



Title	No taxation without representation: China's taxation history and its political-legal development
Author(s)	Xu, Y
Citation	Hong Kong Law Journal, 2009, v. 39 n. 2, p. 515
Issued Date	2009
URL	http://hdl.handle.net/10722/131994
Rights	This work is licensed under a Creative Commons Attribution-NonCommercial-NoDerivatives 4.0 International License.

NO TAXATION WITHOUT REPRESENTATION: CHINA'S TAXATION HISTORY AND ITS POLITICAL-LEGAL DEVELOPMENT

■
Xu Yan*

China's ancient tax system, primarily built on land tax, suited its huge agrarian economic basis, which remained little changed for several thousand years. A variety of other taxes and revenue-like sources including the monopoly of salt and iron and compulsory labour duties were imposed as supplements to formal taxation. Informal taxation existed along with the development of formal taxation because formal tax revenues often could not meet government needs particularly at local levels. An advanced "provincial and prefectural" political regime evolved, from the time of the Qin Dynasty, to enable emperors or rulers to control the large territory. Tax administration was managed by the powerful bureaucratic government which effectively controlled nearly all aspects of state power. Yet taxation appears to have had little or no effect on shaping China's constitutional polity. Given the linkage between taxation and political-legal development in Western countries, this article examines the reason why, during the long period of China's political-legal transition, taxation failed to play a similar role in helping create a more developed constitutional polity.

Introduction

Can an examination of China's taxation history help us to understand China's taxation system and the interaction of that system with China's constitutional development?¹ The answer argued here is yes. Chinese civilisation has clearly developed many distinctive political, economic, social and legal characteristics of its own. Yet, there have also been systems (and political experience) comparable to that found in Western civilisation. Legal concepts advanced by ancient Chinese philosophers are surprisingly

* PhD (Doctor of Philosophy), Faculty of Law of the University of Hong Kong. The author owes a great debt to Professor Richard Cullen who has provided considerable encouragement and provocative ideas from the start to finish of this research. She is fortunate to have had Professor Fu Hualing as her supervisor. Helpful suggestions that arose from discussions with him were useful in structuring this article. The author is also grateful to many people who have read and offered thoughtful comments on some versions of this article. However, the author alone is responsible for any errors and omissions therein.

¹ From the point of view of Beijing, the People's Republic of China (PRC) has four jurisdictions, ie the Mainland, Hong Kong, Macau and Taiwan. Their legal systems are different and the relationship between the Mainland and the other three is complicated, especially with Taiwan. This research is focused on the Mainland and its problems.

similar to those of early Western (Greek) civilisation. Fung Yulan observed that “the great political tendency of the time [the seventh to third centuries BC] was a movement from feudal rule toward a government by rulers possessing absolute power; from government by customary morality (*li*), and by individuals, to government by law.”²

What is striking, though, is the way that through such a long complex history, China has failed to achieve a type of governance under which rulers and their governments employ their powers with some caution, and the rights of those being governed are efficiently protected. This type of governance has, however, been evolved in Western countries over the course of their history, the essence of which is constitutionalism. Although the theoretical understanding and practical application of constitutionalism vary from country to country in the Western world, this term in the Western sense generally refers to two basic maxims. One is the rule of law, which means that the law should be respected everywhere, and no one, including government, can take actions beyond the law. The other is the idea of limited government, which means that government must be controlled by a system of laws and be accountable, in accordance with laws, for its illegal or unconstitutional acts – and for poor general performance (often, but not always through a form of democratic-representative government).³ To some extent, the latter lays down a solid foundation for the former; if government is unlimited, the rule of law is likely to be severely damaged.⁴

The constitutional history of Western countries clearly shows that taxation played an indispensable role in building modern constitutionalism and shaping ideas of limited government. Many studies have found that the modern constitutional polity emerged in early modern Europe when

² Fung Yulan, *A History of Chinese Philosophy* (Peiping: Henri Vetch, 1937), p 312. In this book, Fung introduces the treatise of Kuan Chuang as evidence to illustrate his view. However, Fung also adds that what *Kuan-tzu* said is an ideal which has never been actually attained in China.

³ Hong Kong in the past World War II period under British rule until 1997 and under Chinese rule seems provide an example of constitutionally accountable but non-democratic government. See Yash Ghai, *The Past and the Future of Hong Kong's Constitution* (London: School of Oriental and African Studies, London University, 1991); and Yash Ghai, *Hong Kong's New Constitutional Order: the Resumption of Chinese Sovereignty and the Basic Law* (Hong Kong: Hong Kong University Press, 1997).

⁴ “Rule of law” is an “essentially contested concept”. Peerenboom categorises it into two types, thin and thick. He explains that “[a] thin theory stresses the formal or instrumental aspects of rule of law”; it requires “procedural rules for law-making and laws must be made by an entity with the authority to make laws in accordance with such rules to be valid”; it also requires publicly promulgated laws, knowable in advance, that are generally prospective not retroactive, relatively clear, consistent with other laws, and not subject to rapid changes. Thick conceptions begin with the basic elements of a thin concept of rule of law but then incorporate elements of political morality such as particular economic arrangements (free-market capitalism, central planning, etc), forms of government (democratic, single party socialism, etc), or conceptions of human rights (liberal, communitarian, “Asian values”, etc). He maintains that contemporary China is in the midst of transition toward some version of a thin “rule of law”. See Randall Peerenboom, *China's Long March toward Rule of Law* (Cambridge: Cambridge University Press, 2002), pp 3, 6.

monarchs in England, France and the Austro-Hungary Empire were forced to surrender part of their absolute power to parliamentary institutions most of all in exchange for the agreement to impose new taxes. The War of Independence of the American colonies was directly triggered by the British government's attempts to raise new revenues from the American colonies, which ultimately led to independence and the first modern, written constitutional-based government in the US.⁵ As Brennan and Buchanan argue, constitutional government arises from the efforts of citizens to constrain an absolute monarch's tax-raising powers.⁶ Monarchs' arbitrary use of taxing power aroused people to seek efficient institutions to politically protect their economic rights. It is in this sense that the achievement of constitutionalism in the West cannot be understood separately from understanding how the development of a proper tax system was crucial in helping drive wider political structure development. Nevertheless, taxation historically failed to assume a similar role in China.

What are the underpinning reasons for this failure? From the study of taxation and governmental finance in China's history, we can observe that numbers of unsolved past problems remain in existence today. The argument of this article is that the long-term early tax problems of the past have underpinned continuous difficulties in building China's constitutionalism to this day. These factors seem, too, to have helped underpin a certain remarkable, durable disability in the operation of the Chinese historical political system. This article offers a brief survey of China's taxation history in order to identify these difficulties and their effects. Part 1 briefly discusses China's political, legal and social systems with respect to the tax regime in the past. Part 2 illustrates the tax system which operated in the People's Republic of China (PRC) before reforms commenced in 1978, and the system that is effective to the present day and the enduring tax problems which are especially a legacy of time and history. Part 3 discusses certain funda-

⁵ For detailed analyses, see for example, Douglass C. North and Barry R. Weingast, "Constitutions and Commitment: The Evolution of Institutional Governing Public Choice in Seventeenth-Century England" (1989) 49 *The Journal of Economic History* 803–832; Philip T. Hoffman, "Early Modern France, 1450–1700" in Philip T. Hoffman and Kathryn Noberg (eds), *Fiscal Crises, Liberty, and Representative Government 1450–1789* (Stanford: Stanford University Press, 1994); Joseph A. Schumpeter, "The Crisis of the Tax State" in Richard Swedberg (ed), *The Economics and Sociology of Capitalism* (Princeton, New Jersey: Princeton University Press, 1991); Edmund S. Morgan and Helen M. Morgan, *The Stamp Act Crisis: Prologue to Revolution* (New York: Collier Books, 1963); Samuel P. Huntington, *The Third Wave: Democratization in the Late Twentieth Century* (Norman: University of Oklahoma Press, 1991); Douglass C. North, *Institutions, Institutional Change, and Economic Performance* (Cambridge: Cambridge University Press, 1990); and Michael L. Ross, "Does Taxation Lead to Representation?" (2004) 34 *B J Pol S* 229–249.

