

# 1 China

Zhang Xuan

## I. Introduction

The history of civilization of China may be traced back to 3500 years ago. The first country named Shang was founded in Yin, Henan province about 1500 BC. It had been substituted by 19 dynasties successively until the People's Republic of China was set up in 1949. During one hundred years before that, China had been frequently invaded by many foreign countries. Huge amount of treasures had been plundered and the economy of China was thoroughly damaged, which made China comedown from the richest countries to one of the poorest countries in the world. After new China established, the Chinese Communist Party (CCP) has devoted herself to lead Chinese people constructing a modern and strong country. The magnificent goal of the CCP is to enrich all of the Chinese people, enhance the comprehensive national strength and realize the communist society in the future. Opening policies and economic reforms launched at the end of 1970s are the primary-stage strategies by the CCP to achieve these ambitious goals. Now China is the on way to get rid of poverty and improve economy rapidly although there is still a long way to go and numerous difficulties need to be addressed.

### Geography and Administrative Division

Located at the southeast Eurasia and the west coast of Pacific Ocean, the total territory area of China is approximately 12.6 million including about 9.6 million square kilometers of land area and 3 million square kilometers of ocean area. From northeast to south, there are 14 countries bordering upon China namely North Korea, Russia, Mongolia, Kazakhstan, Kyrgyzstan, Afghanistan, Pakistan, India, Nepal, Bhutan, Myanmar, Laos and Vietnam with roughly 22,000 kilometers of borderline. Simultaneously 6 neighbor countries surround China across seas including South Korea, Japan, Philippines, Brunei, Malaysia and Indonesia. The unique geographic location is prone to conduct trade with these countries.

The main features of hypsography in China are high in the west and low in the east. From Qinghai-Tibet plateau to east plains, the fall of altitude is more than 4000 meters, which leads most of the rivers in China flow east including Changjiang and Huanghe, the first and second longest river in China respectively. More than 130 lakes above 100 square meters scatter all around the country, while the largest freshwater lakes such as Dongting Lake, Hongze Lake, Boyang Lake, and Tai Lake are concentrated along Changjiang.

In China, there are four levels of administrative divisions: 34 province-level localities (including 23 provinces, 4 municipalities directly under the central government, 5 autonomous regions and 2 special administrative regions), 333 municipalities, 2862 towns and 41636 villages (till December 31, 2004). For administrative convenience, 34 provincial localities can be divided into seven regions such as North China region (Beijing, Tianjin, Hebei, Shanxi, and Inner Mongolia), East China region (Shanghai, Jiangsu, Zhejiang, Anhui, Shandong, Jiangxi, Fujian, and Taiwan), South China region (Guangdong, Hainan, Hongkong, and Macao), Mid China region (Hunan, Hubei, and Henan), North East region (Liaoning, Jilin, and Heilongjiang), North West region (Ningxia, Shanxi, Qinghai, Gansu, and Xinjiang), and South West region (Chongqing, Sichuan, Yunnan, Tibet, Guizhou, and Guangxi). East China and South China regions are the most developed ones in China while North West and South West regions are relatively undeveloped.

### Climate

Extending over 50 latitudes from north to south, the territory of China embraces 6 climate zones including the tropics, the subtropics, the warm temperate zone, the moderate temperate zone, the cold temperate zone and Qinghai-Tibet plateau zone. In view of the types of climate, the east region of China has a strong feature of monsoon weather, the northwest region of China falls into temperate and

continental weather, Qinghai-Tibet plateau belongs to Frigid Zone. In winter northwest wind from Siberia prevails in China, bringing cold and dry, and the temperature of the whole country differs far from the north to the south. To north of the 0° isotherm, crossing Huaihe River, Qinling Mountain, and the southeast brim of Qinghai-Tibet Plateau, the temperature is under 0° and the weather is rather cold. To south of the 0° isotherm, the temperature is above 0° and the weather is warm and pleasant. In summer southeast wind from the Pacific Ocean and southwest wind from the India Ocean control China alternately, carrying warm and moist air and plenty of rain. The whole country is under the high temperature except Qinghai-Tibet Plateau. Most regions in south China bear average temperature above 28°. Besides, climates differ from region to region because of the country's extensive territory and complex topography; the weather disasters almost take place every year in China.

### **Natural Resources**

In gross China have abundant natural resources. The main mineral resources include 10 energy sources (petroleum, natural gas, coal, terrestrial heat, etc.), 54 metal mines (thereinto, the proven reserves of tungsten, tin, antimony, tantalum, rare earth metal and titan rank No.1 in the world), and 91 nonmetal mines (for example black lead, phosphor, sulfur, hoesvellite, etc.) and so on. Currently, the total cultivated area in China is 0.1225 billion hectares; the lawn area is 0.393 billion hectares which accounts for almost 41.7% of the total land area and ranks No.2 in the world; the area of woods occupies 0.17491 billion hectares, but the percentage of forest cover is only 18.21%. The aggregate water resources reserve roughly 2800 billion steres, ranking No.3 in the world.

However, on account of the huge population, the per capita volume of various natural resources in China is rather small. For example, the per capita volumes of coal, petroleum, natural gas and fresh water occupy only 55%, 11%, 4% and 25% of that average level in the world respectively. It implies heavy shortage of natural resources in the process of economic development. Saving measures must be taken by every people, every day.

### **Political Structure and Government Organs**

According to the Chinese Constitution, the State organs of China are comprised of the National People's Congress (NPC), the President, the State Council, the Central Military Commission, the Supreme People's Court, and the Supreme People's Procuratorate. The President of the People's Republic of China is the Head of State as well as the supreme representative of China. China's system of the head of state is a system of collective leadership. The president is subordinate to the NPC and directly receives instructions from the supreme organ of State power.

The National People's Congress (NPC) of the People's Republic of China is the highest organ of state power. The Standing Committee of the NPC is the permanent organ of the NPC. The term of office of the NPC and its Standing Committee is five years. The NPC and its Standing Committee are empowered with the rights of legislation, decision, supervision, election and removal. The plenary session of the NPC is held once every year or at any time under special circumstances. Deputies to the NPC are members forming the highest organ of state power to be elected from the provinces, autonomous regions, municipalities directly under the Central Government and the armed forces. When the NPC is not in session, its permanent organ, the Standing Committee, exercises state power. Currently, the President of China is Hu Jintao; the Premier is Wen Jiabao, the Chairman of the NPC is Wu Bangguo.

The State Council of the People's Republic of China, namely the Central People's Government, is the highest executive organ of State power, as well as the highest organ of State administration. The State Council is composed of a premier, vice-premiers, State councilors, ministers in charge of ministries and commissions, the auditor-general and the secretary-general. The premier of the State Council is nominated by the president, reviewed by the NPC, and appointed and removed by the president. Directly under the State Council there are 28 Ministries and Commissions (including the Ministry of Finance), 19 Organization (including General Administration of Customs, the State Administration of Taxation, etc.), 6 Administrative Offices, and 14 Institutions.

The Chinese Communist Party (CCP) has been the ruling party of China for nearly 60 years. The Chinese Government is subordinate to the Chinese Communist Party (CCP) which is established on July 1st 1921 in Shanghai. Till the end of 2005, the members of the CCP have reached 70.8 million. At the same time, there are 8 out-parties in China such as the Revolutionary Committee of Chinese Kuomintang, the Chinese Democratic League and so on. The system of multiparty cooperation and political consultation led by the CCP constitutes one of the features of the fundamental political systems in China.

## Population

Up to now, five National Population Censuses have been carried out in China, respectively in the year of 1953, 1964, 1982, 1990, and 2000. Besides, the National Bureau of Statistics of China (NBSC) conducted one-percent sample census in 2005. Based on statistics by NBSC, the population of China was 1.31448 billion by the end of 2006, increased 6.92 million than 2005. The population of birth in 2006 was 15.84 million with the birthrate of 1.209 percent; simultaneously the population of death was 8.92 million at the death rate of 0.681 percent, totally the natural growth rate was 0.528 percent. Specially, the sex ratio of birth was 119.25 (female=100) in that year.

**Table 1: Population and Structure**

Item	1953	1964	1982	1990	2000	2005	2006
<b>Total Population (Billion)</b>	0.59435	0.69458	1.00818	1.13368	1.26583	1.30756	1.31448
<b>By sex</b>							
Male (Billion)	0.30799	0.35652	0.51944	0.58495	0.65355	0.67375	0.67728
Female (Billion)	0.28636	0.33806	0.48874	0.54873	0.61228	0.63381	0.63720
Sex Ratio (female=100)	107.56	105.46	106.30	106.60	106.74	106.30	106.29
<b>By Age (%)</b>							
0-14	36.28	40.69	33.59	27.69	22.89	20.30	19.80
15-64	59.31	55.75	61.50	66.74	70.15	72.00	72.30
65 and Over	4.41	3.56	4.91	5.57	6.96	7.70	7.90
<b>By Residence (Billion)</b>							
Urban	0.77260	0.12710	0.21082	0.29971	0.45844	0.56212	0.57706
Rural	0.50534	0.56748	0.79736	0.83397	0.80739	0.74544	0.73742

Notes:

1. Data in this table excluded the population of Hong Kong, Macao and Taiwan.
2. Total population from population censuses includes the military personnel. Military personnel are listed as urban population in population by residence.
3. Total population of 1953 census includes the population from indirect survey, but excludes in the nationality population and urban/rural population

Source:

1. *China Statistical Yearbook 2006*, China Statistics Press, 2006
2. *Statistical Bulletin of National Economy and Social Development of China 2006*, National Bureau of Statistics of China, 2007

## Nationalities, Languages, Religions and Beliefs

Chinese people are composed of 56 diverse nationalities including Han, Chuang, Hui, Manchu, Tibetan, and Mongolian and so on. Among them the Han nationality occupies more than 90% of the total population while Chuang has the largest population within the minorities.

Each nationality in China has their own language except Hui nationality and Manchu who speak in Mandarin Chinese as the Han nationality, it means there are totally 54 languages in China. In different regions dialects are popular although the language is the same.

Most Chinese people are atheists, simultaneously some people believe in Buddhism, Taoism, Islam, Catholicism and other Christian religions. Confucianism, founded by Confucius, is regarded as a philosophy in China rather than a religion, which ruled China for about 2,000 years.

## II. Overview of Macroeconomic Activity

### II. 1 Macroeconomic Activity

From the end of 2002 the economy of China has entered into an ascending channel. The GDP rate keeps at or above 10% with moderate fluctuation. During this period, although the prices of crude oil and some raw products in international market have raised sharply, natural disasters such as flooding or drought break almost every year, the pace of economic growth has never stopped. GDP soars from 12 trillion yuan in 2002 to 20 trillion yuan in 2006, GDP per capita reaches to 2000 US dollars.

The general level of price maintains stable. During the period of 2003 to 2006, crude prices rose from \$25 per barrel to \$70 per barrel, the average prices exceeded \$60. This change led the factory prices of industrial goods raised 4.1 percent, the purchase prices of raw materials, fuels, and powers went up 7.6 percent annually, however the Consumer Price Index (CPI) only increased 2.1 percent each year, core CPI kept under 1 percent. It shows the macroeconomic adjustment is effective.

The rapid growth of economy in the past four years has created numerous employment opportunities. The newly added employed persons aggregated to 40 million. In the first half year of 2007, 6.29 million people obtained employment; the registered unemployment rate was 4.1 percent. The rise of employment has put secure foundation to the individual income growth.

The disequilibrium of international payment is getting severer. Since 2005 the international trade surplus has increased distinctly and kept an up trend, which worsens the environment of international trade. In order to cope with this issue, a series measures have been taken including the reform of exchange rate mechanism, enhancing the elasticity of exchange rate and so on. Up to now RMB has been appreciated 8.6 percent against US dollar. Besides, the export rebate of some goods has been abolished; export tax has been introduced or levied at increased rate on regulated export commodities such as rare earth metal, nickel, chrome, and some steel products etc.

**Table 2: Selected Macroeconomic Indicators**

Item	2001	2002	2003	2004	2005	2006
<b>GDP (Billion Yuan)</b>	10965.5	12033.3	13582.3	15987.8	18386.8	21087.1
<b>GDP per capita (Yuan)</b>	8622.0	9398.0	10542.0	12336.0	14040.0	16084.0
<b>GDP Rate (%)</b>	8.3	9.1	10.0	10.1	10.4	11.1
<b>CPI</b>	100.7	99.2	101.2	103.9	101.8	101.5
<b>CPI Inflation Rate (%)</b>	0.7	-0.8	1.2	3.9	1.8	1.5
<b>Annual Mean Exchange Rate (per USD)</b>	8.2770	8.2770	8.2770	8.2768	8.1917	7.8087
<b>Population (Billion)</b>	1.27627	1.28453	1.29227	1.29988	1.30756	1.31448
<b>Birth Rate (%)</b>	1.338	1.286	1.241	1.229	1.240	1.209
<b>Death Rate (%)</b>	0.643	0.641	0.640	0.642	0.651	0.681
<b>Natural Growth Rate (%)</b>	0.695	0.645	0.601	0.587	0.589	0.528
<b>Economically Active Population (Billion)</b>	0.74432	0.75360	0.76075	0.76823	0.77877	N/A
<b>Employed Persons (Billion)</b>	0.73025	0.73740	0.74423	0.75200	0.75825	0.76400
<b>Urban Employed Persons</b>	0.23940	0.24780	0.25639	0.26476	0.27331	0.28310
<b>Rural Employed Persons</b>	0.49085	0.48960	0.48793	0.48724	0.48494	0.48090
<b>Registered Unemployment Rate in Urban (%)</b>	3.6	4.0	4.3	4.2	4.2	4.1
<b>Investment in Fixed Assets (Billion Yuan)</b>	N/A	N/A	N/A	7047.74	8877.36	10987.00
<b>Government Revenue<sup>①</sup> (Billion Yuan)</b>	1638.604	1890.364	2171.525	2639.647	3164.929	3934.362
<b>Government Expenditure (Billion Yuan)</b>	1890.258	2205.315	2464.995	2848.689	3393.028	4021.316
<b>Per Capita Annual Disposable Income</b>						
<b>Urban Households (Yuan)</b>	6859.6	7702.8	8472.2	9421.6	10493.0	11759.0
<b>Rural Households (Yuan)</b>	2366.4	2475.6	2622.2	2936.4	3254.9	3587.0
<b>Total Import Export value (Billion USD)</b>	509.65	620.77	850.99	1154.55	1421.91	1760.70
<b>Inward FDI (Billion USD)</b>	46.88	52.74	53.51	60.63	60.33	69.47
<b>Outward Investment (Billion USD)</b>	N/A	N/A	N/A	5.50	12.26	16.10
<b>Foreign exchange reserve (Billion USD)</b>	212.16	286.41	403.25	609.93	818.87	1066.34

Note:

1. Government revenue here excludes debt.
2. Data in this table are calculated in current prices.

3. Data of outward investment exclude financial investment.

Sources:

1. China Statistical Yearbook, NBSC, 2006;
2. China Statistical Bulletin of National Economy and Social Development 2006, NBSC, 2007
3. State Administration of Foreign Exchange, <http://www.safe.gov.cn>

### II.1.1 International Environment

In 2006 the world economy maintained a strong trend of growth; international trade and investment kept on enlarging. Under such a favorable international context, Chinese economy did not slow down its pace and enjoyed 10.7 percent of GDP rate. However, some disadvantages can not be neglected. The international competition for energies, sources, markets, etc. is getting fiercely which throws China into the central of troubles. After China became a member of WTO, the total value of foreign trade has jumped several times than ever, at the same time the trade frictions with other countries has gone up together. China has been one of the most frequently investigated countries in antidumping disputes. Actually, since 1995 China has been standing in such a situation. By far, the European Union has started 127 cases of antidumping investigation against China. Besides, along with the durative rise of foreign trade surplus, the pressure on the appreciation of RMB is strengthened, which would bring negative effect on foreign trade and worsen the unemployment rate to some extent. How to maintain the ascending trend of economic growth is testing the wisdom of Chinese policy makers.

