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van der Hoek, M. Peter and Kong, Shuhong and Li, Zhenzi

Erasmus School of Economics, University of International Business
and Economics, University of International Business and Economics

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THE DUAL CORPORATE INCOME TAX IN CHINA: THE IMPACT OF UNIFICATION*

Shuhong Kong and Zhenzi Li. University of
International Business and Economics, Beijing, China

and

M. Peter van der Hoek, Erasmus University, Rotterdam,
Netherlands and Academy of Economic Studies,
Bucharest, Romania

ABSTRACT

For many years, foreign funded companies in China enjoyed a relatively low tax rate and a series of preferential policies which were aimed at encouraging foreign direct investment in China. By adopting a new law in 2007, however, the National People's Congress proclaimed the end of the dual corporate-income-tax system. From 2008, the preferential tax treatment of foreign capital will be phased out. As a result, the income tax rate for domestic and foreign funded companies will be unified at the rate of 25%. This paper explores the impact of the dual corporate income tax system on both domestic and foreign funded enterprises and discusses the possible effects of the unification.

1. INTRODUCTION

On March 16, 2007, the fifth Session of the Tenth National People's Congress adopted the "Enterprise Income Tax Law of People's Republic of China (draft)". As a result, the income tax rate for domestic and foreign

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funded companies will be unified at the rate of 25%. This law proclaims the end of the dual corporate-income-tax system, which has been in effect for 30 years.

Foreign funded companies are defined as companies that are funded by foreign investors and with the permission of the Chinese government. The capital of these companies is provided by foreign companies or individuals either wholly or partially. In the former case, they are called wholly foreign funded companies; and in the latter case, they are called joint ventures. The capital of joint ventures is partly provided by foreign and partly by domestic investors, who will share the risks and profits according to their capital shares.

For many years, China has adopted specific legislation and regulations with regard to taxation of foreign funded companies. Foreign funded companies enjoyed a relatively low tax rate and a series of preferential policies which were aimed at encouraging foreign direct investment in China. As a result, the actual tax burden for foreign funded companies was considerably lower than that of the domestic funded enterprises. However, the preferential tax treatment of foreign capital will now be phased out over five years from 2008 and the corporate income tax rate for foreign funded companies will be eventually raised to the same rate as for domestic funded firms, which is 25%.

This paper explores the impact of the dual corporate income tax system on both domestic and foreign funded enterprises and discusses the possible effects of the unification.

2. LITERATURE REVIEW

Taxation is an oft-debated issue in China. Thus, there are a large number of theoretical and empirical

studies concerning taxation in China, including concerning the dual nature of the corporate income tax.

Hu and Wang (1992) developed models of the overall tax burden (defined as the tax/GDP ratio), which they use to simulate tax policies in 1995. They use data for 1979-1989 to test their models by applying the two-stage least squares method and regression models. They conclude that the rapid growth of extrabudgetary revenues had been a vital factor that led to a lower overall tax burden in China than would have been the case in the absence of extrabudgetary revenues.

Wang (1995) analyses the dual tax regime for corporate income tax by examining not only differences between two corporate income tax rates, but also differences in respect of other relevant policies, including regular tax relief and the definition of the tax base. He confirms that tax burden of domestic funded companies is higher than that of the foreign funded companies. He also makes a number of suggestions regarding the unification of the dual tax system:

1. The goal of taxation policy should be to unify all preferential tax systems, although within some reasonable limits special treatment of some foreign funded companies should remain possible.
2. The aim of giving preferential treatment should be mainly for implementing industrial policies in coordination with foreign investment and regional policies.
3. The total amount of tax preferences should be reasonable and efficient.
4. Preferential tax treatment should always be based on legislation, instead of informal and *ad hoc* decisions or regulations.

Yang, Ding and Hao (2000) undertook an empirical analysis of the tax burden of 100 industrial companies using data for 1996-1999. They also confirmed that tax burdens for foreign and domestic funded companies are

unequal, and that the gap between the two categories of companies has been rising gradually year by year.

Using data for 1987-1996 (i.e., for the period mostly before the 1994 fiscal reform), Wei (2000) developed a quantitative model of China's overall tax burden. He argued that while China's overall tax burden at around 15.7% of GDP would be a reasonable level of tax burden, the actual tax burden was some 5 percentage points below that level and was falling. According to the author, this situation was not beneficial to the national economy and for the performance of the overall system of economic regulation.

