

Progress and Problems in the Development of a New Income Tax System for State-Owned Enterprises in China

China's adoption of an income taxation system for state-owned enterprises in the early 1980's marked a significant conceptual departure from the past. It represented yet another step away from centralized socialist control, which had characterized the People's Republic of China (PRC) since 1949. Prior to the adoption of this income tax system, virtually all of the profits and financing of state-owned enterprises, by far the largest sector of the Chinese economy, were directly submitted to and allocated from a centralized state budget.

The process of decentralization began in the late 1970's, when the government began experimenting with profit sharing for state-owned enterprises (*lirun liucheng*) (Profit Sharing System). Under this system, a state-owned enterprise was allowed to retain a portion of its profits before submitting the remainder to the state treasury.

In the early 1980's, China adopted the reform program known as *li gai shui*. Literally translated, this term means "the conversion of profits into taxes" (the Conversion). Rather than allowing an enterprise to share only a small portion of its profits with the state, this new system allowed a state-owned enterprise to retain all of its profits after paying income taxes and other assessments. The Conversion sought to increase the legal and financial autonomy of state-owned enterprises and to reduce their subordination to and dependency on the government.

While the Conversion was a significant reform conceptually, it led to less dramatic changes in reality. The effect on an enterprise of a high effective tax rate under an income tax system is not significantly different from that of a low profit sharing rate under a profit sharing system. Moreover, remaining structural problems in China's economy, such as irrational pricing, shortages of materials, and the budgetary needs of the government, have impeded the development of China's income tax system.

The limited success of the Conversion is largely the result of the formidable economic challenges that face China. Like many countries, China faces the difficult problem of establishing a tax regime that generates sufficient revenues to cover government expenditures. In addition, China must devise a system that rewards economic effi-

ciency while at the same time avoids punishing enterprises for losses caused by irrational pricing, shortages, and other factors beyond their control. Finally, unlike in a capitalist economy, where profits may be distributed to private shareholders in the form of dividends, in China, the income tax system must provide an efficient mechanism for distributing profits to the government owner of state-owned enterprises. This need for distributing profits to the government gives rise to concepts such as the "adjustment tax," which do not have directly corresponding counterparts under United States tax and accounting principles.

This paper will provide a brief survey of the evolution of the income tax system for state-owned enterprises in China. An attempt will be made to elucidate the economic challenges, tensions, and setbacks that continue to face China's tax reformers.

I. EVOLUTION AND DEMISE OF THE PROFIT SHARING SYSTEM

A. *Historical Background*

Prior to recent economic reforms, China maintained a strictly socialist economy. All major enterprises were state-owned and, economic activity was prescribed by the government in accordance with a mandatory economic plan. The state financial system financed the activities of not only the government, but of state-owned enterprises as well.¹ Under this system, the state financed enterprises both directly and indirectly. Funds for capital investment, expansion, product development, plant renewal and renovation, and some employee benefits were allocated directly by the state.² Working capital, within prescribed limits, could be obtained indirectly in the form of loans borrowed from state-owned banks.³

1. JIN XIN, *Guanyu Woguo Gongshang Shuishou Zhidu de Gaige Wenti* (On Problems of the Reform of Our Industrial and Commercial Taxation System), in *DI QI CI QUANQUO CAIZHENG LILUN TAOLUNHUI WENXUAN* (The Seventh National Symposium on State Finance Theory) 255 (1985) [hereinafter Seventh National Symposium]. Mr. Jin is the Chief Commissioner of the State General Bureau of Taxation.

2. HU ZHONGLIU & DONG QINGZHENG, *GUOJIA SHUISHOU* (State Taxation) 104-05 (1984).

3. Prior to the reforms beginning in the late 1970's, the state treasury provided state-owned enterprises with most of their working capital. The remainder could be borrowed from a state bank. During the period of reform, from 1979-1982, however, state banks lent state-owned enterprises approximately 82 percent of the enterprise's working capital. The Ministry of Finance allocated to state-owned enterprises only 18 percent of their working capital. Guanyu Guoying Qiye Liudong Zijin Gaiyou Renmin Yinghang Tongyi Guanli de Baogao (Report of the People's Bank of China on the Conversion to the Consolidated Management by the People's Bank of China of State-Owned Enterprises) sec. 1 (promulgated June 25, 1983), in *ZHONGHUA RENMIN GONGHEGUO XIANXING FAGUI HUIBIAN*, 1949-1985 354 (1985) [hereinafter Current Law Collection].

Over time, the defects of this system became increasingly evident. Because enterprises submitted virtually all of their profits to the state treasury, they lacked both the financial incentive and means to improve efficiency and increase growth. In addition, they were not significantly penalized for poor performance, since losses were compensated by additional allocations from the government.⁴ The inefficiency of state-owned enterprises not only retarded the growth of state revenues, but it also increased state expenditures, causing a drain on the state treasury.⁵

Facing this situation, China's economic reformers sought to transform the financial relationship between the government and state-owned enterprises. The goal was to increase state revenues and reduce state expenditures by increasing the efficiency of state-owned enterprises. This was to be achieved by granting them increased financial autonomy, incentive, and responsibility.

B. Enterprise Fund

The first reform adopted allowed state-owned enterprises to retain a small portion of their profits in the form of a special purpose enterprise fund (*qiye jijin*) (Enterprise Fund).⁶ To qualify to retain an Enterprise Fund, a state-owned enterprise had to fulfill eight targets prescribed in the state's annual economic plan.⁷ The size of each Enterprise Fund was approximately five percent of an enterprise's annual salaries and wages.⁸

C. Profit Sharing System

By 1980, a more comprehensive Profit Sharing System had substantially replaced the Enterprise Fund system.⁹ Profit sharing

4. JIN XIN, *supra* note 1, at 255.

5. YUAN ZHENYU, *You Jihua de Shangping Jingji yu Caizheng Gongzuo de Zhuanzhe* (The Planned Commodity Economy and the Transition of the State Financial Work), in Seventh National Symposium, *supra* note 1, at 163.

6. Caizheng Bu Guanyu Guoying Qiye Shixing Qiye Jijin de Guiding (Provisions of the Ministry of Finance for Trial Implementation Of A State-Owned Enterprise Fund) (adopted Nov. 25, 1978), in GUOYING GONGYE QIYE FAGUI XUANBIAN (Collection of Statutes and Regulations on Industrial State-Owned Enterprises) 174 (1982) [hereinafter Selection].

7. The eight targets of the state plan were annual output; types and specifications of products; quality; consumption of raw and processed materials, fuel, and power; labor productivity; cost; profits; and turn-over of working capital. *Id.* art. 1.