#### A. Trade Balance

Since China joined WTO in the end of 2001, the foreign trade of goods has experienced a rapid increase. The total value of import and export of merchandise has kept rising for 5 years at average speed of 28 percent annually. In 2006 this figure reached to 13748.78 billion yuan or 1760.69 billion US dollars, increased 23.8% compared with that of 2005 and ranked number three in the world. Thereinto the export value and import value got to 7567.41 billion yuan and 6181.37 billion yuan, grown by 27.2% and 20% respectively. The trade surplus touched a new height of 1386.04 billion yuan, increasing 74% than that of last year.

**Table 3: Balance of Foreign Trade**

Item	2001	2002	2003	2004	2005	2006
<b>Total Import Export Value (Billion Yuan)</b>	4218.36	5137.82	7048.35	9553.91	11692.18	13748.78
<b>Total Export</b>	2202.44	2694.79	3628.79	4910.33	6264.81	7567.41
<b>Total Import</b>	2015.92	2443.03	3419.56	4643.58	5427.37	6181.37
<b>Balance</b>	186.52	251.76	209.23	266.75	837.44	1386.04
<b>Total Import Export Value (Billion USD)</b>	509.65	620.77	850.99	1154.55	1421.91	1760.69

Note: Data 2006 is calculated on *China Statistical Bulletin 2006*.

Source: 1. *China Statistical Yearbook 2006*, NBSC

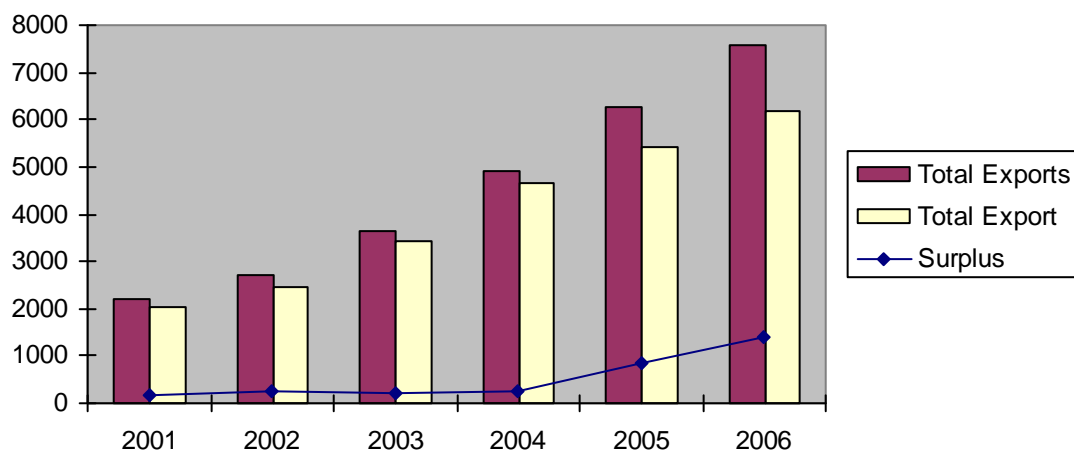
2. *China Statistical Bulletin of National Economy and Social Development 2006*, NBSC,

In the case of export, in 2006, the highlight was the share of “machineries and electrical equipments” and “high and new technology products” climbed fast in the total export. The export value of these two goods amounted to 549.44 billion US dollars and 281.49 billion US dollars, up 28.8 percent and 29 percent respectively. Furthermore, the export value of traditional bulk commodity went up continually. Textiles and garments were exported 48.8 billion US Dollars and 95.19 billion US Dollars at a growth rate of 18.7 percent and 28.9 percent respectively.

In respect of import, primary products were imported 187.14 billion US dollars in 2006, increased by 26.7%. Thereinto the import value of iron ores, crude oil, and product oil showed a rapid increase at the rate of 18.6 percent, 14.5 percent, and 15.7 percent respectively. Moreover, the import value of “machineries and electrical equipments” and “high and new technology products” kept high as usual with a speed of 22.1 percent and 25.1 percent.

**Figure 1: Trend of Foreign Trade Surplus**

Unit: Billion Yuan



Source:

1. *China Statistics Yearbook*, NBSC, 2006;
2. *China Statistical Bulletin of National Economy and Social Development 2006*, NBSC, 2007

The general trade increased fast in 2006 while the improvement trade grew slowly. The total export import volume of general trade was 749.5 billion US dollars at a rate of 26 percent, which increased 5.1 percent than that of last year. The total volume of foreign improvement trade reached 831.88 billion US dollars with a speed of 20.5 percent; the amplitude decreased 5.1 percent than previous year. The total export import volume of civil private enterprises in China got to 307.66 billion US dollars, which accounted for 17.5 percent in the total foreign trade. The export value of civil private enterprises exceeded that of state-owned enterprises for the first time.

The leading trade companions of China in 2006 were as follow: the United States, European Union, Hongkong, Japan, ASEAN, Korea, Taiwan, and Russia. Of the top three companions, the amounts China exported to were much larger than imported from these countries or region, and the share of exports to the three companions occupied 21.0 percent, 18.8 percent, 16.0 percent of the total respectively.

**Table 4: Import and Export by Trading Mode and Type of Enterprises**

(Unit: Billion USD)

Item	Export			Import		
	2005	2006	Increase over 2005 (%)	2005	2006	Increase over 2005 (%)
<b>Total Import and Export</b>	762.00	969.08	27.2	660.12	791.61	20.0
<b>By Trade Mode:</b>						
<b>General Trade</b>	315.09	416.32	32.1	279.72	333.18	19.1
<b>Improvement Trade</b>	416.48	510.38	22.5	274.03	321.50	17.3
<b>Other</b>	30.43	42.38	39.2	106.37	136.94	28.7
<b>By Nature of Enterprises:</b>						
<b>Government Facilities</b>	168.81	191.35	13.4	197.20	225.24	14.2
<b>Foreign Investment Firm</b>	444.21	563.83	26.9	387.51	472.62	22.0
<b>Civil Private Enterprises</b>	148.98	213.90	43.6	75.41	93.76	24.3

Source: *The Situation of Foreign Trade in China 2005, 2006*; Ministry of Commerce of China

## B. Current Account Balance

In 2006 the balance of payment of China continued the trend of “both surplus”. The current account surplus was 249.9 billion US dollars, increased by 55%. Of which, the surplus of merchandise trade was 217.7 US dollars, up 62%; the deficit of service trade was 8.8 billion US dollars, down 6%; profit surplus was 11.8 billion US dollars, went up 11%; current transfer surplus was 29.2 billion US dollars, jumped by 15%. The surplus of capital and finance account was 10 billion US dollars, decreased by 84%. Thereinto, the favorable balance of direct investment was 60.3 billion yuan, down 11%; the deficit of portfolio investment was 67.6 billion US dollars, up 12.7 times; other investment surplus was 13.3 billion US dollars. In the end of 2006, foreign exchange reserve reached to 1066.3 billion US dollars, increasing 247.5 billion US dollars.

There are five outstanding features of international payment in 2006. Firstly, the favorable balance of current account keeps on rising sharply, while the surplus of capital and finance account slows down the speed with only 10 billion US dollars, which was the bottom in the past five years. Secondly, the active balance of merchandise trade sets up a new record. In 2006 the export and import of merchandises was 969.7 billion US dollars and 751.9 billion US dollars respectively, causing a surplus of 217.7 billion US dollars and a growth rate of 62%. Thirdly, the inward FDI maintains the high level. In 2006, the net inflow of FDI was 78.1 billion US dollars, ranking Number one in the developing countries and Number 4 in the world. Fourthly, the outward investment rises fast. The net outward investment got to 17.8 billion US dollars, increased by 58%. Lastly, the financing and investment in foreign securities shows a rapid growth. The net outflow of investment in securities was 110.4 billion US dollars in the whole year, up 3.2 times.

**Table 5: Balance of Payments 2006**

(Unit: Thousand USD)

Item	Balance	Credit	Debit
<b>I. Current account</b>	249,865,995	1,144,498,935	894,632,940
<b>A. Goods and services</b>	208,912,147	1,061,681,544	852,769,397
<b>a. Goods</b>	217,746,060	969,682,307	751,936,247
<b>b. Services</b>	-8,833,913	91,999,237	100,833,150
<b>1. Transportation</b>	-13,353,741	21,015,285	34,369,026
<b>2. Travel</b>	9,627,296	33,949,000	24,321,704
<b>3. Communication services</b>	-26,202	737,871	764,073
<b>4. Construction services</b>	702,918	2,752,639	2,049,721
<b>5. Insurance services</b>	-8,282,919	548,176	8,831,094
<b>6. Financial services</b>	-746,042	145,425	891,467
<b>7. Computer and information services</b>	1,218,860	2,957,711	1,738,851
<b>8. Royalties and licensing fees</b>	-6,429,577	204,504	6,634,081
<b>9. Consulting services</b>	-555,066	7,834,142	8,389,208
<b>10. Advertising and public opinion polling</b>	490,073	1,445,032	954,960
<b>11. Audio-visual and related services</b>	15,954	137,433	121,480
<b>12. Other business services</b>	8,432,227	19,693,334	11,261,106
<b>13. Government services, n.i.e.</b>	72,306	578,685	506,379
<b>B. Income</b>	11,754,607	51,239,761	39,485,153
<b>1. Compensation of employees</b>	1,989,500	4,319,493	2,329,993
<b>2. Investment income</b>	9,765,108	46,920,268	37,155,160
<b>C. Current transfers</b>	29,199,241	31,577,630	2,378,390
<b>1. General government</b>	-146,541	64,714	211,255
<b>2. Other sectors</b>	29,345,782	31,512,916	2,167,135
<b>II. Capital and financial account</b>	10,036,765	653,276,252	643,239,487
<b>A. Capital account</b>	4,020,115	4,102,477	82,362
<b>B. Financial account</b>	6,016,650	649,173,775	643,157,125
<b>1. Direct investment</b>	60,265,011	87,285,179	27,020,168
<b>1.1 Abroad</b>	-17,829,655	717,771	18,547,426
<b>1.2 In China</b>	78,094,666	86,567,408	8,472,742
<b>2. Portfolio investment</b>	-67,557,571	45,601,579	113,159,150
<b>2.1 Assets</b>	-110,418,771	2,740,379	113,159,150
<b>2.1.1 Equity securities</b>	-1,454,000	224,000	1,678,000
<b>2.1.2 Debt securities</b>	-108,964,771	2,516,379	111,481,150

<b>2.2 Liabilities</b>	42,861,200	42,861,200	0
<b>2.2.1 Equity securities</b>	42,861,200	42,861,200	0
<b>2.2.2 Debt securities</b>	0	0	0
<b>3. Other investment</b>	13,309,210	516,287,017	502,977,807
<b>3.1 Assets</b>	-31,808,716	15,755,781	47,564,497
<b>3.2 Liabilities</b>	45,117,926	500,531,236	455,413,310
<b>III. Reserve assets</b>	-247,025,415	446,585	247,472,000
<b>3.1 Monetary gold</b>	0	0	0
<b>3.2 Special drawing rights</b>	135,744	135,744	0
<b>3.3 Reserve position in the Fund</b>	310,841	310,841	0
<b>3.4 Foreign exchange</b>	-247,472,000	0	247,472,000
<b>3.5 Other claims</b>	0	0	0
<b>IV. Net errors and omissions</b>	-12,877,344	0	12,877,344

Note: FDI to or out China include FDI from or to Hongkong, Macao and Taiwan.

Source: State Administration of Foreign Exchange

### C. Exchange Rate and Exchange System

The development of exchange rate system in China can be split into two stages in terms of the nature of exchange rate mechanism. Before 1994, the determination of foreign exchange rate had been strictly managed and controlled by the central bank. Especially before 1980, the fixed exchange rate system made RBM overrated seriously. Foreign exchange transaction was solely dominated by the People's Bank of China (PBC), and enterprises are not allowed to reserve their foreign currency. From 1981 to 1993, a two-tier exchange rate system was introduced as a transition policy from planning economy to market economy. In this period, official exchange rate coexisted with interior settlement exchange quotation for trade (1981 to 1984) or adjustment exchange quotation (1985-1993). Firms could keep part of their foreign currency revenue for future foreign trade and financial institutions other than PBC were permitted to enter the foreign exchange business. Official exchange rate gradually increased from 1.5 yuan/\$ in 1981 to 5.72 yuan/\$ at the end of 1993, while adjustment exchange quotation climbed from 2.8 yuan/\$ to 8.72 yuan/\$ at the mean time. Although the foreign exchange adjustment market played active role in promoting foreign trade and in balancing the foreign exchange budgets for foreign investment enterprises, the two-tier exchange rate system brought chaos to foreign exchange market and gave incentive to speculation. In addition, the black market of foreign currency went against the stability of exchange rate of RMB, which called for reform on the foreign exchange rate system.

On January 1, 1994, a market-oriented reform started. Official exchange rate and adjustment exchange quotation emerged into a single exchange rate (8.70 yuan/\$) according to the <Notice of the Further Reform on the Exchange Management System> by the State Council; the managed floating exchange rate system based on the market supply and demand has been set up formally. Enterprises and individuals buy/sell foreign currency from/to banks in accordance with relative regulations, and the market exchange rate is determined by the inter-bank exchange transaction. At the same time, the central bank takes the responsibility to shape the floating band of foreign exchange rate and try to secure the stability of exchange rate through regulation and control on exchange market. After the reform, exchange rate of RMB appreciated steadily to 8.31 yuan/\$ in 1996 and RMB became freely convertible under the current account. In order to cope with the Asian Financial Crisis, the PBC narrowed the floating band of RMB within 120 basic points, and the exchange rate of RMB was regarded as de facto peg on US dollar by some international organizations at around 8.27 yuan/\$ for several years. Along with the change of economic situation, a new turn of reform on exchange rate mechanism was launched by the State Council. On July 21, 2005, RMB was revalued by 2.1% against the U.S. dollar and reached to 8.11 yuan/\$. Simultaneously, Chinese government announced that RMB would be allowed to fluctuate against a basket of currencies comprised of the dollar, the euro, the yen and the Korean won, taking into account such factors as trade, capital transactions (external claims and debts) and FDI. The authority has also adopted a narrow band of 0.3% (or 3%) on either side of the central rate within which RMB can fluctuate against the dollar (or other currencies).

In 2006, fluctuation of RMB against US dollar had been amplified, and yuan to dollar was revalued as a whole. From 2005 to the end of 2006, RMB was totally revaluated by 6% to 7.8087 yuan/\$, and this



upward trend went on to 2007. Meanwhile, RBM to Hongkong dollar and Japanese yen were also appreciated slightly, whereas it was depreciated a little against Euro and Sterling.

