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Fiscal Reform in China: Implications for Hong Kong

RICHARD CULLEN* AND HUA LING FU** ***

I. INTRODUCTION

Since the Joint Declaration of the Government of Great Britain and Northern Ireland and the Government of the People's Republic of China on the Question of Hong Kong (Joint Declaration)¹ concluded in 1984, scholars and commentators have devoted considerable time studying the future of Hong Kong. Their studies have intensified as the July 1, 1997 transition of Hong Kong into the Hong Kong Special Administrative Region of the People's Republic of China (HKSAR)² approaches.

This Article considers one aspect of the sovereignty change that has been largely ignored: the fiscal relationship between the HKSAR and the People's Republic of China (PRC). This topic deserves careful study for at least three reasons. First, fiscal policy and practice are crucial aspects of every political economy. Sec-

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1. Joint Declaration of the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People's Republic of China on the Question of Hong Kong, Dec. 19, 1984, U.K.-P.R.C., 23 I.L.M. 1371 [hereinafter Joint Declaration].

2. The HKSAR will cover an area of approximately 1000 square kilometers. It will take over the exact parameters of the present territory of Hong Kong.

ond, as the HKSAR becomes the wealthiest component in the post-1997 PRC, Hong Kong will find itself in an unusual position of being an island of comparatively great prosperity within the poor though rapidly developing PRC. Third, in late 1994, the PRC introduced a series of momentous fiscal reforms as a key component in its overall reform process.

Part II of this Article discusses the transition of Hong Kong into the HKSAR. Part III reviews Hong Kong's basic fiscal strengths and weaknesses. Part IV presents an overview of the PRC's recent fiscal reforms. Part V examines the legal rules applicable to the fiscal relationship between the HKSAR and the PRC under the fundamental documents governing the HKSAR. Finally, part VI explores the wider political factors that may impact the fiscal relationship between the HKSAR and the PRC. This Article concludes that, barring exceptional circumstances, the provisions guaranteeing the HKSAR's fiscal independence are stringent and should prove effective due to their significant political and economic underpinnings.

II. THE HONG KONG SPECIAL ADMINISTRATIVE REGION³

The July 1, 1997 sovereignty change will occur pursuant to the Joint Declaration⁴ which embodies the principles intended to shape the manner of the HKSAR's governance for the fifty-year period following 1997. It is based on the Chinese doctrine of "one country-two systems": although Hong Kong will become part of the PRC (one country), it will retain a high degree of autonomy, thus allowing it to maintain its current political economy (two systems). In other words, while the mainland PRC will continue to practice "socialism with Chinese characteristics," Hong Kong will continue to practice "capitalism with Chinese characteristics."⁵

Although the agreements governing the changeover grant Hong Kong a high degree of autonomy, Hong Kong is not free to determine its own future political and economic direction. This

3. The discussion of Hong Kong's fiscal position draws on arguments made in Richard Cullen, *Looking into Hong Kong's Fiscal Ball*, 11 AUSTL. TAXF. 511 (1994).

4. See Richard Cullen, *Hong Kong Revenue Law: The Present, 1997, and Beyond*, 7 TAX NOTES INT'L 1109, 1114-18 (1993).

5. For an explanation of the background to and the process of evolving the formula for Hong Kong's reversion to PRC sovereignty, see *id.* at 1109-18.

autonomy merely grants Hong Kong the right to preserve its current system. Hong Kong has no autonomy to develop, change, or experiment. Ironically, post-1997 Hong Kong may not, for example, decide to adopt socialism as the basis of its political organization. The other side of this irony is that the more than nominally socialist PRC has committed itself to the preservation of a dazzling example of capitalism within its borders. The principal document that will govern the HKSAR, and indicates that it will not adopt socialist policy, is the Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China (Basic Law).⁶

III. A FISCAL OVERVIEW OF HONG KONG

Hong Kong's fiscal year runs from April 1 to March 31 of the following year. Notwithstanding the political and economic fortunes of the previous twelve months, Hong Kong's stability and prosperity seem assured every March as Hong Kong counts its "loot" and announces the next budget. When former Financial Secretary Sir Hamish Macleod introduced the expenditure and revenue estimates for the 1995-1996 Hong Kong budget, he noted that a regular problem for Hong Kong Financial Secretaries was explaining larger than expected surpluses.⁷ Earlier in his speech, Macleod discussed one of the fundamentals of the Hong Kong government's fiscal policy: government expenditure must not grow faster than the economy as a whole.⁸ A practical rule derived

6. Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China (1990), *reprinted in* 29 I.L.M. 1519 (1990) [hereinafter Basic Law]. For further comment on the fundamental political documentation for post-1997 Hong Kong, see Yash Ghai, *Back to Basics: The Provisional Legislature and the Basic Law*, 25 H.K. L.J. 2 (1995); Yash Ghai, *A Comparative Perspective*, in HONG KONG'S BASIC LAW: PROBLEMS & PROSPECTS 1 (Peter Wesley-Smith ed., 1990); Yash Ghai, *The Hong Kong Bill of Rights Ordinance and the Basic Law of the Hong Kong Special Administrative Region: Complementarities and Conflicts*, 1 J. CHINESE & COMP. L. 30, 40-41 (1995). Article 5 of the Basic Law states that "the socialist system and policies shall not be practiced in Hong Kong." Basic Law, *supra*, art. 5, *reprinted in* 29 I.L.M. 1519, 1521 (1990). Moreover, paragraphs 3(3) and 3(5) of the Joint Declaration stress the requirement that Hong Kong's legal, social, and economic systems be maintained after 1997. See Joint Declaration, *supra* note 1, paras. 3(3), (5), at 1371-72.

7. See *Budget Speech in Full*, S. CHINA MORNING POST, Mar. 2, 1995, at 6.

8. See *id.* Article 107 of the Basic Law further provides, *inter alia*, that the HKSAR is to keep expenditure within the limits of revenues and avoid deficits. See Basic Law, *supra* note 6, art. 107, *reprinted in* 29 I.L.M. 1519, 1537 (1990).

from this doctrine is that the government generally does not borrow.