8. *Id.*

9. Guanyu Guoying Qiye Shixing Lirun Liucheng de Guiding (Provisional Regulations on the Implementation of Profit Sharing for State-Owned Enterprises) (promulgated July 13, 1979) [hereinafter Profit Sharing Provisions], in Selection, *supra* note 6, at 383. By the end of June 1980, 6,600 state-owned enterprises (14 percent of all state-owned enterprises) were participating in a trial implementation of the Profit Sharing System. These enterprises produced

allowed state-owned enterprises to retain a larger share of their profits. Correspondingly, funds directly allocated by the state were reduced.¹⁰ After the first several months of implementation, the state made it more difficult to participate in profit sharing by changing the preconditions. State-owned enterprises were required to meet four specific targets prescribed by the annual state plan before they could participate. These targets were based on annual output, product quality, annual profits, and contract fulfillment.¹¹

The formula for determining the profit sharing rate for an enterprise was quite complicated. Each enterprise was subject to two different profit sharing rates. The first rate applied to an enterprise's base profits—a portion of its current profits roughly corresponding to the total annual profits it earned in the previous fiscal year.¹² The second rate applied to an enterprise's incremental profits—the amount by which its total current profits exceeded its base profits.¹³

The purpose of allowing state-owned enterprises to retain a portion of their base profits was to replace allocations for certain expenditures that had previously been made directly from the state treasury. These allocations included expenditures for the development of new products, scientific research, employee training, as well as contributions to the enterprise's employee welfare fund, employee bonus fund, and enterprise fund.¹⁴ The profit sharing rate that applied to base profits approximated the ratio of the sum of these fund expenditures

60 percent of the state's output and constituted 70 percent of all profits realized by state-owned enterprises. Guojia Jingwei Guanyu Kuoda Qiye Zizhuquan Shidian Gongzuo Qingkuang he Jinhou Yijian de Baogao (The Report of the State Economic Commission on the Trial Implementation and Proposal for the Expansion of Enterprise Autonomy) sec. 1 (promulgated Aug. 9, 1980), in Selection, *supra* note 6, at 1.

10. Profit Sharing Provisions, *supra* note 9, art. 2, at 383.

11. Guojia Jingwei Caizheng Bu Guanyu Guoying Gongye Qiye Lirun Liucheng Shixing Banfa (Trial Methods of the State Economic Commission and the Ministry of Finance for Profit Sharing by State Industrial Enterprises) sec. 7 (approved Jan. 21, 1980) [hereinafter Profit Sharing Methods], in Selection, *supra* note 6, at 190.

12. *Id.* secs. 3-4, at 188-89.

13. *Id.* sec. 2, at 187.

14. *Id.* sec. 3, at 188; Profit Sharing Provisions, *supra* note 9, sec. 2, at 383. The Profit Sharing Methods contains guidelines on the percentage of profits which should be allocated to each fund: 1) product development should not exceed one to three percent of the total profits; 2) "scientific research" expenditures and employee training should not exceed the amount previously spent by the state; 3) employee welfare fund should not exceed eleven percent of the total amount of salaries and wages prescribed by the state for an enterprise; 4) employee bonus fund should not exceed twelve percent of the total amount of the salaries and wages; and 5) enterprise fund may comprise up to five percent of the total amount of salaries and wages. These percentages are similar to those in the Profit Sharing Provisions, except for the addition of the enterprise fund. Expenses for these prescribed uses come out of an enterprise's share of profits and are not included in costs. Prior to the adoption of the Profit Sharing System, some of these expenses were included in production cost.

from the previous year divided by the total profits earned in that year.¹⁵

Because of the irrationalities in China's pricing system for raw materials and finished goods, the Profit Sharing System was deliberately designed to avoid the use of a single, uniform sharing rate or formula for calculating base profits which was applicable to all state-owned enterprises. Rather, a flexible profit sharing system was developed to compensate for these price irrationalities. An enterprise's base profits and/or sharing rate were determined by "consultations"¹⁶ between government supervising departments and state treasury departments on one side and the state-owned enterprise on the other. These negotiations were based upon various guidelines and formulas prescribed by government authorities.¹⁷ The guidelines were especially important with regard to issues such as the selection of a base year, special additions and exclusions to base profits, and the actual percentage allowances for product development, employee bonuses, and the enterprise fund. Although the portion of an enterprise's current profits deemed to be base profits was based on the amount of total profits earned in the prior fiscal year, it could be subject to certain negotiated adjustments.¹⁸ Finally, the regulations for the Profit Sharing System allowed for renegotiation of an enterprise's profit sharing rates under certain special circumstances.¹⁹

15. If the profit base is equal to the total profits earned in the previous year, then the base profit sharing rate should be such that the enterprise retains the portion of base profits in the current year which is equal to the sum of fund expenditures made in the previous year.

In mathematical terms, where R_B is the Base Profit Sharing Rate, E_0 is the sum of fund expenditures made in the previous year, P_0 is the total profits earned in the previous year, E_1 is the portion of base profits allowed to be retained in the current year, and P_B is the current year's base profits,

$$R_B = E_0/P_0, \text{ and } R_B \times P_0 = E_0.$$

$$\text{Therefore, if } P_B = P_0, \text{ since } R_B \times P_B = E_1,$$

$$E_1 = E_0.$$

In theory, the portion of base profits allowed to be retained (E_1) can never exceed the sum of fund expenditures from the previous year (E_0) since current profits exceeding the total profits earned in the previous year (P_0) are considered to be incremental profits rather than base profits. E_1 can be lower than E_0 , however, if an enterprise's current total profits are less than the total profits that it earned in the previous year (P_0).

16. "Consultation" in Chinese legal documents means to hold friendly negotiations between parties for the purpose of reaching a certain agreement. The meaning is broader than the mere exchange of views or information.

17. See Profit Sharing Provisions, *supra* note 9, sec. 2, at 383; Profit Sharing Methods, *supra* note 11, sec. 3, at 188.

18. Profit Sharing Methods, *supra* note 11, sec. 3, at 189.

19. Profit Sharing Methods, *supra* note 11, sec. 6, at 189-90. For example, the state may renegotiate the rate if the price of principal raw materials or finished products has significantly changed, if there has been a merger or reorganization in the enterprise, or if there has been a substantial increase in profits generated by state investment projects.

