from production and business operations and other incomes shall include income derived from both within and outside the People's Republic of China.

D.2 Tax base:

Taxable Income = total business income - business expenses

- a) The total business income of a taxpayer shall include:
 - i. Income from production and business operation;
 - ii. Income from the transfer of property;
 - iii. Interest income;
 - iv. Income from leasing;
 - v. Income from royalties and licence fees;
 - vi. Dividend income;
 - vii. Other income
- b) Business expenses for the purposes of arriving at the taxable income are costs, expenses and losses incurred by the taxpayer in earning that income:
 - i. Interest expenses incurred by a taxpayer on borrowings from financial institutions during the course of production and business operations shall be deductible on an actual basis.
 - ii. Salaries and wages paid to employees by a taxpayer shall be deductible based on the amount of taxable salaries and wages. The People's Governments of Provinces, Autonomous Regions and Municipalities Directly under the state council shall determine, within the range set down by the Ministry of Finance, the bases of calculation of the taxable salaries and wages and shall submit them to the Ministry of Finance for records purposes.
 - iii. Employee union's expenses, employees' fringe welfare costs and employees' educational expenses are deductible at 2%, 14% and 1.5% respectively of the amount of taxable salaries and wages.
 - iv. Donations for public welfare and charitable donations by a taxpayer in a year are deductible up to 3% of the taxable income.

- v. Items other than above-listed shall be deducted in accordance with laws, administrative regulations and relevant tax rules promulgated by the State.
- c) Items shall not be deducted:
- The following items shall not be deductible in calculating the taxable income:
- i. Expenditure of a capital nature;
 - ii. Expenditure on acquisition or development of intangible assets;
 - iii. Fines in relation to illegal business operations and losses incurred on confiscation of property;
 - iv. Surcharge on overdue tax payments, fines and penalties in relation to various types of taxes;
 - v. The portion of losses incurred due to natural disasters of accidents, which is covered by compensations receivable.
 - vi. Donations for public welfare and charitable donations in excess of the deductible amounts; and donations other than those for public welfare or charitable donations;

D.3 Tax Rate

| Taxpayer | Taxable income (yuan per year) | Tax rate (%) |
|--|-----------------------------------|-----------------|
| <ul style="list-style-type: none"> ▪ State-own enterprises ▪ Collective enterprises ▪ Private enterprises ▪ Others(except enterprises with foreign investment and foreign enterprises) | Above 100,000 | 33 |
| | 30,000-100,000 | 27 |
| | Below 30,000 | 18 |

E. Individual Income Tax

The basic rules governing individual income tax are set forth in the PRC Individual Income Tax Law (1994) and the PRC Individual Income Tax Law Implementation Rules (1994).

E.1 Taxpayer

- a) Individuals who have domicile in China or have stayed in China for one year or more are liable for individual income tax on income derived from sources within and outside China.

- b) Individuals who are neither domiciled nor resident in China, or who are not domiciled and resident for less than one year in China, shall pay individual income tax on income derived from sources within China.

E.2 Tax Base

Taxable income = gross taxable income – deduction

- a) There are mainly four categories of taxable income:
- i. Income from wages and salaries.
 - ii. Income derived from production and business operations by individual households engaging in industry and commerce.
 - iii. Income derived from contraction or leasing operations by enterprises or institutions.
 - iv. Other individual incomes:

Other individual incomes include remuneration for personal services; remuneration of authors; royalties, interest income, and dividends; income from lease of property; income from lotteries; other kinds of income specified by the State Council.

- b) Deduction:
- i. For income from wages and salaries, a monthly deduction of 800 yuan shall be allowed for expenses.
 - ii. For income from production or business operation derived by individual industrial households, the costs, expenses and losses shall be deducted.
 - iii. For income from remuneration for personal service, author's remuneration, royalties and lease of property, a deduction of 800 yuan shall be deducted for expenses, if the amount received in a single payment is less than 4000 yuan;

For single payment of 4000 yuan or more, a deduction of 20%, shall be deducted for expenses.

- iv. For income from transfer of property, deduction is the original value of the property and reasonable expenses.
- v. For interest, dividends, bonuses, occasional income and other income, no deduction.
- vi. The part of individual income donated to educational and other public welfare undertakings shall be deducted from the taxable income in accordance with the relevant regulations formulated by the State Council.

