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Abstract
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Keywords
VAT, Value Added Tax, GST, Goods and Services Tax

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REFORMING VALUE ADDED TAX IN MAINLAND CHINA: A COMPARISON WITH THE EU

XU YAN*

Value added tax (VAT) is a consumption tax that is applied in many countries today. It was introduced in mainland China during the 1994 tax reform. The Chinese VAT system imitates the European VAT system. This article discusses the Chinese VAT system and its problems with evasion. China's recent reform experience is also compared with the European Union (EU) experience in implementing VAT. The article discusses what lessons can be learned from the experience in mainland China and the EU, so that VAT evasion is minimised.

INTRODUCTION[1]

VAT is a consumption tax imposed on value added during the production and distribution chain. It is nowadays the most common form of consumption tax and has been adopted in more than 135 countries, including all the Organization for Economic Cooperation and Development (OECD) jurisdictions except for the United States (US, which has state-based retail sales taxes). The EU, which introduced VAT as early as in 1967, has comparatively long experience with it.[2] The People's Republic of China (China) introduced VAT to its tax regime in the early-middle stage of the

* Post-doctoral Fellow, Faculty of Law of The University of Hong Kong. The author wishes to thank Professor Richard Cullen for his very helpful comments and general support for writing the article. The author would like to thank Professor Michael Tumpel for his valuable comments on a previous draft and kind direction when the author took up an Austrian Scholarship to study European tax law in Austria. The author is also grateful, too, for a range of other thoughtful comments on earlier drafts. The author, alone, bears responsibility for the content.

1 This article repeats certain arguments drawn from other written work by the author.

2 The predecessor of the modern EU VAT system was the French Tax, *à la valeur ajoutée*, which was formally adopted in France in 1954. In 1967, the member states of the former European Economic Community (EEC) were instructed to replace their existing turnover tax system with a common VAT system. Ever since then, countries outside the EEC like Austria, Sweden, Brazil, and Peru adopted some versions of the VAT. From 1987 to 1997, VAT was introduced to many eastern European countries, the former Soviet republics, and Asia. See R W Lindholm, 'The Value Added Tax: A Short Review of the Literature' (1970) 8 (4) *Journal of Economic Literature* 1178; see also Reference for Business, *Value-added Tax* <http://www.referenceforbusiness.com/management/Tr-Z/Value-Added-Tax.html>.

economic 'open door' reform. The Chinese VAT system has recently been further reformed.

Theoretically, VAT is neutral and easy to administer when compared with other types of consumption taxes, for example, retail sales tax. Instead of collecting tax only from retailers, under a VAT, businesses at each stage of the production and distribution process must remit tax. Each business pays tax on its 'value added', which is simply its total sales value minus the cost of inputs it purchases from other businesses. In this sense, the name 'value added' is more operationally accurate than the title 'goods and services tax' (GST). GST is applied, however, in a very similar fashion to VAT in countries like Australia, New Zealand, Canada and Singapore.

Very often, the VAT/GST uses an invoice credit method to calculate and tax the 'value added' throughout the production and distribution chain.[3] The VAT due on any sale is a percentage of the sale price, but from this the taxable person is entitled to deduct all the tax already paid at the preceding stages for the taxable activities. Therefore, double taxation is avoided and tax is paid only on the value added at each stage of production and distribution. This invoice credit method allows the tax authority to cross-check the VAT paid by the supplier and the input tax deducted by the purchaser, which, to a degree, guarantees that the correct VAT can be paid in stages and avoids the total default of VAT by a supplier in the chain who does not pay VAT for which he is liable.

Notwithstanding these advantages, VAT/GST is by no means flawless. To make a VAT/GST efficient (and resistant to evasion) it is best that it applies to the supply of all, or virtually all, goods and services. One of the major disadvantages is regressivity because low-income persons consume a higher proportion of their income than high-income persons. Some measures, such as providing tax credits, exempting certain basic needs items (like food, medical care, books, electricity, water, etc), and applying a high tax rate on luxury items (like certain automobiles, televisions, jewellery, etc) are of some use to solve this problem and to improve the income distribution situation. Once a 'pure' VAT system is modified in this way, however, it becomes more complex and this will increase implementation costs as well as create a discriminatory environment among various sectors of the economy.

By reflecting on the basic features of VAT, this article discusses the principles, problems, and recent reforms which have aimed at solving VAT problems in mainland China. Since the Chinese VAT system was heavily patterned after European VAT (while having developed distinctive features of its own), this article,

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[3] There are two prevalent methods of calculating VAT. One is the invoice credit method and the other is the subtraction method. The former method is most commonly used in jurisdictions in which a VAT/GST system is in place.

for the purpose of comparison, examines the questions of how problems of VAT fraud and evasion compare within the two existing systems, how those problems are being dealt with in both regimes, and what lessons can be drawn from their experience in terms of VAT legal design so as to avoid fraud and evasion.

This article is divided into a further four sections. The following section briefly talks about the European VAT regime and its recent development. The next section, dealing with the VAT system in mainland China, looks at a series of issues of that 'impure system' including all manner of special problems and the reform agenda. It discusses the problem of VAT evasion in the application of the invoice credit method and the problems caused by the non-neutral system, as well as how these problems are addressed by the recent reforms. The next section is a comparison of VAT problems in the EU and mainland China. It analyses how best to design a VAT system to ensure high levels of compliance and to control fraudulent evasion. The fifth section contains concluding observations.

THE EUROPEAN VAT

Basic characteristics

In 1967, the former European Economic Community (EEC)[4] enacted the First and Second VAT Directives to instruct the member states (MSs) to replace their existing turnover taxes with a VAT, which could link EEC members with a common tax system. The Second VAT Directive was replaced by the Sixth Directive in 1977,[5] which has recently been remodelled and, together with the First VAT Directive, has

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4 The Treaty on European Union, which was signed in Maastricht on 7 February 1992, came into force on 1 November 1993. The Maastricht Treaty changed the name of the European Economic Community to simply 'the European Community' (EC). The Maastricht Treaty created a new structure with three 'pillars', known as the European Union. The three 'pillars' are the decision-making institutional triangle made up of the Council of the European Union (also known as the Council of Ministers) and the European Council, who represent national governments, the European Parliament who represents the EU's citizens, and the European Commission who represents the common interest of the EU. See Europa, *How does the EU Work* <http://europa.eu/abc/12lessons/lesson_4/index_en.htm>.

5 The Third, Fourth, and Fifth VAT Directives were mainly used for extension of the deadline for the implementation of the First and Second Directives in some MSs. Since the adoption of the Sixth Directive, 16 numbered directives have been submitted by the Commission to the Council of Ministers (during the period in which the fiscal frontiers were not yet removed in EU). This was also used for addressing the matter that many newly acceded MSs had difficulty in meeting the deadline of 1 January 1978 prescribed by the Sixth Directive for implementation of that Directive. For detail, see B J M Terra and P J Wattel, *European Tax Law* (5th ed 2008) 123-124, 127-128.

been integrated into the new VAT Directive that came into force from the beginning of 2007. The structure and wording of the Recast VAT Directive (RVD) has been affected by the overhaul.[6] The basic features and principles remain materially the same, however.

Article 1 of the RVD, in particular paragraph 2, describes the common system of European VAT, which has been considered in many judgments by the Court of Justice of the European Communities (ECJ). According to the ECJ, the essential characteristics of the European VAT, inter alia, are as follows:[7] (1) VAT applies generally to transactions relating to goods or services; (2) it is proportional to the price charged by the taxable person in return for the goods and services which he has supplied; (3) that tax is charged at each stage of the production and distribution process, including that of retail sale, irrespective of the number of transactions which have previously taken place; (4) the amounts paid during the preceding stages of the production and distribution process are deducted from the VAT payable by a taxable person, with the result that tax applies, at any given stage, only to the value added at that stage and the final burden of that tax rests ultimately on the consumer.

The gist of the European VAT lies in the deduction of input tax by non-consumers, which ensures competitive neutrality.[8] Under the RVD, a taxable person has the right to deduct the input tax from the output tax. This right arises at the moment when the deductible tax becomes chargeable, that is, when the invoice has been issued.[9] The right to deduction or refund of the VAT is limited to goods and services used for purposes of taxable transactions,[10] which includes taxable transactions in another country, given that the transactions would be eligible for deduction of tax had they occurred in the territory of the home country.[11] Accordingly, no deduction is allowed for goods and services supplied based on exempt transactions[12] or used for non-business purposes. A trader who uses goods and services supplied for both taxable and exempt transactions may deduct only the proportion of the tax that is attributable to the former transactions.[13] The RVD provides for calculation methods,

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6 For detail, see Council Directive 2006/112/EC (Nov. 28, 2006) available from: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:347:0001:0118:EN:PDF>.

7 Joined Cases C-283/06 and C-312/06 (Kögay a.o.) [2007] ECR I-0000.

8 However, it should be noted that the provisions of the RVD currently in force in the EU do not always guarantee that the VAT system is sufficiently neutral, in particular in the case of the financial services sector. For detail, see Terra and Wattel, above n 5, 320, 336-349.