The purpose for allowing state-owned enterprises to retain a portion of their incremental profits was to provide incentive for increasing economic efficiency and growth. The profit sharing rate that applied to incremental profits was a prescribed fixed rate which applied uniformly to all state-owned enterprises in the same industry.²⁰ Generally, the incremental profit sharing rate of an industry was inversely related to the industry's profitability. For example, the incremental profit sharing rate for highly profitable industries such as oil and petro-chemicals was ten percent; the rate for industries with low profitability, such as coal mining and farming equipment, was thirty percent.²¹ The median incremental profit sharing rate for all industries was twenty percent.²²

With regard to use of their retained share of profits, unlike private enterprises in capitalist economies, state-owned enterprises under China's Profit Sharing System did not have complete autonomy in the use of such profits. There were no private shareholders to whom dividends could be distributed. Moreover, the allocation of retained profits within an enterprise was prescribed by the state. All retained profits had to be divided into three special purpose funds (*zhuanxiang jijin*) earmarked for production development, employee welfare, and employee bonuses.²³

Beginning in 1981, an alternative type of profit sharing was applied to a few large state-owned enterprises in the form of responsibility contracts.²⁴ Under this alternative system, some enterprises were required to establish in a contract with their supervising government departments the amount of profits that they could retain. The contracted amount that was negotiated would supercede the amount that would result under the normal Profit Sharing System. The formulas which served as bases for negotiations varied among enterprises, according to their specific economic conditions.²⁵

D. Problems with the Enterprise Fund and Profit Sharing Systems

The Enterprise Fund and Profit Sharing Systems failed to satisfy adequately China's needs for economic reform. The Enterprise Fund

20. Profit Sharing Methods, *id.* sec. 4, at 189.

21. *Id.*

22. *Id.*

23. *Id.* sec. 3, at 188-89.

24. This alternative type of profit sharing was an experiment; and the regulations are not publicly available. See GONG QIFANG & CHEN DEYAN, LIGAISHUI DI ER BU SHISHI ZHUNZE JI JISUAN FANGFA (Implementation Rules and Calculation Method of the Second Step of Conversion from Payment of Profits to Payment of Tax) 21-22 (1984).

25. JIN XIN, *supra* note 1, at 256; see also GONG & CHEN, *supra* note 24, at 20.

System was only a small change within the old economic structure. Although it provided enterprises with some incentive, it did not alter their financial subordination to and dependency on the government.

With regard to the Profit Sharing System, several significant shortcomings also appeared. First, it failed to separate enterprises institutionally from their respective government supervising departments. As in the period prior to the reforms, transferring profits to and obtaining funds from the state treasury had to be done through government supervising departments. Financial transactions of state-owned enterprises were still largely determined by the state plan which was formulated and implemented through a complex hierarchy of regional and sectoral government supervising departments.²⁶ Thus, under the Profit Sharing System, state-owned enterprises were still required to deal with their respective government supervising departments in negotiating their profit bases, sharing rates,²⁷ and in the actual payment of their profits to the state.

Second, because it allowed for excessive negotiations between state-owned enterprises and government supervising departments, the Profit Sharing System failed to rationalize the relationship between profits and productivity. State-owned enterprises still lacked sufficient incentives to increase efficiency. Under China's planned economy, profits made by an enterprise were often attributable not only to the efficiency of internal operations, but also to the irrationality of the pricing system, as well as to other external factors. Government departments prescribed prices for most important goods and services in accordance with various macro-economic, social, and political policy objectives.²⁸ As a result of this pricing system, the costs of an enterprise's productive inputs, as well as the revenues earned from its productive outputs, were often beyond its control. Thus, the profitability of a state-owned enterprise often was not an accurate indicator of its operational efficiency.²⁹

Flexibility through negotiation was designed to compensate for

26. Interview with an official from the Ministry of Finance of the PRC in New York City (April 3, 1989); WANG CHENYAO & YAO DECHAO, *LIGAISHUI JIESHUO* (Explanation of the Conversion) 3 (1983).

27. The Ministry of Finance has the primary authority to determine general profit sharing rates for provinces, cities and industries under the state budget. Local governments and industrial supervising departments then negotiate with enterprises under their jurisdiction a specific profit sharing rate. According to practice, the state treasury regional offices supervise these negotiations. Profit Sharing Provisions, *supra* note 9, sec. 3, at 384.

28. See *Zhonghua Renmin Gongheguo Jiage Guanli Tiaoli* (Regulations of the People's Republic of China on Price Management) arts. 1, 3, 7-11, 13-16 (promulgated Sept. 11, 1987) 1987 GUOWUYUAN GONGBAO 756, 757-59.

29. No quantitative analysis is available on the relationship between an enterprise's economic performance and factors controlling prices of materials and labor and finished products.

these irrationalities caused by China's planned pricing system, but it failed to achieve this objective. While the irrational pricing of China's planned economy gave state-owned enterprises too little control over the amount of profits they could earn, the excessive flexibility of negotiation under the profit sharing system gave them too much control over what they could retain.³⁰ Under this system, an enterprise could easily increase its share of profits by negotiating a low profit base³¹ or a high profit sharing rate rather than by actually increasing its productive efficiency. In addition to profit sharing negotiations, state-owned enterprises often pressured their government supervising departments for the maximum possible allocations of low-priced inputs from the state plan. They also sought permission to sell the maximum possible amount of their outputs at higher market prices outside of the state plan. Elements of China's planned pricing system thus impeded the successful implementation of the Profit Sharing System.³²

Third, the responsibility contract form of alternative profit sharing prevented the state from obtaining its desired majority share of an enterprise's profits.³³ This result was caused by the excessive negotiating power of enterprises vis-a vis the state. In 1983, for example, enterprises in which responsibility contracts were adopted retained 85.5 percent of their incremental profits, thus leaving only 14.5 per-

As a result, policy debates among Chinese scholars and reform designers mainly rely on qualitative studies.

30. See CARL RISKIN, *CHINA'S POLITICAL ECONOMY* 345-47 (1987).

31. Lower base profits usually increased the total profits retained by an enterprise: 1) a lower base profit generally resulted in a higher base profit sharing rate since the base profit sharing rate equals the sum of certain fund expenditures divided by base profits; 2) a lower base profit resulted in higher incremental profits retained by the enterprise since incremental profits equals current profits minus base profits; 3) if an enterprise was efficient, the profit sharing rate for base profits was generally lower than the profit sharing rate for incremental profits. See generally Guanyu Guoying Gongye Qiye Lirun Liucheng Shixing Banfa de Shuoming (Explanation Concerning the Trial Methods for the State Industrial Enterprise Profit Sharing System), in Selection, *supra* note 6, sec. 2, at 193-94.

32. In China's increasing use of market mechanisms, it adopted a "two-track pricing system." Under this system, some prices continued to be fixed by the state plan, while others were allowed to be determined by market mechanisms. State-owned enterprises, however, generally obtained only a part of their productive inputs through the state plan. The remainder of their inputs had to be obtained on the open market, possibly at double or triple the price under the state plan. The percentage of inputs that an enterprise obtained on the market did not necessarily correspond to the percentage of outputs that an enterprise could sell on the open market. Often, state-owned enterprises were required to sell a disproportionate share of their outputs through the state plan at lower than market prices.

