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The Impact of the Global Financial Crisis on Broadly Based Indirect Taxation: A Chinese Case Study

Xu Yan* and Andrew Halkyard**

1. INTRODUCTION

The global financial crisis (GFC) has brought unprecedented challenges to the world economy and numerous demands for regulatory improvements of its financial architecture. China has not been immune from these challenges. Their impact upon its domestic economy has been profound. Like many countries that developed broad stimulus packages to combat the effects of the GFC, China embarked upon various changes and reforms to its taxation system. In the past two years, reforms included structural and targeted tax reductions (corporate taxation and Consumption Tax, CT) and a significant shift to move China's most important indirect tax (Value Added Tax, VAT) towards a consumption-type system.

To what extent are these reforms directly responsive to the effects of the GFC? Using China as a case study, is it possible to propose an effective universal tax response to financial turmoil or economic difficulties generally? Although scholars have argued that, from a tax policy perspective, the conclusion must be that manipulating tax rates as a source of subsidizing finance for distressed business is ill-conceived,¹ does this hold good in China's case which is now only developing a fully mature tax system and whose recent reforms might best be evaluated as key steps in its long-held desire to

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¹ See, e.g., R. Krever, "Taxation Responses to Financial Turmoil" (1998) *Asia-Pacific Tax Bulletin* 452 at p. 454. This conclusion was reached in the context of discussing whether rates of corporate tax (but not indirect taxes which are the focus of this article) generally should rise or fall in response to conditions of economic crisis. Krever notes, however, at p. 452 that: "Different nations will seek different trade-offs between differing objectives. There is, therefore, no universal tax response to financial turmoil or economic difficulties generally."

simplify its taxation system, move towards a broader tax collection base, lower tax rates and enhance tax collection?²

This article seeks to answer these questions. It concludes that some targeted tax reforms in economically stressed times can be implemented swiftly and produce immediate and positive benefits. In this regard, particular attention is paid to China's indirect taxation system, especially the imposition of VAT and CT, since this is critical to its overall tax collections (providing more than half of the taxation revenue obtained by the Central Government) and which directly impacts upon the consumption of all manner of goods.

The article is divided into five parts. Following this Introduction, Part 2 provides a brief account of the genesis of the GFC and its immediate effects on China's economy. Part 3 proceeds to analyze recent reforms in China's indirect taxation system in the post-GFC period in the following areas: (1) reduction in certain tax rates, (2) the move to a consumption-type VAT system and (3) more generally, critiquing that system in light of the imperative to fund and improve its social security system (for instance, reforming medical care insurance and extending the national pension scheme to Chinese rural residents). Part 4 evaluates the effects of the recent reforms and changes to the indirect taxation system, by reference to China's economic performance and tax collections in the post-GFC period. Part 5 concludes that the GFC has had both direct and indirect impacts upon China's taxation system, particularly in relation to indirect taxation. When evaluated from the context of promoting structural reform, the tax responses adopted by China, in particular reducing tax rates to promote consumption in times of economic turmoil, although not necessarily a universal cure for all ills, were not ill-conceived.

2. THE GENESIS OF THE GLOBAL FINANCIAL CRISIS AND ITS IMPACT ON CHINA'S ECONOMY

The outbreak of the GFC in 2008 was abrupt but not entirely unpredictable. Prior to this time, some insightful observers³ had become increasingly pessimistic as a result of the convergence of recession-related phenomena emanating from the United States (US)—such as the escalating deficit in its current account, the tidal wave of speculation on financial derivatives, and the vast number of subprime mortgage loans provided to unqualified borrowers. However, very few members of this sagacious

² A broad summary of China's taxation reforms in recent years is provided at www.chinadaily.com.cn/bizchina/2009-10/26/content_8851299.htm (interview with the Chinese Minister of Finance, Xie Xuren, prior to the opening of the third International Tax Dialogue, held in Beijing in October 2009; accessed 28 January 2010). In this interview, Xie Xuren highlighted the function of taxation as a means for adjusting China's macro economic policy, noting that this "played a major role in boosting the investment capacity in the business sector, enhancing consumer demand, driving growth and shaping [China's] economic development mode."

³ For the US current account deficit, see, e.g., Maurice Obstfeld and Kenneth Rogoff, "The Unsustainable US Current Account Position Revisited" in Richard Clarida (ed.), *G7 Current Account Imbalances: Sustainability and Adjustment* (University of Chicago Press, 2007). For the housing market bubble, see, e.g., Karl E. Case and Robert J. Shiller, "Is there a Bubble in the Housing Market?", *Cowles Foundation for Research in Economics of Yale University*, No.1089, 2004, available at <http://www.econ.yale.edu/~shiller/pubs/p1089.pdf> (accessed 3 February 2010). For the speculative nature of financial markets, see, e.g., Robert J. Shiller, *Irrational Exuberance* (2nd ed., Princeton University Press, 2005).

group foresaw that the US\$1 trillion subprime mess could, one day, paralyze the US\$60 trillion global economy.

To a certain extent, the financial crisis provided a prototype of how turmoil within global financial markets was contagious to virtually all sectors of the world economy and had the capacity to be massively destructive. The crisis, originating within the US, quickly spread worldwide. Not only were financial institutions in many countries forced to accept large amounts of government funding, or go bankrupt, due to the difficulty in obtaining liquidity from the market, but other firms, especially small and medium enterprises, were hard hit by the credit crunch. In response to the unavailability of credit, many firms needed to cut back their investments, lay off employees, or at least freeze payrolls for cost control purposes. The end victims were apparently average persons, whose disposable income stagnated as a result of large scale layoffs and frozen payrolls, and whose household wealth was fiercely attacked by the abruptly sagging equity, bond and housing markets. Under the impact of these financial shocks upon their income and wealth, many households, particularly those in the US, were forced to slash, extensively, their consumption. Combined with reduced investment, heavy downward pressure on global aggregate economic activity was inevitable.⁴

As was the case in many emerging markets, the Chinese economy was not isolated from this catastrophe. Transmission of the crisis to China was primarily effected in two ways—through the problems besetting the complex, intertwined global financial system and the dramatic fall in international trade.

2.1 Financial Channel

Prior to the emergence of the GFC, several large Chinese financial institutions had accumulated sizable holdings of subprime-related assets for “yield chasing”. When the quality of these assets deteriorated, those institutions obviously incurred losses. In part as a result of the Central Government’s strict regulation upon capital outflows, the amount of losses⁵ attributed to subprime-related assets held by China’s financial institutions was much smaller when compared to those suffered by their peers in the US, the United Kingdom (UK) and the European Union (EU). Furthermore, China’s enormous level of foreign reserves, which grew under conditions of continuous surpluses derived from international trade, made the losses relatively affordable. In the event, the GFC did not pose a systemic threat to the strength of China’s financial system and did not affect the availability of credit to the same extent as in other countries (such as those in Eastern Europe).⁶

The advent of the GFC did, however, disrupt the level of foreign direct investment (FDI), which had long functioned as an engine for economic growth in China. After

⁴ See generally, Andrew K. Rose and Mark M. Spiegel, “Cross-Country Causes and Consequences of the 2008 Crisis: International Linkages and American Exposure”, *The National Bureau of Economic Research (NBER) Working Paper* No. 15358, September 2009.

⁵ See Mingchun Sun, “China: Unscathed through the Global Financial Tsunami” (2009) *China & World Economy*, Vol. 17, Issue 6, at pp. 24-42.

⁶ See The International Monetary Foundation (IMF), “Global Financial Stability Report: Responding to the Financial Crisis and Measuring Systemic Risks”, April 2009, available at <http://www.imf.org/external/pubs/ft/gfsr/2009/01/pdf/text.pdf> (accessed 3 February 2010).

the GFC took hold, China experienced a period of negative FDI growth for ten consecutive months from October 2008 to July 2009.⁷ This result was the worst since the Asian Financial Crisis of 1997-1998. Concurrently, China's stock markets were affected by lingering pessimism about the strength of foreign financial markets, and in Shanghai the exchange index plummeted almost 70 percent from its historical peak.⁸ Many investors were forced to dispose of their assets and substantial losses eventuated.

2.2 International Trade Channel

The most serious effect of the financial tsunami upon the Chinese economy can be seen through the prism of international trade. Prior to the onset of the GFC, China's international trade had been in a phase of continuous expansion. According to statistics published by the World Trade Organization (WTO), the average annual growth rate of world trade between 2000 and 2008 amounted to 5 percent, a figure significantly higher than the world aggregate GDP growth rate of 3 percent.⁹ The seeming prosperity of this expansion was, however, largely fueled by the appetite of US consumers, who accounted for tremendous levels of imports (from lower cost countries such as China). This resulted in spirally increasing deficits in the US current account (after netting out its relatively lower level of exports). For example, in 2006 the US current account deficit was about 7 percent of its GDP.¹⁰ Obviously, the US current account deficit corresponded to an equivalent amount of surplus in other countries' current accounts. Of these countries, China stood out for its remarkably high percentage of net exports to total GDP, which since 2005 amounted to almost 33 percent. Table 1 below shows the proportion of exports to GDP in China from 1994 to 2009.¹¹

The GFC interrupted the pattern of "China-produce and US-consume". Nearly all of China's major trading partners, including the US, Japan, the EU and member countries

⁷ See the Ministry of Commerce of the People's Republic of China (MOC), "Statistical Data for the Foreign Direct Investment", available at <http://www.mofcom.gov.cn/static/v/tongjiziliao/v.html/1> (accessed 3 February 2010).

⁸ Although it has been widely acknowledged that certain bubble components in China's stock markets existed before the onset of the GFC, the extent of the slump in market prices appears to represent an overreaction by panicked investors rather than a normal correction. This can be reflected by the sharp fall and rebound of the Shanghai Stock Exchange Composite Index (SSECI). After the demise of Lehman Brothers in September 2008, the SSECI plunged to the level of 1664 on 28 October 2008. However, by the end of 2009 the SSECI had already climbed above the 3000 level. Historical Data on the SSECI is available at <http://www.google.cn/finance/historical?cid=7521596&startdate=2008-07-04&enddate=2010-02-03&start=300&num=30> (accessed 4 February 2010).

