China's Tax Preferences to Foreign Investment: Policy, Culture and Modern Concepts

Zhaodong Jiang

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Zhaodong Jiang*

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I. INTRODUCTION

China first offered preferential tax treatment to overseas investors when it opened its door to foreign direct investment in the late 1970s.1 Over the next several years, the country’s foreign tax preference regime grew in complexity with the proliferation of schemes based on criteria as diverse as a foreign party’s form of investment,2 geographic location,3 in-

1 On July 1, 1979, the Chinese legislature adopted the Law of the People’s Republic of China on Chinese-Foreign Joint Ventures, which, for the first time since 1949, legally permitted private foreign capital investment in Mainland China. Zhonghua Renmin Gongheguo Zhong Wai Hezi Jingying Qiye Fa [Equity Joint Venture Law], 1979 FAGUI HUIYAN 125 [hereinafter EJV Law]. The EJV Law promised tax reductions and exemptions for joint ventures using advanced technology by world standards as well as tax refunds for reinvestment of joint venturer profits. EJV Law, art. 7.


3 According to the Provisional Regulations of the State Council of the People’s Republic of China Regarding the Reduction of and Exemption from Enterprises Income Tax and Consolidated Industrial and Commercial Tax in the Special Economic Zones and the Fourteen
The concept of *shuishou youhui*, or “tax preferences,” encompasses reduced tax rates, tax exemptions, reductions, investment refunds, accelerated depreciation, carry-over loss and other tax burden reducing measures. The government's Tax Preferences to Foreign Investment, 18:549 (1998)

...
government has demonstrated preferential treatment for foreign investors through the enterprise income tax, turnover taxes, and other applicable taxes. Until the early 1990s, the Chinese government created these “preferences” in order to promote foreign investment. As foreign capital has poured into the country in record volume since the early 1990s, however, expenditure in practice have been controversial. A recent Organization for Economic Cooperation and Development [hereinafter OECD] survey on tax expenditures among member countries includes as tax expenditures the following items: (1) exemptions: income excluded from the tax base, (2) allowances: amounts deducted from gross income to arrive at taxable income; (3) credits: amounts deducted from tax liability; (4) rate reliefs: a reduced rate of tax applied to a class of taxpayers or activities; (5) tax deferrals: a relief which takes the form of a delay in paying tax. ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, TAX EXPENDITURES: RECENT EXPERIENCES 9 (1996).


Other than enterprise income and turnover taxes, foreign investments in China are also subject to such taxes as real estate tax, MICHAEL J. MOSER & WINSTON K. ZEE, CHINA TAX GUIDE 105-06 (2d ed. 1993); vehicle and vessel license tax, id. at 106-07; and stamp tax, id. at 108-17. Relief has been granted to foreign investment with regard to some of those taxes. Id. at 114-15. Foreign investors have also been exempted from urban maintenance and construction tax (chengshi weihu jianshe shui), fixed asset investment direction adjusting tax (guding zichan touzifangxiang tiaofie shui) and cultivated land use tax (gengdi zhanyong shui). ZHONGHUA RENMIN GONGI-EGUO CAIZHENG BU SHUIZHENG SI [TAX DEPARTMENT, FINANCE MINISTRY OF THE PEOPLE'S REPUBLIC OF CHINA], ZHONGGUO SHUISHOU ZHIDU [TAX SYSTEM OF CHINA] 220 (1996) [hereinafter TAX SYSTEM OF CHINA].


According to a United Nations Trade and Development Conference report published in September 1996, China attracted U.S. $37.5 billion foreign capital in 1995, which made the country, for the third consecutive year, the second largest foreign investment recipient after the United States, and foreign investment in China represented an estimate 12% of the global foreign investment. XIN BAO (HONG KONG ECONOMIC JOURNAL), Sept. 25, 1996, at 8. In 1996, foreign direct investment in China rose to U.S. $40 billion, Yin Zi Zhengce Quxiang Ze You Er Yong [Direction of Foreign Investment Policy: An Optimal Use], XIANGGANG JINGJI
the official line has changed.\textsuperscript{13} In April 1996, the authorities ended import tax exemptions for new foreign investment projects and scheduled a phasing-out of import tax exemptions for existing projects.\textsuperscript{14} The decision has since had an impact upon foreign investment.\textsuperscript{15} The government has con-

\textsuperscript{13} The official line in 1993, still stressed the important role tax preferences may play in the country's opening-up policy. See Hu Guangbao, Zhuaijin Youli Shiji Jiakuai Yanjiang He Neili Chengshi Duwai Kaifang Bufa [Seizing Opportunities to Speed Up the Pace of Opening Up for Cities Along the Yangtze River and Interior Provinces], 1993 ZHONGGUO JINGVI TEQU DUWAI KAIFAQU NIANJIAN [1993 YEARBOOK OF CHINA'S SPECIAL ECONOMIC ZONES AND COASTAL ECONOMIC AND TECHNOLOGICAL DEVELOPMENT AREAS] 62, 63-64 (He Chunlin ed., 1993) (hereinafter Y.B. SEZs & COASTAL ETDAs) (the author was vice-director of the State Council's Special Economic Zones Office; he discussed at length preferential policies including tax preferences granted to various cities for purposes of attracting foreign business). The tone soon changed. In a 1994 seminar, Vice-Premier Li Lanqing emphasized a necessary transition from preferential policies to non-tax measures to attract foreign investment in various development zones. Li Lanqing Fuzongli Zai Qingzhu Jingji Jishu Kaifaqu Shi Zhounian Zuotanhui Shang De Jianghua [Speech of Vice-Premier Li Lanqing at the Forum Celebrating the Tenth Anniversary of the Economic and Technological Development Areas] [hereinafter Li Lanqing], in 1995 ZHONGGUO JINGVI TEQU KAIFAQU NIANJIAN [1995 YEARBOOK OF CHINA'S SPECIAL ECONOMIC ZONES AND DEVELOPMENT AREAS] 24, 29 (Hu Ping ed., 1995) (hereinafter Y.B. SEZs & DAs). A long-term development plan presented by the State Council in early 1996 no longer mentioned tax preferences as a major tool vying for foreign investment. See Weilai Wu Nian Buzai Youhui Xiyin Waizi [No More Use of Preferences for Attracting Foreign Investment in the Next Five Years], MING BAO (MING PAO) (HK), Mar. 5, 1996, at B2 (hereinafter No More Use of Preferences).


\textsuperscript{15} The cost of doing business in China would rise anywhere between 20 to 50\% as a result of the revocation of import tax exemptions, see Changes to Import Tax Seen Giving Rivals Edge, S. CHINA MORNING POST, Apr. 1, 1996, Business, at 3 (the cost of bringing in equipment for new foreign projects would increase by an average of 23\%); Peng, supra note 14 (an accounting firm partner reckoned that start-up costs could go 40-50\% higher), foreign businesses were upset. See Geoffrey Crothall, Reformist Vanguard Urged to Maintain Leading Role, S. CHINA MORNING POST, Jan. 11, 1996, China Business Review, at 2; see also Changes to Import Tax Seen Giving Rivals Edge, supra (Japanese prediction for a drop in new investment in 1996 as a result of tax changes). The 1996 foreign investment slowdown was attributed to the April tax changes. Quxiao Jinkuo Shuishou Jiannian Waishang Touzi Bufa Fanghuan [Abolition of Import Tax Exemptions and Reductions Slowed Down the Pace of Foreign Investment], XIANGGANG JINGVI RIBAO (HONG KONG ECONOMIC TIMES), Jan. 8, 1997, at A27. Foreign investment also fell in the first quarter of 1997 on a year-to-year basis and the fall was again blamed on the 1996 tax changes. Wang Xiangwei, Tax
templated further restructuring moves. Even the World Bank has offered China advice on how to shape its tax and preference policy for foreign investment. The tax concessions which overseas businesses have taken for granted for years are hanging in the balance. Official rhetoric seems to have softened a bit lately. Vice-Premier Zhu Rongji introduced new tax initiatives during the 1997 World Bank-IMF annual meeting in Hong Kong, including the reintroduction of some of the import tax exemptions abolished just over a year ago.


16 One important move will be the merger of separate income tax regimes governing domestically-owned and foreign investment enterprises. See, e.g., Dong Shukui, General Situation and Development Tendency of Foreign Taxation, 11 CHINA TRADE & INVESTMENT, Aug. 1996, at 10, 11 (under the unifying tax laws and equalizing tax burden guideline, enterprise income taxes and local taxes currently separately applied to domestic and foreign investment enterprises would be unified; the author was deputy Director General of Foreign Investment Taxation Department, State Administration of Taxation). There has been confusion about the timetable for the merger. Compare No More Use of Preferences, supra note 13 (merger of separate income tax regimes within five years from 1996) with Zhongwai Qiyi Shuilu [Uniform Tax Rates for Chinese and Foreign Enterprises], XING DAO RIBAO (SING TAO DAILY) (HK), Nov. 17, 1995, at B1 (unified income tax may come as soon as July 1996) [hereinafter Unified Tax Rates] and Caizhengbu Liao Liang Nian Hou Tongyi Qiyu Suodeshui [The Ministry of Finance Expects Unifying Enterprise Income Tax in Two Years], XIN BAO (HONG KONG ECONOMIC JOURNAL), Oct. 23, 1996, at 13 (two years from 1996) [hereinafter Ministry of Finance on Unifying Tax]. Meanwhile, it has been the official line to use non-tax measures such as promised national treatment to vie for foreign capital and technology. See, e.g., Sun Zhenyu, Woguo Liyong Waizi De Jiben Zhuangkuang He Ruogan Zhongda Zhengce Wenti [The Basic Situation and Some Major Policy Issues Concerning Our Country's Utilization of Foreign Investment], GUOJI SHANGWU [INTERNATIONAL BUSINESS], 1995 No. 5, at 1, 11 [hereinafter Sun, Basic Situation] (the author, a vice-minister of Foreign Economic Relations and Trade in charge of foreign investment, stated that China would gradually give foreign businesses same treatment in areas such as fee charge, loan and credit, and foreign exchange).

17 Shi Hang Zhu Beijing Daibiaochu [World Bank Beijing Office], Zhongguo Dui Waishang Zhiie Touzi De Shuishou Zhengce [China's Tax Policy for Foreign Direct Investment], SHEWAI SHUIWU [INTERNATIONAL TAXATION IN CHINA], 1996 No. 5, at 4 (the paper was presented by the World Bank's Beijing representative to the Chinese Ministry of Finance in August 1995) [hereinafter 1995 World Bank Paper]. For a discussion of the paper, see infra Part VII.

18 See, e.g., China Will Cut Incentives, Premier Says, 22 TAX PLANNING INT’L REV., Nov. 1995, at 19 (Chinese Premier said Beijing would gradually reduce tax reliefs and other preferential measures given to foreign firms operating in China); Crothall, supra note 15 (Director of the State Council's Special Economic Zones Office suggested that foreign investment in SEZs would enjoy no more favorable treatment than in other areas); Unified Tax Rates, supra note 16 (as a result of proposed uniform enterprise income tax, tax rates would rise).

19 Zhu optimistic as reforms pay economic dividends, S. CHINA MORNING POST, Sept. 23, 1997, World Bank/IMF Special, at II. For the latest developments in reintroduced import tax exemptions, see infra note 422.
Chinese tax law and policy involve basic differences from those in the West. There have been many academic and professional writings on China’s tax regimes governing foreign businesses, but the country’s complex preferential tax rules and practice have not been critically reviewed. In addition, the underlying philosophy and approaches behind preferential tax rules and practice have not been adequately examined. This article attempts to fill the gap. The scope of the present study is confined to tax treatment for major forms of foreign direct investment in China, namely, Chinese-

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22 This article excludes tax treatment of portfolio investment as well as foreign representative offices in China. For a discussion of foreign representative offices in China, see Clark T. Randt, Jr., Representative Offices in China: The Legal Aspects of Registration and Control, in FOREIGN TRADE, INVESTMENT, supra note 21, at 304.
foreign equity joint ventures (EJVs), Chinese-foreign contractual joint ventures (CJVs), wholly foreign-owned enterprises (WFOEs), and joint development and exploitation of oil, gas and other natural resources. The Chinese collectively refer to these forms of foreign direct investment as waishang touzi qiye, or “foreign investment enterprises” (FIEs). Chinese neizi qiye, or “domestically owned enterprises” (DOEs), were subject to separate enterprise income and turnover tax regimes until 1994. While

23 A Chinese-foreign equity joint venture is a limited liability company to which Chinese and foreign parties contribute capital and receive an equity interest proportionate to the size of their investment; distribution of profits and return on investment are determined strictly on the basis of the parties’ respective equity contribution. EJV Law, supra note 1, art. 4. For discussions of Chinese-foreign EJVs, see, e.g., Cohen & Valentine, supra note 11, at 179-80; Ann Fenwick, Equity Joint Ventures in the People’s Republic of China: An Assessment of the First Five Years, 40 Bus. L. 839, 843-54 (1985); Michael J. Moser, Foreign Investment in China: The Legal Framework, in FOREIGN TRADE, INVESTMENT, supra note 21, at 90, 100-26.

24 A contractual joint venture, also called cooperative joint venture, is formed by Chinese and foreign parties on the terms and conditions set forth in their joint venture contract and articles of association as to contribution and distribution; thus unlike an EJV, a CJV can distribute profits non pro rata to the parties' contribution, and has more flexibility in determining its management structure; in fact, a CJV can be a limited liability company with a legal person status or just an ad hoc arrangement between the parties. See Zhonghua Renmin Gongheguo Zhong Wai Hezuo Jingying Qiye Fa [Law of the People’s Republic of China on Chinese-Foreign Cooperative Enterprises], art. 2, 1988 FAGUI HUIBIAN 429, 429-30. For discussions of CJVs, see, e.g., Cohen & Valentine, supra note 11, at 180-81; Peter J. Halasz & Lan Lan, New Rules of the Game, CHINA Bus. REV., Jan.-Feb. 1996, at 39, available in WESTLAW, Tp-all database; Moser, supra note 23, at 96-100.


26 Under such joint development arrangements, foreign investors agree to first conduct programs of geophysical exploration of natural resources in China at their own expense and risk; and, once resources are discovered, both Chinese and foreign parties share investment and risk; after cost and taxes are deducted, the parties divide the output or income according to their agreed-upon formula. See, e.g., Cohen & Valentine, supra note 11, at 181-82. See generally, Michael J. Moser, Legal Aspects of Offshore Oil and Gas Exploration and Development in China, in FOREIGN TRADE, INVESTMENT, supra note 21, at 270. For a recent discussion of Chinese-foreign joint development of onshore oil resources, see Kevin M. Wolf, The Legal Framework for Joint Development of China’s Onshore Oil Resources: Negotiation Strategies and Future Prospects, 9 J. CHINESE L. 141 (1995).

FIEs and DOEs have been governed by a single turnover tax system since 1994, separate enterprise income taxes remain to date.

After providing an overview of major preferential tax schemes for foreign investment as they have evolved since 1979, this article discusses how government policies and cultural factors influenced the country's tax preference rule formulation and development. The Chinese Communist Party has long viewed taxation as an important tool to achieve non-revenue policy goals. Just as harsh taxes could penalize and marginalize rural landlords and urban capitalists, tax reductions and exemptions could promote Party political and economic objectives. When the leadership decided to open the door to foreign direct investment in the late 1970s, taxation became one of the preferred instruments to promote that particular policy. References to "international practice" and foreign ideas like profit maximization were used to appeal to overseas business communities. Tax preferences serve the Party's developmental priorities. In foreign investment policy, priorities have been set according to forms, geographic location, industry/sector classification and even ethnic background of foreign investment. Those criteria have undergone constant changes since the opening-up policy began. For instance, forms and ethnic background of foreign investment have become less conspicuous in recent years, if not altogether eliminated. The emphasis on geographic location has also recently shifted in favor of interior provinces although coastal areas still maintain an edge. Once policy priorities move, preference rules have to adjust. Policy factors may consist of competing considerations, however. For example, Chinese fascination with hi-tech projects must be reconciled, for instance, with the Chinese inclination towards ethnic Chinese investors. Additionally, while foreign-funded businesses contribute to Chinese tax collections, tax preferences imply revenue losses. A final example is the government's strong interest in protecting Chinese socialism from the dangers of capitalist pursuit of profits, even as it seeks to open the country to foreign investment.

Cultural factors also affect the formulation and development of Chinese tax preferences to foreign investments. Traditionally, tax leniency was a hallmark of the Chinese ruler's virtue and was intended to win the trust of the people. The proper way of treating foreigners similarly required demonstration of virtue through acts of largess and hospitality. Tax preferences are therefore a modern means of expressing Chinese virtue and generosity, because they are intended to establish good reputations and win trust with foreign businesses. Moreover, by conceptualizing them as a modern expression of generosity, the government has justified tax preferences in a culturally familiar context, not just in terms of international practice or foreign ideas; references to *li* ("trust and generosity") provide the Chinese with indispensable justification and assurance for the tax preferences. Mean-

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28 See text accompanying infra notes 224-29.
29 See text accompanying supra note 1.
while, by invoking the ideas of virtue and generosity, the Chinese hoped to set a moral example for foreigners. The government would have a solid ground for administrative and legal action against those who did not conduct business according to Chinese norms and expectations. Recent efforts to justify preference law changes have invoked the generosity, moral example and state coercion paradigms. The Chinese ideas of virtue and trust through largess and hospitality were reflected in the way the Chinese preference rules were announced. As the tradition stresses an image of sincerity and generosity, tax law contained generous but vague benefit promises without spelling out the exact conditions and limitations. In practice, though, conditions and limitations apply. While foreign business people and lawyers have been troubled by such discrepancies between rhetoric and practice, the Chinese people feel it is quite natural that policy and moral considerations are always relevant to interpretation and application of law. Friendship/relationship building is another factor which explains Chinese preference law. Like generosity, it provides a culturally familiar approach to opening up the country to foreign investment. The friendship/relationship approach embodied the formulation of the policies favoring ethnic Chinese investments and regionally-based schemes.

This article also discusses Chinese views and experiences regarding economic efficiency and tax equities. Chinese officials do not entirely adhere to those concepts as they are used in the West. With regard to economic efficiency, they do not accept, for instance, the notion that the market, and not the government, is the best way to determine resource allocation. As a result Chinese officials do not allow their policy decisions to be challenged on technical grounds or by neutral standards. On the other hand, the Chinese want to utilize the assumptions and uncertainties provided by market-driven, economic analyses — an approach which is consistent with the modern concept of effectiveness and efficiency. This tension is also manifested in the Chinese approach to tax equities. The early Chinese tax policy-making ignored equity issues, such as disparate (and inequitable) tax treatments between FIEs and DOEs, and between coastal and interior areas. Such disparities were inevitable in the early years as tax preferences were supposed to follow then developmental priorities and objectives. Foreign investments received special treatment because they could contribute to the country’s modernization in a way that DOEs were unable. Coastal areas deserved more privileges because they were more likely than the country’s interior to attract overseas capital and technology and therefore make the opening-up policy a success. In recent years, however, as domestically-owned enterprises and interior provinces began to claim more resources, the Chinese have turned to equity arguments to support tax law changes and address revenue concerns. In the West, efficiency and equity analyses militate against the use of tax incentives. In China, however, where policy and cultural factors favor tax pref-
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erences, efficiency and equity arguments have been used as tools to rati-
onalize the preference policy or its change.

In conclusion, policy-making in China is subject to the leadership's perception of problems and solutions. Taxation must reflect political and economic concerns and closely follow policy choice. For the Chinese, the objective, economic value to foreign businesses should not be as important as the Chinese sincerity and friendly sentiments that the preferential measures symbolize. While the Chinese do refer to modern concepts such as efficiency or equity, they tend to apply their own interpretation and understanding.

II. AN OVERVIEW OF CHINESE TAX PREFERENCES TO FOREIGN INVESTMENT

A. Post-Mao China's New Attitude Toward Overseas Private Investment

For historical and political reasons, China's pre-1978 economic ties with the rest of the world were largely confined to imports and exports of goods. Limited exposure to international exchanges hindered the country's modernization efforts. The leadership sensed the gravity of the crisis the country was facing with the political turmoil, economic mismanagement, and stagnation of popular living standards that marked the post-Mao


31 During the 1950s, China relied on aid and advice from the Soviet Union and Eastern European countries to implement its industrialization programs; after the Sino-Soviet split in the early 1960s, Chairman Mao Zedong refused to accept foreign funds, whether in the form of loans or direct investment, out of fear that the arrival of foreign capital would bring with it political pressure from foreign nations, as China's experience with the Soviets demonstrated. See Alexander Eckstein, Communist China's Economic Growth and Foreign Trade: Implications for U.S. Policy 135-82 (1966); George Ginsburgs, The Legal Framework of Trade Between the USSR and The People's Republic of China 6-19, 43-64 (1976); Hsiao, supra note 30; Lee, supra note 30, at 96-182.
years. As a result, during 1977-1978, the Chinese leadership launched gigantic construction plans to speed up the country’s development. While such efforts turned out to be too ambitious to sustain, as indicated by the period of retrenchment that followed, the mentality of pursuing fast development persisted and was later translated into the opening-up policy and other reform programs. Chinese economic policies were subordinated to political considerations and the opening-up policy, like other reform initia-

32 Despite heroic investment rates and rapid growth since the late 1950s, the Chinese people’s living standards were still lagging because of stagnant productivity. See, e.g., CARL RISKIN, CHINA’S POLITICAL ECONOMY: THEQuest FOR DEVELOPMENT SINCE 1949 261-66 (1987); Robert F. Demberger, The Chinese Search for the Path of Self-Sustained Growth in the 1980s: An Assessment, in CHINA UNDER THE FOUR MODERNIZATIONS PART I 19, 20-27 (Joint Economic Committee Congress of the United States ed., 1982) [hereinafter FOUR MODERNIZATIONS].

33 In early 1978, Hua Guofeng, the then Party Chairman and Premier Minister announced an over-ambitious Ten Year Plan which reflected “a sense of urgency about growth”, RISKIN, supra note 32, at 259; this and other ambitious plans for accelerated economic development were initially supported by other leaders like Deng Xiaoping. BARRY NAUGHTON, GROWING OUT OF THE PLAN: CHINESE ECONOMIC REFORM, 1978-1993 62 (1995).

34 See Demberger, supra note 32, at 28-31 (discussing the policy of readjustment).

35 This fast development mentality was traceable to Maoist ideology, as the “Maoist view of how to accomplish development was through a ‘revolutionary’ process entailing rapid, massive, and often violent change.” SUZANNE OGDEN, CHINA’S UNRESOLVED ISSUES: POLITICS, DEVELOPMENT, AND CULTURE 87 (1995). Fast development reflected Mao’s belief not only that “the socialist road was qualitatively different but also that it was faster and more efficient.” Stephen Andors, The Political and Organizational Implications of China’s New Economic Policies: 1976-1979, in ORGANIZATIONAL BEHAVIOR IN CHINESE SOCIETY 162, 165 (Sidney L. Greenblatt et al. eds., 1981).

36 Duiwai Kaifang or “opening to the outside world” was formally announced by Deng Xiaoping in June 1980 when he referred to China’s policy of strengthening international ties, paying particular attention to the acquisition and assimilation of experiences, technology and capital of advanced countries. ZHONGGUO DUIWAI JINGJI MAOYI LILUN HE ZHENGCE [CHINA’S THEORIES AND POLICIES ON FOREIGN ECONOMIC RELATIONS AND TRADE] 88 (Wang Shaoxi ed., 3d ed. 1995). The origin of the policy has been attributed to the Third Plenum of the Chinese Communist Party’s Eleventh Central Committee in December 1978, in which the Party leadership officially abandoned its previous emphasis on political struggle and ideological purity and gave priority to economic development. In fact, the idea of opening-up was formulated and developed over many years. Deng Xiaoping was the “most outspoken advocate” of the introduction of Western technology in the mid-1970s. BROWN, supra note 30, at 76. The Communiqué of the Third Plenum expressly referred to the importance of acquisition of foreign technology, PEKING REV., Dec. 29, 1978, at 6, but did not mention the introduction of foreign capital or investment. Nevertheless, compensation trade, processing agreements, coproduction and licensing were permitted as experiments with new forms of foreign economic cooperation. BROWN, supra note 30, at 80-88. By the end of 1978, the idea of equity joint ventures was presented to foreign companies for consideration. China Offers 49% Equity Ownership in Joint Ventures, CHINA BUS. REV., Nov.-Dec. 1978, at 61.

37 For a discussion of early Post-Mao reform assessment, see Demberger, supra note 32, at 35-72.
tives, sought “to deliver more of the rewards of economic growth to the Chinese people in order to solidify [leaders’] political positions.”

As the country’s economic underdevelopment was attributed to its low technological development, Chinese leaders turned to imports of Western technology in the late 1970s. Massive hardware imports proved to be too expensive and foreign direct investment was therefore sought as an alternative. Overseas investment was intended to introduce advanced technology to the Chinese as well as to help the country resolve shortages of funds, management expertise and other needed skills. Other gains from opening-

38 NAUGHTON, supra note 33, at 61 (citing and interpreting Paul Hare, What Can China Learn from the Hungarian Economic Reform?, in TRANSFORMING CHINA’S ECONOMY IN THE EIGHTIES 51, 58 (S. Feuchtwang et al. eds., 1988)); see also Michel Oksenberg & Richard C. Bush, China, 1972-1982: From Revolution to Reform, in CHINA BRIEFING 1982 11, 18 (Richard C. Bush ed., 1983) (the Chinese Communist Party’s major immediate objective in the late 1970s was to improve the standard of living of the populace). Improvement of the people’s living standards as a policy objective constituted a significant departure from the Stalinist development strategy, which was characterized by a high rate of accumulation and investment, and the concentration of that investment in heavy industry. For a discussion of China’s shift away from the Stalinist strategy, see Demberger, supra note 32, at 54-59.

39 In a major national science conference in March 1978, a government official admitted that China was between fifteen to twenty years behind advanced world levels in many branches of science and technology. Leo A. Orleans, Science, Elitism, and Economic Readjustment, in FOUR MODERNIZATIONS, supra note 32, at 475, 480. The relative weakness of China’s economic modernization was explained by the country’s technological stagnation. See Carl Riskin, Surplus and Stagnation in Modern China, in CHINA’S MODERN ECONOMY IN HISTORICAL PERSPECTIVE 49, 56-83 (Dwight H. Perkins ed., 1975) (containing a summary of technological explanations for traditional Chinese economic retardation).

40 For China’s overambitious plans to import massive amounts of foreign technology in the 1970s, see, e.g., RISKIN, supra note 32, at 259-60; GERAEDTS, supra note 30, at 58-70. China’s development strategy in 1977-78 was similar to its previous practice with the exception of a “greater reliance on foreign sources.” Tien-tung Hsueh & Tun-oy Woo, Reforms of The Economic Structure in the People’s Republic of China, in CHINA: MODERNIZATION IN THE 1980s 231, 264 (Joseph Y.S. Cheng ed., 1989) [hereinafter MODERNIZATION IN THE 1980s].

41 Attempts at massive technology and hardware imports in the late 1970s “not only exceeded China’s ability to pay, but also saddled the country with an obligation to commit an even greater sum to the provision of ancillary equipment and parts.” RISKIN, supra note 32, at 260. According to another observer, “domestic economic and financial limitations and a lack of qualified technical personnel became critical constraints on [China’s] ability to make effective use of this newly acquired technology.” Denis Fred Simon, China’s Capacity to Assimilate Foreign Technology: An Assessment, in FOUR MODERNIZATIONS, supra note 32, at 514, 523.

42 See Demberger, supra note 32, at 40-41 (“the Chinese are attempting to further ease constraints imposed by their limited export earnings on their import capacity by encouraging foreign investment by means of joint ventures, compensation trade, and leasing arrangements”). Efforts started in Guangdong Province as early as 1978 to solicit Hong Kong and Macau businesses to set up processing and assembly operations or other joint undertakings. BROWN, supra note 30, at 80-85.

43 As Chinese Premier Zhao Zhiyang stated in the early 1980s, the opening-up policy would enable China to take advantage of international resources, develop international markets and learn expertise in managing foreign economic relations and trade. Zhao Ziyang,
up were also expected. By welcoming foreign capital, China could present a new image to the world, cementing ties with Western countries against the then common adversary, the Soviet Union. For people in Hong Kong, Macau or Taiwan and for Overseas Chinese, the new image could encourage a renewal of their traditional bonds with their ancestral land. The reunification of Hong Kong, Macau and Taiwan was also much in the mind of Chinese leaders; they thought that the arrival of foreign capital might be further construed as an international endorsement of the new leadership and its policy.

The opening-up policy called for improvements in the country’s investment conditions. Preferential tax treatment was considered vital to the country’s efforts to attract foreign capital and technology. Shewai Shuishou, or “foreign taxation,” became a specialized branch of government whose main objective was to promote the opening-up policy. Various preferential tax schemes were set up over the next several years. Some supposedly applied nationwide and others were available only to foreign investors settled in designated areas. Additional fiscal benefits were offered on the basis of industry/sector classification. Finally, the government handed out special concessions that promoted investment projects by Overseas Chinese. With overlapping and sometimes inconsistent regimes, foreign taxation in general and tax preferences in particular looked so complicated and confusing that “calculating which tax provisions provide any single enterprise or investment possibility the most favorable treatment has become a considerable burden, and expense, for foreign investors.”


See, e.g., NAUGHTON, supra note 33, at 62-63.

The Chinese admitted that their lack of advanced equipment, technology, skilled personnel and management expertise, shortage of funds, and overpopulation were factors unfavorable to Chinese-foreign economic ties. Hongqi Zazhi Bianjibu [Editorial Board, Red Flag Magazine], Guanyu Woguo De Duiwai Jingji Guanxi Wenti [Issues Concerning Our Country’s Foreign Economic Relations], HONGQI [RED FLAG], Apr. 6, 1982, at 2, 3-4 [hereinafter Red Flag Editorial]. There were, of course, more systemic problems such as labor, domestic market access, the planned economy and the state bureaucracy. See, e.g., RISKIN, supra note 32, at 327-38.

See, e.g., LIYONG WAIZI DE LILUN YU SHUJIAN [THE THEORY AND PRACTICE OF UTILIZING FOREIGN FUNDS] 43 (Fang Xiaoqiu ed., 1984) (whether China was attractive to foreign capital depended on whether preferences were granted to foreign investors).


James V. Feinerman, Chinese Law Relating to Foreign Investment and Trade: The Decade of Reform in Retrospect, in CHINA’S ECONOMIC DILEMMAS IN THE 1990S: THE PROBLEMS OF REFORMS, MODERNIZATION, AND INTERDEPENDENCE 828, 832 (Joint Economic
B. Nationwide Enterprise Income Tax Regimes And Preferential Treatment

The 1979 Equity Joint Venture Law promised income tax preferences in two situations. EJVs were eligible for a reduction of or an exemption from their income tax for the first two to three profit-making years if they possessed "advanced technology by world standard." Furthermore, a foreign joint venture could apply for a refund of a portion of the income tax paid if it reinvested its net profit in China. The JVITL, adopted fourteen months later, instituted an enterprise income tax for EJVs. In addition to providing normative rules and a regulatory framework for tax administration, the legislation included a number of measures characterized as tax preferences by the spokesman for the bill's sponsors. First, newly established EJVs could apply for an exemption from income tax in the first profit-making year and a fifty percent reduction of income tax in the second and third years, provided that they were scheduled to operate for at least ten years. Following the expiration of this initial exemption and reduction, EJVs engaged in relatively low-profit sectors like farming and forestry or established in remote and economically underdeveloped regions were eligible for fifteen to thirty percent income tax reduction for ten more years, subject to the approval of the Ministry of Finance. Next, joint venturers that reinvested their shares of profit in China for a period of at least five years could obtain, upon approval, a refund of forty percent of the income tax paid on the reinvested funds. Finally, two provisions for computing...
the taxable income of EJVs were characterized as "preferential." The first was permission to use, upon approval, accelerated depreciation of fixed assets in special circumstances.\textsuperscript{56} The second involved the carry-over of losses to offset profits for five years.\textsuperscript{57} The JVITL imposed a thirty percent tax rate plus an additional three percent local surcharge.\textsuperscript{58} This combined thirty-three percent tax rate was believed to be attractive because corporate income tax rates were around fifty percent in most developed countries and between thirty-five and forty percent in many developing countries.\textsuperscript{59}

The 1980 JVITL applied to EJVs. Foreign investors that chose the investment form of WFOE or CJV were subject to the FEITL, enacted fifteen months later.\textsuperscript{60} The tax on the income of a "foreign enterprise" was computed on a progressive rate schedule with five brackets ranging from twenty percent for the annual income of up to 250,000 Rmb, to forty percent for the annual income exceeding 1 million Rmb.\textsuperscript{61} An additional ten percent local tax was levied on the taxable income.\textsuperscript{62} The FEITL offered fewer preferences to foreign enterprises than the JVITL did to EJVs. There was no general income tax exemption or reduction for newly established foreign enterprises. Only foreign enterprises engaged in farming, forestry, husbandry or other low-profit operations and scheduled to operate for ten years or more could apply for an exemption in the first profit-making year and a fifty percent reduction in the following two years. A fifteen to thirty percent reduction in income tax for another ten years could be available after the expiration of the foregoing exemption and reduction, subject to the ap-

\textsuperscript{56} Gu Ming, \textit{supra} note 52, at 627. The JVITL itself did not explicitly refer to permission of accelerated depreciation. The relevant provision was found, however, in Rules for the Implementation of the Income Tax Law of the People's Republic of China Concerning Chinese-Foreign Joint Ventures (Zhonghua Renmin Gongheguo Zhongwai Hezi Jingying Qiye Suodeshui Fa Shixing Xize), art. 13, approved by the State Council on December 10, 1980 and promulgated by the Ministry of Finance on December 14, 1980, 1980 FAGUI HUIBIAN 116, 119-20.

\textsuperscript{57} JVITL, \textit{supra} note 2, art. 7; Gu Ming, \textit{supra} note 52, at 627.

\textsuperscript{58} JVITL, \textit{supra} note 2, art. 3.

\textsuperscript{59} Gu Ming, \textit{supra} note 52, at 625.

\textsuperscript{60} The FEITL applied to "foreign enterprises" which referred to any foreign companies and business entities that maintained an establishment in China and engaged in business either independently, or in co-operative production or business with Chinese enterprises in a form other than that of an EJV. FEITL, \textit{supra} note 2, art. 1. For discussions of the FEITL, see, Easson & Li, \textit{supra} note 21, at 676-81; Harrison, \textit{supra} note 21, at 387-94; Norberg & Price, \textit{supra} note 21; Simon, \textit{supra} note 21, at 550-55.

\textsuperscript{61} FEITL, \textit{supra} note 2, art. 3.

\textsuperscript{62} FEITL, \textit{supra} note 2, art. 4. The FEITL also imposed a withholding tax of 20% on all China-sourced dividend, interest, rental, royalty and other income of foreign companies and business entities that did not have an establishment in China. \textit{Id.} art. 11.

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proval of the Ministry of Finance. Unlike EJVs, foreign enterprises received no tax benefits under the FEITL for reinvesting their profits in the country. In computing their taxable income, however, foreign enterprises like EJVs could carry forward losses for five years. The foreign enterprises could also use accelerated methods of depreciation of fixed assets, provided that the operation did not involve exploitation of offshore petroleum or other natural resources and subject to the approval by the Ministry of Finance. As a gesture to foreign enterprises with small-scale production and low profit, the legislation allowed provincial governments to waive or reduce local income tax.

The JVITL and FEITL were replaced by a single enterprise income tax in 1991 when the Income Tax Law of the People’s Republic of China Concerning Foreign Investment Enterprises and Foreign Enterprises (Unified Tax Law or UTL) was adopted. The new regime no longer distinguishes between different forms of investment. The UTL applies a thirty percent flat rate to all FIEs, plus a three percent local surtax. FIEs engaged in productive sectors and scheduled to operate for ten years or more are enti-

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63 FEITL, supra note 2, art. 5; see also Xie Ming Tongzhi Guanyu Zhonghua Renmin Gongheguo Waiguo Qiyue Suode Shui Fa Cao’an De Shuoming Zhaiyao [Extracts of Comrade Xie Ming’s Explanations on the Draft Income Tax Law of the People’s Republic of China Concerning Foreign Enterprises], in 1983 FAGUI XUANBIAN, supra note 52, at 621, 622-23 [hereinafter Xie Ming].