Hong Kong's current Financial Secretary, Donald Tsang, has reason to express similar optimism.⁹ By April 1997, three months prior to the July 1, 1997 sovereignty change, Hong Kong's fiscal reserves are estimated to reach U.S.\$22 billion.¹⁰ Combined with the HKSAR Land Fund surplus, the total reaches approximately U.S.\$50 billion.¹¹ This enormous sum does not include the approximately U.S.\$50 billion in hard currencies backing the Hong Kong dollar. Furthermore, Hong Kong's per capita gross domestic product (GDP) is currently around U.S.\$25,000.¹² This is especially impressive because Hong Kong, like Singapore, entered the post-war period with a lower per capita GDP than India.¹³

Occasionally, the government does budget for a small deficit, although Hong Kong typically has a budget surplus. Consequently, stories on the government debt do not make headlines.

Hong Kong has a scheduler taxation system that is modeled after a former British system.¹⁴ The distinguishing features of Hong Kong's taxation system are low tax rates and a narrow tax base.¹⁵ Rather than imposing a general income tax, Hong Kong's system includes a series of separate taxes that apply differently to various types of income.¹⁶ The Inland Revenue Ordinance contains the following taxes: a profits tax, which applies to trade, business, and professional income; a salaries tax, which applies mainly to wage and salary earners; and a property tax, which applies to property income.¹⁷ Hong Kong also imposes duties on pe-

9. See Brian McLeod, *The New Hong Kong*, WINDOW, July 12, 1996, at 32.

10. See Chris Yeung, *Macleod Says SAR Funds to Hit \$361b*, S. CHINA MORNING POST, Mar. 2, 1995, at 1. Annex III of the Joint Declaration led to the Land Fund's creation. See Joint Declaration, *supra* note 1, annex III, at 1380. Since May 1985, when the Joint Declaration entered into force, the Hong Kong government has received considerable income from land transactions, which has been split equally between the government and the Land Fund, which is for the use of the HKSAR government. See *id.*

11. See Yeung, *supra* note 10.

12. See *Budget Speech in Full*, *supra* note 7.

13. See David Kern, *International Outlook*, NAT'L WESTMINSTER BANK ECON. & FIN. OUTLOOK, Oct. 1, 1996, at 2, available in 1996 WL 9687079.

14. See Cullen, *supra* note 4, at 1112.

15. For a detailed explanation of the Hong Kong revenue system, see *id.*

16. See *id.* at 1121.

17. See Inland Revenue Ordinance, LAWS OF HONG KONG ch. 112 (1989).

troleum, alcohol, and tobacco products, as well as an estate duty¹⁸ and stamp duty¹⁹ on instruments principally related to stock market and real estate transactions. Other miscellaneous taxes and duties also apply to various transactions, such as a substantial duty for registration of new vehicles.²⁰

Although disparities in wealth are egregious—for example, Hong Kong has the highest per capita concentration of Mercedes Benz cars in the world²¹—most Hong Kong citizens have benefited from the exceptional material progress of the city-state during the last five decades.²² Mainstream Hong Kong residents pay little or no tax, and enjoy cheap basic housing and rising real incomes.

The achievements of Hong Kong's fiscal system are impressive: no government debt, very low taxes, massive accumulated surpluses, improved basic social services, a quality educational sector, and one of the world's best urban infrastructures, including mass public rail transportation and telecommunications systems. Despite these achievements, commentators still criticize Hong Kong's fiscal system. Their reproaches include the following: (1) the taxation system's failure to address huge disparities in wealth, (2) weak support services for the disadvantaged, including the disabled, infirm, and elderly without families, (3) overcrowded or expensive health services, (4) strains in the education system, (5) neglect of environmental concerns, (6) infrastructure gaps, (7) lack of adequate pension provisions, (8) inadequate control of some governmental spending, and (9) the narrow tax base.²³

Hong Kong's near constant high growth, as well as its lack of political will, have reduced the visibility of a number of these concerns. Although a low growth economy is not certain to develop, the previous high growth rates will probably not continue.

Hong Kong's maturing economy will exacerbate stresses that

18. See Estate Duty Ordinance, LAWS OF HONG KONG ch. 111 (1983).

19. See Stamp Duty Ordinance, LAWS OF HONG KONG ch. 117 (1986).

20. See Cullen, *supra* note 3, at 515.

21. See *id.* at 516.

22. Over the last two decades, income inequalities have tended to increase in the West but decrease in East Asia, including Hong Kong. See George Enderle, *An Outsider's View of the East Asian Miracle: Lessons and Questions*, in WHOSE BUSINESS VALUES?: SOME ASIAN AND CROSS-CULTURAL PERSPECTIVES 87, 88 (Sally Stewart & Gabriel Donleavy eds., 1995).

23. See Cullen, *supra* note 3, at 516-17.

are currently manageable. The future poses significant demands for increased government expenditure. Given that these demands will relate largely to fundamental services, such as care for an aging population, the Hong Kong government cannot ignore them. In addition, as new revenue sources become necessary, Hong Kong's narrow tax base and low tax rates will be increasingly scrutinized. Hong Kong's restrictive position on government borrowing and deficit financing may eventually require the use of tax reform to solve this looming expenditure growth. At the present time, however, this fiscal rectitude has left Hong Kong's finances in excellent condition, with reserves that are enormous by world standards.

Like Taiwan, Hong Kong feels a need to maintain these cash reserves as a bulwark against regional politics that could upset the economic apple cart. A period of serious tension between the PRC and Taiwan in early 1996 demonstrated the wisdom and effectiveness of this approach.²⁴ Despite the most fierce episode of sabre-rattling across the Taiwan Straights in recent memory, the new Taiwan dollar and the Taiwanese economy pulled through in sound condition.²⁵

IV. FISCAL REFORM IN CHINA

A. Introduction

In late 1993, the PRC made the final decision on the basic shape of its broad fiscal reform agenda. This crucial decision was made at the Third Plenum of the Fourteenth Central Committee of the Chinese Communist Party (CCP).²⁶ It was subsequently

24. For a general discussion of the tension, see *China's Foreign Minister: No Winners From Taiwan Tension*, DEUTSCHE PRESS-AGENTUR, Feb. 13, 1996, available in LEXIS, World Library, Allwld File.

