

# Improved legal control over Chinese tax incentives: anything to learn from EU State aid?

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## Abstract

Since the “reform and opening-up” policy in 1978, Chinese tax incentives have experienced fluctuations. China has tailored its tax incentives to create a level playing field in the market, especially after China’s accession to the World Trade Organization (WTO). However, China still has a state-oriented attitude towards the granting of tax incentives. This can be witnessed from conflicts between certain Chinese tax incentives and the WTO’s subsidy rules. China tends to treat tax incentives as instruments to achieve policy goals, but they often lack the necessary legal control. The European Union (EU) is a comparable power as to China in the world. The ultimate objective of the EU is the establishment of an internal market, which is based on market economy and free trade. State aid law, as a part of EU competition law, aims to limit the negative effects of state aid measures, thus creating a level playing field for all member states. In recent years, it plays an increasing role in restricting the harmful effects of tax incentives in the internal market. How can China improve the legal control over its tax incentives? Are there any inspirations for China from the experiences of EU State aid law? This article makes suggestions to an improved legal control over Chinese tax incentives against the background of EU State aid.

**Keywords:** Chinese tax incentives; EU State aid; Legal Control; Fair competition; Ex-ante and ex-post assessment.

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## 1. Introduction

Tax incentives have contributed enormously to the rise of China’s economy. Since the “reform and opening-up” policy in 1978, Chinese tax incentives have experienced fluctuations. China has tailored its tax incentives to create a level playing field in the market, especially after China’s accession to the World Trade Organization (WTO) in 2001.<sup>1</sup> From 2013, the Chinese government decided to further the reform of the tax systems, with the emphasis on the governance of tax incentives. The aim was to promote equality in tax burdens and fair competition in the market.<sup>2</sup>

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1. D. Xu, *Why does China Have a State-oriented Attitude towards Tax Incentives?*, in *Australian Tax Forum*, Vol. 33, 2018, 805.
2. See Section V of the Decision of the Central Committee of the Chinese Communist Party on Some Major Issues Concerning Comprehensively Deepening the Reform (the 2013 Decision). The 2013 Decision announced, “let the market

Nevertheless, China still has a state-oriented attitude towards the granting of tax incentives. The government tends to treat tax incentives as instruments to achieve policy goals, but they often lack the necessary legal control.<sup>3</sup> The government does not consider the granting of tax incentives as an intervention in the market, but as a means of macro-economic control that can achieve the state's function.<sup>4</sup> Even when the Chinese government has realized the importance of reducing the adverse effects of tax incentives, it does not mean that this is due to a concern for infringing the legal order that is based on the Western approach.<sup>5</sup>

The European Union (EU) is a comparable power both geographically and economically as to China in the world. The ultimate objective of the EU is the establishment of an internal market, which is based on market economy and free trade.<sup>6</sup> In order to increase efficiency and equity in the market, it is important to create a fair competition environment for participants. Thus, EU law prohibits Member State's actions that distort competition in the market.

State aid law, as a part of EU competition law, aims to limit the negative effects of State aid measures, thus creating a level playing field for all member states. In recent years, it plays an increasing role in restricting the harmful effects of tax incentives in the internal market.<sup>7</sup> In 2016, the European Commission published a comprehensive notice, which explains how to identify tax rulings and tax settlements as State aid.<sup>8</sup> State aid is not a panacea to solve all the problems of tax competition,<sup>9</sup> however, if taking the objectives of maintaining a level playing field in the internal market as a standard for evaluation, the State aid law is rather effective.<sup>10</sup> It has systematic setting of rules and procedures to control the harms of preferential tax incentives to the internal market. The system is a good example to interpret how well the procedural and institutional mechanism can play a role for protecting efficiency and equity in the market. China is a unified country, but the EU is a supranational organization. In the EU, each Member State still has tax sovereignty. Thus, the starting points of the State aid regime are the common interests of the internal market, which is the common agreement between Member States. Obviously, the idea of the common interests is not applicable in China. Nevertheless, China has its own interests of its own market and its position in the international market. It is possible for China to refer to the State aid regime. What

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decide the allocation of resources, the primary task is to build an open and unified market with orderly competition". For non-official English version of the 2013 Decision, see the English version of the 2013 Decision, *China Daily*, 18 November 2013, available at [http://language.chinadaily.com.cn/news/2013-11/18/content\\_17112855.htm](http://language.chinadaily.com.cn/news/2013-11/18/content_17112855.htm), accessed 25 February 2019.

3. Xu, *supra* note 1.
4. The function of taxation in China is originally based on the economic theory of Karl Marx. P.K. Auyeung, *Taxation Trends and Issues in the People's Republic of China: 1949 to 2006*, in *Bulletin of International Taxation*, Vol. 62, 2008, 250.
5. In 2014, on the Fourth Plenary Session of the Eighteenth Central Committee of the Chinese Communist Party (CCP), it was conveyed that the general target for next stage of the reform was to form a system serving "the socialist rule of law with Chinese characteristics and build a country under the socialist rule of law". See R. Peerenboom, *Fly High the Banner of Socialist Rule of Law with Chinese Characteristics!*, in *Hague Journal on the Rule of Law*, Vol. 7, 2015, 74; S. Zhu, *Socialist Rule of Law in the 21st Century China*, in *Hague Journal on the Rule of Law*, Vol. 7, 2015, 76-81.
6. Article 3 (3) of the Treaty on European Union. The Treaty of European Union [2012] OJ C326/13.
7. Since 2015, the European Commission has identified tax rulings of several Member States as State aid to enterprises, such as State aid from Luxembourg to Fiat, State aid from the Netherlands to Starbucks, State aid from Ireland to Apple, and State aid from Luxembourg to Amazon, etc. See all the final decisions from European Commission's website, [http://ec.europa.eu/competition/state\\_aid/register/](http://ec.europa.eu/competition/state_aid/register/).
8. Commission Notice on the Notion of State Aid as referred to in Article 107 (1) of the Treaty on the Functioning of the European Union [2016] OJ C262/01 (the 2016 Notice).
9. W. Schoen, *Tax Legislation and the Notion of Fiscal Aid-A Review of Five Years of European Jurisprudence* (December 22, 2015). Working Paper of the Max Planck Institute for Tax Law and Public Finance No. 2015-14. Available at SSRN: <https://ssrn.com/abstract=2707049>.
10. For instance, the European Commission decided that selective tax advantages for Fiat in Luxembourg and Starbucks in the Netherlands were illegal under EU State aid rules in 2015. On 19 May 2016, the European Commission published a Notice on the notion of State aid as referred to in Article 107 (1) TFEU. It explains how to identify tax rulings and tax settlements as State aid.

is more, the difficulties of implementing State aid control among EU Member States are likely not constituting concerns for China, because it is easier to carry out reforms on its own tax system in a unified country.

This article discusses the necessity and feasibility of introducing an internal legal control over the granting of Chinese tax incentives. It further refers to EU State aid law and derives inspirations from EU's application of State aid law to tax measures. It consequently raises recommendations for how to introduce a legal control over the granting of tax incentives in China.

## 2. The necessity to introduce an internal legal control over the granting of tax incentives in China

### 2.1. Unfair tax competition in China

Arbitrary granting of tax incentives harms fair competition in both China's domestic market and the international market. A result of China's state-oriented attitude towards tax incentives is that state-owned enterprises (SOEs) enjoy more tax benefits.<sup>11</sup> In China, centrally controlled SOEs are powerful in persuading governments to provide them with preferential tax treatment via special tax rulings.<sup>12</sup> Centrally controlled SOEs are the government's main source of profits, because they are owned by the government. Additionally, considering their national economic importance, centrally controlled SOEs can always bargain with the government to get special tax treatment. For instance, in corporate reorganizations, SOEs normally try to persuade the government to grant tax exemptions for the gains earned on the transfer of assets and stock.<sup>13</sup> Thus, special rulings for the reorganization of those large SOEs are issued.<sup>14</sup> However, private and foreign enterprises are not in a position to benefit from such special tax treatment. Another example occurs in relation to the taxation of corporate consolidated groups. Generally, corporate groups are not allowed to compute tax liability on a consolidated basis or to offset losses against profits within a group due to the corporate income tax sharing between the central and the local governments. Nevertheless, from 1994 to 2009, the central government has permitted such consolidation more and more often for large SOEs, especially centrally controlled SOEs.<sup>15</sup> This kind of consolidation tax treatment is also a result of lobbying by the SOEs. A further consequence, which disturbs the market order is that inefficient SOEs continue to survive in the market due to the tax incentives, thereby resulting in unfair competition.<sup>16</sup> Since 2015, China's economy has slowed down.<sup>17</sup> China expanded tax incentives for small and low profit enterprises.<sup>18</sup> However, compared to SOEs, they are still in a relatively disadvantaged status in the market. Therefore, SOEs with specified tax incentives could gain more competitive places in both domestic and international market, which is detrimental to fair competition.