33. A fundamental principle guiding the allocation of profits between state-owned enterprises and the state is that the state receives the largest portion, the enterprise receives the medium portion and the employee receives the smallest portion. In general, the state will get 80 percent of the base profits and 60-70 percent of the incremental profits. See generally WANG & YAO, *supra* note 26, 2-16.

cent for the state.³⁴

Finally, implementing the Profit Sharing System created a tremendous administrative burden for the government. Negotiating an enterprise's profit base and/or its profit sharing rate was a long and painstaking ordeal for both government supervisory departments and departments of the state treasury.

II. CONVERSION FROM A PROFIT SHARING TO AN INCOME TAX SYSTEM

By 1984, China had abandoned its Profit Sharing System and adopted the Conversion—a new income tax system for state-owned enterprises.³⁵ The primary purposes of the Conversion were to increase the amount of funds paid to the state treasury and to decrease for state-owned enterprises their dependence on, and scope of negotiations with, government supervising departments and agencies. The Conversion was implemented in two steps—the first in 1983 and the second in 1984.³⁶

A. *Components of China's State-Owned Enterprise Income Tax System*

Under China's state-owned enterprise income tax system, taxable income is subject to two principal taxes. They are the State-Owned Enterprise Income Tax (SOEIT) and the State-Owned Enterprise Adjustment Tax (SOEAT).

1. Important Features of Taxable Income Calculation

Various rules apply to the calculation of taxable income under China's state-owned enterprise tax system. For example, both the payment of interest and the repayment of principal for certain capital construction project loans³⁷ are deductible from the profits generated

34. GONG & CHEN, *supra* note 24, at 22.

35. Guowuyuan Pizhuan Caizheng Bu Guanyu zai Guoying Qiye Tuixing Ligaishui Di Er Bu Gaige de Baogao de Tongzhi (State Council's Circular Approving the Report of the Ministry of Finance Concerning the Implementation of the Second Step of the Conversion from Profit Payment to Tax Payment) (promulgated Sept. 18, 1984), *in* Current Law Collection, *supra* note 3, at 144. Caizheng Bu Guanyu zai Guoying Qiye Tuixing Ligaishui Di Er Bu Gaige de Baogao (The Report of the Ministry of Finance Concerning the Implementation of the Second Step Conversion from Profit Payment to Tax Payment) (promulgated Sept. 18, 1984), *id.* at 145.

36. For information on the first step of the Conversion, see GONG & CHEN, *supra* note 24, at 24-26. For information on the second step see sources cited *supra* note 35.

37. There are two different types of capital construction loans. One is a "technology renovation" loan which is used for minor capital construction projects and is usually short-term (1-3 years). The "capital construction project" loan is used only for state approved major

by those projects in the calculation of taxable income.³⁸ Other regulations strictly limit the scope of deductions allowed.³⁹ An important principle in these regulations is that expenditures made out of special purpose funds⁴⁰ may not be deducted as expenses in computing taxable income.⁴¹

2. State-Owned Enterprise Income Tax (SOEIT)

The SOEIT applies different tax rates to the taxable incomes of enterprises of different sizes. Large and medium-size enterprises are subject to a fixed fifty-five percent tax rate.⁴² Smaller enterprises are subject to eight graduated rates ranging from ten percent on the first 1,000 Renminbi (RMB) of taxable income to a maximum rate of fifty-five percent for the portion of taxable income exceeding 200,000 RMB.⁴³ Thus, the SOEIT reduces the scope of negotiations between

construction projects and is a long-term loan with a low interest rate. The "capital construction project" loan took the place of Capital Construction Project Appropriations which were allocated directly from the state treasury. Guowuyuan Pizhuan Guojia Jingwei Zhongguo Renmin Yinhang Deng Bumen Guanyu Qing Pizhun Qinggong Fangzhi Gongye Zhong Duanqi Zhuaxiang Daikuan Shixing Banfa de Baogao de Tongzhi (State Council's Circular Approving the Report of the State Economic Commission, the People's Bank of China, et al., Requesting the Approval for Trial Methods on Short and Medium-Term Special Project Loans Applying to Light Industries and Textile Industries) (promulgated Jan. 14, 1980), in *Current Law Collection*, *supra* note 3, at 282. For information on capital construction project loans see Guowuyuan Shixing Jiben Jianshe Bokuan Gai Daikuan de Baogao de Tongzhi (State Council's Circular Approving the Report of the State Planning Commission, et al., Concerning the Conversion of Capital Construction Project Appropriations to Capital Construction Project Loans) (promulgated Nov. 18, 1980), *id.* at 299.

38. Guoying Qiye Di Er Bu Ligaishui Shixing Banfa (Trial Methods of the Ministry of Finance for the Second Step of the Conversion from Profit Payment to Tax Payment by State-Owned Enterprises) art. 8 (promulgated Sept. 18, 1984) [hereinafter Second Step Conversion Methods], in *Current Law Collection*, *supra* note 3, at 152.

39. Guoying Qiye Chengben Guanli Tiaoli (Regulations for State Enterprise Cost Control) arts. 7-19 (promulgated Mar. 5, 1984) [hereinafter Cost Control Regulations], in *Current Law Collection*, *supra* note 3, at 53-56.

40. See *supra* text accompanying notes 10, 23. These expenditures are made out of after-tax profits and are comparable to a United States company's retained earnings and employee profit sharing arrangements.

41. Cost Control Regulations, *supra* note 39, art. 13, at 55.

42. Zhonghua Renmin Gongheguo Guoying Qiye Shuode Shui Tiaoli (Caoan) (Draft Regulations of the PRC on State-Owned Enterprise Income Tax) art. 4 (promulgated Sept. 18, 1984), in *Current Law Collection*, *supra* note 3, at 203.

43. *Id.* and accompanying table at 205.

Small state-owned enterprises are defined by industry, amount of profit, and number of workers. The following are small state-owned enterprises: 1) industrial and transportation sector enterprises in Beijing, Tianjin, and Shanghai, with fixed assets whose original value did not exceed 4 million RMB and with annual profits not in excess of 400,000 RMB; 2) enterprises in other geographical areas with fixed assets whose original value did not exceed 3 million RMB and with annual profits not in excess of 300,000 RMB; 3) retail establishments and enterprises in Beijing, Tianjin, and Shanghai with annual profits not in excess of 200,000 RMB and/or with not more than 60 workers; 4) enterprises in provincial capitals, capitals of autono-

the government and state-owned enterprises by guaranteeing for the state treasury a minimum percentage of the taxable income earned by state-owned enterprises.