25. See generally *Taiwan to Adjust Policy to Boost Economy*, REUTERS FIN. SERVICE, Apr. 20, 1996.

26. See Jae Ho Chung, *Central-Provincial Relations*, in CHINA REVIEW 1995, at 3.5-3.6 (Lo Chi Kin et al. eds., 1996). The Central Committee of the Chinese Communist Party (CCP) is one of the key formal structures in the CCP's Constitution of the CCP. See ALBERT HUNG-YEE CHEN, AN INTRODUCTION TO THE LEGAL SYSTEM OF THE PEOPLE'S REPUBLIC OF CHINA 70 (1992). In reality, the Political Bureau, or "Politburo", and the Politburo Standing Committee exercise the "leadership" functions of the Central Committee. See *id.* The State Council is the title of the PRC's central government. See *id.* at 59; see also Du Xichuan & Zhang Lingyuan, CHINA'S LEGAL SYSTEM 52-66 (1990);

ratified in March 1994 at the Eighth National People's Congress.²⁷ It is probably safe to say that never before in the history of fiscal policy-making has reform affecting so many people been adopted in such a short time. The PRC comprises well over twenty percent of the world's population, making it the most populous country in the world. The reform is also significant because the PRC is now in the midst of a rapid growth period with improving prosperity unprecedented in the last 200 years of its history. Nevertheless, the PRC remains a country beset with enormous difficulties.

The commencement of the "open-door" policy in the late 1970s²⁸ was, *inter alia*, a reaction and correction to the decade lost to the Cultural Revolution.²⁹ Following the adoption of this "open-door" policy, the PRC entered an era of unprecedented growth that has averaged more than ten percent per year for over a decade.³⁰ If it is able to sustain this pattern, this growth promises to turn the PRC into the world's greatest economic power within the next two decades.³¹

A main factor behind this growth has been the widespread replacement of central planning in the economy with a reliance on market factors. In the PRC, this change is often referred to as the introduction of a socialist market economy. Crucially, this change has involved delegating economic decision-making responsibility to numerous individuals and group enterprises.³² Although the PRC maintains a large state enterprise sector (SES), the importance of the SES has greatly diminished over the last two decades.

XIANFA [Constitution] sec. III (P.R.C.). Several striking features characterize the PRC's political structure. As a matter of form, the government and the CCP are separate institutions. The CCP and the government are so closely intertwined, however, that it is difficult to determine where the CCP ends and the government begins. The need substantively to separate the two is a matter of ongoing debate in the PRC. *See id.* at 39-76.

27. *See Chung, supra note 26.*

28. For a general discussion of the 1970s open-door policy, see INT'L BUREAU OF FISCAL DOCUMENTATION, SUPP. NO. 4, TAXATION & INVESTMENT IN THE PEOPLE'S REPUBLIC OF CHINA 15 (1993).

29. The Cultural Revolution began in 1964 and aimed to reform the minds of the entire nation, particularly intellectuals. *See O. EDMUND CLUBB, 20TH CENTURY CHINA 477 (1978).*

30. *See Chung, supra note 26, at 3.5-3.6.*

31. *See China Looming, ECONOMIST, Aug. 17, 1996, at 13.*

32. There are still limits on just how large and independent private sector enterprises may become. *See The Excellent Chicken-Feed of Liu Yonghao, ECONOMIST, July 6, 1996, at 59.*

The primary disadvantage of the SES, which still employs approximately 100 million people, is that many enterprises within it are operating at huge losses.³³ Because the SES operates as a giant de facto welfare state within the PRC, the Chinese government cannot allow it to deteriorate and deprive millions of citizens of income, education, housing, health, and welfare services. If the SES were fully exposed to market forces, the likely result would be drastic social and economic disruption.³⁴

The move towards a market economy has dramatically exposed the inadequacies of the old revenue regime. Throughout much of the PRC's history, but particularly since 1979, the old regime has been the subject of reform initiatives.³⁵ Nevertheless, the pre-1994 regime remained strongly influenced by its Soviet prototype in that it significantly reflected its reliance on the previously, powerful, central control of the economy.³⁶ With the move towards a market economy, the PRC's entire fiscal regime showed an obvious need for reform. In the wake of these economic changes, the government's share of GDP expenditure has noticeably decreased. In 1978, budgetary expenditures in the PRC

33. See Susan Fenton, *China Sharpens Control Over Loss-makers*, WINDOW, July 19, 1996, at 52. In 1995, 40% of SES enterprises had losses. See *id.* Although the SES share of total industrial output has fallen from 79% in 1979 to 38% in 1995, there are also some real success stories in the SES. See *id.* There is considerable debate about the exact status of the SES: some economists argue that the portrayed peril is overexaggerated. There is consensus, however; that overall, the SES is in poor economic shape and that its reform is one of the major economic and social problems facing China. See Professor Ji Liu, *Perspectives of Economic Reform in China*, Keynote Address at the Eleventh Annual Conference of the Chinese Economists' Society (Aug. 9, 1996) (transcript on file with the *Loyola of Los Angeles International and Comparative Law Journal*). One tactic for dealing with the problem, which seems to be having some success, is the merging of successful and ailing enterprises in the SES. See Gerald Chen, *Two Recipes for Ailing SOEs*, WINDOW, Aug. 16, 1996, at 31; Jean-François Huchet, *Old Age Pensions in China: The Search for a National System*, CHINA PERSP., July-Aug. 1996, at 18.

34. See Donald J.S. Breaun, *Financial Aspects of Fiscal Sector Reform in China*, Paper Presented to the Eleventh Annual Conference of Chinese Economists' Society (Aug. 11, 1996) (on file with author). If dependents are included, around one quarter of the PRC's total population may still be reliant on the SES. See *id.*

35. See Michel Oksenburg & James Tong, *The Evolution of Central-Provincial Fiscal Relations in China, 1971-1984: The Formal System*, CHINA Q., Mar. 1991, at 1; see also ROY BAHL & CHRISTINE WALLICH, *INTERGOVERNMENTAL FISCAL RELATIONS IN CHINA* (World Bank Policy Research Paper WPS 863).

36. See Christine P.W. Wong, *Central-Local Relations in an Era of Fiscal Decline: The Paradox of Fiscal Decentralization in Post-Mao China*, CHINA Q., Dec. 1991, at 691.

were thirty-nine percent of GDP.³⁷ By 1994, budgeting expenditures constituted fourteen percent of GDP, which is even lower than Hong Kong.³⁸ Simultaneously, the central government's share of this component fell from sixty percent in the 1970s to thirty-seven percent in 1993, posing serious implications for the government's ability to implement further economic reforms.³⁹ Reforming the SES, in particular, will require the development of an alternative welfare state system.