In addition, China grants specific tax incentives for special regions such as comprehensive experimental zones including Hengqin New District in Guangdong (Hengqin), Pingtan Comprehensive

11. Xu, *supra* note 1.

12. W. Cui, *Taxation of State-owned Enterprises: A Review of Empirical Evidence from China*, in B.L.Liebman and C.J. Milhaupt (editors), *Regulating the Visible Hand? The Institutional Implications of Chinese State Capitalism*, Oxford, 2015, 109-31.

13. *Ibid.*

14. *Ibid.* Between 2000 to 2011, around 40 rulings were issued granting tax exemptions for these reorganizations.

15. *Ibid.*

16. *Ibid.*, 120-122.

17. The Gross Domestic Product (GDP) growth rate for China was 6.9%, 6.7%, and 6.9% in 2015, 2016, and 2017. It is the first time in past ten years that the growth rate is below 7%. See data from China's Statistical Yearbook 2018, <http://www.stats.gov.cn/tjsj/ndsj/2018/indexeh.htm>, accessed 25 February 2019.

18. Notice by the Ministry of Finance and the State Administration of Taxation of Implementing the Inclusive Tax Deduction and Exemption Policies for Micro and Small Enterprises [2019] No. 13 (17 January 2019).

Experimental Zones in Fujian (Pingtan), and Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone (Qianhai). They are located respectively next to Macau, Taiwan, and Hong Kong.<sup>19</sup> Considering the special location advantages of the three comprehensive experimental zones, they were authorized to grant more preferential tax incentives, including a 15% tax rate for enterprises investing in state's encouraged industries in the three zones.<sup>20</sup> The prosperity of these regions has not only economic effects but also political considerations for China. On the one hand, new incentives of the regions not only can promote the development of the regions themselves, but can also provide more services for the development of Hong Kong, Macao, and Taiwan, thus achieving the expected "win-win" results. On the other hand, taking into account the special political positions of the three islands to China, tax incentives are considered as reasonable instruments to the prosperity of the new zones to maintain political stability of the areas,

## 2.2. Fair competition is critical for China

The maintenance of a level playing field is crucial for China's further integration into the world economy. China is already a member of the WTO and it has marched a long way to meet the international standards. China is also a member of the OECD/G20 Base Erosion and Profit Shifting (BEPS) inclusive framework. It has implemented BEPS minimum standards domestically to a certain degree.<sup>21</sup>

As a member of the WTO, China encounters challenges from subsidy investigations towards certain tax incentives.<sup>22</sup> The WTO is the most influential international legal institution that disciplines subsidies. Its aim is to ensure a level playing field for all members in the international trading system. In order to tackle the harmful effects of subsidies, the WTO has specific rules, i.e. the Agreement on Subsidies and Countervailing Measures (ASCM).<sup>23</sup> According to the ASCM, a subsidy is defined as a financial contribution made by a government or any public body, which confers a benefit that is specific.<sup>24</sup> Chinese tax incentives have suffered from subsidy investigations in the WTO since its accession.<sup>25</sup> Although China has modified major disputed tax incentives according to the ASCM criterion, certain industrial and regional tax incentives still have the potential to constitute subsidies under the ASCM, such as tax incentives favoring SOEs.<sup>26</sup> Hence, certain Chinese tax incentives could harm the level playing field in the international market, which is again the objectives of the WTO. However, as a member of the WTO, China has the obligation to follow the rules of fair competition in the global market.

19. Hengqin is an island located at Zhuhai city in Guangdong province, which is next to Macau. On 14 August 2009, the State Council approved the General Development Plan of Hengqin to explore a new model of cooperation between Guangdong, Macau, and Hong Kong; Pingtan is also an island in Fujian province, which is the closest part of Mainland China to Taiwan. Its construction and development will promote the communication and cooperation between Mainland China and Taiwan. The National Development and Reform Commission issued the Overall Development Plan of Pingtan Comprehensive Experimental Zone in November 2011; Qianhai, located in Shenzhen SEZ, is close to Hong Kong, and is also a combination point for Guangdong-Shenzhen-Hong Kong development area. In 2012, the State Council approved the proposal to further develop the Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone, See Guohan [2012] No.58, Reply of the State Council on the Relevant Policies Supporting the Development and Opening-up of the Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone, by the State Council, 27 June 2012.

20. Caishui [2014] No.26, Notice on Enterprise Income Tax Incentives and Catalogue for Guangdong Hengqin New District, Pingtan Comprehensive Experimental Zones, and Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone, by the MoF and the SAT, 7 May 2014.

21. D. Xu, *The Convergence and Divergence between China's Implementation and OECD/G20 BEPS Minimum Standards*, in *World Tax Journal*, Vol. 10, 2018, 471.

22. D. Xu, *Prospects on the Relationship between Chinese Direct Tax Incentives and Subsidy Rules of the World Trade Organization*, in *Intertax*, Vol. 44, Issue 6/7, 2016, 538-549.

23. Agreement on Subsidies and Countervailing Measures (WTO), [https://www.wto.org/english/docs\\_e/legal\\_e/24-scm.pdf](https://www.wto.org/english/docs_e/legal_e/24-scm.pdf).

24. Article 1.1 of the ASCM.

25. Xu, *supra* note 22.

26. *Ibid*.

Moreover, China considers itself as a strong supporter of globalization, thus defending mutually beneficial relationships in the world market.<sup>27</sup> As a capital importing and capital exporting country, it is not only a taker of international rules, but also a maker of rules itself in the complex political economy of the world.<sup>28</sup> If China still aims to further integrating into the world economy and benefiting from the globalization, it has to adapt itself as a participant and a guard for a level playing field in the global market. Furthermore, as a major economic power, it has the responsibility to safeguard fair competition in the market. Therefore, it is necessary to recommend Chinese tax incentives based on the maintenance of fair competition in the market.

### 2.3. A legal control over tax incentives guarantees fair competition

A legal control over tax incentives is guarantee for a level playing field in both China's domestic and the international market. Rule of law is a very broad and intensive concept, which reflects different values in different social circumstances.<sup>29</sup> However, it is commonly acknowledged that the threshold conditions of rule of law are to restrain the arbitrary and inequitable use of state power and to protect individual rights.<sup>30</sup> In the West, the common form of rule of law is the Liberal Democratic rule of law.<sup>31</sup> In an economic context, governments' behaviors regulated by the rule of law ensures efficiency in the market, since it entails freedom of entry into the market, access to relevant information, and the security of contracts.<sup>32</sup> Based on the basic theory of public finance, in the field of taxation, governments should confine the main economic functions to the stabilization of economic activity, redistribution of income and wealth, and allocation of resources, so that the market still functions as the major actor in allocating resources.<sup>33</sup> A rule-based system can increase the transparency and accountability of governments and minimize the harmful effects derived from the governmental intervention into the market.<sup>34</sup> In order to control the harmful effects of tax incentives, the legal regulation normally entails both ex-ante and ex-post assessment.<sup>35</sup> Ex-ante assessment means that before introducing a tax incentive, governments should estimate the effects of the incentive according to certain legal and economic criteria. Ex-post assessment refers to the termination of tax incentives after periodical reviews on their effects. If there is no renewal, they should be terminated. China does not have a Western Liberal Democratic rule of law, but it has made great achievements with respect to the establishment of its legal system. The introduction of a legal control regime over Chinese tax incentives serves well for the creation of fair competition in the market, which eventually contributes to the promotion of efficiency under a market economy system. The further focus should be on the type of legal control and the approach to establish such a legal regime. According to theories on the rule of law, an essential constituent to the rule

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27. 2018: Xi Tells China Stories to the World, People's Daily Online, 4 January 2019, <http://en.people.cn/n3/2019/0104/c90000-9534841.html>, accessed 25 February 2019.