64 FEITL, supra note 2, art. 6.


66 FEITL, supra note 2, art. 4; Xie Ming, supra note 63, at 623.


68 Under the UTL, “foreign investment enterprises” refers to EJVs, CJVs and WFOEs, and “foreign enterprises” are divided into two categories: foreign companies and business entities that set up an establishment in China and those maintaining no establishment in China, but having earned an income with a source in China. UTL, supra note 67, art. 2. As the Director of the State Administration of Taxation explained, the UTL provided a uniform approach to tax rates, preferential tax treatment and tax collection jurisdiction with regard to all foreign funded businesses operating in China. Jin Xin, Guanyu Waishang Touzi Qiyue He Waiguo Qiyue Suode Shui Fa De Jieshao He Shuoming [Summary and Explanations on the Income Tax Law of the People’s Republic of China Concerning Foreign Investment Enterprises and Foreign Enterprises], ZHONGGUO SHUWU BAO [CHINA’S TAX NEWS], Apr. 29, 1991, at 1. For discussions on the UTL, see Curley & Fortunato, supra note 21, at 546-64; Weber, supra note 21, at 289-92; Wunsch & Liu, supra note 21, at 415-22.

tied to a two-year tax exemption, after they make a profit, followed by a three-year, fifty percent reduction.\textsuperscript{70} FIEs engaged in agriculture, forestry, or husbandry, or those FIEs located in economically underdeveloped remote regions may obtain, upon application and approval, another fifteen to thirty percent reduction in income tax for ten more years after the expiration of the exemption and reduction.\textsuperscript{71} The new regime retains provisions permitting carrying forward of losses\textsuperscript{72} and the use of accelerated methods of depreciation.\textsuperscript{73} It also sanctions various preferential schemes enacted by previous State Council regulations.\textsuperscript{74} The UTL liberalized tax preference rules and practice. The two-year tax exemption and three-year tax reduction are available to productive WFOEs and CJVs,\textsuperscript{75} and are no longer limited to EJVs. Provincial governments can waive or cut down local surtax for all kinds of FIEs in designated industries or sectors,\textsuperscript{76} not just for small scale and low profit foreign enterprises as under the FEITL. While the JVITL allowed only EJVs to apply for the forty percent refund of the tax paid on the portion of any reinvested profit, the UTL extends eligibility for this refund to all FIEs.\textsuperscript{77} Qualified FIEs are automatically granted the two-year exemption and three-year fifty percent reduction without any prior application and approval.\textsuperscript{78} Profits received by foreign investors from FIEs are tax exempt.\textsuperscript{79} The UTL also raises the amount of deduction for business entertainment expenses\textsuperscript{80} and permits businesses to write off bad debts.\textsuperscript{81}

\textsuperscript{70} UTL, supra note 67, art. 8. The tax holidays are not available, however, to petroleum, natural gas, rare metal, and precious metal exploitation projects, which are governed by separate government regulations. \textit{Id.}

\textsuperscript{71} \textit{Id.}

\textsuperscript{72} UTL, supra note 67, art. 11.

\textsuperscript{73} \textit{Zhonghua Renmin Gongheguo Waishang Touzi Qiye He Waiguo Qiye Suodeshui Fa Shishi Xize [Detailed Implementing Rules for the Income Tax Law of the People's Republic of China Concerning Foreign Investment Enterprises and Foreign Enterprises], arts. 34 & 40, 1991 FAGui HuiBiAN 290, 299 & 301.}


\textsuperscript{75} \textit{Wang, supra note 69.}

\textsuperscript{76} UTL, supra note 67, art. 9.

\textsuperscript{77} UTL, supra note 67, art. 10.

\textsuperscript{78} Under the JVITL and FEITL, the granting of tax holidays was not automatic but was subject to approval by government tax officials. \textit{JVITL supra note 67, art. 5; FEITL supra note 2, art. 5. Article 8 of the UTL no longer requires application by FIEs or approval by tax authorities.}

\textsuperscript{79} UTL, supra note 67, art. 19(1); see also \textit{Jin, supra note 67 (abolition of 10% surcharge and remitted profit tax exempt)}.

\textsuperscript{80} UTL Implementing Rules, supra note 74, art. 22. Under previous accounting and tax rules, business entertainment expense deduction was capped at 3% of the net annual sales under 15 million yuan and 1% of any net annual sales exceeding 15 million yuan; UTL Implementing Rules raised the cap to 5% and 3% respectively. \textit{See Wang Xuanhui, Yingna
One change that adversely affects foreign investors is the revocation of tax holidays that the JVITL granted to EJVs engaged in non-productive and service sectors. Pre-1991 EJVs may still retain JVITL tax holidays, though, until the end of the term of their joint venture contracts.

Separate tax and preferential regimes currently apply to FIEs and DOEs. As domestic complaints about preference treatment reserved for FIEs are mounting, the country’s decision-making circle is now in favor of a single enterprise income tax regime for both FIEs and DOEs with near uniformity in preferential treatment. Such uniformity would likely come at the expense of many of the existing preferences enjoyed by foreign businesses. Foreign banks in China, for example, are now charged thirty-three percent income tax for conducting Chinese currency transactions just like domestic banks, while the fifteen percent preferential rate only applies to their foreign exchange business. Moreover, with regard to their income from Chinese currency business, foreign banks cannot enjoy the one-year income tax exemption followed by a two-year, fifty percent reduction. If foreign banks are allowed to conduct renminbi transactions like domestic banks, they must pay the same tax. While reduction or elimination of tax benefits for FIEs may not confer upon DOEs any direct fiscal benefits, it would at least ease domestic discontent.

C. Regional Development Strategy and Enterprise Income Tax Preferences

I. Special Economic Zones

Chinese leaders prioritized the introduction of foreign capital and technology on a gradual, region-by-region basis. This development strategy...

Shui Suode Er Jisuan De Ruogan Xianding [Some Limitations on Computing Taxable Income], ZHONGGUO SHUIWU [CHINA TAXATION], 1992 No. 8, 26, at 26.
81 UTL Implementing Rules, supra note 74, art. 25. Under previous accounting and tax rules, writing off bad debts was not permitted. See Wang, supra note 80.
82 Wang, supra note 69.
83 UTL, supra note 67, art. 27.
84 See supra note 16.
85 See, e.g., Shao Mingjun & Liang Youping, Liang Shui Heyi De Ruogan Sikao [Reflections on the Merger of Two Taxes], SHEWAI SHUISHOU [INTERNATIONAL TAXATION IN CHINA], 1996 No. 3, 8, at 8-10.
86 Foreign Banks Hit by 33% Tax for Yuan Transactions, S. CHINA MORNING POST, July 1, 1997, Business, at 3. For tax preferential treatment of foreign banks and branches in Pudong, Shanghai, see infra note 142 and accompanying text.
87 Id.
89 This strategy followed the idea that investment should be concentrated where it would be most likely to yield higher returns, and investment policy must be tilted in favor of those geographical areas susceptible to fast development. See Liu Fuhuan, Lun Tequ He Pugu Fazhan De Bianzhengfa [On the Dialectic of the Development of Special Zones and Non-Special Zones], in 1994 ZHONGGUO JINGJI TEQU KAIFANGDIQU NIANJIAN [1994 YEARBOOK...
began with the creation of special economic zones. On July 15, 1979, the Party Central Committee and State Council approved the Guangdong and Fujian provincial party committees’ proposals to set up experimental chukou tequ, or “special export zones,” in Shenzhen, Zhuhai and Shantou of the Guangdong Province, and Xiamen of the Fujian Province. These special export zones were created to vie for overseas investment. They were later renamed jingji tequ, or “special economic zones” (SEZs). With its vast expanse, large population, huge regional contrasts, antiquated industrial hardware and infrastructure, and shortage of trained managers and skilled workers, China needed astronomical infusion of foreign capital and massive amounts of imports of modern equipment and technology in order to make an immediate, visible difference in productivity and standard of living.

The country’s business environment in the late 1970s, however, was not conducive to foreign investment. On top of its historic autarky and xenophobia, China maintained a Stalinist political, economic and legal structure when the country was opened up. Strong domestic resistance accompanied any attempt to bring about profound changes. Chinese policy makers had no illusions about a quick result on a national scale, nor did they welcome the drastic transformation that foreign capital inflows could bring to the country’s economy and society. By creating SEZs in three cities in Guangdong and one city in Fujian, Chinese leaders anticipated that funds from Hong Kong, Macau, Taiwan, and other Overseas Chinese would flow into those areas because of geographic proximity, cultural closeness


91 Id.

and kinship. The government could then use the success of the SEZs for a variety of political and economic purposes. For example, prosperous SEZs could be used as showcases for Hong Kong, Macau, and Taiwan. Meanwhile, the concentration of foreign businesses in designated and separated areas would ensure that the impact of foreign capital on Chinese society and domestic economy would remain under control.

Because the SEZs constituted the preliminary phase of the opening-up policy, the government took unprecedented efforts to secure their success.

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94 The idea of SEZs was inspired by free trade zones, or export processing zones in other countries, notably those in neighbouring Asian economies like Hong Kong, Taiwan and Singapore. Liu Enzhao, Lue Lun Duwai Jingji Kaifang [On Economic Opening Up to the Outside World] 58-59 (1985); see also Bucknall, supra note 92, at 143 (The Chinese approached the United Nations for technical assistance and investigated some of the foreign export zones or free trade zones to improve SEZs’ chances of success). One difference was, however, that unlike Kaohsiung Export Processing Zone in Taiwan or the Santa Cruz Electronics Export Processing Zone in India which were industrial sections with limited functions, Chinese SEZs are “permanent modern industrial and economically viable entities.” Ng, supra note 92, at 448; see also Liang, supra note 93, at 106 (in addition to focusing on industrial investment projects, Shenzhen SEZ would also develop commerce, agriculture, animal husbandry, residence, tourism and other industries and sectors).

95 SEZs have been assigned the following functions: (1) serving as bridges for the introduction of foreign capital, technology and expertise and training classrooms for Chinese managers and workers to gain knowledge and experience from foreigners, (2) encouraging regional competition, (3) enhancing the country’s foreign exchange earning capacity, (4) serving as laboratories for experiment for domestic reform efforts, and (5) providing job opportunities. Ng, supra note 92, at 448-49; see also Bucknall, supra note 92, at 144.

96 Liang, supra note 93, at 108 (linking development of Shenzhen SEZ to prosperity and stability of Hong Kong); Sun Ru, Cong Zhanlue Yiyi Tan Jingji Tequ De Zuoyong He Jian she [A Discussion on the Function and Construction of Special Economic Zones from Strategic Viewpoints], in 1983 Y.B. SEZs, supra note 93, at 649, 653 (Shenzhen SEZ as a model for reunification of Taiwan).

97 Chinese literature stressed the importance of separating SEZs from the rest of the country. See Liu, supra note 94, at 60 (SEZs avoid direct exposure of domestic economy to world economy and protect domestic economy); Xu Dixin, Guanyu Jingji Tequ De Jige Lilun Wenti [Some Theoretical Issues Concerning Special Economic Zones], in 1983 Y.B. SEZs, supra note 93, at 573, 575 (arguing that SEZs would prevent foreign investment from reaching the interior unrestrained). By separating SEZs from the rest of the country, the spread of Western ideas and culture would be contained as well. As one commentator observed, there was similarity between SEZs and the trading ports, treaty ports and concessions historically used by China to limit foreign influence. Susan L. Shirk, How China Opened Its Door: The Political Success of the PRC’s Foreign Trade and Investment Reforms 35-36 (1994).
The government reinforced the natural advantages of the SEZs, such as their geographic accessibility and ties with Hong Kong, Macau and Taiwan, by according provincial and local authorities great autonomy and broad powers in such matters as finance, foreign investment/trade, foreign exchange, labor, and price control. This decentralization was expected to stimulate local enthusiasm, which was necessary for the SEZs' development. The government added various preferential measures, including tax reductions and exemptions, to make investment in SEZs look more advantageous. Early preferential tax treatment of foreign investors in SEZs was governed by the Regulations on Special Economic Zones in Guangdong Province, which, in fact, preceded the 1980 JVITL. The 1984 Tax Reduction and Exemption Regulations fine-tuned and augmented the tax preference regime in SEZs by unifying tax treatment for foreign investment projects in all four SEZs and in Hainan Island.  

98 Reports of Guangdong & Fujian, supra note 90, at 38-41; Liang, supra note 93, at 105-06.  
99 Reports of Guangdong & Fujian, supra note 90, at 41 (adoption of preferential tariffs, simplified customs procedure, permission of profit repatriation, easy banking access); Liang, supra note 93, at 105 (low tax rates, tax reduction and exemption, reinvestment tax benefits, import duty exemption, preferential land use, relaxed export requirements in Shenzhen).  
100 Guangdong Jingji Tequ Tioli [Regulations on Special Economic Zones in Guangdong Province], 1980 FAGUI HUIBIAN 175 [hereinafter Guangdong SEZs Regulations]. Fujian Province applied most of the same or similar preferential treatment to Xiamen SEZ. See Zou Erjun & Jiang Ping, Xiamen Jingji Tequ Qingkuang Jieshao [Introduction to Xiamen Special Economic Zone], in 1983 Y.B. SEZs, supra note 93, at 315, 318. Chapter III of Guangdong SEZs Regulations, entitled “Preferential Measures,” promised tax preferences for foreign investment projects in SEZs. Accordingly, the enterprise income tax rate was 15%. Guangdong SEZs Regulations, art. 14. Unspecified “special preferential treatment” was provided to enterprises established within two years of the promulgation of the regulations, with an investment of U.S. $5 million or more, involving higher technology, or having a longer capital period. Id. Foreign businesses that reinvest their profits in SEZs for a period of five years or more may apply for a reduction of or exemption from income tax on the reinvested portion. Id. art. 16. The Shekou Industrial Zone in Shenzhen apparently had its own regulations granting tax holidays and taxing corporate profit at a 10% rate. Thomas J. Rasmussen & Eugene A. Theroux, China’s New Tax Laws for Joint Ventures and Individuals, CHINA BUS. REV., Nov.-Dec. 1980, at 36, 37. There was confusion about which regime should prevail. Id.  
101 A major difference was the distinction made by the 1984 Tax Reduction and Exemption Regulations between productive and service-oriented investment projects; productive enterprises referred to those engaged in manufacturing, communication and transport, agriculture, forestry, husbandry or other sectors deemed productive. 1984 Tax Reduction and Exemption Regulations, supra note 3, 1(a)(3). If they were scheduled to operate for 10 years or more, they would enjoy, upon approval, an income tax exemption for the first and second years after they made a profit and a 50% reduction in income tax from the third year to the fifth year. Id. On the other hand, service-oriented projects were offered a one-year exemption followed by another two years’ 50% reduction if they exceeded U.S. $5 million in capital investment and were scheduled for operation for 10 years or more. Id. 1(a)(2).  
102 Id. 1(a).  
103 Id. 1(j). Hainan Island was subsequently made a new province and the country’s fifth and largest SEZ, with the same attributes as other SEZs, including tax preferences. Decision
China's Tax Preferences to Foreign Investment
18:549 (1998)

Compared to nationwide enterprise income tax treatment, several preferential features in SEZs stood out. All foreign investment projects in SEZs enjoyed a reduced fifteen percent enterprise income tax rate\textsuperscript{104} without the distinctions between forms of investment required by the 1980 JVITL and 1981 FEITL.\textsuperscript{105} The local governments in SEZs could waive or reduce local income tax.\textsuperscript{106} EJVs in SEZs were exempt from the ten percent income tax on their expatriated profits.\textsuperscript{107} Even though the 1991 UTL broadened tax preferences nationwide, FIEs in SEZs still enjoy benefits not generally available such as the reduced fifteen percent income tax rate. Most significantly, SEZs set up precedents for the authorities to create preferences which help channel foreign capital and technology into other designated priority areas. With a plethora of preferential schemes and overlapping promises, foreign investors in a designated area may claim not only benefits that are available nationwide, but also special treatment offered by applicable regional schemes.

\textsuperscript{104} 1984 Tax Reduction and Exemption Regulations, \textit{supra} note 3, 1(a).

\textsuperscript{105} \textit{Id.} Productive CJVs and WFOEs in SEZs were the biggest beneficiaries since the JVITL, as amended in 1983, already offered all EJVs identical tax holidays; service-oriented CJVs and WFOEs in SEZs would also gain from the 1984 Tax Reduction and Exemption Regulations as the 1981 FEITL provided no tax holidays at all.

\textsuperscript{106} 1984 Tax Reduction and Exemption Regulations, \textit{supra} note 3, 1(b).

\textsuperscript{107} \textit{Id.} 1(c).
2. ETDAs, OUDs and COERs

Following the establishment of SEZs, the Party leadership called for the country’s entire coastal area to play an active role in expanding foreign trade and seeking overseas capital and technology. They had geographic advantages, they had a relatively more developed industrial, technological and infrastructure base than the rest of the country, and they were the ancestral home to most Overseas Chinese. In May 1984, the Party Central Committee and State Council designated fourteen coastal cities as Yanhai Kaifang Chengshi, or “Coastal Open Cities” (“COCs”), and granted them enlarged autonomy on economic development and foreign investment matters. The government devised two tiers of preferences.

First, the government designated certain areas within COCs as Jingji Jishu Kaifaqu, or “Economic and Technological Development Areas” (“ETDAs”). ETDAs duplicated some of the characteristics of the SEZs in order to speed up economic development in COCs. ETDAs targeted technology and capital intensive projects. The establishment of ETDAs required injections of massive amounts of funds to build transport, communication facilities and other infrastructure facilities to suit the needs of for-

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109 Id. at 95-96.

110 Id.

111 Zhonggong Zhongyang Guowuyuan Guanyu Pizhuan Yanhai Bufen Chengshi Zuo-tanhui Jiyao De Tongzhi [Notification of the Chinese Communist Party Central Committee and State Council Concerning the Issuance and Approval of the Summary of the Forum on Coastal Cities], in COLLECTED POLICY DOCUMENTS, supra note 90, at 476 [hereinafter Forum on Coastal Cities]. The fourteen coastal cities were Tianjin, Shanghai, Dalian, Qinhuangdao, Yantai, Qingdao, Lianyungang, Nantong, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang, and Beihai. Id. at 480.

112 Local governments in COCs were given autonomy and power to deal with matters such as foreign investment project approval, foreign exchange control, import and export, preferential treatment for foreign investment, and a structure construction. Id. at 480-85.

113 Id. at 482.

114 There were political obstacles to the expansion of SEZs. During the 1980s, Chen Yun, a senior Party leader, identified SEZs with capitalist speculation and advocated a containment policy. CHEN YUN, Jingji Jianshe De Jige Zhongyao Fangzen [Some Important Guiding Principles for Economic Construction] [hereinafter Guiding Principles], in 3 CHEN YUN WENXUAN [SELECTED WORKS OF CHEN YUN] 305, 307 (1986) [hereinafter SELECTED WORKS OF CHEN YUN]; CHEN YUN, Jiaqiang He Gayin Jingji Jihua Gongzuo [Strengthening and Improving Economic Planning Works], in id. at 309, 311. Proponents of the SEZ policy had to take pains to explain the necessity of establishing SEZs and assure critics that the socialist system of the country would not be affected. See Ng, supra note 92, at 449-50; see also BUCKNALL, supra note 92, at 162-64.

115 Forum on Coastal Cities, supra note 111, at 483.
eign businesses, so the central authorities needed to control the number and size of ETDA s to ensure success. The central authorities therefore retained the final say on matters such as whether an ETDA could be established, where in the city it should be located, and how large it should be. As SEZ policy showed, tax treatment was the barometer of how open and favorable an area would be to foreign investment, and, subsequently, efforts to improve investment conditions needed to incorporate preferential tax measures. The government therefore offered a reduced fifteen percent income tax rate, tax holidays and other benefits to productive foreign investment projects in ETDA s.

In an attempt to revitalize the industry and economy of urban areas of COCs through foreign investment, the government created a second tier of preferred areas called Lao Shiqu, or "Old Urban Districts" (OUDs), with limited incentives to foreign investment. The 1984 Tax Reduction and Exemption Regulations have allowed a reduced fifteen percent rate to certain productive EJVs, CJVs and WFOEs in OUDs. In particular, the enterprises must be technology or know-how intensive, with an investment exceeding U.S. $30 million and a long investment recovery period, or they must be projects related to energy, transport or port construction. EJVs, WFOEs and CJVs based in OUDs which are not eligible for the fifteen percent rate receive a twenty percent reduction in their applicable income tax if they fall within one of the following sectors: (1) machinery, manufacturing and electronics; (2) metallurgy, chemical, and building material; (3) light in-

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116 See Hu, supra note 13, at 65 (ETDAs in coastal cities required about 100 million yuan investment per square kilometer for infrastructure development).

117 According to state policy guidelines, ETDA s must be limited and marked geographically and supervised by the state; the set-up of ETDA s must be examined and approved on a case-by-case basis. Kuoda Duiwai Kaizhan Jingji Huodong De Guanzhu Dui Touzi Keshang Shixing Youhui Zhengce [To Enlarge Authorities for Conducting Foreign-Related Economic Activities and Apply Preferential Measures to Foreign Investment], RENMIN RIBAO [PEOPLE'S DAILY], July 13, 1984, at 2.

118 Whether COCs could set up ETDA s and the location and size of ETDA s all needed to be approved by the State Council. See Guowuyuan Pifu Yanhai Gangkou Chengshi Jinyibu Shixing Duiwai Kaifang De Baogao [The State Council’s Approval and Reply on Reports Concerning Further Opening Up of Coastal Port Cities] [hereinafter Opening Up of Coastal Cities], in CHINA'S OPENING, supra note 11, at 62.


120 Productive foreign investment projects scheduled to operate for ten years or more in ETDA s were granted an income tax exemption for the first two years after profit-making and 50% tax reduction for the next three years. Id. They can also enjoy local tax waivers and reductions by municipal governments, id. at 2(b), and tax exemption of repatriated profits, id. at 2(c). Investment in ETDA s was not strictly limited, however, to hi-tech projects, and the government documents approving the creation of ETDA s spoke of goals such as expanding export sectors, upgrading products and industrial production, and renovating old domestic enterprises. Opening Up of Coastal Cities, supra note 118, at 64 (concerning approval of Tianjin ETDA).

121 1984 Tax Reduction and Exemption Regulations, supra note 3, at 3(a).

122 Id.
dustry, textile, and packaging; (4) medical equipment and pharmaceutical; (5) agriculture, forestry, husbandry, aquatic breeding and processing related to any one of these sectors; or (6) construction.123

In January 1985, as yet another regionally-based developmental initiative, the State Council declared cities and counties in the Yangtze and Pearl River Deltas, and the South Fujian (Xiamen-Zhangzhou-Quanzhou) area to be Yanhai Jingji Kaifangqu, or “Coastal Economic Open Regions” (CEORs)124 and bestowed upon them special tax measures.125 Composed of both urban and rural areas, CEORs had been the bases of the country’s traditional export industries like textiles, handicrafts, light industry and native products.126 The introduction of foreign capital and technology, as well as management and marketing skills, was intended to improve and expand export sectors. The government again justified this latest initiative on the regions’ geographic proximity to neighboring countries as well as the fact that the regions were the original home to many Overseas Chinese and Hong Kong, Macau and Taiwan compatriots.127 The Ministry of Finance issued a set of regulations in 1988 to clarify the tax positions of foreign investors in CEORs.128 Tax preferences for foreign investment in CEORs closely track those available in OUDs.129

123 Id. While local authorities may waive or reduce local income tax for investment projects in OUDs, id. at 3(b), neither tax holidays nor refunds were granted.
124 Guowuyuan Guanyu Pizhuan Changjiang Zhujiang Sanjiaozhou He Minnan Xiamen-Zhangzhou-Quanzhou Delta Area’s Taxation [Notification of the State Council Regarding Approval and Issuance of Extracts of the Minute of the Meeting on Yangtze Delta, Pearl River Delta and South Fujian Xiamen-Zhangzhou-Quanzhou Delta Areas], Feb. 18, 1985, in LAWS OF ECONOMIC OPEN AREAS, supra note 5, at 175. The list of CEORs was later expanded to cover over 150 cities and counties in 8 provinces. See Guowuyuan Guanyu Kuoda Yanhai Jingji Kaifangqu Fanwei De Tongzhi [Notice of the State Council Concerning the Enlargement of the Scope of Coastal Open Economic Regions], 1988 FAGUI HUIBIAN 446. As a result, CEORs reach the East Liaoning and East Shandong Peninsulas.
125 Chen Tanqiang, Zhongguo Duiwai Kaifang Zhanxian Xin Geju [Newly Developed Situations for China’s Opening Up], LIAOWANG [OUTLOOK], 1985 No. 8, reprinted in CHINA’S OPENING, supra note 11, at 391, 394-95 (preferential treatment on income tax, turnover taxes and customs duty).
126 See Renmin Ribao Pinglunyuan [People’s Daily Commentator], Yanhai Xing Neidi Wang [Prosperous Coast and Prosperous Interior], RENMIN RIBAO [PEOPLE’S DAILY], Feb. 1, 1985, reprinted in CHINA’S OPENING, supra note 11, at 389, 389-90; Ji, supra note 11, at 401-03.
127 Ji, supra note 11, at 398.
129 Preferential measures include a 15% income tax for certain eligible foreign-funded enterprises in CEORs, and a 20% reduction for foreign-funded enterprises engaged in certain designated sectors like machinery, manufacturing, and electronics. 1988 CEORs Tax Regulations, supra note 128, at 1.
Regional tax preference regimes as established during the 1980s distinguished priority cities and counties like SEZs, ETDAs, OUDs and CEORs from the rest of the country. Further differences were created among priority cities and counties themselves. The country’s SEZs offered the most generous tax benefits to foreign investors because they were the first to be selected for regional development and their top priority status has remained mostly unchanged over the years. China’s leaders attached great importance to the accomplishments of SEZs.\textsuperscript{130} The adoption of other priority schemes was not supposed to threaten the position enjoyed by SEZs. Indeed, to allow exactly the same preferential treatment in non-SEZ areas was thought to lead to unhealthy competition and divert attention from SEZs.\textsuperscript{131} The expansion of the idea of SEZs would have raised eyebrows in the conservative wing of the Party leadership. Tax benefits available to foreign investment in ETDAs, OUDs and CEORs were therefore capped. Similarly, among ETDAs, OUDs and CEORs,\textsuperscript{132} the strategy was to concentrate limited resources for improvement of infrastructures in small geographic areas.\textsuperscript{133}

3. New Waves of Regional Preferences in the Early 1990s

In the aftermath of the Democracy Movement of the spring of 1989 and the sweeping changes in Eastern Europe and the former Soviet Union, Party leaders concluded that their continued grip on power would hinge more than ever on their ability to deliver the material rewards they had promised to the Chinese people a decade before. To accelerate economic development, the central authorities approved the further opening and de-

\footnotesize{\textsuperscript{130} See Deng, Improving Special Economic Zones, supra note 89, at 51 n.* (Deng Xiaoping relying on Shenzhen’s development and accomplishments to prove the correctness of Party policy).}

\footnotesize{\textsuperscript{131} Concerns about competition were expressed when the decision on COCs development was made. Forum on Coastal Cities, supra note 111, at 485-86. Deng Xiaoping himself made it clear that COCs should not be called SEZs. Id. at 478.}

\footnotesize{\textsuperscript{132} Local officials pressed for the development of hi-tech and capital intensive projects, as they were symbols of modernization, and expressed little interest in renovating state enterprises, as some of them were controlled by the central government, whereas the central government policy favored the use of foreign capital and technology to renovate the old industrial base located in coastal cities. Ji Chongwei, Woguo Duiwai Kaifang Zhengce De Lilun He Shijian [Theory and Practice of Our Country’s Opening Up Policy], in LUN ZHONGGUO DUIWAII KAIFANG DE ZHANLUE HE ZHENGCE [ON CHINA’S OPENING UP STRATEGY AND POLICY] 3, 19 (1995).}

\footnotesize{\textsuperscript{133} Chen Zhaobin, Shilun Zhongguo Yanhai Duiwai Kaifang Dai De Xingchengjiegou Ji Fazhan Zhanlue [A Preliminary Discussion on the Formation, Structure and Development Strategy of China’s Coastal Open Belt], in 1983 Y.B. SEZs, supra note 93, at 667, 680-81 (limited geographic areas of ETDAs would produce quick result); Tan Hanhui, Yan Zhe Duiwai Kaifang De Dadao Xiangqiang Maiin [Moving Forward Along the Path of Opening Up], in 1980-1989 Y.B. SEZs & COASTAL ETDAS, supra note 13, at 12, 13 (purpose of ET- DAs was to create favorable investment conditions in smaller areas and accelerate those cities’ economic development).}
development of the Pudong New District in the City of Shanghai.\textsuperscript{134} Shanghai is one of the COCs that benefitted from the 1984 decision to set up ETDA\textsuperscript{s} and designate OUD\textsuperscript{s}.

Shanghai is China's largest and most industrialized city and is strategically located in one of the country's richest and most developed areas, the Yangtze River Delta. Its leading role in the country's industrial and technological sectors coupled with the city's concentrated number of skilled workers, technicians and managers,\textsuperscript{136} offers unparalleled advantages.\textsuperscript{137} The Party leadership chose Shanghai as the leader for the next wave of overseas investment into the country.\textsuperscript{138} By designating a new priority district in Shanghai, the government was repeating the SEZ strategy, focusing on a rather small area to increase the visibility of foreign investments and their success. Preferential schemes comparable to those in SEZs were adopted for foreign investment in Pudong.\textsuperscript{139} The program ap-

\footnotesize{\textsuperscript{134} See Guowuyuan Guanyu Kaifa He Kaifang Pudong Wenti De Pi Fu [Approval and Reply of the State Council Concerning the Development and Opening of Pudong], June 2, 1990, in LAWS OF ECONOMIC OPEN AREAS, supra note 5, at 226.}

\footnotesize{\textsuperscript{135} See supra note 111.}

\footnotesize{\textsuperscript{136} See Huang Qifan, Shenhua Gaige Zhudong Tiaokong Baoshi Dungan Kaifa Kaifang De Lianghao Shitou [Deepening Reform, Undertaking An Active Adjustment and Control to Keep the Momentum of Pudong's Development and Opening], in 1994 Y.B. SEZS & OPEN AREAS, supra note 89, at 248, 248-49.}

\footnotesize{\textsuperscript{137} Deng Xiaoping stated that "Shanghainese are smart and of good quality," "although the decision on Special Economic Zones was then based on considerations of geographic locations, . . . Shanghai has the advantage of talented people." Deng Xiaoping, Shicha Shanghai Shi De Tanhua [Talks During the Inspection in Shanghai], Jan. 28 - Feb. 18, 1991 [hereinafter Deng, Talks in Shanghai], in 3 SELECTED WORKS OF DENG XIAOPING, supra note 89, at 366, 366.}

\footnotesize{\textsuperscript{138} Deng Xiaoping again said that once Shanghai was open, "the situation of reform and opening up in the Yangtze River Delta, in Yangtze River Regions and even in the entire country would be different." Deng Xiaoping, Zai Wuchang Shenzhen Zhuhai Shanghai Deng Di De Tanhua Yaodian [Major Points from the Talks in Wuchang, Shenzhen, Zhuhai and Shanghai], Jan. 18, - Feb. 21, 1992, in 3 SELECTED WORKS OF DENG XIAOPING, supra note 89, at 370, 376.}


Pudong literally means the eastern side of the Huangpu River, which traverses Shanghai. Puxi, the western side of the Huangpu River, has been a modern metropolis with the majority of the city's administration, industry, and commerce. In contrast, prior to the 1990s, Pu-
plies a fifteen percent enterprise income tax rate to FIEs engaged in productive sectors,\(^\text{140}\) large infrastructure development projects, construction of airport, port, railway, road, power station, or other energy and communication projects,\(^\text{141}\) as well as certain foreign banks, branches, and Chinese-foreign joint banking corporations or finance companies established in Pudong.\(^\text{142}\) All FIEs in Pudong are exempt from local enterprise income surcharge until the year 2000.\(^\text{143}\)

In early 1992, the State Council decided to open cities bordering Russia and Mongolia,\(^\text{144}\) and create Bianjing Jingii Hezuo Qu, or "Border Economic Cooperation Zones" (BECZs).\(^\text{145}\) The decision came shortly after political changes in the former Soviet Union and Eastern European block. Not surprisingly, the government stated that the improvement of the living standards of local residents was a major goal of the creation of BECZs.\(^\text{146}\) Concerns for stability in border areas called for fast economic growth; both domestic and foreign investments were encouraged through preferential measures.\(^\text{147}\) The plan offered a preferential income tax rate of twenty-four percent to FIEs incorporated in BECZs.\(^\text{148}\) More border cities and towns

\(^{140}\) 1990 Shanghai Pudong Tax Regulations, supra note 139, art. 2 (productive foreign investment enterprises in Pudong were also offered a two years' exemption followed by a three-year 50% reduction after profit making if they were scheduled to operate for ten years or more).

\(^{141}\) Id. art. 4 (if scheduled for a term of at least 15 years, these projects can enjoy a five-year exemption after profit making followed by a five-year 50% reduction in income tax).

\(^{142}\) Id. art. 6. Foreign-funded banks and branches with a foreign-invested capital or operating funds from foreign headquarters exceeding US$ 10 million and a term of 10 years or more can enjoy the 15% rate for the tax on their income derived from loan businesses as well as a one-year exemption after profit making followed by a two-year 50% reduction in income tax. Id. Like their counterparts in SEZs, FIEs in Pudong are entitled to a refund of 40% of the tax paid on the portion of their reinvested profit. Id. art. 8. FIEs in Pudong are also exempted from income tax on their repatriated profits. Id. art. 9.

\(^{143}\) Shanghai Pudong Regulations, supra note 139, art. 12.

\(^{144}\) Guowuyuan Guanyu Jinyibu Duiwai Kaifang Heihe Deng Sige Bianjing Chengshi De Tongzhi [Notification of the State Council Concerning Further Opening Four Border Cities Including Heihe], Mar. 9, 1992, 1992 FAGUI HUIAN 505 [hereinafter Notification Concerning Heihe]. Those four border cities were Heihe and Suifenhe of Heilongjiang Province, Hunchun of Jilin Province, and Manzhouli of Inner Mongolia Autonomous Region.

\(^{145}\) Id. at 506.


\(^{147}\) Attracting domestic investment was the primary goal of BECZs. See Notification Concerning Heihe, supra note 144, at 506.

\(^{148}\) Id. Provincial and local governments promised, however, more preferential tax treatment such as lower enterprise income tax rates and tax holidays. See, e.g., Manzhouli Shi
were later designated as open border cities and permitted to set up their own BECZs. Recognizing that urban popular discontent was responsible for the unrest in the spring of 1989, the central authorities placed an increased emphasis on economic development in cities in order to maintain political and social stability. These efforts to stimulate economic growth in urban areas spread to non-coastal cities. Large cities alongside the Yangtze River and in interior provinces were accorded a status similar to that of COCs, with permission to set up their own ETDAs. The sphere of CEORs was

The additional border cities and towns were Pingxiang and Dongxing of Guangxi Zhuang Ethnic Autonomous Region, Wangding, Ruili, and Hekou of Yunnan Province, Dandong of Liaoning Province, and Erlianhaote of Inner Mongolia Autonomous Region. See Guowuyuan Guanyu Jinyibu Duiwai Kaifang Nanning, Kunming Shi Ji Pingxiang Deng Wuge Bianjing Chengzhen De Tongzhi [Notification of the State Council Concerning Further Opening the Cities of Nanning and Kunming and Five Border Cities and Towns Including Pingxiang], 1992 FAGUI HUIBIAN 508; Guowuyuan Guanyu Dandong Shi Shi Jiajili Bianjing Jingji Hezu Qu De Pifu [Approval and Reply of the State Council Concerning the Establishment of A Border Economic Cooperation Zone in the City of Dandong], id. at 511; Guowuyuan Guanyu Jinyibu Duiwai Kaifang Erlianhaote Shi De Tongzhi [Notification of the State Council Concerning Further Opening the City of Erlianhaote], id. at 513. Provincial and local governments promised more preferential treatment to foreign investment than the central authorities expressly allowed. See, e.g., Wanding Shi Guanyu Shuishou Youhui De Youguan Guiding [Regulations of Wanding Municipality Concerning Tax Preferences], art. 17, in GUIDE FOR BORDER OPEN CITIES, supra note 148, at 289, 292 (15% enterprise income rate, a total of six years tax exemption and reduction for productive FIEs and exemption for FIEs in agriculture, forestry and animal husbandry).