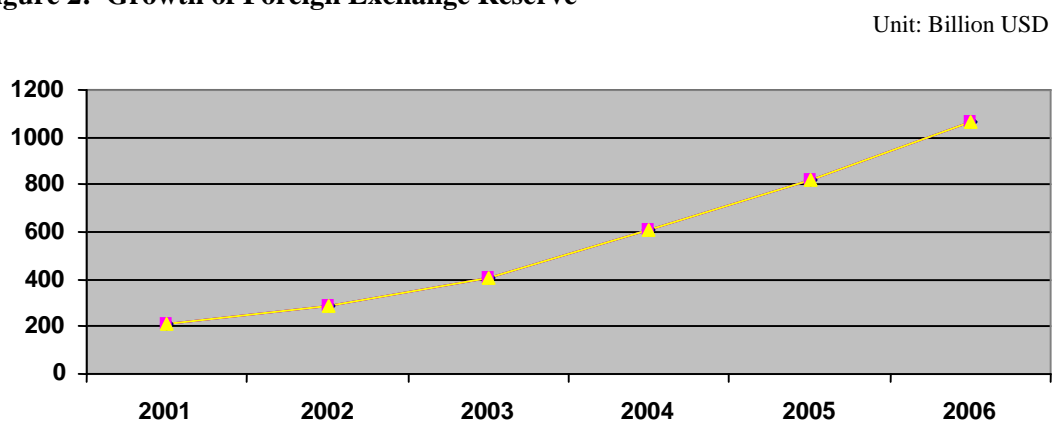
**Table 6: Average Exchange Rate of RMB Yuan To Selected Currencies**

Year	(Middle Rate)			
	100 US Dollars	100 Japanese Yen	100 Hong Kong Dollars	100 Euros
1985	293.6600	1.2457	37.57	
1994	861.8700	8.4370	111.53	
1995	835.1000	8.9225	107.96	
1996	831.4200	7.6352	107.51	
1997	828.9800	6.8600	107.09	
1998	827.9100	6.3488	106.88	
1999	827.8300	7.2932	106.66	
2000	827.8400	7.6864	106.18	
2001	827.7000	6.8075	106.08	
2002	827.7000	6.6237	106.07	800.58
2003	827.7000	7.1466	106.24	936.13
2004	827.6800	7.6552	106.23	1029.00
2005	819.1700	7.4484	105.30	1019.53
2006	780.8700	6.5630	100.47	1026.65

Source: 1. *China Statistical Yearbook 2006*, National Bureau of Statistics of China;  
 2. *The Report of Balance of Payments in China 2006*, State Administration of Foreign Exchange.

With the rapid growth of foreign trade, the foreign exchange reserve of China has experienced a rapid increase. It jumped from 212.16 billion US dollars in 2001 to 1066.34 billion US dollars in 2006, increased by five times (See Table 2). This figure exceeded that of Japan and ranked Number one in the world for the first time.

**Figure 2: Growth of Foreign Exchange Reserve**



Source:  
 1. *China Statistical Bulletin of National Economy and Social Development 2006*, NBSC, 2007  
 2. State Administration of Foreign Exchange, <http://www.safe.gov.cn>

#### D. Foreign Direct Investment

According to the balance of payment statistics, in 2006 FDI inflow to China was 86.6 billion US dollars, up percent than last year. FDI outflow from China because of liquidation or withdraw was 8.5 billion US dollars, growing 33 percent. At a result the net inflow of FDI was 78.1 billion US dollars, decreased by 1 percent. Of which, the share of manufacture industry, real estate industry, financial industry, leasing and business industry, transportation, storage and post service industries was 57.7 percent, 11.8 percent, 9.7 percent, 6.1 percent and 2.9 percent respectively.

Foreign investors had adjusted their investment strategies to a certain degree. In 2006, the agriculture sector only absorbed 0.6 billion US dollars of FDI, down 17 percent. 40.1 billion US dollars went to manufacture sector, decreased by 6 percent. Non-financial service trade got 14.7 billion US dollars, up 26 percent. 6.4 billion US dollars flowed to financial service sector, down 47 percent. In respective of non-financial service sector, real estate industries had attracted 8.2 billion US dollars, improved by 52 percent, which promoted the house price to climb up continually.

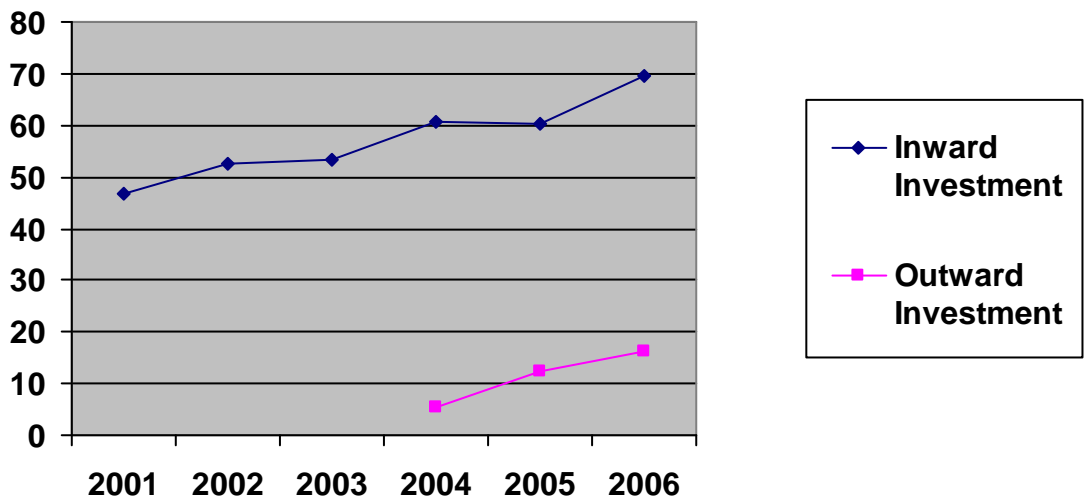
The regional distribution of FDI kept stable basically. The east of China remained to concentrate most of FDI. The inflow amount of FDI to Jiangsu, Guangdong, Shanghai, Zhejiang, and Beijing nearly accounted for 70 percent of the total.

According to the practical investment amount, in 2006, the top ten countries invested to China was followed as Hongkong, Virgin Islands, Japan, Korea, The United States, Singapore, Taiwan, Cayman Islands, Germany, and Samoa. The amount invested by them to outside of banks, insurance companies, and securities occupied 84 percent of the total.

At the same time, the outward investment grew fast. In 2006, the outflow of investment reached 18.5 billion US dollars, up 56 percent. The remittance to China, on account of withdraw or liquidation, was 0.7 billion US dollars, increasing 27 percent. Totally, the net outflow jumped to 17.8 billion US dollars, up 58 percent. However, there is still a large gap between inbound and outbound investments.

**Figure 3: Trend of Inward and Outward Investments**

Unit: Billion USD



Note:

1. Data of this chart is from Table 2.
2. Data of outward investment before 2004 are unavailable.

Sources:

1. China Statistical Yearbook, NBSC, 2006;
2. China Statistical Bulletin of National Economy and Social Development 2006, NBSC, 2007

### **E. Borrowing From Aboard**

By the end of 2006, the balance of foreign debt was 322.988 billion US dollars in China (excluding Hongkong, Macao, and Taiwan), improving 41.943 billion US dollars than the last year, up 14.92 percent. Of which, registered foreign debts and trade credits were 218.988 billion US dollars and 104.00 billion US dollars respectively.

In 2006, 26.033 billion US dollars of mid and long-term foreign debts had been borrowed, increased by 5.53 percent. The refunded capitals of mid and long-term foreign debts were 17.899 billion US dollars; the payment of interests reached to 3.105 billion US dollars.

Domestic and foreign financial institutions and foreign investment enterprises speeded up their pace to borrow new debts. The increment of which was 9.287 billion US dollars, 8.825 billion US dollars and 10.329 billion US dollars, up 15.21 percent, 21.63 percent, and 20.45 percent respectively.

International commercial loans conquered most of the foreign debts. In the end of 2006, the balance of which was 163.511 billion US dollars, occupied 74.67 percent of the total balance of registered foreign debts. Foreign government loans and international financial institution loans shared the other part of the total balance, which was 25.33 percent.

US dollars took over the dominant position in the structure of foreign debts. Among the registered foreign debts till the end of 2006, debts in US dollars accounted for 69.71 percent. It was followed by Japanese yen, which occupied 10.86 percent. The third one was Euro with the share of 7.30 percent.

Mid and long-term loans have been invested in infrastructural construction, manufacture, storage, and post service. Within the balance of registered mid and long-term debts in US dollars, 14.04 percent was invested to utilities, while manufacture, information services, real estate occupied 13.07 percent, 8.33 percent, and 6.81 percent respectively.

**Table 7: Major Indicators of Foreign Debts**

Item	2001	2002	2003	2004	2005	2006
<b>Total Foreign Debts (Billion USD)</b>	170.11	171.36	193.63	228.60	281.05	322.99
<b>Balance of Long-term Debts</b>	119.53	115.56	116.59	124.29	124.90	139.36
Share in the Total, (%)	(70.3)	(67.4)	(60.2)	(54.4)	(44.4)	(43.2)
<b>Balance of Short-term Debts</b>	50.58	55.80	77.04	104.31	156.14	183.63
Share in the Total, (%)	(29.7)	(32.6)	(39.8)	(45.6)	(55.6)	(56.8)
<b>Registered Debts of New Borrowing (Billion USD)</b>	25.16	60.87	101.54	205.97	281.05	26.03*
<b>Registered Debts of Principals and Interests Service</b>	31.28	69.67	98.13	190.24	271.59	21.00*
<b>Net Flows of New Debts</b>	-6.12	-8.80	3.42	15.73	9.46	5.03*
<b>Ratio of Debt Service to Exchange Earning (%)</b>	7.5	7.9	6.9	3.2	3.1	2.1
<b>Ratio of Debt Balance to Exchange Earning (%)</b>	56.8	46.1	39.9	34.9	33.6	30.4
<b>Ratio of Debt Balance to GDP (%)</b>	14.7	13.6	13.7	13.9	12.6	12.3

Note: Data with "\*" are increment of foreign debts, debt services, and net flows respectively in 2006.

Source:

1. *China Statistical Yearbook 2006*, National Bureau of Statistics of China
2. *Report of Balance of Payment in China 2005, 2006*; State Administration of Foreign Exchange

## II.1.2 Domestic Environment

Series of policies had been released by Chinese Government to enlarge domestic demand in 2006. Supported by adjusting economic structures, transiting economic growth mode, and increasing the quality of FDI usage, the national economy kept on rising steadily.

In the end of 2006, GDP got to 20.9 trillion yuan, increased by 10.7 percent. However, the imbalance of industrial structure has been increased to some extent. During this year, the growth rate of secondary industry had been improved by 12.5 percent, which exceeded that of primary industry and tertiary industry by 7.5 percent and 2.2 percent.

Investment in fixed assets as a whole had been increased by 24.5 percent, less 2 percent than the last year. Of which, the fixed capital investments to primary industry, secondary industry and tertiary industry had been improved by 30.7 percent, 25.9 percent, and 23.3 percent respectively.

The income of households and domestic expenditure rose fast. The per capita annual disposable income of urban households had been raised by 12.1 percent, while per capita annual net income of rural households gained the speed of 10.2 percent. The total revenue of retail sales of consumer goods in 2006 ascended by 3.7 percent, with the growth rate up by 0.8 percent.

The supply of credits and asset prices climbed rapidly. By the end of 2006, the supply of broad money (M2) and narrow money (M1) increased by 16.9 percent and 17.5 percent respectively. The increment of RMB saving reached to 2.1 trillion yuan, which decreased by 100 billion yuan.

### A. Economic Growth Rate

In 2006, the GDP of China reached to 21087.1 billion yuan, up by 11.1 percent compared with the previous year. The increment of the primary industry was 2470.0 billion yuan, up by 5.0 percent. The added value of the secondary and tertiary industry was 10200.4 billion yuan and 8270.3 billion yuan, up by 12.5 percent and 10.3 percent respectively. The GDP kept on rising at a rate of 11.1 percent in 2006 which was the fourth year with the GDP growth rate exceeding 10 percent with an accelerating growth tendency.

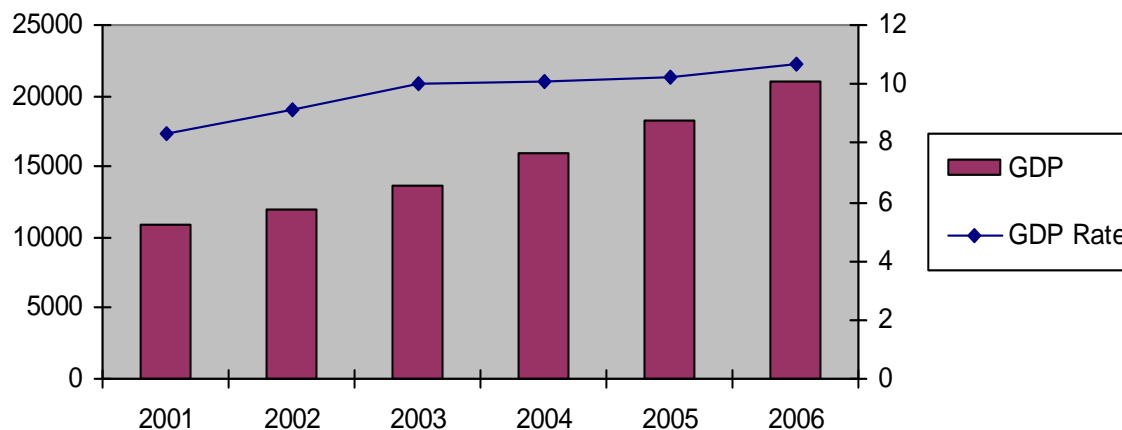
**Table 8: Main Indicators of GDP**

Item	2001	2002	2003	2004	2005	2006
<b>GDP (Billion Yuan)</b>	10965.5	12033.3	13582.3	15987.8	18386.8	21087.1
<b>Primary Industry</b>	1551.6	1623.9	1706.8	2095.6	2307.0	2473.7
<b>Secondary Industry</b>	4951.2	5389.7	6243.6	7390.4	8704.7	10316.2
<b>Industry</b>	4358.1	4743.1	5494.6	6521.0	7691.3	9131.1
<b>Construction</b>	593.2	646.6	749.1	869.4	1013.4	1185.1
<b>Tertiary Industry</b>	4462.7	5019.7	5631.8	6501.8	7296.8	8297.2
<b>Transport, Storage and Post</b>	840.6	939.3	1009.8	1214.8	1052.6	1203.2
<b>Wholesale and Retail Trades</b>	1078.7	1195.1	1348.0	1525.0	1353.5	1515.8
<b>GDP per capita (Yuan)</b>	8622.0	9398.0	10542.0	12336.0	14040.0	16084.0
<b>GDP Growth Rate (%)</b>	8.3	9.1	10.0	10.1	10.4	11.1

Note: Data in this table are calculated at current prices.

Source: *China Statistical Yearbook 2007*, National Bureau of Statistics of China

**Figure 4: GDP (Billion Yuan) and GDP Rate (%) between 2001 and 2006**



Source: *China Statistical Yearbook 2007*, NBSC

The increments of three industries accounted for 11.8 percent, 48.7 percent, and 39.5 percent of the GDP respectively in 2006. Of which the share of primary industry rose by 4.5 percent, which was much faster comparing with the others over the previous year. It might be the fruit of abolishment of Agriculture Tax in this year.

**Table 9: The Share of Increment of Three Industries in GDP**

				Unit: %
Year	Primary Industry	Secondary Industry	Tertiary Industry	Gross Domestic Product
2001	5.0	46.7	48.3	100.0
2002	4.5	49.8	45.7	100.0
2003	3.3	58.5	38.2	100.0
2004	7.7	52.2	40.1	100.0
2005	6.3	54.7	39.0	100.0
2006	11.8	48.7	39.5	100.0

Note: Data in this table are calculated at current prices.

Source:

1. China Statistical Yearbook 2006, NBSC
2. China Statistical Bulletin of National Economy and Social Development 2006, NBSC, 2007

## B. Inflation Rate

The general level of prices in 2006 showed an ascending trend. The consumer price, ranking Number 182 in the world, only increased 1.5 percent over the previous year, of which, service prices up 1.8 percent. Besides, commodity retail prices and factory prices of industry goods respectively improved by 1.0 percent and 3.0 percent. The purchase prices of raw materials, fuels and power climbed by 6.0 percent. The price of fixed capital investment went up by 1.5 percent. The production price of agriculture products grew by 1.2 percent. The sales price of houses in 70 medium and large cities bounced by 5.5 percent.