28. Xu, *supra* note 21.

29. For instance, according to the history of countries, there are four typical types of the rule of law, including the English rule of law, the North American version of the rule of law, the German *Rechtsstaat*, and the French *État de droit*. See P. Costa, D. Zolo and E. Santoro, *The Rule of Law History, Theory and Criticism*, Dordrecht, 2007, 7.

30. The emphasis of the protection of individual rights thrived after the Enlightenment, which then became the values of the law. See A. Bedner, *An Elementary Approach to the Rule of Law*, in *Hague Journal on the Rule of Law*, Vol. 2, 2010, 48.

31. The Liberal Democratic rule of law usually entails free market capitalism, multiparty democracy, and a liberal interpretation of human rights, etc. In Peerenboom's opinion, there are four types of rule of law, i.e. Liberal Democratic rule of law, Communitarian rule of law, Neo-authoritarian rule of law, and Statist Socialist rule of law. R. Peerenboom, *China's Long March toward Rule of Law*, Cambridge, 2002, 69-70.

32. P. Dhonte, *Towards A Market Economy Structures of Governance*, Washington, 1997, 3.

33. R. Musgrave and P. Musgrave, *Public Finance in Theory and Practice*, New York, 1973.

34. The rule of law actually plays a role of balancing the power of the market and the government, but not definitely opposes the two. See J. E. Stiglitz, *The Role of Government in Economic Development*, Washington, 1997.

35. A. Easson, *Tax Incentives for Foreign Direct Investment*, The Hague, 2004, 158.

of law system is to include procedural and institutional elements.<sup>36</sup> These elements embody the functionality of the legislator, the administration, and the court.<sup>37</sup> Performing governmental duties according to law first requires the government making decisions based on statutory procedures.<sup>38</sup> The procedural elements could become starting points when considering establishing a legal control over tax incentives in China.

In summary, it is necessary to introduce an internal legal control over the granting of tax incentives in China and the basis for recommending Chinese tax incentives is to maintain fair competition in the market and to introduce a legal control over tax incentives.

### 3. The introduction of a tax expenditure system to China

#### 3.1. Overview on the tax expenditure system

A commonly adopted legal control method for tax incentives could be the introduction of a tax expenditure system, the concept of which was firstly developed by Stanley Surrey (1970) in the US, but was widely accepted across countries.<sup>39</sup> The most obvious feature of the notion is a deviation from a tax system benchmark.<sup>40</sup> The benchmark normally includes the rate structure, accounting conventions, deductibility of compulsory payment, provisions to facilitate tax administration, and international fiscal obligations, etc.<sup>41</sup>

Such tax expenditure system is an internal legal control mechanism since it combines legal procedures on the control of tax incentives from the perspectives of legislation, administration, and evaluation. Firstly, it subjects tax incentives to budgetary process, which entails necessary legal assessment and authorization. Even though some countries do not involve tax expenditures in the budget processes; they still have a separate evaluation process for tax expenditures.<sup>42</sup> Many countries have established a tax expenditure system that brings tax incentives into the budgetary process.<sup>43</sup> Tax expenditures in different countries have different forms, some are in the form of an annex to the budget, and some are independent documents.<sup>44</sup> It is a higher stage for the administration of tax incentives in a legalized way.<sup>45</sup> The purpose, costs and benefits, and effects for the granting of tax incentives are assessed by the legislative authorities at an initial stage, so that it forms a preliminary ex-ante assessment. In addition, most of those countries file tax expenditure reports regularly in order to provide transparent empirical information on their tax expenditures.<sup>46</sup> As a result, the reports could act as ex-post assessment for the evaluation of implemented tax incentives. Thus, it is simple and efficient for tax authorities to administer and supervise the enforcement of

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36. J. Fleming, *Getting to the Rule of Law*, New York, 2011, 12-14.

37. Ibid.

38. D. Cai and C. Wang, *China's Journey toward the Rule of Law: Legal Reform, 1978-2008*, Beijing, 2010, 38.

39. S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, in *Harvard Law Review*, Vol. 83, 1970, 705.

40. Ibid.

41. Z. Li, H. Brizi and C. Valenduc, *Tax Expenditures: General Concept, Measurement, and Overview of Country Practices*, in H. Brizi and others (editors) *Tax Expenditures-Shedding Light on Government Spending through the Tax System Lessons from Developed and Transition Economies*, Washington, 2004, 3.

42. OECD, *Tax Expenditures in OECD Countries*, Paris, 2010, 60-63.

43. Many Western countries have established the tax expenditure system, such as the US, Canada, Australia, the Netherlands, Belgium, and Germany. See *ibid* 69-132.

44. *Ibid*. Some countries take tax expenditure reports as an annex to the budget, such as Austria, Belgium, France, Germany, and the Netherlands; some countries have separate tax expenditure reports, but provide additional background information for the budget, such as Australia, Canada, Italy, UK, and the US.

45. X. Li, *Legal Analysis of Tax Expenditure System*, Beijing, 2012, 25-27.

46. *Ibid*.

those incentives. Moreover, it increases transparency for the allocation of public revenue.<sup>47</sup> Many developed countries, such as Austria, Germany, France, and the Netherlands, consider it as a legal obligation, and publish it annually.<sup>48</sup> In general, the system forms a procedural guarantee for the implementation of the law on tax incentives. In such a system, governments or tax authorities, as the subjects for the implementation, are also accountable. It therefore forms a regulation on government's arbitrary power of granting tax incentives and increases government's accountability. In summary, the purpose of the establishment of a tax expenditure system is to effectively control and evaluate tax incentives in a legalized way. It contains the basic procedural elements as a means of legal control, i.e. the legislative assessment, the government's accountability, and the evaluation that enables taxpayers to seek for remedies.

### 3.2. Feasibility of tax expenditures in China

The legal control over tax incentives can be considered as a part of the rule of law process in China, which requires basic institutional and procedural elements that could support the system. The Chinese tax law system has developed in diverse aspects, so certain conditions are ready to satisfy those requirements. When matching the existing institutional elements in China with the basic conditions of the tax expenditure system, it is plausible to see the feasibility of introducing such a system to China.

In China, tax legislation includes national tax "laws" (fa lü)<sup>49</sup> enacted by the National People's Congress (NPC, the legislator),<sup>50</sup> "administrative regulations" (fa gui)<sup>51</sup> promulgated by the State Council (the government branch),<sup>52</sup> as well as administrative rules introduced by the Ministry of Finance and the State Administration of Taxation, which are ministries of the State Council.<sup>53</sup> The Legislation Law is the foundational statute that governs the hierarchy of the laws in China.<sup>54</sup> According to the Legislation Law, the Constitution has the highest legal authority in China.<sup>55</sup> National law has a higher legal authority than administrative regulations, local decrees and administrative or local rules; administrative regulations have higher legal authority than local decrees and admin-

47. M. Burton and K. Sadiq, *Tax Expenditure Management a Critical Assessment*, Cambridge, 2012, 31-32.

48. OECD, *supra* note 42, 69.

49. Chinese pin yin.

50. The National People's Congress (NPC) is the supreme organ of state power in China. It is composed of NPC deputies who are elected according to law from 35 electoral units from the people's congress of provinces, autonomous regions, municipalities directly under the central government, the People's Liberation Army, the deputy election council of the Hong Kong Special Administration Region and the Taiwan compatriots' consultation election council. The NPC has the power to amend the Constitution and oversee its enforcement, to enact and amend basic laws governing criminal offences, civil affairs, state organs and other matters, to elect and appoint members to central state organs, and to determine major state issues. The NPC Standing Committee is the permanent body of the NPC. It normally meets once every two months, and is responsible to the NPC and reports to it on its work. It has legislative power, supervisory power, the power to decide upon major state issues, and the power to appoint and remove from office members of state organs. See Article 7, 8, 9 of the Legislation Law of the People's Republic of China. See also the NPC's official website, [http://www.npc.gov.cn/englishnpc/Organization/node\\_2846.htm](http://www.npc.gov.cn/englishnpc/Organization/node_2846.htm), accessed 24 March 2019.