In 1992, the following cities were selected to benefit from special policies: Chongqing, Yueyang, Wuhan, Jiujiang, Wuhu, Harbin, Changchun, Huhehaote, Shijiazhuang, Taiyuan, Hefei, Nanchang, Zhengzhou, Chengdu, Guiyang, Xi'an, Lanzhou, Xining and Yinchuan. “Coastal Open City Policies” would apply to those cities. Guowuyuan Guanyu Jinyibu Duiwai Kaifang Chongqing Deng Shi De Tongzhi [Notification of the State Council Regarding Further Opening Up of Chongqing and Other Cities], 1992 FAGUI HUIBIAN 512. Other cities were later added to the list. See Guowuyuan Guanyu Jinyibu Duiwai Kaifang Huangshi Shi De Pifu [Reply of the State Council Concerning Further Opening Up of Huangshi City], 1994 Y.B. SEZS & OPEN AREAS, supra note 89, at 40 (applying Coastal Open City policies applied to Huangshi).

In 1993, the State Council approved the establishment of ETDAs in Wuhan, Wuhu, Chongqing, Hangzhou, Shenyang, Changchun, Harbin, and Xiaoshan. Guowuyuan Guanyu Shehi Wuhan Jingji Jishu Kaifaqu De Pifu [Reply of the State Council Concerning the Establishment of Wuhan Economic and Technological Development Area], 1994 Y.B. SEZS & OPEN AREAS, supra note 89, at 43; Guowuyuan Guanyu Shehi Wuhu Jingji Jishu Kaifaqu De Pifu [Reply of the State Council Concerning the Establishment of Wuhu Economic and Technological Development Area], id. at 44; Guowuyuan Guanyu Shehi Chongqing Jingji Jishu Kaifaqu De Pifu [Reply of the State Council Concerning the Establishment of Chongqing Economic and Technological Development Area], id. at 45; Guowuyuan Guanyu Shehi Hangzhou Jingji Jishu Kaifaqu De Pifu [Reply of the State Council Concerning the Establishment of Hangzhou Economic and Technological Development Area], id. at 46;
Finally, various newly designated priority zones and areas mushroomed in coastal regions and urban areas. This grant of special status and subsequent preferential measures were designed to attract foreign investment. They included Baoshuiqu, or “Bonded Zones” or “Free Trade Zones,” 5 Gao Xin Jishu Chanye Kaifaqu, or “High and New Technology Industrial Development Areas,” 5 Tai Shang Touziqu, or “Taiwan Investment Zones.”

Guowuyuan Guanyu Shenyang Jingji Jishu Kaifaqu De Pifu [Reply of the State Council Concerning the Establishment of Shenyang Economic and Technological Development Area], id. at 47; Guowuyuan Guanyu Shenyang Jingji Jishu Kaifaqu De Pifu [Reply of the State Council Concerning the Establishment of Changchun Economic and Technological Development Area], id. at 48; Guowuyuan Guanyu Shenyang Jingji Jishu Kaifaqu De Pifu [Reply of the State Council Concerning the Establishment of Fushun Economic and Technological Development Area], id. at 49; Guowuyuan Guanyu Shenyang Jingji Jishu Kaifaqu De Pifu [Reply of the State Council Concerning the Establishment of Xiaoshan Economic and Technological Development Area], id. at 50 (in the case of Xiaoshan ETDA, only 15% enterprise income tax rate explicitly made available).

Later included within CEORs were the city of Jinan, in Shangdong Province, the cities and counties of Sanming, Nanping, Longyan, Fu’an in Fujian Province, and the city of Dongying, Shandong Province. Guowuyuan Guanyu Jiang Jinan Shi Huaru Yanhai Jingji Kaifangqu De Pifu [Reply of the State Council Concerning Incorporating the City of Jinan into Coastal Economic Open Regions], 1990 Fagui Hun Bian 386; Guowuyuan Guanyu Fujian Sheng Jinyibu Duiwai Kaifang Wenti De Pifu [Reply of the State Council Concerning Questions of Further Opening Up of Fujian Province], in 1994 Y.B. SEZs & OPEN AREAS, supra note 89, at 39; Guowuyuan Guanyu Jiakuai Huanghe Sanjiaozhou Kaifang Wenti De Pifu [Reply of the State Council Concerning Questions of Accelerating the Development of Yellow River Delta], id. at 42.

The first Bonded Zone or Free Trade Zone was established in Waigaoqiao, Shanghai Pudong District in 1990. See Lin Qihui, Jianli Baoshuiqu Shi Kuoda Duiwai Kaifang De Zhongdu Buzou [The Establishment of Bonded Areas As A Major Step in Expanding Opening Up], in 1990-1992 Y.B. SEZ & COASTAL ETDAS, supra note 13, at 56, 56. Productive FIEs in bonded zones enjoy a 15% income tax rate. Id. at 57. More than a dozen such zones have been approved so far; they are located in Dalian, Tianjin, Qingdao, Zhangjiagang, Waigaoqiao in Shanghai, Ningbo, Fuzhou, Xiamen, Shatoujiao in Shenzhen, Guangzhou, Haikou, Yalong in Hainan. See Ripe for Investment, BUS. CHINA, May 27, 1996, at 8, 8. Two new ones were set up in 1996, Lantian in Shenzhen, Ming Bao (Ming Pao) (HK), Oct. 10, 1996, at A11, and Zhuhai, Ming Bao (Ming Pao) (HK), Nov. 14, 1996, at A13.

In 1991, as similar high-tech development zones surged across the country, the central government picked over twenty of them as State-level “High and New Technology Industrial Development Areas” [hereinafter HNTIDAS] for special treatment. Guowuyuan Guanyu Pizhun Guojia Jishu Faiba Kaifaqu He Youguan Zhenge Guiding De Tongzhi [Notification of the State Council Concerning the Approval of State High and New Technology Industrial Development Areas and
ment Zones,” and Guojia Luyou Dujia Qu, or “State Tourist and Resort Areas.”

4. Go West

To accommodate the developments of the last several years, the government has seen fit to rebalance regional interests by shifting more resources to favor the development of the Chinese interior regions. According to the 1994 statistics, eighty-five percent of the total foreign investment in China for the previous fifteen years was concentrated in just twelve coastal provinces, municipalities and autonomous regions that covered only 13.4% of the area of the country. Meanwhile, the economic growth in the interior provinces was slower than that of coastal regions.

155 Related Policy Regulations], 1991 FAGUI HUIBIAN 767. A 15% income tax rate applied to qualified enterprises. Guowuyuan Guanyu Pizhun Guojia Gao Xin Jishu Chanye Kaifaqu Shuishou Zhengce De Guiding [Regulations on Tax Policy of State High and New Technology Industrial Development Areas], 1991 FAGUI HUIBIAN 777. A two-year income tax exemption also applies. Id. art. 6. FIEs in State-approved HNTIDAs set up within SEZs or ETDAs can still enjoy tax benefits as provided for in those special investment areas. Id.

156 Two Taiwan Investment Zones were set up in Fujian Province, one in Xiamen and another in Fuzhou. Guowuyuan Guanyu Zai Fujiansheng Yanhai Diqu Sheli Taishang Touziqu De Pi Fu Jielu [Approval and Reply of the State Council Concerning the Establishment of Taiwan Investment Zones in Coastal Areas of Fujian Province (Extract)], in LAWS OF ECONOMIC OPEN AREAS, supra note 5, at 222 (ETDA policy applied to the zone in Fuzhou and SEZ policy applied to the one in Xiamen).

157 Guowuyuan Guanyu Shiban Guojia Luyou Dujia Qu Youguan Wenti De Tongzhi [Notification of the State Council on Issues Concerning Trial Establishment of State Tourist and Resort Areas], in COLLECTION OF OPENING UP POLICIES, supra note 139, at 62. The enterprise income tax for FIEs in State Tourist and Resort Areas is reduced to 24%. Id. Eleven State Tourist and Resort Areas were approved and they are located in Yalong Bay in Hainan, Dianchi in Kunming, Yintan in Beihai, Nanhui in Guangzhou, Wuyi Mountain in Fujian, Meizhou Island, Zhijiang in Hangzhou, Hengsha Island in Shanghai, Taihu in Jiangsu, Shilaoren in Qingdao and Jinshitan in Dalian. See TAX SYSTEM OF CHINA, supra note 10, at 225-26. Other special zones and areas are Yangpu Kaifaqu or Yangpu Development Zone in Hainan Province and Suzhou Gongye Yuanqu or Suzhou Industrial Park Zone in Jiangsu Province. Id. at 226.

158 Liu Xiaohua, Guanyu Jiakuai Xibu Diqu Liyong Waizi De Jidian Kanfa [Views on Speeding Up The Utilization of Foreign Capital By Western Areas], in 1994 Y.B. SEZs & OPEN AREAS, supra note 89, at 220, 220. In contrast, interior provinces including Inner Mongolia, Sichuan, Guizhou, Yunnan, Shaanxi, Gansu, Qinghai, Ningxia and Xinjiang were only able to obtain just over U.S. $2 billion in foreign capital in 1992, a mere four percent of the total overseas investment in China for that year. See Serge Verma, Looking Inland, CHINA Bus. Rev., Jan.-Feb. 1995, at 19, 19.

159 In recent years, according to a critic, the annual economic growth was 20% for eastern provinces, but 8% for interior provinces. Sichuansheng Difang Shuiwuju Ketzuz [Research Group, Sichuan Province Local Tax Bureau], N ewai zi Qye Suodeshui Tongyi De Bu zhou Ji Gui shu [Steps and Classifications of Unifying Enterprise Income Tax for Domestic and Foreign Investments], SHEWAI SHUISHOU [INT'L TAXATION IN CHINA], 1996 No. 3, 19, at 19. But see David L. Denny, Pro vincial Economic Differences Diminished in the Decade of Reform, in CHINA'S ECONOMIC DILEMMAS, supra note 48, at 186 (espousing the belief that provincial economic disparities widened was exaggerated).
Party leaders intended these disparities, to some extent, when they first introduced a regional development strategy that primarily benefited coastal provinces. Some now argue that the uneven economic development justifies the discontinuation of the lopsided preferential policies. In any event, rapidly growing economic gaps between rich coastal regions and poor interior provinces have given rise to unhealthy regional jealousy and competition as well as serious threats to the country's political stability and social order.\textsuperscript{159}

To be sure, tax preferences during the 1980s were not totally lopsided in favor of rich coastal regions. The 1980 JVITL, the 1981 FEITL and the 1991 UTL all contained enterprise income tax exemptions and reductions to encourage investments in economically underdeveloped, remote areas. Such preferences could appease poor areas including those in the interior provinces. With mounting regional frictions, the central authorities have moved away from favoring coastal regions and have instead focused on stimulating economic development in the central and western provinces.\textsuperscript{160} To accelerate interior development, the central authorities also increased state budget allocations and government direct investment,\textsuperscript{162} and urged coastal provinces and cities to provide financial aid and technical assistance.\textsuperscript{163} Interior provincial and local governments were given greater

\textsuperscript{159} For instance, soon after the establishment of SEZs in Guangdong and Fujian provinces, northern provinces sought similar development priority status by proposing the establishment of free port, free trade zones, new economic zones or northern special zones. Yantai Caizhengju [Finance Bureau, Yantai City], \textit{Yantai Jingji Jishu Kaifaqu De Xianzhuang Wenti Ji Duice [The Current Situation, Problems and Solutions in Yantai Economic and Technological Development Area]}, CAIZHENG YANJIU ZILIAO [FINANCE RESEARCH MATERIALS], Oct. 13, 1990, 45, at 47 [hereinafter Yantai Finance Bureau].

\textsuperscript{160} Most of the country's ethnic minorities live in western provinces, and poverty is believed to be a cause of ethnic unrest. Zhou Yi, \textit{Qingxie Xibu Guangkai Caiyuan [Tilting In Favor of the West and Widening Sources for Wealth]}, \textit{XIN BAO [HONG KONG ECONOMIC JOURNAL]}, Aug. 16, 1996, at 9. Prior to 1949, inland provinces were major revolutionary war bases for the Chinese Communist Party, and it is politically and emotionally unacceptable to leave them behind. Inland provinces have already supplied a large army of migrants who are lured by coastal regions' newly found prosperity. These migrants, most of whom are young, unemployed peasants and workers, are perceived as a major force of threat to social stability and have been blamed for dramatic increases in crime nationwide.

\textsuperscript{161} Li Lanqing Fuzongli Zai Jingji Jishu Kaifaqu Waishang Touzi Yantaohui Shang De Jianghua [Speech of Vice Premier Li Lanqing at the Seminar on Foreign Investment in Economic and Technological Development Areas], Oct. 21, 1994 in Dalian [hereinafter Li Lanqing Speech], in 1995 Y.B. SEZS & DAS, supra note 13, at 18, 21-22; see also Verma, supra note 157, at 19. A recent World Bank study has concluded that China must revamp its foreign direct investment policy to channel more foreign funds to the interior. Simon Beck, \textit{World Bank Says China's Poor Interior Being Ignored}, S. CHINA MORNING POST, Mar. 12, 1997, Business, at 1.

\textsuperscript{162} The state has decided, for instance, to invest heavily to improve roads, railways and communications in interior provinces. \textit{WENHUI BAO (WEN WEI PO) (HK)}, July 26, 1996, at A7.

\textsuperscript{163} The State Council reportedly required each of thirteen coastal provinces and municipalities to provide funds and assistance to ten inland provinces for local development.
autonomy for investment purposes. Suggested measures to attract foreign investments in interior provinces include: giving foreign investment enterprises greater access to domestic markets; creating more flexible and preferential policies favoring projects which develop local resources and build infrastructure; giving foreign investors permission to establish holding companies for investment in the interior provinces; and creating measures encouraging foreign investment enterprises in coastal areas to go west and set up new joint ventures locally. As the development strategy changes, so should regional tax preferences.

Two questions have arisen from this growing emphasis on the Chinese interior. First, should interior provinces be able to offer special tax treatment to attract funds? While provincial and local officials tend to take their cue from coastal development experiences, the central authorities appear to be ambiguous on this question. Nevertheless, the central authorities approved new preferential treatment favoring foreign investors in interior regions. Second, and more controversially, what should be done about Zhongguo Yingxing Guiding Dongbu Fuzhu Xibu [China's Mandatory Requirement that the Eastern Part Assist the Western Part], MING BAO (MING PAO) (HK), Oct. 14, 1996, at A8.

Zhong Xi Bu San Juceo Jiasu Fazhan [Three Measures to Accelerate Development in Central and Western Provinces], WEN HUI BAO (WEN WEI PO) (HK), July 26, 1996, at A5 [hereinafter Three Measures].

Li Lanqing Speech, supra note 161, at 21-22; see also Three Measures, supra note 164 (introducing BOT for local infrastructure building, and more reflexibility for foreign exchange control). BOT is short for the foreign investment form of building-operation-transfer in infrastructure projects. Under Chinese regulations, the government awards, “by way of a concession agreement and within the prescribed period, the project to the project company established for the concession project by the foreign company,” “[t]he project company shall be responsible for the investment, financing, construction, operation and maintenance of the project;” “[u]pon expiration of the concession period, the project company shall transfer the facilities of the concession project to the government department without compensation.” Several Issues Concerning the Examination, Approval and Administration of Experimental Foreign-Invested Concession Project Circular, CHINA L. & PRACTICE, May 1996, at 22, 22-23. For a discussion China’s adoption of BOT, see Chris Hunter & Colleen Lau, Facing up the Risk of BOT Investment, CHINA L. & PRACTICE, May 1996, at 14; Sarah Chan, The Laibin B Project: Balancing Risk and Reward, CHINA L. & PRACTICE, May 1996, at 19.

Compare Ministry of Finance on Unifying Tax, supra note 16 (citing an official of the Ministry of Finance as saying no income tax preferences would be granted to enterprises in central and western regions) with Zhongguo Quanmian Jiantao Liyong Waizi Zhengce [China is Conducting an Overhaul of its Foreign Investment Policy], XINBAO (HONG KONG ECONOMIC JOURNAL), Oct. 8, 1997, at 8 (an assistant minister of foreign economic relations and trade revealing that the state was considering preferential treatment to lure foreign capital to interior provinces).

Foreign investments in interior provinces can enjoy the same tax benefits as in OUDs and COCs, namely a 24% rate for enterprise income tax, Sun, Basic Situation, supra note 16, at 6. New enterprises in certain areas in the city of Chongqing continue to benefit from the duty free and tax exempt status for import of materials. Chongqing Yinzi Yong Quanguo Zui Youhui Zhengce [Chongqing Has the Most Preferential Policy for Attracting Investment], XIANGGANG SHANG BAO [HONG KONG COMMERCIAL DAILY], Feb. 1, 1997, at A1. Foreign investors in the Tibet Autonomous Region pay no enterprise income tax. There has been scholarly support for tax preferences for foreign investment in interior provinces. Wang
existing regional preferential schemes in coastal areas? As the country’s regional development focus has changed, old arrangements should be scaled down.\textsuperscript{168} Attempts to reduce coastal privileges\textsuperscript{169} have encountered strong resistance from coastal areas.\textsuperscript{170}

D. Hi-Tech and Industry Specific Enterprise Income Tax Preferences

The 1979 EJV Law promised tax holidays only to enterprises using advanced technology, but this narrow approach was quickly abandoned. The subsequently enacted JVITL provided tax reductions and exemptions without conditioning them upon the use of advanced technology. The 1984 Tax Reduction and Exemption Regulations distinguished between productive sectors and service-oriented sectors, providing more tax benefits for the former in SEZs and ETDAs.\textsuperscript{171} An industry/sector specific preferential regime was simultaneously introduced for foreign investment in OUDs and, subsequently, CEORs.\textsuperscript{172}

In the following years, the government targeted investment projects in preferred sectors/industries for tax preferences.\textsuperscript{173} The 22 Articles issued on

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\textsuperscript{168} See, e.g., Crothall, \textit{supra} note 15 (Director of the State Council’s SEZ Office indicating that SEZs would enjoy no more favorable treatment than is accorded to other regions by the end of the century).


\textsuperscript{170} \textit{See supra} notes 463-72.

\textsuperscript{171} \textit{See supra} notes 101, 119-20 and accompanying text.

\textsuperscript{172} \textit{See supra} notes 122, 129 and accompanying text.

\textsuperscript{173} As the lack of adequate infrastructure seriously hindered economic development and foreign trade and investment flows, the government turned to foreign capital to help ease the country’s bottlenecks. In September 1985, the State Council issued the Provisional Regulations of the State Council of the People’s Republic of China Concerning Preferential Treatment for Chinese-Foreign Equity Joint Ventures for Port and Berth Construction (Zhonghua Renmin Gongheguo Guowuyuan Guanyu Zhongwai Hezi Jianshe Gangkou Matou Youhui Daiyu De Zhanxing Guiding), promulgated on Sept. 30, 1985. \textit{1985 FAGUI HUILAN} 330 [hereinafter 1985 Regulations on Port and Berth Construction]. Accordingly, EJVs in port and berth construction projects would pay income tax at a reduced 15\% rate. 1985 Regulations on Port and Berth Construction, art. 6. If these projects are newly established and scheduled to operate for 15 years or more, they may obtain, upon application and approval, an exemption from income tax for the first five years after they make a profit and a 50\% reduction in income tax for another five years. \textit{Id.} After the expiration of the above exemption and reduction, should such EJVs still encounter difficulty in paying tax, further exemption or reduction may be granted upon approval of the Ministry of Finance. \textit{Id.} Foreign joint venturers are also exempt from tax on the remittance of their shares of profits out of China. \textit{Id.} art. 7. Provincial governments may waive and/or cut down local income tax, if appropriate. \textit{Id.} art. 6. The 1985 Regulations on Port and Berth Construction also tracked preferential provisions in the 1980 JVITL including the refund of 40\% of the tax paid on the portion of the profit reinvested in the construction of new berths or wharfs. \textit{Id.} art. 9.
October 11, 1986 singled out two categories of FIEs for special treatment.174 The first, *Chanping Chukou Qiye*, or "Product-Exporting Enterprises" (PEEs), were defined as enterprises that produce goods mainly for export and maintain a net positive foreign exchange balance at the end of the year.175 On top of any tax exemption and reduction to which a PEE is entitled, the 22 Articles further cut the applicable income tax rate by fifty percent if the value of the PEE’s annual exports exceeds seventy percent of the value of its total production in that year.176 In SEZs, ETDAs, or other areas where the enterprise income tax for FIEs is already reduced to fifteen percent, PEEs whose annual export value meets the above seventy percent ratio would pay a mere ten percent rate for the enterprise income tax.177

The second category of FIEs eligible for special treatment under the 22 Articles is *Xianjin Jishu Qiye*, or "Technologically Advanced Enterprises" (TAEs).178 This category includes those productive enterprises which, with advanced technology provided by foreign investors, are able to develop new products, or upgrade existing products, and therefore earn foreign exchange through exports or import substitution.179 The 22 Articles grant TAEs a fifty percent reduction in income tax for another three years following the expiration of otherwise applicable tax exemptions and reductions.180 If foreign investors reinvest their shares of profit to set up or expand PEEs or TAEs in China for a term of not less than five years, then, subject to examination by tax authorities, the investor may receive a complete refund of the enterprise income tax paid on the portion of the reinvested profit.181

Shenzhen SEZ made ten-year-long tax holidays available to FIEs in harbor and dock development with 11 or more years' management period. *Shenzhen’s New Preferential Policies for Attracting Domestic and Foreign Funds, China Trade & Investment*, Dec. 1994, at 27, 27.


175 22 Articles, *supra* note 4, art. 2.

176 *Id.* art. 8.

177 *Id.* art. 2.

178 *Id.* art. 2.

179 *Id.*

180 *Id.* art. 9.

181 22 Articles, *supra* note 4, art. 10. After the promulgation of the 22 Articles by the State Council, local governments issued their own regulations containing similar or identical preferential treatment. See, e.g., *Neimenggu Zizhiqu Guli Waishang Touzi Tiaoli* [*Regulations of Inner Mongolia Autonomous Region for Encouragement of Foreign Investment*], arts. 6-7; adopted by the Twenty-First Session of the Standing Committee of the Seventh People’s Congress of the Inner Mongolia Autonomous Region on June 29, 1991, in *Laws of Economic Open Areas, supra* note 5, at 1313, 1313 (two years of enterprise income tax exemption and three years of 50% reduction for productive FIEs; continued 50% income tax reduction for qualified PEEs and 50% income tax reduction for another three years for TAEs); *Baotoushi Guanyu Guli Waishang Touzi De Youhui Banfa* [*Methods of Baotou City Concerning Preferences for Encouragement of Foreign Investment*], arts. 4-5, promulgated by Baotou City People’s Government on June 4, 1992, *id.* at 1322, 1322 (same); *Shandong-sheng Renmin Zhengfu Guanyu Guli Waishang Touzi De Youhui Cuoshi* [*Measures of the
In recent years, however, a much greater stress has been placed on the need for foreign investment in hi-tech and other priority industries and sectors. In contrast to the policy of the 1980s, low value-added processing

People's Government of Shandong Province Concerning Preferences for Encouragement of Foreign Investment, arts. 4-5, Oct. 15, 1986, id. at 1555, 1555 (50% income tax reduction for PEEs and 50% income tax reduction for another three years for TAEs); Hunansheng Guli Waishang Touzi Tiaoli [Regulations of Hunan Province for Encouragement of Foreign Investment], art. 14, adopted by the Twenty-Fifth Session of the Standing Committee of the Seventh People's Congress of Hunan Province on November 17, 1991, id. at 1617, 1618 (same); Sichuansheng Guli Waishang Touzi Tiaoli [Regulations of Sichuan Province for Encouragement of Foreign Investment], art. 22, adopted by the Thirty-Second Session of the Standing Committee of the Seventh People's Congress of Sichuan Province on December 1, 1992, id. at 1758, 1761 (two years' enterprise income tax exemption and three years' 50% reduction for productive FIEs; continued 50% income tax reduction for qualified PEEs and 50% income tax reduction for another three years for TAEs); Chengdushi Guli Waishang Touzi Tiaoli [Regulations of Chengdu City for Encouragement of Foreign Investment], art. 19, adopted by the Twenty-Seventh Session of the Standing Committee of the Eleventh People's Congress of Chengdu City on August 28, 1992, and the Thirty-First Session of the Standing Committee of the Seventh People's Congress of Sichuan Province on September 26, 1992, id. at 1775, 1777 (same). The 1991 Unified Tax Law and its implementing rules endorsed industry and sector-specific tax preferences in the 1985 Regulations on Port and Berth Construction and the 22 Articles. UTL, supra note 67, art. 8, UTL Implementing Rules, supra note 74, art. 75(a),(g),(h).

In 1995, for the first time since the opening up policy, the Chinese government made public a set of guidelines for direct foreign investment: all investments are divided into four categories, namely, encouraged, allowed, limited, and banned; encouraged investments include projects using new and high technology, advanced technology, as well as projects in energy, communication and main raw materials industries. Zhidao Waishang Touzi Fangxiang Guiding [Interim Provisions on the Guide of Foreign Investment], arts. 4-5, approved by the State Council on June 7, 1995 and promulgated on June 20, 1995, 1995 FAGUI HumIAN 615, 616. Chinese Vice-Premier Zhu Rongji is reported to have endorsed a more discriminating approach to selecting foreign investment: he argued in favor of more projects which could bring in technology and management skill; he warned of looming dangers from foreign control of Chinese industries and markets. See Daniel Kwan, Zhu Calls for Restraint in Joint Ventures, S. CHINA MORNING POST, Oct. 3, 1996, at 7. Chinese officials also called for restrictions on foreign investment when "domestic production capacity is already abundant." Call to Curb Foreign Investment in Textiles, S. CHINA MORNING POST, Feb. 17, 1997, Business, at 4. The government tries to exercise a greater state control on large foreign investment projects to avoid foreign monopoly of domestic industries, See Jing Mao Wei Tiyi Shouyi Waishang Touzi Zhongdu Xiangmu [The Economic and Trade Commission Suggests Restrictions on Large Foreign Investment Projects], MING BAO (MING PAO) (HK), Jan. 29, 1997, at A11, and use of more portfolio investment and less foreign direct investment. See Zhongguo Zhubu Jianiaoshe Yilai Waizi Zhijie Touzi [China Gradually Reduces Reliance on Foreign Direct Investment], XIN BAO (HONG KONG ECONOMIC JOURNAL), Oct. 22, 1996, at 10 (citing a Chinese government researcher). The Chinese appear to be alarmed by the fast growth of foreign investment enterprises and their ability to grasp domestic market shares; it was recently reported that while foreign investment enterprises represented only less than 10% of the total number of industrial enterprises in the country, their output reached 20% of the domestic industrial production. Liyong Waizi Dalunzhan Xiaoyan Zaizi [Revival of the Debate on Use of Foreign Investment], MING BAO (MING PAO) (HK), Feb. 19, 1997, at A11. Concerns were also expressed that foreign venturers were trying to increase their shares in joint ventures, which constituted a threat to the Chinese side. Geoffrey Crothall, China Fears Lost Control, S. CHINA MORNING POST, Jan. 8, 1997, at A9.
investments have been officially discouraged, especially in coastal areas.\textsuperscript{183} As a result, broad, technology-neutral and industry-neutral tax concessions would be replaced by narrower and more selective preferences. It is possible that only hi-tech and investment projects in some identified industries and sectors would receive meaningful benefits.\textsuperscript{184}

E. Enterprise Income Tax Preferences to Overseas Chinese Investors

Capital from Hong Kong, Macau, Taiwan and Overseas Chinese business communities was the primary target of policy initiatives such as the one establishing SEZs.\textsuperscript{185} Unsure of how Western capitalists would react to

\textsuperscript{183} The benefits of processing and assembling projects are now believed to have been outweighed by numerous problems. For example, such projects are low valued-added and because equipment, machinery and raw materials used for production were imported duty free and tax exempt prior to the 1996 revocation of tax exemptions, they benefitted the Chinese side too little, mainly in the form of processing fee payments received from commissioning parties. See Zhu Rongji Yaoqiu Jianguan Jiagong Maoyi [Zhu Rongji Demands Supervision on Processing Trade], Xin Bao (Hong Kong Economic Journal), Aug. 20, 1996, at 12 (quoting Vice-Premier Zhu Rongji) [hereinafter Zhu Rongji on Processing Trade]. Moreover, China's dependency on massive volumes of low-priced merchandise exports has given rise to constant frictions with trading partners, there is a need for upgrading export sectors and moving towards high value-added products. See Hu Ping, Jiushi Niandai Zhongguo Duiwai Kaifang De Shi Da Qushi [Ten Trends in China's Opening Up During the 1990s], in 1994 Y.B. SEZs & OPENED REGIONS, supra note 89, at 209, 209; Zhou Wendao, Baohu Minzu Gongye Yingyou Zhengti Duice [A Need for An Overall Policy For Protecting National Industry], Xin Bao (Hong Kong Economic Journal), Sept. 16, 1996, at 9. Chinese President Jiang Zemin suggested in 1994 that labor-intensive and low-technology investment projects would be discouraged in coastal areas, although they could still play a role in interior provinces' development. Zeng Chuang Xin Youshi Gengshang Yicenglou [Adding and Creating New Advantages and Moving to a Higher Level], in 1995 Y.B. SEZs & DAS, supra note 13, at 3, 4.

\textsuperscript{184} Tax preferences for high-tech enterprises would be maintained after the merger of two sets of enterprise income tax. Ministry of Finance on Unifying Tax, supra note 16. Preferential treatment was also promised to preferred industries or sectors. See Ruo Cheng, Huagongye Liyong Waizi Tu Xian Yiwozhezu [Utilization of Foreign Investment in the Chemical Industry Emphasizes Serving China], Xin Bao (Hong Kong Economic Journal), Oct. 1, 1996, at 31 (tax preferences accorded to foreign investment in the chemical industry using new technology, producing new products or developing new sectors).

\textsuperscript{185} Deng Xiaoping explained the choice of SEZs in Shenzhen, Zhuhai, Shantou and Xiamen in the following terms: "Shenzhen is next to Hong Kong; Zhuhai is close to Macau; Shantou was chosen because many overseas Chinese in South East Asian countries were
the country's opening up,\textsuperscript{186} Chinese officials naturally turned to those potential investors with whom they were most familiar. The presumption was that Hong Kong, Macau, Taiwan and Overseas Chinese businesses would come to invest in China out of love for their ancestral land and that these businesses would want to help the country's efforts at modernization.\textsuperscript{187} In any event, they were not as threatening to Chinese interests as foreign businesses without any ethnic Chinese background. There was a consensus in the policy-making and academic circles that investors from Hong Kong, Macau, Taiwan and Overseas Chinese communities deserved special considerations and rewards because of their patriotism and great contribution to the modernization of the Motherland.\textsuperscript{188}

Under the 1985 Regulations on Preferences to Overseas Chinese Investment, investors identified as \textit{Huaqiao}, or "Overseas Chinese," could enjoy special tax benefits not available to other investors. For example, Overseas Chinese investors enjoyed a three-year enterprise income tax exemption from the first profit-making year which was followed by an additional four-year, fifty percent tax reduction,\textsuperscript{189} and, ultimately, a permanent twenty percent rate reduction after the expiration of the initial tax holidays.\textsuperscript{190} In addition, particular Overseas Chinese investment projects were taxed at a fifteen percent rate, provided that these projects satisfied the state's urgent needs, were in short supply, or met other technological or developmental requirements.\textsuperscript{191} Overseas Chinese investors were also offered an exemption from income tax on repatriated profits, a refund on reinvested shares of profits, and an accelerated depreciation of fixed assets upon ap-

\textsuperscript{186} Deng Xiaoping stated that some people in Western countries still tried to contain China and did not want to see a modernized China. Deng Xiaoping, \textit{Woguo Jingji Jianshe De Lishi Jingyan} [\textit{Historical Lessons of Our Country's Economic Construction}], May 6, 1982, in \textit{SELECTED WORKS OF DENG XIAOPING}, supra note 89, at 360, 361.

\textsuperscript{187} See, e.g., Ma Hong, \textit{Yanhai Kaifang Chengshi Xuyao Yanjiu De Jige Wenti} [\textit{Issues to Be Studied on Coastal Open Cities}], in 1984 Y.B. SEZs, supra note 93, at 770, 772 (explaining that overseas Chinese care about the motherland). See also Lucian W. Pye, \textit{CHINESE NEGOTIATING STYLE: COMMERCIAL APPROACHES AND CULTURAL PRINCIPLES} 72 (1992) (Chinese officials believed that Overseas Chinese must have feelings of patriotism).

\textsuperscript{188} See Directive of the State Council Regarding Strengthening Works to Utilization of Foreign Investment, Sept. 3, 1983, in \textit{LAWS OF ECONOMIC OPEN AREAS}, supra note 5, at 772, 774 (special preferences for investments by overseas Chinese, Hong Kong, Macau and Taiwan compatriots); Ma, supra note 187, at 772 (it is natural to give greater preferences to overseas Chinese investors); Forum On Coastal Cities, supra note 111, at 489 (overseas Chinese should be given preferential treatment over other foreign investors); \textit{FANG}, supra note 46, at 43 (preferences for overseas Chinese, Hong Kong, Macau and Taiwan investment).

\textsuperscript{189} 1985 Regulations on Preferences for Overseas Chinese Investment, supra note 5, art. 3.

\textsuperscript{190} Id.

\textsuperscript{191} Id.
proval by provincial tax authorities.\textsuperscript{192} The central authorities authorized the provincial governments to adopt detailed measures in order to implement preferences provided by the Regulations in their respective jurisdictions.\textsuperscript{193} The term \textit{Huaqiao}, or "Overseas Chinese," was not statutorily defined, however. The 1985 Regulations on Preferences to Overseas Chinese Investment were designated as an internal document which was not supposed to be publicly disseminated.\textsuperscript{194} Chinese officials expressed concerns about possible diplomatic implications.\textsuperscript{195} Provincial and local governments subsequently issued preferential tax measures patterned on the central directives.\textsuperscript{196}

The 1991 UTL and its implementing rules do not specifically mention preferences granted to Overseas Chinese investment under the 1985 Regulations.\textsuperscript{197} However, local regulations enacted after the 1991 UTL continued to provide special tax treatment for Overseas Chinese investors, and investors from Hong Kong and Macau.\textsuperscript{198} While this author has not been able to find any decision formally repealing the 1985 Regulations on Preferences to Overseas Chinese Investment, the Overseas Chinese Office of

\textsuperscript{192} \textit{Id.} No differentiation was made between EJV and non-EJV investments made by overseas Chinese.

\textsuperscript{193} \textit{Id.} art. 9.

\textsuperscript{194} Guowuyuan Fabu Guanyu Huaqiao Touzi Youhui De Zhanxing Guiding De Tongzhi [Notification of the State Council Regarding the Promulgation of the Regulations Concerning Preferences for Overseas Chinese Investment], \textit{in} \textit{LAWS OF ECONOMIC OPEN AREAS, supra} note 5, at 775, 775.

\textsuperscript{195} Caution and prudence were urged when it came to promoting overseas Chinese investment in order to avoid concerns and suspicions by countries in which overseas Chinese were residing. Forum On Coastal Cities, \textit{supra} note 111, at 489-90.