⁶ See Geoffrey Brennan and James M. Buchanan, *The Power to Tax: Analytical Foundations of a Fiscal Constitution* (Cambridge: Cambridge University Press, 1980); see also James M. Buchanan, *Constitutional Economics* (Oxford, UK: Blackwell, 1991); and James M. Buchanan, *Liberty, Market and State: Political Economy in the 1980s* (Brighton: Wheatsheaf, 1986).

mental, historically dominant taxation problems in China, and examines the reasons why taxation, during the long period of China's political-legal transition, failed to play a role in helping develop a modern constitutional polity. Part 4 concludes the article.

I. Taxation and Political-Legal Development in the Past

(a) *A Brief Account of the Imperial Period*

China has long relied on an agrarian economy. Land was always the first and foremost means to secure the durability of the empire. Imperial control over the state's financial resources had thus to be firm and thorough. The traditional course of its history was in perfect accord with the traditional Confucian doctrine that agriculture alone offered the necessary economic foundations of the state.⁷ The overall tax policy was either for keeping the expropriation of taxes and other charges for government operation to a minimum, or for facilitating agricultural development while reducing commerce and trade, though the specific purpose may vary from dynasty to dynasty.⁸ The main tax type was always land tax.

In the ancient period, the Zhou (1046 to 256 BC) appears to have begun its rule under a feudal system. The King of Zhou at this time, with the assistance of the Duke of Zhou, invoked the concept of the Mandate of Heaven (*Tian Ming*) to legitimate his rule, a concept that would influence almost every successive dynasty. This made it clear that the Emperor was no longer a "God", but, still, was someone permitted to rule through the Mandate of Heaven. The political institution established by the Zhou was a feudal, patriarchal clan system, which was centred on the heir-apparent. The lineage served as a differentiating standard to determine whether the relationship between the King and a man was close or distant, and whether the man was noble or base. This formed a feudal hierarchy. The noble class was ranked from the top, the King, to his vassals, the Duke, to the Duke's

⁷ Confucius said: "who, though poor, is yet cheerful, and to him, who, though rich, is devoted to following the rites [the customary morality, *Li*]. The "poor" embodies a low level of economy. The significance of "Li" is to realise the "equilibration". The Confucian doctrine maintains that the pursuit of society is to reach "peace and tranquility". The economy is necessary for the maintenance of individuals and society, but it must have a limit. Beyond the limit, the economy would do harm to individuals, society, and the state. The natural agricultural basis can provide necessities for life in the material aspect, which is the most proper form of economy. Accordingly, rulers have long been faithful in the economic policies, "abstention of cost and maintenance of limitation" (*Zhi Jie Jing Du*), and "thinking more of agriculture but less of commerce" (*Zhong Nong Yi Shang*). See *The Analects of Confucius*, No 15; *The Lektion of Fealty*, No 3.

⁸ See Wu Zhaoxin, *Zhong Guo Shui Zhi Shi [History of the Tax System of China]* (Taipei: Taiwan Shangwu Press, 1965), pp 1-7.

vassals, and to the intellectuals, who were the lowest aristocrats.⁹ The bottom of this hierarchy was the governed, consisting of the ordinary farmers, a great number of serfs, and any tribes when were conquered.¹⁰ The last two were the lowest rank of society. The governed had no rights in politics.¹¹

A land ownership system was set up to match the political features. In feudal China, owning land had been almost a religious matter, and only nobles could hold it either in fee or in domain. Nominally, the King was the owner of all land, and he had the right to enfeoff a certain estate together with a number of serfs to his vassals.¹² Thereafter, his plots were called “the King’s fields” and private serfs were to be called “private retainers”. The enfeoffed vassals had a similar right to enfeoff their plots and serfs to their liegemen within their feudatory. The farmers were serfs working part of the land for the overlord and part for themselves. Neither plots nor serfs could be bought or sold.

The feudal system just described was eventually abolished by the first Emperor of the Qin Dynasty (221 – 206 BC), who established the Chinese imperial system. This system was basically an administrative system that divided the country into 36 administrative commanderies, which operated under a tightly centralised Legalist government with the support of a professional bureaucracy. It laid the basis of China’s provincial and prefectural system (*Jun Xian*), which has endured as similar provinces to this day (for over two millennia). The Emperor tried to enforce a detailed criminal code, emphasising legalism in place of the essentially feudal customary morality. The politically sophisticated but harsh Chinese doctrine of legalism stressed strict adherence to a legal code and the absolute power of the emperor. The harsh Qin rules were soon replaced by the Han’s more moderate political governance. The Han Dynasty (206 BC – 220 AD) was the first dynasty to

⁹ See “Year Seven of Zhao Gong (Duke of Zhao)” in *Zuo Zhuan* [Chronicle of Zuo], see further “Zuo Zhuan” in Wikipedia, available at http://en.wikipedia.org/wiki/Zuo_Zhuan (accessed 28 July 2009).

¹⁰ In ancient China, people of the tribe being conquered in wars became prisoners and they might have been enslaved, though sometimes might not. When they were enslaved, these prisoners of war formed a source of slaves. The use of slaves as agricultural labour in the economic system of agricultural production of those times is however uncertain in Chinese literature. See C. Martin Wilbur, *Slavery in China during the Former Han Dynasty, 206 BC-AD 25* (New York: Russell & Russell, 1967), pp 98–117. China is, however, not historically known as primarily slave-based economy as were certain countries and regions in history. A serf was different from a slave in China in that a slave was the absolute property of his master and could be sold at will, but a serf was just an unfree farmer under feudalism who provided enforced labour on the fields of landowners.

¹¹ See Zheng Xueming (ed), *Zhong Guo Fu Yi Zhi Du Shi* [China’s Taxation History] (Shanghai: Shanghai People’s Press), p 4.

¹² Within a Chinese context, the term “enfeoff” refers to the process of investing with a feudal estate or fee from an overlord to his vassals in feudal China. See Edward Kaplan, *An Introduction to East Asian Civilizations: The Political History of China, Japan, Korea and Mongolia from an Economic and Social History Perspective* (Washington: East Asian Studies of the Western Washington University, 1997), Ch 4.

embrace the philosophy of Confucianism that provided the ideological underpinning of all dynasties until the end of Imperial China.¹³

It is worth noting that the structure of society had already grown to be quite complex by the time of the Han Dynasty. The populace was referred to as “commoners” (*Min* or *Shu Ren*), in contrast to the two higher classes, officials and aristocrats. The two lower groups were convicts and slaves. Commoners were composed of farmers,¹⁴ artisans, shopkeepers, merchants and people alike. Taxes on the common people varied greatly according to their occupation and place of residence. Aside from the land tax, a poll-tax was imposed on the average adult commoner (and children).¹⁵ Usually, farmers paid one-thirtieth of their crops. Artisans paid taxes on the number (and value) of transactions involving particular crafted goods during a given period of time. Merchants paid double poll-taxes, heavy market dues and assessments on accumulations of all property they owned including coins and goods.¹⁶

The Han government was influenced by the (new) national ideology, Confucianism, which emphasised farming as the root of the national economy. Commerce and trade were controlled to prevent mercantile growth but were allowed so as to encourage agricultural development. The economic philosophy embedded in Confucianism held that the nature of merchants was to maximise profits and engagement in trade would draw people away from the basic pursuits of life, which was unfavourable to people’s cultivation of morality and to the stability of society. This philosophy led to the perception that a money economy upset the basis of an agrarian economy. In accordance with this philosophy, the government frequently reduced taxes on farmers and imposed higher taxes on merchants. Merchants were denied, in theory, the right to hold office, and above all were prohibited

¹³ Although Confucianism is no longer officially part of Communist Party of China (CPC) and Chinese government’s policy since 1949, it has not disappeared from people’s thinking and it remains an influential ideology in Chinese society. In the 20th century, Confucianism was critically attacked as the backward and conservative tradition responsible for all China’s illness. On the other hand, it emerged in new forms tailored by modern Confucian scholars to combine the revival of Confucian values with the transformation of its doctrines in terms of other traditions.

¹⁴ There were three types of farmers, ie free farmers, tenant farmers (*Dian Nong*), and landless farmers (*Gu Nong*). Tenant farmers often had to sell their land to a rich person and worked their fields as tenants. Landless persons, usually refugees (*Liu Min*), were employed as field workers on the land of an estate owner.