51. Chinese pin yin.

52. The State Council is China's central government, which is the executive body of the supreme organ of state power and the supreme organ of State administration. See Article 65, 66, 67, and 68 of the Legislation Law. For the functions of the State Council, see [http://www.npc.gov.cn/englishnpc/stateStructure/2007-12/06/content\\_1382098.htm](http://www.npc.gov.cn/englishnpc/stateStructure/2007-12/06/content_1382098.htm), accessed 24 March 2019.

53. For more information, see Li, *Taxation in the People's Republic of China*; Jinyan Li, 'The Rise and Fall of Chinese Tax Incentives and Implications for International Tax Debates' (2007) 8 Florida Tax Review 628, footnote 67; Wei Cui, 'What is the Law in Chinese Tax Administration?' (2011) 19 Asia Pacific Law Review 73-92.

54. Legislation Law of the People's Republic of China (2015 Amendment), by the NPC, 15 March 2015. See Cui, 'What is the Law in Chinese Tax Administration?' 75-77.

55. Article 87 of the Legislation Law in China.

istrative or local rules;<sup>56</sup> administrative rules and local rules have the same legal authority.<sup>57</sup>

### 3.2.1. Legislative elements

A tax expenditure system requires a regulation on government's arbitrary granting, so the power for granting tax incentives should be limited to legislative authorities. The NPC is the supreme legislative entity in China. However, most tax incentives are granted by the Ministry of Finance (MoF) and the State Administration of Taxation (SAT), which are not official legislators. Tax incentives do not really go through ex-ante assessment, or the assessment procedure is not transparent. Since China has legislative institutions, and it also has a Budget Law,<sup>58</sup> it is feasible to include tax expenditures in the Budget Law or promulgate separate legislation or regulation on tax expenditures. The most essential issue in this process is an ex-ante assessment for the granting of tax expenditures.

### 3.2.2. Budget process

Tax expenditures in the form of a budget report require a budget process that could contain the compilation of tax expenditures. It not only needs subjects or authorities to be responsible for the compilation, but also requires legislations that confirm the validity of such a process. With respect to China, the Budget law of China could form a basis for such a legal control. It regulates powers for budget management, scope of budgetary revenues and expenditures, budget compilation, examination and approval of budgets, implementation and adjustment, final accounts, supervision, and legal responsibility, etc.<sup>59</sup> However, the Budget Law does not specifically take tax incentives into the legal regulation.<sup>60</sup> Nevertheless, it still provides a basis for including tax expenditure. Article 4 of the new Budget Law stipulates, "a budget consists of budgetary revenues and budgetary expenditure. All government revenues and expenditure shall be included in a budget". Tax incentives are also expenditures of government revenues, so it should be included in the budget compilation. Additionally, the Budget Law also stipulates that the State Council is entitled to draft the central budget and final accounts, and report to the NPC.<sup>61</sup> The NPC has the power to review and approve the central and local budgets.<sup>62</sup> The review procedure from the NPC should constitute an ex-ante and ex-post assessment for tax expenditures.

### 3.2.3. Administrative elements

A tax expenditure system requires administrative institutions that can implement and supervise it. China has established a relative mature administrative system for managing the tax expenditure system. Firstly, the fiscal power centralized at the central government's hand is actually efficient for the administration of tax expenditures.<sup>63</sup> The central government is capable to coordinate the implementation with local governments. In addition, tax authorities have some experiences on the assessment of tax incentives. For instance, in certain projects of tax reduction or exemption, tax authorities have conducted basic ex-ante and ex-post assessment, such as the immediate collection

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56. Article 88 of the Legislation Law in China.

57. Article 91 of the Legislation Law in China.

58. Budget Law of the People's Republic of China (2014 Amendment). The Budget Law was promulgated in 1995, and was amended in 2014.

59. Ibid.

60. Article 27 stipulates that by function, the expenditure in a general public budget includes expenditure on general public services, expenditure on diplomatic affairs, public security, and national defense, expenditure on agriculture and environmental protection, expenditure on education, science and technology, culture, health, and sports, expenditure on social security and employment, and other expenditure. It does not separate tax expenditure from other expenditures.

61. Article 23, Budget Law of the People's Republic of China (2014 Amendment).

62. Article 20, Budget Law of the People's Republic of China (2014 Amendment).

63. Article 3, Law of the People's Republic of China on the Administration of Tax Collection (2015 Amendment).

and immediate return for valued added tax.<sup>64</sup> With respect to the identification of tax expenditures, the existing approaches could continue. It mainly involves three methods, automatic identification, identification after the assessment of tax administrations, and identification with the assistance of agents.<sup>65</sup> With these experiences, tax administrations could step further on the management of tax expenditures.<sup>66</sup>

### 3.2.4. Supervisory elements

An important characteristic of a tax expenditure system is an independent institution that could supervise the implementation of tax expenditures. It mainly contains an ex-post assessment, which evaluates fairness, economy, efficiency, and effectiveness of tax expenditures. To perform such an evaluation, the independence of the institution should be highlighted. It should be independent from the government who proposes and implements tax incentives. In China, the NPC and its standing committee has the supervisory power for tax expenditures, and the government has to report to the NPC.<sup>67</sup> Except for the NPC and its standing committee's supervision, the implementation of the budget, tax revenue and expenditure of governments are subject to independent auditing by the National Audit Office (NAO). As confirmed by the Constitution, the NAO is an independent auditing body that exercises its power of supervision in accordance with the law.<sup>68</sup> However, its independence is conditional, which is still subject to the direction of the Premier of the State Council. It means that it is still a department of the government, the State Council. At local levels, local audit offices are departments of local governments. Therefore, the system bears the risk that the NAO will not be independent due to the interference from its higher authority, the government. Nevertheless, it is an institution that could become a supplement to the NPC and its standing committee's supervision on tax expenditures, considering its experience and expertise on auditing. Further reform could focus on increasing its independence from the government.

### 3.2.5. Judicial elements

As a legal control procedure, the system should be guaranteed by judicial institutions.<sup>69</sup> Most countries that have a tax expenditure system also have evaluation procedures to examine the accountability of the government. Accordingly, there are approaches to remedies, which have two major tracks.<sup>70</sup> The first track is to seek for administrative remedies by applying for administrative reconsideration within the administrative system. Since the granting of tax expenditures is a government's administrative act in China, namely administrative rules introduced by ministries of the government, the direct remedy is towards the granting act itself. It has to emphasize that the institution responsible for administrative reconsideration is independent from the tax authority that implements the specific administrative act. The second track is judicial remedy. It requires independent courts that could make judgments and decide on compensations. Normally, in countries where a tax expenditure system exists, taxpayers have rights for administrative litigations

64. Li, *supra* note 53, 132-133.

65. *Ibid* 102-103.

66. G. Ma, *China's Current Tax Expenditure System: Issues and Policy Options*, in H. Brizi and others (editors) *Tax Expenditures-Shedding Light on Government Spending through the Tax System Lessons from Developed and Transition Economies*, Washington, 2004, 199-202.

67. Article 92, Constitution of the People's Republic of China (2004 Amendment).

68. Article 91, Constitution of the People's Republic of China (2004 Amendment). The State Council established an auditing body to supervise through auditing the revenue and expenditure of all departments under the State Council and of the local governments at various levels, and the revenue and expenditure of all financial and monetary organizations, enterprises and institutions of the state. Under the direction of the Premier of the State Council, the auditing body independently exercises its power of supervision through auditing in accordance with the law, subject to no interference by any other administrative organ or any public organization or individual.

69. Y. Li, *The Judicial System and Reform in Post-Mao China: Stumbling Towards Justice (The Rule of Law in China and Comparative Perspectives, Vol. 1)*, Farnhem, 2014, 2.