9 RVD, art 167.

10 RVD, art 168.

11 RVD, art 169.

12 RVD, art 132 (1).

13 RVD, art 173 (1).

the so-called 'pro-rata calculation', to determine the deductible proportion.[14] As to purchase of capital goods, a taxable person may deduct, immediately and fully, the VAT applying to capital goods if fully used for taxable supply under the RVD.[15] If there were no rules governing a change occurring in the deductible proportion during the lifetime of an investment in capital goods, the initial deduction might lead to an unjustified advantage or disadvantage for the taxable person where it is higher or lower than that to which the taxable person was entitled.[16] It is necessary to provide for rules on a limited period during which the original deduction can be adjusted if it turns out to be excessive or inadequate. The RVD provides for a 5-year adjustment period in the case of capital goods,[17] which is deemed to be in line with the normal depreciation period. As to immovable property acquired as capital goods, MSs have discretion to extend the period up to 20 years.[18] MSs also have discretion to define the concept of capital goods for the purposes of applying the rules concerning adjustment of deductions of input VAT on capital goods.[19] These rules may equally apply to services with the characteristics similar to those normally attributable to capital goods.[20]

The establishment of a VAT system in the EU was to meet the demand for an efficient single market in Europe. A neutral and transparent turnover tax system, which did not exist at the time when the EEC was created, was deemed essential to a common market and conducive to free movement of goods, persons, services and capital.[21] The most basic idea of the European Community in many respects can be seen as a

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14 RVD, art 174.

15 Under the European VAT law, input VAT on acquired capital goods that are used in a business over several years is fully deducted in the year which the goods are acquired or manufactured. The amount of input VAT recovered for capital goods, however, needs to be adjusted over time if the use of capital goods changes or the recovery position of taxable person changes during the adjustment period. Usually, for income tax purposes, the expenditure on capital goods is spread over multiple periods and deducted as an expense in each period. The expense is called depreciation if the capital good is a tangible asset like a building or amortization if the capital good is an intangible asset like a trade mark.

16 RVD, art 184.

17 RVD, art 187 (1).

18 Ibid.

19 RVD, art 189.

20 RVD, art 190.

21 The four freedoms were provided for by the Treaty Establishing the European Community, which was originally signed in Rome on 25 March 1957, entered into force on 1 January 1958, and amended by subsequent treaties. See Europa, Treaties and Law, < http://europa.eu/abc/treaties/index_en.htm>. Under Part Three of the Treaty, articles 23 to 27 of Title I prescribe the 'free movement of goods'; articles 39 to 60 of Title III prescribe the 'free movement of persons, services and capital'.

fiscal idea. Although the recent RVD provides a clearer overview of European VAT legislation currently in force and guarantees that the VAT contributed by each MS to the Community's resources can be calculated, it still allows MSs many possible exceptions and derogations from the standard VAT coverage and allows the application of non-uniform rates. The RVD does not fix the rates of VAT for MSs to apply, only a minimum rate of 15% until December 31, 2010[22] and one or two reduced rates of at least 5%,[23] which means that VAT rates differ widely (currently the standard rate among MSs vary between 15% and 25%).[24]

The European VAT applies the invoice credit method to calculate the value-added (*t* (output)-*t* (input), *t* is the tax rate), in which the invoice plays a pivotal role. An invoice has three functions:[25] (1) it contains information as to which VAT regime is applicable; (2) it enables the tax authorities to carry out enforcement controls; and (3) it allows the purchasers to prove, if necessary, their right to a deduction. The invoice has been characterized as the 'admission ticket to deduction.'[26] The important definition of conditions for invoicing with respect to VAT is now provided in the RVD.[27] The RVD aims at simplifying, modernizing and harmonizing the conditions that had been defined by MSs. The invoice credit method, with the help of the VAT Information Exchange System (VIES),[28] facilitates tax payments and has helped make VAT successfully implemented in the EU.

Major problem in practice: carousel fraud

VAT has become a major revenue source in EU countries. On average, VAT yields some 20% (across MSs) of total revenues.[29] Although outright tax evasion is difficult with VAT, it is subject to other fraudulent practices such as carousel fraud. This is

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22 RVD art 97.

23 RVD, arts. 98 and 99.

24 Taxation and Customs Union of the European Commission, *General Overview,* available from: <http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/index_en.htm>.

25 Terra and Wattel, above n 5, 358.

26 Ibid, citing AG Sir Gordon Slynn in Case 123/87(*Jeunehomme*) [1988] ECR 4517.

27 RVD, arts 217-249.

28 Taxation and Customs Union of the European Commission, *VIES (VAT Information Exchange System) Enquires*, available from: <http://ec.europa.eu/taxation_customs/taxation/vat/traders/vat_number/index_en.htm>; see also Revenue VIMA, *Changes to The VAT Information Exchange System (VIES)*, available from: <www.collector-general.com/en/customs/.../vies-information-guide.pdf>.

29 See the OECD, *Consumption Tax Trends – 2008 Edition* (Table 3.6 Value added taxes (5111) as percentage of total taxation), available from: <http://www.oecd.org/document/20/0,3343,en_2649_33739_41751636_1_1_1_1,00.html#TableOfContents>.

one of the prominent modes of theft of value added tax and it has been identified in recent years as a key factor in revenue loss, which is estimated at 2% to 4.4% of total European VAT receipts.[30] Carousel fraud, also referred to as VAT missing trader intra-Community fraud,[31] is prevalent in states where the movement of goods between jurisdictions is exempt from VAT. It consists of chains of supplies of goods in which a defaulting trader is involved, and the defaulting trader is liable to VAT but goes missing without accounting for that VAT.[32]

There are different forms with regard to intra-Community VAT carousel fraud. A typical example of carousel fraud starts when a seller in MS Y makes an exempt intra-Community supply of goods to F, the soon-to-be missing trader in MS X. F supplies the goods to the local customer B for, say 1,000 Euros, and it charges its customer the VAT of MS X (assuming 20%) in accordance with EU common VAT rules. The VAT thus amounts to 200 Euros, and payment of this amount is fully deductible by B from his own VAT liability when B supplies goods to a company C in the same country. The fraud occurs when F fails to remit the tax of 200 Euros to the tax authority in MS X.

The company B, called 'buffer', is usually ignorant of the fraud and purchases goods from F. The fraud could work with the 'missing trader' selling directly to the exporter (company C), known as the 'broker', but this would endanger the existence of the 'broker' if all transactions involved dealing with companies without any tangible assets or identity. The company B, buffer, is therefore put into the chain to distance the broker from the missing trader (thus making investigation difficult) and to make it more difficult to apply the joint and several liability provisions in VAT statutes. The broker, company C, is the exporter at the end of the chain of transactions. It is a key facilitator to the fraud by buying goods from buffers and supplying other MSs to

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30 EC (COM) (2006) 404 final, 4.

31 This particular type of VAT fraud was described by the HM Treasury & Customs and Excise paper as follows:

> VAT intra-Community missing trader fraud is a systematic criminal attack on the VAT system, which has been detected in many EU Member States. In essence, fraudsters obtain VAT registration to acquire goods VAT free from other Member States. They then sell on the goods at VAT paid by their customers to the tax authorities. The fraud is usually carried out very quickly, with the fraudsters disappearing by the time the tax authorities follow up the registration with their regular assurance activities.

Quoted in D Ruffles, G Tily, D Caplan and S Tudor, 'VAT Missing Trader Intra-Community Fraud: The Effects on Balance of Payments Statistics and UK National Accounts' (2003) 597 *Economic Trend* 58.

32 M Tumpel, 'A Hybrid VAT System in the European Union' (2007) 47 *Tax Notes International* 165.

obtain a VAT repayment. The fraudster F, missing trader, refers to a company that is always at the beginning of the chain and effectively facilitates the theft of the VAT by not accounting for it.[33]

In this case, F can use the system of exempt intra-Community supply to cover up taxable domestic transactions. The general rule for intra-Community transactions is that supplies of goods by taxable persons in a MS to taxable persons in another MS are exempt from VAT,[34] with the right to deduction, which means exportations occur and rules for zero-rated supplies apply. Directly corresponding to the supplies of goods that are exempt in the country of departure, the intra-Community acquisitions by taxable persons and non-taxable legal persons are taxable in the country of destination.[35] The VAT due on the acquisitions is deductible as long as the goods are used for activities for which a right to deduction exists.[36] The carousal fraud may be discovered, however, when the tax authority in MS X audits B and finds out that the supplier F has not remitted the VAT that B has deducted as input tax. In most cases the fraudster F has already disappeared or the company performing the fraudulent activity has become insolvent.[37]

VAT carousel fraud is not limited to cross-border transactions in the chain of supplies, though it is often committed in this area. Carousel fraud may occur in domestic transactions if a supplier collects VAT on sales from the purchaser and simply does not remit the VAT to the tax authority. In addition to pure domestic carousel fraud, cross-border carousel fraud is committed when the cross-border supply comes from a non-EU country. Such transactions have been increasing in the EU.[38]

Some reforms and proposals with regard to the above problem

The EU and MSs have sought strategies to combat VAT fraud because it affects not only the tax revenues of the MSs, but the financial interests of the EU. For this reason,

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33 For the terms of buffer, broker and missing trader, see the Financial Action Task Force (FATF), *Laundering the Proceeds of VAT Carousel Fraud* (23 February 2007), available from: <http://www.fatf-gafi.org/dataoecd/16/3/38335020.pdf>.