E.3 Tax rate

- a) Applicable to income from Wages and Salaries
b)

| Grade | Monthly taxable income (unit: RMB yuan) | Tax rate (%) |
|-------|---|--------------|
| 1 | Income of 500 yuan or less | 5 |
| 2 | The part exceeding 500 to 2000 | 10 |
| 3 | The part exceeding 2000 to 5000 | 15 |
| 4 | The part exceeding 5000 to 20000 | 20 |
| 5 | The part exceeding 20000 to 40000 | 25 |
| 6 | The part exceeding 40000 to 60000 | 30 |
| 7 | The part exceeding 60000 to 80000 | 35 |
| 8 | The part exceeding 80000 to 100000 | 40 |
| 9 | The part above 100000 | 45 |

- b) Applicable to income derived from production and business operation by business individuals and income from contracted or leased operation of enterprises and institutions.

| Grade | Annual taxable income (unit: RMB yuan) | Tax rate (%) |
|-------|--|--------------|
| 1 | Income of 5000 or less | 5 |
| 2 | The part exceeding 5000 to 10000 | 10 |
| 3 | The part exceeding 10000 to 30000 | 20 |
| 4 | The part exceeding 30000 to 50000 | 30 |
| 5 | The part exceeding 50000 | 35 |

- c) Tax rate for other individual income is 20%.

E.4 Tax payment

Individual income tax can be declared and paid by taxpayers themselves or withheld once every month or depending on the category of the income.

F. Income Tax for Enterprises with Foreign Investment and Foreign Enterprises

F.1 Tax payers

- a) Enterprises with foreign investment within the territory of the People's Republic of China on their income.
b) Foreign enterprises shall pay income tax on their income derived from sources within China.

F.2 Tax base

Taxable income = gross income – costs – expenses – losses

a) Gross income

- i. Income from production and business operations which includes income from production and business operations in manufacturing, mining, communication and transportation, construction and installation, agriculture, forestry, animal husbandry, fishery, water conservancy, commerce, finance, service industry, exploration and exploitation and other trades.
- ii. Income from other sources which includes profit (dividend), interest income, rental income, income from lease or from the alienation of property, income from provision or transfer of patent, proprietary technology, trademark interests, copyright and other non-business income.

b) Deductible:

In general, revenue expenses incurred in relation to business operations are deductible. Such as:

i. Bad debts:

Bad debts is considered admissible and deductible if:

- It is irrecoverable upon the bankruptcy of the debtor.
- It is irrecoverable from the estate of the deceased.
- It has been outstanding for over two years and is still not recoverable.

ii. Welfare and donations:

- Staff welfare payments are deductible. However, overseas social security payments for staff are not deductible.
- Donations other than those for public welfare or relief in China are not deductible.

iii. Loan interest:

Interest on capital contribution is not deductible, while a reasonable level of loan interest related with production and operation is deductible.

c) Fixed assets:

Refer to building, structures, machinery, mechanical apparatus, and means of transport and other operating equipment, appliances and tools with a useful life of one year or more.

| Fixed asset | Minimum of depreciation period |
|---|--------------------------------|
| Buildings and structures | 20 years |
| Trains, vessels, machinery and other production equipment | 15 years |

| | |
|---|---------|
| Electronic equipment, other means of transport, other appliances and tools and furnishings related to production or business operations | 5 years |
|---|---------|

In general, depreciation is provided using the straight-line method.

F.3 Tax Rate

- i. Income tax rate is 30% and local income tax rate 3%, altogether 33%.
- ii. For those taxpayers of production nature established in coastal economic open zones, or in the old urban districts of cities where the special economic zones or the economic and technological development zones are located, the tax rate shall be 24%.
- iii. The income tax on enterprises with foreign investment established in special economic zones, foreign enterprises which have establishments or places in special economic zones engaged in production and business operations, and enterprises with foreign investment of production nature in economic and technological development zones shall be levied at the reduced rate of 15%.
- iv. Any foreign enterprises which has no establishment or place in China but derives profits, interest, rental, royalties or other income from sources in China, or which, though it has an establishment or place in China and derives such income which however is not effectively connected with such establishment or place, shall pay income tax at the rate of 20%.

F.4 Tax payment

Income tax and local income tax shall be computed on an annual basis but paid in advance quarterly. Such payment shall be made within 15 days from the end of each quarter and the final settlement shall be made within 5 month from the end of each tax year. Any excess payment shall be refunded and any deficiency shall be repaid.

Taxpayers shall file their quarterly interim return in respect of advance payments and shall file an annual final income return together with the final accounting statements within 4 months from the end of the tax year.

3.3.3 The Tax Estimates and Tax Collection

A. Tax Estimation

The Tax Plan and Accounting Sections in tax authorities are responsible for tax estimation.

The Tax Plan and Accounting Sections in the State Tax Administration makes estimation on the basis of that from its sub-bureaus.