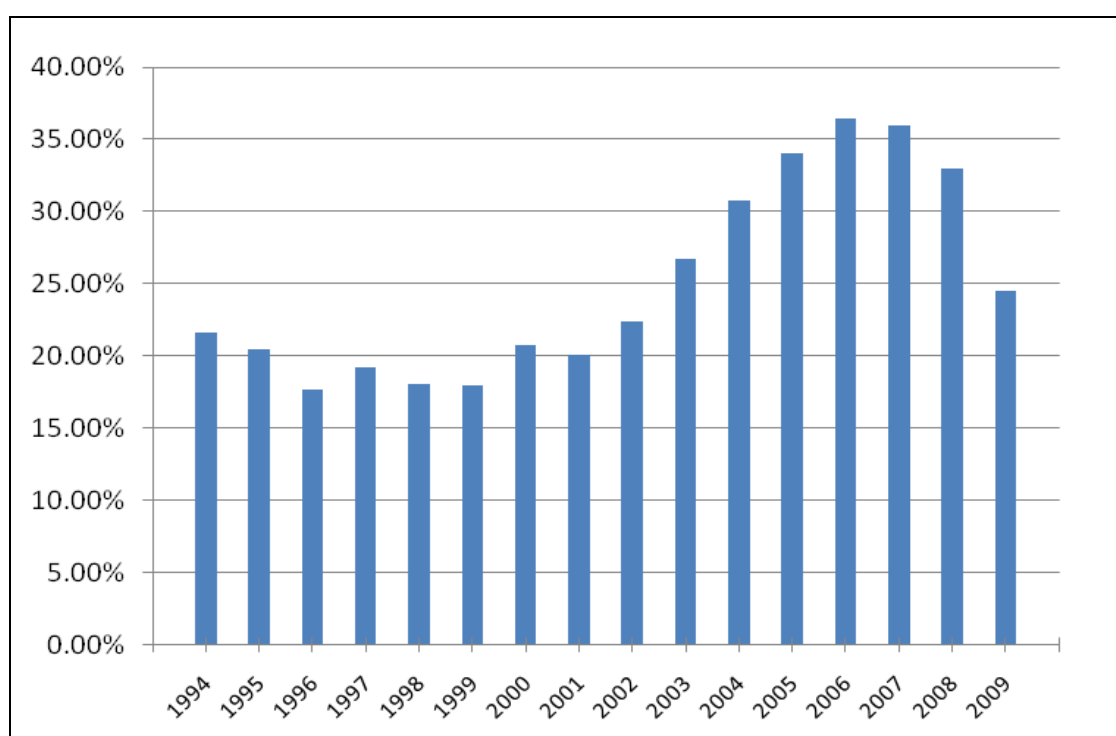
⁹ See The World Trade Organization (WTO), "International Trade Statistics 2009", Chapter 1, available at http://www.wto.org/english/res_e/statistics_e/its2009_e/its09_world_trade_dev_e.pdf (accessed 3 February 2010).

¹⁰ See Robert E. Scott, "Current Account Picture; March 14, 2006", *Economic Policy Institute*, available at http://www.epi.org/publications/entry/webfeat_econindicators_capict_20060314/ (accessed 3 February 2010).

¹¹ Data from 1994 to 2008 is sourced from the MOC, "Export and Import Data", available at <http://zhs.mofcom.gov.cn/tongji.shtml> (accessed 3 February 2010); see also the National Bureau of Statistics of China (NBS), "GDP Data" in *Online Statistics Database*, available at <http://219.235.129.58/indicatorYearQuery.do> (accessed 3 February 2010). Data in 2009 is sourced from the NBS, "National Economy and Social Development Report 2009", 25 February 2010, available at http://www.stats.gov.cn/tjgb/ndtjgb/qgndtjgb/t20100225_402622945.htm (accessed 20 April 2010) [hereinafter 2009 NESD Report].

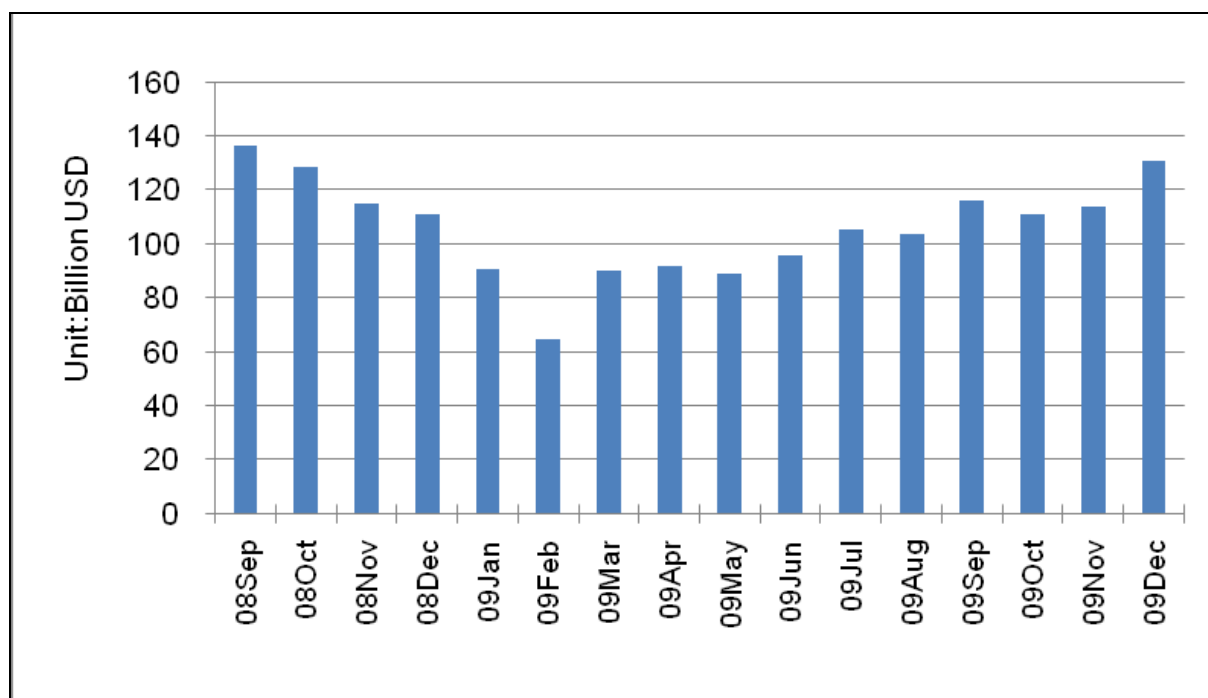
of the Association of Southeast Asian Nations (ASEAN) abruptly slashed their demand for “Made-in-China”. This was largely attributable to the shrinking disposable income of the domestic households in these countries and the reduced investment capabilities of their enterprises. China’s export sector suddenly lost steam. According to China’s Ministry of Commerce, China’s total level of exports in 2009 was 16 percent lower than that for 2008. Table 2 shows China’s exports in the post-GFC period.¹² The decrease in China’s exports further dragged down the growth rate of China’s GDP. Having recognized the significant adverse impact this would have on the economy, the Central Government decided to reset the economic growth target for 2009 at a modest level of 8 percent, a figure significantly lower than the double digit growth achieved in previous years.¹³

TABLE 1: PROPORTION OF EXPORTS TO GDP IN CHINA 1994-2009



¹² Data is sourced from the MOC, “Export and Import Data 2008-2009”, available at <http://zhs.mofcom.gov.cn/tongji.shtml> (accessed 3 February 2010).

¹³ See, e.g., Kevin Hamlin and Jun Luo, “China Says 8% Economic Growth Target Within Reach Amid Crisis”, *Bloomberg Press Online*, 27 February 2009, available at <http://www.bloomberg.com/apps/news?pid=20601089&sid=aL.PytK78PwUw&refer=china> (accessed 3 February 2010).

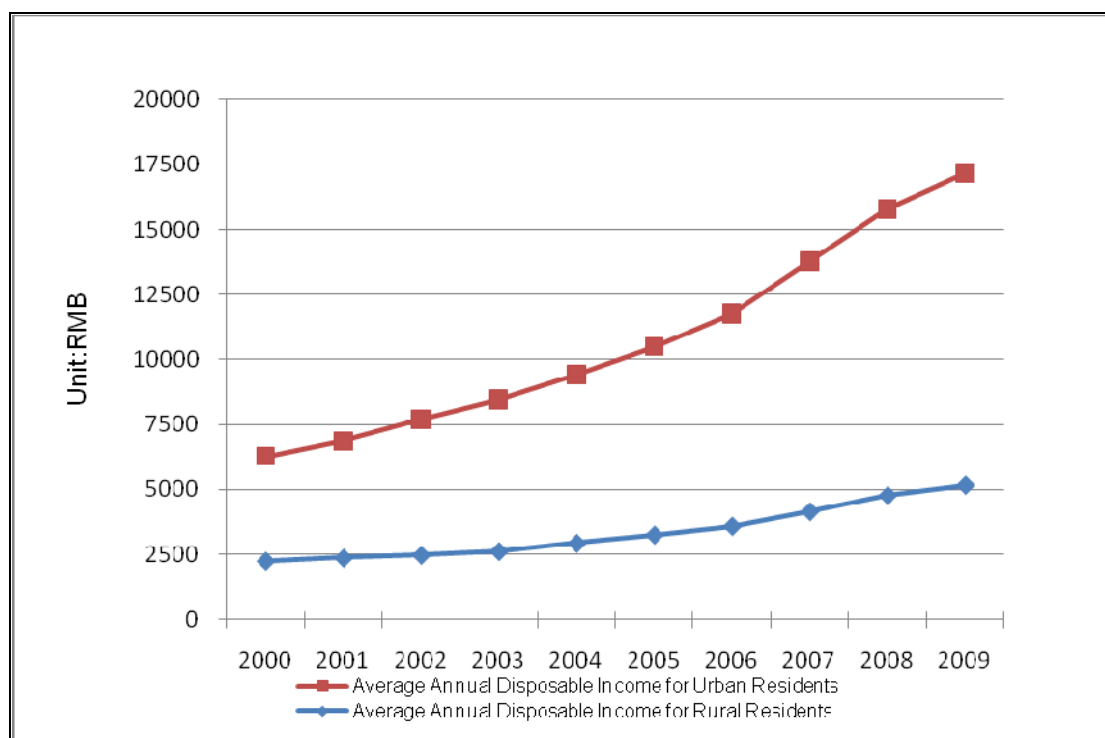
TABLE 2: CHINA'S EXPORTS POST-GFC

The GFC had other far-reaching effects on China's economy and society which cannot be fully reflected by its GDP and export figures alone. As the largest transitional economy in the world, China has a very high ratio of rural to urban population, 53.4 percent (or 713 million people) at the end of 2009.¹⁴ For various historical reasons, the development of China's rural areas has lagged far behind that of its urban areas. This gave rise to substantial disparities in wealth distribution. It goes without saying that the average disposable income of urban Chinese residents is much higher than that of rural Chinese residents (as shown in Table 3) and the living standard in urban China is generally higher than that in rural China.¹⁵ The Central Government has acknowledged these matters as serious social problems and has long endeavored to narrow the gap.¹⁶ To date, however, the effectiveness of these remedial measures appears far from ideal, as indicated in Part III C below.

¹⁴ See the NBS, 2009 NESD Report, *supra* note 11.

¹⁵ For data from 2000 to 2008, see the NBS, "Data of Average Annual Disposable Income of Urban Residents" and "Data of Average Annual Disposable Income of Rural Residents" in *Online Statistics Database*, available at <http://219.235.129.58/indicatorYearQuery.do> (accessed 3 February 2010). For data in 2009, see the NBS, 2009 NESD Report, *supra* note 11. Table 3 is based on the data from these sources.