34 RVD, art 138.

35 RVD, art 2 (1), point b.

36 RVD, art140, point c; see also Terra and Wattel, above n 5, 277.

37 Often the company F is bought off the shelf from company formation agents and is registered at an accommodation address. Named Directors are either front men or completely fictitious. See FATF, above n 33.

38 COM (2006) 254 final, 4.

combating VAT fraud is, as required by Article 280 EC Treaty, a legal obligation for MSs.[39]

The EU Commission relies on administrative cooperation between MSs to deal with VAT fraud, but this has not prevented an increase in VAT fraud since the level of administrative cooperation is not commensurate with the size of intra-Community trade.[40] Some MSs have requested and been authorized by the council to derogate from the provisions of the RVD to prevent some forms of tax evasion or avoidance.[41] Some MSs have tightened their national measures to combat fraud, enforcing additional obligations on taxpayers in the chain of production and distribution to submit information to the tax authorities and to be jointly and severally liable for the payment of VAT.

Some other member states, in particular Germany and Austria, believe that the VAT system should be further amended so that VAT fraud can be more efficiently controlled. They call for extending the reverse charge mechanism[42] to domestic transactions in a member state to combat carousel fraud since this mechanism has proved effective in specific sectors of business such as construction. The reverse charge mechanism prescribed by the RVD allows EU MSs to provide, under certain circumstances, that the person to whom the taxable supply of goods or of services is made is the person liable.[43] This provision is contrast to the general principle that the person liable for payment of the tax should be the taxable person making the supply (whether or not established). Some studies offer more detailed explanations on this mechanism, for example:[44]

> [A] registered trader who receives an [imported] service is required to account for (output) VAT as if he had supplied the service himself, while at the same time claiming a deduction for a corresponding amount of (input) VAT. In the case of a fully or partially exempt business, no input tax (or only part of it) will be recoverable, so that VAT will be payable as a result of the adjustment. The purpose of the reverse charge procedure is to ensure that exempt and partially

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39 This article states:

> The Community and the member states shall counter fraud and any other illegal activities affecting the financial interests of the Community through measures to be taken in accordance with this article, which shall act as a deterrent and be such as to afford effective protections in the member states.

40 COM, above n 38.

41 RVD, art 395 (1).

42 RVD, arts 193-199, 202.

43 RVD, arts 194-199.

44 See A Ogley, 'VAT and Telecommunications Service in the European Union' (1997) 14 *Tax Notes International* 1155.

> exempt business do not obtain a tax advantage by buying service from an overseas supplier who is not required to account for VAT.

Although the Commission admits that the extension of the reverse charge mechanism could reduce some types of fraud, it and some MSs worry that this mechanism entails other problems, like the risk of new types of fraud. Also, some studies believe if Germany and Austria prevail in their reform efforts, the reverse charge mechanism would in effect turn VAT into a hybrid sales tax.[45]

In a sense, the European VAT is vulnerable to fraud and abuse due to the current complexity of the system that was built up, piecemeal. As researchers have noticed, with the 1993 abolition of border controls between the MSs, VAT payment was deferred when goods crossed EU borders. This deferral broke the VAT chain at the interface of domestic and foreign tax administrations. In theory, deferral was a major exception to the fractional payment principle under the European VAT system. It was believed that this change opened the door to carousel fraud.[46] Another contributory factor is the fact that the EU is not a 'single country' but rather a type of special confederation of independent national states all of which still maintain state-based, fiscal separation. This separation provides space for intra-Community carousel fraud activities, which may not occur in a single jurisdiction where standard-rated supply rules apply.

THE VAT SYSTEM IN MAINLAND CHINA[47]

Basic features of mainland China's VAT before January 1, 2009: an impure VAT system

The Chinese VAT system

Having considered the international trend of the adoption of VAT together with domestic fiscal needs in the 1990s,[48] mainland China introduced VAT as part of a

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45 See 'Evasion and Exemptions Erode VAT's Own Value Added' *Financial Times*, 19 June 2006; see also International VAT Association, *Combating VAT Fraud in the EU: The Way Forward* (Report to the European Commission, 2007), available from: <www.iva-online.org/documents/IVA_Paper_FINAL.pdf>.

46 See, eg, R T Ainsworth, 'Carousel Fraud in the EU: A Digital VAT Solution' (2006) 42 (5) *Tax Notes International* 443.

47 For discussion of matters contained in this part, see Y Xu, 'Putting the 'Value Added' in China's VAT' (2010) 58 (6) *Tax Notes International* 487.

48 For discussions of the fiscal difficulties facing China in the early 1990s, see, eg, S G Wang, 'China's 1994 Fiscal Reform: An Initial Assessment' (1997) 37 (9) *Asian Survey* 801; S D Xu, 'The Profound Background for China's 1994 Fiscal and Tax Reforms' (in Chinese), *The*

major general tax reform initiative in 1994.[49] Basic VAT legislation was enacted between 1993 and 1994. On 13 December 1993, the State Council of the PRC promulgated the Provisional Regulations of the Value-Added Tax of the People's Republic of China (VAT Regs), the Provisional Regulations of the Business Tax of the People's Republic of China (BT Regs), and the Provisional Regulations of the Consumption Tax of the People's Republic of China (CT Regs). These three new tax laws took effect as of January 1, 1994, with VAT Regs applying to goods and certain services involving labour provision,[50] BT Regs applying to most services including transfer of intangible assets and immovable property[51] and CT Regs applying very often to luxury goods (eg, cigarettes, wine, and expensive jewellery) in addition to VAT.[52] The impositions of VAT and business tax are mutually exclusive, and by combination they cover the scope of what a classical (say European) VAT covers. On 25 December 1993, the Ministry of Finance of the PRC (MOF) promulgated the Implementation Rules on VAT Regs (VAT Rules) according to Article 28 of the VAT Regs.[53]

This combined collection of tax laws was heavily patterned after the European VAT system. The base of the Chinese VAT was similar to the European practice in some respects, for example, zero-rating exports[54] and exempting certain goods such as instruments directly used in scientific research and education.[55] But it is different in other respects, for instance, permitting no credit for input taxes paid on capital goods if totally used for taxable supply.[56] Nor did it extend the VAT to most services. These differences are discussed at length later in this section.

University Service Centre of The Chinese University of Hong Kong, available from: <www.usc.cuhk.edu.hk/wk_wzdetails.asp?id=1264>.

49 See paragraph 18 of Part 4 of the Resolution on Various Issues Concerning the Building of the Socialist Market Economy. The Resolution was passed by the 14th Central Committee of the Communist Party of China (CCCPC) on 14 November 1993; see also the Implementation Schemes for the Industrial and Commercial Tax Reforms, submitted by the State Administration of Taxation of the PRC (SAT) and approved by the State Council on 25 December 1993.

50 VAT Regs, art 1.

51 BT Regs, art 1.

52 CT Regs, art 1 and sch CT Items and Rates.

53 The MOF also promulgated the Implementation Rules on BT Regs and the Implementation Rules on CT Regs on 25 December 1993. Both of these Implementation Rules took effect from 1 January 1994.

54 VAT Regs, art 2 (3).

55 VAT Regs, art16, para1 (4).

56 VAT Regs, art 10; VAT Rules, art 19.

The Chinese VAT system replaced a pre-existing cascading wholesale turnover tax,[57] and was regarded as, both at home and abroad, a laudable improvement in terms of removing tax distortions and providing a stable revenue source.[58] The VAT system (combination of VAT, BT and CT) has since emerged as the major (and secure) revenue source underpinning the finances of the Chinese state. VAT revenue alone has accounted for 45 to 30% of total tax revenue since 1994.[59] The share of the revenue from VAT, BT and CT in total tax revenue has been around from 67 to 52% during the same period.[60] In 2009, when the global financial crisis affected China's economy, VAT revenue still contributed 31% to the total tax revenue and collections from VAT, BT and CT accounted for 54% of total revenue (excluding revenue derived from Customs' collection of VAT and CT on imported goods and VAT export refunds).[61]

It is evident that VAT is an essential fiscal resource of the Chinese government. It applies at a standard rate of 17% to most taxable activities, including selling or importing goods and supplying services involving labour provision.[62] It is largely restricted to manufactures and is supplemented by a low rate of 3% business tax on key service items.[63] The reduced VAT rate of 13% applies to a range of goods

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57 The cascading effect was the major shortcoming of the old Chinese turnover tax. The turnover tax is imposed on the gross value without allowance of deduction to the taxes paid on inputs. Consequently, the prices for consumers are increased through the business cycle. For example, a manufacturer purchases raw materials (input) worth RMB 500 and pays tax of RMB 50 at the rate of 10%. Since he is not allowed to deduct the input tax, he will add RMB 50 to the cost of input. If the cost of his labor and service and other expenses to produce a commodity using the raw materials is RMB 450, which includes his profit (added value), the value of his product becomes RMB 1000. The tax on his selling is RMB 100 at 10%, which contains the input tax RMB 50 that has already been taxed at the time of purchasing. Thus, the tax RMB 5 is paid again on the tax of RMB 50 paid earlier. In this way, double taxation and tax on tax are created, causing the cascading effect. The product may also be used as an input for manufacturing other products, further cascading the tax.