¹⁵ See Wilbur (n 10 above), p 33; see also Zheng (n 11 above), pp 47–59. Zheng’s study shows that there were four types of poll-tax in the Han period. The first was levied on adult commoners, the second on children, the third was a payment substitute for the labour duty that was assigned to people of the right age to provide service in prefecture each month, and the last was a payment for frontier duty.

¹⁶ This imposition was employed to prohibit merchants, usurers and speculators from lending money or goods at exorbitant rates to ordinary people. See Zheng (n 11 above), pp 63–64; see also Wang Zhiduan (ed), *Zhong Guo Fu Shui Shi [History of China’s Taxation]* (Beijing: Zhong Guo Cai Zheng Jing Ji Publishing House, 1998), pp 36–37.

from investing in farming land which was, though not entirely effective, a serious restriction since there were few other important forms of capital investment at that time.

In addition to the important land tax, taxes on salt and iron, initiated by Kuan Chuang (725 – 645 BC), were used to encourage production of salt and iron, which became state monopolies and then traded under the control of government (by the time of the Han Dynasty). These monopolies, subsequently, evolved into an important revenue resource for following dynasties.

The political and administrative system was further perfected by formalising the national “civil service examinations” (*Ke Ju Kao Shi*) during the Sui Dynasty (581 – 618 AD) and Tang Dynasty (618 – 907 AD). The highly competitive procedure for selecting officials was designed to draw the best talent from society into government. The greater political role was, however, to create a body of competent and well-trained career officials who had no autonomous territorial or functional power base and thus would devote all their energies to making the empire work. This design lowered imperial dependence on powerful aristocratic families and warlords, and consequently lowered the risk of destabilising effects of any such dependence. This institution remained in force till the last imperial dynasty.

Although the economic philosophy and tax policy restricted trade and commerce, the door to outside exchanges did not fully close until the Ming Dynasty (1368 – 1644 AD). Quite unlike previous dynasties who relied on both commerce and agriculture to drive the economic development, the Ming's greater emphasis on agrarian sources for government income and a stricter control over maritime trade virtually led China to a state of limited seclusion until the collapse of the last dynasty, the Qing Dynasty (1644 – 1912 AD). This deliberate seclusion reflected the founding Ming Emperor's ruling ideology, that is, to secure the durability of the empire and to reduce considerable regional imbalances in the economy that had existed before the Ming, it was better to keep all provinces on the same agricultural footing for fear that some regions might grow disproportionately to threaten the empire's political unity.¹⁷ This ideology played a manifestly important role in preventing China from developing modern political and legal institutions. The Ming tax system, which was characterised by complexity and administrative difficulties, had long term consequences on its successor, the Qing, and it has even influenced modern China in many respects.¹⁸

¹⁷ See Ray Huang, *Taxation and Governmental Finance in Sixteenth Century Ming China* (London: Cambridge University Press, 1974), pp 1–2.

¹⁸ For details, see Huang (n 17 above).

(b) *General Taxation Problems During the Social Transition of the Republic of China*

The Republic of China succeeded the Qing in 1912, ending around 2,000 years of imperial rule. From the moment of its founding, the new Republic experienced tremendous political and social difficulties. It was dominated by numerous domestic warlords and divided by foreign invading powers. Its economy was in the early stages of industrialisation and modernisation, but the tax regime was extremely unstable and capricious due to continuous political and social upheaval.

Major changes in the tax system were reflected in three aspects. First, income tax, customs duty, salt tax and general consumption tax became more predominant than land tax in the tax regime. Secondly, the taxing power was decentralised from the central to local governments. Thirdly, a direct tax system was established. These changes had some merits on the surface, but the entire tax system was still underdeveloped and problematic. Inequality in land and income taxation, arbitrary imposition of charges and surtaxes, and brutal collection methods were all widespread across the country. Ordinary people suffered heavy tax burdens, especially the burden from informal taxation. Local governments operated under great financial strain because formal tax revenues were too tiny to maintain the necessary administration and therefore they had to resort to informal taxation. Informal taxes and charges like the onerous internal transit duties, *Li-Jin* and *Chang Guan Shui* (CGS), together with unequal agreed customs duty produced by unequal treaties, brought immense harm to the domestic economy and made competition between foreign and domestic merchants quite unequal.¹⁹

Basic tax laws were too vague and disordered, and even conflicted with each other, plus these were many problems with the enforcement of tax laws. Nationally, the central government failed to take account of local financial needs when allocating taxing powers. Individually, the land and income taxes were not imposed according to the economic capacity of individuals or households. Economically, different, or more correctly, unequal tax treatments applying to foreign and domestic industry and commerce greatly impaired China's national economic growth. Administratively, arbitrary tax assessment and collection as well as brutal coercion were all too common. Socially, deceit, fraud, speculation, tax evasion, and bureaucratic corruption spread throughout the whole society, indicating a serious decline of social moral standards.

¹⁹ *Li-Jin* and *CGS* were imposed on goods transported and traded within domestic areas, and they were paid every time they passed through an inland barrier (repetitive payment). Foreign merchants were exempt from these taxes. For details of Republican taxation, see Ma Yinchu, *Cai Zheng Xue Yu Zhong Guo Cai Zheng* [*Public Finance and China's Practice*] (Beijing: Shang Wu Yin Shu Guan, 2001).

Although new ideas and thoughts such as republicanism, democracy and the rule of law had been imported to China since the late Qing, the essence of the political regime was left virtually unaltered – it was still controlled by a powerful administrative bureaucracy. Even though there was an elected congress in the Republic, it transpired that it could not play a role in preventing the abuse of power.

When tax burdens become an intolerable burden and when taxation drives mass, immediate resentment, people often feel driven to overthrow the old regime. The English Glorious Revolution, the American War of Independence, and the French Revolution all proved how important equality and justice in the operation of taxation policy should be. In China, people never stopped their continuing revolt against bitter oppression in taxation. Indeed, their dashed hopes for equality and fairness in taxation during the Republic period made a major contribution to the victory of the Communist revolution.²⁰

II. Taxation in the People's Republic Of China

Since the first chairman, Mao Zedong, declared the birth of the PRC in October 1949, the new state has undergone decades of political struggle, and economic and social reform, as well as many movements that left marks inside China and internationally. Mao's first aim was to overhaul land ownership by extensive land reforms. China's old system of landlord ownership was replaced with a more equal distribution system that favoured poor peasants. Former landlords and capitalists were suppressed through various often deeply violent and disruptive campaigns in 1953. Foreign investment was largely wiped out.

Beginning in late 1978, the Chinese leadership launched significant economic reforms, which changed a Soviet-style centralised planned economy (with attendant Soviet-style revenue regime) into a market-oriented mixed economy. The reforms legalised certain types of private land ownership, increased local authorities' responsibility for industrial development, allowed a wide range of small-scale enterprises to flourish, promoted foreign investment in the economy, and relaxed price controls to a certain extent. The current Constitution of the PRC was legislated on 4 December 1982 (with

²⁰ Some studies show that during the Civil War of China, although peasants in the Nationalist areas did not rise up, they made a "real, perhaps even decisive...indirect" contribution to the Communist victory. For instance, in 1947 when nominally the Nationalist' territorial control reached its greatest extent, "the central government collected only...57 per cent of the amount collected in 1942." See Lloyd E. Eastman, *Seeds of Destruction: Nationalist China in War and Revolution, 1937–1949* (Stanford: Stanford University Press, 1984), p 85.

several modifications since), admitting the need to develop economy for the public welfare. Despite many problems arising from the mixed economy, the PRC is nowadays the second largest economy in the world (after the US) in terms of purchasing power parity.²¹

Although China needed economic growth to spur its development, the government has begun to worry that rapid economic growth would negatively affect the country's environment and the quality of natural resources. Another important concern is that large a number of people have not benefited from the economic miracle. Failures in education, housing and public health-care, along with government corruption and huge disparities in wealth distribution, have become focuses of concern for today's government and millions of Chinese citizens. How to solve these problems – and how to make China a real rule of law State with a constitutionally limited government – are key matters of political and economic concern at present. The following discussion looks at a number of these issues from a tax-constitutional perspective.