3. State-Owned Enterprise Adjustment Tax (SOEAT)

The SOEAT is a tax levied on the remaining taxable income of a state-owned enterprise after payment of its SOEIT.⁴⁴ While labelled as a tax, its economic purpose appears to be similar to that of the old Profit Sharing System—to establish a standard for allocating profits between state-owned enterprises and the state treasury while at the same time compensating for the impact on profitability resulting from the irrationalities in China's planning and pricing systems. Thus, the SOEAT appears to serve the economic purpose of a "dividend" paid to the government owner of state-owned enterprises.

The SOEAT only applies to large and medium-size enterprises.⁴⁵ However, if the taxable profits of smaller enterprises exceed a certain level, they too, may be required to pay a portion of such profits to the state in the form of contracting fees. The determination of such fees may depend on many factors, such as its number of employees and capital renovation needs.⁴⁶ Moreover, if a state-owned enterprise's annual taxable income exceeds 300,000 RMB, (or 400,000 RMB if located in Shanghai, Beijing, or Tianjin) it may automatically be treated as a large or medium-size enterprise for SOEAT purposes.⁴⁷

The method used to calculate taxable income for the SOEAT is the same as that for the SOEIT.⁴⁸ Unlike the SOEIT, however, the tax rates applied under the SOEAT are not fixed, but calculated individually for each enterprise under guidelines which are somewhat similar to the guidelines that had been used for determining profit sharing rates under the old Profit Sharing System. There are essentially two different SOEAT rates: the first applies to an enterprise's

mous regions, and in Chongqing with annual profits not in excess of 150,000 RMB and/or not more than 60 workers; and 5) enterprises in smaller cities and towns with annual profits not in excess of 80,000 RMB and/or not more than 30 workers. Despite the above guidelines, whether a retail establishment has exceeded the maximum amount of profits or the maximum number of workers ultimately is left to the discretion of local government authorities. Second Step Conversion Methods, *supra* note 38, art. 3, at 149-50.

44. Second Step Conversion Methods, *supra* note 38, art.1(11), at 148.

45. Guoying Qiye Tiaojie Zhengshou Banfa (Methods for Collecting the State-Owned Enterprise Adjustment Tax) art. 1 (promulgated Sept. 18, 1984) [hereinafter SOEAT Tax Methods], in Current Law Collection, *supra* note 3, at 207.

46. Second Step Conversion Methods, *supra* note 38, art. 3, at 149.

47. *Id.* at 149-150; see also *supra* note 43.

48. SOEAT Tax Methods, *supra* note 45, art. 4, at 207.

base profits, and the second applies to its incremental profits.⁴⁹

Article 5 of the SOEAT Regulations provides that the SOEAT rate for each state-owned enterprise should be determined by offices of the state treasury after consultation with the enterprise's supervising department.⁵⁰ On their face, the Regulations do not give any official role to state-owned enterprises themselves in determining their SOEAT rates. In reality, however, state-owned enterprises appear to be able to influence or even participate in the determination of their SOEAT rates. In general, the formula for determining the SOEAT rate to be applied to an enterprise's base profits is as follows:

SOEAT Base Rate = [Base Profits — (Imputed SOEIT + Approved Retained Profits)] / Base Profits.⁵¹

For purposes of this formula, an enterprise's base profits and its approved retained profits are based on its corresponding total and retained profits for 1983, the year immediately preceding the Conversion to the current tax system. The imputed SOEIT is the amount of SOEIT that an enterprise would have paid had the SOEIT been applied in 1983.⁵²

The SOEAT incremental rate is applied to an enterprise's incremental profits and encourages state-owned enterprises to increase annual earnings by providing them with a significantly lower SOEAT incremental rate. An enterprise's SOEAT incremental rate is approximately thirty percent of its SOEAT base rate (SOEAT Incremental Rate = SOEAT Base Rate \times (1 — 70%)).⁵³

To illustrate the application of these formulas, if the total profits of an enterprise in 1983 were 100 RMB, and its approved retained profits were 10 RMB, its SOEAT base rate would be 35 percent $[(100 - (100 \times 55\% + 10)] / 100 = 35\%$). If in 1987, its total taxable income were 200 RMB, its SOEIT liability would be 110 RMB $(200 \times 55\% = 110)$. Its SOEAT liability for its first 100 RMB of taxable income (i.e., its base profits) would be 35 RMB. Its SOEAT liability for the remaining 100 RMB of taxable income (i.e., its incremental profits for 1987) would be 10.5 RMB $(35\% \times 30 \times 100 = 10.5)$.

49. In the SOEAT, the incremental profit means current profits minus base profits (base profits equals the total profits in 1983). *Id.* arts. 6-7, at 207-08.

50. *Id.* art. 5, at 207.

51. *Id.* art. 7, at 208.

52. For example, in order to achieve a rational rate for the adjustment tax under the new tax structure, the imputed SOEIT must take into account the change in the turnover tax rate. See *infra* part II(B)(1).

53. The profit base is the adjusted profits of 1983 rather than that of the year immediately prior to the current fiscal year. The beneficial 30 percent SOEAT rate is applicable only until 1991. GONG & CHEN, *supra* note 24, at 66; SOEAT Tax Methods, *supra* note 45, art. 7, at 208.

B. Other Changes Related to the Income Tax Conversion

1. Reformed Turnover Tax

Under the second step of the Conversion of 1984, China's turnover tax system⁵⁴ was significantly reformed. For domestic enterprises, the Consolidated Industrial and Commercial Tax (*Gongshang Tongyi Shui*) has been essentially replaced by a set of four different turnover taxes applicable to different industries.⁵⁵ The most important of these turnover taxes is the Product Tax,⁵⁶ which applies to most manufacturing industries. The Value-Added Tax is applicable to a few select manufacturing industries such as automobiles, bicycles, sewing machines, and steel.⁵⁷ The Salt Tax is only imposed on salt producers.⁵⁸ Finally, the Services Tax is applicable to enterprises engaged in commerce and services.⁵⁹

The new turnover tax separates goods and services into more specific categories, resulting in a greater differentiation of tax rates between different items. These changes were instituted to accomplish three primary purposes: 1) to increase tax revenues for the state;⁶⁰ 2) to give the state greater flexibility in using differential tax rates to encourage or discourage with greater specificity the production of certain products;⁶¹ and 3) to attempt to use tax rates to compensate enterprises for irrational pricing.⁶²

2. Enterprise Contributions to Key Energy and Transportation Projects

On January 1, 1983, the State Council authorized the Ministry of Finance to require all domestic entities holding funds outside of the state budget⁶³ to contribute to the State Fund for Construction of Key Energy and Transportation Projects (*Guojia Nengyuan Jiaotong Zhongdian Jianshe Jijin*) (Construction Fund).⁶⁴ After-tax profits

54. A turnover tax in China is essentially a tax based on gross revenues. HU & DONG, *supra* note 2, at 110-111.

55. The Consolidated Industrial and Commercial Tax still applies to imported goods and foreign investment.

56. See generally HU & DONG, *supra* note 2, at 118-33.

57. See generally *id.* at 140-150.

58. See generally *id.* at 165-171.

59. See generally *id.* at 151-160.

60. WANG & YAO, *supra*, note 26; JIN XIN, *supra* note 1, at 258.

61. GONG & CHEN, *supra* note 24, at 45-46.

62. *Id.* at 43-44.