58 See, eg, W Zhang, *Taxation Policy and the Economy of China* (2006), 12-14; see also R Bahl, *Fiscal Policy in China* (1999), 36-41.

59 Data sourced from the National Bureau of Statics of China, *China Statistical Yearbook 2009: 7-2 Taxes*, available from: <http://www.stats.gov.cn/tjsj/ndsj/2009/indexch.htm>. For the 2008 data, see the Tax Policy Department of the MOF, *Analysis on the Increase in Tax Revenues in 2008* (in Chinese), available from: <http://szs.mof.gov.cn/zhengwuxinxi/gongzuodongtai/200903/t20090304_118900.html#>.

60 Ibid. VAT and CT are only domestic VAT and CT, and do not include those from imports that are collected by the Customs on behalf of the SAT.

61 See the Tax Policy Department of the MOF, *Analysis on the Increase in Tax Revenues in 2009* (in Chinese), available from: <http://szs.mof.gov.cn/zhengwuxinxi/gongzuodongtai/201002/t20100211_270552.html>.

62 VAT Regs, art 2 (1) and (4).

63 BT Regs, art 2, para 1 and sch BT Items and Rates.

including basic staples or household necessities such as food, fuel, electricity, books, newspapers and magazines, and agricultural products.[64] The zero rate applies to export goods, as noted above, except for those that are stipulated otherwise by the State Council on the ground that the VAT is levied on domestic goods and services.[65]

There are two types of taxable persons in the VAT law, and the taxpayer's status may affect their VAT liabilities. The first category is 'general taxpayers' whose annual sales reached RMB 1 million or above (production type) or RMB 1.8 million (non-production type) and who have a sound accounting system to enable tax officials to ascertain the output and input VAT.[66] VAT payable by them is calculated according to a general computation method, which is output VAT minus input VAT.[67] For this method to apply, purchase invoice must be certified by the tax authority.

The second category is 'small-scale taxpayers' who have a relatively small amount or infrequency of taxable sales and incomplete accounting records.[68] They are levied based on a simple computation method, that is, multiply sales amount by applicable rate. Small-scale taxpayers do not have the right to deduct the input VAT[69] while general taxpayers have.[70] It should be noted that general taxpayers may lose their right to deduct when they do not have a sound accounting system, or are unable to provide accurate tax information, or their sales amount exceeds the standard for small-scale taxpayers but they fail to apply for determination as a general taxpayer.[71]

With regard to tax computation, it is important to note that first, with respect to general taxpayers' input VAT deduction calculation, purchased capital assets, goods and services for internal use, and damaged or lost inventory were not eligible.[72] Applicable input VAT deduction rates were usually the same as that paid for the

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64 VAT Regs, art 2 (2).

65 VAT Regs, art 2 (3).

66 VAT Rules, arts 11, 24, 27, 28 and 30.

67 VAT Regs, art 4. According to articles 5 to 7 of VAT Regs, the calculation of output VAT = current taxable sales x applicable VAT rate. According to articles 8 to 10 of VAT Regs, the calculation of input VAT = costs of eligible goods or services purchased in the current period x applicable deduction rate for input VAT. The current period refers to a period set by the relevant tax authorities. It is usually depends on the nature of the business a taxpayer has engaged in and the location of the taxpayer. The overall requirement for determining the meaning of 'the current period' is that the payment of the output tax cannot be deferred and the deduction of the input tax cannot be made in advance. *See* L Du and Y Xu, *Chinese Taxation System* (in Chinese) (3rd ed 2008), 56.

68 VAT Regs, art 14; VAT Rules, arts 11, 24, 27 and 29.

69 VAT Regs, arts 11 and 13; VAT Rules, art 25.

70 VAT Regs, art 4.

71 VAT Rules, art 3.

72 VAT Regs, art 10; VAT Rules, art 19.

purchased goods and services, but they were capped at 10% for agricultural materials or products purchased in the current period.[73] General taxpayers may adopt the simple computation to compute the VAT payable for the supply of certain specified goods if they found it to be advantageous to do so.[74] Second, the VAT rate for small-scale taxpayers engaging in commercial activities was 4%,[75] and for small-scale taxpayers engaging in mainly production activities, 6%.[76]

Mainland China's VAT is administered by the State Administration of Taxation (SAT) and the tax regulations and rules are uniformly applied across the country. VAT revenues collected are split at a ratio of 75 to 25 between the central and local governments.

Chinese features compared with the European VAT

Though the Chinese VAT borrowed basic ideas and principles of the European VAT when it was legislated, it has since evolved in ways which are quite different from VATs elsewhere, being used both as a stabilization device and an incentive mechanism for policy aims such as location of businesses and areas of economic activities (eg, technology products).[77] Compared with European VAT, Chinese VAT

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[73] VAT Regs, art 8, para 3. The 10% deduction rate has been increased to 13% by the recent VAT reform at the end of 2008.

[74] The MOF and SAT Notice of Adjusting the Value Added Tax Rates on Agricultural Products and Exempting the Value Added Tax on Certain Items, No 004 (94), 1994. According to it, the types of specified goods include: electricity supplied by small thermal electricity generating or hydro-electricity generating plants at or below the county level; sands, soil, and quarry for construction use and manufacture of construction materials; the supply of bricks, soil, and lime that are made of self-excavated sand, soil and quarry, building materials that are made of coal ash and boiler slag; biological products that are made of micro-organism, animal toxins, human or animal bloods; and the supply of water.

[75] From 1998, the tax rate for small-scale taxpayers was divided into two types. The tax rate for small-scale taxpayers engaging in commercial activities was reduced to 4%, while for all other small-scale taxpayers the tax rate remained at 6%. The MOF and SAT Notice on the Tax Policy for Small-scale Commercial VAT Taxpayers, No 113 (1998); see also 'The State Council, MOF and SAT Press Conference on Amending the VAT Regs, BT Regs, and CT Regs' (in Chinese), available from: <http://61.152.208.78/gate/big5/www.csj.sh.gov.cn/gb/csj/szpd/xfs/node5357/userobject7ai35530.html>. These differential tax rates have been incorporated into one rate, 3%, by the recent VAT reform in 2008, see discussion below.

[76] VAT Regs, art 12.

[77] See, eg, J Whalley and L Wang, *Evaluating the Impure Chinese VAT Relative to a Pure Form in a Simple Monetary Trade Model with an Endogenous Trade Surplus* (NBER Working Paper No 13581, 2007).

can be described as 'impure'.[78] Specifically, first, it is not a general tax as it only applies to tangible goods and very limited services such as assembling, processing, and repairing, while most services and other sectors are currently subject to the business tax. This means that the application of VAT is limited in scope.

Second, it is a production-based not consumption-based tax as purchase of capital goods like equipment and fixed assets are not allowed to form the basis for certain deductions.[79] Indeed, the basic principle of the EU consumption type VAT that is reflected in the treatment of deduction of the tax on capital goods is not in the case of China.[80] According to some studies, VAT may have three different forms in terms of the specific tax base, namely: production-based VAT; revenue (income)-based VAT; and consumption-based VAT. The major difference among them is their treatment on the deduction or tax credits for input VAT related to capital assets purchased during the relevant period.[81] Deduction of the input VAT is not allowed under the Chinese production-based VAT, but it is fully allowed against output VAT when capital assets are purchased under, eg, the European consumption-based VAT in the EU. The input VAT for capital assets acquired can be partially deducted in proportion to the values of the capital assets that have been consumed (through depreciation) in the relevant period under the revenue (income)-based VAT.[82] It is worth mentioning that the adoption of the production-based VAT with the narrowest deduction base for input tax in China's 1994 tax reform was primarily for solving fiscal difficulties facing both the central and local governments in early 1990s.[83] The other concern was that the great inflation pressure in the Chinese economy at that time needed to be constrained. A production-based VAT was thus a natural choice.[84]

Third, the tax is not consistently charged and collected on all transactions by business throughout the production and distribution process. As previously noted, with the differentiation between general taxpayers and small-scale taxpayers, varied tax rates

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78 Ibid.

79 VAT Regs, art 10; VAT Rules, art 19.

80 See Terra and Wattel, above n 5, 334; see also RVD, arts 184-192.

81 See Z J Lin, 'Evaluating the VAT in China' (2004) 30 *International Tax Journal* 65; see also James G S Yang and Robert Zheshi, 'Problems Implementing the VAT in China' (2004) 30 *International Tax Journal* 46.