(a) Before the “Open Door” Policy: 1949–1978

The first generation of Communist leaders clearly observed that exorbitant taxes and levies capriciously and brutally collected during the Civil War were a major, if not the greatest, source of rural grievance. They thus had to differentiate their tax policies from those of their rivals. A series of efforts was made to establish a new tax regime to meet the new political situation after the establishment of the PRC. From 1950–1957, a compound tax system was built up based on sorting out the old system. The newly designed system played a significant role in increasing government revenues, stabilising the economy, and helping to achieve overall unification of the country. Sequentially, in 1958, large-scale tax reform was launched with the aim of simplifying industrial and commercial tax structures through the adoption of consolidated industrial and commercial taxes on a trial basis. However, taxation development was disrupted during the Cultural Revolution (1966 to 1976), and the simplified industrial and commercial tax system was simplified further because it was criticised as “scholasticism”.²² Many tax administration centres were closed and a large number of staff were forced to leave tax offices because they were deemed unnecessary in a simplified tax

²¹ See World Bank, “ICP 2007”, available at <http://www.adb.org/statistics/icp/icp.asp> (accessed 18 August 2009).

²² This word means that the tax system was too scholarly conservative or pedantic for ordinary people to follow. Some radicals at the time even suggested that the tax system should be abolished because all properties belong to people, and no one can get extra profits from public-owned properties. See Liu Zuo, *Taxation in China* (Singapore: Thomson Learning, 2006), pp 3–4.

regime. This reform sharply reduced the role of taxation and tax policy in the state's economy and politics.²³

In the quarter century of Maoist rule, fundamental changes took place in rural taxation. With the onset of planned industrialisation in 1953, agriculture became a major resource for investments in the urban-industrial sector. Peasants became residual claimants to the harvest after the state and collectives took their shares. Moreover, the state, through the collective system, controlled the harvest and decided not only the amount of compulsory grain (*Gong Liang*) but the amount of surplus grain (*Yu Liang*) that should be sold to the state at state-determined prices, often lower than market price. Sale of industrial goods to the countryside was however set at high prices. By means of this process, the Maoist state massively transferred resources from the countryside to the urban sector. Despite the “workers’ revolution”, the peasants, yet again, had to carry the heaviest tax burden, which did not come in the form of taxes as such but in the form of the compulsory procurement programme (and the sale of government-profit goods back to the peasantry).

Taxing power was centralised in the Maoist era. The government relied more on procurements (and sales) than direct taxation for revenue flows. Apart from individual peasants, the production team, as the major working unit of rural China, claimed a significant share of the harvest and of earnings from sales to the state. The distribution ratio among state, collectives, and individual peasants fluctuated from time to time. During the Great Leap Forward (GLF), the policy of “equalisation and transfer” (*Yi Ping Er Diao*) resulted in huge amounts of household and team resources, especially building materials, being accumulated in the higher collective and state units. It was not until 1965 that the ratio of redistribution came back to normal.²⁴ In the mid-1970s, the collective retention and government exactions however reached another new high, resembling the situation of “equalisation and transfer” during the GLF. In June 1978, a Central Committee instruction of the Communist Party of China (CPC) (Circular no. 37) was disseminated nationwide as a measure to curb tax burdens in the post-Mao era, foreshadowing the burden-reduction efforts made throughout the later reform period.

Historical examinations reveal significant similarities and differences. It can be seen how, over time, the combined burdens of formal and informal taxes fall disproportionately on grain-producing regions and peasants. Historical efforts to redesign the relationship via fiscal decentralisation often

²³ *Ibid.*

²⁴ The Ministry of Finance of the PRC (MOF), *Zhong Guo Nong Min Fu Dan Shi* [A History of Peasant Burden in China] (Beijing: China's Public Finance and Economy Press, 1991), pp 275–276.

resulted in more local taxes and levies. The main conflict, on the whole, was always between peasants and government.²⁵ Radical Maoism left large parts of rural China deeply impoverished.²⁶ The fear that peasant poverty might lead to mass migration, unrest, disturbances, and rebellion was not far from the minds of Chinese leaders, who believed in the traditional (imperial era) assumption that peasant contentment was the basis of social stability. This fear played an important role in motivating the government to launch rural reforms in the early post-Mao period, but the impact of the failure in tax policies during the Maoist era extended beyond the economic field.

(b) Major Reforms in the Tax System since 1979

With the commencement of the “open door” policy adopted in late 1978, the old and nearly paralysed tax system was revived to meet the needs of a market-oriented economy. The first priority for China’s economic reform was the Chinese peasant. In 1979, the government increased state grain procurement prices and meanwhile reduced delivery quotas, creating the incentive for peasants to sell more above-quota grain to earn more income for themselves. More importantly, the government replaced the commune system with a new household contract system that allowed households to use land for production while retaining the land ownership in the collectives. This contract system, combined with a series of liberalisation policies, unleashed the peasants’ entrepreneurial energies to develop agriculture, which led to a rapid transformation across most of the Chinese countryside. Township and village enterprises (TVEs) experienced extraordinary growth in some regions, especially in the eastern provinces and within the suburbs of major cities. The government also promoted self-management in state-owned enterprises (SOEs), increased competition in the marketplace, and facilitated direct contact between mainland Chinese and foreign enterprises.²⁷

Among a number of tax reforms since 1979, the 1984 and 1994 reforms are the two most important. Recently a new tax reform initiative commenced in 2006.

²⁵ See Kathryn Bernhardt, *Rents, Taxes, and Peasant Resistance: the Lower Yangzi Region, 1840–1950* (Stanford: Stanford University Press, 1992).

²⁶ In 1978, two-thirds of China’s 2,100 counties were less well off than they had been in the early 1950s, and in the remaining one-third, they were less well-off than they had been in the 1930s. See Yang Lianbai and Li Xuezheng, “The Relations between Agriculture, Light Industry, and Heavy Industry in China” (1980) 2 *Social Sciences in China* 182–214.

²⁷ See Thomas P. Bernstein and Xiaobo Lü, *Taxation without Representation in Contemporary Rural China* (Cambridge: Cambridge University Press, 2003), p 45.

1. The 1984 Tax Reform

This reform was aimed mainly at building and improving the income tax system applying to SOEs and other types of domestic enterprises. The enterprise income tax was introduced to China on a piecemeal basis. First, the State Council implemented a tax on the profit of SOEs in 1983. Next, the Regulations of the SOE Income tax and Regulations of SOE Regulation Tax were promulgated. These changes were characterised by a transformation of the payment from profit delivery (*li*) to tax payment (*shui*).²⁸ Later on, the Provisional Regulations on the Collective Enterprise Income Tax (PR-CEIT) and the Provisional Regulations on the Private Enterprise Income Tax (PRPEIT) were promulgated in 1985 and 1988, respectively. Under these reforms, domestic enterprises, especially SOEs, became independent producers, gaining the right to determine a variety of issues from production, investment, to employees' bonus. The system of profit distribution was changed also, which meant a recovery of the adjustment role of taxation in economy.

A formal foreign income tax structure was set up before establishing the domestic enterprise income tax system. The Income Tax Law on Chinese-Foreign Equity Joint Ventures (ITLCFE)²⁹ and the Foreign Enterprise Income Tax Law (FEITL)³⁰ were enacted by the National People's Congress of the PRC (NPC) between 1980 and 1982. The Law of Individual Income Tax (LIIT) was passed by the NPC in 1980 as an integrated part of foreign tax legislation in the reform period.³¹

These laws established a basic income tax system in China, helping improve the whole tax regime to meet the rapid economic and social changes. Over the reform period, SOEs moved from a situation in which everything was determined by government to one in which enterprise managers had substantial rights to make decisions and had begun to take responsibilities for profits and losses of the enterprise. TVEs, joint ventures, and private enterprises also gained considerable freedom in decision-making from the time they were legally allowed to exist within the state economy.

²⁸ As some scholars explained, in Chinese, profit is *li* and tax is *shui*. During the period of the command economy, when profit and tax were indistinguishable, the compound word *lishui* – basically “profit-tax” referred to the flow of funds from SOEs to the treasury. In the post-reform period, the language has reverted to *li* and *shui* to reflect the distinction between profit and tax. See Donald J.S. Brean, “Fiscal Reform in Modern China” in Donald J.S. Brean (ed), *Taxation in Modern China* (New York; London: Routledge, 1998), p 29.