\textsuperscript{196} See, \textit{e.g.}, Tangshanshi Renmin Zhengfu Guanyu Guli Waishang Touzi De Ruogan Guiding [Regulations of Tangshan City People's Government Concerning Encouragement for Foreign Investment], \textit{in} \textit{LAWS OF ECONOMIC OPEN AREAS, supra} note 5, at 1308, 1310 (enterprises funded by overseas Chinese, Hong Kong and Macau compatriots enjoy three years' enterprise income tax exemption followed by another four years' 50\% reduction); Huang Jiaxiu, \textit{Fuzhoushi Shewai Shuishou He Sanzi Qiye Mianlin Wenti De Tantao} [A Preliminary Discussion on Problems Faced by Foreign Investment Enterprises and Foreign Taxation in Fuzhou City], \textit{CAIZHENG YANJIU ZILIAO} [FINANCE RESEARCH MATERIALS], Aug. 2, 1986, at 6, 7 (three years' income tax exemption followed by another four years' 50\% reduction for investment projects funded by overseas Chinese, Hong Kong and Taiwan compatriots in Fujian Province).

\textsuperscript{197} Article 75(i) of UTL Implementing Rules recognizes "exemption and reduction of enterprise income tax contained in other regulations which were promulgated by or with the approval of the State Council." UTL Implementing Rules, \textit{supra} note 74. It is unclear whether tax exemptions and reductions in the 1985 Regulations on Preferences to Overseas Chinese Investment are covered by this provision.

\textsuperscript{198} Baotoushi Guanyu Guli Huaqiao He Xianggang Aomen Taiwan Tongbao Touzi De Youhui Banfa [ Preferential Measures of Baotou City for Encouragement of Investment by Overseas Chinese, Hong Kong, Macau and Taiwan Compatriots], art. 4, promulgated by Baotou City People's Government on June 4, 1992, \textit{in} \textit{LAWS OF ECONOMIC OPEN AREAS, supra} note 5, at 1321, 1321 (income tax for enterprises funded by overseas Chinese, Hong Kong, Macau and Taiwan compatriots reduced to 14\% rate).
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the State Council suggested, in a recent telephone inquiry, that the Regulations as such were no longer in force. On the other hand, it is possible that some of the provincial and local preferential measures for Overseas Chinese investment may still be effective, so long as they are within the authority of the local governments and they do not infringe upon state revenue collections.

F. Turnover Taxes and Preferential Treatment for Foreign Investment

Liuizhuan shui, or “turnover taxes,” have provided the Chinese State with the bulk of its tax revenues. In 1958, the Chinese government imposed a single tax called Gongshang Tongyi Shui, or “Consolidated Industrial and Commercial Tax” (CICT), to replace a number of separate taxes that had existed since the early 1950s. Described as “a broadly-based turnover tax or as a combination of cascading sales and excise taxes,” the CICT applied to business entities and individuals whenever industrial products changed hands, farming products were purchased, foreign goods were imported, goods were sold at retail, or communication, transport or other services were rendered. In 1973, the CICT, together with some other taxes, was replaced by a new Gongshangshui, or “Industrial and Commercial Tax” (ICT). Unlike the CICT, whose rates varied depending on

199 Telephone Interview with an official at the Overseas Chinese Office of the State Council (Oct. 9, 1996).
200 In 1994, various turnover taxes including value-added tax, consumption tax, business tax and custom duties provided the state with almost 4.058 trillion yuan in revenue, or 72.05% of the country’s total taxes collected. TAX SYSTEM OF CHINA, supra note 10, at 20.
201 Zhonghua Renmin Gongheguo Gongshang Tongyi Shui Tiaoli Cao'an [The Consolidated Industrial and Commercial Tax Regulations of the People’s Republic of China (Draft)] adopted in principle by the Standing Committee of the National People’s Congress on September 11, 1958 and promulgated by the State Council on September 13, 1958 for trial implementation, July-Dec. 1958 FAGUI HUIBIAN 126 [hereinafter CICTR]; Zhonghua Renmin Gongheguo Gong Shang Tongyi Shui Tiaoli Shixing Xize Cao’an [Detailed Implementing Rules for the Consolidated Industrial and Commercial Tax Regulations of the People’s Republic of China (Draft)], promulgated by the Ministry of Finance on September 13, 1958 for trial implementation, id. at 137 [hereinafter Implementing Rules for CICTR].
202 For a summary of pre-CICT turnover taxes, see Pomp et al., supra note 21, at 16-18.
203 Id. at 19.
204 CICTR, supra note 201, arts. 4-8; Implementing Rules for CICTR, art.3. The CICT applied to “all units or individuals” engaged in taxable activities including foreign businesses operating in China. CICTR, supra note 201, art. 2. It was calculated on the amount of proceeds received from the sale of goods or services at a rate ranging from 1.5% for raw cotton cloth to 69% for luxury cigarettes; the CICTR had a list of over forty different rates, governing more than one hundred categories of specified items; unlisted goods were subject to a 5% catch-all rate. Tax Rate Schedule attached to CICTR, 1958 FAGUI HUIBIAN, 129, 129-37; see also Pomp et al., supra note 21, at 22-24.
205 On March 30, 1972, the State Council formally approved the report of the Ministry of Finance concerning the implementation of the ICT and, at the same time, promulgated the Industrial and Commercial Tax Regulations of the People’s Republic of China (Draft) (Zhonghua Renmin Gongheguo Gong Shang Shui Tiaoli Cao’an). See 2 ZHONGHUA RENMIN
products and services of the taxpayer, the ICT taxed businesses and enterprises at a single rate according to the sectorial classification of their main line of trade and business. The Chinese government never attempted, however, to apply the ICT to businesses with private capital from abroad.

When the country opened its door to foreign direct investment, it was uncertain whether FIEs should pay the CICT. Because foreign investors could not credit the CICT against foreign tax liability, there were concerns that the combined effect of the enterprise income tax and the CICT would discourage investment from overseas. On the other hand, because turnover taxes constituted important revenue sources for the state, there was strong resistance to exempting foreign businesses from the CICT. Proponents of the latter position argued that any disincentive created by the CICT was alleviated by generous income tax preferences. They also argued


Id. at 246. There were 16 different rates under the ICT, ranging from 3% for such industrial and business sectors as textile dying enterprises specializing in production of raw cotton cloth, commercial retailers, and public utility sectors, to 66% for producers of luxury cigarettes. Id. at 246-47. Different rates applied, however, to cigarettes, liquor and sugar as these products were continually taxed on a product-basis, no matter how the producer’s main line of business was classified. Id. at 255.

The Ministry of Finance explained that before the ICT was formally promulgated, old rules continued to apply to tax matters involving non-domestic businesses. Id. at 257. As the ICT had never been formally promulgated, it did not affect foreign direct investment under the opening up policy. LI BICHANG, ZHONGGUO DUIWAI SHUISHOU FALU ZHIDU [CHINA’S FOREIGN-RELATED TAX SYSTEM] 101 (1988).

See Pomp et al., supra note 21, at 30 n.106, 31-32; Pomp & Surrey, supra note 21, at 21-22.

See Pomp & Surrey, supra note 21, at 15 n.60 (CICT unlikely to qualify as an income tax or as a tax in lieu of an income tax to be creditable against U.S. income tax).


Wang, supra note 210, at 4; CONTEMPORARY CHINESE FINANCE, supra note 210, at 424. The CICT remained the major tool for the government to raise revenue from foreign businesses. From 1981 to 1983, CICT represented 48.3% of the total foreign-related tax revenue for the state; in contrast, enterprise income tax only represented 27.2%; here, foreign-related tax referred to enterprise income tax, individual income tax, CICT, real estate tax and vehicle license tax paid by FIEs, other foreign businesses and individuals. Lin Rongsheng, San Nian Lai Shewai Shuishou De Jiben Qingkuang He Jinhou Gongzuofei De Yi- jian [Basic Situations Concerning Foreign-Related Taxation in the Last Three Years and Views on the Future Work], in GUOJIA SHUWUU [STATE ADMINISTRATION OF TAXATION], SHUISHOU GONGZUO WENXIAN HUIBIAN [COLLECTION AND COMPILATION OF TAX RELATED DOCUMENTS] 788, 789 (1993) [hereinafter COLLECTION OF TAX DOCUMENTS].
that the CICT would not increase the tax burden in any significant fashion because it could be passed to consumers. After the central authorities formally decided to subject foreign investment projects to the CICT, they simultaneously offered relief from the tax through various measures. They granted FIEs an exemption from CICT for imports of materials for production of goods for export, as well as for imports of capital goods.

212 Wang, supra 204, at 4; CONTEMPORARY CHINESE FINANCE, supra note 210, at 424. This argument was problematic as the price of goods is controlled by the government in a planned economy and the tax burden may not be shifted through pricing. See RICHARD K. DIAO, ZHONGGONG SHUISHOU ZHIDU [TAXATION SYSTEM OF COMMUNIST CHINA] 150-51 (1969); see also Ruhe Jianli Jingji Tequ He Shewai Shuizhi Tixi De Yanjiu Baogao [Report on the Study of How to Establish Special Economic Zones and Foreign Related Taxation System], CAIZHENG YANJIU ZILIAO [FINANCIAL RESEARCH MATERIALS], Feb. 6, 1987, at 38, 39 (as turnover taxes were included in the price, the burden was not as easily shiftable as in a free price system).

213 In 1983, the Ministry of Finance issued a circular declaring that the CICT was applicable to EJVs, CJVs, WFOEs, and other foreign businesses operating in China. Caizhengbu Guanyu Dui Zhongwai Hezi Jingying Qiye He Waishang Duzi Qiye Zhenghou Gongshang Tongyi Shui Wenti De Tongzhi [Notification of the Ministry of Finance Concerning Issues of Collecting the Consolidated Industrial and Commercial Tax from Chinese-Foreign Equity Joint Ventures, Chinese-Foreign Cooperative Joint Ventures and Wholly-Foreign-Owned Enterprises], in COLLECTION OF TAX DOCUMENTS, supra note 211, at 460 [hereinafter 1983 Notification on CICT]. See also Pan Jing, Shilun Woguo Shewai Shuifa De Fa Ding Xing Yuanze [A Preliminary Discussion on the Principle of Legal Basis for Foreign Related Taxation in Our Country], SHUIWU YANJIU [TAX STUDIES], 1995 No. 9, at 55, 56. The 1983 Notification on CICT, interestingly enough, requested provincial authorities not to make the notice public for a while, although local officials were permitted to refer to the contents of the notice upon public inquiry. 1983 Notification on CICT, supra.

214 As the CICT contained higher rates for certain products and services than the ICT did, the Ministry of Finance agreed to lower the CICT as applied to FIEs to the same level as the ICT on domestic producers. See 1983 Notification on CICT, supra note 213. In 1984, the ICT was broken down into four separate taxes, namely, product tax, value-added tax, business tax, and salt tax; consequently, the Ministry of Finance issued a circular on April 29, 1985, stating that future FIEs were not permitted to claim lower rates under the ICT as the ICT no longer existed. Li, supra note 207, at 103. For a short discussion of product tax, value-added tax, business tax, and salt tax under the 1984 reform, see MOSER & ZEE, supra note 10, at 99-104. Product tax, value-added tax, and business tax applied to all enterprises including FIEs in Shenzhen and Hainan SEZs. Shenzhenshi Renmin Zhengfu Guanyu Shenzhen Tequ Qiye Shuishou Zhengce Ruogan Wenti De Guiding [Regulations Concerning the Supervision and Tax Collection and Exemption of Imports and Exports of Goods by Chinese-Foreign Cooperative Joint Ventures], art. 6, promulgated by the General Customs Office, Ministry of Finance and Ministry of Foreign Economic Relations and Trade on January 31, 1984, 1984 FAGUI
which were a part of foreign investors' capital contributions.  Moreover, the central authorities granted CICT exemptions and reductions to FIEs having financial difficulties. Finally, exports by FIEs were generally ex-
empt from CICT except for a few controlled items. Like enterprise income tax preferences, relief from the CICT varied depending on applicable regional preferential schemes. On top of benefits available nationwide, foreign investment projects in SEZs enjoyed additional CICT exemptions and reductions. Similarly, the government provided special relief from the CICT to foreign investment in ETDAs, OUDs, and other priority actions. See, e.g., Beijing Shi Renmin Zhengfu Guanyu Shishi Guowuyuan Guanyu Guli Waishang Touzi De Guiding De Ruogan Wenti [Provisions of Beijing Municipal People's Government Concerning the Implementation of the Provisions of the State Council for the Encouragement of Foreign Investment], art. 23, Oct. 11, 1986; Beijing Shi Fagui Guizhang Huijian [1986 Collection of Beijing Municipal Laws and Regulations] 398, 403 (CICT reduction and exemption for newly established product-exporting enterprises and technologically-advanced enterprises upon application and approval); Shanghai Shi Minhang Hongqiao Jingji Jishu Kaifaqu Waishang Touzi Youhui Guiding [Provisions Concerning Preferences for Foreign Investment in Minhang Hongqiao Economic and Technological Development Areas of the City of Shanghai], art. 5, promulgated by Shanghai Municipal Government on March 3, 1987; Shanghai Shi Fagui Guizhang Huijian [1986-1987 Collection of Shanghai Municipal Laws and Regulations] 341, 341 (CICT reduction or exemption to FIEs in ETAs upon application and approval).

See, e.g., 22 Articles, supra note 4, art. 11; Caizheng Bu Guanyu Zhongwai Hezi Jingying Qiye He Waishang Duzi Jingying Qiye Shengchan De Chukou Chanping Zheng Mian Gongheng Tongyi Shui Wenti De Tongzhi [Notification of the Ministry of Finance Concerning Issues of Collection and Exemption of the Consolidated Industrial and Commercial Tax for Exports of Products Manufactured by Chinese-Foreign Equity Joint Ventures, Cooperative Joint Ventures and Wholly Foreign-Owned Enterprises], July 30, 1986; Guojia Shuiwuju [State Administration of Taxation], in Zhongguo Shiyi Shui Fagui Zhizhi [1984 Tax Reduction and Exemption Regulations], supra note 3, 2(e) (CICT exemption for imports of capital goods, raw materials, spare parts, office items as long as the imports would be used by enterprises themselves, and imports of raw materials, spare parts, components and packing materials for production for exports); 2(f) (CICT exemption for all exports except for products under state control); 2(g) (CICT exemption for imports of reasonable amounts of household items and vehicles by foreign business personnel in SEZs for their own use). Local regulations provided additional CICT benefits to FIEs in ETDAs. See, e.g., Guangzhou Jingji Jishu Kaifaqu Gongshang Shuishou Shixing Banfa [Trial Methods of the Implementation of Industrial and Commercial Taxes in Guangzhou Economic and Technological Development Areas], art. 5, promulgated by
More CICT benefits were granted to technologically advanced and export-oriented foreign-funded projects.\textsuperscript{222}

In December 1993, as part of a national tax reform package,\textsuperscript{223} the Chinese government overhauled the country's turnover tax system and re-

\textsuperscript{222} See 1984 Tax Reduction and Exemption Regulations, \textit{supra} note 3, 3(d) (CICT exemption for imports of equipment for production or business operation and construction materials if they were part of the original or additional investment and imports of vehicles and office items for use by these foreign enterprises); 3(e) (CICT exemption for all exports except for products under state control); 3(f) (CICT exemption for imports of raw materials, spare parts, components and packing materials for production for exports); 3(g) (CICT exemption for imports of reasonable amounts of household items and vehicles by foreign business personnel in OUDs for their own use).

\textsuperscript{223} See 1988 CEOR Tax Regulations, \textit{supra} note 128, at 4 (CICT exemption for imports of equipment for production or business operation and construction materials in CEORs if they were part of the original or additional investment and imports of vehicles and office items for use by these foreign enterprises); \textit{id.} at 5 (CICT exemption for all exports from FIEs in CEORs except for crude oil, petroleum products and other goods under state control); \textit{id.} at 6 (CICT exemption for imports of raw materials, spare parts, components and packing materials for production for exports by FIEs in CEORs); \textit{id.} at 7 (CICT exemption for imports of reasonable amounts of household items and vehicles by foreign business personnel in CEORs for their own use); 1990 Shanghai Pudong Tax Regulations, \textit{supra} note 139, art. 7 (three percent CICT for income from loans by foreign investment banks, branches and Chinese-foreign joint venture banks in Shanghai Pudong); \textit{id.} art. 12 (CICT exemption for imports of capital goods, construction materials, spare parts, vehicles, office items in Pudong as long as the imports would be used by FIEs themselves, and imports of raw materials, spare parts, components and packing materials for production for exports); \textit{id.} art. 13 (CICT exemption for imports of reasonable amounts of household items and vehicles by foreign business personnel in Pudong for their own use).

\textsuperscript{224} See, e.g., Fujian Sheng Zhengfu Guanyu Guli Waishang Touzi De Buchong Guiding [Supplementary Provisions of Fujian Provincial Government for the Encouragement of Foreign Investment], art. 7, promulgated by Fujian Provincial People's Government on October 15, 1986, \textit{in LAWS OF ECONOMIC OPEN AREAS, supra} note 5, at 1481, 1482 (a two-year CICT exemption for new products developed by FIEs which were considered to be domestically advanced and import substitutes).

\textsuperscript{224} In addition to restructuring the country's turnover tax system as discussed below, the 1993 tax reform enacted a uniform enterprise income tax for domestically owned enterprises to replace disparate existing enterprises income tax regimes, Provisional Regulations of the People's Republic of China on Enterprise Income Tax (Zhonghua Renmin Gongheguo Qiye Suodeshi Zhanxing Tiaoli), promulgated by the State Council on December 13, 1993, \textit{TAX SYSTEM OF CHINA, supra} note 10, at 270, a new individual income tax law, Individual Income Tax Law of the People's Republic of China (Zhonghua Renmin Gongheguo Geren Suodeshi Fa), revised by the Standing Committee of the National People's Congress on October 31, 1993, \textit{id.} at 303, and new enactments and changes in resource tax, Provisional Regulations of the People's Republic of China on Resource Tax (Zhonghua Renmin Gong-
structured the three existing taxes which governed DOEs into three new taxes; namely, Zengzhi Shui, or “value-added tax” (VAT), Xiaofei Shui, or “consumption tax,” and Yingye Shui, or “business tax.” The new

heguo Ziyuanshi Zhanxing Tiaoli), promulgated by the State Council on December 25, 1993, id. at 320, and land value-added tax, Provisional Regulations of the People’s Republic of China on Land Value-Added Tax (Zhonghua Renmin Gongheguo ‘Tudi Zengzhishui Zhanxing Tiaoli), promulgated by the State Council on December 13, 1993, id. at 360, urban construction and maintenance tax, and land use tax. See Gongshang Shuizhi Kaige Shishi Fang’an [Plan of the Implementation of the Reform of the Industrial and Commercial Tax System], issued by State General Administration of Taxation on December 11, 1993, in ZHONGHUA RENMIN GONGHEGUO GONGSHANG SHUISHOU JIBEN HUIBIAN [COLLECTION OF BASIC LAWS AND REGULATIONS REGARDING INDUSTRIAL AND COMMERCIAL TAXES OF THE PEOPLE’S REPUBLIC OF CHINA] 1, 3-9 (GUOJIA SHUIWU ZONGJU [OFFICE OF THE STATE GENERAL ADMINISTRATION OF TAXATION] ed., 1994) [hereinafter Plan of 1993 Tax Reform]. The 1993 tax reform also changed the fiscal relationship between the national and local governments. Tax revenues are classified into three categories: the central government’s fixed tax revenue, local governments’ fixed tax revenue and shared revenue between the central and local governments. Tax revenues are classified into three categories: the central government’s fixed tax revenue, local governments’ fixed tax revenue and shared revenue between the central and local governments. TAX SYSTEM OF CHINA, supra note 10, at 21. The central government’s fixed tax revenue includes consumption and value-added taxes collected by Chinese customs, consumption tax, and enterprise income tax paid by centrally-controlled enterprises; local governments’ fixed tax revenue includes business tax and enterprise income tax paid by local enterprises; shared tax revenue is mainly value-added tax. Income tax collected from Chinese-foreign joint ventures is the central government fixed revenue if the Chinese venturer is an enterprise or entity under the control of the central government, or its ministries and departments; if the Chinese partner is a local enterprise or entity, then income tax collected from the joint venture is local government fixed revenue. Guanyu Zuohao Waishang Touzi Qiye Suodeshui Ruku Guanli Youguan Wenti De Tongzhi [Notice Regarding Issues of Managing Receipt of Foreign Investment Enterprises Income Tax by State Treasury], Mar. 28, 1995, id. at 766. Two separate tax organizations have been set up: one is the state taxation bureau in charge of collecting the central government’s fixed tax revenue and shared tax revenue; the other is the local taxation bureau responsible for local governments’ fixed tax revenue collection. See Guojia Shuiwu Zongju Guanyu Zujian Zai Ge Di De Zhishu Jigou He Difang Shuiwu Ju De Shishi Vijian [Opinion of the State General Administration of Taxation Concerning the Implementation of the Organization and Establishment of Direct Tax Organs in Localities and Local Tax Bureaus], Dec. 4, 1993, id. at 450. While collecting enterprise income tax, value-added tax and consumption tax from FIEs is the responsibility of state taxation bureaus, other taxes to be paid by FIEs fall within the competence of local taxation bureaus which may ask for help, however, from state taxation bureaus. Dong, supra note 16, at 11.


Zhonghua Renmin Gongheguo Xiaofei Shui Zhanxing Tiaoli [Provisional Regulations of the People’s Republic of China on Consumption Tax], promulgated by the State Council on December 13, 1993, TAX SYSTEM OF CHINA, supra note 10, at 256 [hereinafter Consumption Tax Regulations]; Zhonghua Renmin Gongheguo Xiaofei Shui Zhanxing Tiaoli Shishi
turnover taxes have applied to both DOEs and FIEs since January 1, 1994. As a result, the CICT is no longer applied to foreign businesses.

China’s new VAT is imposed at fixed rates and at each stage of the production and distribution of goods, including wholesaling, retailing, and imports. The VAT is also imposed on the processing and repair of goods. Most services and transactions in intangibles and real property are governed, however, by the business tax, not the VAT. The VAT was


229 Quanguo Renmin Daibiao Dahui Changwu Weiyuanhui Guanyu Waishang Touzi Qiye He Waiguo Qiye Shiyong Zengzhi Shui Xiaofei Shui Yingye Shui Deng Shuishou Zhanxing Tiaoli De Jueding [Decision of the Standing Committee of the National People’s Congress Regarding the Application of Provisional Regulations on Taxes Such as Value-Added Tax, Consumption Tax, and Business Tax to Foreign Investment Enterprises and Foreign Enterprises], adopted at the Fifth Session of the Standing Committee of the Eighth National People’s Congress on December 29, 1993, TAX SYSTEM OF CHINA, supra note 10, at 243 [hereinafter Decision on Taxes].

230 Id. at 243 [hereinafter Decision on Taxes].

231 Id. art. 1; VAT Implementation Rules, supra note 225, arts. 2-4. Exemptions from VAT include sales of agriculture products by producers, imports of instruments or equipment for scientific research, experiments and teaching, donation of materials and equipment by foreign governments or international organizations, imports of equipment used to process goods under a processing contract or compensation trade arrangement with foreign business. VAT Regulations, supra note 225, art. 2; and a flat 6% rate on small businesses, id. art. 12.

232 Id. art. 1; VAT Implementation Rules, supra note 225, arts. 2-4. Exemptions from VAT include sales of agriculture products by producers, imports of instruments or equipment for scientific research, experiments and teaching, donation of materials and equipment by foreign governments or international organizations, imports of equipment used to process goods under a processing contract or compensation trade arrangement with foreign business. VAT Regulations, supra note 225, art. 16.

233 Id.
designed to be borne by the final consumer of the product.\textsuperscript{224} It is computed on the invoiced amount of each taxable transaction,\textsuperscript{235} and collected from the seller.\textsuperscript{236} The seller, however, may claim a tax credit for VAT that the seller previously paid on inputs into production against the output tax or VAT collected from the seller’s sales.\textsuperscript{237} In other words, the seller only pays the remaining output VAT, or net VAT payable, to the tax authorities. The VAT removed the cascade of taxes which typified the old CICT and ICT. A direct consequence of the VAT input credit is an export VAT refunding mechanism. Because exports attract a zero percent VAT, and the net VAT payable therefore becomes negative, exporters are entitled to a refund from the state for the input VAT they paid for the production or processing of exported goods.\textsuperscript{238} The business tax, on the other hand, applies to most services as well as transactions involving intangible property like copyrights, patents, trademarks and real property, provided that such services or transactions take place in China.\textsuperscript{239} The consumption tax applies to the production, processing or imports of certain specified goods.\textsuperscript{240}

\textsuperscript{224} See Liu, supra note 9, at 152 (arguing that tax burden borne by the purchaser of goods or services, not the VAT tax payer.).

\textsuperscript{235} VAT Regulations, supra note 225, arts. 3-6.

\textsuperscript{236} Id. art. 1.

\textsuperscript{237} Id. art. 8.

\textsuperscript{238} Id. art. 25; see also Chukou Huowu Tui Mian Shui Guanli Banfa [Methods of Administration of Tax Refunds or Exemptions for Exports of Goods], Feb. 19, 1994, TAX SYSTEM OF CHINA, supra note 10, at 657. Accordingly, VAT refunds could be obtained by exporters from tax authorities on a monthly basis; however, exports of certain goods are not eligible for tax refunds, including crude oil and sugar. Id. at 658. The VAT tax refund mechanism applies to FIEs exporting their products. Guanyu Waishang Touzi Qiye Chukou Huowu Shuishou Wenti De Tongzhi [Notification Concerning Issues of Taxation on Exports of Goods by Foreign Investment Enterprises], Aug. 25, 1994, id. at 664.

\textsuperscript{239} Business Tax Regulations, supra note 227, art. 1. Exempt from business tax are nursing, medical and educational services, certain cultural events, agricultural training programs, labour services provided by handicapped individuals. Id. art. 6. There are two basic rates for business tax: 3% for transportation, construction communications, sports, and cultural activities, and 5% for transfers of intangible assets and real property, banking, insurance, tourism, hotel, food catering, and other services; entertainment services are taxed, however, at 5% to 20%, to be determined by local governments; business tax is levied on the turnover of the taxpayer, id. art. 5, to be assessed at an interval of every five, ten, fifteen days or monthly, or on a transaction-by-transaction basis. Id. art. 13.

\textsuperscript{240} Consumption Tax Regulations, supra note 226, arts. 1 & 2. According to the Consumption Tax Table of Taxable Items and Tax Rates attached to Consumption Tax Regulations, taxable items include beer, liquor, cosmetics, fireworks, jewelry, motorcycles, skin and hair care products, small motor vehicles, tires, tobacco, gasoline and diesel fuel; consumption tax is levied on the basis of the sales value of taxable goods, at a rate ranging from 3% for certain motorcycles and cars to 45% for luxury cigarettes, but gasoline, diesel fuel and certain type of alcohol are taxed at a fixed amount for goods of the same quantity. Id. at 258-59.
The impact of new turnover taxes on existing FIEs has been mixed.\textsuperscript{241} While some FIEs found no difficulty in adjusting to new taxes, others saw their overall tax burden rise following the change.\textsuperscript{242} As a concession to existing FIEs, the Chinese government agreed to provide refunds to cover any increase in taxes paid under the new system for a period not exceeding the term of the joint venture contract or, at most, not beyond the end of 1998.\textsuperscript{243} On the other hand, while FIEs established after January 1, 1994 are entitled to a refund for their input VAT when their products are exported, FIEs established prior to 1994 may not receive such a refund.\textsuperscript{244} In defense of the disparate treatment between post- and pre-1994 FIEs, the government argued that the lack of a VAT export refund would not disadvantage pre-1994 projects because they received no equivalent benefit un-

\textsuperscript{241} Many factors might be involved in considering the impact of new turnover taxes on foreign investors. It was observed:

Foreign businesses that do not add much value in production may benefit from the new regime, as these businesses now have a means of recovering some of the tax they paid to acquire the goods they ultimately will sell. If the VAT rate on their purchases of inputs is lower than the old CICT rate was, the benefit is even greater. However, companies making or selling items which were subject to high CICT rates, such as cigarettes, are likely to find their new combined VAT and [consumption] tax bill is even higher than their old CICT bill.

Peck et al., \textit{supra} note 225, at 42.

\textsuperscript{242} According to one study on FIEs in Xiamen City, of 165 FIEs which were liable for business tax, the tax bill of 148 rose as a result of the new business tax, largely because tax rates under the new business tax are higher than those under the old CICT; it was also found that the more value-added their products were, the more tax FIEs would pay. Sun Longying, \textit{Guanyu Waishang Touzi Qiye Zengjia Shuiwu Panhuan Rougan Wenti De Tantao [A Preliminary Discussion on Some Issues Concerning Refunds To Offset Tax Increases for Foreign Investment Enterprises]}, \textit{Shuiwu YUANJIU [Tax Studies]}, 1995 No. 9, 52, at 52.

\textsuperscript{243} Decision on Taxes, \textit{supra} note 229, art. 2; Guowuyuan Guanyu Waishang Touzi Qiye He Waiguo Qiye Shiyong Zengshi Shui Hou Waiguo Qiye Shiyong Zengshi Shui Hou Kuoliang \textit{Tiaoli [Notification of the State Council Concerning the Application of the Provisional Regulations of the Value-Added Tax, Consumption Tax, Business Tax and Other Taxes to Foreign Investment Enterprises and Foreign Enterprises], effective Jan. 1, 1994, TAX SYSTEM OF CHINA, \textit{supra} note 10, at 244; Guanyu Tulianhuan Waishang Touzi Qiye Gaizheng Zengzhi Shui Hou Duo Jiao Shuikuan Rougan Juti Wenti De Tongzhi [Notification Concerning Some Concrete Issues of Tax Refunds for Additional Payments by Foreign Investment Enterprises Subsequent to Their Being Subject to the Value-Added Tax and the Consumption Tax], issued by State General Administration of Taxation on April 21, 1994, \textit{id.} at 511.

\textsuperscript{244} Guanyu Waishang Touzi Qiye Chukou Tui Shui Wenti De Tongzhi [Notification Concerning Issues of Tax Refund for Exports by Foreign Investment Enterprises], issued by the State General Administration of Taxation on February 6, 1995, and retroactively effective from January 1, 1994, \textit{id.} at 668 [hereinafter 1995 Notification on FIEs Export Refunds]. Accordingly, only FIEs registered after January 1, 1994 are entitled to the zero VAT rate and therefore a tax rebate for their exports. \textit{Id.} As to FIEs established prior to January 1, 1994, their exports are only VAT exempt. See Dong, \textit{supra} note 16, at 10. The difference between VAT-exempt and zero VAT rate goods is that zero VAT rate goods attract rebate upon export, but VAT exempt goods do not. \textit{See infra} note 238 and accompanying text.

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der the old CICT system. The disparity has since been narrowed, but not because pre-1994 projects have gained any tax breaks; instead, post-1994 enterprises have seen their export VAT refund benefits quickly erode. At the time of the enactment of the new turnover tax system, the input VAT was wholly refundable; i.e., exporters could get back the full VAT they had previously paid. The Chinese government was soon alarmed by the cost of this refund system. There also appeared to be a growing number of fraudulent claims for export refunds. Consequently, the government decided to abandon the full refund system on July 1, 1995, and introduced instead a partial refund system that allowed exporters to claim back only a portion of input VAT they had previously paid. Another export tax refund cut occurred in 1996.

When Chinese officials introduced the new turnover taxes, they reassured foreign investors that exemptions and reductions existing under the old CICT would remain unchanged and continue to apply in cases in which the new taxes replaced the CICT. The government nevertheless soon took steps to curtail tax benefits. In early 1995, it revoked exemptions from taxes and custom duties for imports of twenty household and office items previously enjoyed by foreign businesses. The most important move

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245 See Sun, supra note 242, at 54. For the Chinese, VAT-exempt exports by FIEs established prior to January 1, 1994 were merely the continuation of the previous CICT exemption for exports. Dong, supra note 16, at 10.

246 1995 Notification on FIEs Export Refunds, supra note 244, art. 2.


248 See Guanyu Jiaqiang Chukou Tui Shui Guanli Yange Shenhe Tui Shui Pingzheng De Tongzhi [Notification Concerning Strengthening the Administration of Export Tax Refunds and Strictly Examining Documentation Supporting Tax Refunds], issued by the State General Administration of Taxation, June 30, 1994, TAX SYSTEM OF CHINA, supra note 10, at 673, 673-74 (discussing illegal efforts to seek export tax refunds through forgery and other fraudulent acts; serious frauds in Guangdong and other coastal areas); see also Joseph Kahn, Beijing Struggles to Stem Slide in Taxation Power, ASIAN WALL ST. J., July 24, 1995, at 4 (export claims increased by 50% in the first half of 1995 compared to the year before and frauds were suspected).


250 See Becky Lai et al., Exporters Face Higher Costs After Changes to VAT Rules, S. CHINA MORNING POST, Sept. 12, 1996, China Business Review, at 2. According to the latest change, of the 17% VAT on export sales value, 9% is refunded and the remaining 8% is charged to the cost of sales and therefore is an additional cost to the business. Id.; see also Edward Shum, A VAT Progress Report, CHINA BUS. REV., Sept.-Oct. 1996, at 43.

251 See New Taxation System Adds No More Burden on Foreign Investors, CHINA TRADE & INVESTMENT, Apr. 1994, at 6, 6 (citing Jin Xing, Director of the State General Administration of Taxation, who stated that various CICT exemptions and reductions would be retained).

took place in 1996 when major import tax exemptions were repealed for FIEs established after April 1, 1996.\textsuperscript{253} For FIEs established before April 1, 1996, duty free and tax exempt imports would be phased out by the end of 1996 if the FIE had a total investment of less than U.S. $30 million, or by the end of 1997 if the FIE had a total investment of U.S. $30 million or above.\textsuperscript{254} Various duty free and tax exempt import privileges enjoyed by FIEs in SEZs and other priority areas were terminated as well.\textsuperscript{255} The Chinese government recently announced reinstatement of import tax exemptions which were intended to benefit certain hi-tech investment projects\textsuperscript{256} like telecommunications and semiconductors.\textsuperscript{257} As pressure for extending preferential treatment for FIEs to DOEs is growing strong, the central authorities are considering allowing domestic enterprises to enjoy the same import tax exemptions.\textsuperscript{258}

III. POLICY FACTORS

A. Domestic Experiences and Precedents

The Chinese government has long used financial and fiscal policies to promote the Communist Party's political and economic objectives.\textsuperscript{259} In addition to the revenue-raising function of taxation,\textsuperscript{260} the government used

\textsuperscript{253} 1995 Notification on Import Taxation, supra note 14 (revocation of duty-free and tax-exempt imports of capital goods and raw materials previously granted to FIEs as part of their investment contribution).

\textsuperscript{254} Id. (abolition of duty-free and tax-exempt imports of goods into various specially-designated areas such as SEZs, ETDAs, HNTITAs, COCs, CEORs, Border Open Cities, BECZs, Yangtze Riverside Open Cities, Inland Open Cities, State Tourist and Resort Areas and Shanghai Pudong New District). The government also repealed exemptions from customs duty and turnover taxes previously granted to importers of machinery and equipment as part of a processing contract or compensation trade arrangement between Chinese and foreign parties. Id.

\textsuperscript{255} Id.

\textsuperscript{256} See supra note 19.

\textsuperscript{257} Tax Breaks Only on Hi-Tech Imports, S. CHINA MORNING POST, Sept. 24, 1997, Business, at 7. For a discussion of the latest regulations on import tax exemptions, see infra note 422.


\textsuperscript{259} Mao Zedong stated that the economy determines finance and fiscal policies, not the other way round. Wang Shaofei, Mao Zedong Caizheng Sixiang De Kexue Neihan [The Contents of Mao Zedong's Finance Thoughts], in MAO ZEDONG CAIZHENG SIXIANG YANJIU [STUDIES ON MAO ZEDONG'S FINANCE THOUGHTS] 23, 24 (Yang Zhilin ed., 1991).