With these imperatives in mind, the PRC government embarked on its massive fiscal reform program in early 1994. The revenue side of this program consisted of two principal elements. The first element involved reforming the PRC's broad taxation base. Existing taxes in the PRC were consolidated, further developed, or eliminated and replaced with new direct or indirect taxes.⁴⁰ These massive changes were principally designed to remove the old system's obvious drawbacks and establish a more transparent taxation system capable of providing the government with continuously growing revenue in the future. The second principal aspect of the fiscal reform program was an attempt to redraw the fiscal relationship between the central government and local governments in China.⁴¹

37. *See id.*

38. *See* Brean, *supra* note 34. Two qualifications need to be noted about these figures: (1) the impact of losses in the SES, and (2) the impact of extra budgetary items (EBIs). Some commentators say that covering losses in the SES accounts for close to 10% of GDP and EBIs may account for up to another 10%. *See A Funny-Looking Tiger*, *ECONOMIST*, Aug. 17, 1996, at 17. Real government expenditure may thus be 30% or more of GDP in the PRC.

39. *See* Brean, *supra* note 34. Some observers see significant economic incentives from this apparent lowering of the government's profile. This reduction appears, however, to be more a matter of accident than policy, and most observers see the drawbacks of the government's current weak fiscal position as outweighing any incentive benefits.

40. *See generally* Christine Wong, *Fiscal Reform in 1994*, in *CHINA REVIEW* 1995, at 20.1, 20.3-20.4 (Lo Chi Kin et al. eds., 1995).

41. In many jurisdictions, the term "local government" indicates a small government entity at the county, city, township, or village level usually with quite limited responsibilities. Discussions of the PRC's fiscal reforms, however, commonly use the term "local government" as a global expression for a non-central, governing entity. Many other jurisdictions commonly use the term "regional government" to indicate this type of entity. This Article uses the term "local government" in the global, PRC sense.

B. Background of the Taxation System Reforms

1. The Political Geography of China

The PRC has been the world's most populous country for much of recorded history. It has mostly been a unitary state, but sometimes it has been a collection of several warring states.⁴² Notwithstanding its ability to maintain a united political structure, the PRC also has a long history of administrative decentralization. Given its immense size and population and the very early invention of proto-bureaucratic government during the Chou Dynasty (1027-256 B.C.),⁴³ this decentralization is not surprising. The PRC currently consists of twenty-three provinces,⁴⁴ five autonomous regions,⁴⁵ and three central government municipalities.⁴⁶ The core of the current provincial structure was established more than 600 years ago during the early years of the Ming Dynasty.⁴⁷ Beginning July 1, 1997, the PRC will also include one special administrative region: Hong Kong.⁴⁸

The PRC also maintains a wide range of administrative units below a province or an autonomous region. These third level administrative units include prefectures, autonomous prefectures, leagues, cities, counties, autonomous counties, banners, and

42. For example, the Warring States period at the end of the Chou Dynasty lasted from 464 to 221 B.C. See FRANZ MICHAEL, *CHINA THROUGH THE AGES* 38 (1994). The Three Kingdoms and North-South periods ran from 265 to 589 AD. See *id.* at 90-101.

43. See *id.* at 27-43.

44. The PRC always includes Taiwan in this total. See *ATLAS OF THE PEOPLE'S REPUBLIC OF CHINA* 34 (1989). The full list of provinces is: Anhui Province, Fujian Province, Guangdong Province, Gansu Province, Guizhou Province, Hebei Province, Hubei Province, Henan Province, Hainan Province, Heilongjiang Province, Hunan Province, Jilin Province, Jiangsu Province, Jiangxi Province, Liaoning Province, Qinghai Province, Sichuan Province, Shandong Province, Shanxi Province, Shaanxi Province, Taiwan Province, Yunnan Province, and Zhejiang Province. See *id.* at 4-33.

45. The most well-known autonomous region is Tibet. See *id.* at 34. The full list of autonomous regions is: Guangxi Zhuang Autonomous Region, Nei Mongol (Inner Mongolia) Autonomous Region, Ningxia Hui Autonomous Region, Xinjiang Uygur Autonomous Region, and Xizang (Tibet) Autonomous Region. See *id.* at 6, 24, 26, 29, 37.

46. The three central government municipalities are: Beijing, Shanghai, and Tianjin. See *id.* at 3. They are soon to be joined by Chongqing.

47. See MICHAEL, *supra* note 42, at 146. The Ming Dynasty lasted from 1368 to 1544 A.D. See *id.*

48. On December 20, 1999, Macau will be added as another special administrative region.

autonomous banners.⁴⁹ The adjective “autonomous” identifies an area occupied predominantly by one of the PRC’s many minority groups, which comprise about five percent of the PRC’s total population of approximately 1.2 billion people.⁵⁰ The PRC’s political structure also includes a fourth level comprised of townships, nationality townships, and towns, all of which answer to the counties and autonomous counties.⁵¹

The long established practice of administrative decentralization partly explains the longevity of formal unitary government in the PRC. Central governments throughout the imperial era were usually politically wise enough to realize that central authority was best ensured with strongly enforced central government restrictions. Other factors favoring a unitary state include: the largely agrarian nature of the PRC’s historical political economy, the memory of havoc during periods of disunity, the ethnic and cultural homogeneity of the majority of the population, and the remarkable unifying power of the political dimension of the “mandate of heaven” concept.⁵²

2. The Failure of the Previous Revenue Regime

The PRC’s old system relied on and was intimately linked with the operation of a centrally planned economy, where virtually all enterprises were either state-owned or state-controlled.⁵³ In this immensely complex system, different rates of indirect taxes applied to products and sectors according to location. The tax matrix, even under the centrally planned system, produced distortions and wasteful industrial development.⁵⁴ This system, which did not really distinguish between taxes and profits in the dominating public sector, has been aptly described as “mushy.”⁵⁵