¹⁶ See the Outline of the Tenth Five-Year Plan for National Economic and Social Development of the People's Republic of China [hereinafter 10th FYP], passed by the 9th National People's Congress on 15 March 2001; and the Outline of the Eleventh Five-Year Plan for National Economic and Social Development of the People's Republic of China [hereinafter 11th FYP], passed by the 10th National People's Congress on 14 March 2006. The Central Government is in the process of drafting its 12th FYP which covers the period from 2011 to 2015. The issue of narrowing rural and urban wealth disparity is mentioned in the Suggested Outline describing the broad themes of the 12th FYP, which has been passed by the 5th Plenary Session of the 17th Central Committee of The Communist Party of China (CPC) on 18 October 2010, http://news.xinhuanet.com/politics/2010-10/27/c_12708501.htm. For

TABLE 3: INCOME DISTRIBUTION BETWEEN URBAN AND RURAL RESIDENTS IN CHINA

In the pursuit of a better life, millions of rural residents left their homes to work in cities and townships. This was, perhaps, the only avenue open to them to find opportunities to relieve poverty and to help their families. Unfortunately, the economic sector most hard-hit by the GFC, the small and medium enterprises (SMEs) in China, happened to be the major employers of these rural migrant workers. With the resulting increase in the number of bankruptcies among SMEs, a large number of rural migrant workers found real difficulty in obtaining jobs in cities and towns and had to return to their rural homes. Such a phenomenon was particularly conspicuous in the Pearl River Delta¹⁷ which, over the past three decades, has been home to China's most concentrated manufacturing base absorbing a vast number of lower paid workers. It has been estimated that in late 2008, nationwide, around 20,000,000 rural migrant workers were unemployed.¹⁸ The immense scale of layoffs of such workers may

a general summary of the Outline, see, e.g., "Premier-To-Be Expounds The Five-Year Plan", *Wall Street Journal*, available at http://chinese.wsj.com/big5/20101118/rlw181156_ENversion.shtml (accessed 22 November 2010).

¹⁷ The Pearl River Delta is in southern China. The delta covers nine prefectures of Guangdong province, and the Hong Kong Special Administrative Region and Macau Special Administrative Region. Since economic liberalization took place in China in the late 1970s, the delta has become one of the leading economic regions and a major manufacturing centre of China. For the economy in the delta during the GFC, see Huang Yanjie and Chen Shaofen, "Crisis of Industrialization in the Pearl River Delta", *EAI Background Brief* No. 444, available at <http://www.eai.nus.edu.sg/BB444.pdf> (accessed 3 February 2010).

¹⁸ See "Chen Xiwen: Around 20 Million Rural Migrant Workers Unemployed and Government Responds Actively", *Xinhua News*, available at http://news.xinhuanet.com/politics/2009-02/02/content_10750425.htm (accessed 22 November 2010). Because of the GFC it has been reported that 40 percent of SMEs went into bankruptcy, and another 40 percent were struggling to make ends

indicate that only a relatively small percentage of China's rural residents could harness the so-called miracle economic growth to promote their living standards. In the event, one likely consequence of the GFC in China has been to aggravate the inequality in wealth distribution between urban and rural residents, fueling the risk of social unrest.

3. CHINA'S TAX RESPONSE TO THE GFC: RECENT REFORMS IN THE INDIRECT TAXATION SYSTEM

Like many countries that developed stimulus packages to fight the GFC, China adopted tax reform as part of a plan to offset the adverse effects of the GFC on the economy. As will be shown below, some of those reforms – particularly those related to indirect taxes affecting consumption – were implemented swiftly and had immediate effect. Given the importance of China's indirect tax regime in terms of the Central Government's total tax collections, Part III of this article focuses upon that regime. Table 4 below shows the tax revenue referable to indirect taxation (VAT, Business Tax (BT) and CT) as compared to direct tax revenue (Enterprise Income Tax and Individual Income Tax).

How then did China's indirect taxation system change as a result of the GFC? In short, this involved: (1) a reduction in certain tax rates (and allowing various forms of tax relief) particularly in relation to CT and VAT, (2) the transformation from a production-based VAT into a consumption-based VAT, and (3) an appreciation of the necessity to improve – and of course fund – the social security system for transition to a consumption-led economic development model.

Before embarking upon our analysis, it is useful to provide some background from which we can appreciate the implementation of the reforms summarized above. It is now accepted in Beijing that China's economic development model of export-oriented, high input, high consumption, high pollution, but low output in terms of energy intensity,¹⁹ is no longer affordable or sustainable. Accordingly, the Central Government resolved to shift the balance of growth from reliance upon exports towards promoting domestic spending.²⁰ Indeed, the proportion of consumption to GDP in China has been on the decline from 2000 to 2008 (as Table 5 below shows), even though China's GDP showed substantial increases throughout this period. There was, however, a slight increase in the ratio of consumption to GDP in 2009. This was

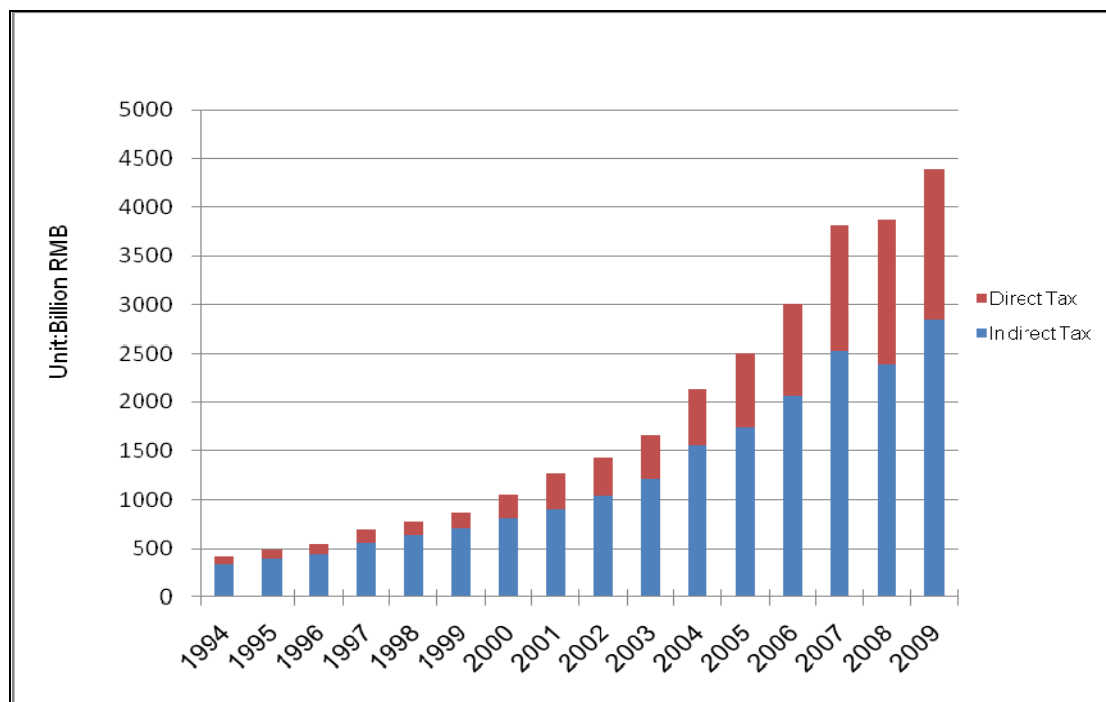
meet, see "Tax Cut for Low-Profit Small Enterprises", *China Daily*, 15 December 2009, http://www.chinadaily.com.cn/bizchina/2009-12/15/content_9181949.htm (accessed 22 November 2010).

¹⁹ Energy intensity is a measure of the energy efficiency of a nation's economy, which is calculated as units of energy per unit of gross domestic product (GDP). High energy intensity indicates a high price or cost of converting energy into GDP. A nation that is highly economically productive will have a far lower energy intensity than a nation that is economically unproductive. According to some studies, energy consumption in 2000 in China was 14.32 billion tons of coal equivalent (tce) and in 2005 was 22.25 billions tce, which represents an average annual increase of 11.1 percent. There was a significant deterioration in energy use efficiency in China compared to the preceding 20 years during which a 400 percent increase in GDP was accompanied by an increase in energy consumption of only 200 percent. See the Asian Development Bank (ADB), *Country Environmental Analysis for the People's Republic of China*, May 2007, available at <http://www.adb.org/Documents/Produced-Under-TA/39079/39079-PRC-DPTA.pdf> (accessed 2 February 2010).

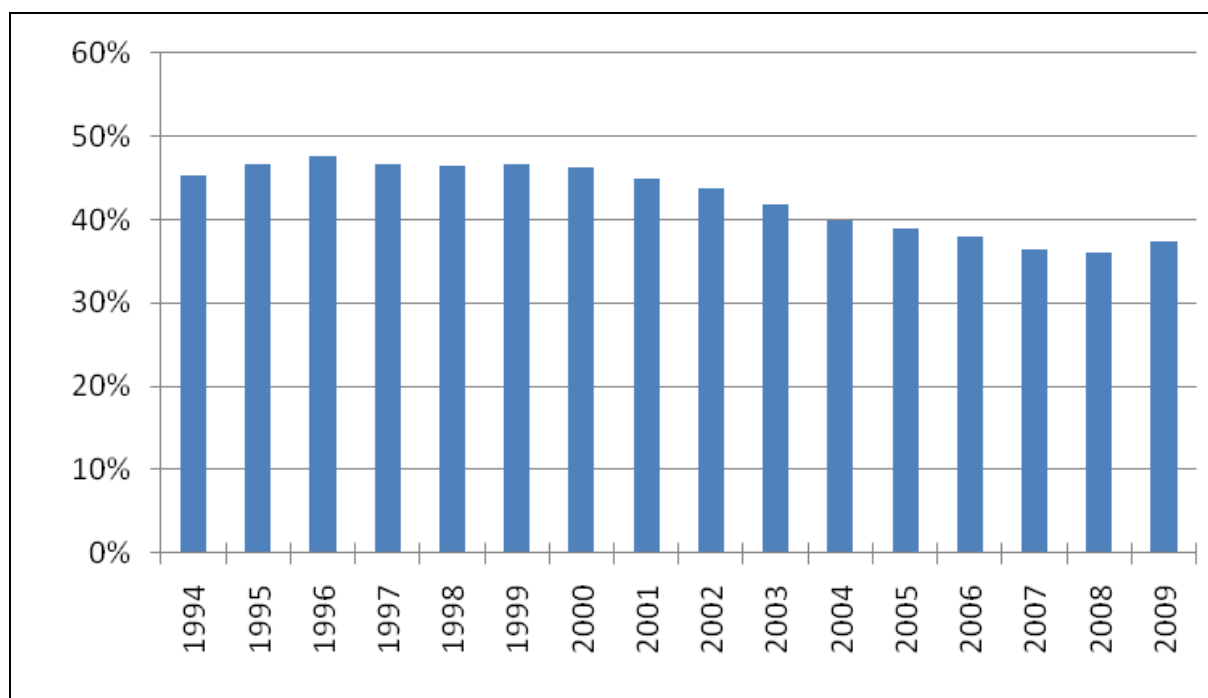
²⁰ See Premier Wen Jiabao, "Government Report 2008 for the 11th National People's Congress" (in Chinese), 5 March 2008, available at <http://www.xinhuanet.com/2008lh/gzbg/20080305.htm> (accessed 1 February 2010).

most probably attributable to the Central Government's stimulus measures (which, in part, incorporated the indirect tax reforms discussed below) for expanding domestic consumption as part of its overall plan to deal with the GFC.