Among factors affecting CPI, five of them namely food, alcohol and cigarettes, household facilities and services, medical care and personal articles, and housing increased by 2.3 percent, 0.6 percent, 1.2 percent, 1.1 percent, and 4.6 percent respectively. On the contrary, the price of other three commodities including clothes, transportation and telecommunication, supplies and services for recreation, education and culture decreased by 0.6 percent, 0.1 percent, and 0.5 percent. The rising of prices of housing and food contributed most to the climbing of CPI.

**Table 10: Price Indices**

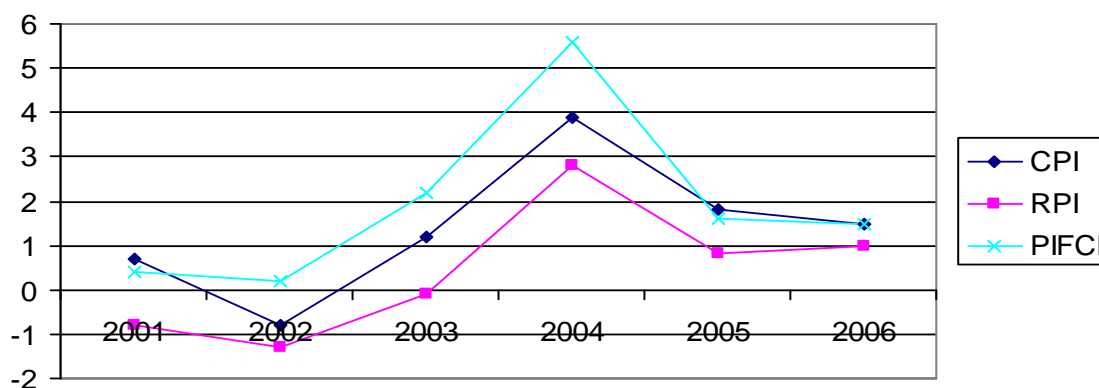
Year	Consumer Price Index			Retail Price Index	Factory Price Index of Industry Goods	Purchase Price Index of Raw Materials, Fuels and Power	Price Index of Fixed Capital Investment
	Total	Urban Habitants	Rural Habitants				
2001	100.7	100.7	100.8	99.2	98.7	99.8	100.4
2002	99.2	99.0	99.6	98.7	97.8	97.7	100.2
2003	101.2	100.9	101.6	99.9	102.3	104.8	102.2
2004	103.9	103.3	104.8	102.8	106.1	111.4	105.6
2005	101.8	101.6	102.2	100.8	104.9	108.3	101.6
2006	101.5	101.5	101.5	101.0	103.0	106.0	101.5

Note: Indices of preceding year are presumed to be 100.

Source:

3. China Statistical Yearbook 2006, China Statistics Press, 2006
4. China Statistical Bulletin of National Economy and Social Development 2006, NBSC, 2007

**Figure 5: The Trend of Selected Price Indices**



Note:

1. CPI, RPI, and PIFCI in this figure refer to Consumer Price Index, Retail Price Index and Price Index of Fixed Capital Investment respectively.
2. For drawing convenience, Indices in this figure have been reduced by 100.

Source:

1. *China Statistical Yearbook 2006*, National Bureau of Statistics of China
2. *China Statistical Bulletin of National Economy and Social Development 2006*, NBSC, 2007

### C. Consumption

The absolute value of household consumption and government consumption grew steadily over the previous years. In 2006, the growth rate of household consumption and government consumption against the preceding year was 13.0 percent and 16.5 percent. However, the shares of household consumption and government consumption in the final consumption demonstrated a reverse trend except in 2003. The former declined from 73.6 percent in 2001 to 72.6 percent in 2006 down by 1 percent, while the latter increased from 26.4 percent to 27.4 percent up by 1 percent; as a result the ratio of household consumption to government consumption stated a downward tendency. At the same time, urban households always consumed two times more than rural households and this gap had been enlarging from 2.15 times in 2001 to 2.79 times in 2006.

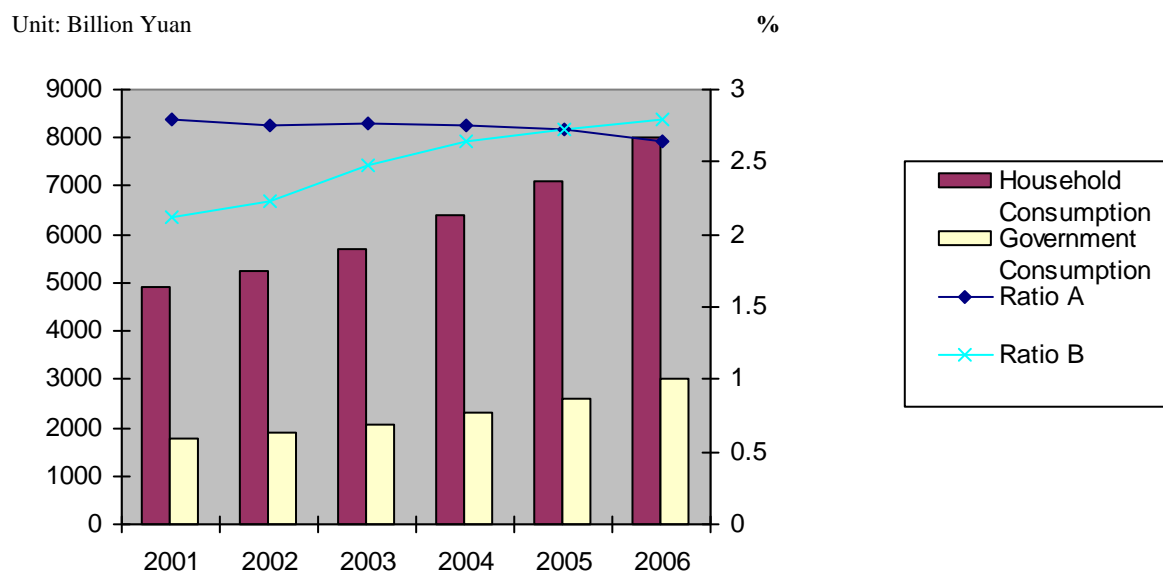
**Table 11: Final Consumption and Structure**

Year	Household Consumption (Billion Yuan)			Government Consumption (Billion Yuan)	Structure of Final Consumption (%)		Structure of Household Consumption (%)	
	Total	Rural	Urban		Household	Government	Rural	Urban
2001	4921.32	1579.10	3342.22	1766.51	73.6	26.4	32.1	67.9
2002	5257.13	1627.17	3629.96	1911.99	73.3	26.7	31.0	69.0
2003	5683.44	1630.57	4052.87	2061.51	73.4	26.6	28.7	71.3
2004	6383.35	1755.06	4628.29	2319.94	73.3	26.7	27.5	72.5
2005	7090.60	1901.41	5189.19	2601.21	73.2	26.8	26.8	73.2
2006	8012.05	2111.49	5900.56	3029.27	72.6	27.4	26.4	73.6

Note: Data in the table are calculated at current price.

Source: *China Statistical Yearbook 2007*, NBSC

**Figure 6: Structure of Final Consumption**



Note: 1. Ratio A is the share household consumption to government consumption.

2. Ratio B is the share of urban consumption to rural consumption.

Source: *China Statistical Yearbook 2007*, NBSC

#### D. Investment (Total Capital Formation)

In the past several years investment made greater contribution to GDP growth than consumption and export and conferred prominent draw to GDP. In 2006 the contribution of consumption, investment and export to GDP growth was 39.2 percent, 41.3 percent and 19.5 percent respectively with obvious fluctuation over the last year.

**Table 12: Contribution of Consumption, Investment and Export to GDP Growth**

Year	Consumption		Investment		Export	
	Rate of Contribution (%)	Draw (Percentage Points)	Rate of Contribution (%)	Draw (Percentage Points)	Rate of Contribution (%)	Draw (Percentage Points)
2001	50.0	4.1	50.1	4.2	-0.1	
2002	43.6	4.0	48.8	4.4	7.6	0.7
2003	35.3	3.5	63.7	6.4	1.0	0.1
2004	38.7	3.9	55.3	5.6	6.1	0.6
2005	36.1	3.7	38.1	3.9	25.8	2.6
2006	39.2	4.3	41.3	4.6	19.5	2.2

Note:

1. The rate of contribution refers to the ratio of increment of consumption, investment and export against the increment of GDP respectively.
2. Draw means the arithmetic product of GDP growth rate and three rates of contribution.

Source: *China Statistical Yearbook 2007*, China Statistics Press, 2007

Of the total capital formation, the share of fixed capital formation always occupied the dominant position of more than 94 percent. The amount of fixed capital formation kept climbing steadily while that of increase in stock appeared unstably with a visible fluctuation.

**Table 13: The Amount and Structure of Total Capital Formation in 2001-2006**

Year	Total Capital Formation		Structure of Total Capital Formation			
	Amount (Billion Yuan)	Weight in GDP (%)	Fixed Capital Formation		Increase In Stock	
			Amount (Billion Yuan)	Weight in the Total (%)	Amount (Billion Yuan)	Weight in the Total (%)
2001	3976.94	36.27	3775.45	94.9	201.49	5.1
2002	4556.50	37.87	4363.21	95.8	193.29	4.2
2003	5596.30	41.20	5349.07	95.6	247.23	4.4
2004	6916.84	43.26	6511.77	94.1	405.07	5.9
2005	7955.98	43.46	7746.44	97.4	209.54	2.6
2006	9410.32	44.63	9015.08	95.8	395.24	4.2

Source: *China Statistical Yearbook 2007*, China Statistics Press, 2007

### E. Stock Market

The first stock exchange of China was founded in Shenzhen in 1990. Up to now two stock exchanges have been set up: one is Shenzhen Stock Exchange, the other is Shanghai Stock Exchange. The stock market in China experienced a flexuose development with inflation and depression in turn. Now it is in an extremely booming period in the history.

In 2006, 559.4 billion yuan were raised from stock market, increased 371.1 billion yuan or up 197.09 percent over the last year. Of which, 130 kinds of newly issued A shares (including reissued shares and convertible debts) raised 246.4 billion yuan with the increment of 212.5 billion yuan, grown by more than 6 times; newly issued 34 pieces of H shares brought 313.1 billion yuan, which was 158.6 billion yuan more or 102.65 percent up than the previous year. And from 2005, the issue of Band H shares has exceeded A Shares. By the end of 2006, the quantities of listed companies (A shares and H shares) in China have reached to 1434 with the total market value of 8940.4 billion yuan, up 175.7 percent over the last year.

**Table 14: The Overview of Stock Market in China**

Year	Newly Issued Stocks (Billion Yuan)			Quantities of Listed Companies	Total Market Value of Stocks (Billion Yuan)
	Total	A Shares	B and H Shares		
2001	116.8	109.8	7.0	1160	4352.2
2002	96.2	78.0	18.2	1224	3832.9
2003	135.8	82.0	53.7	1287	4257.8
2004	151.1	83.6	67.5	1377	3705.6
2005	188.3	33.8	154.5	1381	3243.0
2006	559.4	246.3	313.1	1434	8940.4

Note:

1. A shares are stocks issued in mainland China and transacted in RMB only.
2. B shares are stocks issued in mainland China but transacted in foreign currencies.
3. H shares are stocks issued outside China by Chinese companies and transacted in foreign currencies.

Sources: *China Statistical Bulletin of National Economy and Social Development 2001-2006*, NBSC

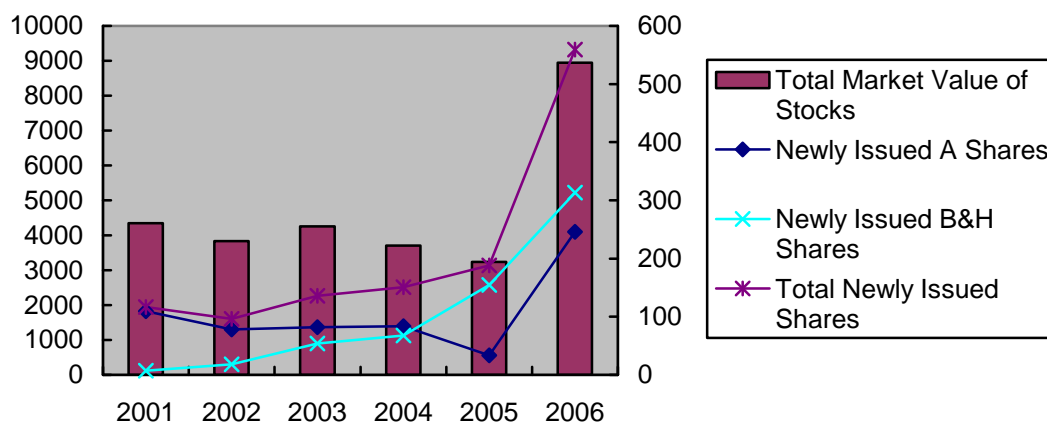


**Figure 7: Changes of Stock Market**

Unit: Billion Yuan

Total Market Value of Stocks

Newly Issued Shares



Source: *China Statistical Bulletin of National Economy and Social Development 2001-2006*, NBSC

The newly issued corporate bonds in 2006 got to 101.5 billion yuan, increasing 36.1 billion yuan. 294.3 billion yuan financed through short-run bonds, growing 155.1 billion yuan than the previous year. The income of insurance premium was 564.1 billion yuan, up 14.4 percent; while all types of indemnities amounted to 143.9 billion yuan.

## F. Money Supply

Compared with last year, by the end of 2006, the balance of broad money supply ( $M_2$ ) was 34.6 trillion yuan, increased by 16.9 percent; the balance of narrow money supply was 12.6 trillion yuan, up 17.5 percent; the balance of cash in circulation amounted to 2.7 trillion yuan, up 12.7 percent.

The total balance of savings in financial institutions reached to 34.8 trillion yuan, up by 16.0 percent; the total balance of loan added up to 23.9 trillion yuan, increased by 14.7 percent. Of which, the financial cooperative institutions in the country (including credit cooperatives, cooperative banks, and commercial banks) possessed 2.6 trillion yuan of balance of loans, adding to 427.7 billion yuan. The total balance of consumption loans from financial institutions as a whole reached to 2.4 trillion yuan, increasing 206.8 billion yuan, thereinto, the balance of loans to individual housing amounted to 1.99 trillion yuan, growing 143.9 billion yuan.

**Table 15: Total Savings and Loans of Financial Institutions and Growth Rates In 2006**

Item	Total Amount (Billion Yuan)	Growth Rate Over Previous Year (%)
<b>Balance of Savings</b>	34806.5	16.0
Enterprise Savings	11888.1	16.8
Household Savings	16661.7	13.3
RMB Savings	16158.7	14.6
<b>Balance of Loans</b>	23851.9	14.7
Short-term Loans	10176.2	10.9
Mid and long-term Loans	11317.3	21.3

Source: *China Statistical Bulletin of National Economy and Social Development 2001-2006*, NBSC

## G. Employment

Over the past five years, the total employed persons went up steadily from 737.4 million in 2002 to 764.0 million in 2006, increasing 26.6 million. Of which the employed persons in urban areas grew from 247.8 million to 283.1 million, while that in rural areas decreased from 489.6 million to 480.9 million. It means large population in rural areas has been shifted to cities.

At the mean time, the structure of employment has been improved further. On the one hand, in 2006, persons working in primary industry were 325.61 million, decreasing 43.09 million than in 2002, down 11.7 percent. On the other hand, persons employed by secondary industry reached to 192.25 million, adding 34.45 million and up 21.8 percent. Besides, people working in tertiary industry got to 246.14 million with a growth rate of 16.7 percent and an increment of 35.24 million over the past five years. Manufacturing becomes the leading industry to absorb new workers, which followed by sales industry, hotel and restaurant service, etc. Nonpublic economy employing more persons than state-owned and collective units contributes to another hallmark of employment situation in China.