²⁹ The law was passed on 10 Sept 1980. It was of no effect from 1 July 1991.

³⁰ The law was adopted on 13 Dec 1981 and was invalidated from 1 July 1991. On 9 April 1991, the 7th NPC decided to incorporate the law with the ITLCFE into the Income Tax Law on Enterprises with Foreign Investment and Foreign Enterprises (ITLEIFE), which was effective until 2008.

³¹ The law was adopted on 10 September 1980 and it has been modified five times, respectively on 31 Oct 1993, 30 Aug 1999, 27 Oct 2005, 29 June 2007, and 29 Dec 2007.

The sequence of reforms just noted created three stakeholders in SOEs and Collective Enterprises (CEs): government, enterprise managers, and employees, whose long-term interests in an enterprise may have overlapped but were not fully convergent.³² The government, as tax authority and enterprises' owner, has substantial power in decision-making which may immediately affect an enterprise's operation. Managers have their interests that may not fully coincide with those of government and employees, such as salary and promotion prospects, much the same as their counterparts in a free market, which may give rise to an "agency problem".³³ Employees began to pay attention to an enterprise's economic performance because their salaries and importantly, their jobs, depended on the success of the enterprise, which was not the case in the pre-reform period.

The SOE tax reform not only standardised the financial relationship between government and SOEs, but involved a broad structural change in China's public economy system. The responsibility for providing public services including pensions, health-care and education that had been assumed by the SOEs was passed back to the government.

In China's countryside, the 1984 reforms ended the favourable policy for peasants, and the agricultural sector was once again disadvantaged to further the urban-industrial sector, resulting in enormous growth in urban-rural income disparity.³⁴ That adverse impact has been felt across the whole tax-legal-political regime in China over the last two decades, especially. The rapid development of TVEs in the countryside was, however, remarkable.³⁵ TVEs became pillars of local economies and contributed a great deal to local revenues, though performance of TVEs varied from region to region. In some areas where TVEs were booming, tax and fee burdens on

³² See Christopher Heady and Shi Yaobin, "Marginal Effective Tax Rates in the Reformed Tax System" in Brean (n 28 above), p 70; see also Athar Hussain and Juzhong Zhuang, "Enterprise Taxation and Transition to A Market Economy" in Brean (n 28 above), p 46.

³³ The term, "agency problem", is used in political economy discourse. It refers to conflicts of interest among stockholders, bondholders and managers. The problem arises due to the separation of ownership and control of business firms. In practice, the large modern corporation has a diffuse and fragmented set of shareholders and control often lies in the hands of directors. More often, managers may use the managerial discretion to further parochial interest. Thus, the problem also refers to as the principal-agent problem. See Hussain and Zhuang (n 32 above), p 47; see also "Agency Problem" in A Glossary of Political Economy Terms, available at http://www.auburn.edu/~johnspm/gloss/agency_problem (accessed 28 July 2009).

³⁴ In 1985, a reform sought to reduce the high cost incurred by state purchasing of grain during the period from 1979–1984. This was mainly because that cost could not be transferred to urban consumers in the form of high food prices. In the following years, the grain market became a severe source of conflict between the state and peasants. See Bernstein and Lü (n 27 above), p 63.

³⁵ TVEs were more usually concentrated in the eastern belt of provinces, but less in the central and western provinces. The coastal provinces were advantaged by easier access to markets, proximity to large cities, better transportation, preferential policies (the product of the coastal development strategy of the 1980s), and availability of overseas Chinese investment, especially in Guangdong and Fujian.

farming households could be relieved to a certain extent.³⁶ But the different development level of TVEs helped lead to an imbalance in wealth distribution across the whole country: the eastern provinces were industrial China, the central province primarily agricultural China, and most western and southwestern provinces, subsistence China.

Despite the remarkable economic progress during the reform period, problems including regional and personal wealth differences and government failure in designing an institutionalised division of fiscal power between central and local governments became evidently unsustainable. The (theoretical, at least) fairness of the socialist state faded steadily. A more rule-based revenue system that was based on appropriate measures of taxable flow and the financial needs of governments was needed.

2. The 1994 Tax Reform

The “open door” economic transition helped local governments gain enormous discretion to advance their economic development agenda and to pursue their revenue mobilisation policies. The decline in central government revenues and rise in local government revenues compromised the centre’s ability to successfully implement macro-economic policies. The 1994 tax reform was therefore designed by the centre to “recentralise” fiscal power and to raise the long-run GDP elasticity of the revenue system.³⁷ A new tax assignment system was established for this aim.

The 1994 reform addressed the following issues.³⁸ First, there was an all-around reform in indirect taxes for the purpose of simplifying the turnover tax structure. It took a large step toward the aim of making the value-added tax (VAT) the principal turnover tax and phasing out old product taxes.³⁹ Before the 1994 reform, there were three types of turnover tax in China: the VAT, product tax, and business tax, which were designed at the time of converting from SOE(s) profit into collection of SOE(s) income tax. The product tax was imposed on a variety of commodities at rates ranging from 3

³⁶ Some researchers observe that highly industrialised villages were able to build infrastructure and provide free schooling, health-care, social welfare, and other benefits, sometimes on a remarkable scale. In contrast, villages without or lack of TVEs tended to remain poor. See *Nongmin Ribao* [Farmers' Daily], 26 September 1988; see also Jean Chun Oi, “The Fate of the Collective after the Commune” in Deborah Davis and Ezra Vogel (eds), *Chinese Society on the Eve of Tiananmen: the Impact of Reform* (Cambridge, MA: Council on East Asian Studies, Harvard University, 1990), pp 18, 30.

³⁷ See Brean (n 28 above), p 15. The long-term decline in tax revenues as a share of GNP, and an increasing share of revenues used for extra-budgetary purposes at the local level contributed to the overhaul of the tax regime in 1994.

³⁸ See Roy Bahl, “Central-Provincial-Local Fiscal Relations: The Revenue Side” in Brean (n 28 above), pp 136–149; see also Liu (n 22 above), pp 7–9.

³⁹ See Hussain and Zhuang (n 32 above), pp 60–63.

per cent to 60 per cent of the sales value as an instrument of government to regulate prices, which caused many serious problems.⁴⁰ A substantial reform in the VAT was made to absorb most sectors covered under the previous product tax.⁴¹ The pre-reform multiplicity of VAT rates was reduced to two rates (as in many European countries): a standard rate of 17 per cent and a reduced rate of 13 per cent applying to foodstuffs and agricultural inputs. It was extended from the production stage, to which it was previously limited, to cover the wholesale and retail stages. A few industrial sectors including cigarettes, alcohol, and gasoline, apply the consumption tax (CT) as an additional excise, and most sales of services such as telecommunications apply the business tax (BT).⁴² More importantly, the invoice method was to be used for the assessment of the VAT: the tax paid on inputs is deducted from the tax payable on sales.

Secondly, a new law, Provisional Regulations on the Enterprise Income Tax (PREIT) replaced the old separate income taxes on domestic enterprises that were based on ownership.⁴³ The new law was devoted to solving various problems produced by the old system,⁴⁴ and to provide a more uniform “playing field” for all domestic enterprises. The unification of the income tax for Chinese and foreign enterprise was nonetheless delayed for further consideration. The top bracket income rate was reduced from 55 per cent to 33 per cent, and a variety of surtaxes and tax contracts were eliminated,⁴⁵ making the tax structure simpler and more transparent than before.

⁴⁰ Major problems of the pre-reform indirect tax system especially product tax included: first, it acted as a substitute for the market process and was a hindrance to competition and efficient resource allocation; secondly, it was biased against capital investment and capital-intensive industries; thirdly, certain exporters (subject to the product tax) were disadvantaged by it; fourth, the indirect tax system was subject to substantial cascading since it was a mixture of a VAT and a turnover tax; and last, the system was unduly complicated due to the multiple tax rates and the three separate taxes. See Bahl (n 38 above), pp 136–137; *see also* Hussain and Zhuang (n 32 above), pp 60–62.

⁴¹ The Provisional Regulations on the VAT (PRVAT) was issued by the State Council in 1993. The 1982 Provisional Rules on the VAT issued by the MOF was invalid.