The beginning of market economy reforms further exposed

49. See ATLAS OF THE PEOPLE’S REPUBLIC OF CHINA, *supra* note 44, at 1.

50. See *id.* at 6.

51. See *id.* at 1.

52. See MICHAEL, *supra* note 42.

53. See Wong, *supra* note 40, at 20.2-20.3.

54. See *id.*

55. See Brean, *supra* note 34. For a “working” view of the old system, look at the present-day Russian Federation. Since the collapse of the Communist Party tax reform in Russia has made little headway. See *id.*

the old tax system's inadequacies. Moreover, high income tax rates and differential tax rates based on the type of enterprise produced both evasion and further distorted economic development. The most significant failure was the breakdown of the system concerning intergovernmental fiscal relations. Local governments collected virtually all taxes and remitted the funds to the central government according to a formula. As more of the PRC's economy slipped beyond direct central government control and into local control, local governments had less incentive to gather taxes effectively for remittance to the central government.⁵⁶ By the early 1990s, the contract based system of intergovernmental fiscal transfers was also largely discredited.⁵⁷

3. Pressures for Change

By the time the market reforms were implemented, the pressures made change inevitable. These pressures included internal, as well as external pressures on the PRC.

a. Internal Pressure

The pre-reform system was economically distorted and becoming increasingly inefficient in raising revenue. Moreover, it was breaking down as the principal basis for intergovernmental fiscal relations.

The widespread recognition of the need for reform in the SES was another dominant pressure for change. The PRC faces huge problems with the SES. On the one hand, it cannot simply stop subsidizing the SES due to the immense potential for social dislocation and political instability.⁵⁸ Simultaneously, maintenance of the SES exacerbates the central government's large budget deficit.⁵⁹ Due to its tendency to fuel inflation, this deficit may be a po-

56. See *id.*; see also Xuejin Zuo, China's Fiscal Decentralization and Local Services Financing in Poor Townships (Aug. 9-11, 1996) (unpublished paper, 11th Annual Conference of the Chinese Economists' Society) (on file with author).

57. See Zuo, *supra* note 56.

58. See Brean, *supra* note 34.

59. This deficit has recently shown signs of slightly shrinking. See *This Week, WINDOW*, July 5, 1996, at 2. This reduction is partly due to the voluntary movement of employees out of the SES and into the private sector. Over the last twelve months, the SES reportedly shed 10% of its employees. See *A Funny-Looking Tiger*, *supra* note 38, at 18.

tential factor in increasing political instability. Although current inflation appears relatively stable,⁶⁰ no one has forgotten that a surge in inflation played a significant part in precipitating the mass protests of 1989 that lead to the bloodshed in Tienanmen Square on June 4, 1989.⁶¹ Reform of the SES is simply inconceivable without reform of the PRC's revenue regime.

Another major pressure for change comes from the problem of regional disparities, which fit into two broad categories: absolute and relative deprivation. The first and most serious problem is the absolute deprivation in certain, extremely poor regions of the PRC. These regions are simply unable to provide basic food, housing, health care, and education.⁶²

The second category of disparity may be termed relative deprivation. Widespread concern and resentment exist in the PRC's inland provinces, which relative to the coastal provinces, did not benefit from the period of unprecedented growth due to the open-door policy that began in the late 1970s. As a result of central government planning, the benefits of the open-door policy have frequently tended to favor specific regions in the PRC. For example, the central government decided to encourage activity in Special Economic Zones along the eastern and southern coasts of the PRC because of their attractiveness to offshore investors, particularly the "overseas" Chinese in Hong Kong, Taiwan and beyond.⁶³ Areas in Guangdong Province, such as Shenzhen and Zuhai and areas in Fujian Province, such as Xiamen, have sometimes seen spectacular rates of growth, while very poor inland areas have benefited far less, if at all, from the move towards a market economy.⁶⁴

60. See Tim Wilson, *Full Yuan Convertibility Moves Step Nearer*, WINDOW, July 5, 1996, at 51.

61. See Morton Kondracke, *The China Syndrome*, COURIER (Louisville, KY), May 7, 1989.

62. See Wong, *supra* note 40, at 20.1; see also Zuo, *supra* note 56 (detailing the extent of deprivation in a comparative case study between the prosperous Huacao Township in the Shanghai Municipality and the Taiping Township in the Guangxi Zhuang Autonomous Region).

63. See Mark LaPedus, *Hong Kong Electronic: Malaise, Opportunities*, ELECTRONIC BUYERS' NEWS, Sept. 27, 1993.

64. See Mark LaPedus, *Contrasts Abound in PRC*, ELECTRONIC BUYERS' NEWS, Oct. 25, 1993.

It is well-recognized that these disparities must be addressed. The SES reform, however, may potentially further aggravate the disparity problem. SES businesses provide the economic backbone in some of the PRC's poorer regions, such as the North-East. There also are disparities within regions, especially between rural and urban areas. For example, Sichuan, the most heavily populated province of the PRC, has average annual incomes that in the countryside are one-third of average city incomes.⁶⁵ All these pressures have combined to generate massive internal migration in the PRC. Due to the household registration system, most of this migration is still not permanent.⁶⁶

B. External Pressures

External pressures for fiscal reform came from a variety of sources, including foreign investors in the PRC. Foreign investors demanded greater clarity and transparency in the operation of the PRC's revenue system. Advisors to the PRC government, such as the Asian Development Bank, the World Bank, and the International Monetary Fund also argued for comprehensive fiscal reform.

C. The 1994 Reforms

1. The Reformed Tax Regime⁶⁷

In 1994, the PRC yielded to pressures for fiscal reform by an-

65. Sichuan, with a population of 110 million, has almost as many people as France and England combined. See *China on the Move*, *ECONOMIST*, July 6, 1996, at 33.

66. See *id.* at 33-34. Although it is now possible to move freely in the PRC, permanent relocation is difficult and expensive. PRC citizens are entitled to certain benefits, schooling for example, free of charge or at low cost where they are registered, but they must pay for such benefits when received away from their registered home. As a result, able-bodied male and female peasants, rather than entire families, migrate, while older relatives and children usually remain at home.