Unemployment rate has been kept under control effectively. The registered unemployment rate remained at a low level of 4.0 percent to 4.3 percent during 2002 to 2006 with a slight increase.

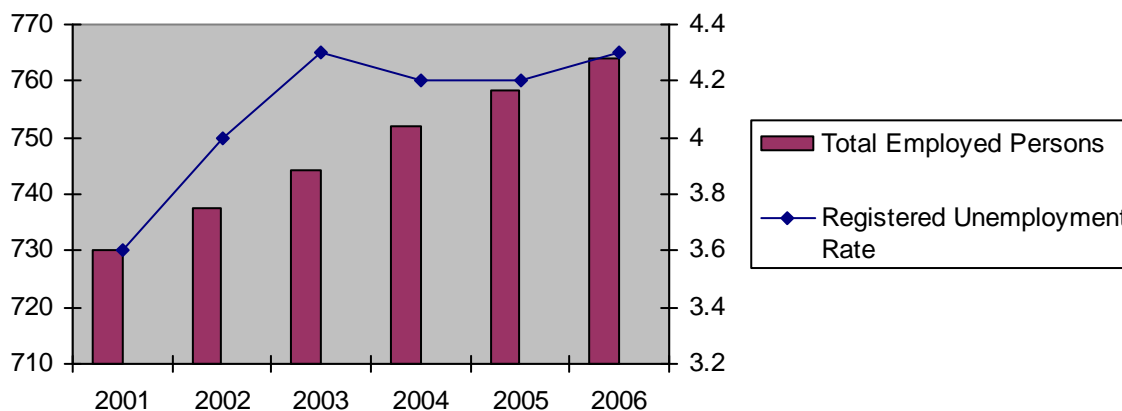
**Table 16: Total Employed Persons and Registered Unemployment Rate in Urban Areas**

Item	2001	2002	2003	2004	2005	2006
Total Employed Persons (Billion)	730.25	737.40	744.32	752.00	758.25	764.00
Registered Unemployment Rate (%)	3.60	4.00	4.30	4.20	4.20	4.30

Source:

1. *China Statistical Yearbook 2006*, China Statistics Press, 2007
2. *Series Report on Development Review 3: Employment Scale Is Enlarged Steadily*, NBSC, 2007

**Figure 8: Trend of Total Employed Persons (Million) and Registered Unemployment Rate (%) in Urban Areas**



Source:

3. *China Statistical Yearbook 2006*, China Statistics Press, 2007
4. *Series of Reports on Development Review 3: Employment Scale Is Enlarged Steadily*, NBSC, 2007

## II. 2 Fiscal Position

Since 2001 the government revenue has experienced a high increase from 1638.6 billion yuan to 3876.02 billion yuan in 2006, increased by nearly 2.4 times with an annual growth rate over 14 percent. The increase rate of government expenditure appeared a slow trend compared with that of government revenue. The balance (gap) of government revenue and expenditure had been controlled almost between 200 billion yuan to 300 billion yuan, which took less than 3 percent of GDP. It means the pressure on government revenue is not too much. The proportion of government revenue to GDP kept on rising from 14.9 percent in 2001 to 18.3 percent in 2006.

Especially in 2006, the consolidated government revenue showed a rapid increase, up by 22.5 percent than the previous year, and while government expenditure only climbed by 19.1 percent, which led the deficit shrink to 216.25 billion yuan. The reasons of high jump of government revenue included some temporary factors besides the rapid improvement of economic output, such as the introduction of oil abnormal gain charges, the increasing income tax revenue from the improved profits of commercial state banks on account of the equity reform, etc. The dramatic increase of government revenue directly produced the central steady budget adjustment fund of 500 million yuan.

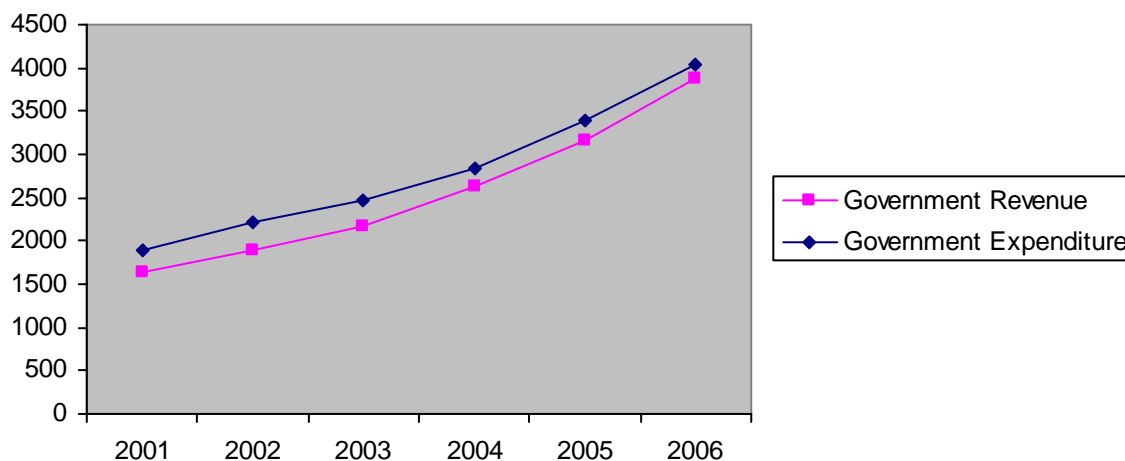
**Table 17: Government Revenue and Expenditure and Increase Rate**

Year	Government Revenue (Billion Yuan)	Government Expenditure (Billion Yuan)	Balance (Billion Yuan)	Increase Rates (%)		Percentage of Government Revenue to GDP (%)
				Government Revenue	Government Expenditure	
2001	1638.604	1890.258	-251.654	22.3	19.0	14.9
2002	1890.364	2205.315	-314.951	15.4	16.7	15.7
2003	2171.525	2464.995	-293.470	14.9	11.8	16.0
2004	2639.647	2848.689	-209.042	21.6	15.6	16.5
2005	3164.929	3393.028	-228.099	19.9	19.1	17.3
2006	3876.020	4042.273	-216.253	22.5	19.1	18.3

Note: Debts are excluded from the government revenue.

Source: *China Statistical Yearbook 2007*, China Statistics Press, 2007

**Figure 9: Government Revenue and Expenditure Gap**



Note: Debts are excluded from the government revenue.

Source: *China Statistical Yearbook 2007*, China Statistics Press, 2007

## II .2.1 Government Expenditure

In recent years, the deficit budget has been implemented to financial policies to encourage the domestic demand. The balance of government revenue and expenditure is supplemented by deficits and national bonds.

The main expenditures cover 5 types by functions such as economic construction; social, cultural and educational development; national defense; administrative expenses; and other expenditure as follow. According to this classification, economic construction expenditure occupied the most of the government expenditure except in 2006, while national defense expenditure list at last.

**Table 18: Government Expenditure by Function**

(Billion Yuan)						
Year	Total Government Expenditure	Economic Construction Expenditure	Social, Cultural and Educational Development	National Defense Expenditure	Administrative Expenses	Other Expenditures
2001	1890.258	647.256	521.323	144.204	351.249	226.226
2002	2205.315	667.370	592.458	170.778	410.132	364.577
2003	2464.995	691.205	646.937	190.787	469.126	466.940
2004	2848.689	793.325	749.051	220.001	552.198	534.114
2005	3393.028	931.696	895.336	247.496	651.234	667.266
2006	4042.273	1073.463	1084.620	297.938	757.105	829.147

Note: The expenditure for the payment of the principal and interest of domestic and foreign debts and the expenditure for capital construction handled by foreign loans are excluded in this table.

Source: *China Statistical Yearbook 2007*, China Statistics Press, 2007

Government expenditures also can be classified as follow 11 main items. By this way, expenses on culture, education, science and public health take over the prominent position, while additional appropriation for circulating capital of enterprises possesses the least.

**Table 19: Government Expenditure by Main Item (Billion Yuan)**

Items	2001	2002	2003	2004	2005	2006
Expenditure for Capital Construction	251.064	314.298	342.930	343.750	404.134	439.038
Additional Appropriation for Circulating Capital of Enterprises	2.271	1.897	1.195	1.244	1.817	1.658
Innovation Funds and Science and Technology Promotion Funds	99.156	96.838	109.299	124.394	149.459	174.456
Geological Prospecting Expenses Operating Expenses of the Departments of Industry, Transport and Commerce	9.901	10.289	10.694	11.545	13.270	14.182
Operating Expenses of the Departments of Industry, Transport and Commerce	20.012	23.238	28.523	36.821	44.415	58.125
Expenditure for Supporting Rural Production	91.796	110.270	113.486	169.379	179.240	216.135
Expenses on Culture, Education, Science and Public Health	336.102	397.908	450.551	514.365	610.418	742.598
Expenditure for Pension and Social Welfare	26.668	37.297	49.882	56.346	71.639	436.178
Expenditure for National Defense	144.204	170.778	190.787	220.001	247.496	297.938
Administrative Expenses	219.752	297.942	343.768	405.991	483.543	563.905
Expenditure on Policy-related Subsidies	74.151	64.507	61.728	79.580	99.847	138.752

Source: *China Statistical Yearbook 2007*, China Statistics Press, 2007

In 2006, the total government expenditure was 4042.27 billion yuan up by 19.1 percent than the last year. Of the total, central government expenditure was around 999.16 billion yuan, occupied 24.8 percent, and increased by 13.9 percent; while local government expenditure was 3022.16 billion yuan, accounted for 75.12 percent, up by 20.1 percent.

Expenditures were supported by priority, for example, employment and social security expenditure (433.77 billion yuan, up by 17.3 percent), education expenditure (475.27 billion yuan, increased by 19.6 percent), public health expenditure (131.16 billion yuan, grown by 26.5 percent), science and technology expenditure (126.04 billion yuan, improved by 26.2 percent), and so on.

## II .2.2 Public Borrowing

In order to cover the gap of government expenditure over government revenue and promote the development of economy, Chinese government has to finance from domestic and foreign markets. In 2005 and 2006, domestic debts largely exceed foreign debts and the proportion of total debts to GDP maintained roughly 17 percent, of which foreign debts account for less than 0.4 percent.

**Table 20: Central Government Debts (Billion Yuan)**

Year	Total	Domestic Debts	Foreign Debts	Proportion of Total Debts to GDP (%)
2005	3261.421	3184.859	76.552	17.7
2006	3501.528	3438.024	63.502	16.6

Note: Since 2006, the Chinese government had executed debt balance management.

Source: *China Statistical Yearbook 2007*, China Statistics Press, 2007

## II .2.3 Tax Revenue

Taxes are major sources of government revenue, which occupied almost 90 percent of the total revenue. The proportion of tax revenue to total government revenue declined gradually from 93.38 percent in 2001 to 89.81 percent in 2006, however the amount of tax revenue in 2006 jumped by 21 percent over the preceding year. The main reason contributed to the revenue collected from Enterprise Income Tax and Value Added Taxes increased by 28.5 percent and 20.5 percent respectively over the last year. Tax revenue is also the main source of government expenditure; it took over more than 80 percent of the total during the previous years. The share of tax revenue to GDP climbs steadily from 13.95 percent in 2001 to 16.51 percent in 2006, increased by 2.56 percent.

**Table 21: Government Revenue by Items (Billion Yuan) and Proportion of Tax to Major Items (%)**

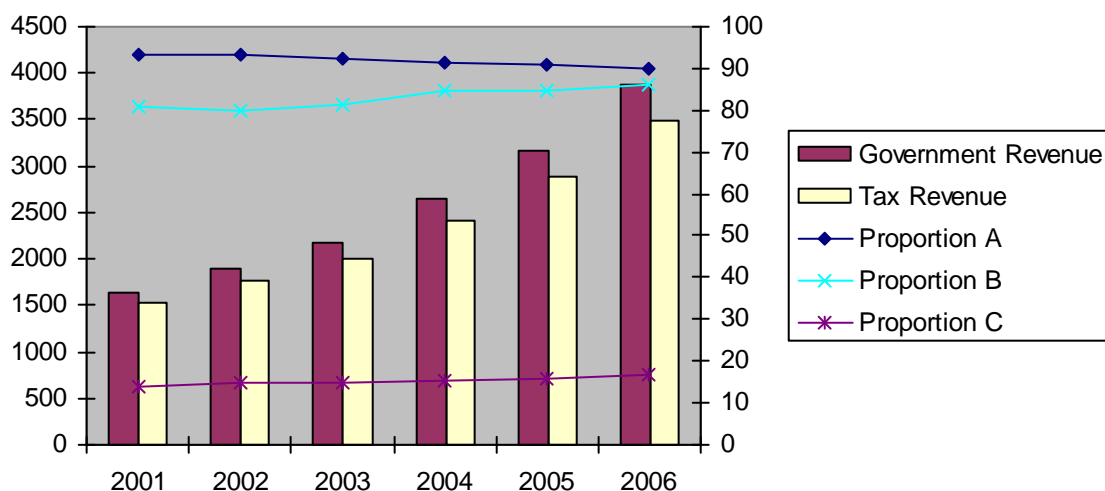
Year	Total Government Revenue	Tax Revenue	Subsidies to Loss-making Enterprises	Revenue from Extra-charges for Education	Other Revenue	Proportion of Tax Revenue to		
						Government Revenue	Government Expenditure	GDP
2001	1638.604	1530.138	-30.004	16.660	121.810	93.38	80.95	13.95
2002	1890.364	1763.645	-25.960	19.805	132.874	93.30	79.97	14.66
2003	2171.525	2001.731	-22.638	23.239	169.193	92.18	81.21	14.74
2004	2639.647	2416.568	-21.793	30.040	214.832	91.55	84.83	15.12
2005	3164.929	2877.854	-19.326	35.618	270.783	90.93	84.82	15.72
2006	3876.020	3480.972	-18.022	44.685	368.385	89.81	86.11	16.51

Source: *China Statistical Yearbook 2007*, China Statistics Press, 2007

**Figure 10: Trend of Tax Revenue**

Unit: Billion Yuan

%



Note: Proportion A, B, C refer to proportions of tax revenue to government revenue, government expenditure, and GDP respectively.

Source: *China Statistical Yearbook 2007*, China Statistics Press, 2007

In China, there are totally 23 types of taxes to be levied in 2006. In 1999, the total tax revenue exceeded 1 trillion yuan for the first time according to the statistics of the State Administration of Taxation, and the annual growth rate of total tax revenue was over 13 percent, which is faster than the growth rate of GDP. Among the taxes, VAT occupied the largest proportion, while the agricultural and related taxes took over the least part.

**Table 22: Tax Revenue Statistics (Billion Yuan)**

year	Total Tax Revenue	Value Added Tax	Business Tax	Consumption Tax	Tariffs	Agricultural and Related Tax	Enterprise Income Tax	Growth Rate of Tax Revenue (%)
2001	1530.138	535.713	206.409	92.999	84.052	48.170	263.087	--
2002	1763.645	617.839	245.033	104.632	70.427	71.785	308.279	15.26
2003	2001.731	723.654	284.445	118.226	92.313	87.177	291.951	13.50
2004	2416.568	901.794	358.197	150.190	104.377	90.219	395.733	20.72
2005	2877.854	1079.211	423.246	163.381	106.617	93.640	534.392	19.09
2006	3480.972	1278.481	512.871	188.569	114.178	108.404	703.960	20.96

Note:

1. The agricultural and related taxes include Agricultural tax, Animal Husbandry Tax, Tax on the Use of Cultivated Land, Tax on Special Agricultural which remained in 2006.
2. The statistics in this table do not include those of Hong Kong, Macao and Taiwan.