⁴² See the Provisional Regulations of the Consumption Tax and the Provisional Regulations of the Business Tax in 1993.

⁴³ The 1984 tax reform created three types of domestic enterprise income tax laws applying, respectively, to SOEs, CEs, and private enterprises. Most SOEs paid income tax on the basis of a contractual agreement with the provincial government (that may not be agreed to by the central government). CEs and private enterprises could face higher effective tax rates since they were not allowed to negotiate tax contracts with government. See Bahl (n 38 above), p 132.

⁴⁴ Major problems were identified as follows: (1) the enterprise income tax system was too complex to be properly administered or easily understood, which aggravated the difficulty of budgeting and auditing; (2) the contractual agreements impaired tax regulations and rules, and they led to unequal competition among domestic enterprises; (3) the marginal tax rates were thought as too high that may have dampened incentives for enterprise investments; and (4) the true production cost of enterprises and enterprise profit were overstated. For details, see Bahl (n 38 above), p 133.

⁴⁵ These surtaxes included income adjustment tax, budget adjustment fund contribution, extra-budgetary construction tax, energy and transportation contribution, and wage bonus taxes.

Thirdly, the reform in the individual income tax merged the taxes on Chinese and foreign residents into the LIIT (with amendments).⁴⁶ The individual income tax had long been a small levy in China, though this situation has changed recently. The revenues were retained by local governments according to the revenue-sharing scheme provided by this reform.⁴⁷ The tax base in the early 1990s appeared very narrow, but it did not mean that Chinese workers in urban enterprises bore no income tax burden. Much of the payment did not come in the form of taxes as such; it came in the form of SOE profits, which was in nature, much like the compulsory procurement system for peasants in the countryside.

Finally, the 1994 reform separated national and local tax administrations. Before this, about two-thirds of State Administration of Taxation (SAT) staff worked at the lowest level of government, with weak central supervision. Local staff developed close ties with local finance offices and local-owned enterprises, which was thought to further weaken the central government's capacity in revenue sharing.⁴⁸ The 1994 reform, by establishing local tax administrations, forced local tax services to take responsibility for local tax collection. Although the SAT still operates on a regional basis, it is independent of the local tax administrations. This reform helped solve a longstanding problem of divided loyalties of the local officers in the SAT, and helped improve tax administration at both national and local levels.⁴⁹

With the reform, China's tax structure was transformed into a kind of dual-track system that was controlled by a unitary and centralised legislative power.⁵⁰ The legislative power for taxation and tax policy resides in certain state organs, including the NPC and its Standing Committee (SC-NPC), the State Council, the MOF, the SAT, the General Administration

⁴⁶ Initially, the LIIT was applied mainly to foreign residents, though it applied to Chinese residents also. To efficiently tax Chinese, the State Council issued the Provisional Regulations of Individual Income Adjustment Tax in September 1986 and the Provisional Regulations of Individual Industrial and Commercial Households Income Tax in January 1986. The latter two regulations were no effect from January 1994.

⁴⁷ According to the scheme, the central government collected income tax from central enterprises and financial enterprises licensed by the People's Bank of China, while local governments collected income tax from local enterprises and individual income tax. See Brean (n 28 above), p 16.

⁴⁸ See the International Monetary Fund (IMF), "Economic Reform in China: A New Phase" (1994) *IMF Occasional Paper 114*; see also World Bank, *Revenue Mobilization and Tax Policy* (Washington, DC: World Bank, 1990).

⁴⁹ For example, a local tax service has advantages in collecting local enterprise income taxes since it is more familiar with local enterprises than the centre. The indirect taxes are better administered by the centre since they are national and should be treated as uniform across the country. See Bahl (n 38 above), pp 139–140.

⁵⁰ The 1994 reform shifted fiscal contract practice to tax assignment system. Tax revenues were shared between central and provincial governments according to the rates determined by the centre. For detail, see Jiang Yonghua and Zhao Huaitan (eds), *Cai Zheng Shui Shou Xin Zhi Du Xiang Jie [Detailed Explanations of the New Fiscal and Tax System]* (Beijing: Qiye Guan Li Publishing House, 1994), Ch 3; see also Jin Jing, *Fiscal Federalism or Tax Farming: Political Economy of Fiscal Decentralization in China* (PhD Dissertation, The Johns Hopkins University, 2003), p 48.

of Customs, and the Tariff Policy Commission under the State Council.⁵¹ In addition, under certain circumstances, local legislative authorities and governments may enact local tax decrees provided that the decrees do not contravene any provision of the Constitution, national laws, or administrative regulations. Unfortunately, the 1994 reforms limited local governments' fiscal autonomy and hence restricted their ability to address development problems and to efficiently provide public services at the local level. The new tax system benefited some provinces at the expense of others. From the perspective of tax policy and administration, the following problems stand out.

First, there was still a lack of timely accurate data under the new system that could be used for budgeting and auditing. Accuracy in tax records has always been a problem in China. Underdeveloped banking and accounting systems have created difficulties in achieving efficiency and legitimacy in tax administration. Secondly, for audit purposes, enterprise taxation was separated from individual taxation. Separation of responsibility for enterprise sales and income taxes is not an improvement, however, but a drawback as the high-income group has emerged and grown. Finally, dividing tax administrations into national and sub-national administrations inflicted duplication of effort and a rise in administration costs. It added difficulty to the rule of law in taxation, as well. In principle, tax administration should be imposed strictly in accordance with laws and regulations enacted by the national legislature and for practical purposes, a number of businesses do need central regulation since they operate across regions. On the other hand, if national laws and policies cannot fully consider local needs and conditions, they would be "adjusted" to the reality when they come into force. Under such circumstances, local revision or manipulation would become necessary, and abuse of administrative power would be unavoidable.⁵²

The 1994 tax regime, as was intended, increased the flow of resources to the centre, but widened fiscal disparities among regions, though unintentionally. It assisted those rich governments to acquire stronger bargaining clout than poor governments, but the centre lacked sufficient fiscal strength

⁵¹ See Liu (n 22 above), p 12.

⁵² The notorious "off-budget" problem may be a good example in this point. It has widely existed in local areas and it became an apparently chronic defect over the reform period. It had grown to account for more than one-third of total government revenues by the mid-1990s, and in many areas, the off-budget system dwarfed the official budget. It negatively affected the social aim of equalisation and amplified the already large regional differences in income and government services. It was easy to abuse since local spending was hard to control by the centre. See Christine P. W. Wong, "Fiscal Dualism in China: Gradualist Reform and the Growth of Off-Budget Finance", in Brean (n 28 above), pp 188–208.

to address the problem.⁵³ Inequality in wealth distribution also emerged among urban citizens and countryside farmers, which reflected the distorted resource allocation for public services in rural China. A national social security system for all urban and rural Chinese citizens has yet to be established to help institutionally equalise basic individual socio-economic rights protection.

In summary, the 1994 reform can be judged a success in terms of some usual norms for evaluating a tax structure change.⁵⁴ The enterprise tax burden was equalised, tax structures were simplified, tax administration efficiency was enhanced, and the taxation system became more transparent and understandable than ever before. It improved the centre's ability to use taxation as an instrument to pursue macro-economic policies. The re-setting of taxing power in favour of the centre created a new balance in the intergovernmental relationship. Notwithstanding these improvements, China's tax regime is still problematic in many aspects. Moreover, new problems have emerged to cast a shadow on today's taxation development.⁵⁵

3. Recent Tax Reforms

Since 2003, the Chinese government has been considering a new-round of tax reform building on the 1994 tax regime in order to further improve the socialist market economy. The reform concept was written into the Eleventh Five-Year Plan Guidelines for National Economic and Social Development of the PRC (Guidelines) in 2006.⁵⁶ The three important reform targets identified were the individual income tax, enterprise income tax and the VAT.