82 Ibid.

83 Studies showed, in the years between 1978 and 1995, the ratio of total government revenue to gross national product (GNP) in China fell from over 34% to less than 12%. The central government was particularly constrained by the fiscal difficulty. The share of central to total government revenue declined to only one-third in 1993. See Wang, above n 48, 801-802; see also Bahl, above n 58, 5-11; and T M Atinc and B Hofman, 'China's Fiscal Deficits, 1986-1995' in D J S Brean (ed), *Taxation in Modern China* (1998), 31-42.

84 See Lin, above n 81, 71; see also Yang and Zheshi, above n 81, 56.

and deduction treatments apply. If a transaction is a supply of service not relevant to assembling, processing and repairing, the transaction cannot apply the deduction rule and computation of tax payable for this supply is different from that for VAT. If a supply is made by a small-scale taxpayer, the small-scale taxpayer cannot deduct its input tax from output tax. Even for general taxpayers, disparities in VAT payment and collection exist in different industrial sectors. A bias was built into the VAT system against capital investment and against capital-intensive industries as the 1994 VAT regulations did not allow deduction of input tax on purchased capital investment. The capital-intensive industries were therefore subject to a comparatively higher burden than labour-intensive industries.

Finally, the Chinese VAT is not a neutral tax in that the tax is formally administered on a destination basis, though rebates of input taxes are variable by sector and commodity (and it is used also in an on-off manner for stabilization purposes, which is particularly true with respect to exports).[85] mainland China normally practices zero-rating on exports as do most countries, but the government frequently adjusts the rates at which input taxes are credited or rebated on exports.[86] In theory, neutral refunds should be equal to the domestic VAT paid for the exported goods. In practice, VAT refunds for exported goods have been determined by government, which has become a difficult task because there has been a significant difference between the statutory and effective VAT rates under the production-based VAT system. The government may increase the refund amount when it attempts to encourage exports but reduce the amount when it needs to avoid conflicts with foreign trade partners.[87] This has made the VAT on exports internationally non-neutral and an instrument of trade policy (typically in the textile and clothing sectors).

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85 See Whalley and Wang, above n 77.

86 There were certain reasons to explain why the Chinese government opted to this export refund system. Briefly, in the first year of formally implementing VAT in Mainland China, due to rapid export growth and fraudulent invoices and rebate claims, much of the claimed 1994 rebates had to be deferred. In the following two years, the government budget still could not satisfy requested rebates and as a result it had to change the rebate rates. For detail, see Whalley and Wang, above n 77.

87 See Whalley and Wang, above n 77. In China, VAT refunds on exported goods and the VAT exemption on importation of capital equipment were often subject to official adjustments. The government has issued a number of circulars on this matter. Normally, most taxpayers must pay VAT for VAT goods first and then they can claim VAT refunds from the tax authorities based on the Exported Goods Declaration certified by Customs. The procedure and assessment of VAT refunds are very complicated and adjusted from time to time. See Lin, above n 81, 68.

The prominent characteristic of the 1994 VAT law is the requirement that businesses apply for a Special VAT Invoice (SVI) in all commercial transactions in mainland China. According to the VAT regulations, the amount of input VAT which the taxpayer pays for the purchase of input goods can be used as a tax credit to offset the sales VAT (output VAT). This credit is available only to the extent that input VAT payments can be verified by SVIs received from the input seller (or by the special receipt of payment of import VAT obtained from the Customs).[88] Therefore, to qualify for input VAT credits for purchased goods, the purchaser must always ask the seller to issue an SVI as opposed to an ordinary commercial invoice.[89] The seller should issue SVIs accordingly, indicating the amounts and the output tax, separately, in the SVIs.[90] When the supply of goods or taxable services is made to consumers, or the supply is VAT exempt, or the supply of goods or taxable services is provided by small-scale taxpayers, ordinary commercial invoices but not the SVIs should be issued.[91]

The SVIs are wholly controlled by the SAT,[92] and their forms, uses, and basic contents cannot be modified by the tax authorities at or above the county level.[93] All types of taxpayers must purchase the tax invoices from a relevant local tax bureau. While usually general taxpayers can purchase both SVIs and ordinary commercial invoices for own use according to the type of goods sold and the tax status of the buyer,[94] the small-scale taxpayers cannot purchase SVIs for own use.[95] If a small taxpayer wants to sell goods to general taxpayers, he may request the governing tax authority to issue the SVI on his behalf, which is to be provided to the buyer.[96] It is worth noting that illegal printing any type of tax invoices, purchase of any type of tax invoices from bodies other than the tax authority in charge, forging and selling forged SVIs,

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88 VAT Regs, art 8, para 2.

89 The ordinary commercial invoice is used for supplies that are not for VAT purposes, that is, supplies that are not subject to VAT regulations and rules.

90 VAT Regs, art 21, para 1.

91 VAT Regs, art 21, para 2.

92 See article 4 of the Regulations on the Administration of Invoices of the PRC (RAI) 1993, State Council.

93 See articles 4, 5 and 6 of the Implementation Rules on the RAI (IRRAI) 1993, State Council.

94 RAI, art 16; IRRAI, art 16.

95 See article 1 of the Provisions on the Use of Special VAT Invoices (Trial Implementation) 1993, the SAT. The Provisions have been amended by the SAT, changing the title to the Provisions on the Use of Special VAT Invoices (PUSVI), on 17 October 2006, which took effect from 1 January 2007.

96 PUSVI, art 10, para 3.

illegal selling SVIs, forging and selling other forged invoices are in violation of the PRC law.[97]

Moreover, the VAT regulations and rules do not permit the use of SVIs in some transactions. Qualified users of SVIs cannot always issue SVIs where the subject matter they sell is either a consumer good or a non-VAT item. According to the relevant provisions,[98] the following transactions are not allowed to use SVIs: (1) sale of goods or supply of taxable services to small-scale taxpayers; (2) sale of VAT-exempt goods; (3) sale of goods or taxable services to the final consumers; (4) sale of specific types of goods at the retail sector (such as cigarettes, wine, food, clothing, shoes, hats, and cosmetics products); (5) sale of export goods or taxable services for consumption outside the PRC; (6) use of goods for non-taxable items (such as using stock-in-trade for the construction of own assets); (7) use of goods for collective or personal consumption; (8) supply of goods at no consideration (a gift); and (9) provision of non-taxable services (except for those subject to VAT in mixed sales). Sellers must, in such circumstances, issue ordinary commercial invoices instead of SVIs.

If sellers make sales of goods, VAT services, and sale of non-VAT services, ie mixed sales, they must maintain separate and accurate accounts for those activities, because otherwise their sales of non-VAT services would be subject to VAT, and the tax rate levied on the non-taxable services would be the highest one applicable.[99] For mixed sales, only those entities who engage in production, wholesale, or retail, including engaging in activities cantered on goods producing, wholesaling and retailing, and concurrently tied to non-taxable services are deemed to be VAT taxpayers, subject to VAT. Business tax but not VAT is levied on the mixed sales made by other entities and individuals.[100]

For transactions in which intermediate goods or non-consumer goods are involved, SVIs serve both as evidence of VAT payment and as the ordinary commercial invoice. The form of an SVI is only slightly different from an ordinary Chinese commercial invoice. Generally, an SVI contains certain items not found on an ordinary commercial invoice, namely the rate and amount of VAT payment and the registered tax numbers of both supplier and purchaser.[101] The unit price and total price indicated on an SVI are VAT-excluded prices, while those on an ordinary commercial invoice are VAT-included prices.

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97 Law of the Administration of Taxation of the PRC (LAT), art 71; Criminal Law of the PRC (CL), arts 206-209; RAI, arts15, 36 and 38; IRRAI, art 47.

98 VAT Regs, art 21; PUSVI, art 10.

99 VAT Regs, art 6; VAT Rules, arts 5,6 and 10.

100 VAT Rules, art 5.

101 IRRAI, art 5.

Under the Chinese VAT law, the SVIs play a predominate role in that they are used by the tax authorities as the sole legitimate source documents to assess the VAT due, input VAT deduction, or export VAT refunds. This function is quite different from the functions of an invoice under the European VAT. Since only those who are entitled to use the SVIs can get a deduction of input tax or tax refunds for exported goods, and only those transactions that are carried on with the SVIs can get money (tax paid already) back, the SVI becomes a valuable document for both suppliers and purchasers. This invoice-based VAT system however has to face a large number of cash transactions carried on by small-scale businesses, in addition to other administration problems produced by the special features of the regime.