Source: *China Statistics Yearbook 2007*, China Statistics Press, 2007

### III. Tax Structure: Institutions and the Reality

#### III.1 Overview of Tax System in China

The current tax system of China was established in 1994 after comprehensive finance-tax administration system reform had been carried out. In this reform, the previous industrial and commerce tax system had been changed to a large extent to respond the requirement of socialist market economy and opening policy. This reform establishes the foundation of modern tax system, reorganizes the tax administrations, and plays an important role in financing the economic reform and social development in China.

The fruits of this reform include:

First, the tax authority is separated into National Tax Authority and Local Tax Authority which take in charge of national tax collecting and local tax collecting respectively. Correspondingly, taxes as a whole have been split into national taxes and local taxes.

Second, a new turnover tax system with the feature of VAT as the core supplemented by Business Tax and Excise Tax has been set up.

Third, income taxes levied on different domestic enterprises have been unified to be Enterprise Income Tax.

Forth, uniform Individual Income Tax has been introduced to substitute three income taxes levied on various individuals.

Fifth, some taxes have been adjusted the scope of collection like Resource Tax, some been abolished like Salt Tax, and some new taxes been introduced as Land Appreciation Tax.

At present, there are totally 23 taxes levied in China. According to the nature, they can be classified into four groups as follow:

**Table 23: Types of Taxes by Nature 2006**

Categories of Taxes	Type of Taxes	Tax base
Goods and Service Taxes (5)	Value-Added Tax, , Business Tax ,Excise Tax, Vehicle Acquisition Tax, Customs Duty	the value (volume) of turnover or sales; or import & export value (or quantity)
Income Taxes (4)	Enterprise Income Tax, Income Tax on Enterprises with Foreign Investment and Foreign Enterprises, Individual Income Tax, Land Appreciation Tax	Net profits or net income.
Property Taxes (9)	House Property Tax, Urban Real Estate Tax, City and Township Land Use Tax, Farmland Occupation Tax, Deed Tax, Resource Tax, Vehicle and Vessel Usage Tax, Vehicle and Vessel Usage License Plate Tax, Vessel Tonnage Tax	Original value of real estate less a proportion of deduction; or the purchase/sale price of property.
Other taxes (5)	Stamp Tax, City Maintenance and Construction Tax, Fixed Asset Investment Orientation Regulation Tax, Banquet tax, Tobacco Leaf Tax	

Notes:

1. If Banquet Tax to be levied or not has been decentralized for the local government's decision on account of local conditions, and it has been ceased to levy all over the country.
2. The levying of the Fixed Asset Investment Orientation Regulation Tax has been suspended.
3. On 16 March 2007, the new Corporate Income Tax Law ("CIT") has been passed by the NPC of China, which consolidates domestic Enterprise Income Tax and Income Tax on Enterprises with Foreign Investment and Foreign Enterprises into a single one. The new CIT Law will come into effect from 1 January 2008.
4. Tobacco Leaf Tax was introduced in April 2006 after Agriculture Tax was abolished in the same year.

Source: Liu Zuo, *Tax System of China*, P187, China Taxation Press, 2006

Among these taxes, turnover taxes like VAT, Business Tax, and Excise Tax (including import VAT and Excise Tax) together have taken the prominent position in the total tax revenue since they were introduced

in 1994. The performances of these three taxes produce great effect on the total tax revenue. In 2006 three of them collected 2487.63 billion yuan accounting for 66.1 percent of the total. Recently, revenue from both enterprise income taxes levied on domestic companies and foreign companies increased fast. They occupied 18.82 percent of total tax revenue in 2006. The revenue from Individual Income Tax also grew rapidly, which took over 6.52 percent of the total.

**Table 24: Tax Revenue 2006 by Composition**

(Billion Yuan)		
Item	Tax Revenue	Weight in the Total Tax Revenue (%)
<b>Total Taxes</b>	<b>3763.62743</b>	<b>100</b>
<b>Of Which: National Taxes</b>	<b>2618.79728</b>	<b>69.58</b>
<b>Local Taxes</b>	<b>1144.83015</b>	<b>30.42</b>
Domestics VAT	1289.46033	34.26
Excise Tax	188.56694	5.01
Import VAT and Excise	496.71062	13.20
Business Tax	512.88897	13.63
Enterprise Income Tax	554.58781	14.74
Income Tax on Foreign Enterprises and Enterprises with Foreign Investments	153.48161	4.08
Individual Income Tax	245.23244	6.52
Resource Tax	20.72555	0.55
City Maintenance and Construction Tax	94.02283	2.50
House Property Tax	51.51830	1.37
Stamp Duty	37.65864	1.00
City and Township Land Use Tax	17.68893	0.47
Land Appreciation Tax	23.13205	0.61
Vehicle and Vessel Usage Tax	4.99611	0.13
Vehicle Acquisition Tax	68.75109	1.83
Tobacco Leaf Tax	4.13176	0.11
Other Taxes	0.07345	0.00
Total Export Rebates	-428.48854	--

Note:

1. Customs Duty is excluded from the total tax revenue.
2. Export rebates are not counted in the total tax revenue.

Source: State Administration of Taxation of China, 2007

### III.2 Framework of Tax Legislation in China

In China the power of tax law legislation and tax policy formulation are concentrated in the central government. Departments under the State Council and local governments are authorized to enact the detailed regulations and local tax rules within the scope of tax laws and tax ordinances.

Currently, four levels of tax laws, ordinances and regulations are constituted as follow:

First, tax laws are enacted by the National People's Congress. Till now three tax laws have been released: Individual Income Tax Law, Tax Collection and Administration Law, and Corporate Income Tax Law (which will take the place of Income Tax Law on Enterprises with Foreign Investment and Foreign Enterprises on the January 1, 2008).

Second, tax ordinances are legislated by the State Council, such as the Provisional Ordinance of Value Added Tax.

Third, the departmental rules and regulations are formulated by the Ministry of Finance, the State Administration of Taxation, the General Administration of Customs, and the Tariff and Classification Committee of the State Council in accordance with tax laws and ordinances, for example, the Detailed Rules for the Implementation of the Provisional Ordinance of Value Added Tax.

Forth, local tax rules and regulations are formulated by the local People's Congresses and their Standing Committees, and local governments without conflicting with laws and ordinances.



Up to now, totally thirty laws, ordinances, and rules related to tax collection and administration have been enacted, however, the formal tax laws enacted by the NPC (only three) account for a small part of them. All of these laws and ordinances are substantive laws or procedural laws; a basic tax law on tax policies, tax system and basic issues of tax laws is still absent but in the procedure of draft by the standing committee of the NPC now. Besides, although local tax authorities and local taxes have been established according to tax ordinances or circulars, a special local tax law is still out of the consideration of the central government.

### **III.3 Organizations of Tax Administration**

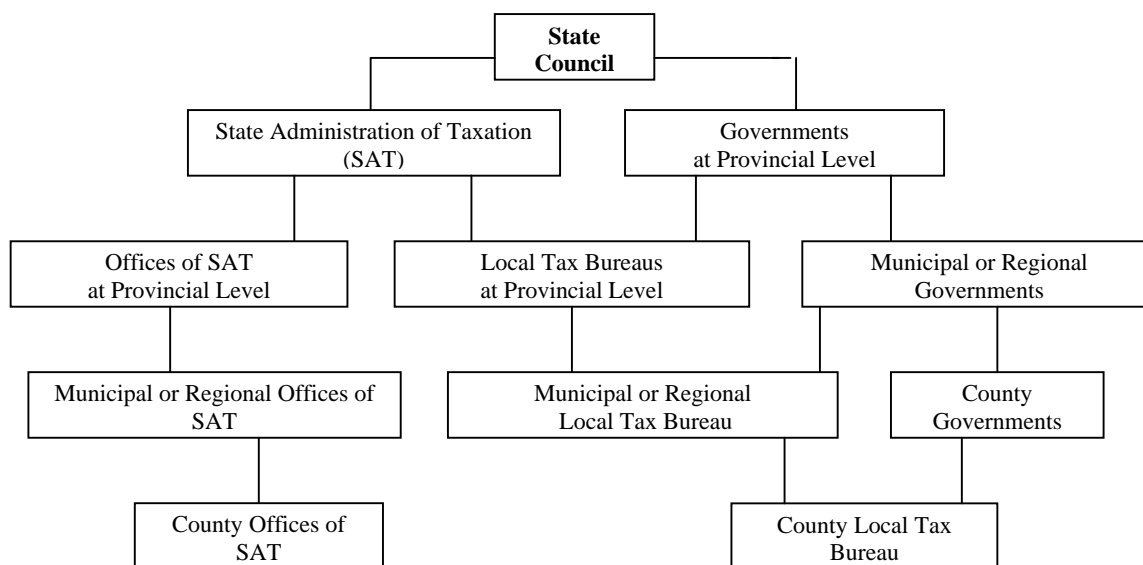
There are three departments in charge of tax collection and administration in China: tax authorities, financial authorities, and the customs.

Most of taxes are collected by tax authorities, except Farmland Occupation Tax and Deed Tax are levied by local financial authorities; Customs Duty, Vessel Tonnage Tax are under the charge of the Customs. VAT and Excise Tax on import are also collected by the Customs on behalf of tax authorities.

In addition to taxes, tax authorities are also in responsible of imposing three kinds of non-tax revenue, namely Educational Surcharge, Mining District Use Fee, and Culture Construction Fee. The provincial Governments may assign tax bureaus to collect social insurance fees (including basic pension, basic medical insurance, unemployment insurance and work injury insurance) as well.

Tax authorities are composed of national tax bureaus and local tax bureaus. National tax bureaus include four levels of organizations namely the State Administration of Taxation (the SAT, headquarter), and offices of SAT at provincial level, city level and county level, while local tax bureaus only have three levels according to the division of administration regions. A vertical administration model is applied to national tax bureaus. It means the budget, personnel, organization and business administration of the lower office of SAT is under the control of the upper one. In respective of local tax authorities, a dual-administration system is applied in terms of executive administration and business administration. The executive administration of budget, personnel and organization of lower tax bureau is taken the charge by the upper level of government, while the business administration of lower tax bureau is guided by the upper level of local tax authority. The local tax authorities at provincial level should accept the guidance of the SAT on business administration.

**Figure 11: Organization Chart of Tax Authorities in China**



Note:

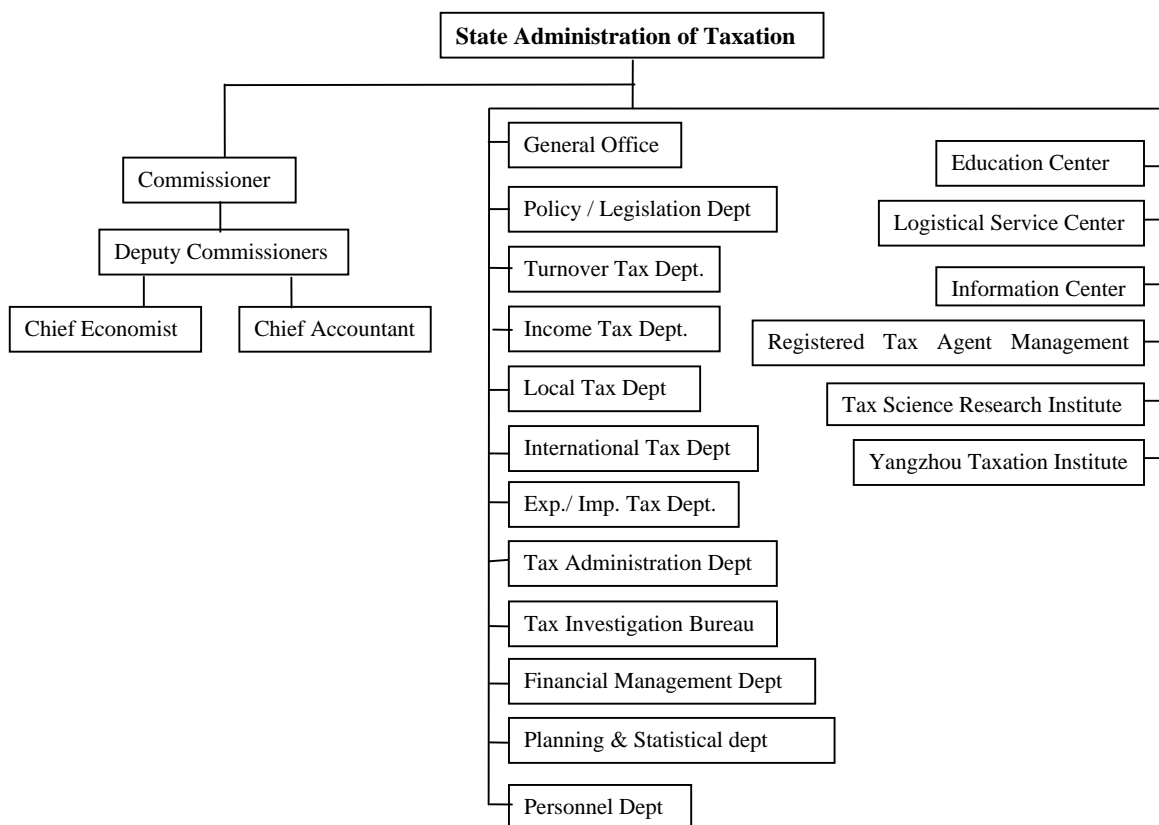
1. The Headquarter of SAT conducts vertical leadership over its offices across China, and assists provincial governments in form of dual leadership over local tax bureau.
2. The local tax bureaus below provincial level are under the dual leadership of both the higher local tax bureaus and the governments at the same level, and the former takes the predominant position.

Source: Liu Zuo, *Tax System of China 2006*, P201, China Taxation Press, 2006

Tax management in China is still in a traditional way. The inner structure of tax bureaus is organized according to types of taxes and different functions. Under the SAT, there are 12 departments in charge of different taxes and functions. Besides, 6 non-administration institutions are directly under the lead of SAT headquarter. Tax bureaus at provincial level, municipal level, and county level usually follow the organization structure of SAT.

By the end of 2005, there are totally 91 tax offices at provincial level, 1027 tax offices at municipal level, 5288 tax offices at county level. In service staffs in tax authorities as a whole amounted to 0.747 million, of which national tax staffs and local tax staffs were 400000 and 347000 respectively.

**Figure 12: Organization Structure of the SAT**



Source: State Administration of Taxation of China

### III.4 Local Tax System

The existing local tax system in China was set up in 1994 as mentioned before. From then on, the local tax system has not been changed much except the distribution of tax revenue between central government and local government.

#### III.4.1 Legal Foundation and Administration of Local Taxes

There is still not a professional local tax law in China. However, the Constitution and Budget Law have established the foundation of local tax system, which stipulate the executive responsibilities of local governments and their budgets and expenditures basically. Two circulars released by the State Council named the Decision on Implementation of Financial Administration System of Tax Distribution (GF [1993]85) and the Notice of Implementation of Industrial and Commercial Tax Reform (GF [1993]90) are special documents on the establishment of local tax authorities and how to allocate taxation powers and taxes between central government and local government.

According to the circulars, taxes are divided into national taxes, local taxes and sharing taxes. National taxes are those good for protecting national interests and undertaking macroeconomic adjustment. Local taxes are those suitable for collection by local governments. Taxes related to national economic development directly should be shared by the central government and local government jointly at some proportion. National taxes and sharing taxes are assigned to be under the charge of national tax bureaus, while local tax bureaus are in responsible for local taxes.

These circulars also prescribe that the legislative power of national taxes, local taxes, and sharing taxes are concentrated in the central government. Local governments are entitled to assess, collect and

administrate local taxes. The power of adjusting applicable tax rates, tax items and other elements of taxation within the regulated scope is decentralized to local governments on account of local conditions. Simultaneously national tax bureaus and local tax bureaus have been set up to collect respective taxes.