Some significant and commendable reforms have been achieved. First, the tax threshold for individual incomes from wages and salaries was firstly increased to RMB 1,600 (per month) in January 2006, and then to RMB 2,000 in March 2008 to cope with the fast-rising living costs and increased inflation rates in recent years. The tax threshold had remained at the standard RMB 800 as stipulated in the original individual income tax law in 1980. Since the mid-1990s, this rendered a large portion of population, especially ordinary labours living off wages and salaries, liable to an income tax burden. The low threshold had also become a source of unequal dis-

⁵³ For instance, the fee-to-tax reform that supposed to abolish unauthorised fees and irregular exactions particularly in the countryside was suspended in the summer of 2001 as the central capacity to provide funds for the poor rural areas "has been further examined". *Ren Min Ri Bao [People's Daily] Overseas Edition*, 23 July 2001.

⁵⁴ See Liu (n 22 above), p 8; and Bahl (n 38 above), p 141.

⁵⁵ See Bahl (n 38 above), pp 142–147; see also Wong (n 52 above), and Fan Gang, "Market-Oriented Economic Reform and the Growth of Off-Budget Local Public Finance", in Brean (n 28 above).

⁵⁶ Ch 32 (2), Part 8 of the Guidelines.

tribution of tax burdens between the high-income group and the general working class. The recent amendment of the LIIT is however limited since it still primarily applies a “schedular system”, though it has adopted some design aspects of “global taxation”.⁵⁷ A global tax is needed for China since it is closer to equality in taxation than a schedular system.⁵⁸

Secondly, the separate income tax laws for domestic and foreign enterprises were finally unified into the Enterprise Income Tax Law (EITL) on 16 March 2007. This landmark law can be regarded as a pivotal signal of a phased-in end of preferential treatments for foreign investors (for over two decades) and equalisation of discriminatory tax burdens on all market players. It brings greater clarity, transparency and fairness to the tax system and makes competition more just and efficient. Moreover, it makes some headway towards achieving the “rule of law” in enterprise income tax legislation. Before the reform, domestic enterprises were subject to lower level laws made by the State Council, unlike their foreign counterparts (subject to NPC laws).

Thirdly, a major overhaul of the VAT, with related revisions of BT and CT, was made by the State Council at the end of 2008. According to the revisions, registered VAT general taxpayers are allowed to deduct input tax on purchases of equipment and other non-real property fixed assets,⁵⁹ and the VAT rate is reduced for small-scale taxpayers in all industries. These changes mark a major step in rationalising China’s VAT system and signal the government’s willingness to contemplate, in due course, the integration of the current VAT, BT and CT into a single, standard VAT regime comparable to international VAT practice.⁶⁰

Apart from the above reforms, another signal feat is worth noting. The Regulations on the Agricultural Tax (RAT) enacted by the SCNPC in 1958 were repealed on 1 January 2006. This means that the agricultural taxes (land tax in the past) that had been applied to Chinese peasants since the first dynasty eventually departed from the arena of history. This is potentially of very great significance with respect to the reduction of peasant burdens. But without further substantial reforms in political, economic and

⁵⁷ Article 9 of the amended LIIT.

⁵⁸ Briefly, a schedular income system taxes according to quite separate types of income based on different “schedules”. A global income tax system treats all sources of income collectively as a single income tax.

⁵⁹ According to Arts 21 and 25 of the Implementation Rules on VAT, fixed assets include machinery, transport vehicles and other equipment, tools and apparatus for production and operation use which have a life of usage for more than 12 months. They however not include motor vehicles, motor cycles, boats or yachts which are subject to consumption tax and for private use.

⁶⁰ This reform is partial in that the full deduction right to capital investments is not available to VAT taxpayers, and the VAT tax base still does not cover sales of services, most of which remain subject to BT.

legal institutions in rural China, full protection of peasants' socio-economic rights cannot be achieved.

III. Historically Dominant Taxation Problems

The major difficulties hindering crucial taxation reform in modern China are rooted in three interrelated, zones of concern: the existence of informal taxation, an underdeveloped income tax system, and lack of accountability. All of these are historically entrenched, problem areas.

Informal taxation has never been absent in China's history. It adversely affects the state's public finance, impairing the efficiency and accuracy of formal taxation and creating difficulties in government budgeting, monitoring and accounting. It also affects public administration and legal development, doing much harm to the binding force of formal laws, and providing opportunities for abuse of power, to name just a few of its ill effects. Central leaders (and emperors in the past) had to tolerate informal taxation because it is, in large part, a response to the ineffective and unreasonable operation of the formal tax system. The central government lacked the capability of adjusting tax laws and policies to specific local conditions. The concern of maintaining political stability and security was the first priority at all times, which often had to be achieved at the cost of equality, consistency, and fairness of the state's tax system. The impracticalities of the tax system caused an accumulation of resultant defects and problems at the lowest level, creating a large gap between theory and practice.

Secondly, the income tax system, in a modern sense, developed comparatively late in China. During the imperial era and the early stages of Republican China, land tax was the major type of direct tax. The enduring problem with this tax was the difficulty in recording and assessing land and households. This problem had never been solved throughout China's long history. Fair distribution of tax burdens was, as a result, rarely achieved, even though it might be attained at some historical points in parts of China. At present, with the strong, steady rise in China's GDP, most common Chinese citizens' living standards have increased and many persons' incomes have grown quickly, which upgrades the importance of income taxation in the country's economic and political regimes. However, inequality in the income tax system has emerged in China recently to mirror the wretched millennial unfairness of the land tax. The difficulty is similar: how to assess, fairly and equally, the real incomes of individuals or enterprises to make distribution of tax shares more just? The widening difference between rich and poor is, in large part, induced by the unequal, underdeveloped income tax system.

This similar difficulty in land tax and income tax highlights a very long, still *unlearned* lesson of history: China needs to establish effective accounting and banking systems to provide useful and reliable information for taxation purposes. The ultimate soundness of the tax system depends on an effective information system that generates reliable measures of income, valued-added amounts, capital gains and things alike that make up the tax base. This need is all the more urgent as China's economic reforms deepen. Furthermore, provision of public welfare and establishment of the social security system are shifting – slowly perhaps but inevitably – to more individual-based systems for which wages and salaries and workers' productivity must be more accurately measured. To reach desired outcomes for these substantial reforms, there has to be a properly designed information system.

The third problem is lack of accountability. Throughout China's history, government officials always viewed themselves as supervisors, but not servants, of the people. They have no organisational and individual incentives to satisfy the populace since their privileged post is granted by the superior leader, and this is why in the past and even at present, most government officials clearly know how to answer to their superiors but not to the populace. This institutional arrangement remains largely intact today, even though in somewhat new forms. Problems in taxation in contemporary China clearly reveal this long-lasting, problematic institutional arrangement: the badly defined relationship between power and accountability.

Although the country has declared that state organs are responsible to the people and subject to their supervision,⁶¹ the fact is that officials, as agents of state organs, are seldom held accountable to the people. The populace also lacks efficient institutionalised mechanisms to supervise them, and such weaknesses facilitate official corruption while aggravating the lack of individual rights protection.

These taxation problems do not merely tell a story of the drawbacks of China's tax regime, but reflect the social-political reality that is deeply rooted in China's history, political philosophy and economic structures. From these problems, we may find certain answers to the question of why, historically, China failed to build some sort of constitutional polity comparable to that found in Western countries.

First, the long predominance of traditional Confucianism was (and still is) entrenched in the thinking of both rulers and ordinary people. It emphasises the absolute superiority of rulers and obedience of the masses. Confucianism is by no means all bad. It is a virtue-based, ethical and political doctrine. Since Emperor Wu of the Han Dynasty approved and accepted

⁶¹ Art 3 of the Constitution of the PRC.

it, Confucianism had become the official state philosophy. Study of the Confucian classics was the basis of the government examination system and the core of the educational curriculum. No serious attempts were made to replace the centrality of Confucianism until the May 4th Movement in the twentieth century.⁶² Amongst Confucian doctrines, the major one is the emphasis on “Rite” (*Li*).⁶³ Externally, it is used to distinguish between people; internally, it indicates to people their duty among others and what to expect of one another. Ritual divides people into a variety of categories and builds hierarchical relationships through protocols and ceremonies, assigning everyone a place in society and a corresponding form of behaviour. Rulers, who have received the “Mandate of Heaven”, are on the highest position in this pyramid. *Li* keeps a firm hand on popular thinking – even until the modern time – by stressing loyalty between ruler and ministers, and obedience between the superior and inferior. Ordinary people usually have great toleration of various kinds of tax extractions and suppression from officials, unless the pressures are as such to make basic subsistence impossible. (People can usually cope with some level of unfair burden – they apply themselves, collectively and individually, to getting on with life – so the “burden” can be kept marginalised to an extent.) Such a ritual hierarchy does not easily give birth to “equality-of-man” concepts. In China’s history some farmers’ tax revolts did claim land equalisation treatment but never equality of individuals.