Hao (2001) argues that the higher tax burden for domestic funded companies relative to foreign funded enterprises is an incentive for capital investment to transfer from the domestic funded to the foreign funded businesses. Furthermore, the dual system of taxation affects the capital market by generating two kinds of excess burden. One kind of excess burden is similar to the excess burden of a commodity tax causing a loss of consumer surplus. The second excess burden arises from the distortion of the allocation of capital noted above.

The Sichuan Provincial Finance Bureau (2002) carried out an investigation and a statistic analysis using data for 2,158 companies. They found that the actual income tax burden of foreign funded companies was lower by one-half than that of the domestic funded enterprises.

Cheng (2003) found that the difference in tax burdens of foreign and domestic funded companies is due to a combination of the different requirements for tax deductibles and the different tax rates (preferential rates for foreign funded enterprises). His empirical analysis also shows that the tax burden of domestic

funded businesses is double heavier than that of foreign funded companies.

Whalley and Wang (2007) identify a different problem with a unified enterprise tax structure in which tax treatment of state-owned enterprises, other private enterprises and foreign funded enterprises is similar. They argue that a higher tax rate on state-owned enterprises is called for on efficiency grounds as taxes on state-owned enterprises reduce shirking by the workers (resulting in lower productivity) and a reduced state-owned enterprise tax rate under a unified tax would relax the discipline on state-owned enterprises resulting in losses. Their results indicate a 0.26% of GDP welfare loss using 2004 data from a unified tax, and a larger loss relative to an optimal tax scheme. Alternatively, if they use a managerial control model instead of a worker control model, they find a 0.19% welfare loss from a unified tax, and larger losses relative to initial higher state-owned enterprise tax rates.

Although some of this literature is partly normative in nature, the empirical studies reviewed here clearly show that under the current dual corporate income tax regime in China, foreign funded companies are taxed at lower tax rates than domestic funded enterprises, and that non tax concessions offered to the foreign funded enterprises significantly add to the gap between the two groups of companies. Generally, however, little attention has been paid in the literature to the economic consequences of different tax regimes for foreign and domestic funded enterprise, in particular the consequences for the enterprises' behavior and their efficiency. This article aims to fill this gap in the literature, at least partially.

3. DIFFERENCES IN CORPORATE INCOME TAX BURDENS

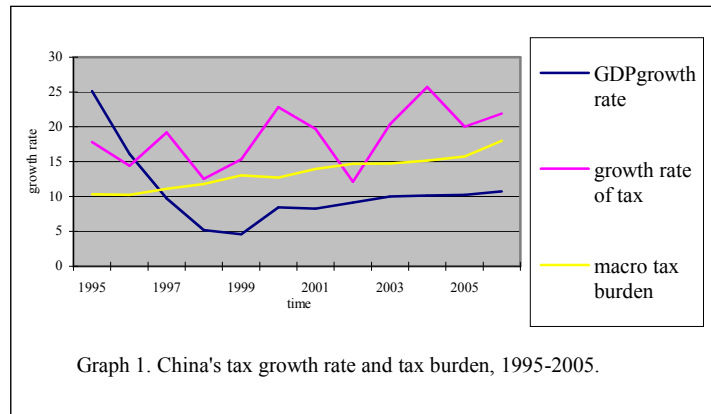
3.1. CORPORATE INCOME TAX BURDEN

The corporate income tax refers to the income tax liability of a certain company in a certain period of time, while the income tax rate is expressed as a percentage of taxable income. We can discern the absolute corporate income tax burden (the absolute amount) and the relative corporate income tax burden (relative to taxable income). The relative tax burden can be subdivided into the statutory tax burden and the effective tax burden. The statutory tax burden refers to the tax rate set by the government, that is, the amount of income tax as a proportion of taxable income. The effective tax burden refers to the enterprises' final tax settlement verified by the tax authorities as a proportion of the company's taxable income.