### III.4.2 Structure of Local Taxes and Other Taxes

Actually, when local tax system set up in China, it focused on how to distribute tax revenue between the central government and all levels of local governments as a whole with less consideration on matching different levels of local governments to different levels of local taxes. It means local taxes are essentially provincial taxes, governments below providences such as municipal governments, county governments and village governments have not their own taxes at all, they are financed by other means. This is a big issue of local tax system and financial system we have to face, and solutions are still open.

In accordance with the mentioned principles, national taxes, local taxes and sharing taxes are allocated as follow:

**Table 25: Composition of National Taxes, Local Taxes and Sharing Taxes**

Item	Composition of Different Groups of Taxes
<b>National Taxes (4)</b>	Excise Tax, Vehicle Acquisition Tax, Customs Duties, Vessel Tonnage Tax
<b>Local Taxes (11)</b>	House Property Tax, Urban Real Estate Tax, City and Township Land Use Tax, Farm Land Occupation Tax, Deed Tax, Vehicle and Vessel Usage Tax, Land Appreciation Tax, Vehicle and Vessel Usage Plate Tax, Tobacco Leaf Tax, Fixed Assets Investment Orientation Tax, and Banquet Tax
<b>Sharing Taxes (8)</b>	<p><b>VAT:</b> Central government and local government respectively possess 75 percent and 25 percent of the total domestic VAT, and VAT collected by Customs at import belongs to the central government.</p> <p><b>Business Tax:</b> Revenue collected from the Railway Department, the headquarters of banks, and the headquarters of insurance companies goes to the central government, and the rest turns to local governments.</p> <p><b>Enterprise Income Tax:</b> Income revenue paid by railway companies, national postal services, Industrial and Commercial Bank of China, Agricultural Bank of China, Bank of China, Construction Bank of China, State Development Bank, Agricultural Development Bank of China, Import &amp; Export Bank of China, China Oil and Natural Gas Company Limited, China Oil Chemical Company Limited and offshore oil and natural gas enterprises belongs to the central government is assigned to the central government, and the rest is shared by the central government and local governments at the ratio of 6:4.</p> <p><b>Income Tax on Foreign Enterprises and Enterprises with Foreign Investments:</b> The income tax collected from offshore oil and natural gas enterprises is assigned to the central government, and the rest is allocated between the central government and local governments by 60 percent and 40 percent.</p> <p><b>Individual Income Tax:</b> The proportion shared by the central government and local governments is 60 percent to 40 percent.</p> <p><b>Resource Tax:</b> The revenue paid by the offshore oil enterprises goes to the central government (not levied), the rest to local government.</p> <p><b>Stamp Duty:</b> 97 percent of tax on security transactions belongs to the central government, the other 3 percent and the rest revenue of Stamp Duty flows to local governments.</p> <p><b>City Maintenance and Construction Tax:</b> Tax revenue paid by Railway Department, headquarters of banks and insurance companies is assigned to the central government, and the rest to the local government.</p>

Note: Two local taxes namely Fixed Assets Investment Orientation Tax and Banquet Tax are ceased to levy.

Source: Liu Zuo, *Tax System of China 2006*, China Taxation Press, 2006

According to a study, the proportion of local tax revenue in total tax revenue is decreasing slightly from 31.10 percent in 2001 to 30.42 percent in 2006. Nevertheless the structure of local tax revenue is regarded as severe disparity. Over the previous years, local tax revenue from sharing taxes accounted for more than 70 percent of the total local tax revenue, while the revenue from local taxes only occupied less than 30 percent.

### **III.5 Rights and Obligations of a Taxpayer**

#### **III.5.1 Rights of a Taxpayer**

- A. To know the information about tax laws, tax regulations and tax collection procedures.
- B. To receive professional service and assistance from tax authority.
- C. To entrust an enrolled tax agent to handle the tax affairs on behalf of taxpayer himself or herself.
- D. To enjoy tax preferences and tax exemptions according to tax laws or ordinances.
- E. To postpone tax declare and tax payment when requirements are satisfied.
- F. To request tax authority to refund over collected tax payment.
- G. To apply for tax administrative review and conduct administrative litigation if he/she disagrees with the decision by tax authority.
- H. To sue the tax authority to the court or apply for an arbitrament from the State Council if he/she disagrees with the tax executive review.
- I. To request compensation for his or her unwanted loses.
- J. To ask for tax authority to keep his or her information secret.
- K. To make a representation or averment when necessary.
- L. To request tax authority to hold a hearing when necessary.
- M. To impeach and accuse tax staffs if they misuse laws.
- N. Other rights authorized by laws.

#### **III.5.2 Obligations of a Taxpayer**

- A. To make tax registration, alternation, or logout according to tax laws and ordinances, and use tax registration certificate as required. Subtenancy, obliteration, damage, buying and selling, or forgery of tax registration certificate is absolutely forbidden.
- B. To set up accounting books as required. If not, it should be approved by tax authority.
- C. To make tax declaration and submit tax returns, accounting statements, and other materials in according with tax laws and ordinances. If not, it should be allowed by tax authority.
- D. To pay taxes within tax term. If not, it should be approved by county tax bureaus at least and tax term can be extended three months longer at most.
- E. To keep and use invoices in compliance with tax laws and administrative regulations.
- F. To settle his or her tax liabilities or provide guarantee to tax authority if he/she owe taxes and need to go aboard.
- G. To accept tax examination and furnish related materials according to the facts without refusal and concealment.
- H. To pay off taxes and delinquency charges before applying for tax administrative rejudgement, when dispute occurs between taxpayer and tax authority.
- I. Other obligations regulated by tax laws and rules.

These rights and obligations of a taxpayer are also applicable to withholding agents.

### **III.6 Tax Enforced Collection**

#### **III.6.1 Liens and Levies**

If a taxpayer engages in production and business activities without registration to tax authority, taxes can be assessed and collected by tax authority directly. If he/she refuses to pay taxes after tax assessment, tax authority can levy on his or her goods or products equal to the value of overdue taxes for 15 days. After the taxpayer has paid taxes, tax authority must release the levied goods or products promptly and return them back to the taxpayer. If the taxpayer still pays no taxes after lien, tax authority may sell the goods or products subject to levy to satisfy tax debts by auction or other means with approval by director

general of county tax bureau at least. In the case of food or other live goods, the period of levy can be shortened.

### **III.6.2 Tax Protective Measures**

If tax authority deems the collection of taxes to be at risk, the taxpayer should be asked to pay taxes within a prescribed period before the legal tax term comes due. During this period if taxpayer is observed to escape tax payment by concealing or transferring goods, products, and other properties or income from the reach of tax authority, he/she is required to provide tax warrant to tax authority. If the taxpayer can not observe the rule, following tax protective measures should be taken with the approval of the director general of county tax bureau at least:

First, informing banks or other financial institutions to freeze an amount of money equal to the value of owed taxes from the account of taxpayer in written.

Second, goods, products or other properties of the taxpayer equal to the value of owed taxes should be levied by lien or seizure.

If the taxpayer has paid taxes during the prescribed period, the tax protective measures should be released within 1 day from the day of payment. If the prescribed period comes due however the taxpayer has not paid the owed taxes yet, tax authorities may inform banks or other financial institutions to deduct an amount of money equal to the value of the owed taxes from the frozen account, or sell the goods, products, and other properties subject to levy or seizure by auctions or other means.

If there is some money left after the payment of overdue taxes, fines, late fees and disposal charges, it should be returned to the taxpayer within 3 days.

If the taxpayer has paid taxes during the prescribed period, nevertheless the tax authority has not released tax protective measures promptly which causes damage to the rights of taxpayer, the tax authority should take the responsibility of compensation.

### **III.6.3 Tax Enforcement Measures**

If a taxpayer engaging in production and business activities does not pay taxes or a withholding agent does turn over taxes to tax authority in stated period, furthermore the tax warrantor does not pay taxes on behalf of them on time either, the tax authority will inform the taxpayer and the withholding agent to pay taxes in a prescribed period. If he/she has not paid taxes during the time limit, tax authority may take the following tax compulsory measures after these measures have been approved by the director general of county tax bureau at least:

First, banks or other financial institutions should be informed to deduct the amount of money equal to the value of overdue taxes and late fees from the account of taxpayer or withholding agent directly.

Second, to levy, seize, auction or sell goods, products or other properties equal to the value of overdue taxes and late fees to satisfy tax debts.

When tax authority conducts the enforcement measures like lien, levy or seizure of goods, products or other properties, there must be more than two tax officials to execute the mission together. Taxpayer or his/her adult relatives or representative must be informed in advance to come to the spot. However, even if they refuse to come, the enforced actions will be executed as planning.

Tax protective measures and tax enforcement measures should be executed by tax administration within the extent of authority and in accordance with the legal procedure. Personal effects, household goods less than 5000 yuan per unit, and the residence of taxpayer and his/her dependent necessary for life are exempted from tax protective measures and tax compulsory measures. However automobiles, gold or silver jewelries or decorations, antiques, luxury houses are excluded from the necessary household goods and residences.

### **III.6.4 Restricted to Leave Country**

If a taxpayer or legal representative of taxpayer with overdue taxes applies for going abroad, he/she must settle the owed taxes and late fees in advance or supply a receivable warrant to tax authority. Otherwise, the tax authority may inform the immigration bureau to prevent him from leaving country.

### III.6.5 Retroactive Collection

If a taxpayer or withholding agent has not paid taxes or only paid fewer taxes because of the fault of tax authority, he/she will be asked to pay overdue taxes without any penalty within three years since it occurred. If such a matter happened on account of calculation errors or others caused by taxpayers, tax authority may ask them to pay overdue taxes plus late fees within three years, and it can be extended to 5 years in special cases.

### III.7 Brief Introduction of Main Taxes

#### III.7.1 Value Added Tax

As mentioned before, on 1 January 1994 China introduced a turnover tax system consisting of three taxes—VAT, Business Tax, and Consumption/Excise Tax. Under the new system the sale or importation of goods and the provision of repairs, replacement, and processing services are subject to VAT.

VAT is charged at a standard rate of 17%. The sale of certain necessity goods and the importation of certain special equipment may be exempt from VAT (zero rates) or be subject to VAT at a reduced rate of 13 percent, as specified in the VAT regulations.

**Table 26: VAT Taxable Items and Rates**

Coverage of collection	Rates
Exportation of goods (except otherwise stipulated By the State)	0%
1. Agriculture, forestry, products animal husbandry, aquatic products;	13%
2. Edible vegetable oil and food grains duplicates;	
3. Tap water, heating cooling, hot applying, hot water, coal gas, liquefied petroleum gas, natural gas, methane gas, coal/charcoal products for household use;	
4. Books, newspapers, magazines (excluding the newspapers and magazines distributed by the department);	
5. Feeds, chemical fertilizers, agricultural chemicals, agricultural machinery and plastic covering film for farming;	
6. Dressing metal mineral products, dressing non-metal mineral products, coal.	
1. Crude oil, mine salt and goods other than those listed above;	17%
2. Taxable services.	

Source: Liu Zuo, *Tax System of China 2006*, P43, China Taxation Press, 2006

Except for commodities listed in the “Catalogue for Prohibited Commodities for Processing Trade” and those whose export VAT refund entitlement have been withdrawn, most types of goods that are manufactured and exported by foreign investment enterprises are effectively tax exempt under the “exempt, credit, refund” mechanism. However, this does not mean that all input VAT will be refunded because the refund rates vary depending on the type of product. At present, the refund rates of VAT consist of 5 percent, 6 percent, 8 percent, 11 percent, 13 percent, and 17 percent in respect of different goods.

VAT is typically a recoverable tax, except for VAT incurred at the importation or local purchase of fixed assets. Such VAT is generally treated as part of the cost of the fixed assets and depreciated. However, China launched a trial run of “consumption based” VAT system whereby input VAT incurred in purchases of fixed assets by enterprises of selected industrial sectors in North-east region and 26 cities in Central region may be recovered by offsetting against output VAT of regular sales.

The exempted items include: the agricultural production materials as regulated; self-produced primary agricultural products sold by agricultural producing units and individuals; imported goods being processed for exportation; self-use equipment imported out of the total investment for the projects with foreign investment or domestic investment which are encouraged by the State; contraceptive medicines and devices; antique books purchased from the public; instruments and equipment imported for direct use in scientific research, experiment and education; imported materials and equipment granted by foreign governments or international organizations; materials imported directly to support the poverty relief and charity cause donated freely by overseas natural persons, legal persons and other organizations; articles

imported directly by organizations for the disabled for exclusive use by the disabled; and the taxable services provided by individual disabled laborers.

### III.7.2 Excise Tax

When Excise Tax was introduced in 1994, it was imposed on 11 types of special consumer goods after VAT had been levied on them first. The taxpayers of Excise Tax are the producers or distributors of consumer goods include enterprise, household businesses and individuals engaged in production, importation and /or retails of taxable consumer goods.

As the time past, domestic industrial structure and consumers' consumption standard and consumption structure have changed dramatically while Excise Tax can not adapt to these changes any more. Some previous luxury consumer goods subject to Excise Tax have become common commodities like shampoo; the tax rate structure of some taxable consumer goods can not catch up with the changes of production and consumption; moreover, some environment unfriendly behaviors should be discouraged or restricted by Excise Tax. Therefore in 2006 a significant reform of Excise Tax was launched. Some new taxable items have been supplemented namely naphtha, solvent-oil, lubricating oil belonging to finish oil products, golf and tools, high-grade watches, yachts, one-off wood chopsticks, and wood floor. Simultaneously, some commodities such as hair-care products and skin-care products have been eliminated from the taxable goods.

When taxable consumer goods are exported, no Excise Tax is levied on them except for some export-restricted goods.

The new Excise Tax table involving 14 taxable items is as follow:

**Table 27: Table of Consumption Tax Taxable Items and Rates**

<b>Taxable items</b>	<b>Tax rates (tax amount per unit)</b>
1. tobacco	(1) 150 Yuan per box (50000 pieces) + sales value × 45%
(1) Grade A Cigarettes	(2)150 Yuan per box (50000 pieces) + sales value × 30%
(2) Grade B Cigarettes	(3) 25%
(3) Cigars	(4)30%
(4) Cut tobacco	
2. alcoholic drinks and alcohol	
(1) white spirits made from cereal, white spirit made from potatoes	(1) 0.5 Yuan per Jin or 500ml + factory price × 20%
(2) yellow spirits	(2)240 Yuan per ton
(3) beer of class one	(3)250 Yuan per ton
(4) beer of class two	(4)220 Yuan per ton
(5) other alcoholic drinks	(5) 10%
(6) alcohol	(6)5%
3. cosmetics	30%
4. precious jewellery, pearls, precious jade and stones	
(1) cold and silver jewellery, diamond and decoration thereof	(1) 5%
(2) other jewellery, pearls, precious jade and stones	(2) 10%
5. firecrackers and fireworks	15%
6. finish oil products	(1.a) 0.2 Yuan per litre
(1) gasoline: a. unleaded; b. leader	(1.b) 0.28 Yuan per litre
(2) diesel oil, fuel oil, aviation oil	(2) 0.10 Yuan per litre
(3) naphtha, solvent-oil, lubricating oil	(3) 0.20 Yuan per litre
7. motor vehicle tyres	3% □
8. motor-cycles	
(1) cylinder capacity less than 250 ml	(1)3%
(2) cylinder capacity over 250 ml	(2)10%
9. motor cars	
(1) passenger cars (with 9 seats or less)	(1)3%, 5%, 9%, 12%, 20%
(2) medium and light commercial cars (with 10 to 23 seats)	(2)5%
10. golf and tools	10%
11. high-class watches	20%
12. yachts	10%



13. wood chopsticks for use only once	5%
14. wood floor	5%

Note:

1. Meridian tyres and renovated tyres are excluded.
2. Rate applied is based on the cylinder capacity of the car.

Source: Liu Zuo, *Tax System of China 2006*, P49-51, China Taxation Press, 2006

On account of the rapid increase of oil price in the international market, taxation on aviation kerosene is postponed, furthermore naphtha, solvent-oil, lubricating oil and fuel oil is levied at 30 percent on tax amount for the time being.