The Tax Plan and Accounting Sections collect following information for estimation:

- a) Tax revenue composition and growth rate of previous years.
- b) The trend of macroeconomic development.
- c) The effects of new economic policies.
- d) Important social events that may have impacts on tax.
- e) Any changes of major tax bases.
- f) Routine investigations and ad hoc investigations are conducted for making tax estimation.

B. Tax Estimation

Tax authorities collect taxes mainly based on two methods: examination of the accounting books and fixed-period-fixed amount collection.

Except withhold taxes, during tax payment period, taxpayers themselves go to tax offices to file the tax return and pay the tax.

In some areas, taxpayers can appoint the newly appeared tax agents to handle tax affairs on behalf of them.

3.3.4 Tax Revenue by Composition 1995

In 1995, tax revenue was 581.4billion yuan, composed more than 95% of total budget revenue. 80% of tax revenue was indirect tax, 45% of which was domestic VAT. Individual income tax, which accounted only 2% of total revenue, is strikingly small when compared with that of other countries.

Unit: one hundred million yuan (Source: China tax authorities)

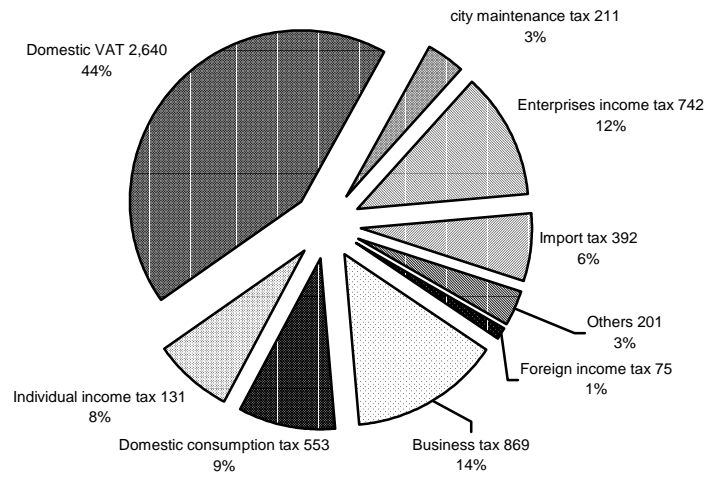
- Foreign income tax is income tax for enterprises with foreign investment and foreign enterprises
- Import duty is import tax collected by the Customs on behalf of tax authorities.
- Others refer to all other taxes less refund VAT for export.

3.4 Country-specific Fiscal Issues

3.4.1 Problems

The bottleneck of China's further economic development is lack of an effective infrastructure

Figure 3.10



for macroeconomic management and a sound market mechanism has not been fully applied. Problems about state-owned enterprises and intertwined relation between government and enterprises, about banking and investment system, inter-province disparity, population and tax system are all Gordian knots and should be handled with prudence and resolution.

A. State-owned Enterprises (SOE) Problem

As mainstay of Chinese economy, SOE account for 48% of gross industrial output in 1993 and 63% of total tax revenue in 1994. However, the overall economic performance of the SOE has remained weak. Since 1985, the percentage of losses made by SOE has remained 25%-30%. In 1996, the first time in the history, the aggregate loss of SOE as a whole exceeded its profit.

The continuing weakness in enterprise performance is mainly due to structural factors. The most important reason is organizational structure of SOE, which is characterized by a lack of managerial autonomy and accountability, rigidities in wage and employment, overstaffing, heavy burden of social benefits, and obsolescent technology. The losses of SOE have been covered almost equally through budgetary subsidies and bank loans, and the latter have adversely affected the portfolio quality and capital structure of banking system.

B. The Problem of Banking System

State-owned specialized banks and local branches of central banks are not exactly commercially oriented and are vulnerable to pressure from government to provide non-performing loans.

In addition, payment system is outdated and inefficient. National integrated inter-bank market has not been established.

C. Inter-provincial Disparity

As a consequence of favorable geographic location and preferential policies granted by central government, coastal areas of China have attracted enormous investment from both inside and outside China. The inter-provincial disparity has been so large that residents of central and west areas just stampede to coastal areas, and this has also caused a lot of problems to transportation, social security and employment as well as “brain drain” of backward areas.

D. Problems in Investment System

The investment system that has evolved since 1978 contains weaknesses that have been obstacles of maintaining macroeconomic stability. The approval mechanism for fixed investment by state-owned units provides little incentive for the relevant authorities to take into account of the project risk and the cost of funds reflected in interest rate. The only constraint has been the availability of funds. As a result, the state's capacity to intervene in the investment process through the use of indirect instrument has been limited; the primary mean of intervention is administrative and then flexible.