Major problems in practice: tax evasion in invoice-credit method and non-neutrality

Although the VAT has been the most important revenue source for the government in recent years, tax losses arising from various causes are substantial. Some studies estimate that about 55% of VAT revenue is lost to tax evasion and various deficiencies in tax administration, most notably the control of SVIs and related fraud.[102]

VAT invoices seem more valuable than money itself. In theory, there is a paper trail that tax authorities can follow to track the VAT paid at all stages of production and distribution until the taxable goods or services are purchased by the final consumers. In practice, the paper trail is full of twists and turns.[103] When forged or fraudulent invoices are used to claim input VAT refund without actual payment made by the claimant, the amount refunded may be constrained only by the claimant's greed. Although the SVIs are printed exclusively by an authorized agency in accordance with a designated form set down by the SAT[104] and only those invoices can be used to claim VAT refunds,[105] verifying the authenticity of the invoices is fairly difficult for several reasons including information asymmetry among tax authorities at the local level.[106] For instance, when input tax is paid in one region and a refund is claimed in another region as the tax authorities in these two regions do not have integrated processing systems, forged or fraudulent invoices may not be detected. Indeed,

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102 See J Y Li and B Wang, 'Efficiency, Exports, and Evasion: Triple-E Concerns in the Chinese VAT Reform' (2005) 37 *Tax Notes International* 775.

103 See J K Winn and A Zhang, 'China's Golden Tax Project: A Technological Strategy for Reducing VAT Fraud' (Working Paper, 2010) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1641379>.

104 RAI, art 7; IRRAI, art 6, para 1 and art 8.

105 RAI, art 22; IRRAI, art 32; PUSVI, art 11.

106 See X J Liu, 'Study on VAT Loss in China' (in Chinese) (Xiamen University PhD Dissertation, 2007).

forged VAT invoices, invoices for fictitious transactions, illegally selling or purchasing SVIs, and the failure to report the VAT by not issuing invoices to purchasers are common means of evading the tax. These activities may be subject to criminal charges when they constitute an offence according to law.[107]

The SAT has recently focused on controlling invoices from the very beginning of the process in order to reduce the notorious level of VAT evasion. The control measures include the mandatory use of state-regulated, computerized cash registers by retailers, the use of an SVI antifraud control system to print and verify SVIs,[108] and improvements in the networking of various tax offices to enable cross-checking invoices issued in different locations. Nevertheless, these measures likely have minimal impact on the vast majority of businesses that conduct cash transactions. Even though forged SVIs can be restricted to a certain extent, fraudulent claims of input VAT for transactions that did not take or take place with lesser amounts than the current claimed are not easy to detect (due to the impurity and complexity of the VAT system).[109] Although one of the main purposes of making SVIs mandatory is to bring the chaotic record-keeping practices of Chinese businesses under the control of government, the achievement of this purpose seems a long way off.

Another notably severe problem is the non-allowance of deductions of input VAT for purchases of capital assets, which is at odds with international (including the EU) practice. The production-based VAT has a certain relative advantage. It gives no right to deduct input VAT for purchased capital assets, indicating a relatively broad tax base, which can ensure more tax revenues for government. On the other hand, the input VAT that must be capitalized adds to the cost and sale price of manufactured goods within the production and distribution chain. This can lead to duplicated VAT levies through the supply chain in the entire business cycle and it increases the tax burden on enterprises in general. In particular, it penalizes the purchase of assets by a business, and more broadly penalizes capital-intensive production techniques. Though the standard tax rate is 17%, the effective tax rate may amount to 23% when the production-based VAT is converted into the consumption-based VAT, a high rate in a worldwide perspective.[110] This practice of no credits of input VAT for capital

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[107] See LAT, art 69; see also CL, arts 205-210.

[108] The SVI antifraud control system refers to the computer management system which manages VAT invoices by using special-purposed equipment and general-purposed equipment and applying the digital ciphering technology and the electronic storage technology. The State Council approved using the system nationwide. See the PUSVI, art 3.

[109] See B Yang, 'The Institutional Impediment and Administrative Inefficiency of China's VAT system and The Design for a New Chinese-Characteristic of VAT Regime' (in Chinese) (2001) 2 *Cai Zheng Yan Jiu* (*Public Finance Study*) 52.

[110] For example, the minimum standard VAT rate in the EU is 15% before 31 December 2010. The standard rate of VAT in the UK has been 17.5% since 1 January 2010. The current

assets has also helped cause an imbalance in the industrial structure in China. In view of the regional disparities in production, this type of VAT further penalizes the non-coastal regions as the coastal regions' business tends to be labour-intensive while the inland regions are capital-intensive, mining for instance.[111] This production-type VAT has unintentionally become a negative factor with respect to technology upgrading and economic growth in the country, further weakening the competitive edge of Chinese enterprises in international markets.

Moreover, the VAT applies multiple-rates and is subject to various adjustments, which has not only caused the loss of uniformity of VAT treatment and loss of consistency of input deduction at each stage of production and distribution process, but has led to inequality in tax burdens on different types of VAT taxpayers. There are limits placed on export VAT refunds.[112] Unlike the conventional invoice-credit VAT such as that in the EU, export VAT rebates in mainland China are unrelated to input taxes paid on materials and the schedules of allowable refund rates are changed by government from time to time. This ad hoc approach may be not so bad in terms of guaranteeing government revenues and dealing with international trade, but it makes the tax impure and the allocation of the tax burden unequal.

The third problem is that not all sales of goods and services bear the same tax since goods and limited service relating to the sales of goods are governed by VAT while most services are taxed by BT. This separation has, in fact, improperly cut off the input VAT deduction chain from the flows of services in the entire business cycle, and it has become impossible to fully reflect the value-added processes in the cycle. Contrary to the VAT under which the input tax usually can be deducted from the output tax, the BT does not allow any deduction of the input tax from the output tax.[113] As a result, the most important advantage of an invoice-credit based VAT

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standard rates of VAT in Australia, Japan and Singapore are 10%, 5%, and 7%, respectively. The highest standard VAT rate among countries that have a VAT/GST system is 25% in Denmark, Norway, and Sweden.

111 See P Garello, 'The Road to Efficient Taxation in China' in T Eger, M Faure and Z Naigen (eds), *Economic Analysis of Law in China* (2007) 29-54.

112 According to some study on China's export rebates based on statistical data in 2002, the export refunds divided by the exports produced an average actual rebate rate across all goods of about 5%. There were surely various refund rates that applied to exported goods. See Whalley and Wang, above n 77.

113 According to articles 4 and 5 of the BT Regs, the tax payable for BT taxpayers who provide taxable services, transfer intangible assets, or sell immovable properties should be computed on the basis of the turnover and the applicable tax rates. The turnover of a taxpayer should be the total consideration and additional fees and charges it received from the provision of taxable services, transfer of intangible assets or sale of immovable properties.

system, ie cross-checking input and output VAT as that applied under the European VAT law, is interrupted under the Chinese VAT and BT Regs. Furthermore, with growing integration of business activities, the distinction between supply of goods and supply of services has become blurred. More and more enterprises engage in diversified economic activities including mixed supplies of goods and services across traditional industrial and commercial lines. The current VAT system, in practice, encourages tax arbitrage to minimize tax burdens. And the coexistence of parallel taxes, ie the VAT, BT (and on some occasions CT) with varied tax rates on the turnovers of service, tends to induce tax evasion or abusive activities by enterprises through taking advantage of different taxes. With respect to the administration and collection of BT, there remain conflicts of interests between the central and local tax authorities. This is because BT is a local tax and revenues from it belongs to the local governments, while VAT is governed by the central tax authority and the major part of VAT revenues goes to the central government.[114] The incomplete and impure VAT in mainland China thus poses real difficulties to tax administration.

Indeed, problems exist not only in the VAT system but in the tax administration, generally. Chinese tax administration has long relied mainly upon manual operations for tax collection, refund and audit. Tax administration lacks efficiency and accuracy in monitoring tax payments. The tax authorities are unable to cross-check detailed information of VAT taxpayers on all of their transactions due to the problematic use of SVIs and the incomplete application of VAT. The present practice of relying solely on SVIs for VAT imposition and auditing cannot ensure reliable controls on taxpayers' compliance. Large numbers of tax frauds or evasions exist with regard to fake SVIs or illegitimate claims of input VAT or export refunds, which have severely eroded the government's fiscal revenues every year. The complicated and vague provisions in VAT regulations and rules further create considerable room for arbitrary decisions in the enforcement of the tax, which providing incentives and possibilities to manipulate or evade taxes.[115] Such a system also invites direct corruption.

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[114] China is a unitary state. The taxing power is centralized in the central government. The 1994 tax reform introduced a tax-sharing system and separated tax administration into central and local levels, however. In political-economic discussion about China, the terms, 'central government' and 'local government' are typically used to mean the central government in Beijing, and local governments at and below the provincial level (which includes all governments at different levels from the provincial level downwards).

[115] See Lin, above n 81, 74-5.

Recent reforms and unresolved problems

The government launched a pilot program in three north-eastern provinces (Heilongjiang, Liaoning, and Jilin) in January 2004 to evaluate the application of VAT on a consumption basis in order to address some of the above problems. The pilot program covered eight industrial sectors including oil, chemical, and automobiles. It was then extended to 26 cities in the central region in July 2007 and to certain parts of Inner Mongolia Autonomous Region and the hard-hit areas of Wenchuan, Sichuan province (affected by the Wenchuan earthquake in July 2008).[116] Based on these experiments, the State Council of the PRC approved a major overhaul of the VAT law, together with related revisions on BT Regs and CT Regs, as part of a large fiscal stimulus package (dealing with the onset of the global financial crisis) before the close of the year 2008.[117] Following the revisions, the MOF and SAT jointly published revised implementation rules on VAT Regs, BT Regs, and CT Regs for the purpose of providing more detailed rules on the administration of these three turnover taxes.[118] Both of the revised regulations and rules took effect from January 1, 2009.