67. For a comprehensive treatment of the new tax regime, see JINYAN LI, *TAXATION AND INVESTMENT IN THE PEOPLE'S REPUBLIC OF CHINA* (1995); JINYAN LI, *CHINA TAX MANUAL* (1995). For an overview of the new tax regime, see Chung, *supra* note 26, at 3.9-3.17. See also Wong, *supra* note 40, at 20.3-20.4. For an English translation of all the relevant tax laws, see *A COLLECTION OF TAX LAWS AND REGULATIONS OF THE PEOPLE'S REPUBLIC OF CHINA* (1994). See also HOWARD GENSLER & JILIANG YANG, *A GUIDE TO CHINA'S TAX AND BUSINESS LAWS* (1995).

nouncing a series of reforms. The most important reform was a far reaching value added tax (VAT). The new VAT replaced the old product and business taxes with respect to many services. The earlier taxes included thirteen tax rates ranging from eight to forty-five percent.⁶⁸ The new VAT has a single basic rate of seventeen percent. Preferential rates, however, apply to certain agricultural items and certain urban services, such as urban water supply.⁶⁹ The new VAT also eliminated differential treatment of domestic and foreign enterprises with respect to product and service-related taxes.⁷⁰

The next principal area of reform concerned direct and income taxes. The new general business tax eliminated the distortions that occurred under the previous system where tax treatments differed according to the owner of the business.⁷¹ This reform has unified the tax rate on profits for state-owned, collective, and private enterprises. Furthermore, the top nominal tax rate has been reduced from fifty-five percent to thirty-three percent, while a number of other taxes have been adjusted and certain concessions have been eliminated.⁷² Despite the introduction of a unified tax rate, however, foreign enterprises and joint ventures will still enjoy certain tax benefits during the transition period.

The new personal income tax replaced three former taxes.⁷³ Chinese citizens and foreigners are now subject to the same schedule.⁷⁴ The tax rates range from five to thirty-three percent, with only limited deductions and a tax-free threshold.⁷⁵

Another new important tax was the consumption tax. The consumption tax replaced the previous system of excise taxation.⁷⁶ The consumption tax applies to a wide range of commodities, including tobacco products, alcohol products, cosmetic products, pe-

68. See Allison E. Wielobob, *China's Choice: Tax Incentives to Fund Economic Development*, 9 TEMP. INT'L & COMP. L.J. 413, 428 (1995).

69. See *id.* at 428-29.

70. See Wong, *supra* note 40, at 20.3.

71. See *id.* at 20.4.

72. See *id.*

73. See *id.* China raises less than two percent of budgetary revenues from the individual income tax. See *id.*

74. See *id.*

75. See *id.*

76. See Wielobob, *supra* note 68, at 426.

roleum fuels, and motor vehicles.⁷⁷ Other new taxes include the resource tax, which applies to natural resources including oil, gas, coal, non-metal ferrous ores, and salt,⁷⁸ and a new tax that works much like a capital gains tax on land transfers.⁷⁹ Other less important tax reforms include land-related taxes, stock market transaction taxes, an inheritance tax, and a stamp tax.⁸⁰

2. Fiscal Layering

An important factor in the design of the new broad tax base was the element of fiscal layering. Outside the PRC, fiscal layering means the allocation of *taxation powers* to different levels of government.⁸¹ Different levels of government are given the right to apply certain kinds of taxes and to decide the tax rate and the appropriateness of concessions.⁸² These levels of government also enjoy a certain amount of control over the spending of those taxes.

In the PRC, fiscal layering means the specific allocation of rights to taxation revenues between central and local governments.⁸³ Actual taxation powers are not allocated to local governments, though they may grant some concessions when applying certain local taxes.⁸⁴ Instead, the central government gives local governments the right to collect and retain specified taxes and to share in other taxes.⁸⁵ Local governments in the PRC thus lack the fiscal flexibility that states in the United States of America, Australia, and the provinces in Canada enjoy.

3. Fiscal Equalization

Under the previous fiscal contract system, sixteen budget-deficit provinces received fixed subsidies from the central govern-

77. *See id.* at 431.

78. *See id.* at 427 n.176.

79. *See id.* at 432.

80. *See id.* at 425.

81. *See* Tsang Shu-Ki & Cheng Yuk-Shing, *Tax Break Dancing "China's Tax Reforms of 1994-Breakthrough Compromise?"*, 3 *ASIAN CENTURY BUS. REP.* 82 (1994).

82. *See* Xiangyuan Jiang & Jack Huang, *China on the Horizon: Exploring Current Legal Issues*, 28 *J. MARSHALL L. REV.* 62 (1995).

83. *See* Shu-Ki & Yuk-Shing, *supra* note 81.

84. *See* Howard Gensler, *Legal Aspects of Conducting Business in Asia*, 8 *TRAN-SNAT'L LAW* 103, 111 (1995).

85. *See id.* n.80.

ment.⁸⁶ By 1990, however, it was apparent that this system was defective, and certain cities in the PRC began to experiment with different sorts of revenue-sharing arrangements.⁸⁷ The tax reforms of 1994 reflected the lessons learned from this experience, especially lessons related to fiscal equalization.⁸⁸

A major, though transitional, provision in the 1994 tax reforms guarantees to all provinces that revenues in 1994 and beyond would be no less than revenues in 1993.⁸⁹ The central government promised to transfer any funds necessary to raise post-1993 annual revenues to the 1993 levels. Given its greater role in tax collection under the reforms, the central government's guarantee of this base revenue level was reassuring. It should be noted, however, that this guarantee is not indexed—it is only set at *nominal* 1993 figure. Therefore, although this guarantee is continuous, the effect of inflation will make it much less significant with the passage of time.

The central government included a provision in the implementation mechanism to prevent provincial abuse of the revenue guarantee. The provision ensures that any abnormal surge in the provinces' 1993 tax collection does not distort the base figure established.⁹⁰ Essentially, provinces suspected of "padding" their 1993 tax collections were given targets for revenue collections in 1994. If a province could not meet its target, its right to receive central government transfers was affected.⁹¹

4. Tax Administration

Another major component of the reform process has been a major reorganization of the PRC's tax administration. Under the old system, local governments collected all the sums remitted to Beijing as taxes due to the central government. The new system established a two-level system of tax collection.