3.2. TAX BURDEN OF DOMESTIC AND FOREIGN FUNDED COMPANIES

3.2.1 The growth rate of tax revenues exceeds that of GDP, raising the overall tax burden

Since 1997, the overall tax burden increases on average by one percentage point per year. In 1999, tax revenues amounted to 1.068 trillion yuan, in 2003 it had reached 2.047 trillion yuan and in 2005 it is up to 3.087 trillion yuan. In 2006, it reached 3.764 trillion yuan, an increase of 677 billion yuan in one year. In 2006, the growth rate of tax revenues was over 15% and the overall tax burden increased to 18%, which was 1.3% higher than in 2005. Total income tax paid by companies and individuals amounted to 953.3 billion yuan and showed an increase of 25.4% relative to 2005. Total income tax revenue now accounts for 25.3% of total tax revenues.

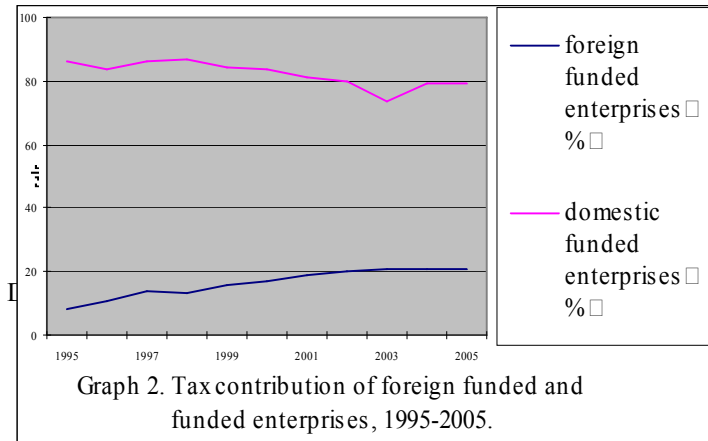


Source: China Statistical Yearbook (2006) and China Tax Statistical Yearbook (listed years)

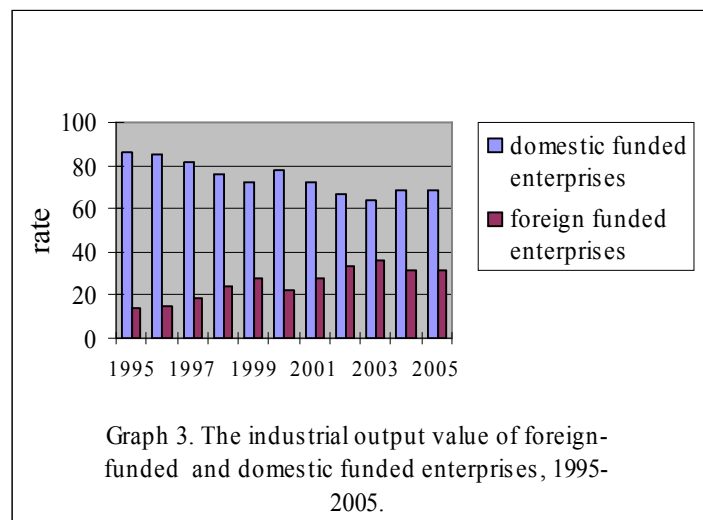
The graph above clearly shows that the growth rate of tax revenues consistently exceeded GDP growth rate over the last decade, raising the overall tax burden.

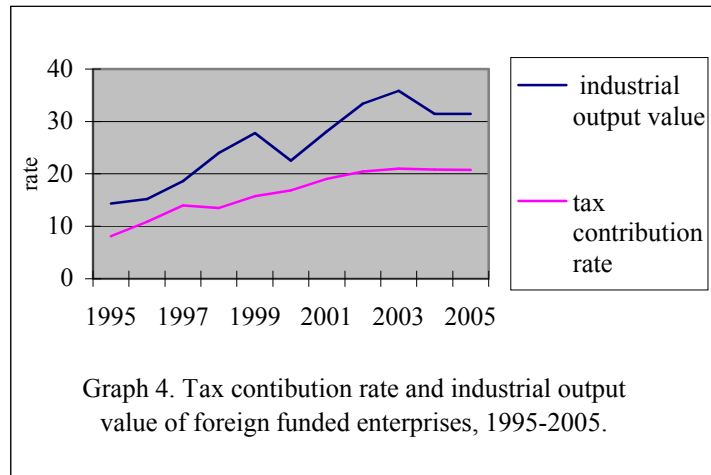
3.2.2 Foreign funded companies' share in tax revenues does not keep pace with their growing share in industrial output

Since China's economic reform and opening up, both domestic and foreign funded companies have made remarkable progress during the past 25 years and have played an important role in the development of the Chinese economy. However, the tax burden of domestic funded enterprises is much higher than that of foreign funded firms. Especially, the share of foreign businesses in total tax revenues did not match their rising share in industrial output.