70. *Ibid* 19-20.

against government's action, so judicial independence is a necessary condition for safeguarding taxpayer's rights.<sup>71</sup>

China has its own circumstances with respect to these judicial elements. Tax incentives are government's administrative actions. Most tax incentives in China are issued by the SAT and the MoF in the form of regulatory documents, such as decisions and circulars. The main remedy mechanisms in China for administrative actions are administrative reconsideration and administrative litigation.<sup>72</sup> Plaintiffs may choose either of the two ways to seek for remedies. They could go to the administrative organ at the next higher level for administrative reconsideration, or could go directly to the courts.<sup>73</sup>

As to administrative litigation, the Chinese Administrative Litigation Law permits courts to review regulatory documents<sup>74</sup> when plaintiffs litigate against concrete administrative actions. Therefore, this provision endows taxpayers' rights to litigate against specific tax measures conducted by governments together with a claim for reviewing the legality of regulation that is the reliance for such a tax measure. It is considered as an improvement for increasing government's accountability.<sup>75</sup> This provision provides a possibility to include legal remedies for establishing the legal system of tax expenditures.

However, direct litigations against administrative regulations or decisions or orders with general binding forces will not be accepted by courts.<sup>76</sup> The rationale behind this is that these administrative regulations are stipulated by the State Council, which could be reviewed by legislative bodies through its supervisory system. As an independent supervisory institution, the NPC is capable to review and annul administrative regulations.<sup>77</sup>

As pointed out by some authors, there has been a long debate on such a distinction between litigations against regulations or regulatory documents by governments at different hierarchies.<sup>78</sup> The provision assumes that government's administrative actions will only harm individuals' rights

71. Ma, *supra* note 66, 9-11; R. Peerenboom, *Judicial Independence in China : Lessons for Global Rule of Law Promotion*, Cambridge, 2009, 24-26.

72. Administrative Reconsideration Law of the People's Republic of China (2009 Amendment); Administrative Litigation Law of the People's Republic of China (2014 Amendment). See also Li, *supra* note 69, 19-20.

73. *Ibid.*

74. See Article 53 of the Administrative Litigation Law in China. Where a citizen, a legal person, or any other organization deems that a regulatory document developed by a department of the State Council or by a local people's government or a department thereof, based on which the alleged administrative action was taken, is illegal, the citizen, legal person, or other organization may concurrently file a request for review of the regulatory document when filing a complaint against the administrative action. The term "regulatory document" as mentioned in the preceding paragraph does not include administrative rules. For the English version of the Administrative Litigation Law, see <http://www.lawinfochina.com>.

75. As to the application of the Administrative Litigation Law, the Supreme People's Court published an interpretation. Article 21 of the interpretation states a people's court shall not rely on an illegal regulatory document to determine the legality of an administrative action and shall state so in its legal reasoning. A people's court issuing an effective ruling shall provide the enacting authority of the regulatory document with recommendations and may also send copies to the people's government at the corresponding level or the administrative agency at the level immediately above. See Interpretation No.9 2015 of the Supreme People's Court, 20 April 2015. For English translation, see B. Chen and Z. Li, *Interpretation of the Supreme People's Court on Several Issues Concerning the Application of "Administrative Litigation Law of the People's Republic of China"*, in *Washington International Law Journal*, Vol. 25, 2016, 133. See also B. Chen and Z. Li, *Explaining Comparative Administrative Law: the Standing of Positive Political Theory*, *Washington International Law Journal*, Vol. 87, 2016, 116-117.

76. Article 13 of the Administrative Litigation Law. The courts shall not accept complaints filed by citizens, legal persons, or other organizations against the following: (2) administrative regulations and rules or decisions and orders with general binding force developed and issued by administrative agencies.

77. There is no constitutional court in China. The NPC is the supreme organ that has the legislative supervisory power. Its standing committee has the power to annul those administrative rules and regulations, decisions or orders of the State Council that contravene the Constitution or the law. See Article 67 (7), Constitution of the People's Republic of China (2004 Amendment).

78. Li, *supra* note 69, 22-23; Peerenboom, *supra* note 71, 131-132.

through concrete administrative actions. Therefore, as the source of a concrete administrative action, such an administrative regulation could be reviewed by courts.<sup>79</sup> However, if plaintiffs could not justify that their rights are directly harmed by general regulations themselves, they could not directly challenge the regulation itself. Supporters maintain that if plaintiffs could directly challenge a law or a State Council administrative regulation, there would be abuse of such a right.<sup>80</sup> In addition, the present courts in China, especially lower courts lack the resources and competence to solve such cases due to the lack of expertise and experience.<sup>81</sup> Moreover, courts will not be able to handle the mass number of cases. In contrast, opponents claim that there lacks legal guarantee for merely relying on legislative supervision.<sup>82</sup>

In summary, there are judicial elements to support the introduction of a legal control system over tax incentives. The focus should be on how to consider legal remedies that could embed such a legal control into China's current judicial system.

## 4. Anything to learn from EU State aid law?

### 4.1. An overview of EU State aid law to fiscal measures

Articles 107, 108, and 109 of the Treaty on the Functioning of the European Union (TFEU) are the main regulations on State aid measures.<sup>83</sup> Article 107 has provided a definition of aid, which is widely used as a benchmark to identify State aids, and Article 108, Article 109 introduce procedures on State aid control, such as the interaction between the Commission, the Member States and the Council.<sup>84</sup> In addition, the Commission has issued a notice on the notion of State aid as referred to in Article 107 (1) (the 2016 Notice).<sup>85</sup>

According to Article 107 (1) TFEU,<sup>86</sup> there are steps to identify a tax incentive as a State aid measure: whether the tax incentive is granted by a Member State or through State resources; whether it confers on recipients an advantage, which relieves them of charges that are normally borne from their budgets; whether it is selective; and whether it affects competition and trade between Member States. The crucial element is the determination of selectivity. According to the 2016 Notice, selectivity is classified as material and regional selectivity. There are three steps to identify material selectivity. Step 1, there is a reference legal system; step 2, the aid measure derogates from the reference system; and step 3, to determine whether the derogation could be justified by the nature or general scheme of the taxation system.<sup>87</sup> Regional selectivity means that if a tax measure favors a region or a local scope in a jurisdiction.<sup>88</sup>

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79. Taxpayers could apply for administrative reconsideration as well. Article 7 of the ARL: if a citizen, legal person or any other organization considers any of the following provisions, which is the basis of a specific administrative act of an administrative organ, to be illegal, he or she or it may, when filing an application for administrative reconsideration on a concrete administrative act, file an application to the administrative reconsideration organ for reviewing the provisions: provisions of departments under the State Council; provisions of local people's governments at or above the country level and their departments; provisions of people's governments of towns or townships.

80. Peerenboom, *supra* note 71, 94.

81. *Ibid* 79.

82. Li, *supra* note 69, 22.

83. The Treaty on the Functioning of the European Union, <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:12012E/TXT&from=EN>.

84. See Article 107, 108, and 109 of the TFEU.

85. *Supra* note 8.

86. Article 107 (1) TFEU: any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.

87. The 2016 Notice, pp. 27-29.

88. The 2016 Notice, pp. 32-33.

When a tax incentive satisfies all the above elements, it is likely to constitute a State aid. However, it can still find justifications for exemption if it is a compatible State aid. The most frequently adopted justifications for an aid measure are discretionary exemptions<sup>89</sup> and the General Block Exemption Regulation (GBER),<sup>90</sup> including tax incentives for regional development, small and medium enterprises, environmental protection, research, development and innovation, etc. Once the tax incentive meets those conditions, they become compatible State aids that are not obliged to notify the Commission. Moreover, the Commission has discretionary power to assess the compatibility of an aid according to the assessment criteria listed before.