63. Funds outside of the state budget are funds not directly controlled by the state budget.

64. *Guojia Nengyuan Jiaotong Zhongdian Jianshe Jijin Zhengji Banfa* (Method for Collection of the State Fund for Construction of Key Energy and Transportation Projects)

retained by a domestic enterprise are considered to be funds outside of the state budget and therefore fifteen percent of these profits must be contributed to the Construction Fund.⁶⁵

3. Use of Retained Profits

Like the old Profit Sharing System, the income tax system does not grant state-owned enterprises unlimited discretion in their use of retained after-tax profits. Chinese law requires an enterprise to allocate its retained profits among several special purpose funds.⁶⁶ Similar to the Profit Sharing System, these funds generally include the production development fund,⁶⁷ the employee welfare fund, and the employee bonus fund. According to the regulatory guidelines for state-owned enterprises, 50 percent of retained profits should be allocated to the Production Development Fund, 20 percent to the Employee Welfare Fund, and 30 percent to the employee bonus fund.⁶⁸

C. A Case Study

The tax situation of a medium-size state-owned enterprise in Shanghai engaged in manufacturing heavy machinery provides a useful illustration of China's current tax system.⁶⁹ The enterprise employed approximately 2,000 workers and had annual gross profits of approximately 20 million RMB. Its effective combined base and incremental SOEAT rate was approximately 28%. After paying its SOEIT and its SOEAT, it was left with 3.429 million RMB of after-tax profits. Of this amount, 968,000 RMB (28.2 %) went to its production development fund; 1.192 million RMB (34.7%) went to its employee welfare fund;⁷⁰ and 1.098 million RMB (32%) was placed in the employee bonus fund. Another 170,000 RMB (approximately 5%) was used for miscellaneous purposes.

(promulgated Dec. 15, 1982) [hereinafter Construction Fund Methods], in Current Law Collection, *supra* note 3, at 40.

65. *Id.* art. 5, n.1. China will create a new fund this year called the State Budget Adjustment Fund. Most domestic enterprise taxpayers will be obligated to contribute to this fund. See *Guojia Yusuan Tiaojie Jijin Yicheng Tou Nong*, Renmin Ribao-Haiwai Ban [RMRB-HB], Mar. 9, 1989, at 1.

66. Second Step Conversion Methods, *supra* note 38, art. 10, at 152.

67. *Id.*

68. *Id.*

69. Interview with a director of a state-owned enterprise in Shanghai (June, 1986).

70. A large portion of the employee welfare fund was reserved to build employee housing. In China, housing is the most important welfare benefit an employer provides for its employees, and enterprises are primarily responsible for financing their housing programs. The employee welfare fund may also include a health plan for employees and their family members, and subsidies for employees' children's education.

Of the amount placed in the production development fund, 239,000 RMB (25%) had to be paid to the enterprise's supervising department, 145,000 RMB (15%) to the Construction Fund, and 80,000 RMB (8%) to purchase State Treasury Bonds, leaving approximately 500,000 RMB (52%) for use by the enterprise for new capital investments. Similarly, 77,000 RMB (6%) from the welfare fund was paid to the supervising department, and 179,000 RMB (15%) was paid to the Construction Fund, leaving 936,000 RMB (79%) for use by the enterprise. Finally, with respect to the employee bonus fund, 72,000 RMB (7%) was paid to the supervising department, and 155,000 RMB (15%) was paid to the Construction Fund.

In addition to the profits retained in production development funds, for purposes of minor capital investment and renovation, a state-owned enterprise may also utilize a separate depreciation fund.⁷¹ Unlike in American tax accounting, where depreciation deductions only reduce the taxable income of a company, state-owned enterprises in China must also set aside in a separate depreciation fund an amount equivalent to that which is deducted for depreciation. In the 1985 fiscal year, the fixed assets of the enterprise studied generated approximately 1.014 million RMB of depreciation funds. Of this amount, it paid 267,000 RMB (26%) to its supervising department and 156,000 RMB (15%) to the Construction Fund. The remainder was left to the enterprise for minor capital investment and renovation.⁷²

III. EVALUATION OF CHINA'S STATE-OWNED ENTERPRISE INCOME TAX SYSTEM

One of China's primary purposes in adopting the Conversion to the income tax system for state-owned enterprises was to increase the proportion and amount of government revenues derived from state-owned enterprises. In the first two years of the Conversion, however, this goal was only partially realized. In 1986, for example, although the turnover tax, SOEIT, and SOEAT revenues reached the targets set forth in the state budget, and although overall state revenues⁷³

71. Guoying Qiye Guding Zichan Zhejiu Shixing Tiaoli (Trial Regulations on Depreciation of State-Owned Enterprise Fixed Assets) (promulgated Apr. 26, 1985), in *Current Law Collection*, *supra* note 3, art. 20, at 91; Howard Chao & Yang Xiaoping, *The Reform of the Chinese System of Enterprise Ownership*, 23 *STAN. INT'L L.J.* 374 (1987).

72. Interview with director of a state-owned enterprise in Shanghai (June, 1986).

73. In China, approximately 90 percent of state revenue comes from taxes. *See* Hu & Dong, *supra* note 2, at 53. Of this 90 percent, over 50 percent is from the turnover tax paid by state-owned enterprises. Of the remaining 40 percent, approximately 35 percent comes from SOEIT and SOEAT. Only 5 to 6 percent comes from other taxes. *See generally* PEOPLE'S REPUBLIC OF CHINA YEARBOOK, 1987 285 (1987).

increased by 5.8 percent over the previous year, the growth rate of state revenues was substantially less than that of state expenditures and the overall economy. In 1986, the increase in state revenues did not keep pace with the national industrial output⁷⁴ increase of 11 percent. In addition, China had a budget deficit of over 7 billion RMB even after reducing many state expenditures.⁷⁵

The second purpose of the Conversion was to provide state-owned enterprises with greater financial autonomy. This goal, however, was only partially achieved. The production development fund and depreciation fund could provide state-owned enterprises with relatively reliable sources of finance. Nevertheless, after the various assessments levied on these funds by government departments, most state-owned enterprises still lacked sufficient funds to meet their renovation and development needs.