Another major Confucian doctrine is, (to use a modern term) physiocracy, meaning that agriculture alone provides the economic foundation of the state, and thus commerce should be restrained. This doctrine greatly influenced all dynasties especially in post-Tang China. The empire’s vastness and its regional diversities produced difficulties in securing the empire’s durability. Under such circumstances, it was thought far more desirable for rulers to keep all regions on the same footing at the cost of development of advanced economic sectors since if certain regions developed strongly (through trade and commerce for instance), they could more easily challenge the centre’s ruling power. This concern influenced rulers and top

⁶² Roughly speaking, the May 4th Movement refers to the massive popular protest that took place in China on 4 May 1919, following the announcement of the terms of the Versailles Treaty that concluded World War I.

⁶³ “*Li*” carries great weight in the Confucian doctrine system. Confucius believed that “[l]ead the people with administrative injunctions and put them in their place with penal law, and they will avoid punishment but will be without a sense of shame. Lead them with excellence and put them in their place through roles and ritual practices, and in addition to developing a sense of shame, they will order themselves harmoniously.” *Analects of Confucius [Lun Yu]*, II. 3. It explains that with ritual, patterns of behavior are internalised and exert their influence before actions are taken, so people behave properly because they fear shame and want to avoid losing face. The meaning of *Li* ranges from politeness and propriety to the understanding of each person’s correct place in society. See Yao Xinzong, *An Introduction to Confucianism* (Cambridge: Cambridge University Press, 2000).

officials when making fiscal and tax policies. It appears to be an important reason why China has so long remained an agrarian economy despite the aspiration (intellectual and physical) to develop. This also helps explain why a modern tax system was never successfully developed across China's long history. A developed commodity economy, presumably, was intentionally blocked. Therefore, modern legal and political institutions that would typically be created to protect a free market were "not needed" and, thus, did not find place to grow in the soil of the country.

Secondly, the Western-style concept of private property also never took root in Chinese history. The right to private property, in the modern Western sense, is the social-political principle that adult human beings may not be prohibited or prevented by anyone from acquiring, holding, and trading with willing parties valued items not already owned by others. The essence of the right is the concept of "exclusion", that is, once an owner may exclude all others including the state from his property, such a right can be safe. An institutionalised legal system eventually evolves for protecting this fundamental right. The essential elements of the right were virtually non-existent (in the modern sense) in China's history. In cities, small craftsmen and merchants were unable to develop a large-scale commercial sector due to government restrictions. They were subject to a variety of taxes and charges as a means of limiting their development – and this also provided another means to build government revenues. In the countryside, (peasant) landowners usually had the ability to shift tax burdens to ordinary and tenant farmers, but they also suffered heavy taxes when government badly needed money to meet public and private needs.⁶⁴ The widespread and continuous informal taxation system served as an example how fragile people's right to private property was. In the past and even today's China, ordinary

⁶⁴ Landowners or landlords were primarily rural landowners during the imperial era in China. These were persons who owned more land than ordinary peasants. They were rich peasants in terms of the amount of land owned. They hired landless peasants to work on their land, and they might let out a certain amount of land to other peasants for rent. They were liable to land taxes and other types of charges that were imposed by government. All land and households had to be registered with the government during the imperial era in China. There were significant functional differences between this imperial Chinese "real property law" system and the sort of historical, law regime which developed in England. For example, rural landowners in imperial China might purchase land from other people. But land transactions were restricted by government, and when land began to be highly concentrated in a particular family, government might take action to control this sort of land accumulation. Land would typically always be locally held (rather than across large distances). In sum, why one held land and, more importantly, what one could do with land were each subject to a very different more restrictive set of "private property" norms than those which developed in (common law) England. For further information on the notably restricted rural property ownership regime which applied in imperial China, see Wang Yanan: *Zhong Guo Di Zhu Jing Ji Feng Jian Zhi Du Lun Gang* [Chinese Feudalism of Landlord Economy] (Beijing: China Social Science Press, 2007).

people generally lack, or have few, official and formal channels to protect private property rights.

Last but not the least, there has long existed in China, a highly advanced bureaucratic system in which government officials hold the real political power to control the society. Since the first imperial dynasty, China had developed a “provincial and prefectural” political regime which replaced the phased-out feudal political system. This new regime enabled emperors to control the large territory, and to centralise all political powers including legislation, administration, adjudication, and personnel management in their hands with the assistance of top bureaucratic scholar-officials. Local governments were the agents of the centre. They were divided into several tiers, each of which was similarly staffed with professional bureaucrats. Usually, provinces (*Jun*) were the most important administrative region, in which the head was in charge of all political, economic, judicial and military affairs within his administration boundary. Prefectures (*Xian*) were the sub-level of provinces, whose head was similarly responsible for all public affairs in his region. This administrative system is different from the feudal system because it based political division not on the kinship but on a politically advanced, impersonal bureaucratic administration. Although this system has changed its name across China's history, it has retained its essence until this day.⁶⁵

Before the national “civil service examination” was formally established in the Sui Dynasty, bureaucratic personnel were appointed through a system of aristocratic intellectual family elections.⁶⁶ Since Confucianism was in favour of the emperors and the imperial system, Confucian doctrines became the selection criteria in the national civil examination. A government system was thus supported by a large class of Confucian intellectuals, who helped disseminate Confucian doctrines, including the idea of hierarchical obedience, to the populace. From the Sui and Tang times to the closing days of the Qing Dynasty, scholar officials functioned as intermediaries between the grass-roots population and government. The national examination provided hope and incentive for ordinary people, (except, normally, merchants), to join the government. Today, the present Chinese national university examination still offers similar possibilities for common people to enrol into the governing class. The populace is therefore “captured” by the system, which reduces their incentive to seriously overhaul the centralised unlimited bureaucratic government. Moreover, this same system continu-

⁶⁵ See Qian Mu, *Methodology on China's History [Zhong Guo Li Shi Yan Jiu Fa]* (Taiwan: Sushulou Cultural and Educational Foundation and Lantai Press, 2001), pp 19–22.

⁶⁶ *Ibid*, pp 41–44.

ally draws the best and brightest from the general population, reducing the “supply” of potential leaders who might seriously challenge the system itself.

Government bureaucrats usually held important information that would not, or would inaccurately, be reported to the top and the bottom. They developed various kinds of complex but affinitive networks among their circles for mutual interest and support. It is hard to expect that they would ever be willing to limit their powers and give up their privileges, given all these advantages. In fact, there was no comparable power to vie with them since common people, under such a highly advanced bureaucratic system, had far too little economic or political strength to challenge the potentially unlimited government.

IV. Conclusion

Despite a long-lasting and powerful intellectual tradition in China, the nation retained, for millennia, a remarkably undeveloped tax regime. This regime was shaped by and worked with a vast agrarian state dominated by traditional Confucian philosophy. A well-developed centralised bureaucratic system and deliberately underdeveloped commodity economy reduced the need (and political demand) for a system to secure individual rights, in particular private property rights of the kind which evolved within feudal and post-feudal Europe. Farmers were scattered and bound to the soil, and the group of craftsmen and merchants was generally unable to accumulate substantial wealth to expand their businesses due to strict government controls. The political-institutional design efficiently hindered a comparatively strong power emerging from within the populace, a power that could play a role in checking and balancing government power.

For today's China, the aim to build constitutionalism, or more specifically, to build an accountable and limited government, cannot be achieved separately from consideration of a just tax regime. Tax, as the most important basis for maintenance of a modern state is crucial to help improve the state's political and legal regime. The rule of law in taxation should be a maxim, today, shaping the foundations for proper, general constitutional development in China in the new era. Chinese history shows that the failure to address the need for fundamental tax reform—combined with the millennial (peasant) mass capacity to live within such a flawed system—each help explain (ironically, perhaps) both the durability of the old (in many ways, still current) system and the unjust nature of China's remarkably arrested, political structure development.