In recent years, the European Commission has widely used State aid law to tackle harmful effects of tax rulings. The European Commission has identified tax rulings of several Member States as State aid to enterprises, such as State aid from Luxembourg to Fiat, from the Netherlands to Starbucks, from Ireland to Apple, and from Luxembourg to Amazon, etc.<sup>91</sup> The Commission follows a three-step test to determine whether a tax measure confers a selective economic advantage on enterprises.<sup>92</sup> Firstly, the Commission has to identify the reference tax system. It usually considers the national corporate tax system as the reference system. Secondly, the Commission evaluates whether the tax ruling deviates from the reference system. It assesses whether the tax ruling lead to unequal treatment between group and independent enterprises. It does not examine the existence of an advantage and selectivity separately, but presumes that the existence of an economic advantage is sufficient to demonstrate selectivity.<sup>93</sup> Thirdly, it is the Member State's burden of proof on the justification of the selectivity. State aid law is already a powerful measure to combat harmful tax competition in the EU.<sup>94</sup>

## 4.2. Reference from EU State aid

### 4.2.1. The identification of a tax aid

The State aid regime has relatively clear steps of identifying a State aid measure since it has provided a concrete definition of State aid. Additionally, there are Commission regulations and case laws that assist the actual identification.<sup>95</sup> Although the State aid law's validity towards taxation is evolving, it has to be acknowledged that it is effective in controlling the adverse effects of selective tax aid to the internal market.<sup>96</sup> The effectivity is mainly for the reason that it has established a systematic procedure for the assessment of aid measures, which involves basic elements for tax expenditures.

What can be learnt for China is that when designing the tax expenditure system, it is necessary to provide a clear definition of tax expenditure that is subject to legal enforcement. This concept should reflect that there is a deviation for rendering tax benefits from the benchmark tax system. It is also important to clarify the benchmark system or provide instructions on how to identify the

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89. Article 107 (3) of the TFEU listed five items that may be considered to be compatible with the internal market that are at the discretion of the European Commission.

90. Commission regulation (ECU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty (General Block Exemption Regulation, GBER) [2014] OJ L187/1, see <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0651&from=EN>.

91. *Supra* note 7.

92. N. Robins, *The Tax State Aid Investigations, and the Role of Economic and Financial Analysis*, in *Derivatives & Financial Instruments*, Vol. 19, 2017.

93. E. Fort, *EU State Aid and Tax: An Evolutionary Approach*, in *European Taxation*, Vol. 57, 2017.

94. P. Lampreave, *Harmful Tax Competition and Fiscal State Aid: Two Sides of the Same Coin?*, in *European Taxation*, Vol. 59.

95. L. Hancher, T. Ottervanger, and P. Jan Slot, *EU State Aids*, London, 2016; R. Barents, *Directory of EC Case Law on State Aid*, the Hague, 2016.

96. The Apple case, Amazon case, and Starbucks case are good examples. See the final decisions of these cases at [http://ec.europa.eu/competition/state\\_aid/tax\\_rulings/index\\_en.html](http://ec.europa.eu/competition/state_aid/tax_rulings/index_en.html), accessed 4 March 2019.

benchmark system. Furthermore, since the design for such a tax expenditure system in China is for creating fair competition in the market, it can refer to the State aid law's selectivity standard so that the targets of regulating discriminative specific tax incentives are clear. With respect to the identification of a tax measure's selectivity, the testing steps in the State aid regime could be inspiring for China. There are three basic steps to determine selectivity. Firstly, to fix a normal tax benchmark; subsequently, to examine whether there is a deviation from the general benchmark; and lastly, to testify whether the measure can be justified on the nature or general scheme of the system. With these basic testing steps, the identification of specific tax incentives will become enforceable.

#### 4.2.2. Compatible State aid: the Commission's assessment

##### 4.2.2.1. The ex-ante assessment

Some aid measures are regarded as compatible with the internal market because they are in line with the objectives of the internal market. However, compatible State aid has to satisfy strict conditions. Member States have to notify compatible State aid to the Commission before their implementation.<sup>97</sup>

For aid that must be notified, the controlling procedures are different for existing aid and new aid.<sup>98</sup> For existing aid, no notification is required, but the Commission shall review them continually and propose any appropriate measures to be taken in relation to the aid required by the progressive development or by the functioning of the internal market. If the recommendation with regard to the amendment is not taken by the Member State, the Commission can start an investigation into the aid immediately. For new aid, the Member State shall notify the Commission and the Commission, therefore, shall examine the aid as soon as the notification is received. During the investigation period, the Member State shall not put the measure into effect before the Commission's official decision.

When the Commission has received the notification of State aid, it shall start a preliminary investigation to examine the compatibility of the aid measure. After the examination, if the notified measure does not constitute aid or the measure is compatible with the common market, the Commission shall communicate the finding by way of decision. If the Commission finds that doubts are raised as to the compatibility of the measure, it shall initiate a formal investigation procedure.<sup>99</sup>

In addition, in order to minimize the disadvantages of State aid and carry out the ex-ante assessment, the Commission has established specific controlling procedures in Article 108 TFEU and in procedural regulation.<sup>100</sup> The State aid regime has taken into account the category of compatible State aid, which provides certain tax incentives justifications under a balancing test. The test enables the Commission to conduct an ex-ante assessment, so it can effectively regulate the harmful effects of unlawful State aid. The Commission's assessment includes consecutive questions for the balancing test. Those questions actually embody the principle of proportionality, cost-benefit analysis, and transparency.<sup>101</sup>

97. Ibid.

98. Existing aid includes aid that exists prior to the entry into force of the Treaty; aid authorized by the Commission; aid that the Commission has approved by default; aid that was held to be unlawful, but the 10-year limitation period for recovery has expired; and aid that was put into effect at a time when it did not constitute an aid and subsequently became an aid due to the evolution of the common market and has not in the meantime been altered by the Member State. New aid means all aid that is not existing aid, including alterations to existing aid. See Article 1 of the Procedural Regulation.

99. If, within the two months of the examination period, the Commission does not take a decision, the aid shall be deemed to be authorized by the Commission, and thus the Member State may implement the measures thereafter.

100. Council Regulation (EU) 2015/1589 of 13 July 2015 laying down detailed rules for the application of Article 108 of the Treaty on the Functioning of the European Union [2015] OJ L248/9 (the Procedural Regulation).

101. The questions are 1. Is the aid measure aimed at a well-defined objective of common interest, like efficiency objective, equity objective, or transition to better functioning markets? 2. Is the aid well-designed to deliver the objective of

For China, when introducing the legal system of tax expenditures, it is inspiring to refer to this ex-ante assessment from the State aid control. In the context of the EU, the balancing test takes the common interest of the internal market as the benchmark for balancing harms and benefits estimated by the aid measure. However, China could find its own benchmark to design the ex-ante assessment.

The concept of a level playing field is ambiguous. There can be different interpretations on fairness. Back to the basic principle of equality by treating unequals unequally,<sup>102</sup> considering the circumstance of China, the level playing field in China's market should take into account the regional disparities and the imbalanced development of industries. It is the requirement of a level playing field *per se* for supporting the development of less developed regions, and for those activities the market mechanism does not allocate the resources properly. For instance, research and development activities, environment protection activities, big infra-structural projects, and the promotion of small and medium enterprises, etc. Therefore, it is rational to have compatible tax incentives in China, so the balancing test for Chinese tax incentives should take into account the need for these regions and activities.<sup>103</sup> When evaluating the tax incentive, the objective of the measure should be assessed as well. Afterwards, the proportionality test contributes to the cost and benefit analysis of the measure, thus determining the granting of the measure or not.

#### 4.2.2.2. The institution: the Commission

The institutional guarantee for the State aid control is the European Commission.<sup>104</sup> The complete and systematic controlling procedure enables the Commission to be powerful in administering and supervising the effect of aid measures. The Commission is not only the authority to conduct ex-ante assessment on notified State aid, it also has the power to investigate any tax measure provided by Member States that is likely to constitute State aid. Most importantly, it is an independent institution on the EU level, which has superior power over Member States. Thus, its decisions are authoritative for Member States to adjust or regulate their tax measures.<sup>105</sup>

As to China, what can be learnt is to establish an independent authority, which has the superior power to assess and supervise tax expenditures. This authority should have legislative power that is at the highest level. In China's circumstance, the NPC is the supreme organ of state power, which has the legislative power and supervisory power. It is an appropriate institution for controlling tax expenditures. The governmental branches of the SAT and the MoF could be authorized institutions

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common interest, i.e. does the proposed aid address the market failure or other objectives? Is State aid an appropriate policy instrument? Is there an incentive effect, i.e. does the aid change the behavior of firms? Is the aid measure proportional, i.e. could the same change in behavior be obtained with less aid? 3. Are the distortions of competition and effect on trade limited, so that the overall balance is positive? 4. Is the aid transparent that Member States, the Commission, economic operators, and the public have easy access to all relevant acts and information about the aid? See Community Framework for State Aid for Research and Development and Innovation [2006] OJ C323/1; Community Guidelines on State Aid to Promote Risk Capital Investments in Small and Medium-sized Enterprises [2006] OJ C194/2.