TABLE 4: TAX REVENUE COMPOSITION IN CHINA²¹



²¹ For the purposes of this comparison, direct tax revenue only includes revenue from Enterprise Income Tax and Individual Income Tax; indirect tax revenue only includes revenue from VAT, BT, CT, and revenue from Customs' collection of VAT and CT on imported goods (after deduction of export tax refunds). For data, see the SAT, "Statistical Data of Tax Revenues from 1994 to 2008", available at <http://www.chinatax.gov.cn/n8136506/n8136593/n8137633/n8138817/index.html> (accessed 5 February 2010). For data in 2009, see the Tax Policy Department of the Ministry of Finance of China (MOF), "Analysis on the Increase in Tax Revenues in 2009" (in Chinese), published by the MOF, available at http://szs.mof.gov.cn/zhengwuxinxi/gongzuodongtai/201002/t20100211_270552.html (accessed 24 March 2010) [hereinafter 2009 Tax Analysis].

TABLE 5: PROPORTION OF CONSUMPTION TO GDP IN CHINA²²

China's focus upon increasing exports to promote economic growth proved problematic however, as shown by the consequences of the GFC's impact on China's major trading partners such as the US, the UK and the EU. Moreover, there is an insufficient level of domestic demand in China.²³ And, in this regard, an imbalance exists between urban and rural household consumption. To help deal with the increased difficulties facing China's economy brought about by the GFC (specifically, the shrinkage in exports and consumption), the Central Government decided to implement important reforms to China's indirect tax system (as one part of its stimulus package).

3.1 Reduction in Certain Tax Rates

China's Central Government is clearly determined to increase domestic consumption as a key to maintaining long-term, sustainable development. Indeed, at an early stage it provided a host of incentives to boost domestic household consumption as a means of dealing with the adverse effects of the GFC.

One of the most significant of these incentives was to cut certain tax rates. For instance, the rate of vehicle acquisition tax on cars with a capacity of less than 1.6 liters was reduced from 10 percent to 5 percent during the period from 20 January

²² For data from 1994 to 2008, see the NBS, "GDP Data" in *Online Statistics Database*, available at <http://219.235.129.58/indicatorYearQuery.do> (accessed 6 February 2010). For data in 2009, see the NBS, 2009 NESD Report, *supra* note 11.

²³ See Xiaolu Wang and Fan Gang, "Economic Crisis, Keynesianism and Structural Imbalance in China", 8 July 2009, available at http://epress.anu.edu.au/china_new_place/pdf/ch08.pdf (accessed 21 April 2010).

2009 to 31 December 2009. The reduction was continued throughout 2010, albeit at the rate of 7.5 percent.²⁴ The CT rate on cars with a capacity of less than 1 liter was also reduced from 3 percent to 1 percent by the CT reforms introduced at the end of 2008.²⁵ By way of contrast, the CT rates on motor cars with a capacity of 3 liters to 4 liters and more than 4 liters have been increased by 10 and 20 percent, respectively.

The 2008 CT reforms also changed the tax rate structure on fuel products. Previously, petrol was taxed at RMB 0.2 per liter without differentiating whether it was leaded or non-leaded.²⁶ After the reforms, leaded petrol was taxed at RMB 0.28 per liter, but non-leaded petrol remained taxed at RMB 0.2 per liter.²⁷ Although the CT rate was not altered drastically, new taxable items including aviation kerosene, fuel oil, solvents and lubricant oil were added to the category of taxable oil products.

Soon after these reforms were implemented however, CT on petrol was increased by up to seven-fold starting from 1 January 2009, as part of a broader reform relating to fuel taxation and pricing approved by the State Council.²⁸ The tax rate for leaded petrol climbed to RMB 1.4 per liter from RMB 0.28. Importantly, this figure is higher than the rate for unleaded petrol of RMB 1 per liter and the rate for diesel of RMB 0.8 per liter.²⁹ Concomitant with the increase of the tax rate on oil products, six types of government charges were waived, namely, road maintenance fee, channel maintenance fee, administration fee for highway transportation, highway transportation surcharges, administration fee for water transportation, and water transportation surcharges. Phasing out these administrative charges was intended to offset the increased burden borne by the public for fuel consumption as well as to simplify the tax (and fee) regimes relating to fuel. As stated in the Notice promulgated by the State Council, the intention is to promote energy-saving, cut pollution in cities and reduce oil imports.³⁰ The adjustment of CT on oil products is also aimed at playing a role in promoting economic restructuring, standardizing the imposition of administrative charges, and ensuring equal sharing of the tax burden among users.³¹ To counterbalance the effect of these tax increases, government subsidies were provided for certain sectors such as public transportation and particularly affected groups of people such as grain-producing farmers.

The fuel taxation and pricing reforms described above constitute one part of the Central Government's fiscal and tax policy to respond to the numerous challenges produced by the GFC on China's domestic economy. In short, increasing energy efficiency and reducing dependence on external resources through the mechanism of

²⁴ See the MOF and the State Administration of Taxation (SAT) Notice No. 154, 2009.

²⁵ The Provisional Regulations on Consumption Tax (CT Regulations) were issued by the State Council on 13 December 1993, and amended on 5 November 2008 by the State Council Order No. 539. The Regulations came into effect on 1 January 2009. For the tax rate on cars, see Amended CT Regulations, Schedule of Tax Items and Tax Rates, item 9 (1).

²⁶ CT Regulations, Schedule of Tax Items and Tax Rates, item 7.

²⁷ Amended CT Regulations, Schedule of Tax Items and Tax Rates, item 6 (1).

²⁸ See the State Council Notice of Implementing the Reform on Fuel Taxation and Pricing, No. 37, 2008 [hereinafter SCN Fuel Reform].

²⁹ The MOF and SAT Notice of Increasing the Consumption Tax Rates on Fuel Products, No. 167, 2008, Art. 1.

³⁰ See the SCN Fuel Reform, Sec. 1, *supra* note 28.

³¹ *Id.*

taxation are intended to play a positive role in responding to the ongoing impacts of the GFC on China's economy and in furthering China's long-term development plan.

In addition to these tax reforms, an array of fiscal incentives has been provided for rural residents to buy vehicles, appliances and agricultural machines, and other goods such as refrigerators and computers. Urban residents can also receive a subsidy if they trade in cars and home appliances for new goods.³²

Apart from reducing taxes on motor vehicle acquisitions, the Central Government *increased* tax rates on selected items. For example, from 1 October 2009 the CT rates on certain tobacco products were increased by varying amounts. An additional 5 percent surtax based on the sales value of tobacco products is now also charged at the wholesale stage. Furthermore, with effect from 1 August 2009 the method for imposing CT on alcohol (white spirits) has been adjusted to combat avoidance.³³ This adjustment was made to regulate spirit producers, usually large-scale enterprises who set up their own agencies to manipulate "transfer prices". The protection of the tax base and the efforts to combat tax avoidance and tax evasion (which are not limited to the imposition of CT on spirits) were deemed necessary in difficult economic times.

In summary, it is obvious that the reformed CT rates relating to motor vehicles and fuel encourages the purchase and use of smaller low emission cars and discriminates against larger high emission cars. This change illustrates that the Central Government intends to employ economic instruments, in particular taxation, to foster China's economic development in a sustainable manner, but without creating too great an impact on the economy especially during times of economic difficulty.

3.2 Move to a Consumption-based Value Added Tax System

VAT, together with BT and CT, was formally introduced in China during the 1994 tax reform. VAT applies to goods and certain services involving the provision of labour,³⁴ BT applies to most other services as well as to the transfer of intangible assets and immovable property,³⁵ and CT applies to, typically, luxury goods (such as cigarettes, wine, and expensive jewelry, as well as motor vehicles and fuel) in addition to VAT.³⁶ The imposition of VAT and BT are mutually exclusive, and in combination they cover the scope of a classic VAT system (such as the European-style VAT).

³² See "China's Expanding Domestic Consumption is Helpful to Balance Global Economic Development" (in Chinese), *The Xinhua News Agency*, 12 November 2008, available at http://www.gov.cn/wszb/zhibo281/content_1148168.htm (accessed 1 February 2010); see also "Shopaholics Wanted", *Economist*, 25 June 2009; and Laurence E. Lipsher, "Asian Tax Review: A Fast and Furious Tax Year-End in China" *Tax Notes International* (18 January 2010), at p. 261. Lipsher states: "Starting in January 2010, those trading in will get between RMB 5,000 to RMB 18,000, a substantial stimulus. In effect, this will create a used car business the likes of which [in China] has never existed ..."

³³ See the SAT, Circular for Strengthening Tax Administration on Spirits Consumption Tax and the appended Management Measure for the Approval of Minimum Prices for Tax Assessment of Spirits Consumption Tax, SAT Circular No. 380, 2009.

³⁴ VAT Regulations, Art. 1.

³⁵ BT Regulations, Art. 1.

³⁶ CT Regulations, Art. 1; Schedule of Tax Items and Tax Rates.

The standard VAT rate of 17 percent was imposed on most taxable activities including selling or importing goods and supplying services involving the provision of labour.³⁷ It is largely restricted to manufacturing activity and is supplemented by a low rate of 3 percent for BT imposed on the provision of key service items including transportation, post and telecommunications, as well as a rate of 5 percent for professional and financial services.³⁸ A reduced VAT rate of 13 percent applies to a range of goods including basic staples and household necessities such as food, fuel, electricity, books, newspapers and magazines and agricultural products.³⁹ There is a notional zero rate scheme for exports⁴⁰ but in practice, this is not applied and instead a completely separate export rebate system has been established. There are two types of taxable persons under the VAT law, and a taxpayer's status may affect its VAT liabilities. The first category comprises general taxpayers who have the right to deduct input tax while the second category, small-scale taxpayers, have no such right (although reduced tax rates can apply to their taxable activities). Initially, the VAT rate for small-scale taxpayers engaging in commercial activities was 4 percent,⁴¹ and 6 percent for small-scale taxpayers engaging mainly in production activities.⁴²

The most distinctive characteristic of the 1994 Chinese VAT is that it was a production-based not consumption-based tax—since the VAT paid on the purchase of capital goods such as equipment and fixed assets was not allowed to be credited against VAT payable.⁴³ The non-allowance of input tax for purchased capital assets added to the cost and sale price of manufactured goods within the production and distribution chain. This led to duplicated VAT levies through the supply chain in the entire business cycle and increased the tax burden on enterprises in general. In particular, it penalized the purchase of fixed assets by a business, and more broadly penalized capital-intensive production techniques. Though the standard VAT rate is 17 percent, the effective tax rate could amount to around 23 percent when converting the production-based VAT into the consumption-based VAT. Thus, this production-type VAT had, perhaps unintentionally, become a negative factor in promoting the upgrading of technology and economic growth in China, further weakening the competitive edge of Chinese enterprises in international markets. This issue became particularly severe in the face of economic adversity brought on by the GFC.

In order to encourage investment in infrastructure, reduce the tax burden on capital investment by enterprises, and accelerate technology development within the overall context of adjusting China's industry structure and transforming the pattern of its

³⁷ VAT Regulations, Art. 2 (1) and (4).

³⁸ BT Regulations, Art.2, para.1; and Schedule of Tax Items and Tax Rates.

³⁹ VAT Regulations, Art. 2 (2).