Unlike VAT, Excise Tax is not recoverable but is deductible as expenses for income tax purposes.

### III.7.3 Business Tax

Business tax is imposed on services, transfer of intangible assets and immovable property taking place within China, which is the main tax source of local governments. Business tax rates are 3% or 5%, except for the leisure and entertainment industry which may attract a rate of up to 20%.

**Table 28: Taxable Items and Rates of Business Tax**

Taxable items	Tax rates (%)
1. communications and transportation	3
2. construction	3
3. financial and insurance businesses	5
4. post and telecommunications	3
5. culture and sports	3
6. entertainment	20 or 5
7. services	5
8. transfer of intangible assets	5
9. sales of immovable properties	5

Note: for financial insurance businesses located in the area of experimental reform of countryside credit firm, the tax on countryside credit may be 3%.

Source: Liu Zuo, *Tax System of China*, P65, China Taxation Press, 2006

For qualified foreign institutional investors, an exemption to business tax is granted on their income derived from securities trading through domestic securities companies.

Business tax is not recoverable but may be deductible for income tax purpose.

### III.7.4 Individual Income Tax

Taxpayers of Individual Income Tax refer to individuals who have a “place of abode” in China, who are subject to individual income tax on their worldwide income. For this purpose, “individuals have a place of abode” in China means those who maintain a place of residence in China because of their legal residence status, family, or economic ties.

Individuals who do not have a “place of abode” in China are taxed in accordance with their length of residency in China, as follows.

First, non-residents or resident foreign expatriates who reside in China for less than one year will be taxed only on their China-source income.

Second, foreign expatriates who reside in China for more than one year but not more than five years will be subject to tax on both their China-source income and their foreign-source income. However, upon application to and approval from the tax authorities, the taxation of foreign-source income can be limited to that received from Chinese enterprises, Chinese establishments, Chinese economic organizations, and Chinese individuals.

Third, foreign expatriates who reside in China for more than five consecutive years will be subject to tax on their worldwide income from the sixth year onward.

Forth, foreign expatriates who travel in China and derive income from an overseas employer with no permanent establishment in China will be tax exempt if they do not physically stay in China, consecutively or cumulatively, for more than 90 days in a calendar year. The 90-day test is extended to 183 days if the individual is a tax resident of a country/region that has executed a taxation treaty/arrangement with China.

Taxable income of an individual has been classified into 11 items including wages and salaries, income derived by households from production or business operation, income from contracted or leased operation of enterprises or institutions, remuneration from personal services, author's remuneration, royalties, interest, dividends, bonuses, income from lease of property, income from transfer of property, incidental income, and other income specified as taxable by the finance department of the State council. Of which, salaries or wages of an individual include basic salary, bonus, foreign service premium, area allowance, cost-of-living allowance, housing allowance in excess of actual rental, local tax reimbursement, insurance and pension contributions, stock benefits, other cash benefit, and other benefits in kind discharging personal liabilities. For an individual who receives dividend income from listed companies, he/she is entitled to a 50% reduction of individual income tax since 13 June 2005. Exemption is also available to foreign individuals for dividend received from B shares and overseas listed shares of Chinese companies.

All individuals are allowed a standard deduction of RMB1600 per month from wages and salaries since January 1, 2006. Foreign expatriates, who include Hong Kong, Macao, and Taiwan residents, are given an additional allowance of RMB3200 per month. Accordingly, the monthly deduction from wages and salaries available to such a foreign expatriate is RMB4800.

Specific deductions are given for income from compensation for personal services, that is, income of independent contractors; income from the publication of articles; royalties; or income from the lease of property. First, if the amount received in a single payment is less than RMB4000, a standard deduction of RMB800 is given. Second, if the amount received from a single economic transaction exceeds RMB4000, a deduction equal to 20% of the payment is allowed.

Interest and dividends are taxed on the gross amounts received without deductions. For sales of property, the original value of the property and reasonable expenses incurred are deductible from the sales proceeds to arrive at the taxable income.

Tax rates for wages and salaries are progressive, varying from 5 percent to 45 percent at 9 brackets. Income earned by individuals from privately-owned business, sole proprietorship enterprises and partnership enterprises is subject to five progressive rates from 5 percent to 35 percent. Contract income or lease income are taxed either as employment income or as business income depending on different situations. A flat rate of 20% is applied on other categories of income including royalties, incidental income, author's income, rental income and capital gains except special situations regulated by the State Council.

In general, individual income tax payers do not need to file the tax return because almost all kinds of income have been withheld by withholding agents. However, the following taxpayers are obliged to declare their income to tax authorities: First, individuals gain annual income more than RMB120000. Second, individuals earn salaries or wages from more than two sources within China. Third, individuals derive income from outside China. At last, individuals earn income without withholding agents.

The first requirement is applied to income derived on or after 1 January 2006. The second and third are applied to income derived on or after 1 January 2007.

### **III.7.5 Corporate Income Tax (take effect on Jan. 1, 2008)**

Currently China has two different enterprise income tax regimes, one (so-called Income Tax on Foreign Enterprises and Enterprises with Foreign Investments Foreign) is applicable to foreign investment enterprises and foreign enterprises and the other (named Enterprise Income Tax) applicable to domestic enterprises. On 16 March 2007, China's top legislature National People's Congress passed the new Corporate Income Tax Law ("CIT") which consolidates the two separate enterprise income tax regimes into a single one. This CIT reform is regarded as a significant milestone in China's tax history since the turnover tax reform in 1994. It aims at establishing an income tax regime that reflects four main themes: "Simplified Tax System", "Wide Tax Base", "Low Tax Rate", and "Stringent Administration". Indeed, the

uneven tax playing field coming from the superior tax preferences to foreign investment enterprises is inequitable to the Chinese enterprises especially after WTO accession and must be changed.

The new CIT Law will come into effect from 1 January 2008. At present the new law only provides a framework of general tax provisions which will come into effect from 1 January 2008. Important details on the definition of numerous terms are left to the detailed implementation regulations and supplementary tax circulars which will be released by the end of 2007.

The new CIT Law has important changes in the following aspects:

- A. Concept of "Tax Resident Enterprise" ("TRE"). TRE concept is introduced whereby TREs are subject to China income tax on worldwide income, and non-TREs on China source income. Foreign Investment Enterprises (FIEs) registered in China are always TRE. Foreign Enterprise ("FE") whose effective management institute is based in China is also regarded as a "TRE" and should pay tax on worldwide income.
- B. Tax rates. Standardized rate is 25 percent with reduced rate of 20 percent for qualified small and thin-profit companies and 15 percent for encouraged high/new-tech enterprises. FIEs approved before the publication date of the CIT Law and currently taxed at 15 percent or 24 percent will be offered a gradual increase to 25 percent within 5 years. 20 percent withholding tax ("WHT") rate is specified for passive income derived by Non-TREs.
- C. Tax incentives. Tax reduction and exemption treatments are targeted primarily towards □ agriculture, forestry and animal-husbandry, fishery projects; □ basic infrastructure projects; □ environment protection projects and energy/water conservative projects; □ qualified technology transfer. Moreover, "Super deduction" is allowed for R&D expenses for new technology, new products, and new craftsmanship. Taxable income may be reduced by a deemed deduction calculated as a percentage of investment amounts for venture capital businesses engaged in encouraged industries. Shorter tax depreciation life or accelerated depreciation is allowed for particular types of fixed assets due to advancement of technology. Reduction allowance may be allowed for revenue earned from products manufactured with comprehensive resources pursuant to the State industry policies. Investment tax credit is allowed on qualifying expenditures on plant and machinery for environmental protection, energy and water conservation, and production safety.
- D. Tax deduction. Most rules similar to current law for FIEs, so domestic enterprises will face less limitation in deducting expenses when compared to before. But FIEs will be subject to new deduction limitations, e.g. sponsorship fees.
- E. Anti-avoidance rules. □ Cost sharing is allowed in respect of intangible assets developed and shared among related parties, and for the provision and receiving of common services, as long as the sharing basis is on arm's length. □ "Controlled Foreign Corporation Rules" ("CFC Rules") such that undistributed profits derived by CFCs located in low-tax jurisdictions may be taxed in China as a deemed distribution. □ "Thin-capitalization Rule" such that excessive interest expense may be disallowed. □ General anti-avoidance provision for making adjustments to taxable revenue or taxable income where business transactions are regarded as arranged without reasonable commercial purpose. □ Tax adjustments made under the Anti-avoidance Chapter may be subject to interest levy.
- F. Tax consolidated filing for groups of companies. Tax consolidated filing is currently allowed for some domestic state-owned conglomerates under special approval of the State Council. It is uncertain whether FIE groups in the future may apply for consolidated tax filing in light of the "National Treatment" principle.
- G. Tax Filing Administration. Filing of annual tax return period is extended from 4 months to 5 months after year end. Provisional reporting and payments may be made on monthly basis or quarterly basis.

Unused tax holiday of FIEs approved to be established before CIT Law is grandfathered till the expiry. Where the tax holiday has not yet started because of tax losses, it shall be deemed to commence from the first effective year of Unified CIT Law.

The new CIT Law is expected to result in a reduction of income tax revenue by as much as RMB 93 billion, within which collection from domestic enterprises may reduce by some 134 billion yuan and collection from FIEs may increase by some 41 billion yuan.

#### **IV. Country-Specific Fiscal Issues**

**Growth rate of government revenue exceeding that of GDP calls for tax cut reform.** From 2001 to 2006, government revenue especially tax revenue experienced an amazing increase with an average growth rate more than 17 percent (also see Table 27). During the same period GDP rate never exceeded 10.7 percent (see Table 2). It implies the increment of value/capital goes to the public sector more than to the private sector, which inevitably reduces the investment capability of the latter and causes the low efficiency of domestic investment as a whole. The tax-oriented investments of local governments not only squeeze private investment but also waste various sources. From this point, a tax cut reform to raise the strength of private sector is necessary.

**Government revenue relies heavily on turnover tax which aggravates the burden on individuals.** From Table 21 we can see in 2006 nearly 90 percent government revenue comes from taxes, whilst more than 66 percent of total tax revenue derived from turnover tax like VAT, Business Tax, and Excise Tax, revenue from income taxes involving both domestic and foreign enterprise income tax plus Individual Income Tax accounted for around 25 percent of the total (see Table 24). Turnover tax can be easily shifted to consumers thus reduce the income level of residents and put negative impact on domestic demand. Besides, although direct tax on agriculture has been abolished, turnover tax is still a heavy burden on farmers who are weak in improvement of income. Overloaded turnover taxes contribute to the rapid growth of tax revenue but hurt the benefits of individuals.

**Government investment should lean to agricultural production and rural area.** In the previous months of 2007, the CPI inflation rate rises faster than expected at 5 percent. This inflation started from the rise of agricultural product prices. The increase of pork price due to scant supply causes a series of price jumping related to vegetables, eggs, rice and so on. Although the inflation has been controlled by the government to some extent, it calls for more investments should be poured into agricultural production and rural area to improve the productivity of agriculture sector. Furthermore, the infrastructure and public service in countryside also need to be improved to narrow the gap between rural area and urban area. All these strive will not only benefit the price stability but also help to raise the income of peasants and make contribution to the construction of socialist new country.

**Government expenditure structure is unreasonable in terms of low social security expenditure but high administrative expenses.** Table 19 (Government Expenditure by Main Items) demonstrates that administrative expenses occupied more than 14 percent of the total government expenditure in 2006 while less than 10.8 percent was allocated to social security. It is harmful for Chinese people to ameliorate the welfare level and enjoy the achievement of economic development. In view of the trend of demographic society, the proportion of social security expenditure needs to be increased dramatically in the near future. Moreover, excessive administrative expenditure will worsen the public corruption and then deepen the unfairness of society.

**The weakness of local tax system leads to the shortage of local government revenue.** As mentioned before, the local taxes are not parallel to different levels of local governments. Only provincial governments are guaranteed by the local tax system. Base level governments are always harassed by the lack of revenue sources and rely heavily on transfer payments from the upper governments. That is one of major reasons of numerous indiscriminate charges in local area. However, since there are five levels of government in China, it is difficult to design a corresponding tax system to match the expenditure demand

of each levels of government. How to solve this fiscal puzzle in China so as to secure local public services is still open.

## **V. Conclusion: Where We Stand and Where We Go?**

**“Three highs” are outstanding issues Chinese economy facing and require to be coped with carefully.**

After several years of speedy increase, Chinese economy emits some over-heating signals: high stock price, high CPI, and high housing price. In capital market, the market value of stocks flied from 3 trillion yuan in July 2005 to 21.147 trillion yuan in August 2007, which exceeded GDP (21.087 trillion yuan in 2006) for the first time and increased more than 7 times during this period. The CPI in July 2007 grew up 5.6 percent comparing with that of last year and increased by 3.5 percent over the previous months as a whole. While the housing prices in many big cities such as Beijing, Shenzhen, and Shanghai jumped up 10 percent over the previous year and this trend have almost lasted for three years.

“Three highs” call for the coordination of monetary policy and fiscal policy to cool down the fever of economy. In respect of high housing price and high CPI, enlarging supply is necessary. The government should invest more sources to construct “public houses” in order to satisfy the demand of low income individuals by rent, and develop more “economic houses” to compete with the high-grade houses which almost conquer the whole market of private houses. Simultaneously, the constrictive loan policy should be taken to reduce excessive investments flow into real estate development. Otherwise the “housing issue” will put some negative impact on the harmonization of society undoubtedly. Since this year’s CPI flying caused by the rise of agricultural product price, in consideration of the climb of productive material price and labor price, the government should grant allowances or provide non/low interest loans to assist farmers expanding production. If farmers can not get reasonable profits from agricultural products, their motives of production will be hurt, which will give rise to under supply directly.

Currently the excess liquidity is blamed to be the engine of stock price soaring. The excess liquidity comes from diverse sources including foreign “hot money” which speeds up the increase of housing price as well. The central bank has adopted related measures including improvement of the interest rate and reserve against deposit rate to cut down the liquidity. If these issues can not be addressed effectively, the sustainable advance of Chinese economy is hard to obtain.

**Tax system reform will help to accumulate more capitals in the private sector and optimize the structure of investment.** Fortunately, Chinese government has done something in this aspect to improve the situation. On 16 March 2007, the NPC of China has passed the new Corporate Income Tax Law which will take effect on January 1, 2008. It is significant to domestic enterprises because they can enjoy the same tax rates, tax references, and tax deductions and so on as foreign investment enterprises and escape from extra tax burden as usual. It will enhance their competitive power, increase their profits, and then speed up their capital accumulation. Actually, this tax reform is reallocated the profit between the government and companies, which will transfer some revenue from the government to the companies so that boost up the investment of private sector.

Besides, the “production base” VAT should be substituted by “consumption base” VAT all over the country not only restricted in the scope of north-east region and the middle region. This reform will allow the input VAT of fixed assets to be deducted from the output VAT instead of depreciation. As a result, companies will be encouraged to invest more capital on new machines and equipments, and promote the upgrade of technologies and products. If the government reduced the VAT rate to some extent considering the rapid increase of government revenue, this process would be accelerated.

**Government expenditure should pay more attention to the social welfare.** Currently, Chinese people are suffering several troubles like expensive tuition, expensive medical fee, expensive housing, and so on. These issues are partly derived from the passive effects of previous reforms such as education system reform, medical system reform and housing system reform, etc. The government should take the

responsibility to resolve the problems by providing more basic social welfare. The nine-year compulsory education is a basic right of each citizen, which can not be implemented without government support. Basic medical care and housing are the rewards of a taxpayer. Along with the growth of government revenue, the welfare of Chinese people should be improved by adjustment of the structure of government expenditure.

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