The investment system also carries disadvantages for banks and is detrimental to the development of market-based financial system. An important part of banks portfolios consist of policy loan that were made mandatorily, many of which may not commercially sound. And this discourages banks from transforming themselves into commercial financial institutes.

E. Weakness Concerning Tax System

In my opinion, the most remarkable character of Chinese tax administration is that tax revenue is collected not in accordance with the real tax base but with the "tax target" assigned by the State Tax Administration at outset of every year. And the "tax target " is based on the estimation of the State Tax Administration. "Tax target" phenomenon is a mirror that reflects main problems existing in Chinese tax system.

E.1 The Reasons for "Tax Target" Phenomenon

Violation of tax laws is pervasive. To ensure tax revenue, the State Tax Administration has to assign "tax target" to every level of tax authorities.

- a) At the first stage of socialist market economy, many economic laws can not be carried out faithfully; tax laws are no exception.
- b) In order to attract new investment to their jurisdiction, local governments incline to grant tax preferences to investors despite infringing tax laws, which also create tension with tax authorities and complicate tax administration.
- c) Because about 60% of tax revenue will be submitted to central government, local governments always view the taxpayers, especially those enterprises invested by local government, their own property. And local governments want to keep as much money as possible within their territory to promote local economic development. Locally located tax authorities sometimes are vulnerable to the pressure from local governments to collect less

tax than what is stipulated by tax laws.

- d) Without going through required procedure, local governments and their branches charge taxpayers numerous kinds of “administrative fees” when they exercise administrative functions from public security maintaining to garbage collecting. This “administrative fees”, the main source of extra-budgetary receipts that are very important to the finances of local governments and their branches, weight taxpayers’ tax burden. In some instances, “fees” can even exceed taxes and tax authorities have to be “considerate” and give way to these illegal “fees”.

E.2 The Aftermath of “Tax Target”

- a) The tax laws and regulations become too complex. Poor performance of legal implementation brings about further bad effects to the society.
- b) Weaken central government’s ability to implement macroeconomic management and hinder the tax revenue buoyancy.
- c) Normally, the “tax target” would rise at certain percentage year by year. For one tax authority, the more tax it collected this year, the higher target it might be assigned to next year. And the fulfillment of the “tax target” will be taken into consideration when the efficiency of one tax authority and the capability of its director are under assessment. In order to avoid too rapid growth in “tax target” and be able to achieve the “target” in following year, the common practice is that—just reach the “target” and save the remainder to following years.
- d) Once a taxpayer’s tax due is selected as “remainder”, he could delay the tax payment to next period without paying any charge and could have more cash flow for this period. Naturally, almost all taxpayers want to be chosen. The selecting which somehow depends on the negotiating ability of taxpayers which provides a hotbed for corruption.

3.4.2 Counter Measures

A. For SOE

With a view to establishing a “modern enterprise system” in SOE, China try to convert SOE into shareholding companies by implementing a new Company Law. Through this, the authorities aim to achieve a separation of the ownership functions of the state from the management of the enterprises within a framework of greater autonomy and accountability.

B. Reform Goals for Banking System

To establish a strong central bank and a modern banking system that is competitive and meets the needs of a market-based economy;

- a) Establish an update and nationally integrated inter-bank market.
- c) Establish a diversified financial system to meet the needs of a market-based economy.

C. To Inter-province Disparity

As to inter-provincial disparity, the central government has eliminated some preferential policies for coastal areas. And hopefully, the new grants system will help diminish the gap.

D. Reform to Investment System

Move toward a new system in which most investments are determined primarily by market forces, so that the aggregate level of investment can be influenced through indirect instruments. Under the reform plan, investment projects will be separated into three categories:

- a) *Projects with social benefits* will continue to be financed by the budget;
- b) *Key state infrastructure projects* will need government's approval and will be financed by the newly established policy banks;
- c) Borrowing from the commercialized banks, other financial institutions and from the rapidly emerging capital market will finance *commercial projects*.

E. How to Solve the "Tax Target" Problem

- a) Codified a clear and scientific fiscal relation among all levels of governments.
- b) Except public goods, forbids governments investment in any kinds of enterprises.
- c) Draw a clear demarcation between government and business entities.

3.5 Where We Stand and Where We Go?

China now is middle of the transmission from central planning system to socialist market economy system and has achieved rapid development in past 15 years and emerged as an economic power in world market. People enjoy a better life and a closer connection with outside world than before.

Notwithstanding all above, China is still a developing country in labor of transformation.

The goal of establishing a “socialist market economy” is included in the Constitution and Chinese people is striving to evolve China into a prosperous country.

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