Alternative financing could be obtained through loans from state banks and other state financial institutions. But these sources of financing have been less reliable because China uses state financial institutions as government macroeconomic policy instruments. Thus, obtaining loans from state financial institutions is dependent upon obtaining approval from government supervising departments and planning commissions.⁷⁶ This is particularly true for loans obtained for capital construction.⁷⁷ Thus, government departments still retain significant control over the financing of state-owned enterprises.

While China is beginning to develop alternative sources of financing independent from the state, the significance of these alternatives for state-owned enterprises remains rather small. China has not yet developed a mature financial market separate from the government. Issuing bonds is still unrealistic for most state-owned enterprises, and public issuance of stock is still at the experimental stage and involves only a very few state-owned enterprises.⁷⁸

Alternative financing is also available through the establishment

74. CHEN XIAN, *JIHUA GONGZUO SHOUCE* (Manual for Planning Work) 518 (1985). Total value of national industrial output before the cost deductions.

75. Tian Yinong, *Guanyu 1986 Nian Guojia Jiusuan de Baogao* (Report on Final Accounting of the State Budget of 1986 Fiscal Year), 8 CAI ZHENG 1-3 (1987).

76. Zhongguo Renmin Yinhang Fafang Qinggong Fanzhi Gongye Zhong Duanqi Zhuanxiang Daikuan Shixing Banfa (Trial Methods of the People's Bank of China on Short and Medium-Term Special Project Loans Applying to Light Industries and Taxable Industries) arts. 8-10 (promulgated Jan. 14, 1980), in *Current Law Collection* at 285-286.

77. Jiben Jianshe Daikuan Shixing Tiaoli (Trial Regulations on Capital Construction Project Loans) art. 4 (promulgated Aug. 28, 1979), in *Current Law Collection*, *supra* note 3, at 270.

78. See generally Liu Hongru, *Developments in the Reform of China's Banking and Financial Systems*, 2 J. CHINESE L. 348-352 (1988).

of a joint venture with another entity. Under a joint venture arrangement, an enterprise short on cash may make in-kind capital contributions of technology, land use, labor, or equipment.⁷⁹ Although joint ventures are becoming increasingly common, finding a compatible joint venture partner and meeting various regulatory requirements remain rather difficult tasks.

In summary, although the production development fund and depreciation fund provide state-owned enterprises with relatively reliable sources of finance, they are generally insufficient to meet enterprises' financing needs. Alternative sources of financing therefore continue to be needed. Thus, improving China's financial system is just as important as improving its income tax system.

The third purpose of the Conversion was to compel state-owned enterprises to improve their economic performance and efficiency. It appears that this goal has not been completely fulfilled. In 1986, the total operating expenses of all state-owned enterprises exceeded the state's prescribed target by 6.6%.⁸⁰ Profits and taxes paid to the state decreased by 0.2%, and the percentage of state-owned enterprises with operating deficits increased to 14.2%.⁸¹ These problems became worse during the first seven months of 1988. By the end of July 1988, the percentage of state-owned enterprises with operating deficits reached 17%, and the total deficit nationwide reached 3.637 billion RMB, a 27% increase over that of the same period in 1987.⁸²

Nevertheless, these apparent failures to increase efficiency cannot be attributed entirely to the new income tax system. Although new tax burdens and benefits may have affected the operational efficiency of enterprises, performance may have been equally affected by other factors beyond the enterprises' control, such as price fluctuations and the limited availability of needed resources.

Many raw materials are currently in short supply in the Chinese economy. In addition, the state has been allocating fewer materials through the state plan while new market distribution channels have not been effectively developed at a corresponding pace. Consequently, prices have increased rapidly, causing many enterprises to lose money. The unavailability of resources also makes idle a large part of the operational capacity of state-owned enterprises.⁸³ Because

79. Chao & Yang, *supra* note 71, at 390-92.

80. Ge Weixi, *Woguo Shuizhi Gaige de Chulu Hezai* (What is the Direction of Our Tax System?), 12 CAIJING YANJIU 3 (1987).

81. *Id.*

82. Guoying Gongye Qiye Kuisun Yanzhong, RMRB-HB, Aug. 31, 1988, at 1.

83. According to one estimate, at the end of 1985, about one third of the total fixed assets of all state industrial enterprises was not being used due to energy shortages or shortages of

overhead expenses may not be proportionately reduced, the average costs of goods which are produced are significantly increased. Thus, the apparent failure of state-owned enterprises to improve efficiency is at least partially attributable to problems in China's general economic environment, rather than to the new state-owned enterprise income tax system.

Nevertheless, remaining imperfections in the state-owned enterprise income tax system bear partial responsibility for the failure to improve efficiency further. The continuing role that government negotiations have in determining the ultimate profitability of a state-owned enterprise remains the most detrimental. Under China's current economic structure, an enterprise can almost always find some justification in arguing for a lower SOEAT rate. Justifications have included the substantial cost increases of raw materials resulting from the narrowing scope of state planning and controlled prices, the need to retain profits sufficient to replace allocations no longer made from the state treasury, and the need to compensate for the artificially depressed prices of outputs which are still determined by the state plan.

Although state-owned enterprises in China may still increase their profitability by negotiating with government authorities rather than by increasing their actual efficiency, under the new income tax system this problem only applies to the SOEAT and is therefore narrower in scope than under the old Profit Sharing System. Moreover, financial data accumulated by departments of the state treasury provide a more objective basis for negotiations between state-owned enterprises and government departments.

IV. INTRODUCTION OF THE RESPONSIBILITY CONTRACT SYSTEM—A STEP BACKWARD?

In 1987, China began to "deepen" (*shenhua*) the reform of the income tax system for state-owned enterprises. It implemented an operational responsibility contract system (*chengbao jingyin zeren zhi*) (Operational Responsibility Contract System) for state-owned enterprises.⁸⁴ The Operational Responsibility Contract System appears to

other raw and processed materials. LIU HONGRU, *ZHONGGUO CAIZHENG JINRONG TIZHI GAIGE DE YANJIU* (Studies on Issues of the Chinese Financial System Reform) 200 (1987).