Source: China Tax Statistical Yearbooks 1998-2006.





Sources: China International Trading Statistical Yearbooks (2003), China Business Yearbook (2006), and China Tax Statistical Yearbooks 1998-2006.

These graphs demonstrate that the share of domestic funded companies in gross industrial output has fallen in the period 1995-2003, whereas the share of foreign funded enterprises has been increasing. In the same period, the share of domestic funded firms in total tax revenues also decreased while that of foreign funded businesses increased. Since China's reform and opening up, many foreign funded enterprises came to China to start their business and invest in China, which increased China's total tax revenue. Graph-4 shows that although foreign funded enterprises have experienced a rapid growth in their share of total tax revenues from 1995 to 2003, their industrial output value is still much higher than their tax contribution rate. From 2003 to 2005, the shares of domestic and foreign funded companies in total tax revenues and industrial output stabilized. However, a nearly 10% gap remained, which was even higher than the 7% gap of 1995. This clearly shows that foreign funded companies' tax contribution rate does not match their industrial output share.

3.3. DIFFERENT TAX BURDENS FOR DOMESTIC AND FOREIGN FUNDED COMPANIES

3.3.1 Differences summarized

In the early 1980s, when China just began its economic reforms and opening up its markets, the lack of capital and technology were bottlenecks hampering the economic development. Hence, the government introduced policies that aimed at encouraging foreign investments, not only to attract foreign capital, but also to introduce new technologies. For example, special economic zones were created along the southeast coast to attract foreign capital that would benefit from tax holidays and other preferential tax policies. These policies have contributed considerably to the surge of foreign investments in China that persisted for three decades and that belong to the most important driving forces behind China's dramatic economic growth.

Although statutory tax rates for foreign and domestic funded enterprises are equal (normal tax rate: 33%), foreign funded enterprises actually benefit from different tax treatments in many ways. That makes the effective tax rate much lower than 33%. Table 1 summarizes the main differences.

Table 1. Differences in tax treatment of foreign and domestic funded enterprises

Programs	Foreign funded enterprises	Domestic funded enterprises
Starting dates for tax liabilities	From the date the first profit is made	From the date of registration
Wage deduction	Can deduct their total actual wages	Cannot deduct all wages
Tax rate	Can enjoy preferential income tax rate of 15% from central government and no local tax	Taxable incomes: < 30,000 yuan: 18%; 30,000-100,000 yuan: 27%
Specific fees and taxes	None	Taxes and fees – including urban construction and maintenance taxes, the surcharge for education, and the urban land-use tax - are only imposed on domestic funded enterprises

Table 1 (cont'd)

Preferential tax treatment	If a production oriented foreign funded enterprise invests in infrastructure over 10 years, its tax assessment can be halved for 5 more years; reinvestments yield tax rebates; others	None
Specific tax deductions	Can deduct more expenses including interest payments, trade unions fees, welfare and education fees, charitable contributions	None

Sources: Foreign Investment and Foreign Enterprise Income Tax Law of People's Republic of China (applicable from July 1, 1991 to January 1, 2008). Interim Regulations on the PRC enterprise income tax (applicable from July 1, 1994 to January 1, 2008).

At the beginning of the reform and opening up, the Chinese government introduced a number of preferential policies for foreign funded companies to attract foreign investment. The inflow of foreign capital in 2005 was 63.81 billion US dollars (excluding external borrowing), which is 28.2 times the amount in 1985 and 1.7 times the amount in 1995.¹ The large inflows of foreign capital promoted the economic development in China. However, this whole process was coupled to the differences in tax treatments of

¹ Sources: Chapter 18 International Business and Economics, China Statistical Yearbook, 2006; National Bureau of Statistics of China (www.stats.gov.cn), February 25, 2008

foreign and domestic funded companies as summarized in Table 1.

The differences in tax rates need some clarification. For domestic funded businesses the tax rate is 33% consisting of a central government tax of 30% and a local government tax of 3%. Foreign funded enterprises are subject to a central government tax of 15%, but pay no local tax. Therefore, the real tax rate for foreign funded firms is 15%. Moreover, the foreign funded enterprises are exempt from some other taxes and fees that are only imposed on domestic funded companies.