⁴⁰ VAT Regulations, Art. 2 (3).

⁴¹ In 1998 the tax rate for small-scale taxpayers was divided into two types. The tax rate for small-scale taxpayers engaging in commercial activities was reduced to 4 percent, while for all other small-scale taxpayers the tax rate remained at 6 percent. *See* The MOF and SAT Notice on the Tax Policy for Small-Scale Commercial VAT Taxpayers, No. 113, 1998; *see also* the State Council, MOF and SAT, "Press Conference on Amending the VAT Regulations, BT Regulations, and CT Regulations" (in Chinese), available at <http://61.152.208.78/gate/big5/www.csj.sh.gov.cn/gb/csj/szpd/xfs/node5357/userobject7ai35530.html> (accessed 3 February 2010).

⁴² VAT Regulations, Art. 12.

⁴³ VAT Regulations, Art. 10; VAT Rules, Art. 19.

economic growth,⁴⁴ towards the end of 2008 the Central Government decided to reform the VAT, along with BT and CT. It should be noted, however, that the most significant element of the VAT reform (namely, enacting a nationwide consumption-based VAT) was planned well before the GFC, but was only implemented after 2008. Specifically, this change allowed registered VAT general taxpayers to credit input tax incurred on purchases of equipment and other non-real property fixed assets against output VAT levied on their taxable supplies.⁴⁵ Input VAT is not however creditable for (1) fixed assets used solely for tax exempt activities, (2) activities not subject to VAT or (3) personal consumption.⁴⁶ Concurrently, VAT exemptions for imported equipment and VAT refunds for domestically produced equipment purchased by qualified foreign invested enterprises were abolished, although Customs Duty exemptions continue to apply.⁴⁷ All these reforms came into effect on 1 January 2009. Although purchase of real property and intangible property still fall outside the scope of this reform, the change marks a major step in relieving the tax burden on enterprises in China in general and on capital-intensive industries in particular. At the same time, the VAT rate for small-scale taxpayers in all industries was reduced and standardized to 3 percent and the VAT rate on some mineral resources reverted to the standard rate of 17 percent (previously 13 percent) since VAT payers in the mineral industry were allowed to deduct input tax when purchasing fixed assets.

Another important instrument of tax policy concerning the imposition of VAT in China relates to the adjustment of the VAT refund rate for exports. As indicated

⁴⁴ Conceptually, a country's industrial structure may be defined as the relative distribution of its resources and total output among industries differentiated by the raw materials they use, their productive processes, and the finished products that they turn out. Industrial structure has a bearing upon a country's total output, namely, its national income or product, so far as differences among industries are seen as differences in the basic pattern of social and economic institutions under whose aegis the industries are carried on. See Simon Kuznets, "National Income and Industrial Structure" (1949) *Econometrica*, Vol. 17, at pp. 205-241. In the 10th FYP, the Central Government admitted that China has entered into a stage that only by making structural adjustments can the economy be developed further. It decided in the 10th FYP to optimize and upgrade the industrial structure and to strengthen China's international competitiveness. The major targets set in the 10th FYP were to achieve growth for the primary, secondary and tertiary industries at the rates of 13, 51, 36 percent, respectively, of GDP, and to improve national economic and social information technologies as well. In the 11th FYP, the Central Government stated that to maintain balanced, sustainable economic and social development, six principles should be adhered to, among which, speeding up the transformation of economic growth pattern and improving the capacity of independent innovation stand out. China's shortage of natural resources has posed a serious constraint on its economic development. The government is determined to transform China's economy into a "recycling economy", accelerating the construction of a resource-saving and environmentally-friendly society. It has decided to promote information technology development and adopt a new mode of industrialization based on the principles of conserving energy and protecting the environment. See the 10th FYP and the 11th FYP, *supra* note 16.

⁴⁵ See Amended VAT Regulations, Arts. 8 and 10; Amended VAT Rules, Arts. 21 and 25 (issued respectively by the State Council on 10 November 2008 and the MOF on 18 December 2008). According to these provisions, the term "fixed assets" includes machinery, transport vehicles and other equipment, tools and apparatus for production and operation use which have a useful life of more than 12 months. The term "fixed assets" does not however include motor vehicles, motorcycles, boats or yachts which are subject to CT and those for private use.

⁴⁶ Amended VAT Rules, Art. 21, para. 1.

⁴⁷ See the Decree Regarding the Adjustments to Some Preferential Import Tax Policies Jointly Issued by the MOF, SAT and the General Administration of Customs of the PRC (GAC), No. 43, 2008 and the Notice Regarding the Abolition of VAT Refund Policy on the Purchase of Domestically Manufactured Equipment by Foreign Invested Enterprises, The MOF and SAT No. 176, 2008.

above, China notionally practices zero-rating on exports (as do most countries), but the Central Government frequently adjusts the rates at which input taxes are credited or rebated.⁴⁸ The government may increase the refund amount when it desires to encourage exports but reduce the amount when budgetary demands dictate or when it seeks to avoid conflicts with foreign trade partners.⁴⁹ From 1 August 2008 to 1 June 2009, the State Administration of Taxation of the PRC (SAT) adjusted the VAT refund rate for exports no fewer than seven times. The object was to support China's export enterprises in a context of global economic downturn. For instance, on 1 June 2009 the export tax rebate was raised in varying degrees for selected items, in particular for farm produce and labor-intensive products such as luggage, shoes, and household electrical appliances, and for certain products manufactured with a higher level of technology.⁵⁰ It is worth noting that these adjustments were not made simply for stimulating exports. They were also made for stabilizing China's foreign trade situation and facilitating changes to the country's industrial structure. This purpose can be gleaned from examining the different rebate rates among commodities that were eligible for export refunds—for example, mechanical and electrical goods produced with a high level of technology were given the highest rebate rate of 17 percent while steel products with high energy consumption were given the much lower rate of 9 percent.⁵¹

A further taxation policy designed to stimulate China's declining export sector as a result of a deteriorating global economy should be noted. In the Export Duty Notice published on 13 November 2008 Customs Duty was abolished on 68 types of base metals and articles of base metal, and reduced or abolished on 26 types of fertilizers and 52 types of cereals and products of the milling industry.⁵²

To help China's financial institutions (which are generally subject to BT rather than VAT) through the GFC, the securities exchange tax rate was reduced from 0.3 percent to 0.1 percent from 24 April 2008 and the tax was levied solely on the sellers of securities from 19 September 2008.⁵³ (In addition, interest derived by individual

⁴⁸ There were several reasons why China opted for an export refund VAT system. Briefly, in the first year of formally implementing VAT in China, due to rapid export growth, and fraudulent invoices and rebate claims, a large number of the rebates claimed had to be deferred. In the following two years, the government budget still could not satisfy the claims and as a result the rebate rates were reduced. See J. Whalley and Li Wang, "Evaluating the Impure Chinese VAT Relative to a Pure Form in a Simple Monetary Trade Model with an Endogenous Trade Surplus" *NBER Working Paper* No.13581, 2007.

⁴⁹ In China, VAT refunds for exported goods and the VAT exemption on importation of capital equipment were often subject to adjustment. Normally, taxpayers pay VAT first and then claim VAT refunds from the relevant tax authority based on the Exported Goods Declaration certified by Customs. The procedures and assessment of VAT refunds are very complicated and the Central Government has issued a number of circulars in relation thereto. *China Briefing* reported on 23 December 2009 that export VAT rebates would continue through 2010.

⁵⁰ See the MOF and SAT Notice on Further Increasing Export Refund Rates on Certain Commodities, No.88, 2009.

⁵¹ *Id.* Export tax refunds for some steel products involving high energy consumption were recently repealed, see the MOF and SAT Notice on Invalidating VAT Refund for Certain Products, No. 57, 2010. The repeal was effected mainly for the purposes of reducing pollution and saving energy, as well as for fostering industrial structural change.

⁵² See the Notice of the Customs Tariff Committee of the State Council on Revising the Export Customs Duty Rates, 13 November 2008.

⁵³ For details, see "Adjustment of Imposition Method on Securities Exchange Tax", available at http://www.gov.cn/jrzq/2008-09/18/content_1098950.htm (accessed 23 March 2010).

investors on the settlement of securities transactions was temporarily exempted from Individual Income Tax.⁵⁴) This reduction and change of the imposition method served as a fillip to China's securities market.

Finally, the Central Government is still considering plans to extend the tax base of VAT to cover BT in order to eliminate the double taxation on service providers produced by the separation of these two taxes. Currently BT is levied on gross turnover derived from provision of services, assignment and licence of intangible assets, and sale or rental of real estate, provided that such activities are rendered or carried on within China. There is no credit for BT paid along the supply chain as is the case with VAT. Separation of the tax base thus means that VAT taxpayers still do not get any relief for BT paid on the provision of services and other items that would be credited under a comprehensive VAT or goods and services tax (GST).

As we will see below, the timing of the VAT reforms could not have taken place at a better time. VAT reform has long been considered an important policy goal by the Central Government,⁵⁵ and experiments were carried out in some parts of the Northeast and Central regions of China as well as for certain industries including the oil, chemical, and automobile sectors with a view to eventually extending it nationally.⁵⁶ According to official reports, the move to a consumption-based VAT was effective from an economic perspective during the trial phase.⁵⁷ The major overhaul was, nonetheless, undertaken only after the GFC emerged, which shows the GFC prompted the government to apply the reforms to the whole country and to all industries in order to help increase investment in fixed assets and relieve the tax burden placed on many enterprises. The GFC had a negative impact on industrial production, with many enterprises suffering shortfalls of working capital. The inability to expand production and the consequent shrinkage of investment in fixed assets were, for many enterprises, serious problems. Allowing input VAT paid for the purchase of fixed assets to be credited against VAT payments clearly provided immediate cash flow benefits for enterprises in China during a time of financial turmoil, and in the long term facilitates development of capital-intensive industries and a platform for upgrading technology.

⁵⁴ See the MOF and SAT Circular on the Policy of Individual Income Tax on the Income Derived from Interests of Securities Trading Settlement by Individual Investors of Securities Market, No.140, 2008.

⁵⁵ See Gao Peiyong, "Implementation of a New Round of Tax Reform Under a Structural Tax Reduction" (2009) *Asia-Pacific Journal of Taxation* 62. Gao notes that the 2008 reforms can be traced back to the Third Plenary Session of the 16th Party Central Committee of the CPC held in October 2003. During this meeting proposed changes included the reform of the export tax refund system and a reform of VAT from a production-oriented to a consumption-oriented system.

⁵⁶ See the SAT, "VAT Transformation: Win-Win for Taxation System Reform and Economic Development", 6 February 2009, available at <http://www.chinatax.gov.cn/n8136506/n8136593/n8137537/n8138532/8814903.html> (accessed 5 February 2010). The Central Government began a pilot reform in Northeast China, which covered three provinces, namely, Heilongjiang, Liaoning, and Jilin in January 2004. The pilot reform covered eight industrial sectors including oil, chemical, and automobile production. The trial scheme was extended to 26 cities in the central region in July 2007 and to parts of the Inner Mongolia Autonomous Region and the areas hit hard by the Wenchuan earthquake in July 2008.