The most significant change in the revised VAT law is that registered VAT general taxpayers are allowed to deduct input tax related to purchases of equipment and other non-real property fixed assets.[119] If the fixed assets used in VAT taxable items are also used in non-VAT taxable items, VAT exemption items, collective welfare and personal consumption, the relevant input VAT is still creditable.[120] It is however not clear how such input tax credits should be attributed to a taxable item. This change only partially transformed China's production-type VAT into a conventional consumption-type VAT in that purchase of real property and intangible property still falls outside of the deduction scope, which means capital investments in these types of property are not creditable in the production and distribution process. The term 'real property' has been clarified by the amended VAT Rules as property which is

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116 The SAT, 'VAT Transformation: Win-Win for Taxation System Reform and Economic Development' (in Chinese), 6 February 2009 <www.chinatax.gov.cn/n8136506/n8136593/n8137537/n8138532/8814903.html>.

117 See Amended VAT Regs, State Council Order No 538, Amended BT Regs, State Council Order No 540, and Amended CT Regs, State Council Order No 539, 10 November 2008.

118 See Amended VAT Rules, MOF and SAT Order No 50, Amended BT Rules, MOF and SAT Order No 52, and Amended CT Rules, MOF and SAT Order No 51, 15 December 2008.

119 Amended VAT Regs, arts 8 and 10; Amended VAT Rules, arts 21 and 25. According to these provisions, the term fixed assets should 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. The term fixed assets should however not include motor vehicles, motor cycles, boats or yachts which are subject to consumption tax and for private use.

120 Amended VAT Rules, art 21, para 1.

immovable or the nature or shape of which will be changed after movement, including buildings, structures, and other land attachments.[121] The real property that is newly built, rebuilt, expanded, repaired, or decorated by a taxpayer should be termed as a real property project under construction.[122] Nevertheless the limited change, the provision of deduction right for input tax on non-real property fixed assets, marks a major step in rationalizing the Chinese VAT system.

There are other important revisions in VAT. First, the annual sales thresholds for being qualified as general VAT taxpayers have been reduced from RMB 1.8 million to RMB 800,000 for commercial enterprises and from RMB 1 million to RMB 500,000 for industrial enterprises.[123] This means that some previous small-scale taxpayers may be included into the category of general taxpayers so that they can enjoy the input deduction benefit. Moreover, the previous practice of dividing small-scale taxpayers into commercial and industrial types and applying different tax rates has been repealed also. This was mainly because that it was very difficult for the tax authority to clearly define the different type of small-scale taxpayers in terms of real economic activities.[124] The VAT rate for small-scale taxpayers in all industries is now reduced and standardized to 3%. This revision may help balance the tax burden between general and small-scale taxpayers and advance small and medium enterprises' development as well as increase employment.[125]

Second, preferential treatment of VAT exemptions on certain imported equipment and VAT refunds on the purchase of domestically-produced equipment by foreign investment enterprises have both been abolished by the 2008 VAT reform. This was to conform to the (partial) transformation from a production-based VAT into a consumption-based VAT brought about by the reform.[126] Prior to this reform, the VAT exemption policy for imported equipment was provided for the purpose of encouraging certain domestic industries to expand the scope of utilizing foreign investments and to introduce advanced technologies as well.[127] Implementation of this policy, however, led to some problems in practice. For instance, due to the relatively broad scope of the exemption, the policy could not stimulate domestic independent innovation initiatives and nor could it help develop domestic manufacturing industry. It also caused inequality in allocating tax burdens on foreign and domestic enterprises as the scope of exemption for domestic enterprises was

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121 Amended VAT Rules, art 23, para 2.
122 Amended VAT Rules, art 23, para 3.
123 Amended VAT Rules, art 28.
124 The SAT, above n 116.
125 Ibid.
126 Ibid.
127 Ibid.

narrower than that for foreign enterprises.[128] Since the reform now allows deduction of input tax on the purchased equipment, whether imported or domestically-made, the exemption policy for imported equipment is no longer needed. The same is true with the case of VAT refund policy for domestically-produced equipments.

Third, the VAT rate for mineral products has been reset to 17% (in contrast to the prior rate of 13%). Since the reform provides input tax credit for purchased equipment for general taxpayers including mining enterprises, the tax burden on mining enterprises was set to decrease. In order to equalize the tax burden, standardize the VAT system, and promote energy conservation and efficient utilization, the government therefore returned the tax rate for mineral products including metal and non-metal mineral products to the standard rate of 17%.[129]

Fourth, there are changes for certain mixed sales activities and all composite sales activities. For mixed sales, the taxpayer who supplies self-produced goods and concurrently provides construction services should separately account for its sales amount of goods and the turnover of non-VAT services. VAT should apply to the sales of goods, while BT applies to the provision of non-VAT services. If the taxpayer fails to do so, the tax authority in charge is empowered to determine the sales amount of the goods.[130] For the composite sales, the previous rule was that if a taxpayer failed to separately account for the sales amount of goods or taxable services and the turnover of non-VAT taxable items, it should charge VAT on the whole transaction. Under the revised VAT rules, however, the tax authority in charge is empowered to determine the sales amount of goods or taxable services.[131] Therefore, the taxpayer pays VAT and BT separately according to the prices determined by the tax authority. This would help reduce the double taxation problem caused by the old rule.

The major change in BT regulations and rules is to render the BT treatment of cross-border services analogous to the Chinese VAT, which practices destination taxation with respect to the cross-border flow of goods, ie taxing imports but exempting exports. The revision in BT regulations and rules was also made to mixed sales and composite sales activities in order to be in line with the relevant change in VAT regulations and rules as discussed above.[132] The major changes under the new CT regime are to include the changes to CT policies provided in various tax regulations

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128 Ibid.

129 Ibid.

130 Amended VAT Rules, art 6.

131 Amended VAT Rules, art 7.

132 The MOF and SAT, 'Press Conference on the Revisions in VAT Rules, BT Rules and CT Rules' (in Chinese), 18 December 2008, available from: <www.chinatax.gov.cn/n8136506/n8136593/n8137681/n8532970/n8533009/8730046.html>.

promulgated during the past 15 years as well as to help the CT conform to changes in the VAT and BT. A key underlying theme in all these reforms is that they signal the policy-makers' willingness, eventually, to contemplate the integration of the current VAT, BT and CT into a single, standard VAT regime.

But, as explained by the officials at SAT, this recent reform in mainland China's turnover tax system is limited, in particular, in two ways. First, the right to deduct input VAT on the purchase of fixed assets is not applicable to real property and intangible property, though their values are allowed to be included in the fixed assets for accounting purpose.[133] Second, small-scale taxpayers cannot benefit from the transition to VAT since their input VAT on the purchase of fixed assets is still not creditable. However, the government is well aware that the next step after this partial transition will be: replacing BT with VAT and allowing full deductions. But it has already perceived how difficult and complicated this step will be. First, VAT remains the largest source of fiscal revenues for government at present as noted previously. The government itself estimated a loss of revenue of RMB 120 billion in 2009 from the changes.[134] The most important yet sensitive issue involves inter-governmental fiscal institutional reform, specifically the fiscal and political relationship between central and local governments.[135] Currently, most sales of service are subject to BT instead of VAT and revenues from this source belong to local governments as stipulated under the 'revenue-sharing' scheme in the current Chinese tax system. The BT revenues have been the largest revenue source of local governments, and, as a result, the immediate consequence of replacing them, if without efficient compensation, would cause a substantial loss of local revenues, which is unacceptable to local governments. Third and last, the tax administration in mainland China is separated between the state administration (central) and local administration. The major function of local administration relates to the imposition and collection of BT. If VAT applies to cover all the tax base of BT, the need for the existence of local administrations becomes questionable.

The full right of deduction that is argued to be needed by reformers and market operators, if it extends to the entire production and distribution process regardless of taxpayers' status and supply type, would greatly affect government revenues---though this would promote fairness and equality in tax impositions. Therefore, numbers of officials and researchers believe a safer way to transform the present system into a purely consumption-based VAT in mainland China would be to phase

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133 The SAT, above n 116.