Special preferential treatment of foreign funded enterprises was introduced for those industries that the Chinese government wants particularly to encourage. One example is that if a production-oriented foreign funded firm invests in infrastructure with an operation period over 10 years, its tax assessment can be halved for five more years, whereas domestic funded businesses do not have this concession. Another example is that if foreign funded enterprises reinvest their profits in China they are eligible for tax rebates, whereas domestic funded companies are not eligible. Admittedly, the government also provides tax incentives for domestic funded small and medium-sized enterprises (SMEs). SMEs with taxable incomes less than 30,000 yuan enjoy a reduced income tax rate of 18%, whereas SMEs with taxable incomes from 30,000 to 100,000 yuan qualify for a reduced tax rate of 27%. However, these reduced rates are still higher than the rate of 15% for foreign funded companies.

As a result, the preferential coefficient² for foreign funded companies is higher than that of domestic funded enterprises. According to a survey carried out by the tax regulation department of the Sichuan Provincial

² The preferential coefficient is the nominal tax burden minus the actual tax burden.

Tax Department, the preferential coefficient was 5.6 for domestic funded firms (see, Table 3) and 10.28 for foreign funded businesses.

The fact that foreign funded companies can deduct more expenses and to a larger extent than domestic funded firms has important consequences. The capital depreciation rate that the tax law allows for domestic funded enterprises is too low compared with their actual capital consumption. As a result, their capital consumption is partly taxed. Yang, Ding and Hao (2000) analyzed the capital depreciation rate by using data about 100 manufacturing companies including domestic and foreign funded firms and covering 21 different industries for the period 1996-1999. They found that for domestic funded enterprises the annual capital depreciation rate was 0.045, while for foreign funded companies it was 0.073.

3.3.2 ANALYSIS OF DIFFERENT EFFECTIVE TAX RATES

Empirical data (see Table 2) show that the actual corporate income tax rates for foreign funded companies were within the range of 10-15% in recent years (Zhang, 2006), which is less than half the nominal rate of 33%.

According to a survey held by the Sichuan Financial Bureau in 2000 among 2,158 domestic funded companies, the actual tax burden varied between 23.3% and 29.4%. The average burden amounted to 26%, which was considerably higher relative to foreign funded firms' tax burdens.

Table 2. Actual tax rate of foreign funded companies

Year	(1)	(2)	(3)
2002	61.60	510.87	12.06
2003	70.54	680.00	10.37
2004	93.25	693.32	13.45
2005	114.77	790.18	14.52

Notes:

- (1) Income tax paid by foreign funded companies (billion yuan)
- (2) Profits of foreign funded companies (billion yuan)
- (3) Actual income tax rate of foreign funded companies (%)

Sources:

- (1) Income tax paid by foreign funded companies is taken from www.chinatax.gov.cn/data.jsp.
- (2) Profits of foreign funded companies are accounted according to the statistics in China quarterly tax revenue report (2002-2005).

Table 3. Analysis of tax burden of domestic funded companies

Type	Nominal tax rate	Actual tax rate	Preferential coefficient
State-owned companies	32.96	29.39	3.57
Collective-owned companies	29.20	24.02	5.18
Limited corporation	31.35	23.31	8.04
Average	31.17	25.57	5.6

Source: Tax Regulation Division of Sichuan Provincial Finance Department, *Analysis of the Corporate Tax Burden in 2000*.

The overall tax burden of domestic funded companies includes not only the corporate income tax, but also various fees and levies imposed by local governments. According to statistics published by the National Bureau of Statistics, large and medium-sized state-owned companies subsidize workers' housing, medical care, tuition, etc. to a total amount of 15-20%

of total costs. More than 50% of the payroll is spent on pensions of retired staff and subsidies for extra staff.