In one level, the State Administration of Taxation's (SAT) national tax offices collect taxes throughout the PRC while local

86. See Chung, *supra* note 26, at 3.6.

87. See *id.* at 3.7.

88. See *id.* at 3.12.

89. See *id.* at 3.12-3.13.

90. See Wong, *supra* note 40, at 20.8.

91. See *id.*

governments simultaneously maintain a separate system of tax collection offices.⁹² A principal reason for this reform is to improve tax enforcement and administration, particularly for the central government's benefit. In the long run, these reforms may prove to be the most important because many taxes still go uncollected in the PRC.⁹³

5. Responses to the Reform

Reports indicate that both rich and poor provinces in the PRC are concerned about the 1994 reforms.⁹⁴ Other reports from Hong Kong and Taiwan reveal several difficulties with implementing the reforms.⁹⁵ For example, the central government modified the tax on land sales profits after strong protest from Guangdong Province and the city of Shanghai.⁹⁶ The government apparently agreed to the modifications in the interest of maintaining investor confidence.⁹⁷

Another difficulty is that, in many cases, the provinces are confronting severe problems in meeting expenditure responsibilities using only the budgetary resources granted by the central government. To meet their responsibilities, the provinces rely heavily on extra budgetary items (EBI),⁹⁸ which include various levies, charges, and fees for services, many of which lack transparency in their devising and application.⁹⁹ In some cases, EBIs may now account for the major component of local government budgets.¹⁰⁰ The lack of transparency of EBIs and their significant but uncertain fiscal impact obstruct the goal of improved intergovernmental

92. See Brean, *supra* note 34.

93. See *id.* An interesting experiment in improving tax collection processes, which appears to be meeting considerable success, is currently underway in Uganda. Key components in this plan include: carefully choosing tax officials to ensure personal probity, paying tax officials Western-level salaries to attract the best talent and to put them beyond temptation, and providing money incentives for citizens to report tax dodgers. The World Bank has hailed the plan. See *Born Again to Gather Uganda's Tax*, *ECONOMIST*, July 27, 1996, at 38.

94. See Chung, *supra* note 26, at 3.12-3.13.

95. See *id.* at 3.17.

96. See *id.*

97. See *id.*

98. See Zuo, *supra* note 57.

99. See *id.*

100. See *id.*

fiscal relations and create a "chicken and egg problem." The budgetary demands and the restrictions on deficit budgeting often lead local authorities to "innovative" revenue raising. The central government, on the other hand, is concerned that its limited fiscal equalization resources are distributed, as far as possible, on the basis of genuine need. The EBIs make the task of accurately establishing need particularly difficult.

V. THE FISCAL RELATIONSHIP OF THE HKSAR WITH THE PRC

After July 1, 1997, there will be concern over how much the HKSAR's fiscal regime will have to adapt to adjust to the PRC's 1994 fiscal reforms. The formal answer is clear: the HKSAR will not be required to adapt. The legal position concerning fiscal relations between the HKSAR and Beijing is set out in the Basic Law. Article 106 of the Basic Law provides that no PRC taxes are allowed in Hong Kong.¹⁰¹ Further, HKSAR revenues are to be used exclusively for HKSAR purposes and are not to be handed over to the PRC.¹⁰² In addition, article 108 of the Basic Law provides that the HKSAR will have an independent taxation system.¹⁰³ Apart from these particular Basic Law provisions, the Joint Declaration provides that Hong Kong's current legal, social and economic systems are to be maintained after 1997.¹⁰⁴

These Basic Law and Joint Declaration provisions have significant practical economic and political underpinnings. Since its inception in 1949, the PRC has benefited from Hong Kong's stability and prosperity.¹⁰⁵ As time has passed, these benefits have increased significantly. Today, the continued growth of massive PRC investments in the Hong Kong economy depend on Hong Kong's stability and prosperity. The PRC is a major investor in all important sectors of Hong Kong's economy, including banking, property, aviation, and telecommunications.¹⁰⁶ Moreover, Hong Kong is the PRC's single most important source both for raising and

101. See Basic Law, *supra* note 6, art. 106, reprinted in 29 I.L.M. 1519, 1537 (1990).

102. See *id.*

103. See *id.* art. 108.

104. See Joint Declaration, *supra* note 1, paras. 3(3) & (5), at 1371-72.

105. See Cullen, *supra* note 5, at 1112.

106. See *Skillful Master of the Balancing Act*, ASIAN BUS., Sept. 1996, at 4.

mobilizing domestic investment capital.¹⁰⁷ Thus, Hong Kong will be especially important in future decades when the PRC investment program requires vast sums to implement more planned infrastructure development. In addition to the vast amount of direct trade between the PRC and Hong Kong, the PRC also benefits from the large flow of individual remittances from mainlanders working in Hong Kong.

Because instability in Hong Kong will have enormous negative repercussions for the PRC, the PRC may risk serious destabilization by blatantly circumventing the Basic Law provisions mandating the fiscal separation of the HKSAR and the PRC. Other factors reinforcing the HKSAR's special separate status include: the role of the HKSAR as a model for eventual reunification with Taiwan, the PRC's strong nationalistic desire to see the HKSAR remain a success in the world's eyes, the world's scrutiny of this unique political experiment, and the proven resourcefulness and resilience of Hong Kong.¹⁰⁸ Although it may be possible to find subtle ways to circumvent the fiscal separation provisions in the Basic Law,¹⁰⁹ there is no certainty that any such attempts are planned. It should also be noted that the economies of Hong Kong and the PRC are closely intertwined. In fact, the PRC once provided major assistance to Hong Kong's financial system after the 1987 world stock market crash.¹¹⁰ Thus, an experience of recip-

107. *See id.*

108. For a discussion of these factors, see Cullen, *supra* note 5 at 1114-16. *See also* Willy Wo-lap Lam, *Beijing's New HK Policy*, S. CHINA MORNING POST, Sept. 10, 1996, at 1.

109. Possible circumvention methods include the PRC leaning on the HKSAR to take up PRC government bonds or to provide soft loans to the PRC. There has also been speculation about the possibility that mechanisms may be found to transfer some of the financial burden of stationing the People's Liberation Army Forces in the HKSAR. Moreover, Hong Kong is heavily dependent on the PRC for the supply of basic utilities like water and electricity plus food stuffs. It is conceivable that funds could be raised by the PRC by the imposition of an export tax on services and goods flowing from the PRC to the HKSAR. Such a tax would not appear to infringe the letter of the Basic Law provisions on fiscal separation. Whether any such tax might contravene principles of international law (assuming the PRC becomes a member of the World Trade Organization) is another issue. There is not enough space to discuss the issue fully here. For a more in depth discussion of several of these issues see Jae Ho Ching & Shiu-hing Lo, *Beijing's Relations with the Hong Kong Special Administrative Region: An Inferential Framework for the Post-1997 Arrangement*, 68 PAC. AFF. 167, 175 (1995).

110. *See id.*

rocal fiscal support indeed exists.