84. Quanmin Suoyou Zhi Gongye Qiye Chenbao Jingying Zeren Zhi Zanxing Tiaoli (Interim Regulations on the Operational Responsibility Contract System for State-Owned Industrial Enterprises) (promulgated Feb. 27, 1988) [hereinafter Operational Responsibility System Regulations], in 4 *XIN FAGUI* (New Legislation and Regulations) 1 (1988). Quanmin Suoyou Zhi Gongye Qiye Tuixing Chengbao Jingying Zeren Zhi Youguan Caiwu Wenti de Guiding (Provisions Concerning Financial Matters Relating to the Adoption of the Opera-

work as follows: State-owned enterprises are required to pay all taxes under existing tax laws. In addition, these enterprises are required to enter into an operational responsibility contract with state financial departments and/or their supervising departments, guaranteeing a minimum amount of total profits to be paid to the state through the SOEIT and SOEAT.⁸⁵ The contracted profit payment target (*lirun shangjiao mubiao*) is generally based upon an enterprise's profit payment base, which is the total taxes paid by the enterprise in the previous year.⁸⁶ If a state-owned enterprise does not reach its contracted profit payment target, it must make up the difference with payments to the state treasury out of its after-tax retained profits.⁸⁷ In addition, managers of state-owned enterprises are often required to assume personal liability for these payments.⁸⁸ If combined SOEIT and SOEAT payments to the state exceed the contracted target, a predetermined share of the excess is refunded to the enterprise.⁸⁹

Under the Operational Responsibility Contract System, determining the contracted profit payment target is crucial. Because it is a contractual provision, a state-owned enterprise must negotiate its profit payment target with government departments subject to the guidelines prescribed by the Operational Responsibility Contract System Regulations.⁹⁰ The Regulations require that the profit payment

tional Responsibility Contract System by State-Owned Industrial Enterprises) (promulgated Apr. 27, 1988), 1988 GUOWUYUAN GONGBAO 852.

85. Operational Responsibility System Regulations, *supra* note 84, arts. 5, 11, 14-15, at 1-3.

86. Quanmin Suoyou Zhi Gongye Qiye Tuixing Chengbao Jingjing Zeren Zhi Youguan Caiwu Wenti de Guiding (Provisions Concerning Financial Matters Relating To The Implementation Of The Operational Responsibility System For Industrial State-Owned Enterprises) art. 4 (promulgated Apr. 27, 1988) [hereinafter Operational Responsibility System Financial Provisions], 1988 GUOWUYUAN GONGBAO 853, 852.

87. Operational Responsibility System Regulations, *supra* note 84, art. 35, at 6-7.

88. Operational Responsibility System Financial Provisions, *supra* note 86, art. 10, at 854.

89. Operational Responsibility System Regulations, *supra* note 84, arts. 10-11, at 2-3; Operational Responsibility System Financial Provisions, *supra* note 86, art. 6, at 853.

90. Operational Responsibility System Regulations, *supra* note 84, art. 16, at 3; Operational Responsibility System Financial Provisions, *supra* note 86, arts. 3-4, at 852-53. The following three guidelines are most commonly used in negotiating operational responsibility contracts:

Where BP = base profit, R = contracted profit payment annual growth rate, and n = number of years since the year immediately prior to the enterprise's adoption of this system:

- 1) The contracted profit payment target is equal to base profits compounded at the contracted profit payment annual growth rate $[BP \times (1 + R\%)^n]$. If the enterprise meets the target, then it can retain all incremental profits;
- 2) If the enterprise meets the target calculated according to the above equation, it can share the incremental profits with the state according to a negotiated sharing rate of up to 70 percent;
- 3) The same conditions apply as in 2) except the target is either the actual profit paid in the

base is to be determined in accordance with the SOEIT and SOEAT paid by the enterprise in the fiscal year immediately preceding the year in which it became subject to the Operational Responsibility Contract System. The annual growth rate of the enterprise's profit payment target is to be determined on the basis of its potential for operational growth and in light of its financial needs for minor capital construction and technological renovation.⁹¹ Thus, there is wide latitude for negotiation under the Operational Responsibility Contract Regulations.⁹²

Although the SOEIT and SOEAT still apply to state-owned enterprises under the Operational Responsibility Contract System, their combined SOEIT and SOEAT liabilities based on their taxable income in a given year are no longer dispositive in determining their total income tax liability. What is dispositive is the contracted profit payment target, which supersedes the SOEIT and SOEAT. Thus, it appears that the Operational Responsibility Contract System represents a reversion to a system which is essentially the same as the responsibility contract form of profit sharing. Unlike under the Profit Sharing System, however, under the Operational Responsibility Contract System, an enterprise's combined SOEIT and SOEAT liability establishes a minimum floor of profit payments that it must make to the state.

Although the Operational Responsibility Contract System may increase revenues for the state, it appears that an unfortunate by-product of the new system may be the reemergence of many of the weaknesses and defects of the old Profit Sharing System. First, an enterprise's financial obligations to the state is again subject to broader government negotiations.⁹³ Thus, like under the old Profit Sharing System, an enterprise's retained profits may again result largely from its negotiating strategy rather than its efficiency. In addition, increased negotiations will likely renew the administrative burdens that were placed on the state treasury and government supervising departments under the old Profit Sharing System. Finally, with the increased role of government negotiations under the Operational Responsibility Contract System, unfairness and distor-

year prior to the current year or it is the actual profit paid the year prior to the adoption of this system by the individual enterprise.

91. Operational Responsibility System Regulations, *supra* note 84, art. 10, at 2.

92. According to one source, the profit payment bases and annual growth rates for many state-owned enterprises located in Hunan Province were determined "to a very large extent" by negotiations between enterprises, their supervising departments, and state financial departments. Kuan Yaoren, *Tuixing Chengbao Jingying Zeren Zhi de Jige Wenti Qianyi*, 12 *CAL ZHENG* 27 (1987).

93. See *supra* text accompanying notes 16-19, 27-34.

tions in competition between enterprises will likely reemerge.⁹⁴ This would frustrate a primary goal of the Conversion to the income tax system, which is to enable state-owned enterprises to compete equally on the basis of efficiency.

CONCLUSION

The development of the Chinese income tax system for state-owned enterprises illustrates the dilemmas that China faces in transforming its planned economy into a controlled market economy. It must find a method of allocating profits between state-owned enterprises and the state treasury which generates sufficient revenues for the government while at the same time providing state-owned enterprises with sufficient financial autonomy and responsibility. In addition, China must reconcile the tensions between compensating for irrational pricing on one hand, and excessive opportunities for negotiations on the other. Resolution of these problems will likely require further restructuring of China's economy with an emphasis on market mechanisms rather than on state planning. The income tax system for state-owned enterprises is a first step towards greater independence from the government. However, the Operational Responsibility Contract System may prove to impede such progress, for it emasculates the essence of the income tax system. It reverts to a system under which payments to the government are determined primarily by individualized negotiations rather than by uniform rates. While it may increase government revenues in the short run, it does not resolve the fundamental underlying problems that China's economy continues to face.

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94. Under the Profit Sharing System, an efficient enterprise might be penalized rather than rewarded because it could only negotiate a low profit sharing rate and has nearly reached its limits of performance. At the same time, an inefficient enterprise may benefit from its previous poor performance because it negotiated a high sharing rate and has ample room for improvement.

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