⁵⁷ See the SAT, "VAT Reform Trial in Northeast China Achieved Positive Effects", 21 December 2005, <http://www.chinatax.gov.cn/n480462/n480483/n480549/1009527.html>; and "SAT: VAT Reform Trial in Central China Had Evident Effects", 6 February 2008, <http://finance.people.com.cn/GB/6869248.html> (accessed 23 November 2010).

3.3 General Measures to Improve the Social Security System

The GFC clearly made it more urgent for China to change the focus of its domestic economic development from an export to a consumption model. Indeed, what China's economy faced during and after the GFC is not simply a short-term difficulty, but a fundamental challenge to its development model that originated from East Asia's economic success led by Japan.⁵⁸ The eruption of the GFC and its impacts on China betrayed a severe problem in the Chinese economy, namely, structural imbalance, which is reflected by not only the heavy reliance on export-oriented manufacturing and processing industries, but also the excessive expansion of industrial capacity at the cost of consumption.⁵⁹ Despite a steady increase in GDP, China's consumption rate as a percentage to GDP has kept falling (as noted in Table 5 above).

Compared with the low consumption rate however, the savings rate in China has remained high.⁶⁰ This is not necessarily because the Chinese people are economically prudent, but because the inadequate socio-economic welfare system makes them feel insecure about healthcare, children's education, unexpected rainy days and eventual retirement from the workforce. Taking the savings rate of urban households for example (as data for the savings rate of rural households is limited), the average savings rate relative to disposable income rose from 17 percent in 1995 to 24 percent in 2005, against a background of rapid income growth and an interest rate on bank deposits that was very low throughout the period.⁶¹ The unique pattern of savings behavior in China at present – relatively high savings rates at the early and late stages of the life cycle – is inconsistent with the standard life cycle model in which young workers save little in anticipation of rising income but then savings rates tend to peak when earnings potential is the highest in middle age and fall off as workers approach retirement.⁶² A detailed study by Chamon and Prasad on the increase in savings rates of urban households in China suggests that habit formation cannot provide sufficient evidence to explain the rise in saving rates; but rather that the declining public provision of education, health, and housing services seems to offer more convincing explanations, at least during a transitional period.⁶³ Interestingly, Chamon and Prasad contend that the build-up in savings would have been smaller if financial markets in China were more developed,⁶⁴ since this would allow households to borrow against future income, diversify their assets, and obtain better rates of return on their savings. Importantly, improvements in the social security system would pool the risks associated with unusual income shocks and health expenditures, reducing the need for

⁵⁸ See Huang Jing, "Social Security Crucial to Higher Consumption", *China Daily*, 15 January 2009, available at http://www.chinadaily.com.cn/bizchina/2009-01/15/content_7400619.htm (accessed 6 February 2010).

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ See Marcos Chamon and Eswar Prasad, "Why are Saving Rates of Urban Households in China Rising?" *NBER Working Paper* No. 14546, December 2008.

⁶² *Id.*

⁶³ *Id.*

⁶⁴ Chamon and Prasad found that most house purchases in China were financed from savings and that this was an important reason for increased household savings over the past decade. They conclude that although house purchases would continue on an upward trend as income levels rise and the capacity to buy better houses increases, nonetheless saving rates could stay high given that the mortgage market in China is still underdeveloped.

households to save for the purposes of self-insurance.⁶⁵ In the event, Chamon and Prasad's study illustrates that the long-term remedies for China's economic problems lie in increasing the consumption level while developing an adequate socio-economic welfare system. Simply put, these two aspects are essentially interrelated.⁶⁶

The Central Government has been well aware of these challenges and has taken serious steps to improve China's social safety net to achieve sustainable development in the economy and society. One key goal of this plan is, in the long run, to encourage people to save less and spend more.⁶⁷ One of essential aims of China's massive stimulus package for the GFC,⁶⁸ which was to be spent on improving the standard of living of rural households, infrastructure, raising the level of social security and public housing, improving public healthcare and education and so on, is to develop a strong and balanced internal market (so as to increase domestic demand and promote healthy economic development).⁶⁹ The GFC has shown that only a transformation in the growth model in China from heavy reliance on external demand to domestic-based demand will provide a basis for continued growth.⁷⁰ It has been argued that an improved social security system may be able to reduce savings and increase consumption, which, along with other measures, would effectively correct the saving-consumption imbalance in China.⁷¹

The sufficiency of the social security system is indeed hugely problematic in China.⁷² Throughout the economic reform period from the 1980s onwards, individual expenditure on medical-care, pension and education by ordinary individuals has

⁶⁵ *Id.*

⁶⁶ *Id.* See also Huang, *supra* note 58.

⁶⁷ Consumption can be seen as the part of disposable income that does not go into savings. Generally, as wealth rises, consumers will substitute less costly inferior goods and services and choose higher priced alternatives. Consumerism refers to economic policies placing emphasis on consumption. It has strong links with the western world – modern capitalism. However, unnecessary, irrational and excessive consumption is more likely to damage the environment and use up resources at a higher rate. Conspicuous consumption has been on the rise throughout the 20th century and beyond. A consumer can have the instant gratification of purchasing an expensive item that will help improve his or her social status. Many developed countries have a high-income and a high (indeed excessively high) consumption model, which has helped trigger the GFC. Thus, China needs to be clear about what kind of consumption it aims to promote for sustainable development. While the Central Government has encouraged domestic household consumption, it also stresses that it is necessary to pursue an environmental-friendly, rational and limited consumption model. See the 11th FYP, *supra* note 16.

⁶⁸ For details of the stimulus package, see the Appendix.

⁶⁹ See, e.g., Paul Maidment, "China Announces Massive Stimulus Package", *Forbes*, 9 November 2008, available at http://www.forbes.com/2008/11/09/china-stimulus-economy-biz-cx_pm_1109notes.html (accessed 6 February 2010); see also "China's Stimulus Package", *The Economist*, 12 November 2008, available at http://www.economist.com/blogs/theworldin2009/2008/11/chinas_stimulus_package (accessed 6 February 2010).

⁷⁰ See Wang and Fan, *supra* note 23; see also Huang Yiping and Tao Kunyu, "Causes and Remedies of China's External Imbalances", *China Center for Economic Research Working Paper Series No. E2010002*, 25 February, 2010, available at <http://www.ccer.edu.cn/download/10946-1.pdf> (accessed 21 April 2010).

⁷¹ *Id.*

⁷² See generally, "Social Security Reform in China: Issues and Options", 27 January 2005, available at http://www.oup.com/us/pdf/social_security_study_2005 (accessed 6 February 2010); see also Li Jieli, Yi Feng, and Ismene Gizelis, "China's New Social Security System in the Making: Problems and Prospects" (2008) *International Journal of Public Administration* 31, at pp. 5-23.

increased dramatically (as the national share in these areas has reduced).⁷³ The level of expenditure on consumption as a contribution towards economic growth has dropped from around 46 percent of GDP in 2000 to 36 percent of GDP in 2008.⁷⁴ The main problem is “high-income earners are unwilling to spend, and low-income people have no capacity to spend.”⁷⁵ Due to large differences in wealth distribution, consumption by low-income earners is limited to basic living items. According to the National Statistical Bureau sample survey in 2007, around 60 percent of the urban population (about 365 million people) had a monthly disposable income on average of only RMB 1,000 per person. And sadly, during this time the average monthly net income of 40 percent of the rural population (about 291 million people) did not exceed RMB 220 per person.⁷⁶

Having realized the problem, the Central Government began serious efforts to reform the medical system and to extend the pension scheme to Chinese rural residents. However, neither of these social security benefits has yet been comprehensively expanded to fully cover rural residents. Things have been changed since 2006 when a nationwide rural cooperative medical service was determined to be generally established in rural areas in 2008.⁷⁷ According to a recent policy statement,⁷⁸ a basic medical care system is expected to be established by 2011 to cover all Chinese urban and rural residents. A basic pension scheme benefiting rural residents has been incrementally implemented on a trial basis, and is expected to cover all rural residents by 2020.⁷⁹

Improvements in the social security system are clearly conducive to maintain socio-political stability. However, to operate a fair and efficient social security system it is also obvious that the government needs to raise sufficient funds. Although increasing the rates of direct taxation, such as Enterprise Income Tax and Individual Income Tax, may not be politically and economically desirable, raising money from broadly-based indirect taxation seems feasible. This could be achieved by broadening the VAT base, increasing tax rates on certain consumer goods such as luxury vehicles and expensive jewelry, and introducing a comprehensive environmental tax regime.

Reforms in VAT, BT, and CT occurred after the outbreak of the GFC. These reforms are partly—and importantly—driven by China’s domestic economic and taxation concerns. But they have also undoubtedly been accelerated by the GFC. The crisis has also revealed that the high input but low output and high pollution developmental model in China is reaching the end of its useful life. Greening the tax regime will also

⁷³ For example, Chamon and Prasad’s study found that health and education expenditures have increased from 2 percent of consumption expenditures among urban households in 1995 to 14 percent in 2005.

See Chamon and Prasad, *supra* note 61.

⁷⁴ See the NBS, *supra* note 22; see also Table 5.

⁷⁵ See Qing Zhu, “China’s Response to the International Financial Crisis, Fiscal Policy Research” in *SourceJuice*, available at <http://www.sourcejuice.com/1258106/2009/09/21/China-response-international-financial-crisis-fiscal-policy-research/> (accessed 22 October 2009).

⁷⁶ *Id.*

⁷⁷ See the Central Committee of CPC and State Council, *Some Opinions on Furthering Construction of New Socialist Countryside*, 31 December 2005.

⁷⁸ See the Central Committee of the CPC and State Council, *Opinion on Deepening the Medical and Health Care Reforms*, 17 March 2009.

⁷⁹ See the State Council, *Guideline on Implementing the Pilot Reform of New Pension Insurance System for Rural Residents*, No. 32 [2009].

help provide an opportunity for China's sustainable development. Introducing environmental taxes and reforming the indirect tax regime should result in a number of distortionary taxes being phased out. This will be of significant help to rationalize China's overall tax system. As will be shown in Part IV below, it will also help provide sustainable tax revenues for the provision of social security for the people.

4. EVALUATION OF THE RECENT TAX REFORMS

The series of structural tax cuts and reform measures described above, as explained by China's Vice Premier Li Keqiang, were intended to combat the challenges produced by the GFC.⁸⁰ Specifically, tax policy was used as a means to adjust and control the national economy, to improve people's livelihood, and to influence behavior. In this regard, the reforms were carried out to expand domestic demand, assist structural adjustment so as to promote economic growth both in terms of quality and overall productivity, and to promote sustainable development. This then gives rise to what we perceive to be the crucial question—were the tax cuts and reforms effective in achieving the desired goals?

4.1 Growth Effects of Tax Reforms (economic recovery)

If the tax cuts and reforms were effective, we should clearly be able to see increases in investment, employment, and consumption as targeted by the Central Government. In this regard, various statistics show that the reforms and changes to China's indirect taxation system have played their part in pushing the Chinese economy far away from the edge of the doldrums.