\textsuperscript{260} In a command economy the government's decisions on economic matters did not depend upon its ability to raise funds through taxation or public borrowing; the state could move resources directly thanks to its monopoly of political and administrative powers and state ownership of the means of production. See FRANKLYN D. HOLZMAN, SOVIET TAXATION – THE FISCAL AND MONETARY PROBLEMS OF A PLANNED ECONOMY 13-18 (1962). In other words, direct physical controls, rather than government revenue, constituted the foundation of the state's ability to plan and achieve developmental goals; taxation was, nevertheless,
taxation to achieve non-revenue objectives. During the 1940s and early 1950s, Party class policy and agrarian reform led to the imposition of onerous tax burdens on landlords. In urban areas, taxation was “a tool to protect and develop socialist and semi-socialist economies and gradually, conditionally and discriminatingly use, restrain and transform capitalist industry and commerce.” In 1950, the new regime introduced Gongshan-
gye Suodeshui, or “Industrial and Commercial Income Tax” (ICIT),\textsuperscript{264} which targeted “capitalist industrial and commercial businesses” in order to restrict their capital growth and divert their profits to strengthen public sectors.\textsuperscript{265} Public or state-owned enterprises paid no ICIT; instead, they remitted profits to the state treasury under separate regulations.\textsuperscript{266} In 1958, the government raised taxes on the profit of private enterprises — including firms with private capital from overseas — by ten to one hundred percent.\textsuperscript{267} This tax brought the total income tax rate of private enterprises to as high as sixty-seven per cent.\textsuperscript{268} In the early 1970s, the ICT created a special category labelled “temporary business” to catch any business activities that were unregistered or unauthorized.\textsuperscript{269} In 1977, a circular of the Ministry of Finance imposed an ICT penalty of up to one hundred percent against unauthorized business activities.\textsuperscript{270} Although the scope of the penalty provision broadly covered any individuals and units, its primary targets were non-state and private businesses.\textsuperscript{271}

On the other hand, favorable treatment was accorded to industries or enterprises that met policy criteria. The 1950 ICIT mirrored the Party industrial policy that favored industries over commerce and heavy industries over light industries, by providing such favored industries with tax reductions ranging from ten to forty percent.\textsuperscript{272} During the 1960s, the govern-


\textsuperscript{265}2 HISTORY OF INDUSTRIAL AND COMMERCIAL TAXATION, supra note 205, at 474.

\textsuperscript{266}Regulations on Industrial and Commercial Taxes, supra note 243, art. 5.

\textsuperscript{267}2 HISTORY OF INDUSTRIAL AND COMMERCIAL TAXATION, supra note 205, at 476.

\textsuperscript{268}See also Li, supra note 207, at 5 (previous tax rate of 34.5\% doubled to 67\%).

\textsuperscript{269}See Guojia Shuishou Jiaocai Bianxie Zu [The National Taxation Teaching Materials Editorial Group], Guojia Shuishou [National Taxation] 38 (1979) [hereinafter NATIONAL TAXATION]. A 10\% rate was imposed on any “temporary business” but government officials could double that rate. BEIJING JINGUAN XUEYUAN CAIZHENG JINGONG JIAOYAN SHI [Finance and Monetary Section, Beijing Institute of Economics], Xin Zhongguo Shuishou Yanbian [The Evolution of New China’s Taxation] 153 (1985).

\textsuperscript{270}WANG, supra note 261, at 51.

\textsuperscript{271}Id.

\textsuperscript{272}Regulations on Industrial and Commercial Taxes, supra note 264, Tables for Industrial and Sectoral Income Tax Reduction. Accordingly, a 40\% income tax reduction applied to heavy industry machine manufacturers, steel, oil and non-ferrous metal producers, as well as power plants and producers of heavy transportation vehicles and equipment; a 30\% reduction was granted to manufacturers of light industry machinery, coal producers, basic chemical producers, and electronic producers; a 20\% income tax reduction applied to producers of farming machinery, export producers, import-substitute producers; a 15\% reduction applied to producers of printing machine, rubber and lather products as well as construction sectors; and finally, light industry, producers of ordinary transportation means, handicraft sectors, medical sectors, and animal feeding sectors received a 10\% income tax reduction.
ment lowered the ICIT rates to encourage small businesses to supplement the public sector and created tax holidays for individual businesses that formed collectives or cooperatives.\textsuperscript{273} To promote Party propaganda efforts, the government exempted publishing houses and printing factories from ICT for the production and distribution of the works of Chairman Mao, Marx, Engels, Lenin and Stalin, as well as other political materials.\textsuperscript{274} To upgrade technology and products, the government granted relief from ICT to enterprises engaged in the development and manufacturing of new products approved by the state.\textsuperscript{275} The state also allowed various tax exemptions and reductions for farm-related businesses, such as agricultural machine repair and leasing, small fertilizer and cement producers, and newly established enterprises in people’s communes.\textsuperscript{276} Tax exemptions and reductions were also offered to businesses and enterprises encountering financial adversities.\textsuperscript{277}

Preferential tax measures allocated resources among industries, enterprises and even provinces.\textsuperscript{278} Benefits derived from tax and fiscal measures provided funds for investment in state-defined desirable areas. Without such tax and fiscal benefits, enterprises might have had to compete for funds through the state budgeting process, which was costly and time-consuming. It was preferable, therefore, to let enterprises retain more of their profit for business expansion and investment. To prevent diversion of funds for unauthorized uses, the state required enterprises to place retained profit into accounts designated for specific purposes.\textsuperscript{279} Moreover, state tax authorities were given the power to supervise the way tax savings were utilized.\textsuperscript{280} Based on these measures, preferential tax treatment reduced the

\footnotesize{273} 2 HISTORY OF INDUSTRIAL AND COMMERCIAL TAXATION, supra note 205, at 491.
\footnotesize{274} NATIONAL TAXATION, supra note 269, at 51.
\footnotesize{275} Id. Factories using recycled energy or materials were also granted ICT exemptions and reductions. Id.
\footnotesize{276} Id.
\footnotesize{277} SHUWU GONGZUO SHOUCE [MANUAL OF TAXATION] 54 (Zou Yunfang ed., 1987) (enterprises that encountered difficulties in paying turnover taxes as a result of major changes in their production, operation or price may apply for tax exemptions and reductions with local tax authorities).
\footnotesize{278} LIU, supra note 7, at 456 (noting that tax preferences were used as tools to rationalize resource allocation among different enterprises, industries and regions since price and profit could be subject to various irrational factors). Tax exemptions and reductions were also identified as effective measures to stimulate production as taxpayers retained more money for business expansion. WANG, supra note 261, at 184-89. Exemptions and reductions were granted to enterprises in preferred businesses or operations such as new industries, new product development, and industrial recycling. NATIONAL TAXATION, supra note 269, at 51.
\footnotesize{279} The most important of such accounts were designated for enterprises’ production expansion, new product development and scientific research. TIANJIN CAIJING XUEYUAN KUAIJI JIAOYANSHI [ACCOUNTING DEPARTMENT, TIANJIN FINANCIAL AND ECONOMIC INSTITUTE], GUOYING GONGYE QIYE CAIWU KUAIJI [STATE INDUSTRIAL ENTERPRISES FINANCIAL ACCOUNTING] 289 (1981) [hereinafter STATE ENTERPRISES FINANCIAL ACCOUNTING].
\footnotesize{280} LIU, supra note 7, at 469-70.
nominal revenue of the state, but the government’s investment policies were well-served.\(^{281}\)

In the early years of its opening-up policy, China suffered from serious image problems due to its previous policies. Among these previous policies was the discriminatory and prohibitive ICIT,\(^{282}\) which still governed businesses with foreign interest.\(^{283}\) Rather than devising a new set of income tax rules to govern foreign direct investment, however, the sponsors of the 1979 EJV Law first opted to create preferential tax treatment.\(^{284}\) Just as punitive rates under the ICIT were the legacy of policies that reflected past hostility toward foreign and private capital, the promised preferential tax treatment in the country’s first foreign investment legislation since 1949 was testament to a favorable policy change. As domestic experiences demonstrated, the very word “preferences” conveyed a positive message. “Low tax burden and broad preferences” soon became the leitmotiv of official statements regarding taxation of foreign investment.\(^{285}\) Chinese officials spent a great deal of time and effort propagating new tax preference provisions.\(^{286}\) Widespread dissemination of preferential rules was viewed as a key to the success of efforts to promote foreign investment.\(^{287}\)

\(^{281}\) In the United States, defenders of tax incentives claimed that tax incentives provided a desirable way for resource allocation because of less government supervision and less red tape. See Surrey, Tax Incentives, supra note 7, at 16. The claim was fallacious according to critics because government supervision was still necessary in administering incentive programs. Id. at 17. In China, while government bureaucracy was necessarily involved in administering the tax’s preferences and use of tax-saving funds, tax measures still provided an alternative to state direct administrative control and allocation of resources.

\(^{282}\) For a discussion of the ICIT, see text accompanying supra notes 264-268.

\(^{283}\) NATIONAL TAXATION, supra note 269, at 88-89; see also Reynolds, supra note 21, at 59-61.

\(^{284}\) EJV Law, supra note 1, art. 7. Flexible approaches had been taken by the Chinese prior to the adoption of the JVITL, including the reduction of foreign investors’ tax burden through contractual arrangements between the Chinese government and individual foreign interests. Pomp et al., supra, note 21, at 52-53.


\(^{286}\) Lin, supra note 211, at 790-91 (illustrating propagation of tax laws and preferences favorable to foreign investment by provincial and local officials).

\(^{287}\) See, e.g., Xi Jing, Zai Gaige Kaifang Zhong Qianjin De Shewai Shuishou Gongzuo [Foreign Related Tax Works in the Reform and Opening Up Era], Zhongguo Shuiwu [China Taxation], 1992 No. 20, at 21 (Shanghai tax bureau officials actively propagated tax preference rules applicable to foreign businesses).
B. International Practice and Profit Maximization

To make its opening-up policy a success, the Chinese government had to appeal to foreign business communities by referring to practices and ideas these communities could easily identify with. When explaining tax preferences for foreign investments, officials drew comparisons with tax incentive laws in other countries. As the country had no modern corporate income tax of its own, the government used the experiences of other nations as references for both normative rules and special treatment to induce the inflow of foreign capital. Because tax incentives have been used worldwide to compete for investment funds, China felt pressure to emulate other countries’ endeavors. Parallels with foreign incentive legislation were intended to show a true change in the country’s policies as well as its willingness to keep up with international competition for foreign capital. Chinese officials seemed to have been influenced by the concepts and practice of using fiscal incentives to attract investments in other parts of the world.

288 The Chinese explicitly referred to guoji guanli, or international practice, as a guide to regulate economic activities in China. Gu Ming, supra note 52, at 624; Wang, supra note 69; Jin Xin, supra note 68.

289 For instance, when explaining the one-year exemption followed by a two-year 50% reduction in the 1980 JVITL, the spokesman of the draft bill referred to different tax holidays in other countries: some countries provided a one year exemption only, others provided a one-year exemption followed by a two-year 50% reduction, still others provided a three-year exemption or reduction; the Chinese chose the middle one. As to preferences for investment in agriculture, forestry or other low-profit sectors and in remote, underdeveloped areas, the spokesman noted that some developing countries already had similar tax benefits. Tax refunds for reinvestment of distributed profit by foreign venturers were also compared with various benefits for foreign reinvestment provided in other countries’ incentive legislation. Gu Ming, supra note 52, at 626.

290 In the summer of 1979, the Harvard Law School International Tax Program organized a six-week long seminar on various aspects of international taxation in Dalian, China with the participation of over 120 Chinese officials from the Ministry of Finance and other government agencies. Pomp & Surrey, supra note 21, at 1. This seminar together with subsequent consultations with international accounting/law firms, foreign companies and tax research institutes helped Chinese officials draft income tax legislation governing foreign investment. Li, supra note 207, at 5-6.


292 See, e.g., Wang Xuanhui, Waiguo Qiye Suodeshui Fa Gailun [An Introduction to the Foreign Enterprise Income Tax], CAIZHENG YANJU ZILIAO [FINANCE RESEARCH MATERIALS], Jan. 15, 1985, at 1, 38 (noting that foreign businesses pressed for tax concessions); Du, supra note 47, at 187 (arguing that the foreign press focused on tax preferences as signs of improved investment conditions in China).
world. In the West, the capital arbitrage theory, which suggests that investors seek to maximize the rate of return, supports tax incentives for investments.\(^{293}\) According to the theory, "[b]ecause taxes are negatively related to net profits and therefore negatively related to the net rate of return, it follows that to increase [foreign direct investment] is to decrease the taxes on foreign investment income."\(^{294}\) The Chinese government also relied on the concept of profit maximization\(^{295}\) in its decision-making to send the message that the country had become a friendly and profitable place for business.\(^{296}\) The government believed that tax breaks were necessary for luring foreign capital because factors such as state control of the economy and protection of market were not going to change any time soon.\(^{297}\) The Chinese were aware that access to their immense market was the dream of many overseas investors and opening domestic markets to foreign investors could be very attractive, but the Chinese were concerned with the domestic impact of such a move, especially in the early years. As a result, foreign investment enterprises had to be outward-oriented and export most of their products.

Given the many basic differences between FIEs and DOEs, the authorities enacted separate tax regimes and preference rules for each.\(^{298}\)

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\(^{294}\) Id.

\(^{295}\) See, e.g., Red Flag Editorial, *supra* note 45, at 5-6 (supporting a loosening policy to allow foreign investors make a profit); Forum on Coastal Cities, *supra* note 111, at 477 (discussing preferential treatment for foreign investments as a means of satisfying the profit-making motivation of foreign investors); *Zhang Bingguang*, *Duiwai Kaifangqu Jingji [Economy of Open Areas]* 176-78 (1988) (explaining that tax preferences could lower cost of doing business as well as reduce tax burdens, and therefore provide a satisfactory return on capital for foreign investors); *Fang*, *supra* note 46, at 43-44 (arguing that tax preferences were based on theory that capitalists by nature seek high profit, and capital moves to the area or region where profit can be maximized).

\(^{296}\) See, e.g., *Fang*, *supra* note 46, at 44-45 (discussing use of tax preferences to raise foreign investors’ profitability).

\(^{297}\) Cf. Liu, *supra* note 94, at 60 (preferential treatment to foreign businesses while controlling market access).

\(^{298}\) See *Chu Baotai*, *Zhongwai Hezi Jingyin Qye Fa Shishi Jingyan Wenda [Questions and Answers on The Implementation of the Chinese-Foreign Equity Joint Venture Law]* 6 (1983). The Chinese did not rule out, however, the possibility of domestic sales of goods produced by Chinese-foreign joint ventures, but stringent restrictions were imposed on such sales. See *EJV Implementing Rules*, *supra* note 217, art. 61 (EJVs may sell products domestically provided that their products are in urgent need in China or are import-substitutes). Cheap labour was another advantage of investing in China, but, in the early years, the state’s traditional rigid control of the country’s employment system had not sufficiently changed to accommodate to foreign-funded businesses. See, e.g., Riskin, *supra* note 32, at 327. Adopting tax preferences to foreign investments was a departure from domestic experiences. The task of socialist enterprises was to contribute to the state and the society at large. In a communist state, the state must use “profits” from individual enterprises to support social programs, and since enterprises were state owned and operated, this enlightened
Foreign investors were thus isolated from tax, finance and accounting rules governing domestic enterprises which, during the 1980s, still operated according to command economy principles. Different tax regimes also gave Chinese policy makers more room for manipulating the illusion of preferential treatment for foreign investors. As Chinese domestic parties were governed by stringent rules and restrictions, any relaxation or flexibility allowed to foreign investors from such “norms” or “normative treatment” could be characterized as “preferences.” For instance, exemptions from import taxes were labelled as preferential measures because domestically owned businesses had to pay such taxes. While foreign investors received special treatment in some tax and non-tax areas, domestic enterprises were given state subsidies as well as market protection. This “trade-off” enhanced domestic acceptability for tax preferences to foreign investments.

C. Policy Targets and Changes

Since its inception in the late 1970s, China’s foreign investment policy has been dominated by the pursuit of rapid economic growth. This policy led to the adoption of a particularistic approach. The government would first identify particular areas or types of investment that would most likely make the opening-up policy look successful. Then the government would adopt tax and non-tax measures to target and promote such investments. Thus, national tax legislation has been augmented by a myriad of particularistic rules designed for targeted foreign investments, either regionally-oriented, industry/sector-specific or ethnically-based. SEZs and other priority areas were created in coastal regions because they were in the best position to attract foreign business. Overseas Chinese businesses received sense of “social responsibility” was also imposed on enterprises as part of their objectives. To the extent that tax preferences could bring material benefits to enterprise managers and workers, they were rewards for labor and management performance, and not associated with the notion of increased profit or returns on capital. As the aims of tax preferences for foreign investment were not the same, separate regimes were initially created for FIEs and DOEs.

Besides its allocative and incentive functions, taxation in a planned economy performed other non-revenue generating functions such as price adjustment. See Perkins, supra note 260, at 369 (discussing the control of the inflationary gap through consumer tax in China); see also Holzman, supra note 260 (describing and analyzing Soviet experiences with taxes to control price).

Preferences presuppose the existence of norms or normative treatment. See, e.g., Survey & McDaniel, supra note 7, at 229 n.9 (“[t]ax expenditure analysis is based on the concept of a normal or normative tax of the type under consideration”). An example of the use of “norms” and “preferences” is seen in different customs and immigration treatment of Chinese business people and foreigners. For instance, the customs and immigration regulations for Chinese business people to go abroad were quite restrictive; a promised simplified procedure for customs and immigration treatment for foreign business people was described by the Guangdong SEZs Regulations as preferential treatment. Guangdong SEZs Regulations, supra note 100, art. 18.
additional preferential treatment because they were more likely to invest in the Motherland.

How fast economic development can be achieved through such policies has been heavily debated. The contending views and their corresponding concerns dominate the direction of the preference policy and provide ambiguous or even contradictory results. A case in point is the debate as to whether hi-tech investment should be given top priority. The leadership initially endorsed the concept of Chinese-foreign joint ventures because Chinese enterprises could easily benefit from the technology and business skills provided by foreign partners. The 1979 EJV Law offered unspecified income tax exemptions and reductions only to EJVs using advanced technology by international standards. No preferential treatment was promised to non hi-tech projects, as they were not a priority. This policy soon shifted. Most investment in the early days of the opening-up policy was in labor-intensive industrial projects which relied on imported designs and materials to manufacture textiles, apparel, shoes, toys and other light-industry products for export or re-export. Although these investments fell short of the hi-tech type projects to which the Chinese aspired, they still contributed to the country's exports and job creation. Chinese decision-makers realized that the country was more likely to attract labor-intensive investments than hi-tech projects because of the comparative advantages. Small projects were also more likely to produce quick results. The 1980 JVITL extended tax holidays to all new EJVs without conditioning them

301 According to statistics compiled by Guangdong province, between September 1978 and September 1979, over one thousand processing and assembling contracts were signed between Chinese and foreign investors mainly from Hong Kong and Macau; seventeen of these took the form of an EJV or CJV with a total foreign investment of US$ 250 million. Fan Bing, Guangdongsheng Kaizhan Jiagong Zhiangpei Buchang Maoyi De Qingkuang He Wenti [The Situation and Issues Concerning Processing, Assembling and Compensation Trade in Guangdong Province], CAIZHENG YANJIU ZILIAO [FINANCE RESEARCH MATERIALS], May 15, 1980, at 2.


303 Red Flag Editorial, supra note 45, at 5 (early focus was on small and medium investment projects). This soon became the so-called “placing the two ends of production outside” strategy according to which China encouraged investment in industrial-processing projects which relied on imports of designs and raw materials for production of exports. For a discussion of the strategy, see Chang Chen-pang, Communist China's “Strategy” in Developing the Coastal Areas, 24 ISSUES & STUDIES, Mar. 1988, at 1.
upon the use of advanced technology, thereby accommodating labor-intensive processing projects.

The Chinese have not abandoned their fascination with Western technology and know-how. The Chinese concept of modernization is closely connected with images derived from Western technological achievements. After the adoption of the 1980 JVITL, the government attempted to re-target technology intensive investments through special treatment. As labor-intensive investments were still welcomed during the 1980s, hi-tech specific preferences had to take the form of added benefits to existing reductions and exemptions available to non-hi-tech projects. The 22 Articles promulgated in 1986 promised an additional three-year fifty percent enterprise income tax reduction to foreign investment projects qualified as TAEs, following the expiration of otherwise-applicable tax exemptions and reductions. The Chinese inclination to favor certain hi-tech investments is highlighted by a recent announcement of new import tax exemptions for such investments. The government’s policy of favoring capital intensive, hi-tech investments could produce, however, relatively few benefits for many Hong Kong and Overseas Chinese investors who engage in labor-intensive processing projects. As foreign investment policy has become more selective in recent years, the government has concentrated on promoting hi-tech and other priority investments; meanwhile non-hi-tech, non-priority projects, including many Hong Kong and Overseas Chinese investments, face preference cuts. While the pursuit of fast development led the government to target the areas and projects most likely to succeed, the need for regional balance has pulled in another direction. Both the 1980 JVITL and 1981 FEITL demonstrated this countervailing trend, as each provided extensive tax holidays for investment projects in economically backward, remote regions. The 1991 UTL continued these tax holidays.

304 See ZHANG, supra note 295, at 180 (discussing policy in the 1980s which encouraged high-tech projects, but still sought labor-intensive investments by giving additional preferences for hi-tech, and maintaining ordinary preferences for labor-intensive projects). In fact, the 22 Articles simultaneously offered a 50% enterprise income tax reduction to foreign investment enterprises qualified as PEEs with 70% of the value of their products coming from exports. 22 Articles, supra note 4, art. 8. PEEs may not necessarily be hi-tech type projects, though they receive more attractive benefits than tax reductions accorded to TAEs.

305 22 Articles, supra note 4, art. 9.

306 Tax Breaks Only on Hi-Tech Imports, supra note 257.

307 See, e.g., ZHANG MINRU ET AL., SHENZHEN LIYONG WAIZI DE TANSUO [SHENZHEN’S EXPLORATORY EXPERIENCES WITH FOREIGN INVESTMENT] 25-30 (1993) (noting most foreign investment projects in Shenzhen SEZ came from Hong Kong and were small-scale and low-tech); Su Guoyuan & Tang Caibin, TIANJIN WAIHANG TOUZI QIYE KUISUN YUANJIN POXI [ANATOMY OF LOSSES OF WHOLLY FOREIGN OWNED ENTERPRISES IN TIANJIN], CAIZHENG YANJU ZILIAO [FINANCE RESEARCH MATERIALS], No. 22, Aug. 10, 1993, at 29, 29 (noting that 45% of foreign investment in Tianjin was from Hong Kong).

308 See supra notes 54, 63 and accompanying text.

309 See supra note 71 and accompanying text.
D. Capitalist Profit Motive and Chinese Control

According to Deng Xiaoping, China sought foreign capital for the "development of productive forces." The country used the policy of opening up and domestic reform to help build "a socialism with Chinese characteristics." The Chinese authorities had to convince themselves and the Chinese people that the use of tax preferences would benefit the country. The concept of profit maximization did not resonate well domestically. According to Communist thinking, the capitalist idea of profit was offensive because it was related to exploitation and cheating, and profit motivation was synonymous with selfishness and greed. Moreover, there was fear that purely profit-motivated investment decisions would harm the country's long term development goals. The leadership feared that such decisions could lead to chaotic competition with foreign forces for domestic market shares and threaten Chinese national industries. It was accepted that the pursuit of profit by foreign investors, while unavoidable, must therefore be controlled by the state. Finally, the opening up policy assumed that the country would receive many benefits, including more tax collections, from the arrival of overseas capital. However, many feared that because they received preferential treatment, foreign investors might benefit more from the country's opening up than the Chinese themselves.

The Chinese devised accounting and financial mechanisms to hold foreigners' profit-seeking behavior in check. The 1979 EJV Law required EJVs to contribute to a reserve fund and a venture expansion fund from their after-tax profit, before distribution of any profit could be made to venture partners. A portion of tax savings would, therefore, be spent for reinvestment and joint venture expansion. The Chinese were also able to

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311 Deng Xiaoping, *Jianshe You Zhongguo Tese De Shehui Zhuyi* [Building the Socialism With Chinese Characteristics], June 30, 1984, in 3 Selected Works of Deng Xiaoping, supra note 89, at 62, 63-64 (explaining socialism in terms of developing productive forces); Deng Xiaoping, *Yi Kao Lixiang Er Kao Jilu Caiyuan Quanlie Qilai* [Unit on the Basis of Idealism and Discipline], Mar. 7, 1985, id. at 110, 110 (explaining that socialism with Chinese characteristics depends on spiritual civilizations, idealism, ethics, morality, culture and discipline).
312 See, e.g., Xu Xuehan et al., *Guanyu Jingji Tegu Jianshe Zhong De Jige Wenti* [Some Issues Concerning the Construction of Special Economic Zones], 1983 Y.B. SEZs, supra note 93, at 634, 635 (necessary to control profit motive of foreign investors).
313 Deng, *Talks in Shanghai*, supra note 137, at 373.
314 See Red Flag Editorial, supra note 45, at 5 (foreign businesses may take unfair advantage of the opening up policy).
315 EJV Law, supra note 1, art. 7 (after-tax profit must go to the following three funds first: a reserve fund, a bonus and welfare fund for staff and workers, and a venture expansion fund).
316 The reserve fund is used to offset any losses of EJVs, increase enterprise capital and expand production. EJV Implementing Rules, supra note 217, art. 87.
influence the way profit was used if they controlled the board of directors of joint venture enterprises. Chinese joint venture partners had to hand over their distributed profits to their superior government department. Certain tax benefits were explicitly tied to reinvestment by foreign investors in China. The profit that foreign investors could actually repatriate represented only a small portion. China’s tax preferences also played a role in controlling foreign investment through information gathering and other monitoring.

IV. CULTURAL FACTORS

The Chinese adoption of tax and non-tax preferences to foreign investment must also be explained and examined in light of cultural factors. Tax reductions and exemptions were traditionally associated with the Confucian idea of a virtuous and benevolent government founded on popular trust and support. The idea, when applied to interactions with foreigners, required the Chinese government to express largess and hospitality to win a favorable reputation and trust from foreigners. In return, foreigners were expected to behave according to Chinese norms. Another cultural trait was the friendship/relationship approach. Tax and non-tax preferences were presented as gifts or rewards to overseas investors who were supposed to reciprocate the gesture. Through the generosity and friendship/relationship models, the government stressed sincerity and appealed to emotions, sense of shame and moral obligation. The government believed that its friendship/relationship approach, in addition to the economic incentives, would stimulate foreign business communities to respond to China’s opening-up policy. Moreover, the model provides a framework by which they can

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317 Id. The board of directors of the EJV determines the proportion of profits going to each of the three funds.

318 Since Chinese joint venture participants are usually state-owned enterprises, their distributed profits from joint ventures should be remitted to the state treasury. See Liu Yushan & Xu Yaping, Yanhai Kaifang Chengshi Caizheng Diaoyan Baogao [Report on the Financial Investigation of Coastal Open Cities], CAIZHENG YANJIU ZILIAO [FINANCIAL RESEARCH MATERIALS], Oct. 15, 1985, at 8, 11.

319 See supra notes 55, 77 and accompanying text.


321 Pitman B. Potter, Foreign Investment Law in the People’s Republic of China: Dilemmas of State Control, CHINA QUARTERLY, Mar. 1995, at 155, 173 ("the Chinese state seeks to strengthen its capacity to obtain information on the financial condition, sales activities and technology base of foreign investment projects" through tax preferences).
blame any lack of enthusiasm on the part of foreign investors on their insensitivity. Finally, moral superiority would give the Chinese a strong justification for responding to foreigners’ misbehavior.

A. Tax Leniency and Trust

An editorial published in the August 1982 issue of *Hongqi*, or *Red Flag*, the official magazine of the Communist Party Central Committee, stated that, when dealing with foreigners who “are sincerely seeking cooperation, and using legitimate means, to do business with us,” the Chinese should “give them a welcome, treat them with *li* (rites), and stress friendship, even though no deal is concluded in the end.”322 Because foreigners came for material gains, the country would “loosen policies and permit profit to be made”323 — a reference to the adoption of tax and non-tax preferences. The editorial urged people to take efforts to win “reputation and trust” from foreign businesses.324 The Party Secretary in the Fujian Province made the point more explicitly in the early 1980s by arguing that tax and other preferential measures were a capital investment on the part of China to build reputation and trust with potential investors.325

Conforming to *li* and winning trust through tax leniency are typically Confucian ideas. While the Chinese monarch possessed absolute powers according to the concept of Mandate of Heaven,326 the exercise of that power was under moral constraints. According to Confucian teachings, the state was analogous to a family and the ruler played a role similar to that of the head of the family.327 The relationship between the ruler and his subjects then followed kinship ethics and power structures.328 The ruler was

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323 Id.
324 Id. at 4-5.
325 Id. at 4-5.
326 Id.
327 Id. at 4-5.
328 Id. at 4-5.
329 Xiang Nan, *Tequ Yao Shixing Si Te* [Implementing Four Special Characteristics in Special Economic Zones], in 1983 Y.B. SEZs, *supra* note 93, at 113, 114.
330 In Imperial China, “all under the heaven belonged to the emperor.” *See* RAY HUANG, *TAXATION AND GOVERNMENTAL FINANCE IN SIXTEENTH-CENTURY MING CHINA* 6 (1974). For a discussion of the Mandate of Heaven, see C.K. YANG, *RELIGION IN CHINESE SOCIETY* 127-29 (1967). The Chinese word *tian* or Heaven has a number of meanings and origins. *See generally* ROBERT ENO, *THE CONFUCIAN CREATION OF HEAVEN: PHILOSOPHY AND THE DEFENSE OF RITUAL MASTERY* (1990); GIANNARO Finazzo, *THE PRINCIPLE OF TIEN: ESSAY ON ITS THEORETICAL RELEVANCY IN EARLY CONFUCIAN PHILOSOPHY* (1967). This idea linked the ascendency to the throne or change of dynasties to supernatural forces, and provided an acceptable explanation for the origin of monarchical power, based on “the awe and respect of the supernatural” of common people. YANG, *supra*, at 132. It sanctified the supreme power and utmost privileges enjoyed by Chinese rulers. *Id.* at 128.
331 For a comparison of the ruler of the state with the head of a family, see HSU CHO-YUN, *ANCIENT CHINA IN TRANSITION: AN ANALYSIS OF SOCIAL MOBILITY* 722-222 B.C. 78-79 (1965).
332 *See*, e.g., ETIENNE BALASZ, *CHINESE CIVILISATION AND BUREAUCRACY: VARIATIONS ON A THEME* 18 (H.M. Wright trans., 1964) (discussing kinship virtues of “respect, humility, docility, obedience, submission, and subordination” as state ideology).
supposed to lead, protect, and take care of the welfare of his subjects just as
the head of a family should do for his members. In turn, the people owed
loyalty and obedience to the state just as family members did to the fam-
ily. The kinship analogy operated as a check on the theoretically unbridled
imperial power. While the Chinese State did not tolerate popular
claims to rights, it had to show sympathy and pity to the people. The
Mandate of Heaven was bestowed to “the office of the throne, rather than in
the person of the ruler,” and it could be revoked if the ruler was no longer
virtuous and benevolent. Confucian texts supplied examples of how a
good ruler should treat his subjects. Mencius, when advising the King
of the state of Liang, associated virtue and benevolence with, among other
things, “reducing taxes and levies.” While the state power to collect land
tax and levies was theoretically unrestrained, it had to be exercised leni-

329 See also Roger T. Ames, The Art of Rulership: A Study in Ancient Chinese
Political Thought 158-59 (1983) (the relationship between the ruler and his subjects is
that of parent and child, the welfare of the child being the parents’ most vital concern).
330 As it was noted,

The traditional family served as the paradigm for the moral life, but the moral life
did not end with family obligations. There were obligations to society as well: obliga-
tions modeled on the structure of the family.

Philip J. Ivanhoe, Ethics in the Confucian Tradition: The Thought of Mencius and

Professor Arthur Wright also noted that the norms of proper social behavior in Chinese
society started with one’s family and “would in turn foster social virtues: filial submission,
brotherliness, righteousness, good faith, and loyalty.” Arthur F. Wright, Values, Roles, and
Personalities, in Confucian Personalities 3, 7 (Arthur F. Wright & Denis Twitchett eds.,
1962). For a further discussion of the influence of filial piety, a key concept in Chinese
family ethics on the social relationship, see Hsieh Yu-wei, Filial Piety and Chinese Society,
(Charles A. Moore & A.V. Morris eds. 1967).

331 In China, “[a] form of paternalism was the highest ideal of government, and every-
thing was done to envelop transactions between government and the public in layers of diff-
use human emotion. Citizens never demanded their rights; they sought instead the
sympathy, and indeed the pity, of those more powerful than themselves.” Lucian W. Pye,
The Spirit of Chinese Politics 19 (1992). For another discussion of individual rights and
state power in China, see Randall P. Peerenboom, Rights, Interests, and the Interest in Rights

332 Yang, supra note 326, at 133.

333 As a Chinese writer put it, “[h]eaven, being not a selfish god who cared only about his
‘first son’, had the well-being of the people on his mind and was ready to change his man-
date any time ‘his son’ did not behave.” Chang Ch’i-yun, Confucianism: A Modern
Interpretation 162-63 (1980). As Mark Mancall describes, the Chinese emperor had two
personalities: one was the “embodiment of virtue” with the title of “son of heaven”, and the
other was “the man at the apex of organized civilization”; and in the latter personality he
could “stray from the path of true virtue, betraying his role as son of heaven and causing dis-
harmony in the universe” Mark Mancall, China at the Center: 300 Years of Foreign

334 Mencius 31 (Zhao Zhentao et al. trans., 1993).

335 During the first two hundred years of the Qing Dynasty (1644-1911), the land tax sup-
plied more than 75% of the government revenue, Edwin George Beal, Jr., The Origin of
ently.\textsuperscript{336} Tax leniency became the litmus test of the ruler’s virtue, and lower tax rates and fewer levies coupled with generous exemptions and reductions were the hallmarks of a humane government.\textsuperscript{337} Excessive taxation, on the other hand, demonstrated “widespread dissatisfaction and confusion, and .. . the downfall of the dynasty.”\textsuperscript{338} Tax leniency was especially urged in times of need such as crop failures.\textsuperscript{339}

Tax reductions and exemptions were considered to be favors granted by the ruler. The Chinese word en, or “favor,” usually goes hand in hand

\begin{itemize}
\item\textit{Liko}, 1853-1864 3-4 (1958); it was not until the second half of the nineteenth century that other forms of taxes and levies, especially new taxation on trade and industry, surpassed the land tax and became the major sources of revenue. \textit{Id.} at 3-5. Land, as the most important form of wealth in a predominantly agricultural society, belonged to the emperor. Although there were forms of private land ownership in the sense that land could be bought and sold between individuals, “the lands in China before the Republic were considered as belonging to the emperor. . . . Throughout the various dynasties, at least from Ch’in on, this theory of absolute ownership of land by the sovereign had found expression in the decrees, edicts, memorials and other state papers.” \textsc{Han Liang Huang}, \textsc{The Land Tax in China} 71 (Ams ed. 1968). Private ownership in traditional China was different from private ownership in the West. Chinese traditional form of property was identified as the “Asiatic” or “Oriental” form founded on “tribal or common property” with the community as the “hereditary possessor,” but subordinated to the state, which is “the real owner, and the real precondition of common ownership.” \textsc{Karl Marx}, \textsc{Pre-Capitalist Economic Formations} 69-70 (Eric Hobsbawm ed., 1965).

As an old Chinese saying goes, “All the land under heaven is the property of the sovereign; all the dwellers on the land are the subjects of the king.” \textsc{Han Liang Huang}, \textit{supra}, at 71.