102. There are two basic principles of fairness. First, everyone will have an equal right to the most extensive basic liberties compatible with similar liberty for others; second, social and economic inequalities must satisfy two condition: they are to the greatest benefit of the least advantaged and they are attached to positions open to all under conditions of fair equality of opportunity. See J. Rawls, *A Theory of Justice*, Cambridge, 1999.

103. F. Vanistendael, *Fiscal Federalism, Are There Lessons to be Learnt for China?*, in *Asian-Pacific Tax Bulletin*, Vol. 17, 2011, 426-427.

104. The European Commission is the EU's politically independent executive arm. It proposes new laws, manages EU policies and allocate EU funding, enforces EU law, represents the EU internationally. Its members are appointed by national governments. The EU's broad priorities are set by the European Council, which brings together national and EU-level leaders. The Court of Justice of the EU upholds the rule of European Law and settles legal disputes between national governments and EU institutions. For more information, see the official website of European Union, Institutions and bodies, [https://europa.eu/european-union/about-eu/institutions-bodies\\_en](https://europa.eu/european-union/about-eu/institutions-bodies_en), accessed 25 March 2019.

105. A. Reinisch, *Essentials of EU Law*, Cambridge, 2012, 58-76.

as well, which assist the administration of tax expenditures.<sup>106</sup> Furthermore, independence of the authority is essential for assessing and supervising. If the NPC is the authority who decides on tax expenditures, there should be another independent auditing organ, which supervises the implementation of tax expenditures. This organ should conduct ex-post assessment of tax expenditures and report to the NPC. Currently, there is no such an institution in China, but it is recommended to set one to guarantee the system could really act as a legal control over tax expenditures.

#### 4.2.3. Remedies

The remedies of State aid law are rather powerful for the Commission to carry out ex-post assessment on the impacts of aid measures, especially for unnotified new aids. It has strong warning influence on Member States when they intend to render specific tax aid measures, because once the measure is identified as a State aid, the beneficiaries have to recover the benefits with interests. Moreover, the Court of Justice of the European Union (CJEU) acts as a supreme court of the EU exercising judicial review over both the EU and Member States. It could review the legality of legislative acts of the Commission, which include regulations, directive, and decisions. The judgment of the CJEU has supremacy that the Commission or Member States must follow. Since it is an independent judicial institution, it has absolute authority.<sup>107</sup> The Commission and the Court always take a very strict attitude towards the recovery. It makes the State aid regulation effective in reality, and enables it to be a powerful legal control over the adverse effects of unlawful aid measures.

In China's circumstance, in a short term, there are concerns for implementing such a strict recovery of tax incentives. On the one hand, it requires the well establishment of institutions to perform and supervise the enforcement of the recovery, which is costly. On the other hand, when involving tax issues, they can be technical so the cases always require expertise. At present, there is no specialized tax court in China, and there are no real tax experts in the courts.<sup>108</sup> However, in the long run, it is necessary for taxpayers having rights to litigate against harmful tax incentives that infringe fair competition in the market. Therefore, the remedies in the form of recovery could be a powerful solution. Accordingly, there should be associated institutions, such as an independent supervisory authority and independent courts, which could assist the implementation of the remedies.

### 4.3. Summary

EU State aid law introduces a system of legal control over tax incentives. As argued previously, what China lacks is an internal legal control over the granting of tax incentives. Such legal control is based on the objective of creating a level playing field for competition in both China's domestic market and the international market. The State aid system serves for the creation of an internal fair market in the EU, which could be an example for China to refer to. Moreover, under such a legal system, certain Chinese tax incentives can find justifications if they are in line with the object and purpose of fair competition and fulfill the procedural requirement. For instance, specific Chinese tax incentives are likely to constitute State aid if going through the testing steps hypothetically, because they usually confer economic advantages to specific enterprises or regions.<sup>109</sup> However, tax incentives to supporting research and development activities, environment protection, and less

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106. Li, *supra* note 69, 144-145.

107. Reinisch, *supra* note 105, 77-89.

108. In fact, tax litigations are rather rare in China. Some authors attribute this phenomenon to the uncertainty and inconsistencies caused by the rapid changing tax laws and the abuse of discretionary power in tax administration. Y. Xu, *Tax Dispute Resolution, Judiciary Independence and Property Rights* (2013 Summer Institute for Law and Economics, University of Chicago Law School); W. Cui, *What is the Law in Chinese Tax Administration?*, in *Asia-Pacific Law Review*, Vol. 19, 2011, 73.

109. D. Xu, *Interactions between Chinese Tax Incentives and WTO's Subsidy Rules against the Background of EU State Aid*, Tilburg University, 2016, pp.176-180.

developed regions can also find justifications under the compatible State aid procedure.<sup>110</sup> Therefore, EU State aid law inspires China on establishing an improved legal control over the granting of tax incentives.

## 5. Legal recommendations on the enforcement of the tax expenditure system in China

### 5.1. Legislative elements

In order to ensure the legal enforcement of the tax expenditure system, it is suggested to embed tax expenditures into the Budget Law with amendments, or to promulgate separate legal regulations.<sup>111</sup> This way subjects tax expenditures to high legislative authority. In a short term, including tax expenditures into the Budget Law could achieve the basic goal of a legal control. However, the Budget Law itself has to be amended in many aspects, considering the complexity of stipulating all relative provisions related to tax expenditures. It seems costly and time-consuming for such amendments. Thus, this way could work merely in a short term. In the long term, it is recommended to issue separate regulation on tax expenditures, which could explicitly and comprehensively include all elements of the legal control.

Moreover, China is also a member of the WTO, so it has the obligation not to grant prohibited subsidies under the WTO's subsidy regime. As a result, tax expenditures in China should not be specific to limited enterprises or regions. With respect to the promulgation of a separate regulation on tax expenditures, in principle, the legislation should embrace the aim of creating a level playing field in the market. In addition, such an objective should fit in China's circumstances, i.e. creating a level playing field in China's market. Nevertheless, the market level in China differs from the international level with respect to its imbalanced economic development. Therefore, a level playing field should permit support for undeveloped regions and industries. This rationale is also justified in EU State aid regime. When making legislation on tax expenditures, it should take into account procedures for the approval of compatible tax incentives in China.

As to the content of the regulation, it should not only take into account the legal control elements such as procedural and institutional elements, but should also specify different institutions' responsibilities in order to enforce and supervise tax expenditures. Moreover, it should contain legal responsibilities for the abuse of tax incentives. Once the tax expenditure system is enforceable according to law, it could form a legal restriction for the government.

To be specific, the content of the regulation should include: (1) aim and principle of tax expenditures, with a guiding principle on creating fair competition in the market; (2) scope of the regulation, definition of a tax expenditure, and methods of identification; (3) allocation of powers between institutions, including legislative, administrative, and judicial institutions; (4) process of initiating and approving tax expenditures, which should involve ex-ante assessment; (5) supervision and evaluation, which should include ex-post assessment; (6) responsibilities of each institution; (7) legal remedies; etc. The lawmaking is rather technical, which requires more expertise. This recommendation only depicts a framework containing essential elements that are necessary to form a legal control on tax expenditures.

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110. Ibid.

111. W. Xiong, *Normative Research on the Cleaning up of Tax Incentives from the Perspective of the Rule of Law*, in China Legal Science, Vol. 6, 2014, 166-167 (in Chinese).