The quarterly figures for China's GDP growth rate in 2009 increased from a disappointing 6.2 percent for the first quarter to an admirable 10.7 percent for the fourth.⁸¹ This was achieved notwithstanding reduced external demand. In the event, the GDP growth rate for 2009 was 8.7 percent, which significantly surpassed the previous target of 8 percent. This was in sharp contrast to the significant economic downturn and soaring unemployment rates in other major economies.⁸² The promising prospect for China's economy that is apparent from these statistics is also reflected in the recent FDI environment—since August 2009, China has witnessed a steady

⁸⁰ See the SAT, "Li Keqiang: Give Full Play to the Role of Fiscal and Tax Policy for Advancing Development and Improving People's Livelihood", 12 November 2009, available at <http://202.108.90.130/n6669073/n6669118/9341095.html> (accessed 3 February 2010).

⁸¹ See Ma Jiantang, "National Economy Overall Rebounded in 2009" in the *Official Website of NBS*, 21 January 2010, available at http://www.stats.gov.cn/tjfx/jdfx/t20100121_402615506.htm (accessed 6 February 2010).

⁸² For instance, the US economy lost more jobs than expected in December 2009 while the unemployment rate held steady at 10 percent. The Euro zone jobless rate also rose to 10 percent in November 2009 for the first time since the single currency was introduced at the beginning of 1999. See the United States Department of Labor, "International Unemployment Rates and Employment Indexes, Seasonally Adjusted, 2008-2010" Table 1, available at http://www.bls.gov/fls/intl_unemployment_rates_monthly.htm#Rtable1 (accessed 25 March 2010); and The Associated Press (London), "Euro Zone Jobless Rate Hits 10%" in *The Globe and Mail*, 8 January 2010, available at <http://www.theglobeandmail.com/report-on-business/euro-zone-jobless-rate-hits-10/article1423501/> (accessed 7 February 2010).

upward trend of FDI for five consecutive months.⁸³ And, it has been estimated that FDI to China can rise a further 10 percent in 2010.⁸⁴ This strong increase clearly reveals foreign investors' confidence in the Chinese economy.

Turning now to the plight of rural migrant workers, the severe unemployment problem has been somewhat mitigated. Stimulated by the more favorable arrangement of VAT refunds on exports as well as certain direct subsidies from the Central and local governments, the export-oriented SMEs in the Pearl River Delta have rebounded.⁸⁵ Indeed, at the end of 2009, it has been reported that some SMEs found it difficult to recruit new workers given the fact that the improving job market has already pushed wage levels higher.⁸⁶

Though the Central Government has called for a shift of focus in China's development model to promoting domestic consumption, export growth still matters to China's economy, particularly during this transitional period. Export figures reveal that only a moderate decline has occurred for the major labor-intensive products for which VAT refund rates have been raised. For example, in the first three quarters of 2009, the year-on-year decrease for China's exports for major labor-intensive products was lower than the overall decrease for exports of 21.3 percent for the same period.⁸⁷ The highest export rebate industries generally performed better than less favoured sectors during the GFC. The example in Part III B above illustrates this conclusion—in 2009 the highest rebate industries producing mechanical and electrical goods only suffered a year-on-year decrease in exports of 11 percent, while the lower rebate steel industry suffered a year-on-year decrease in exports of 67 percent.⁸⁸ Since June 2009, the decline in China's export sector began to stabilize, and it then quickly regained upward momentum. China's imports and exports surged 32.7 percent year-on-year in December 2009.⁸⁹ The level of exports of US\$130.7 billion even reached a historical high, which has helped China replace Germany as the world's number one exporting country.⁹⁰ The Central Government continued providing VAT rebates on exports through 2010 after China's foreign trade performance for November 2009 showed the

⁸³ See the MOC, "Statistics on the FDI", available at <http://www.mofcom.gov.cn/static/v/tongjiziliao/v.html/1> (accessed 6 February 2010); see also the MOC, "Press Conference (15 January 2010)" (in Chinese), available at <http://www.mofcom.gov.cn/aarticle/ae/ah/201001/20100106748039.html> (accessed 6 February 2010).

⁸⁴ See Liu Lulu and Sun Shaohua, "Economic Forecast: 10% Expected Growth of FDI to China in 2010" (in Chinese), *Xinhua News Online*, 25 December 2009, available at http://big5.xinhuanet.com/gate/big5/news.xinhuanet.com/fortune/2009-12/25/content_12701757.htm (accessed 6 February 2010).

⁸⁵ See Qiu Quanlin, "Worker Shortage Grips Export Hub", *China Daily Online*, 23 January 2010, available at http://www.chinadaily.com.cn/china/2010-01/23/content_9366179.htm (accessed 6 February 2010).

⁸⁶ *Id.*

⁸⁷ See the SAT, "Export Tax Rates in September Recorded a New High", 12 November 2009, available at <http://202.108.90.130/n6669073/n6669118/9341082.html> (accessed 4 February 2010).

⁸⁸ These statistics were obtained from the CEIC Database, "Foreign Trade China".

⁸⁹ See the MOC, "Briefing of China's Imports and Exports in December 2009", available at <http://zhhs.mofcom.gov.cn/aarticle/Nocategory/201001/20100106747574.html> (accessed 6 February 2010).

⁹⁰ See "China Overtakes Germany as World's Largest Exporter", *BBC News Online*, 10 January 2010, available at <http://news.bbc.co.uk/2/hi/8450434.stm> (accessed 21 April 2010).

healthiest increase in over a year, rising 9.8 percent year-on-year.⁹¹ This was the first increase after 12 consecutive months of decline. The actual decline in exports narrowed to 1.2 percent in November while imports climbed 26.7 percent.⁹² Correspondingly, VAT collections at the import stage reversed the downward direction that has been apparent since October 2008.⁹³ VAT refunds for exports also increased from October 2008, by a rate of 10.6 percent.⁹⁴ The reasons for the rapid increase in VAT refunds for exports, as analysed by the Central Government, mainly lie in the rise in VAT refund rates for exported products as well as the overall improvement in China's export performance.⁹⁵

It has also been reported that:

“China's SAT on November 12 [2009] announced that general taxpayers claimed RMB 74.1 billion in credits for input VAT paid on purchases of fixed assets during the first half of 2009, and estimated that the new VAT regime ... will ultimately lessen the VAT burden on taxpayers by more than RMB 140 billion this year. The new [VAT] reform is the biggest tax relief measure in the history of China's single-tax reforms and will help to promote technology, optimize industry structure, upgrade economic growth, and enhance Chinese enterprises' ability to compete in the global market, observers say. In the first three quarters of this year, nationwide investments in fixed assets increased by 33.4 percent over the same period in 2008, according to China's National Bureau of Statistics.”⁹⁶

Turning to consumption, recent data shows that household consumption in 2009 increased 15.5 percent year-on-year and this accounted for 37 percent of GDP in that year,⁹⁷ a slight rise compared with previous years (as shown in Table 5) when China's GDP experienced two-digit growth rates. This was achieved against the backdrop of GDP growth rate of 8.7 percent in 2009, a rate lower than that for previous years. It has also been reported that the rate cuts for vehicle acquisition tax and for CT applying to cars with lower emission capacity provided a strong incentive for the increase in vehicle production and sales. Specifically, there was a 46.2 percent increase in sales volume (and a 48.3 percent increase in production volume) of domestic passenger vehicles in 2009. Sales of vehicles with a capacity of less than 1.6 liters contributed a remarkable 63.5 percent share of total sales in 2009.⁹⁸ These

⁹¹ See “China to Maintain Export Tax Rebates in 2010”, *China Briefing*, 23 December 2009, <http://www.china-briefing.com/news/2009/12/23/china-to-maintain-export-tax-rebates-in-2010.html> (accessed 23 November 2010).

⁹² See the MOC, “Briefing of China's Imports and Exports in November 2009”, available at <http://zhhs.mofcom.gov.cn/aarticle/Nocategory/200912/20091206666658.html> (accessed 21 April 2010).

⁹³ See 2009 Tax Analysis, *supra* note 21; see also the Tax Executive Division of the SAT, “Analysis on the Increase in Tax Revenues in 2008” (in Chinese), published by the MOF, available at http://szs.mof.gov.cn/zhengwuxinxi/gongzuodongtai/200903/t20090304_118900.html# (accessed 24 March 2010) [hereinafter 2008 Tax Analysis].

⁹⁴ *Id.*

⁹⁵ See 2009 Tax Analysis, *supra* note 21.

⁹⁶ J. Wei, “VAT Reform Expected to Greatly Reduce Taxpayer Burden” *Tax Notes International*, 23 November 2009; see also the SAT, “Overall Transformation of VAT May Bring About Tax Abatement in Excess of RMB 120bln”, 16 December 2009, available at <http://202.108.90.130/n6669073/n6669118/9397383.html> (accessed 6 February 2010).

⁹⁷ See the NBS, 2009 NESD Report, *supra* note 11.

⁹⁸ See “Automobile Industry Association: China's Automobile Production Volume Became the No. 1 in the World in 2009” (in Chinese), published by the State Council, available at

achievements are in sharp contrast with the position in 2008 when both automobile production and sales experienced significant decreases due to the shrinkage of individual incomes and the lack of confidence in the economy caused by the GFC.⁹⁹ The tax cut policy which came into force from the very beginning of 2009 has directly and efficiently contributed to China's automobile industry maintaining growth amid conditions of downturn in the global automobile market. All in all, it seems a reasonable conclusion that, given the gradual recovery of China's economy in 2009, many Chinese citizens regained confidence and were willing to consume in order to seize the tax rate reduction opportunity before it disappeared.

As to whether the growth in investment, employment and consumption discussed above was attributable to increased private consumption, the indirect tax reforms as analyzed in Part III, or, more broadly, the Government driven stimulus package, is a question which requires comprehensive research involving the use of economic methodology which is beyond the scope of this article (such as engaging with multiple regression theory and undertaking a detailed study of whether other exogenous factors exist and, if so, what their impact may have been). It is fair to argue, however, that the growth effect in China is attributable to both factors. The growth may in large part be led by the Central Government's efforts in investing in infrastructure-building and social welfare development. But it also appears to have been driven by domestic consumption that was incentivized by the policy of cutting indirect taxes, which steadily increased throughout 2009, and should continue to increase as many ordinary Chinese people have begun to move to more advanced consumption from the purchase of basic necessities.

4.2 Budget Effects of Tax Reforms (tax revenue increase since the tax reforms launched)

The structural tax reduction in China has apparently been effective not only in stimulating economic development but also in generating tax revenue. According to the SAT, the total cost of the tax reductions for 2009 was expected to exceed RMB 140 billion, surpassing the amount of RMB 120 billion forecast in 2008.¹⁰⁰ But the costs have paid off. Data from the SAT shows that its total tax collections for 2009 amounted to RMB 5.95 trillion with a year-on-year growth rate of 9.8 percent,¹⁰¹ which created another historical high. Total collections from VAT, BT and CT were RMB 3.23 trillion, rising by 2.7 percent, 18.2 percent, and 85.3 percent, respectively.¹⁰² This accounted for 54 percent in total tax revenues (excluding revenue derived from Customs' collection of VAT, CT on imported goods and VAT export refunds). The revenue from vehicle acquisition tax also increased remarkably by 17.5 percent, amounting to RMB 116.3 billion, notwithstanding the tax rate cut.¹⁰³ The effect of the reduction in indirect taxes seems clear: it was quick to implement and had immediate benefit.

http://big5.gov.cn/gate/big5/www.gov.cn/jrzg/2010-01/11/content_1507693.htm (accessed 25 March 2010).