\textsuperscript{336} Mencius was one of the most influential advocates for lenient tax policy and identified low tax burdens with the virtue and benevolence of the state; he believed that after tax, people should be able to support their parents, wives and other family members; in other words, the state should only tax the surplus of what people have left after satisfying their normal needs. \textsc{Wang Chengbo et al.}, \textsc{Zhongguo Fushui Sixiang Shi [A Chinese History of Ideas on Taxation]} 74 (1995); \textit{see also} \textsc{Hu Jichuan & Tan Min}, \textsc{Zhongguo Caizheng Sixiang Shi [A Chinese History of Thoughts on Finance]} 51-55 (1989).

\textsuperscript{337} For a discussion of tax leniency throughout Chinese history, see \textsc{Wang et al.}, \textit{supra} note 336, at 127 (Han Dynasty), 238-43 (Tang Dynasty), 312-13 (Song Dynasty); 457-60 (Ming Dynasty); 522-23 (Qing Dynasty). While the extent to which Confucian teachings about morality played a restraining role in the imperial exercise of taxing powers was always difficult to measure, some effect should be expected; as one author noted, “considering the unlimited power at the disposal of the crown, one might wonder what would have happened had this power never been subject to any moral restraint.” \textsc{Huang}, \textit{supra} note 326, at 7. Other evidence of the effect of the Confucian teachings on tax policy can be found in the fact that proponents of higher taxes and levies were usually forced into a defensive posture. \textsc{Beal}, \textit{supra} note 335, at 59 (officials in Qing Dynasty tried to justify a new tax on grounds that it was “absolute necessity” and, if properly administered, “would never have become a burden upon the people”).

\textsuperscript{338} \textsc{Huang}, \textit{supra} note 335, at 54.

\textsuperscript{339} Usually, tax exemptions and reductions were granted when there were crop failures. \textit{See}, e.g., \textsc{Wang et al.}, \textit{supra} note 336, at 114, 245 (different tax reliefs depending on the seriousness of natural calamities during Han and Tang Dynasties).
with the word *de*, or “virtue.” The ruler’s willingness to grant favor showed his care for the people. Modelled on these family and kinship patterns, the Chinese State traditionally was responsible for the economic welfare of its subjects. Chinese people tended to depend upon the state for food and other handouts. A key Confucian element of government was confidence or trust of the people. To have popular trust—which Confucius ranked higher in priority than economic self-sufficiency and military prowess—the ruler must consult and care for the interest of the people. The parallel between the family and state fostered a sense of “fiduciary community.” Favors were evidence of the ruler’s sense of responsibility for the people and “community.” In spite of its ruthless side, authority in China was also seen as “subtle, wise, and the source of..."
morality. The Confucian way of government stressed moral examples and persuasion rather than the use of physical force. In the ideal Confucian order, "[t]he good ruler and his ministers would, on the one hand, provide the people with an example of proper behavior according to li," and on the other hand "educate the people in li." Li, a key Confucian concept, referred to "the rules governing the behavior of the individual in his own social role and governing his behavior toward others in their social roles." Handing out tax reliefs and other forms of favor was an indication that the ruler conducted himself according to li. The people then "should be positively motivated by li, to do that which they ought," namely "render[ing] loyalty and willing obedience" to the ruler. The ruler could grant tax preferences discriminately, depending on the nature and extent of loyalty and support that he was seeking. Just as his subjects were classified according to different status and categories, the ruler could grant special preferential tax treatment to nobility, officials, and bureaucrats as rewards to further distinguish them from the rest of society. As they were treated more favorably than the rest of society, those beneficiaries owed commensurately greater duties to the ruling house. This was the application of Chinese particularism to taxation. Chinese rulers used tax reductions and exemptions as tools to win the acceptance and allegiance to newly conquered areas.

After 1949 the leadership continued to win popular trust through state favor. For political and ideological reasons, though, new slogans replaced Confucian vocabulary. The Stalinist political and economic system fused with a Confucian spirit. Confucian ideas were consistently brought into the battle to 'temper the rigor of the law' by injecting into juristic considerations the classical Confucian emphases on ethics and li, propriety. Thus, law, though elaborately codified, remained the instrument of morality." Id. at 185.


In China, "the granting of presents by superiors has belonged to the ritual of power"; and "[g]enerosity is the service in return for the privileged position." HEINER ROETS, CONFUCIAN ETHICS OF THE AXIAL AGE: A RECONSTRUCTION UNDER THE ASPECT OF THE BREAKTHROUGH TOWARD POSTCONVENTIONAL THINKING 88 (1993).

Herrlee Glessner Creel, Legal Institutions and Procedures During the Chou Dynasty, in ESSAYS ON CHINA'S LEGAL TRADITION 26, 39 (Jerome Alan Cohen et al. eds., 1980).

Early tax benefits of this kind could be traced to Zhou Dynasty (1122-770 B.C). See WANG ET AL., supra note 336, at 18.

Contemporary Chinese intellectuals and political figures expressed vehement anti-Confucian sentiments, and the explanation was "cultural iconoclasm," a desire to see China's
China adopted in the 1950s was characterized by state ownership of land, means of industrial production and financial institutions. The leadership changed its rhetoric as well, carrying out its actions in the name of "the People" rather than "Heaven." This new system gave the Party and state powers to command and allocate resources, and therefore practice state favor, that were at least as broad as those of previous dynasties. In Maoist China, the Party and state dictated investment, production and distribution policies, and engaged in day-to-day management of hundreds of thousands of state enterprises. Forms of state favor ranged from the "iron rice bowl" life-time job guarantee to subsidized housing, health care and public transportation — from approving college admissions to granting library cards. The state’s monopoly of political and economic power made the ubiquitousness of state favor not only possible, but also inevitable. Any achievements in the country were inexorably attributable to the wisdom and correctness of Party policy. In return, the Chinese people were expected to love and trust the Party leadership.

Since the communist state already had a variety of means at its disposal to show its care for the people, it was not as dependent on tax reductions and exemptions to build reputation and popular support. Moreover, the Party viewed taxation as a means of proletarian dictatorship to effect social and economic changes. It had to defend the tax policy’s social and economic objectives and castigate the belief that state taxation should conform to the Confucian idea of benevolent government. On the other hand, the government intended tax preferences to strengthen the relationship between the state and those who derived benefit from state favor. Increased investment funds as a result of tax saving aggrandized the power of the state.

"cultural values supplanted by new ideas imported from the West." Tu, supra note 346, at 36. Meanwhile, Confucianism continues to exert an undeniable influence on modern China, and “[t]he pervasiveness of Confucian symbols in Chinese culture is certainly the main reason why the unprecedented change in China since the Western impact of mid-nineteenth century has brought about many waves of anti-Confucian campaigns.” Id. at 39. In any event, Confucian ideas are very relevant in identifying substantive issues in contemporary China. Id. at 42-47. After 1949, many changes appeared to be more rhetorical than substantive; the Confucian concepts of virtue and benevolence were carefully repackaged under communist ethics and morality. Cf. Ogden, supra note 35, at 188 (while post-1949 communist leaders relied on cultural values, they were reluctant to admit it).

358 The communist state's taxing power remained as absolute as ever before; however, contemporary Chinese literature on taxation usually describes the nature of state taxing power as qiangzlixing or compulsory, wuchangxing or non-compensatory and gudingxing or fixed. See, e.g., Zou, supra note 277, at 3-4; Yin Zuoran et al., Guojia Shuishou [State Taxation] 1-2 (1995). The compulsory nature of taxation means that "the state, in reliance on its political power, forces taxpayers to pay taxes according to law." Zou, supra note 277, at 3.

359 NATIONAL TAXATION, supra note 269, at 7.

360 See Li, supra note 262, at 23 (attacks on government tax policy on grounds of benevolence were associated with landlords and bourgeois viewpoints); see also Wang, supra note 259, at 25 (Mao Zedong refused to link tax and finance policy to the traditional idea of benevolence of the government).
and sphere of influence of department bureaucrats and enterprise managers. Tax treatment affected the balance sheet of an enterprise and fewer taxes were translated into a higher profit on paper. Profitability was a measurement of managers' and workers' performance, and high profits entitled them to political and social honors, as well as material rewards. By giving benefits to bureaucrats, enterprise managers and even workers, the state could claim trust and support from them. The government also used tax benefits to demonstrate care for ethnic minorities.

B. Expression of Largess and Hospitality

The idea of also applied to foreigners. The Confucian way of dealing with foreigners was to be “generous with gifts without calculating the value of tribute and to grant them honors without making heavy demands.” The Chinese believed that by showing generosity and hospitality they could exert moral influence on non-Chinese and lead them to “participate in the benefits of (Chinese) civilisation.” This view on foreign affairs was an extension of:

the Confucian doctrines by which Chinese rulers gained an ethical sanction for their exercise of political authority... Just as the virtuous ruler by his moral example had prestige and influence among the people of the Middle Kingdom,

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361 Non-material rewards for managers and workers included “recognition by their work units, a big red ribbon, and perhaps a promotion.” Ogden, supra note 35, at 108; see also Riskin, supra note 32, at 122 (non-material external incentives like “ emulation campaigns, the designation of model workers and work teams, and the publicizing of accomplishments and faults by means of dazibao (wall posters);” internal incentives like “ job enlargement and worker participation in management”).

362 Allocation of enterprise profit for welfare purposes was subject, however, to state regulations and supervision. See State Enterprise Financial Accounting, supra note 279, at 288-89. In Maoist China, Party leaders were divided on whether economic incentives should be used in a socialist system; the radical faction of the Party, which prevailed during the years prior to the death of Mao Zedong, insisted on the importance of ideological works and administrative controls and the use of economic incentives was brandished as political deviant. See, e.g., Riskin, supra note 32, at 122 (individual material incentives were attacked and many of them were eliminated in late 1950s).

363 Tax exemptions and reductions granted to individual businesses were labelled as zhaogu or care by the state. Liu, supra note 7, at 454. As an official tax treatise stated, “tax preferences have already existed in everyday life and benefited the way we dress ourselves, eat, live and move around.” Id. at 455.

364 See, e.g., Wang et al., supra note 167, at 28 (tax preferences have always been given to ethnic minorities).


so he irresistibly attracted the barbarians who were outside the pale of Chinese culture.\textsuperscript{367} The tribute system\textsuperscript{368} is a good illustration. Formally, the system referred to foreign rulers' periodical visits bringing local produce to the Chinese emperor who gave gifts and instructions in return.\textsuperscript{369} In substance, it described a particular relationship between China and foreign countries under which "non Chinese people were expected in theory to participate in the Chinese world order by observing the appropriate procedures and ceremonies in their contact with the Son of Heaven."\textsuperscript{370} For foreigners, the tribute system was "a formality connected with trade."\textsuperscript{371} For the Chinese, however, the system had important non-economic objectives such as "peace and security."\textsuperscript{372} The Chinese assumed that the foreigner was so bound by and dependent upon trade with China\textsuperscript{373} and that the Chinese could "use the lure of trade and profit to meet the foreigner's desires and thus appease him and avoid military conflict."\textsuperscript{374} Thus, economic benefits were not a major concern:

The imperial gifts bestowed in return were usually more valuable than the tribute. . . . On China's part the permission to trade was intended to be a mark of imperial bounty and a means of keeping the barbarians in the proper state of submissiveness.\textsuperscript{375} In a Sinocentric world, the emperor of the Middle Kingdom "at the apex treats the rulers of peripheral peoples with an overwhelming benevolence (\textit{jen}) and thereby ensures their allegiance and subordination."\textsuperscript{376} The arri-

\textsuperscript{367}\textsc{John King Fairbank, The United States and China} 158 (4th ed. 1979). For discussions on historical Chinese views on foreigners and foreign relations, see \textsc{Yen-p'ing Hao \& Erh-ming Wang, Changing Chinese Views of Western Relations, 1840-95, in 2 The Cambridge History of China: Late Ch'ing, 1800-1911, Part 2, 142 (John K. Fairbank \& Kwang-Ching Liu eds., 1980); Mancall, supra note 333, at 13-39. For a discussion of the incorporation of virtue in Chinese views on foreign relations, see Wang in \textsc{Chinese World Order, supra note 366, at 111.}

\textsuperscript{368}For a summary of the tribute system, see \textsc{Fairbank, supra note 367, at 158-63. For more elaborate discussions of the system, see Fairbank \& Teng, supra note 366; Chinese World Order, supra note 365.}

\textsuperscript{369}In fact, "the concept of the 'tribute system' is a Western invention for descriptive purposes." Mark Mancall, \textit{The Ch'ing Tribute System: An Interpretive Essay, in Chinese World Order, supra note 365, at 63, 63.}

\textsuperscript{370}Hao \& Wang, supra note 367, at 144.

\textsuperscript{371}Fairbank \& Teng, supra note 366, at 112.

\textsuperscript{372}Id. (quoting T. F. Tsiang, \textit{China and European Expansion}, 2 Politica No. 5, Mar. 1936, at 1, 3-4).

\textsuperscript{373}See Hao \& Wang, supra note 367, at 154 (during the Opium War period, there was a firm belief that "the foreigners needed tea and rhubarb so much that if the supply were cut off, they would become blind and subject to diseases of the intestines").

\textsuperscript{374}Id. at 151.

\textsuperscript{375}Fairbank \& Tseng, supra note 366, at 112 (quoting T. F. Tsiang, \textit{China and European Expansion}, 2 Politica No. 5, Mar. 1936, at 1, 3-4).

\textsuperscript{376}John K. Fairbank, \textit{The Early Treaty System in the Chinese World Order, in Chinese World Order, supra note 365, at 257, 264.}
vals of foreign tribute bearers were interpreted as “a sign of great virtue” of the Chinese empire. The tribute system crumbled when Western powers forced their way into China in the mid-nineteenth century and rejected Chinese condescension and hierarchical inequality as symbolized by the tribute system.

Traditional ideas and attitudes nevertheless live on. Not surprisingly, the August 1982 Red Flag editorial spoke of li, reputation and trust and alluded to the idea of generosity. Li referred to proper ways of dealing with foreigners. As the Chinese were seeking to gain reputation and trust from foreign business communities, they had to demonstrate virtue through acts of sincerity and generosity. Tax and non-tax preferential treatment were modern expressions of Chinese sincerity and generosity, used to win a good reputation among foreigners. Only with reputation and trust would the country be able to attract overseas capital and technology. Reliance on these traditional ideas added a non-economic dimension to tax and other preferential policies and brought comfort and assurance to the Chinese. From a purely economic point of view, investors would come to do business only if the host country matched their profit expectations. Therefore, it was the host government’s responsibility to adjust its tax and preferential rules to suit foreign business expectations. According to Chinese ideas of li and generosity, however, it was not necessary to match exactly foreigners’ economic expectations (in fact the Chinese admitted that they were not able to do so). Instead, it was of utmost importance to show sincerity and generosity to motivate foreigners. If foreigners failed to respond, it would demonstrate their insensitivity because they failed to appreciate Chinese virtue.

The August 1982 Red Flag editorial identified two common attitudes among contemporary Chinese toward foreigners. Some worshipped everything Western and suffered from an intolerable cultural inferiority complex, while others resisted opening up and held to the belief that things would be better with little or no foreign contacts. Both attitudes were harmful to the objectives of the country’s opening up and promotional efforts such as tax preferences. For those who believed in autarky and xenophobia, tax and other preferential treatment amounted to kowtowing to foreign interests. Those who suffered from the inferiority complex feared that the adoption of tax preferences could aggravate the perceived inferiority and cause a com-

377 Chusei Suzuki, China’s Relations With Inner Asia: The Hsiung-Nu, Tibet, in CHINESE WORLD ORDER, supra note 365, at 180, 184. The tribute system was “the mechanism by which barbarous non-Chinese regions were given their place in the all-embracing Chinese political, and therefore ethical, scheme of things.” Fairbank & Teng, supra note 366, at 111.

378 The tribute system began to disintegrate with the establishment of a treaty system in the mid-nineteenth century, FAIRBANK, supra note 367, at 163-71, although underlying concepts persisted for many years. Fairbank, supra note 376, at 257.

379 Red Flag Editorial, supra note 45, at 4.
plete loss of faith in the country’s system and future.\textsuperscript{380} References to li and generosity were therefore necessary to convince the domestic audience that tax preferences were not only consistent with, but even compelled by Chinese tradition, and being generous was not weakness, but virtue. Such tradition would boost self-confidence and assurance; as a result of Chinese generosity and reputation foreigners would have trust in the country and would therefore rush to China to do business.

C. Generosity, Moral Example and State Coercion

For the Chinese State, generosity would not only win reputation and trust, it would also show virtue and set a moral example to be followed by others. Tax leniency had been a familiar form of state favor and set a moral example for the Chinese people.\textsuperscript{381} This tradition has gained favor in recent years. Domestically, a decade-long economic reform has diminished the leadership’s ability to grant favors because the government’s role in economic management and provision of subsidies has been significantly reduced. The state no longer claims absolute control over the country’s economic life. Dependency on state financial support is no longer encouraged. Decentralization of economic responsibility, while necessary for the country’s long-term performance, has created uncertainties in society and in people’s lives. On the other hand, the state taxing power has not been decentralized. Taxation is one of the last few tools under the firm control of the state, which can be used to influence business decisions and the welfare of the people. The importance of taxation is only heightened by loosening government control in other areas. Popular pressure now focuses on the exercise of the taxing power for welfare purposes. As the role of the state in the economy has diminished in other areas, tax reliefs and concessions have become significant benefits to individuals and businesses. Party leaders have turned to the so-called “socialist spiritual civilization” to counter the trend of materialism that was unleashed by economic reform.\textsuperscript{382} Meanwhile, state favor, like tax leniency, is given in exchange for compliance.\textsuperscript{383}

\textsuperscript{380} Sensing the importance of national dignity and pride in the maintenance of political faith, Deng Xiaoping declared that the Chinese people would never become dependent on any foreign powers, nor accept any infringement upon their national interest. Deng Xiaoping, Zhongguo Gongchandang Di Shier Ci Quanguo Daibiao Dahui Kaimucii [Speech at the Opening Ceremony of the 12th National Congress of the Chinese Communist Party], Sept. 1, 1982, in 3 SELECTED WORKS OF DENG XIAOPING, supra note 89, at 1, 3.

\textsuperscript{381} Supra Part IV.A.

\textsuperscript{382} Chinese President Jiang Zemin recently said: “Developing socialist spiritual civilization is related to the fate and prospects of the party and the nation and to the Chinese people proudly towering among the people of the world.” Jiang Praises Tough Drive on Morality, S. CHINA MORNING POST, May 27, 1997, at 9.

\textsuperscript{383} The central government recently promised, for instance, that farmers’ taxes would not be raised before the end of the century in order to quiet rural discontent, but then required farmers not to use farmlands for other purposes. Farmers’ Tax Freeze to Avoid Risk of Riots, S. CHINA MORNING POST, Apr. 2, 1997, at 10.
Similarly, preferential tax and non-tax treatment for foreigners has manifested the Chinese virtue to foreigners. Tax and non-tax benefits serve as a reminder that the welfare and profitability of foreign investors depend on the Chinese State's generosity. The country is craving advanced technology and expertise, but hi-tech foreign investments can be seen as posing a competitive threat to domestic technological development efforts.\footnote{See, e.g., Xiao Yu, Feeling the Downside of Foreign Capital, S. CHINA MORNING Post, July 13, 1997, at 5.}

Viewing tax and non-tax benefits as a moral example of the Chinese State is, again, the Confucian way of solving the dilemma. The government offers economic benefits to induce hi-tech foreign investments and, at the same time, to motivate or shame foreign investors into behaving properly. Foreign businesses are expected to conform with their proper role, which is to help China's modernization by bringing in the capital, technology and expertise the country needs. They must refrain from doing harm to the Chinese by relentlessly taking market shares from DOEs. Just as the West can influence the Chinese society with modern ideas such as the rule of law and human rights, the Chinese believe their virtue and moral example can have a universal validity or, at least, should be learned and assimilated by foreigners doing business in the country.\footnote{The Chinese government recently even urged Western advertisers to promote Party propaganda for Marxism and socialist morality. Tom Korski, Western Advertisers Urged to Push Ethics, S. CHINA MORNING Post, May 14, 1997, at 8.}

If foreigners "held ulterior motives, or used illegitimate means," as the August 1982 Red Flag editorial warned, "they should be vehemently resisted by the Chinese people and even face court trial according to law."\footnote{Red Flag Editorial, supra note 45, at 5. The Chinese tend to make a simplistic distinction between friends and foes among foreigners which seems to be the legacy of diverse traditional attitudes towards foreigners ranging from "an idealistic 'Mencian' view that barbarians could be easily 'transformed' (hua) by simple exposure to Confucian culture" to "views that compared the barbarians to beasts and birds doomed to eternal inferiority." Benjamin I. Schwartz, The Chinese Perception of World Order, Past and Present, in CHINESE WORLD ORDER, supra note 365, at 276, 281.}

Showing virtue and moral example may be obtained through use or threat of use of coercive force.\footnote{Chinese scholars referred to the Confucian and Legalist traditions and advocated a combined use of moral education and legal rules. See, e.g., Cao Jianming & Li Ran, Lun Shehui Zhuyi Jingshen Wenming Yu Fazhi Jianshe [On Building Socialist Spiritual Civilization and Legality], FAXUE [SCIENCE OF LAW], 1996 No. 12, at 4.}

The Chinese State makes clear that overseas investors are subject to its power,\footnote{When speaking of the principles governing enterprise income taxes on EJVs and other forms of foreign investment, officials and commentators referred to China's sovereign power over foreigners doing business in the country. See Gu Ming, supra note 52, at 624 (JVITL made in accordance with the 'principle of state sovereign right and interest'); Xie Ming, supra note 63, at 621 (same); see also Niu, supra note 47, at 159; Wang Xuanhui, Qiantan Woguo Shewai Shuizhi Jiangshe Suo Yixun De Yuanze [A Preliminary Discussion on the Principles Governing Foreign Related Taxation in Our Country], SHIWIU YANJU
The authorities have insisted on yifa zhishui, or “taxing according to law,” and taxpayers are bound by their legal duties to pay taxes. The government does not spare foreign businesses from its increasing legal and administrative control. FIEs are Chinese legal entities and subject to the state power just like other domestic concerns. In fact, the Chinese government seems to be more willing to sanction foreign investors who violate the law. In a publicized case involving a joint venture golf club in Shenzhen, the Chinese tax authorities accused a Japanese investor of evading seventy-seven million yuan in tax payments since 1988. They froze the club’s assets and claimed that the taxpayer was “resisting to pay tax” which, under Chinese criminal law, carries a maximum of seven years’ imprisonment. The Japanese joint venturer deserved punishment for flagrantly disregarding Chinese norms. The case showed other foreign firms the undesirable yet
unavoidable consequences they would face if they failed to behave the way the Chinese expect.  

The generosity, moral example and state coercion paradigms provide justification for recent preference rule changes in response to policy shifts against tax benefits to foreign investment. FIEs have been accused of tax evasion and abuse of preferential treatment, as well as falsifying claims of losses and hiding profit. Other alleged abuses and illegalities include failures to make capital investment as promised, lack of business activity after registration, and refusal of government supervision. Some have argued for a reduction or elimination of tax benefits to foreign investments based on these allegations. In particular, critics of broadly-available tax benefits such as the two-year income tax exemption and three-year fifty percent reduction holidays, and five-year carry-over loss have argued for cuts on those benefits based on reports that some FIEs evaded tax by claiming continuous losses. There are no greater arguments in support of preference cuts than the faults of foreign investors themselves. This argument is in line with the Chinese belief in the power of moral example and shame. It is worth noting that Chinese generosity and virtue can hardly be tested by objective criteria while foreigners' morality and intention are judged on the basis of their economic behavior. The Chinese could present almost any kind of benefits as the expression of their virtue and moral example. On the other hand, if foreign businesses appear to be too calculat-

396 The Chinese understood the importance of threats of force, as the old tribute system was possible only with backing of coercive power. See, e.g., Suzuki, supra note 377, at 183-85.

397 See, e.g., Huang Jianqing, Fujiansheng Sanzi Qiye De Fazhan Xianzhuang Wenti He Duouce [Development of Foreign Investment Enterprises in Fujian: Current Situation, Problems and Solutions], CAIZHENG YANJIU ZILIAO [FINANCE RESEARCH MATERIALS], Mar. 10, 1994, at 19, 21 (serious tax evasions by FIEs in Fujian); Wu Youdong et al., Kuishun Shuyu Guanli Chula Zaiyu Wanshan [Losses Were Due to Loose Management and Solution Resides on Improvement], CAIZHENG YANJIU ZILIAO [FINANCE RESEARCH MATERIALS], Feb. 28, 1994, at 30, 34 (abuses of tax preferences by FIEs in Hubei Province); Su & Tang, supra note 307, at 29 (abuses of tax law by FIEs in Tianjin); Liu & Xu, supra note 318, at 13 (abuse of tax preferences).

398 From 1988 to 1993, 35% to 40% of FIEs were reportedly making a loss, and the number of FIEs in the red went up from 50% to 60% in 1994-95. It was believed that many of the loss-making cases were attributable to transfer pricing, heavy debt, or other abuses. Waiqi Kuisun Guoban Wei Xu [More Than Half of Foreign Investment Enterprise Loss-Making Cases Are False], MING BAO (MING PAO) (HK), Nov. 13, 1996, at A13.

399 See, e.g., Henan Diaoxiao 82 Waiqi Zhizhao [Henan Province Revoked 82 Licenses of Foreign Investment Enterprises], MING BAO (MING PAO) (HK), Aug. 10, 1995, at C2 (FIEs licenses were withdrawn for abuses and illegalities).

400 For such tax holidays under the present law, see text accompanying supra note 70.

401 For such benefits under the present law, see text accompanying supra note 72.

402 Xin Bian Bishui Yu Fan Bishui Shiwu Quanshu [Guide to Tax Evasion & Anti-Evasion] 116-17 (Zhang Zhongxiu et al. eds., 1995) (as foreign businesses may have attempted to avoid enterprise income tax because of losses and/or tax holidays, such preference rules should be restricted).
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ing, the government can imply bad faith, "ulterior motives" and even ille-
galities.

D. Image and Substance

The Confucian tradition stresses rituals and an image of sincerity and
generosity. The Chinese government typically made generous but vague
promises of benefits through its preference legislation and regulations,
without spelling out the exact conditions and limitations on these benefits.
For instance, the government promised turnover tax exemptions and reduc-
tions to FIEs in financial difficulty, but failed to clarify what would con-
stitute financial difficulties. Similarly, the government promised special tax
treatment to Overseas Chinese investors without explaining exactly
which investors qualified, or whether an investment needed to be wholly-
owned and controlled by a qualified Overseas Chinese investor. Chinese
tax authorities and government agencies usually refused to issue formal tax
rulings in advance because rulings are case specific; they can look eco-
nomically calculating and contrary to the message of generosity. On the
other hand, policy considerations impose conditions and restrictions in par-
ticular cases, and might, therefore, give rise to discrepancies between
Chinese rhetoric and practice.

Some foreign companies used the names of Overseas Chinese they
hired or contracted for registration purposes in China in order to get special
preferential tax treatment granted to Overseas Chinese investments. Because
the law did not adequately explain which investors were eligible (except
for the vague term "Overseas Chinese"), or the required form of
ownership and registration of the invested capital, an investment project in
the name of an ethnic Chinese person residing abroad was arguably cov-
ered. From the policy point of view of the Chinese government, however, it
was wrong to grant special tax treatment in those cases. Special treat-
ment for Overseas Chinese investors was intended to either promote or re-
ward them for their patriotic deeds. Special treatment was also intended to
promote investment by a group of people more susceptible to the influence
of the Chinese State and therefore not as threatening to the state as other
foreign businesses. Investments which used the name of Overseas Chinese
but were in reality controlled by non-ethnic Chinese investors circumvented
these policies. Nevertheless, for the sake of image, the law did not contain

403 See supra note 217 and accompanying text.
404 See supra notes 189-96 and accompanying text.
405 Cohen & Valentine, supra note 11, at 205.
406 Chinese tax officials insisted that joint ventures’ tax status be examined only after the
joint venture contract is in effect or at least signed. In either case, "it is then too late for a
foreign investor who is disappointed with the tax treatment to change his mind about the
project." Cohen & Valentine, supra note 11, at 205.
408 Id.
more specific restrictions, and officials had to grant tax preferences when the investors had abided by the letter of the law but not the spirit. This law gave rise to complaints of abuses and of the bad faith of foreign investors.

For the Chinese, a business arrangement that is not legally prohibited and may be based on a reasonable interpretation of the law can nevertheless be condemned as an arrangement in bad faith because it was either not intended to be permitted or incompatible with the law's policy goals. The fact that an arrangement is not specifically prohibited by regulation does not make it permissible. Western foreign investors may be tempted to fully exercise their individual (or business) rights, as they understand them, and conduct business within a strict reading of the law. However, the Chinese tend to also consider policy and moral considerations; the written law does not preclude the use of moral or other standards. Foreign businesses can be charged for misconduct although there may not have been illegal activity in a technical sense.

However, keeping an image of generosity is always important. As long as the Chinese seek foreign investment, they cannot dispose of sincerity and generosity. In order to reconcile the idea of generosity with the changes and reductions in preference law that were mandated by policy shifts, the authorities have tried to divert attention away from tax treatment; instead, they have emphasized non-tax incentives such as national treatment.

While foreign investors have long enjoyed preferential tax treatment not available to Chinese businesses, they have also been subject to discriminatory charges and fees for goods and services ranging from power and water supplies to airplane tickets. Pressure has gone up for China to

409 Another important advantage of broad promises and refusal to issue advance rulings is flexibility in tax treatment administration. The Chinese wanted flexibility in making a case-by-case determination as special treatment may be warranted for certain non-ethnic Chinese controlled projects or borderline cases.

410 Some FIEs received tax reduction and exemption for enterprises in financial difficulties by taking advantage of the lack of a definition as to what constituted financial difficulties and by appealing to tax officials' sympathy. Such cases were criticized as abuses. Li, supra note 407, at 80.

411 Chinese writers argued that whether a particular foreign investor's move to avoid or minimize its Chinese tax liability was legitimate or not should be determined not only in light of law as written but also according to "social morality and behavioral norms." Liu Yunguo, Guanyu Woguo Waizi Qiye Bishui Wenti De Zaisikao [Reflection on Issues Concerning Tax Avoidance by Foreign Investment Enterprises in Our Country], SHUIWU YU JINGJI [TAXATION AND ECONOMY], 1995 No. 3, at 35, 37; Li, supra note 407, at 189.

412 The Chinese government has stated that it will "continue to use foreign funds actively, rationally and effectively." Li, supra note 392, at VI. The focus of China's foreign investment policy is now to seek investments in "the comprehensive development of agriculture, infrastructural facilities, comprehensive utilization of resources, industries using high and new technologies as well as in the central and western parts of China." Id.

413 See Sun, supra note 16, at 10-11 (gradually granting national treatment to FIEs).

414 Id. at 11 (admitting that foreigners paid higher fees for airlines, transportation, public park admission, and foreign firms also paid extra fees to the state as food subsidies for em-
get rid of its double standard treatment, and, in response, government officials have created regulations that apply domestic charges to foreign businesses and nationals and give them access to China’s huge domestic market. Such non-tax benefits help maintain the image of generosity. On the other hand, there are limits on how far non-tax measures can go. Despite promises for easing market access, for instance, serious barriers, such as the government pricing policy, persist in key industries, like employees). To fly on Chinese domestic airlines, for instance, non-Chinese nationals have paid double the price that the Chinese are charged. Zhongguo Minhang Dafo Xuejian Waibin Cheng Neilu Jipiao Jia [Chinese Airlines Greatly Reduce Airline Ticket Prices for Foreigners], DONGFANG RIBAO [ORIENTAL DAILY NEWS] (HONG KONG), Feb. 5, 1997, at A13. 416 See, e.g., European Companies Complain of “Incomprehensible” Regulations, S. CHINA MORNING POST, Apr. 25, 1997, Business, at 4 (European firms complained about the application of different rules to Chinese and foreign companies, dual pricing systems which mean expatriates pay higher rent and energy bills than the Chinese, and problems of market access). One reason for the Chinese to consider national treatment for FIEs is China’s application for membership in the World Trade Organization. See Sun, supra note 16, at 10. The World Bank has also argued for non-discriminatory treatment for foreign investment. 1995 World Bank Paper, supra note 17, at 7. Double standard treatment has heretofore been justified on grounds that the government subsidized such good and service consumption and therefore only Chinese individuals and businesses who bore the cost through payment of high taxes and other forms of contribution should enjoy their benefits. Cf. Xin Bochun, Shixing Guomin Daiyu Yu Fazhan Shehui Zhuyi Shechang Jingji [Implementation of National Treatment and Development of the Socialist Market Economy], LILUN TANTAO [DISCUSSION ON THEORY], 1997 No. 2, at 57, 57 (state subsidy to enterprises in a planned economy not applicable to foreign investors). If tax gaps close up, justification for the application of a double standard may no longer hold up.

According to a set of regulations issued by Shenzhen officials in August 1996, starting from 1997, foreigners including Chinese from Hong Kong, Macau and Taiwan would be charged the same fees as Chinese nationals for purchasing or renting real properties, power supplies, medical treatment, tourist visits and other services. Waishang Zai Shenzhen Xiaofei Xiang Guomin Daiyu [Foreign Businesses Enjoy National Treatment for Consumption in Shenzhen], MING BAO (MING PAO) (HK), Aug. 23, 1996, at A10. National treatment measures announced by Hainan Province include the extension of domestic charges to FIEs in the areas of water and power supplies, transportation, communication, hotel and other services, allowing foreign investors to enter service sectors such as information consultancy, accounting and legal services, retail businesses, and permitting more domestic sales by FIEs. Hainan Yu San Zi Guomin Daiyu [Hainan Gives Three Forms of Foreign Investment National Treatment], MING BAO (MING PAO) (HK), Nov. 12, 1996, at A15. Liaoning Province decided to abolish 118 types of charges and fees on foreign investment firms, Foreign Funds Flood Liaoning Industrial Hub, S. CHINA MORNING POST, Jan. 27, 1997, Business, at 4. It was also reported that charges would be uniform for tourist spots and airline tickets. Min Hang Liang Zhong Piaojia Jiang Binggui [Double Pricing for Airline Tickets Will Merge], XIANGGANG SHANG BAO [HONG KONG COMMERCIAL DAILY], Feb. 6, 1997, at B8.