## 5.2. Institutional elements

With respect to the responsibilities of institutions, there should be allocation of powers between different organs for the implementation of the tax expenditure system.<sup>112</sup> The drafting body of tax expenditures should be the government. As a part of the budget control, the draft of tax expenditures should be in line with the overall budgeting process. The government is responsible for the initiative of the budget. With respect to tax incentives, the MoF and the SAT can take the main role to draft tax expenditures, since most previous tax incentives are issued by these two institutions. In addition, local governments and local bureaus of tax administration could assist the drafting of tax expenditures by reporting local tax expenditure requirement to the central government.

The authorization power of tax expenditures should be with the NPC and its standing committee. The ex-ante assessment should embrace testing on the specificity of tax incentives, which could refer to EU State aid law's testing steps.<sup>113</sup> Besides, the assessment should also contain procedures that are subject to testing based on criteria of proportionality, effectiveness, efficiency, and transparency, etc. Specific assessment standards could be flexible according to the objectives of the tax expenditure system, but the assessment process itself should include these basic elements. If a tax incentive could satisfy the basic ex-ante assessment, the NPC and its standing committee could approve the granting of such an incentive. On the other hand, as to the authorization of compatible tax incentives, the NPC and its standing committee should rely on this ex-ante assessment procedure or the balancing test to make decisions on the compatibility of certain tax incentives.

As to the enforcement and administration, the power should be at the hands of tax administrations at different levels. Tax administrations, including state tax bureaus and local tax bureaus, are entities that are in charge of the collection of tax revenues.<sup>114</sup> They should be responsible to grant and manage those expenditures.

The supervising power can be divided into two aspects. The first aspect is external supervision from the legislative authority, the NPC and its standing committee. Independent from the government, the NPC and its standing Committee has the authority to conduct both ex-ante and ex-post assessment of tax incentives. In addition, the NAO could play a more important role in auditing tax expenditures independently. It is recommended to increase the power of the NAO that enables it to audit tax expenditures and directly report to the NPC and its standing committee. Accordingly, it does not have to be subject to the interference of governments. The second aspect is the internal supervision by the tax administrations themselves, the higher tax authorities, the MoF and the SAT at a national level, could supervise local tax authorities. The main purpose of this internal supervision is to prevent local protectionism by abusing tax expenditures at local levels. As to the content of the supervision, an ex-post assessment is necessary. The design of the legal control system is based on the objective of creating a level playing field in China's market, so it is necessary to evaluate tax expenditures after implementation, whether or not the incentive *de facto* harms fair competition in the market. Normally, tax incentives serve for policy goals, so it is logical to examine their effectiveness. Consequently, the NAO and the government should both report the implementation to the NPC and its standing committee. Accordingly, the NPC and its standing committee could publish reports on tax expenditures regularly.

## 5.3. Judicial elements

As to remedies, the tax expenditure system, as means of legal control, should also allow individuals and companies to use legal remedies against tax incentives. When the governments illegally issue or implement tax incentives, individuals or companies are entitled to go to the court to make their

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112. X.Wang, *On Legal System of Tax Incentives: Perspective for the Normative and Legitimacy Requirements of Law*, Beijing, 2012, 118-120.

113. *Supra* note 69.

114. W. Cui, *Fiscal Federalism in Chinese Taxation*, in *World Tax Journal*, Vol. 3, 2011, 461-462.

claims.<sup>115</sup> Therefore, it requires the court as an independent and separate institution to make judgment on the legitimacy of tax incentives. In the law, it should clarify the function of the court and remedies for government's illegal actions towards tax expenditures. The Administrative Litigation Law of China actually provides access of remedies to government's administrative actions. However, it has limits, as discussed previously. Therefore, with further stipulation on remedies in the law, it provides direct guarantee for taxpayer's rights and legal control on government's actions.

#### 5.4. Practical concern: judicial independence for administrative litigations

As a legal control system, the fundamental guarantee is judicial remedies for government's accountability. It requires courts that could independently decide cases on government's administrative actions. The Administrative Litigation Law *de jure* stipulates that courts could review regulatory documents associated with a plaintiff's complain on concrete administrative actions. However, it does not necessarily mean that courts *de facto* could make an independent judgment.<sup>116</sup> Judicial independence is a very broad and vague concept that has no single model.<sup>117</sup> Nevertheless, it entails general ideas that judges have the ability to decide cases independently according to law and without interference from other parties or entities.<sup>118</sup>

As observed by Peerenboom (2009), judicial independence could be reviewed from internal and external perspectives. Internal independence means judges could decide cases without interferences from internal administrative hierarchy or senior judges. External independence refers to judges being able to decide cases without interference from external sources such as the government, the military, or the society.<sup>119</sup> In China, as analyzed by some authors, the independence of courts has been strengthened overall with respect to litigations against administrative actions since the promulgation of the Administrative Litigation Law in 1989.<sup>120</sup> From the internal perspective, appointments and promotions of judges are more merit-based, which gives more authority to the court. Judges could make decisions by resisting other forms of nonsystematic interference.<sup>121</sup> From the external perspective, studies show that except for political sensitive cases,<sup>122</sup> judges are generally able to make their own decisions.

Nevertheless, there are still concerns for the independence of judges towards administrative litigations on tax expenditures. The major influence is likely from the government, who is the defendant in such cases. This is especially a concern on the level of local courts, which are inclined to form local protectionism for local governments. The reason is that local courts are funded by local governments, and the human, financial, and material resources are controlled by local authorities.<sup>123</sup> When accepting cases against local governments, local courts are less likely to gain independence from local governments. Additionally, local people's congresses could influence the independence of local courts as well. Because the local people's congress have the authority to appoint and remove from office chief justices.<sup>124</sup> The standing committees of local people's congress could supervise

115. Xu, *supra* note 108.

116. Peerenboom, *supra* note 71, 131-132.

117. *Ibid* 71-72.

118. *Ibid*.

119. *Ibid* 71.

120. *Ibid* 87-88, 129-132.

121. *Ibid* 100-101.

122. Political sensitive cases are normally complicated and courts may get influences from various sources. Thus, courts often limit access to such cases, and steer disputes to other channels of settlement. See R. P. Peerenboom, *China Modernizes : Threat to the West or Model for the Rest?*, Oxford, 2007, 100-118.

123. K. Yu, *Democracy and the Rule of Law in China*, Beijing, 2010, 257-258.

124. Article 101, Constitution of the People's Republic of China (2004 Amendment).

courts within their administrative jurisdiction.<sup>125</sup> Therefore, without reforming the relationship between local courts and local governments, and the relationship between local courts and local people's congresses, there would be concerns for the independent function of judges, particularly in undeveloped regions.<sup>126</sup>

In summary, if promoting the sustainable development of market economy in China is the primary objective, it is necessary to introduce such a legal control system on tax incentives in order to maintain fair competition in the market. As a result, independent courts are essential legal guarantees for this system. The system has already been established, so more reforms for establishing independent courts are expected.<sup>127</sup>

## 6. Conclusion

If further integrating into the world economy is the trend, China has to prepare for a more open market with an internal legal contrive over its tax incentives. Simultaneously, as an emerging power, China should also find its own way of establishing a legal system for tax incentives, thus gaining a better position in the world economy. Therefore, it is necessary to introduce an internal legal control over the granting of tax incentives, namely the tax expenditure system. The main recommendation for Chinese tax incentives at a macro level is the introduction of the tax expenditure system, which attributes the granting of tax incentives into the budget process or promulgates separate regulations on tax incentives. The EU State aid law could be a reference given that it is effective to achieve the objective of maintaining fair competition in the internal market. To be specific, it is recommended for China to embed tax expenditures into the Budget Law or to promulgate separate legal regulations on tax incentives. The law could include ex-ante and ex-post assessment, cost-benefit analysis, evaluation on effectiveness and efficiency, proportionality test, and transparency report, etc. Moreover, to implement the law, there could be allocation of powers among different organs to conduct and supervise the enforcement of the legal control. Accordingly, citizens and companies could have access to legal remedies against tax incentives.

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125. Article 104, Constitution of the People's Republic of China (2004 Amendment).

126. Yu, *supra* note 123, 261-265.

127. *Ibid* 269-273; Peerenboom, *supra* note 71, 92-94.