⁹⁹ See 2008 Tax Analysis, *supra* note 93.

¹⁰⁰ See the SAT, "Looking into the RMB 550bln Structural Tax Deduction Program", 17 December 2009, available at <http://202.108.90.130/n6669073/n6669118/9397442.html> (accessed 6 February 2010).

¹⁰¹ See 2009 Tax Analysis, *supra* note 21.

¹⁰² *Id.*

¹⁰³ *Id.*

In so far as VAT is concerned, allowing input VAT paid on purchases of fixed assets to be credited against VAT payable appears to have had a positive effect on investment in fixed assets. During the first three quarters of 2009, the total investment in fixed assets by registered VAT payers reached more than RMB 15 trillion, a rise of 33.4 percent as compared to 2008.¹⁰⁴ The contribution of the rate of investment in fixed assets to GDP growth amounted to 7.3 percent.¹⁰⁵ The VAT transformation towards a consumption-based system and the successive increases in export rebate rates may decrease the total VAT collections in the short term; but, on the other hand, these measures will help reduce costs of enterprises for the expansion of production and export, thereby contributing to the long-term strength of this critical source of tax revenue. Despite the widespread concern that Central Government played a dominant role in allocating investments in fixed assets, statistical data shows that investment by private enterprises has increased significantly in tandem with the stimulus provided by China's vigorous public investment programme.¹⁰⁶

In addition, the VAT transformation and increase in export rebate rates have paid off in an indirect manner. The relief of the VAT burden reduced the costs of production for many enterprises, and would surely have assisted them in times of financial distress. From the second half of 2009, the business environment for many enterprises began to pick up when the decline in exports narrowed month by month and some started to gain a firm foothold in the domestic market.¹⁰⁷ Industrial enterprises were thus able to earn greater profits, and these increased by 7.8 percent during the period from January to November 2009 compared with the negative rate of 22.9 percent from January to May.¹⁰⁸ The improvement in enterprise profitability eventually led to an increase of 3.2 percent in Enterprise Income Tax collections in the difficult year of 2009.

However, the situation for the SMEs (who generally suffered much more than large state-owned enterprises (SOEs) during the GFC) may still be difficult. As noted above, SMEs have played a significant role in promoting China's economic development and boosting market prosperity. They have also played an increasingly important role in easing employment pressure and maintaining social stability. The GFC had a significant impact on SMEs in China, ranging from limiting access to credit and decreasing orders from overseas, to rising costs due to the increasing pressure brought about by the appreciation of the RMB. To help SMEs deal with these difficulties, the Central Government decided that in 2010 small and low-profit enterprises whose annual taxable income is less than RMB 30,000 should be assessed on 50 percent of their income and then pay Enterprise Income Tax at a reduced rate of 20 percent (as compared to the normal rate of 25 percent).¹⁰⁹

The most astonishing aspect of China's tax collections in 2009 was that CT collections increased more than that for any other tax. Specifically, the increase in CT collections

¹⁰⁴ See the SAT, "Overall Transformation of VAT May Bring About Tax Abatement in Excess of RMB 120bln", *supra* note 96.

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ See 2009 Tax Analysis, *supra* note 21.

¹⁰⁸ *Id.*

¹⁰⁹ See the Circular of the Policy on Small and Low-profit Enterprises' Enterprise Income Tax, MOF and SAT No. 133, 2009.

for the year contributed an impressive 41.4 percent of the total increase.¹¹⁰ This was different from the position in 2008 and previous years when the largest tax collection increase was referable to VAT.¹¹¹ The 2009 statistics can be mainly attributable to the VAT and CT reforms that took effect from 1 January 2009. Four taxable items, namely, fuel, cigarettes, wine, and motor vehicles, accounted for 98.5 percent of the total CT revenue. Of these items, the CT revenue from fuel increased nearly 4.5 percent.

BT collections also began to rise from March 2009. Of those taxpayers subject to BT, the operations of construction and real estate enterprises expanded rapidly due to the increase in government investment in infrastructure projects. Other businesses such as telecommunications, services, finance and insurance also performed well. Notwithstanding these results however, many businesses in China have called for a further reform in BT. The transformation of VAT has impacted on the service industries that are subject to BT and therefore cannot offset input tax on fixed asset purchases. Replacing BT with VAT may help China's service industry develop, facilitating an effective adjustment of China's industrial structure for the future.

Finally, it should be noted that when the reforms in VAT, BT and CT were implemented, the Central Government was also aware of the potential for revenue loss. Collection and administration procedures were therefore strengthened. This may help explain the increase in tax revenues in 2009, although the precise extent of the role which such strengthening has played in collecting taxes remains unclear due to limited data.

The above analysis shows generally that revenues from enterprise taxes (corporate tax) may take a longer time to recover from the GFC and there will be an increased reliance in China on other forms of taxes, in particular indirect taxes—with VAT remaining as the centerpiece. There is a global tendency that growth-oriented tax reforms have involved shifting revenues from corporate and personal income taxation, or social security contributions (which is not the case in China) to consumption and property taxes. It is now recognized that strengthening and relying upon VAT (or some other form of broadly-based GST) is likely to be of crucial importance to maintaining government finances (this statement is particularly true in China), and could become even more significant as the world emerges from recession and countries seek to deal with their public debt imbalances. When seeking to bolster taxation revenue, countries may have two choices to consider—broadening the existing tax base or increasing standard VAT rates. In the case of China, however, the VAT system *can* be further modified to incorporate VAT and BT into a single advanced VAT system. Indeed, modernizing China's VAT system to keep pace with changes in the technological and economic environment would be beneficial to its long-term interests.

5. CONCLUSIONS

China's fiscal responses to the GFC have involved a combination of continuing structural reforms accompanied by a very specific focus—through reforms to its

¹¹⁰ See 2009 Tax Analysis, *supra* note 21.

¹¹¹ See 2008 Tax Analysis, *supra* note 93.

indirect tax system—to facilitate the development of capital-intensive industry, upgrade technology, and enhance consumer spending to promote growth and shape economic development. The tax cut measures adopted by the Central Government include the reduction of certain indirect tax rates such as vehicle acquisition tax, and relieving tax burdens through increasing export refund rates, allowing deduction of input VAT on purchases of fixed assets, and so on.

China has thus far consolidated its economic recovery, but it is vulnerable to major adverse shocks generated domestically or internationally. From a macro-economic perspective, further adjustments are needed to develop an economy demanding both new investment and increased domestic consumption. It is also true that some crisis-fighting measures, such as the granting of certain tax exemptions on real property transactions,¹¹² only have a one-off effect and may fuel a renewed risk of creating asset bubbles.

Most importantly, the stimulus package and related fiscal and tax measures can be credited with limiting the potential economic difficulties associated with the GFC and assisting China's recovery therefrom. From any perspective, such an achievement is more laudable than China's accession to the throne of the world's biggest exporter. Although it would be overreaching to claim that the taxation reforms were simply a product of economic crisis, at the very least it seems clear that by late 2008 the GFC had directly influenced the Central Government to implement reforms to China's indirect tax system and, most importantly, apply the VAT reforms to the whole country and to all industries. In terms of increasing investment in capital assets, stimulating domestic consumption and increasing tax collections, Part IV above has shown that the reforms have apparently been successful and that their timing could not have been more opportune.

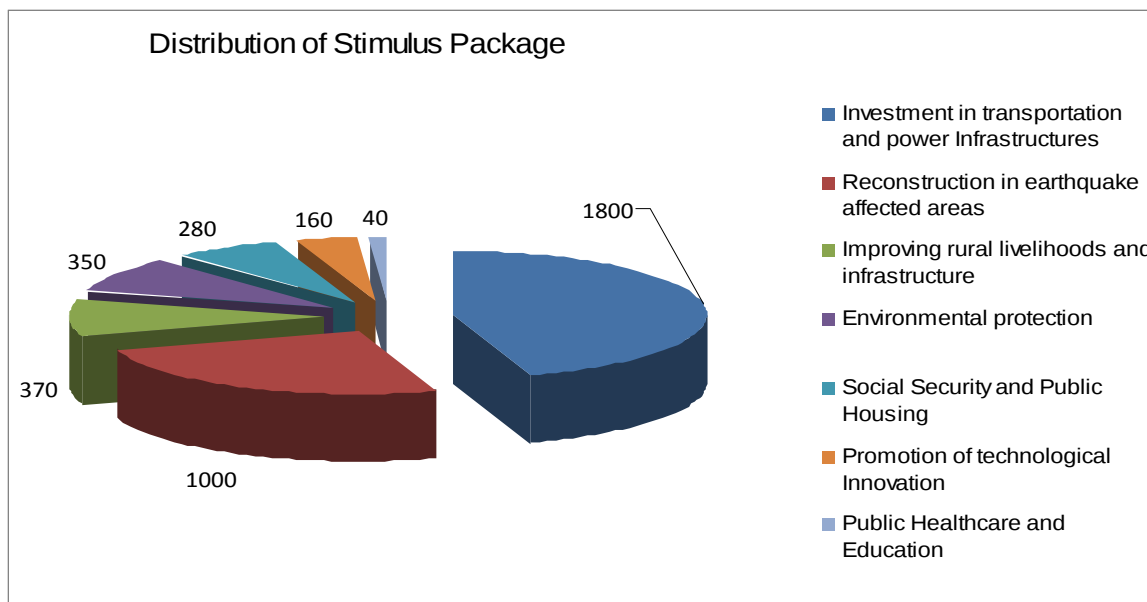
The success in adopting taxation reform, particularly in relation to indirect taxes, to deal with the economic difficulties associated with the GFC should encourage the continuation of China's ongoing tax reform programme, particularly in light of the revenue demands that will arise from increased expenditure upon social security. Both now and in the future, China will need to find sustainable ways to finance the cost of exiting the GFC and, in the long term, improve the efficiency of its taxation system.

When viewed in the context of promoting structural reform, reducing the tax burden to promote capital investment and consumption in times of economic turmoil, though not necessarily a panacea for curing all manner of ills, is not necessarily ill-conceived. Applied to indirect taxation, the reductions can be implemented swiftly and, as has been shown in the case of China, appear to have had immediate and positive benefits.¹¹³

¹¹² In 2009, the five-year limit for tax exemption from BT on transfers of residential property was reduced to two years. This preferential tax policy was abolished from the beginning of 2010 in order to curb speculation.

¹¹³ See further, D. Williams, "Direct Taxes or Indirect Taxes? Considering the Merits of the Two Approaches" *Tax Planning International: Indirect Taxes* 4, June 2009, at p. 8. Williams concludes at p. 11 that: "Indirect taxation probably has the advantage for governments in terms of revenue-raising, flexibility and administrative convenience. It also enables the achievement of more precisely targeted behavioural effects than direct taxation." In short, it seems clear—and the economic statistics referred to

APPENDIX 1: DISTRIBUTION OF 4 TRILLION RMB STIMULUS PACKAGE BY THE CHINESE GOVERNMENT



in Parts III and IV of this article bear this out—that tax reductions that are peculiar to particular goods and services will encourage consumption thereof.