Guangdong Province allowed more domestic sales by FIEs. Guangdongshen Fangkuan Wazi Qiye Chanping Nebiao Bili [Guangdong Province Relaxes the Ratio of Domestic Sales for Products of Foreign Investment Enterprises], XIN BAO (HONG KONG ECONOMIC JOURNAL), Sept. 13, 1996, at 29.
ergy\textsuperscript{418} and automobile manufacturing.\textsuperscript{419} Unreliable distribution systems and lack of information also inhibit market access.\textsuperscript{420} Many of those problems are structural and systemic. Quick solutions are unlikely. By comparison, tax preferences remain familiar and easily convey the message of generosity. Vice-Premier Zhu Rongji’s September 1997 promise to reinstate certain import tax exemptions, which were abolished a year before was the government’s latest attempt to claim sincerity and generosity.\textsuperscript{421} Consistent with the Chinese practice of underscoring generosity and averting unpleasant limitations and restrictions, the promise was announced without any necessary details, such as eligibility or time of implementation.\textsuperscript{422}

E. Friendship/Relationship Approach

The August 1982 \textit{Red Flag} editorial also stressed “friendship.”\textsuperscript{423} As observed, the Chinese in international commercial negotiations have placed a repeated emphasis on friendship,\textsuperscript{424} because of the belief that true friends of China would commit themselves to assist the country’s modernizations. The Chinese sought friendship in a manner similar to the way in which they built relationships.\textsuperscript{425} The Chinese are known for their dependency on relationships, or \textit{guanxi},\textsuperscript{426} rather than on legal rules and institutions. A \textit{guanxi}
relationship is possible when a basis for familiarity exists between the parties.\textsuperscript{427} Closeness starts with shared characteristics like common birthplace, lineage, or surname or shared experiences like schooling or working together.\textsuperscript{428} On the basis of objective criteria of commonalities, one party to the relationship can then tax the other repeatedly as long as the latter is in a position to help.\textsuperscript{429} For those without common characteristics, familiarity may be based on intermediates such as a third party\textsuperscript{430} and gift or favor exchanges.\textsuperscript{431} One may also establish a relationship with another through symbols and gestures like showing of elaborate courtesy, self-deprecation,\textsuperscript{432} loyalty or friendship.\textsuperscript{433} The recipient must then decide whether to accept the offeror's initiative and build a relationship.\textsuperscript{434} The Chinese usually accept a person's initial attempts to build a \textit{guanxi} relationship because the established relationship would presumably benefit all parties sooner or later.\textsuperscript{435} In fact, even where commonalities like family ties or a shared birthplace already exist, exchanges of gifts are the usual practice to enhance \textit{ganqing}, or "affection between the parties." \textit{Guanxi} then provides a basis for reciprocal obligation.\textsuperscript{436} The principle of obligation "complex

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meaning of \textit{guanxi} in the Chinese culture, see Mayfair Mei-hui Yang, Gifts, Favors, and Banquets: The Art of Social Relationships in China 49-74 (1994).
\textsuperscript{427} See, e.g., Yang, supra note 426, at 111. In the Chinese culture, of course, family constitutes the most important relationship binding on an individual. Michael Harris Bond, Beyond the Chinese Face: Insights from Psychology 56 (1991).
\textsuperscript{428} Yang, supra note 426, at 111-19; see also J. Bruce Jacobs, The Concept of Guanxi and Local Politics in a Rural Chinese Cultural Setting, in Social Interaction in Chinese Society 209, 210-20 (Sidney L. Greenblatt et al. eds., 1982) (bases for closeness include common locality, kinship, co-worker, classmate, sworn brotherhood, surname, teacher-student, business, and public/bureaucratic).
\textsuperscript{429} Pye, supra note 187, at 102. At the same time, the principle of indebtedness or reciprocity acts as a safeguard against \textit{guanxi} abuses, as one cannot always take without giving. Yang, supra note 426, at 142.
\textsuperscript{430} See Bond, supra note 427, at 59 (indirect relations can be established by "pulling" on one's direct relationship with a third party who knows both); Yang, supra note 426, at 123-26 (using intermediaries to expand one's \textit{guanxi} network); Jacobs, supra note 428, at 231-32 (pulling \textit{guanxi} through reliable third party).
\textsuperscript{431} Michael Harris Bond & Kwang-kuo Hwang, The Social Psychology of Chinese People, in The Psychology of the Chinese People 213, 225 (Michael Harris Bond ed., 1986); see also Yang, supra note 426, at 126-30 (discussing gift exchanges in \textit{guanxi} relationships).
\textsuperscript{432} Deferential acts and modest speeches are important elements in the art of \textit{guanxi}. Yang, supra note 426, at 109.
\textsuperscript{433} Although a friendship is not the same as a \textit{guanxi} relationship, the former can serve as a basis or potential tie for \textit{guanxi} practice. Id. at 111.
\textsuperscript{434} Id. at 131.
\textsuperscript{435} The author mentions two additional reasons the Chinese tend to accept an offer: acceptance prevents losing face and avoids insulting the offeror. Id.
\textsuperscript{436} For the Chinese, once a relationship is believed to be established, the obligation to help each other would arise. The Chinese notion of reciprocity based on \textit{guanxi} differs from Western reciprocity which relies on a "natural give-and-take." Lucian W. Pye, The China Trade: Making the Deal, in The Art of Business Negotiation 79, 83 (1991).
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ments the principle of ‘familiarity’ and the orientation toward relying on others. One’s attempt to renege on a reciprocation duty leads to loss of face in the eyes of the public.

Private practice of guanxi in the domestic context was denounced in official state discourse because it was thought to undermine state power. The Chinese also avoided mentioning the subject because they felt culturally embarrassed about its feudal origin. They have, however, lavishly talked about friendship with foreign businesses since the country’s opening up in the late 1970s. Tax preferences were part of Chinese efforts to seek friendship and closeness. By referring to international practice and the capitalist concept of profit, the Chinese could get closer to foreign businesses. Tax benefits were seen as gifts which could be used to build a relationship. Whether foreign investors actually came to China or even expressed an interest in doing business with the country, the Chinese claimed them as friends and hoped to tap foreign capital and technology continuously. Investors could interpret tax reductions and exemptions as reciprocation for their friendly acts of investing in the country.

In any event, foreign investors were expected to take into consideration their Chinese friends’ interests and concerns and refrain from behaving as if they were solely profit-motivated.

Like generosity, guanxi values the importance of rituals and gesture. Both traditions stress sincerity and appeal to the sense of obligation rather than pure profit motivation. If the parties were solely profit-motivated, they could only have “impersonal money relations.” Those involved in an impersonal money relation only valued the exchange rather than the parties themselves. The gift in a guanxi relationship was, on the other hand, “a medium for introducing the personal substance of its donor into the person of the recipient.” The instrumentalist nature of the gift was so carefully disguised that the parties would pay very little attention to its economic benefit; instead the the recipient was to appreciate the donor’s sentiments.

437 YANG, supra note 426, at 139.
438 Id. at 140. Another important reason cited for the obligation to repay is a sense of self-interest as someday one may need to rely on that relationship again. Id.
440 In his studies on business negotiations between the Chinese and Westerners, Professor Pye has found a strong cultural influence of the guanxi approach. See PYE, supra note 187, at 101-04; PYE, supra note 436, at 80-83.
441 Tax benefits accorded to economically depressed foreign investment projects were presented, for instance, as an indication of Chinese chengyi or sincerity to foreign businesses. ZHANG, supra note 295, at 178.
442 YANG, supra note 426, at 123.
443 Id. at 195.
that the gift expressed.\textsuperscript{444} After showing their sentiments, the Chinese expect reciprocation. Like the idea of generosity, the friendship/relationship approach shifts the blame of the foreigners’ lack of enthusiastic response to the country’s opening up to the foreigners themselves. Again, there is no way to objectively measure the friendship/guanxi building efforts. Only the Chinese can declare when their efforts were sufficient or when such friendship came into being.

The relationship approach may have a special appeal to businesses with ethnic Chinese backgrounds.\textsuperscript{445} Familiarity with the approach already existed through common ethnic and cultural backgrounds. Because Overseas Chinese businesspeople were affected by the Communist Party’s previous harsh policies, gestures such as granting preferential treatment acted as implied apologies and compensation for past ill-treatment. Once the government made those gestures, it believed ethnic Chinese were likely to respond. They were supposed to show a strong attachment to their ancestral land even after they had lived elsewhere for years, decades or even generations. In fact, after the country was opened up in the late 1970s, Overseas Chinese returned to their native villages and hometowns for sentimental as well as business reasons. The feeling was mutual. Provincial and local officials similarly preferred to deal with native sons and daughters. The 1985 Regulations on Preferences for Overseas Chinese Investment sanctioned local efforts to beef up guanxi with Overseas Chinese by authorizing provincial and local authorities to adopt detailed measures implementing special tax preferences for Overseas Chinese investors.\textsuperscript{446} Special treatment seemed natural also because ethnic Chinese businesses probably expected the country’s government to offer rewards for their patriotic deeds of investing in their home country.

While the generosity, moral example and state coercion paradigms are unilaterally based on the Chinese State, friendship/relationship depends more on the emotion and familiarity of both of the parties. The investors are expected to confer special advantages upon local governments and officials. The friendship/relationship approach helped promote the regional development strategy. During the 1980s and early 1990s, foreign investment was introduced on a regional priority basis to produce quick results that addressed political and social stability concerns. Consequentially, the government spawned various regionally-based preferential schemes. Under the Chinese tax system, only the central authorities have the power to adopt and

\textsuperscript{444} The value of the good and service given by one party to another in a guanxi relationship is often very subjective, and a number of elements must be taken into account, including the timing and availability of gifts and the status of the person making gifts. \textit{Id.} at 143.

\textsuperscript{445} For Hong Kong business people’s use of guanxi when doing business in China, see T.K.P. Leung et al., \textit{A Study of Hong Kong Businessmen’s Perceptions of the Role [of] “Guanxi” in the People’s Republic of China}, 15 J. BUS. ETHICS 749 (1996).

\textsuperscript{446} 1985 Regulations on Preferences for Overseas Chinese Investment, \textit{supra} note 4, art. 9.
amend tax law, including preferential tax treatment. Centrally-issued tax measures were inadequate, however, to build a relationship with foreign businesses because localities could claim and depend upon the businesses for their own benefit. In relationship building, gifts or gestures of friendship symbolized the donor's "regard," "sentiment" or "spirit" and those symbols were tied to the person of the donor. Tax preferences announced by Beijing represented the "sentiment" or "spirit" of the central government, not necessarily that of locals. It was therefore important for local authorities to express their own "sentiment" or "spirit" to potential investors. After Beijing's approval of a new regional priority and preference scheme, it was almost a ritual for the provincial and municipal authorities to announce their own regulations which incorporated centrally-promulgated preferential treatment. Many of the provincial and municipal tax preferences were technically redundant and legally unnecessary, but they were indispensable symbols of local sentiments to foreign businesses. The national and local authorities have routinely promised similar and overlapping preferences. Repetitive preference rules and regulations not only enhanced the image of generosity but also contributed to the building of

447 This centralized tax system was established in 1950 by the Principal Rules for the Implementation of the National Tax Administration (Quanguo Shuizheng Shishi Yaoze), adopted by the Seventeenth Session of the Government Administration Council on January 27, 1950 and promulgated on January 31, 1950, available in 1949-1950 FALING HUIBIAN 283. Previously, tax legislation and collection powers had been invested with regional governments. The Chinese centralized tax power as established in 1950 applies to both national taxes and local taxes. Issues concerning the types of local taxes and the way they should be collected fall within the central government's authority. The central government may authorize, however, local governments to act with regard to specific local tax matters. For instance, the 1991 UTL authorizes provincial governments to waive or reduce local income tax of FIEs. UTL, supra note 67, art. 9. In practice, local governments can issue rules and regulations on tax matters. If local rules and regulations conflict with the central power, they are technically invalid. See John S. Mo, Taxation Power and Invalidity of Certain Local Tax Concessions in China, 26 INT'L LAW. 933 (1992). The central government may tolerate technical violations if locally-provided tax benefits are supported by local revenue. Zhang Fuzhen, Woguo Shewai Shuishou De Yuanze Ji Tedian [Principles and Characteristics of Foreign Taxation in Our Country], CAIZHENG YANJIU ZILIAO [FINANCE RESEARCH MATERIALS], Aug. 10, 1993, 19, 20 (local tax preferences in violation of national law could be tolerated if they took the form of reimbursement from local revenue).

448 YANG, supra note 426, at 195.

449 As far as FIEs are concerned, only exemptions from or reductions in local taxes fall within the provincial or municipal government powers and local regulation to that effect is legally required. See UTL, supra note 67, art. 9.

450 The fact that provincial or municipal authorities can issue preferential measures in their own names denotes local autonomy to deal with foreign businesses. This provides an additional reason for those who appreciated Chinese guanxi practice to enter into a local relationship. A good guanxi relationship does not always depend on whether the other party is a high ranking official, but more on whether the person is directly in charge and, therefore, in a better position to help. See YANG, supra note 426, at 73-74.

451 For examples of overlapping national, provincial and local preference regulations, see, e.g., supra notes 100-103 (SEZs); note 139 (Pudong); note 181 (PEEs and TAEs).
guanxi, because relationships in the Chinese context must be reaffirmed time and time again. The act of reaffirmation reminds foreign businesses of friendship and good feeling between the parties and also, of course, how foreign investors should behave towards their Chinese friends.\footnote{As Professor Pye commented on business negotiations between U.S. and Chinese businesspeople, the reaffirmation of a relationship as part of the Chinese rules enhances the Chinese claim for friendship to exact more favors from foreign parties. \textit{See PYE, supra} note 436, at 80-81.}

The friendship/relationship approach has not been without its problems, however. Particularistic treatment in favor of ethnic Chinese investors might create diplomatic implications\footnote{\textit{See supra} note 195.} and has certainly resulted in administrative confusion.\footnote{It was complained that the 1985 Regulations on Preferences to Overseas Chinese Investment created confusion as overseas Chinese investors, no matter where they invested, received more tax benefits than foreign investors even in SEZs. It was also difficult to distinguish overseas Chinese investment from other foreign investment as many investors were companies, rather than individuals. \textit{Ruhe Jianli Jingji Tequ He Shewai Shuizhi Tixi De Yanjiu Baogao [A Study Report on How to Establish Special Economic Zones and Foreign Related Tax System]}, \textit{CAIZHENG YANJIU ZILIAO}, Feb. 6, 1987, at 38, 42-43.} For these reasons the government has avoided special tax treatment for ethnic Chinese investors in recent years, at least at the national level.\footnote{\textit{See supra} note 197 and accompanying text.} Moreover, local officials attempted to build ties with foreign businesses, which might work against the state’s interest. The lure of benefiting from a regional development priority scheme was irresistible and the over-enthusiasm of local authorities could undermine the national leadership’s strategy.\footnote{Local officials have sought priority status by proclaiming the establishment of local economic and technological development zones and promising tax preferences for foreign investment within their jurisdictions. In the early 1990s, 26 provinces and municipalities self-proclaimed 2025 economic and technological development zones covering a total area of 9558 square kilometers. \textit{See Hu, supra} note 183, at 210. Local initiatives irritated the central government as the proliferation of preferences could divert attention from SEZs, ETDAs, OUDs and other existing preferred areas, and thwart the objectives of the regional development strategy. As a result, the central government took steps to crackdown on local economic and technological development zones. Notification of the State Council for Strictly Controlling the Approval and Earnestly Cleaning Up Various Development Zones (Guowuyuan Guanyu Yange Shenpi He Renzhen Qingli Gelei Kaifaqu De Tongzhi), Apr. 28, 1993, \textit{in 1994 Y.B. SEZs & OPEN AREAS, supra} note 89, at 52. Only 470 local economic and technological development zones covering a total area of 3238 square kilometers survived the crack-down. \textit{Hu, supra} note 183, at 210; \textit{see also} Verma, \textit{supra} note 157, at 22 (the State Council in early 1994 closed about 1,000 local industrial zones).} Self-proclaimed tax preferences by local officials threatened the central government’s political authority as well as its revenue base.\footnote{Cases of self-proclaimed tax preferences included the reduction of enterprise income tax to five percent for productive FIEs, extension of tax holidays for one or more years, and promised tax exemptions through the end of JV contracts. \textit{See Lin Rongsheng, Shiying Duiwai Kaifang Xin Xingshi Jinyibu Zuohao Duiwai Shuishou Gongzuo [Adjusting to the New Situation of the Opening Up and Further Improving Foreign Taxation Works]}, \textit{in COLLECTION OF TAXATION DOCUMENTS, supra} note 211, at 904, 908.} Autonomy emboldened localities to act without regard to national
It was believed that foreigners' misconduct was made possible because of the localities' failure to stick to the central policy and maintain an appropriate degree of control. There were even signs of "conspiracy" between local officials and foreign interest to the detriment of the state. In foreign dealings, just as in the domestic context, guanxi cuts across the authority of the state — more precisely, that of the central government. The priority status and "special policies and flexible measures" were sometimes used for the benefit of the localities only and, even worse, turned "state power" into "official power," exercised for the gain of an individual local official. The central government also feared that for-

458 Some local officials were eager to attract foreign investment and went so far as to suggest that the very existence of taxes hampered foreign investment and technology transfer. Thus, they set obstacles to tax collection. In one case, a city official prevented collection of taxes from a foreign investment project for over a year. Id. at 792.

459 Local officials were blamed for failing to supervise and control FIEs and turning a blind eye to illegal activities. Pan Liyun, Dui Lianyungangshi Zhongwai Heying Qye Fazhan Wenti De Tantao [A Preliminary Discussion on Development Issues of Chinese-Foreign Joint Ventures in Lianyungang City], CAIZHENG YANJIU ZILIAO [FINANCE RESEARCH MATERIALS], Nov. 8, 1986, at 15, 17-18 (lax tax supervision in Lianyungang City); Niu Guoqi, Wenti Yu Jianyi [Problems and Suggestions], CAIZHENG YANJIU ZILIAO [FINANCE RESEARCH MATERIALS], Oct. 15, 1985, at 14, 17 (lack of tax control in SEZs).

460 One serious problem identified by the Chinese concerning foreign investment has been the low ratio between the agreed-upon investment amount and the actual investment amount. According to one account, the ratio between the agreed-upon investment amount and the actual investment amount was 100:62.3 in 1987 and fell to 100:18.98 in 1992. Waizi Da Baitiao Yinqi Guanzhu [IOU by Foreign Investors Raises Concerns], SHEWAI SHUIWU [FOREIGN TAXATION], 1994 No.1, at 47, 47. One reason for this ratio was that local and departmental officials relied on the agreed-upon investment amounts to boost the record of their performance, and even conspired with foreign investors for personal benefits. Id.; see also Yin Cui & Ding Ying, Heci Chao Zhong De Biduan Ji Duice [Disadvantages and Solutions for Joint Ventures], CHANGZHANG JINLILIBAO [FACTORY MANAGERS DAILY], Oct. 15, 1996, at 10 (Chinese officials and cadres helped foreigners by "pulling" guanxi, disclosing sensitive information). It was reported that local officials forced domestic enterprises to form joint ventures without regard to the outcome of feasibility studies. Liu & Xu, supra note 318, at 12. Misconduct of local officials also included promised tax treatment in contracts with foreign businesses, which was a violation of tax law. Wang, supra note 292, at 37-38; Du, supra note 47, at 190-91.

461 From the beginning, there was a divergence between the interest of localities and the priorities of the central government. Supra note 132. As a result, the 1984 decision to open 14 COCs to foreign capital permitted the creation of ETDAs to accommodate local yearnings for hi-tech and modern sectors. This also allowed measures to help urban areas of those cities. However, a State Council's circular stressed the priority given to the renovation of state-owned enterprises in old city districts. Opening Up of Coastal Cities, supra note 118.

462 There are important differences between "state power" and "official power." As Mayfair Mei-hui Yang noted:

State power is a form of state rationality whose scope of operation and concern extends beyond the narrow class interests of official power. These two types of power formation do not represent two separate groups or institutions, but are two dimensions of power, often exercised by the same people. Officials may serve state power in carrying out its edicts, seeing to social control, and disciplining wrongdoers and even other officials. The same officials may also employ guanxi methods to promote their private gain, for they too are subjects of the state.

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eign businesses might have been trying to build relationships with local of-
ficials for their own advantage.\footnote{463}{Foreign investors invited local leaders to banquets and made business proposals during the banquets before any negotiations started. Such deals would not be challenged later on technical grounds. Liu & Xu, supra note 318, at 12. Foreign investment decisions made by local officials were sometimes based on “emotional” factors. Yantai Finance Bureau, supra note 159, at 48.}

Because local officials used tax preferences as a way to build and cement ties with overseas businesses, attempts by the central government to change preference rules encountered resistance.\footnote{464}{Local officials thought that reduction of tax benefits would raise eyebrows and might undermine the promotion of foreign investment. Just as granting preferential treatment signified a favorable attitude toward foreign investment, revocation of tax preferences might be interpreted both at home and abroad as a negative sign of policy reversal. Chinese officials understood that cuts in tax preferences would amount to policy changes and therefore would adversely impact foreign business confidence in China. Such concerns were expressed during the debate on the adoption of the 1991 UTL, and many officials opposed a provision authorizing the State Council to withdraw tax benefits from existing FIEs as a result of state industrial policy change. I Song Rufen, Canhia Li Fa Gongzuo SuoI [Notes from My Participation in Legislative Works] 277-78 (1994).}

SEZs and other priority cities in coastal areas have been zealously defending their status.\footnote{465}{“Repeated hints in the official media that Beijing may cancel low-tax advantages of special economic zones . . . met with strong local opposition.” Joseph Kahn, Beijing Struggles to Stem Slide in Taxation Power, ASIAN WALL ST. J., July 24, 1995, at 1, 4.}

The Shenzhen Party secretary argued, for instance, that SEZs should be able to continue developing themselves and for that purpose their priority status must be maintained.\footnote{466}{Jin Chenglong, Zhongguo Jinji Tequ Jiben Zhengce Bubian Yixie Juti Bushu Jiang Tiaozheng He Wanshan [Basic Policy Regarding Chinese Special Economic Zones Remains Unchanged, But Some Arrangements Will Be Made and Ameliorated], JINJI YU FALU [ECONOMY AND LAW] (HK), Feb. 1996, at 30, 30. SEZs have been trying to maintain their preferential policies. See Shao Mingjun & Liang Youping, Liang Shui He Yi De Ruoqian Si-\n\nsiao [Reflection on the Merger of Two Taxes]; SHEWAI SHUIWU (INT’L TAXATION IN CHINA), 1996 No. 3, at 8, 9-10 (tax preferences in SEZs are needed to facilitate economic integration with Hong Kong).}

\footnote{467}{See, e.g., Li Xiuheng, Difang Zhengfu Buman Quxiao Jinkou Shebei Mianshui Youhui [Local Governments’ Discontents for the Abolition of Tax Exemptions for Imports of Equipment]; Xin Bao (Hong Kong Economic Journal), June 3, 1996, at 16 (municipal governments in the Pearl River Delta region complained about the move).}
zones\textsuperscript{468} in which tax exemptions for imports survived after April 1, 1996. The central authorities have permitted compensatory measures to offset the impact of tax change on foreign investment\textsuperscript{470} because prosperous SEZs and coastal areas epitomize the success of the country's opening up policy. On the other hand, not all aspirations of SEZs and coastal areas can be accommodated. Local requests for the status of free port were turned down, for instance.\textsuperscript{471} In return, Beijing has agreed to keep regional preferential schemes for the time being.\textsuperscript{472} Localities seeking to attract foreign investment through tax preferences are by no means limited to SEZs and coastal areas.\textsuperscript{473} Officials in interior provinces have been just as eager and

\textsuperscript{468} See Ripe for Investment, supra note 153, at 9 (Shenzhen is doubling the area of one of its two bonded zones and looking to set up a third); Shenzhen Lantian She Baoshuigu [A New Bonded Zone at Lantian Gang, Shenzhen], MIN BAO (MING PAO) (HK), Oct. 10, 1996, at A11 (a third bonded zone in Shenzhen was approved). With the abolition of import tax exemptions, it was reported that foreign investment in bonded free trade zones surged. Elaine Chan, Investment Surges as Taxes Rise, S. CHINA MORNING POST, Oct. 14, 1996, Business, at 3 (increased foreign investment in Tianjin bonded zone); see also Agnes Cheung, Shenzhen Fights For Investment Edge, S. CHINA MORNING POST, Apr. 9, 1996, at 7 ("Shenzhen is pressing for central government approval of incentives aimed at keeping the special economic zone competitive in attracting foreign investment" as well as incentives for opening the domestic market and lowering project service charges).

\textsuperscript{469} For various advantages of free trade zones, see also Anne Stevenson-Yang, Quiet Incursions, CHINA BUS. REV., Sept.-Oct. 1996, at 36.

\textsuperscript{470} See, e.g., Willy Wo-Lap Lam, SEZs Again Seen as Economic Beacons, S. CHINA MORNING POST, Dec. 20, 1996, at 12 (Shenzhen was given experimental enterprises grouping with the creation of an industrial village, a hi-tech park and an estate for privately owned hi-tech firms). As recently as April 1997, one year after the 1996 sweeping change in import tax, the Guangzhou municipal government apparently got approval from the central authorities for import tariff cuts for foreign investment projects. Cheung Lai-Kun, Tax Breaks Approved, S. CHINA MORNING POST, Apr. 30, 1997, Business, at 6.

\textsuperscript{471} Shenzhen long hoped to obtain a free port status comparable with that of Hong Kong, but Beijing rejected the idea. Jin Ziyian, Ziyougang Meng Cheng Paoying [The Dream of Becoming A Free Port Did Not Come True], MIN BAO (MING PAO) (HK), Jan. 27, 1997, at A12; see also Free Port Status Ruled Out, S. CHINA MORNING POST, Jan. 27, 1997, Business, at 3.

\textsuperscript{472} Despite the warning that SEZs may lose their tax preference status, the Shenzhen Party secretary got assurance from the central authorities that "the policies towards special economic zones will remain unchanged and the 15% corporate tax rate for foreign joint ventures will be kept." Cheung, supra note 468. Zhuhai, another SEZ adjacent to Macau, was reported to reduce enterprise income tax to the limit allowed by the state in order to attract or retain foreign investment. Zhuhai Youhui Waishang Dijia Jiang Wucheng [Zhuhai Grants Preferences to Foreign Businesses and Land Price Reduces by 50%], MIN BAO (MING PAO) (HK), Sept. 12, 1996, at A15. There have been reports that under pressure of the coastal regions, the central government may even reconsider its previous decision to revoke import tax exemptions. Renee Lai, Second Thoughts on Tax Exemption, S. CHINA MORNING POST, Aug. 8, 1997, Business, at 5. As one official admitted, SEZs still "excel in many areas including lower import tariffs, foreign trade and finance." Xiao Yu, SEZs Continue to Hold Key for Reform Drive, S. CHINA MORNING POST, Feb. 5, 1997, at 7.

\textsuperscript{473} For other coastal preferential schemes, see Waishang Touzi Jin Jiaotong You Youhui [Preferences for Foreign Investment in Transportation in Tianjin], MIN BAO (MING PAO)
aggressive in pushing for special tax and non-tax privileges as their coastal counterparts.474

V. ECONOMIC EFFICIENCY AND CHINESE ASSUMPTIONS

Advocates of the concept of economic efficiency as used in Western literature claim that market forces are the only efficient way to allocate resources.475 This market efficiency view strongly militates against government intervention in a free market, including government manipulation of tax law.476 Perfectly competitive markets are presumably the only way to achieve the optimal allocation of resources in a society. As tax incentives are intended to affect resource allocation by deviating from market principles, they are objectionable per se.477 In contrast to the market efficiency view is what is called "technical efficiency" 478 which accepts government intervention in the economy and does not bar tax incentives. According to the technical efficiency view, the issue is one of cost/benefit analysis: whether a tax incentive is the "cheapest way the government can induce" the particular economic behavior it is seeking.479 The objectives of business

(HK), Sept. 6, 1996, at A13 (a five-year income tax exemption followed by another five-year 50% reduction granted to foreign investments in transportation by the city of Tianjin).


475 There appear to be three different notions of efficiency as applied to the analysis of tax incentives. The first one is called "universal market efficiency" which assumes that perfectly competitive markets would lead to the optimal allocation of resources in a society. Edward A. Zelinsky, Efficiency and Income Taxes: The Rehabilitation of Tax Incentives, 64 Tex. L. Rev. 973, 980-86 (1986). Those who doubt the existence of such markets might prefer the concept of "sectorial efficiency" which focuses on "discrete parts of the economy to determine if profitability could be increased or consumers' choice improved as between them." Id. at 986. Like universal market efficiency, however, sectorial efficiency concludes that "the government ought not be intervening in the economy at all." Id. at 987; see also Edward McCaffery, Tax Policy under a Hybrid Income-Consumption Tax, 70 Tex. L. Rev. 1145, 1155 (1992) (the most common meaning of the word "efficiency" refers to "the neoclassical economic ideal involving the allocation of resources in society"); Stanley A. Koppelman, Tax Arbitrage and the Interest Deduction, 61 S. Cal. L. Rev. 1143, 1188 (1988) ("efficiency refers to an allocation of resources under a perfectly competitive market"). The third notion of economic efficiency refers to "technical efficiency." See infra notes 478-82 and accompanying text.

476 Zelinsky, supra note 475, at 981 (universal market efficiency) & 987 (sectorial efficiency).

477 Id. at 980-92 (discussing arguments and analyses against use of tax incentives).

478 Id. at 992.

479 Id. at 992; see also Roger Cowie, Using Tax Incentives to Improve American Competitiveness: A Framework for Normative Analysis, 31 Am. Bus. L. J. 417, 440 (1993) ("The primary concern with technical efficiency is determining which element of net taxes (i.e.,
tax incentives in the West are defined in terms of economic growth, stability, and structural changes in regional development, sectorial orientation and asset composition. Tax incentives are efficient if they actually induce desirable changes with minimum cost. If a tax incentive merely rewards business activities which would have taken place anyway, the government has acted inefficiently. Profitability and investment decisions may be influenced by a myriad of factors such as the investor’s assessment of market conditions, or the availability of credit, raw materials, labor, utilities, transportation, distribution facilities, and qualified professional, technical and managerial staff. As a result there have been tremendous doubts as to how tax incentive legislation could remedy deficiencies related to such factors. A causal link between tax treatment and investment decisions is always difficult, if not impossible, to prove.
For some, absence of proof indicates that tax incentives are generally inefficient.\textsuperscript{485}

For others, "[i]n a world of uncertainty and imperfect information, a world in which most significant policy decisions rest on assumptions and conjectures, certain reasonable suppositions lead to the conclusion that tax incentives can serve the cause of efficiency."\textsuperscript{486} Based on these suppositions and conclusions, politicians and government officials pass tax incentive legislation for political purposes. Taxation is "one of the range of governing instruments at the disposal of government"\textsuperscript{487} and can be utilized "to maintain the acceptability and influence of the governing party with important segments of opinion."\textsuperscript{488} Business demands as well as competitive moves by neighboring states have aroused and influenced domestic political pressure. The adoption of incentive measures represents a positive sign, both internally and externally, of governmental efforts and attitude toward business. Internally, "[t]he offering of incentives, and the consequent successful recruitment of a new corporation, give the appearance that the administration is doing something to help the state."\textsuperscript{489} Externally, tax incentives could create an impression of a favorable investment climate as that in neighboring states and municipalities.\textsuperscript{490} Only a government that is friendly to foreign businesses is thought to grant tax concessions and the enactment of tax incentive legislation is seen as prima facie evidence of a favorable official disposition toward private investors.\textsuperscript{491}

\textsuperscript{485} As one scholar argued:

The fact that there might be an observed negative relationship between taxes and net profits does not necessarily imply a causal relationship between taxes and FDI. Even an observed negative relationship between taxes and FDI would not imply a causal relationship. Taxes and FDI might be functionally correlated, but they are not necessarily causally related. Statisticians, for example, would consider correlation between two or more variables to be causally related if the system were entirely linear and one identified all the influences within that system.

Yelpaala, supra note 293, at 379 (emphasis in original).

FDI is short for "foreign direct investment." Yelpaala, supra note 293, at 365. In the Chinese context, the definition of FDI has usually been broad, "embracing not only investment in equity joint ventures (JVs) and wholly foreign-owned ventures (WOVs) but also the use of foreign funds for co-operative ventures (CVs), cooperative development of oil resources, compensation trade and on some occasions even processing and assembly arrangements." Cohen & Valentine, supra note 11, at 163 n.3.

\textsuperscript{486} Zelinsky, supra note 475, at 977.

\textsuperscript{487} Bird, supra note 479, at 59.

\textsuperscript{488} Id.

\textsuperscript{489} Id.

\textsuperscript{489} Kolesar, supra note 291, at 307.

\textsuperscript{490} Id.

\textsuperscript{491} See generally Heller & Kauffman, supra note 291, at 60-65 (discussing the role of tax incentives in improving investment climate). In fact, the belief that tax incentives would help induce investment decisions was so strongly and widely shared that politicians and legislators never ceased their efforts to attract investment inflows through fiscal measures. Yelpaala, supra note 293, at 380.
The Chinese were aware of efficiency arguments against tax incentives as early as the late 1970s.\textsuperscript{492} Economic efficiency, which relied on market forces and opposed the role of government in resource allocation, was ideologically out of place in China. As to technical efficiency, like their counterparts in the West, Beijing policy makers have been interested in the achievement of their policy goals. Decision making in China traditionally relied on an "extensive use of general criteria of choice ... that were passed down from the central party and government organs as general directives,"\textsuperscript{493} and substitution by "ideological values ... for objective engineering or economic standards of choice."\textsuperscript{494} As noted, political power in China was "a vital matter ... for all welfare and human concerns," and Chinese officials "found it painfully difficult to accept economic theory as a proper element in the determination of policies and priorities."\textsuperscript{495} Naturally, "skilled economists have won little power or respect and the political leaders are nearly illiterate in economic theory."\textsuperscript{496} The Chinese leadership's policy decisions, like its tax preference rules, were not supposed to be questioned on technical grounds or by neutral standards;\textsuperscript{497} it was a political choice to attain policy objectives while bearing high fiscal cost,\textsuperscript{498} and the government had to follow with economic measures to implement the political decision.\textsuperscript{499} Chinese economists and tax experts might also feel reluctant to talk about efficiency for cultural reasons. Under the friendship/relationship approach, for instance, the Chinese were supposed to seek long-term commitments from parties. A meticulous economic calculus would violate the spirit of friendship and guanxi. In the art of guanxi, it would be better for a party to be the donor without an immediate full return.\textsuperscript{500} The expectation for an immediate full return could demean the relationship into “an overt instrumentality of ‘buying and selling’” and run

\textsuperscript{492} Pomp & Surrey, supra note 21, at 12.

\textsuperscript{493} Riskin, supra note 32, at 83 (such general criteria were “that industry should support agriculture, that each locality should strive to build up a comprehensive and relatively independent industrial system, that rural incomes should be distributed basically according to work done and secondarily on a per capita ‘supply’ basis”).

\textsuperscript{494} Id. at 84.

\textsuperscript{495} Pye, supra note 331, at 25-26.

\textsuperscript{496} Id. at 26.

\textsuperscript{497} Although the post-Mao leadership disfavored policies and ideologies associated with the Maoist development model, Demberger, supra note 32, at 35-72, the politicization of economic-decision making remained largely untouched.

\textsuperscript{498} See, e.g., Fang, supra note 46, at 44; Du, supra note 47, at 192 (discussing revenue sacrifice in exchange for advanced technology).

\textsuperscript{499} It is interesting to note that the Chinese word for “economy” is \textit{jingji} which is short for \textit{jingshi Jimin}, which literally means “to order the world and succor the people”; the concept of economy in China is therefore inextricably tied with the social order and the function of the state. Gernet, supra note 341, at xxxi. Unlike other civilizations, the Chinese have never separated economy from political authority. Pye, supra note 331, at 24-26.

\textsuperscript{500} See Yang, supra note 426, at 144 (“[T]he other person owes [the donor] something, the longer the better, because [the donor is] in a superior position in future dealings.”

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counter to the main tenet of a guanxi relationship, namely, the notion that “the instrumental nature of the gift must be masked.”

Because tax benefits were presented as gifts to solicit friendship and relationship building, it would be inappropriate to ask for any short-term dollar-for-dollar returns. In short, under Chinese tradition, one should not openly calculate economic gains or losses when stressing friendship/relationship.

As stated in the August 1983 Red Flag editorial, the Chinese should treat foreigners with li and friendship even though no deal was made in the end.

Because tax preferences meant the state would forego revenue, it would be politically unacceptable to concede tax revenue to foreigners without sufficient benefits in return. Chinese officials and commentators pointed to Lenin’s support for Western firms’ participation in oil, timber, mining, and manufacturing operations in the Soviet Union in the 1920s.

They quoted Lenin who said that by allowing concessions and letting concessionaires earn profits, the Soviet Union should be able to gain much more from foreign capitalists than the other way around. To show that

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501 Id.
502 Ordering human relationship is as important to the Chinese as efficiency is to the Westerners:

Confucian rationalism puts a premium on the affective relations of human beings ...

In Max Weber’s terms, China is a “familistic state”: the family is a miniature state; the state, an enlarged family. To the Chinese, the preservation of this pattern of interpersonal relationships has long remained a matter of fundamental importance.

In contrast, Western rationalism is aimed at achieving efficiency, which refers to the relationship between effort and result, input and output. Efficiency is achieved with a small commitment of the former and a great gain of the latter. In the pursuit of efficiency, objectivity assumes fundamental importance; human emotions and human relations should not interfere with the search for efficiency. Centralization, specialization, standardization are emphasized; quantitative analysis is vigorously pursued so that everything can be measured in terms of an input-output ratio.