134 Ibid.

135 Many of local governments here refer to provincial governments in Mainland China.

it in step-by-step to minimize any adverse impact on the government's tax revenues as well as government relations in the short-term.[136]

Finally, as to the problem produced by SVIs, it is in effect part of the problems caused by the hybrid VAT system. It is worth thinking why the credit-invoice method in VAT has achieved a success in, for example, the EU, but leads to such an uncomfortable failure in China. The SAT started the construction of the so-called 'Golden Taxation Project' in 1994,[137] which is a nationwide taxation database connecting multiple-source databases run by the public finance departments, banks, customs authorities, securities exchanges, and/or large enterprises. This computerized taxation data network was targeted to be in full operation by 2005, with the hope that tax authorities would be able to monitor taxpayers' transactions beyond what has been based solely on the SVIs and thus reduce tax evasion from illegal uses of SVIs.[138] Though the technical improvement is commendable and of great use to prevent SVI evasions,[139] the most efficient and thorough way to solve VAT evasions and abuses is to change the currently impure VAT system into a pure one so that the tax authorities can cross-check the input and output VAT at each stage of production and distribution of goods and services. But, as it has just been discussed above, implementing this change means confronting and resolving major revenue risks and major intergovernmental finance issues.

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136 See, eg, Xi Si, 'The Second Step of VAT Reform: Eliminating Double Taxation' (in Chinese), *Economic Observer Online*, 5 January 2009, <www.eeo.com.cn/finance/other/2009/01/04/126195.shtml>.

137 The 'Golden Taxation Project' consisted of three stages. The first stage (1994-1995) only provided for a computerized database of the records of both taxpayers and tax collectors in 50 cities. The second stage of the project began in 1998. The computerized network was applied to all the provinces and it was extended to the tax authorities above the country level. The third stage of the project stared in 2005, aimed at establishing a more comprehensive information and management system. See S L Lin, *The Rise and Fall of China's Government Revenue*, (EAI Working Paper No150, 2009), available from: <www.eai.nus.edu.sg/EWP150.pdf>; see also 'The Golden Taxation Project' (in Chinese), available from: <www.china.com.cn/chinese/zhuanti/283779.htm>.

138 Ibid.

139 It should be noted that although the Golden Taxation Project has achieved major success, it has had serious shortcomings created by the network system. One loophole is that certification is only made to the content of the invoice, and tax authorities do not check whether a VAT return was submitted or VAT paid by the supplier. There are other operational problems. See Winn and Zhang, above n 103.

A COMPARISON OF VAT PROBLEMS IN THE EU AND MAINLAND CHINA

From the discussions of the VAT practices in the EU and mainland China, we can see that both of these two regimes face significant problems (in China's case often more severe) related to VAT evasion. Comparatively, the European VAT, a consumption-type VAT, is purer, more advanced, sophisticated, and neutral than the VAT in mainland China. EU MSs generally have sound accounting systems to facilitate domestic tax collection and administration as well as mutual cooperation between themselves. The invoice credit method allows tax authorities to cross check VAT paid by suppliers and VAT deducted by purchasers. The information management system in the EU, along with quality accounting and banking systems, helps tax authorities to look over nearly all transactions carried on by VAT payers. There is no differentiation of taxpayers' status and the deduction right is available to all registered taxpayers for transactions where a right to deduct exists.

On the other hand, such an advanced system cannot efficiently prevent tax theft, especially theft based around these transactions involving supply within the EU. Three reasons, among others, may help explain the EU intra-Community tax evasion problem. First, the EU, unlike mainland China, is not a single jurisdiction. The border-controls have been abolished --- but the fiscal controls by the independent MSs still exist. Special rules for cross-border supplies and acquisitions of goods and services are needed to solve double taxation problems. This however makes European VAT law complex and creates opportunities for cross-border fraudulent activities. Second, the administrative cooperation between MSs has been improved, but it may be understaffed and underfunded and thus not able to meet the aim of securing efficient control over cross-border fraud. Third, although the European VAT is a standard VAT and it provides uniform treatment for transactions of goods and services, it does not offer uniformity of tax rates. MSs are allowed to set up specific tax rates within a certain range. There is an incentive to engage in VAT designed activities that practice arbitrage of the discrepancies in rates.

The VAT problems in mainland China are generally of a different sort. It is only a partially consumption-based VAT, and it is not neutral with respect to exportation and deduction. It does, however, have a fundamental advantage which the EU does not: it is a single jurisdiction. This reduces the necessity of extra rules applying to supplies of goods and some services across regions, thus avoiding complexity of the system and giving no chance for the so-called carousel fraud (of the EU-type) across jurisdictions. VAT evasion problems in mainland China are mostly related to the impurity and non-neutrality of the system. The design features of the partially production-based and partially consumption-based system provides incentives for tax evasion, in part, because the tax burden is not evenly allocated among industrial sectors. The use of the invoice credit method is very problematic due to various

discriminatory rules which apply to small-scale taxpayers and general taxpayers, to sales of taxable goods and services and sales of non-taxable services, and so on. Moreover, since there is a lack of sound accounting systems with many small-scale taxpayers and there is a lack of effective information systems for VAT administration for government, outright fraudulent activities are hard to prevent with regard to the illegal use of SVIs. Also, the Chinese VAT system is non-neutral on exportation as the government adjusts refund rates for exported goods from time to time. The adjustments and control over international supply are, however, to some extent, conducive to the collection of VAT payments, helping prevent the sort of cross-border fraudulent activities which have happened in the EU.

When we look at the advantages and disadvantages of the VAT systems in the EU and mainland China, it is, prima facie, difficult to answer the question, which one is less prone to fraud and evasion? If the EU can effectively solve the problem of cross-border carousel fraud, its VAT system will be certainly even better than the current Chinese VAT system. This, however, may call for substantial and even bold reforms to further harmonize VAT law in EU MSs, to increase administrative cooperation, and to promote fiscal collaboration between MSs. The most difficult task is the fiscal separation among the EU, which seems unlikely to be resolved in a short term. For mainland China, the major reason for VAT evasions in the invoice credit method lies in its special features of impurity and non-neutrality as well as inadequacy in accounting and information management systems. But the government is determined to transform the hybrid system into a 'clean-bred' system. Strong (well founded) political will may help overcome reform difficulties concerning inter-governmental fiscal relationship. In the case of mainland China, achieving this, probably, seems to be more foreseeable than the sort of reforms needed in the EU.

The lessons which can be drawn from the experience in the EU and mainland China may be generalized into two points. First, a VAT system should be designed to be as simple, neutral, and clear as possible, avoiding excessive exemptions and derogations. Otherwise the administrative and compliance costs will be high, and tax fraud and evasion will be more difficult to control. Second, to prevent possible VAT evasions in cross-border transactions (and domestic transactions as well), a sound accounting system and an advanced information management system are very much needed. In some circumstances, necessary, effective governmental regulations are needed also.

CONCLUSION

VAT or GST is good at raising revenues, which forms a significant reason for governments to apply such a tax. The EU introduced VAT in 1960s as a key means to help develop a common market in the region. mainland China adopted VAT in its

early-middle economic reform period. It has been a pillar of the Chinese tax regime since 1994. Though the VAT in both the EU and mainland China has achieved certain successes, especially in terms of generating revenues, both of them face serious VAT problems regarding evasion and fraud.

VAT problems most often relate to local political and economic context. Some successful practices in one jurisdiction produce big problems in another jurisdiction. Compared with mainland China, the European VAT is more general as it covers the supply of all goods and services. The European VAT also charges only the value added at each stage of the production and distribution process, and allows full deduction for the input tax from the output tax on the transactions with respect to which VAT is deductible according to provisions of the European VAT law. The invoice credit method is said to be self-enforceable as it (in many cases) helps the tax authority cross-check the VAT paid by the supplier and the input tax deducted by the purchaser. Nonetheless, the European VAT is susceptible to fraud due to its complexity and the state-based, fiscal separation within the EU.

Mainland China's VAT problems are very different from those in the EU, though the Chinese VAT was patterned after the European VAT system. It is not a general tax as it only covers goods and very limited services. It is not neutral as it does not tax only the value added at each stage of the production and distribution; it does not provide the full right to deduction of input tax throughout the supply chain; and it does not guarantee the full implementation of zero rating on exported goods. It is problematic in the invoice credit method due to the impurity and non-neutrality of the VAT system. The legal design of the VAT system has contributed to and facilitated VAT evasion in mainland China.

The VAT systems in the EU and mainland China have undergone certain reforms in recent years. The effects of these reforms remain limited in addressing fraud and evasion problems, however. For the EU, future VAT reform will depend on political and economic development within the EU. Combating fraudulent activities will call for more comprehensive administrative cooperation between EU MSs. For mainland China, it needs to learn from the EU experience (and other countries' experience as well). China, especially, can do so, however, only to a limited extent because of the specific features of a range of mainland China's VAT problems. The recent reform in VAT in mainland China is clearly in the right direction. Given that mainland China is a single jurisdiction, future VAT reform to make the VAT system more pure and more neutral and to reform the invoice credit mechanism should reduce the high level of VAT evasion and increase the efficiency in tax administration. In dealing with some particular unresolved issues such as how to treat the deduction of the input tax for purchased capital goods, the EU practice may provide a good example for mainland China.

A famous economist once said, '[t]he solution exists --- the problem is --- how to find it?'[140] It is fair to say that recent solutions have now, at least, become clear in China and also in the EU. The largest problem today, relates to implementing them.

[140] P Samuelson, 'The Pure Theory of Public Expenditure' (1954) 36 *The Review of Economics and Statistics* 387.