The HKSAR was left out of the policy development process in the course of planning and implementing the PRC's 1994 fiscal reforms. In view of the legislative history of the Basic Law and the Joint Declaration, this was not entirely surprising. Given the enormous difficulties that the PRC faced in reforming its intergovernmental fiscal relations, the isolation of the HKSAR from the reform process suggests that the principle of fiscal separation carries real weight, at least in the period leading up to the change of sovereignty.

In the event of some particularly pressing need arising in the mainland PRC, such as a series of major natural disasters on the mainland or the outbreak of serious hostilities between the PRC and Taiwan, however, the HKSAR may be expected to assist the PRC financially in ways not previously mentioned. In the case of natural disasters, it is entirely reasonable to imagine the HKSAR government offering substantial voluntary assistance. In the case of serious hostilities, article 18 of the Basic Law allows the Standing Committee of the National People's Congress (SCNPC) to apply Chinese laws in Hong Kong.¹¹¹ If the SCNPC decides that a state of emergency exists in the HKSAR as a result of war or turmoil that is beyond the control of its government, Chinese laws will be applied.¹¹² In other words, if formal hostilities were to break out with Taiwan, the Basic Law provides a formal mechanism for overriding the fiscal separation of the HKSAR and the PRC.

The possibility that the PRC may reach its borrowing limit with the World Bank within the next two to three years is another situation that may require Hong Kong's financial assistance. Although the PRC's spending and repayment record makes it a valued customer, the World Bank usually cannot allow more than ten percent of its total lending to be devoted to one country;¹¹³ the PRC may hit this limit quite soon. Due to its chronic budget deficit, the PRC relies heavily on World Bank loans and related soft loans from the International Development Agency for its mod-

111. See Basic Law, *supra* note 6, art. 18, reprinted in 29 I.L.M. 1519, 1523.

112. See *id.*

113. See *A Problem with the Bank*, ECONOMIST, July 13, 1996, at 32.

ernization drive.¹¹⁴ If these sources dry up, the resulting budgetary stress will trigger a search for cheap alternatives such as the HKSAR reserves.

All the above instances that may compromise fiscal separation involve exceptional circumstances. Under more realistic circumstances, however, it is clear that the HKSAR is designed to stand alone economically. Thus, the 1994 tax reforms are likely to have a less dramatic impact on the reform of Hong Kong's narrow tax base. Rising expenditure pressures in Hong Kong makes this reform a matter of *when* rather than *if*. The PRC's formal tax regime is more consistent with contemporary tax policy thinking than is Hong Kong's tax system. In particular, the 1994 reforms have stressed the importance of making full use of indirect taxes, such as the VAT, when building a modern tax system. The lack of explicit indirect taxes in Hong Kong stands in stark contrast to the PRC. The PRC's shift of emphasis points the way for a major first step in reforming Hong Kong's tax system.

Another matter worth watching relates to the likelihood that Beijing will insist on being consulted on the contents of the HKSAR's budget each and every year. Some speculate about whether this process may be less than benign.¹¹⁵ It is certainly likely that government procurement and tendering processes will be influenced by the new relationship just as British contractors tended to be well treated in such exercises in the past.

A final note needs to be made concerning the Double Tax Treaties (DTTs) of the PRC. The Hong Kong government has (and the HKSAR will retain) the power to enter into DTTs. Thus far, Hong Kong has virtually no DTTs with other jurisdictions. The PRC has signed many DTTs with other jurisdictions. Typically, these DTTs address cross-border taxation problems and issues. There is a question, whether, after July 1, 1997, the PRC DTTs will apply in the HKSAR. Although the matter is not beyond doubt, the better view is that they will not apply. Accordingly, the fiscal separation of the HKSAR within the PRC is un-

114. *See id.*

115. *See The Fifth Man*, ECONOMIST, Oct. 5, 1996, at 26.

likely to be compromised via this route.¹¹⁶

VI. CONCLUSION

As Hong Kong prepares to become the HKSAR and join the PRC, it finds itself on the brink of becoming part of an economy that is engaged in a monumental fiscal reform program. This reform program is significant both due to its formal scope and the conditions under which it is being implemented. These conditions include the sheer size of the PRC, the economic underdevelopment of this huge nation, and the urgency of the task. The achievements to date are significant especially when one considers the formal changes achieved through legislation and regulation. Nevertheless, many difficulties remain. These difficulties include: major tax collection and enforcement problems throughout the system, the frightening budgetary problems facing many local governments throughout the PRC, the almost insoluble problems of the SES, and the distorting effects of the EBIs.

One of the driving forces behind fiscal reform in the PRC has been the problem of regional disparities. For example, the income disparity between poor inner regions and coastal regions has reached as much as four to one.¹¹⁷ There are also major disparities between rural and urban areas.¹¹⁸

Following the PRC's 1994 fiscal reforms, the HKSAR's fiscal relationship with the PRC looks more unusual than ever. The unique fiscal position of the HKSAR is enshrined in the Basic Law; the Joint Declaration further supports Hong Kong's special situation. The legal guarantees are very clear. Moreover, the PRC derives great economic benefit from a separate and prosperous Hong Kong through investments, trade, provision of services, and remittances. In addition, Hong Kong has been crucial in providing and mobilizing the capital that has fueled the PRC's extraordinary economic development since the late 1970s. Despite the predic-

116. The arguments for and against the possibility of the PRC DTTs applying in the HKSAR are canvassed in Cullen, *supra* note 4.

117. See Ronald A. Edwards, Some Provincial Level Development Observations in China (July 12, 1996) (unpublished paper, 11th Annual Conference of the Chinese Economists' Society) (on file with author). In the United States, Canada, and Australia, effective regional disparities are typically below two-to-one at their worst.

118. See *China on the Move*, *supra* note 65.

tions of professional doomsayers, the legal guarantees and the practical economic and political reasons for maintaining the HKSAR in a stable and prosperous condition should allow it to remain a separate fiscal island within the PRC, subject to the proviso that *exceptional* circumstances may alter this outcome.¹¹⁹

119. Well-known and highly successful contrarian investor, professional prophet of doom, and Hong Kong resident, Dr. Marc Faber, claims that the PRC will certainly use HKSAR revenues whenever the PRC needs money. See David Ivison, *Moneymen Add Up the Odds for '97*, S. CHINA MORNING POST, Feb. 17, 1996, at 13.