4. EFFECTS OF PREFERENTIAL TAX TREATMENT

4.1 NEGATIVE EFFECTS

Undoubtedly, preferential tax policies for foreign investment have contributed to increasing the inflow of foreign capital and, thereby contributing to the growth rate of the Chinese economy. However, these policies also have certain disadvantages.

a. The phenomenon of "fake foreign capital"

Domestic funded companies tend to transfer their capital to foreign countries and reinvest it in China in order to enjoy preferential tax treatment. This phenomenon of "fake foreign capital" reduces the economy's efficiency. For example, total foreign direct investments in China amounted to 60.63 billion dollars in 2004, but almost 1/3 of them were provided by domestic companies registered abroad. This suggests that an amount of up to 20 billion dollars was "fake foreign capital". Most of these investments came from off shore financial centers (like Hong Kong), where it is relatively easy to register companies, rather than from the developed countries.

b. Preferential tax treatment leads to unfair competition

Many large domestic funded companies have not only to pay different taxes, various fees, and apportions, but also to provide newspapers and to engage in sponsorships, payments of schools, hospitals, kindergartens, etc. These extrabudgetary fees amount to 15-20% of total costs, reducing companies' profitability. According to the 2004 economic census, the fees paid by domestic funded SMEs are estimated at about 300

billion yuan, whereas foreign-funded companies do not have to pay this kind of fees.

The additional burden resulting from extrabudgetary revenues increases the cost of domestic funded companies, which makes domestic capital less attractive than foreign capital. Therefore, it gives rise to unfair competition. What is more, the extra tax burden of domestic companies leads to tax avoidance and tax evasion, which aggravates the problem of unfair competition.

4.2 THE NEW POLICY

Although under the new legislations the corporate income tax rate for foreign funded companies will increase, the unification will most likely not reduce foreign direct investment dramatically for the following reasons.

a. A transition period

The new "Enterprise Income Tax Law of People's Republic of China (draft)" provides for a transition period of five years. Thus, the effective tax rate of foreign companies will be increased gradually over this period. Moreover, the preferential policies will not be completely abolished, but rather adjusted to a reasonable mode, which aims at encouraging foreign capital flows to specific industries. For example, the 15% corporate income tax rate will continue to apply to hi-tech companies to encourage innovation. Moreover, even a 25% corporate income tax rate is still relatively low compared to the 29% average rate in the developing countries.

b. Enterprises' responses

Although the tax policy of the Chinese government affects foreign investment, it is not the only reason that makes the nation attractive to foreign capital. The Chinese government particularly stresses nontax factors

that attract foreign capital including the huge and growing domestic market, a favorable investment climate, low labor costs, the presence of trained and diligent workers, etc. These factors would continue to make China a favorable choice for foreign capital.

Only after the new law will have been in effect for a number of years the actual effects on enterprise behavior can be established. At this point we can only formulate hypotheses that can be tested later on.

First, it can be hypothesized that domestic enterprises, whether they are state-owned or privately owned, will not respond differently to the unification compared with private companies. If they seek profit maximization there is no reason to respond to the unification in the first place. If profits have been maximized before tax, they are also maximized after tax.

Second, the phenomenon of “fake foreign capital” may be reduced in size as the incentive for its very existence will gradually diminish. This should increase the economy’s efficiency.

Third, the inflow of foreign capital may diminish even though the position of the Chinese government is that it will not. Alternatively, if non tax factors are as important as the Chinese government’s claims, the inflow of foreign capital may not diminish, but rather become more selective in respect of the sectors into which foreign capital is invested. That is, the inflow of foreign capital may be redirected to the most innovative sectors, which may positively affect the growth rate of the Chinese economy.

6. CONCLUSION

Tax revenues have shown a substantial growth over recent years. The growth rate of tax revenues exceeded

the growth rate of GDP for several years and, as a result, the overall tax burden rose to 20% in 2006. This paper has shown that although the share of total tax revenues that can be attributed to foreign funded companies also grew, it is relatively low compared with the rate of growth in their industrial output. The actual income tax burden for foreign funded companies is less than 15% (Table 2) and for domestic funded companies about 26% (Table 3).

There is a big gap between tax rates for foreign and domestic funded companies. The main reason for this difference is the preferential tax treatment of foreign funded firms in terms of the tax rate. Other factors include differences in tax deductions and extrabudgetary fees that come on top of the corporate income tax for domestic funded enterprises.

The difference in tax burdens has brought about several disadvantages that need to be addressed. In this context, the unification of the income tax rate is an essential reform. The main (nontax) reasons for China's attractiveness for foreign investments will continue to exist as before. As a result, it can be expected that the new policy will not adversely affect the robust trend of growing foreign investment in China. Furthermore, because the future inflows of foreign capital may be redirected to the most innovative sectors, the new policy may indeed positively affect the growth rate of the Chinese economy. Finally, the phenomenon of the "fake foreign capital" should gradually diminish, thereby increasing the efficiency of China's economy.

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