503 See, e.g., Red Flag Editorial, supra note 45, at 3; Yu Liangzao, You Liening Zurangzhi Sixiang Dao Deng Xiaoping Jingji Tsqu Lilun De Fazhan [From Lenin’s Ideas for Foreign Concessions to the Development of Deng Xiaoping’s Theory on Special Economic Zones], SHEHUI KEXUE YANJIU [Social Science Research], No. 6, at 50 (1996). For an English discussion of Lenin’s view on allowing foreign concessions in the Soviet Union, see Louis Fischer, The Life of Lenin 474 (1964).

504 Lenin said:

The concessionaire is capitalist. He conducts his business on capitalist lines, for profit. He is willing to enter into an agreement with the proletarian government in order to obtain extra profits, over and above ordinary profits, or in order to obtain raw materials which he cannot otherwise obtain, or can obtain only with great difficulty. Soviet power gains by the development of the productive forces, by securing an increased quantity of goods immediately, or within a very short period. We have, say, a hundred concerns, mines and forest territories. We cannot develop all of these - we lack the machines, food, and transport . . . . By “implanting” state capitalism in the form of concessions, the Soviet government strengthens largescale production as against petty production, advanced production as against backward production, machine production as against hand production.
China would gain more from opening up and from preferential treatment, the authorities sought to create the presumption that the benefits of tax preferences would induce investors to do business in China, making the country the ultimate beneficiary.505

The 1980 JVITL promised a lower rate, tax holidays and other preferences to EJVs, as most early foreign joint venturers came from Hong Kong or used Hong Kong as a springboard into investment in China. Hong Kong taxes the income and profits of its residents and corporations only if they have a local source.506 Profits from investment outside the territory are exempt from local profit taxes.507 When Hong Kong-based businesses invested in Mainland China, profits earned from China would therefore not be taxed in the territory. Moreover, Hong Kong and Overseas Chinese investors were engaged in labor-intensive manufacturing sectors. Because such projects tended to be low-profit and therefore cost-sensitive,508 preferential treatment would have had a visible impact on their bottom line. Arguably, as Hong Kong and Overseas Chinese businesses were the most likely to invest in China anyway, tax preferences intended for these investors might look redundant and unnecessary. For Chinese decision-makers, however, since Hong Kong and Overseas Chinese investors would most likely appreciate tax preferences,509 fiscal measures would not be wasted. Indisputably,


Lenin also argued: "Our existence and the hastening of our escape from a critical situation and from hunger is a gigantic force and a revolutionary factor much greater, from the view point of world economy, than the few pennies they [foreigners] will earn from us." FISCHER, supra note 503, at 474 (quoting Eighth Congress of Soviets, Dec. 21, 1920).

505 See, e.g., Qingdao Shi Guoshuju Ketizu [Study Group, Qingdao City State Taxation Bureau], Dui Woguo Shixing Shuishou Youhui Zhengce De Jidian Sikao [Some Reflections on Our Country's Tax Preference Policy], SHUISHOU YANJIU ZILIAO [TAX RESEARCH MATERIALS], Feb. 29, 1996, at 17, 17-18 (assuming that tax preference policy made great contribution to the success of inducing foreign capital to China) [hereinafter Qingdao Tax Bureau].

506 Under Hong Kong revenue law, one is liable for profits tax only if all the following conditions are fulfilled: (1) the taxpayer carries on a trade, profession or business in Hong Kong, (2) the taxpayer derives profits from that trade, profession or business and (3) those profits arise in or are derived from Hong Kong. Inland Revenue Ordinance, §14 (H.K.).

507 When business operations which give rise to profits have been conducted both within and without Hong Kong, an apportionment of profits can be done for assessment of tax liability. DAVID FLUX & DAVID G. SMITH, HONG KONG TAXATION: LAW & PRACTICE 158-59 (1996-1997 ed.).

508 For instance, export-oriented foreign investment enterprises in Shenzhen were usually small capital type, and their profit margin was below five percent. ZHANG, supra note 307, at 36.

509 For Hong Kong investors, tax incentives have been important considerations for investment decisions. See, e.g., Daniel K C Cheung et al., Taxation and Its Implication on Cross-Border Profits of Manufacturing Businesses in Hong Kong, 4 J. ENTERPRISING CULTURE 401, 408 (1996) (according to one survey, "government attitude and investment incentives" including tax incentives ranked only after the "cost" factor in impacting Hong
China's Tax Preferences to Foreign Investment
18:549 (1998)

the country's foreign investment policy direction determines tax preferences. Hi-tech investments were most likely to come from U.S., Japanese and Western European multinational companies, which as the Chinese were aware, were more interested in access to the Chinese domestic market and technology protection than in tax treatment. As hi-tech investors were less likely to react to tax preferences than investors in labor-intensive projects, there would be more uncertainty about the impact of tax treatment on hi-tech investment decisions. Because the acquisition of advanced technology is now identified as the chief goal of opening up, however, hi-tech specific tax preferences are more likely to benefit the country. The Chinese approach satisfied political needs without painstakingly establishing a causal link between tax preferences and investment decisions through rigorous analyses. It was also consistent with the cultural factors discussed. To the Chinese, tax preferences are not supposed to work only on economic grounds. Economic benefits are intermediaries that transmit Chinese virtue, sincerity, and friendly sentiments.

Only when tax benefits go to foreign governments instead of investors would preference rules cease to be justified. The 1981 FEITL provided very limited tax benefits as compared to the 1980 JVITL. The legislation was primarily aimed at foreign oil companies engaged in joint development and exploration of offshore oil and gas reserves, and seventy percent of


The Chinese might also argue that “incentives limited to particular sectors or industries will be effective in diverting capital to such industries.” MUSGRAVE & MUSGRAVE, supra note 6, at 603. The effectiveness of current attempts targeting hi-tech projects is reduced by the fact that many run-of-the-mill investments are already offered tax benefits. See Qingdao Tax Bureau, supra note 505, at 19 (discussing lack of investment in transportation, energy, power supply, communication, new-tech and other state priority sectors because of deficient preferential treatment); Yu Bo, Shewai Shuishou Youhui Zhengce De Sikao [Reflection on Foreign Related Tax Preferences], CAIZHENG YANJIU ZILIAO [FINANCE RESEARCH MATERIALS], Feb. 17, 1990, at 22, 25 (stating that preferences broadly available to all kinds of FIEs encouraged investment in labor intensive and service industries, but hindered foreign investment in state priority sectors).

See supra Part IV.

Helping financially-difficult foreign projects was an important way to show Chinese sincerity. ZHANG, supra note 295, at 178.

See supra text accompanying notes 60-66.
those investments involved U.S. oil companies. Countries like the United States have taxed the income of their citizens and corporations on a worldwide basis, including income derived from foreign investment, though they allowed taxpayers to credit domestic taxes against certain taxes paid or accrued in other countries. A host country’s lower taxes and tax holidays for foreign investors would not be accepted as a basis for the home country’s tax credit, as in the case of the United States, which has not recognized tax sparing. The tax positions of foreign companies contemplated by the 1981 FEITL were therefore different from those of investors targeted by the 1980 JVITL. If the 1981 FEITL granted similar tax benefits, the Chinese government would simply concede revenue to foreign governments which collected the difference. Tax rates for those foreign companies were therefore set at relatively high levels to minimize revenue outflows in joint oil and gas exploitation projects. Meanwhile, the 1981 FEITL legislation

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516 Under the United States foreign tax credit rule, a credit is allowed for foreign income tax paid or accrued, or for foreign taxes paid in lieu of income taxes, 26 U.S.C. §§ 901-03 (1987), the credit is allowed to American citizens, residents and corporations for foreign taxes levied directly on income received by them, like dividends, royalties or income from a branch, id. § 901; an American party can also claim a credit for any income taxes levied on the income of a foreign corporation from which it receives a dividend, id. § 902. For a discussion of the complex U.S. tax credit rule, see Elisabeth Owens, The Foreign Tax Credit (1961); Elisabeth A. Owens & Gerald T. Ball, The Indirect Credit (1975).

517 Tax sparing describes tax exemptions and reductions a country grants to encourage certain activities including foreign investment, see Stanley S. Surrey, The Pakistan Tax Treaty and “Tax Sparing,” 11 Nat’l Tax J. 156, 157 (1958), and if recognized for purposes of foreign tax credit, such forgiven or spared taxes would entitle the taxpayer to a credit in its home country, even though they were unpaid in the host country. Id. For arguments against tax sparing in the United States, see id. at 157-67.

518 See, e.g., Caizhengbu Shiwu Zongju Fuzeren Chanshu Waiguo Qiye Suodeshui Fa [A Leading Official of the Taxation Bureau of the Ministry of Finance Expounds The Income Tax of Foreign Enterprises], WENHUI BAO (WEN WEI PO) (HK), Dec. 12, 1981, reprinted in Manual of Chinese Foreign Tax, supra note 285, at 124, 129 (stating that tax must encourage foreign investment and make foreign investors profitable, but state interest must be protected against revenue losses to other governments; when it came to relationships between China and foreign investors’ home countries, China must safeguard its sovereignty and economic interest on the basis of equality and mutual benefits); Editorial, Cujin Guoji Jingji Hezuo De Xin Shui Fa [New Tax Laws for Promoting International Economic Cooperation], CAIMAO ZHANXIAN [FINANCE AND TRADE FRONT], Sept. 19, 1980, reprinted in Manual of Chinese Foreign Tax, supra note 285, at 134-36 (income tax on EJVs involved distribution between states; Chinese JVITL safeguarded state economic interest).

519 Yin, supra note 515, at 24. Those who advocated a tough position vis-a-vis foreign companies were associated with the finance and tax departments of the central and local governments. Understandably, finance and tax officials were most concerned about revenue losses as their responsibility was to insure the adequacy of tax revenue and its collection; how much tax they collected was also the indication of their job performance. For instance,
provided low tax rates to small-scale, low profit foreign enterprises, which included most investors from Hong Kong. As Hong Kong investors would actually benefit from low tax rates under Hong Kong’s tax law. The authorities created a uniform income tax regime in 1991 to replace differentiated treatment under the 1980 JVITL and 1981 FEITL. As to whether foreign investors would benefit from the 1991 UTL preferential scheme, the Chinese finance minister explained that corporate tax rates in countries like the United States came down significantly during the 1980s. Moreover, China concluded many bilateral tax treaties that recognized the concept of tax sparing and therefore allowed foreign investors...

Shenzhen tax bureau officials once opposed tax holidays for all foreign investment enterprises even though such measures were widely accepted as necessary to promote opening up. Mo Wangyun et al., *Shenzhen Jingji Tequ Caizheng Jingji Qingkuang De Kaocha* [Observation of the Financial and Economic Situations of Shenzhen Special Economic Zone], CAIZHENG YANJIU ZILIAO [FINANCE RESEARCH MATERIALS], Aug. 25, 1984, at 6, 10.

520 Yin, *supra* note 515, at 22.

521 During the early years of the opening up policy, EJVs were preferred to non-EJV forms of investment. On the basis of Eastern European countries’ experiences, the Chinese government felt more comfortable with EJVs which would provide Chinese enterprises easy access to technology, management and other skills brought in by foreign partners, see, e.g., Yang Yali, *Dui Woguo Liyong Waizi Fangshi De Chutan* [A Preliminary Discussion on Forms of Foreign Investment To Be Utilized by Our Country], CAIZHENG YANJIU ZILIAO [FINANCE RESEARCH MATERIALS], Sept. 9, 1982, at 9, 9. In contrast, WFOEs, by definition, would exclude participation by the Chinese and therefore looked less attractive in terms of technology access. See *Liyong Waizi Jige Wenti* [Some Issues on Using Foreign Investment], XUESHU YANJIU ZILIAO [FINANCE RESEARCH MATERIALS], Jan. 1, 1985, at 11.

522 Revenue concerns such as those present during the drafting of the 1981 FEITL were said to be largely resolved because corporate income tax rates had been lowered to around 34% during the 1980s in countries like the United States, Great Britain, Singapore and Malaysia. Wang, *supra* note 69.
to keep tax preferences they were entitled to under Chinese law.\textsuperscript{523} Double taxation risks were therefore much reduced.\textsuperscript{524}

VI. TAX EQUITIES, DOMESTIC DISCONTENTS AND REVENUE CONCERNS

In the West, fairness generally requires that "taxes . . . bear similarly upon all people in similar circumstances."\textsuperscript{525} The rule of horizontal equity is said not only to "offer protection against arbitrary discrimination" but also to "reflect the basic principle of equal worth."\textsuperscript{526} Because tax incentives are usually selective, they are generally considered to be against equity.\textsuperscript{527} The Chinese seemed to pay little or no attention to tax equity when they first introduced separate tax and preferential rules for domestically-owned enterprises and foreign investment enterprises. Separate preferential treatment for overseas businesses was initially thought to be practical and desirable as it allowed the government to apply "international practice" to foreign investment projects with as few domestic implications as possible.\textsuperscript{528} China's economic reform has since brought about tremendous changes to domestic enterprises.\textsuperscript{529} The development of markets and the weakening of state planning were two significant changes.\textsuperscript{530} The state no longer sets the price for goods and does not dictate wages for workers, or at least not directly.\textsuperscript{531} Enterprises have been forced to make ends meet on their own without state subsidy. The government replaced profit remittance by state enterprises with income taxes,\textsuperscript{532} which were designed to reward

\textsuperscript{523} See \textit{Zhongguo Shewai Shuishou Shiwu [A Taxation Guide to Foreigners in China]} 289-94 (Wang Xuanhui ed., 1996) (tax sparing was accepted by tax treaties with countries like Japan, Great Britain, Malaysia, Denmark, Finland, Canada, New Zealand, Pakistan, Singapore, Australia, Kuwait, Italy, South Korea; tax treaties with United States, Russia, Israel, Brazil, and a few other countries did not accept tax sparing).

\textsuperscript{524} Wang, \textit{supra} note 69.

\textsuperscript{525} \textit{Henry Simmons, Federal Tax Reform} 8 (1950).


\textsuperscript{527} See Deborah M. Weiss, \textit{Tax Incentives Without Inequity}, 41 \textit{UCLA L. REV.} 1949, 1955 (1994) (tax incentives created horizontal inequity); Yelpaala, \textit{supra} note 293, at 386 (when tax incentives were offered against domestic entrepreneurs, there would be serious distortional effects); Kolesar, \textit{supra} note 291, at 296 (the principal inequity of tax incentive programs may be that businesses that do not qualify for tax abatement are placed at a competitive disadvantage). In practice, of course, there is a question of how "similar circumstances" should be defined. Musgrave, \textit{supra} note 526, at 113.

\textsuperscript{528} See \textit{supra} notes 298-300 and accompanying text.


\textsuperscript{530} As William A. Byrd observed, as a result of the 1980s reform, "directive planning and administrative allocation of industrial goods has declined sharply, while the role of markets and marketlike mechanisms has greatly expanded." \textit{Id.} at 14.

\textsuperscript{531} \textit{Id.} at 5-9.

\textsuperscript{532} Experiments with enterprise income taxes started in 1979, and comprehensive changes occurred in 1983 when the State Council approved the Ministry of Finance's Trial Methods
good performance. It was assumed that production would respond to market demands, and managers and workers could personally benefit from the success of their businesses thanks to a liberalized incentive mechanism.\textup{333} As state protection has been reduced, SOEs have encountered tough market competition from non-state sectors, which received state encouragement. In 1985, the State Council revised the progressive income tax schedule for collectively-owned enterprises, and reduced their tax burden.\textup{334} After the Party changed the country’s Constitution to allow for privately-owned businesses in 1988, the government applied a favorable thirty-five percent income tax rate to private enterprises,\textup{335} compared with the then fifty-five percent rate for large and medium state-owned enterprises.\textup{336} Because non-state sectors are thriving, the performance of many SOEs remains dismal.\textup{337} Critics blamed disparate tax treatment for the plight of the state sector. By 1991, large- and medium-sized SOEs paid a higher percentage of their

of Li Gai Shui [Changing Profit to Tax] for State Enterprises [Caizhengbu Guanyu Guoying Qiye Li Gai Shui Shixing Banfa] on April 24, 1983,\textsuperscript{3} 1983 FAGUI HUIBIAN 132. Accordingly, all profit-making state-owned large and medium enterprises would pay income tax on their realized profit at a flat rate of 55%. Id. After-tax profit was divided into two parts: one part was to be remitted to the state treasury, and the other part would be retained by enterprises according to state regulations. Id.

\textup{333} Chinese enterprises have since demonstrated a strong orientation toward profits and “profits were valued primarily because they could be used to improve workers’ living standards, through bonuses, welfare, and enterprise-provided housing.” BYRD, supra note 529, at 14.


\textup{335} ZHONGGUO XIANFA [CHINESE CONSTITUTION], art. 11 (1988).


\textup{337} For a discussion of domestic enterprise income tax prior to 1993 reform, see WONG ET AL., supra note 27, at 56-59; CHINA: REVENUE MOBILIZATION, supra note 27, at 40-43.

\textup{338} Problems faced by Chinese SOEs are serious and several. One is chronic waste. According to a recent official estimate, Chinese factories have stockpiled a record U.S. $60.2 billion worth of goods, the equivalent of more than a quarter of the entire nation’s 1996 industrial output. Tom Korski, Mainland Push to Curb Massive SOE Waste, S. CHINA MORNING POST, Apr. 28, 1997, Business, at 1, 5. Another problem is worker surplus. It has been reported that China’s public sector has a surplus work force of up to 34 million or 36 per cent of the entire state payroll, and between 15 to 20 million of these workers would become unemployed by the year 2000. Tom Korski & Agatha Ngai, 20m Jobs to Go by 2000 in China’s State Sector, S. CHINA MORNING POST, May 7, 1997, at 1. Today, 43% of state enterprises employing 20 million workers are losing money; another 30% of state enterprises employing another 20 million workers are only making money through accounting manipulation; state enterprises have bank debts of more than 2,000 billion yuan. Vivien Pik-Kwan Chan, State Firms in Rush to Go Bankrupt, S. CHINA MORNING POST, May 2, 1997, at 8. State sector losses totalled 61.6 billion yuan in 1996, a 30% increase from 1995. Wang Xiangwei, China Digs Deep to Aid State Sector, S. CHINA MORNING POST, Mar. 4, 1997, Business, at 1.
profits in income tax than did the non-state enterprises.\(^\text{539}\) Differences in tax treatment between the state and non-state sectors were eliminated on January 1, 1994, when a set of uniform income tax regulations governing all DOEs, whether state-owned or not, took effect.\(^\text{540}\) Since then, the critics have shifted the thrust of their complaints to various tax and non-tax preferences benefitting FIEs.

To be sure, the government has granted tax breaks to DOEs in general and SOEs in particular.\(^\text{541}\) Overall, FIEs seem to pay less income tax than DOEs do, however.\(^\text{542}\) A comparative study has concluded that the income tax burden of FIEs is less than that of DOEs.\(^\text{543}\) While the nominal rates for both DOEs and FIEs remain the same (\textit{i.e.}, thirty-three percent — the rate for FIEs includes three percent local surtax), FIEs have enjoyed reduced rates, generous tax holidays and other preferences.\(^\text{544}\) As a result, the amount of their income tax payment for 1991 represented only 12.7\% of their profits, and, if tax-exempted profits are also included, the ratio further dropped to 8.1\%.\(^\text{545}\) While the tax burden of FIEs stayed unchanged in 1994, the actual tax liability of DOEs was estimated at twenty-eight percent

\(^{539}\) In 1991, the tax burden for large- and medium-sized state-owned enterprises was 40\%, that of collective enterprises was 25.8\% and the tax burden of private enterprises stood at 30\%. Wang Chengrao, \textit{Shilun Liangzhong Qiye Suodeshui Youhui Zhengce De Tongyi Yu Wanshan} [A Preliminary Discussion on the Unification and Improvement of Two Enterprise Income Taxes and Preferential Policies], \textit{SHUIwU YANJIU} [TAX STUDIES], 1995 No. 12, at 7, 10.

\(^{540}\) Zhonghua Renmin Gongheguo Qiye Suodeshui Zhanxing Tiaoli [Provisional Regulations of the People’s Republic of China on Enterprise Income Tax], promulgated by the State Council on December 13, 1993, \textit{TAX SYSTEM OF CHINA, supra} note 10, at 270.

\(^{541}\) For instance, domestic enterprises using certain resources for production are exempt from income tax for five years, \textit{TAX SYSTEM OF CHINA, supra} note 10, at 230-31, and a variety of domestic service enterprises enjoy income tax exemptions and reductions, \textit{id.} at 234: new enterprises in old revolutionary base regions, minority areas or economically underdeveloped areas may be granted two years’ income tax exemptions or reductions, \textit{id.} at 236: certain food producing enterprises are granted income tax exemptions or reductions, \textit{id.} at 239: enterprises listed on the Hong Kong Stock Exchange pay a reduced 15\% enterprise income tax rate, \textit{id.} at 239. Local governments also use tax reductions to help industries, \textit{Shanghai Baijia Shangshi Gongsui Huo Jianshui Cheng Ba} [Tax for A Hundred Listed Companies in Shanghai was Reduced by 18\%], \textit{MING BAO (MING PAO)} (HK), Sept. 13, 1996, at A12. Chinese domestically-owned enterprises also set up companies abroad and use such foreign companies to invest in China in order to benefit from tax preferences as foreign investment. \textit{See Shier Nian Zhongguo Liuchu Zijin 2035 Yi Meiyuan} [China’s capital outflow amounts to US$ 203.5 billion in 12 years], \textit{XIANGGANG SHANG BAO} (HONG KONG COMMERCIAL DAILY), Nov. 6, 1996, at B6.

\(^{542}\) Since 1988, however, FIEs and DOEs in Shenzhen SEZ and Hainan SEZ have been subject to the same normative and preferential treatment under the enterprise income tax and turnover tax systems. \textit{See supra} notes 103 and 214; \textit{WU SHENGWEN, SHENZHEN JINGH TEQU NASHUI SHIWU} [TAX PRACTICE IN SHENZHEN SPECIAL ECONOMIC ZONE] 63-74 (1995) (discussing various tax preferences enjoyed by FIEs and DOEs in Shenzhen).

\(^{543}\) Wang, \textit{supra} note 538, at 10.

\(^{544}\) \textit{Id.}

\(^{545}\) \textit{Id.}
of their profits for the same year.\textsuperscript{456} Tax preferences favoring FIEs have been contrasted to the plight of DOEs and have been criticized as inconsistent with the development of a socialist market economy.\textsuperscript{457} While many other factors may have contributed to DOEs' dismal performances, disparate tax treatment has received the most criticism. Take, for example, the tax exemptions enjoyed by FIEs for imports of capital goods. An original purpose of import tax exemptions was to reduce foreign investors' start-up costs so their contribution in kind could be brought into China duty-free and tax exempt.\textsuperscript{458} Because DOEs were not generally offered similar benefits, the abolition of import tax exemption for FIEs "was necessary to create a level playing field as China progressed toward a market economy."\textsuperscript{459} Moreover, the tax breaks discouraged purchases of capital goods in the domestic market.\textsuperscript{460}

The Chinese use of equity arguments has a distinctive flavor of patriotism or nationalism. A strong national interest is thought to be at stake when foreign capital is perceived to have seriously menaced domestic industries.\textsuperscript{451} As SOEs constitute the backbone of the country's socialist economy and provide most jobs and state revenue, their predicaments have as many political consequences as economic implications.\textsuperscript{452} In the early years of its opening-up policy, the Chinese government assumed that the

\textsuperscript{456} Id.


\textsuperscript{458} For the impact of the abolition of import tax exemptions on FIEs' cost, see supra note 15.

\textsuperscript{459} Xiao Yu, \textit{SEZs Continue to Hold Key for Reform Drive}, S. CHINA MORNING POST, Feb. 5, 1997, at 7 (quoting vice-director of the State Council's Special Economic Zones Office who defended the April 1996 abolition of import tax exemptions).

\textsuperscript{451} As was recently observed, "cries of despair were heard from China's shipping industry, textile industry, bicycle makers, and paper manufacturers. With varying degrees of urgency, these sectors warned that their share of China's domestic market was being gobbled up by foreign firms." Ted Plafker, \textit{Repellent Sought for Blood-Sucking Pests}, S. CHINA MORNING POST, Sept. 2, 1996, Business, at 3.

\textsuperscript{452} Chinese Premier Li Peng stated that SOEs have constituted the economic foundation of socialism and that the issue of how SOEs are managed is a life and death issue for the socialist system. \textit{Li Peng Biaoshi Guoqi Guanhu Shehui Zhuyi Zhidu Xingwang [Li Peng States State-Owned Enterprises Relate to the Rise and Fall of the Socialism]}, \textit{XIN BAO (HONG KONG ECONOMIC JOURNAL)}, Jan. 27, 1997, at 10. He ruled out radical steps such as privatising large state firms and reiterated that the state would continue to financially support large state enterprises which constituted the pillar of national industry. Willy Wo-Lap Lam, \textit{Premier Rules Out Big Privatisation}, S. CHINA MORNING POST, Feb. 28, 1997, at 8.
domestic market would stay largely closed to foreign funded businesses and that any domestic sales, if permitted, would be subject to tight control. While legal and administrative hurdles blocking access to the Chinese market remain formidable to date, official rhetoric has become more flexible and increasingly concessive lately. The Chinese now accept the notion of national treatment. As domestic anxieties are addressed, however, national treatment is used as a double-edged sword. If FIEs receive national treatment in terms of market access and other benefits, tax gaps between FIEs and DOE must close. The recent use of horizontal equity in China is limited, however, to differences between FIEs and DOE, and disparate tax treatment among FIEs is not affected. The Chinese continue to take a particularistic approach in favor of certain types of foreign projects like hi-tech projects.

In the West, tax incentives are associated with horizontal inequity. For the Chinese, however, equity does not militate against tax preferences. In fact, advocates for uniform taxation of FIEs and DOE usually have assumed that, although the rules should be changed, the preferential policy would be kept. DOE have been eagerly seeking tax benefits for themselves. The domestic parties' use of equity does not lead to condemnation of tax preferences per se; it is mostly an excuse for claiming the same tax benefits given to foreign businesses. In reality, however, it is unlikely that existing tax preferences favoring foreign businesses can indiscriminately be extended to domestic enterprises. One reason is the seriousness of the revenue impact, as DOE provide the most tax revenue to the state. To achieve horizontal equity, the Chinese first have to reduce existing tax preferences favoring foreign investment. This move would also raise revenue. The 1993 tax reform was supposed to equalize turnover tax burden for FIEs and DOE and, not surprisingly, resulted in tax increases for some FIEs. The April 1996 revocation of tax exemptions for imports of capital goods sought to treat DOE and FIE equally by terminating one of the most significant tax benefits FIEs enjoyed for over a decade.

Another aspect of tax equity — vertical equity — requires "an appropriate differentiation among unequals." Vertical equity is more controversial than horizontal equity because the differentiation is made based on

553 Sun, supra note 16, at 10.
555 See Wang Xuanhui, Qian Tan Tongyi Nei Wai Liushuanshui Zhi De Biaoxing [A Preliminary Discussion on the Necessity for A Unified Turnover Tax System for Domestic and Foreign Parties], SHEWAI SHUWU [FOREIGN TAXATION], 1994 No. 4, at 7, 8 (noting that prior to the 1993 tax reform, in comparison to turnover taxes paid by DOE, some FIEs' CICT burdens were heavier, but other FIEs' CICT burdens were lighter. A unified turnover tax system was intended to even up such differences).
556 Musgrave, supra note 526, at 113.
"social taste and political debate." Prior to 1994, China had a revenue-sharing arrangement under which a portion of locally-collected revenues were set aside as the central government’s revenues. The rest went into a pool to be shared between the central and provincial/local governments according to pre-determined formulas or contracts. Under this structure, rich provinces could forego tax revenues because they shared the cost of tax breaks with the central government, whereas poor provinces had little room to maneuver because they desperately needed all the revenue they could get. Poor regions tended to view tax preferences as abuses and perversion on the part of rich provinces. Without regional preferences, rich provinces would have contributed more to the state treasury. Equity considerations argue for increasing state revenue in order to allocate more resources to the development of the interior provinces. Deng Xiaoping had assured the interior regions that the rich coastal regions, which benefited from special policies, would assist in developing other regions through increased tax payments or profit remittances to the state. Opponents to preferential treatment in SEZs and other coastal areas believed that SEZs and coastal areas failed to live up to Deng’s expectation because their contribution to state revenue remained small compared to their shares of gross national product. Direct state investments and financial support for interior provinces required more government spending, which is possible only with increased revenue. Reforming preferential schemes to increase revenue collection from coastal areas would therefore enable the state to allocate more resources for interior development.

For the central government, an approach based on equity could achieve significant revenue gains. There has been growing interest in the impact of preference rules on government revenue. Since the early 1980s, the central government’s tax revenue, as a share of the gross domestic product,
steadily declined because of tax concessions made to local governments and companies.\textsuperscript{565} The 1993 tax reform rebalanced inter-governmental fiscal relations by allocating more tax revenues to the central government.\textsuperscript{566} Customs duties, VAT and consumption taxes collected by the state customs authorities have become the fixed tax revenues of the central government.\textsuperscript{567} The abolition and phase-out of duty-free and tax-exempt imports in April 1996 were therefore expected to significantly contribute to the central government's coffers.\textsuperscript{568} The decision to end import tax exemptions coincided with a tariff reduction package,\textsuperscript{569} as some of the negative impact of the revocation of import tax exemptions on foreign investors could be absorbed by lower custom duties. Overall, the move to undo tax breaks has netted a gain to the state treasury. During the first seven months of 1996, for instance, the Chinese customs reportedly collected 47.4 billion yuan in import duties and taxes — a 27.4\% jump from the previous year — and the abolition of import tax exemptions alone brought in about ten billion yuan.\textsuperscript{570} The April 1996 decision hit coastal areas the hardest and narrowed tax gaps between coastal areas and interior provinces.\textsuperscript{571} Meanwhile it helped the state collect more tax revenues. In summary, DOEs and interior areas complain about inequities in order to advance their own claims for more resources, and the government's revenue goal has been wrapped in tax equity clothes.


\textsuperscript{566}Plan of 1993 Tax Reform, supra note 224, at 3 (the purposes of the 1993 tax reform include reinforcing the central capacity to macro-manage economy, re-arranging the fiscal relationship between the center and localities, and increasing the ratio of tax revenue in GNP).

\textsuperscript{567}See supra note 224.

\textsuperscript{568}Previous import tax exemptions, while rewarding "placing the two ends outside" projects, also discriminated against export producers relying on domestic supplies. See Sun, supra note 242, at 54 (export enterprises using domestic supplies had to pay turnover taxes whereas export enterprises using imported materials were tax-exempt). Western economists have long argued that host countries should benefit more from investments using domestic resources and materials than they would from foreign capital, which brings its own resources with it and uses the host country as a production site only. Therefore, tax incentives "should be linked to domestic value added which the foreign capital induces." MUSGRAVE & MUSGRAVE, supra note 6, at 604.

\textsuperscript{569}1995 Notification on Import Taxation Policy, supra note 14. Before the 1996 tariff cut, China's nominal tariffs on imports remained unacceptably high — 40\% on average. However, because of various duty-free and tax-exempt imports, the sums actually collected were aberrantly low. China then announced its intent to lower tariffs in a bid for membership in the World Trade Organization. After April 1, 1996, China's overall tariffs fell to an average of 23\%. Id.

\textsuperscript{570}Impact from Duty Cuts Minimal - Income from Tariffs Soars, S. CHINA MORNING POST, Sept. 2, 1996, Business, at 3.

VII. CONCLUSION

The 1995 World Bank Paper examined China’s tax preferences favoring foreign investors from efficiency and equity perspectives. It found no evidence indicating that foreign investment came to China because of the country’s tax concessions. Assuming China’s tax preferences worked effectively only for ten percent of foreign investment in the country, the paper put revenue loss at U.S. $5 billion. It believed that special tax treatment reserved for foreign firms encouraged domestic capital to go abroad and then come back as “foreign investors” to enjoy preferences, evidencing a strong case of inefficiency and waste. The 1995 World Bank Paper criticized regionally-based preferential schemes for distorting investment location decisions and fostering regional economic disparities. It also pointed out that tax preferences favoring foreign investment placed DOEs in a disadvantageous position. Findings of inefficiency and inequities led to the conclusion that the use of tax preferences as an instrument to vie for foreign investment should be phased out within the next few years.

The Chinese, however, are not ready to abandon tax preferences as an instrument to promote their opening-up policy and vie for foreign capital and technology. First, like politicians in many other countries, Chinese officials assume that fiscal measures can act as a strong incentive to affect investment decisions. This is especially true given the fact that reforms in areas such as market access will have a long way to go in order to satisfy many of the foreign demands for improvement of investment conditions in China. Moreover, as domestic and international precedents have shown, fiscal measures are an important indication of the leadership’s policy orientation and preference. An attempt to deny all tax benefits is almost certain to wreak havoc. Officials eager to attract foreign investment for local economic development would resist such an attempt. Foreign business communities would interpret the attempt as an unfavorable policy shift. The negative impact of such a move on the image of the country as well as actual inflows of foreign investment could outweigh any resulting benefits, as Chinese officials seemed to recognize when they recently decided to restore some of the import tax exemptions they had abolished just over a year before. Finally, the symbolism of tax preferences is even more significant according to Chinese culture and tradition. Tax reductions and exemptions are the expressions of Chinese sincerity, generosity and moral superiority.

573 Id. at 5-6. Relying on “international experiences,” the 1995 World Bank Paper concluded that tax preferences were ineffective in terms of attracting foreign investment because taxes represented only a small part of cost and foreign investors had to pay tax in their home countries anyway. Id. at 4, 5.
574 Id. at 4, 6.
575 Id. at 5.
576 Id.
577 Id. at 6.
For the Chinese, only if one acts sincerely and generously can one win respect, a good reputation and trust from others. Without respect, a good reputation, and trust from others, a person cannot receive outside help. As the success of the country's modernization depends on foreign assistance in terms of capital investment and transfers of technology and expertise, the Chinese people have felt compelled to demonstrate sincerity and generosity through grants of tax or non-tax benefits. Meanwhile, favors and gifts granted to foreign businesses have placed the Chinese people in a superior position for action in case foreign investors fail to meet the Chinese expectations. Fiscal sacrifices are not deadwood losses; they can be translated into political, moral and psychological advantages.

On the other hand, as recent shifts in the foreign investment policy require adjustments on preference rules, the Chinese people have been looking for new justifications. Chinese officials should have found the conceptual basis of the World Bank Paper — economic efficiency and tax equity — inspirational and helpful as many of the points that the Paper made appeared to be in line with the Party's new policy orientation. A difference between Chinese decision-makers and the authors of the World Bank paper lies, however, in their respective starting points and beliefs. The authors of the World Bank Paper started from economic concepts. The Chinese have focused on how to justify their intended tax preference law changes; the modern concepts are the means to an end. So far, the cultural traditions have escaped analysis and scrutiny thanks to an apparent agreement among many Chinese that a discussion on such a topic is as useless as it is embarrassing. If the country sticks to its path of reform and modernization as the post-Deng leadership vows, however, efficiency and equity questions would likely gain more meaningful understanding. Meanwhile, the Chinese people would better appreciate and squarely deal with the thorny issues such as differences between tradition and modernity and their implications for the country's future, which they have so far chosen to brush aside.

578 A recent study on foreign investment in Tianjin City concluded that there was a relationship between tax preferences and arrival of foreign investment, as statistics showed that ETIDA and other areas with a lower 15% rate attracted more foreign capital than the rest of the city with the 24 or 30% rate. Tang Caibin, Xiyin Waishang Zhijie Touzi Yu Shuishou Youkui Xiangquanxing De Tantao [An Investigation into the Relationship Between Luring Foreign Investment and Tax Preferences], SHUISHOU YANJIU ZILIAO [TAX RESEARCH MATERIALS], Feb. 29, 1996, at 21, 23-24. Such studies support the official position that while the past preference policy was a success, existing preferences should be changed to suit changing policy concerns.