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**Tax Administration Reform in China:
Achievements, Challenges, and Reform Priorities**

by John Brondolo and Zhiyong Zhang

I N T E R N A T I O N A L M O N E T A R Y F U N D

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Fiscal Affairs Department

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Authorized for distribution by Juan Toro

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Abstract

Tax administration improvements have contributed significantly to a doubling of China's tax-to-GDP ratio and the substantial reduction in taxpayers' compliance costs since the mid-1990s. This paper describes the key features of China's tax administration and their evolution over the last 20 years. It also identifies emerging challenges to the tax system and areas where further tax administration improvements are needed to sustain tax revenue and reduce taxpayers' compliance costs in the future.

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I. INTRODUCTION

China's tax administration has improved substantially over the last two decades in the face of major changes in the economy and the tax system. This has contributed importantly to a doubling of the tax-to-GDP ratio and the significant reduction in taxpayers' compliance costs since the mid-1990s. As the State Administration of Taxation formulates its modernization plan for 2016–20, this paper examines the results and impacts of previous tax administration reforms, and identifies areas where further reforms are needed to sustain revenue collection and reduce compliance costs over the next five years.

During the early 1990s, China's tax administration was ill-suited to and performed poorly at collecting taxes from an increasingly market-oriented economy. The tax system included some 35 different taxes many of which accounted for little revenue. A single tax agency collected both national and local taxes, with complex intra-governmental revenue sharing arrangements. The tax authorities' powers were set out in various statutes and circulars whose legal standing were not clearly established. Most tax administration functions were performed manually and required laborious checking procedures. Tax evasion and taxpayers' compliance costs were very high, and the tax yield had fallen to below 10 percent of GDP.

Since the early 1990s, China has made great progress in creating a modern tax administration. The system now comprises 18 taxes with clear apportionment of revenue between central and local governments. It set up separate national and local tax authorities to collect central and local government taxes, simplified the revenue-sharing arrangements and made them more transparent. It has codified the tax authorities' powers and taxpayers' rights in a tax procedures law and many tax administration procedures have been automated based on a standardized computer system. These changes have reduced tax evasion and compliance costs, and helped raise the tax yield to nearly 20 percent of GDP.

Today, China's tax administration finds itself at a new crossroads. The economy is again undergoing significant restructuring, major changes to the tax laws are currently under way, and the relatively easy gains from previous tax administration reforms have been largely reaped. At this juncture, it is useful to ask whether further improvements in tax administration are needed and, if so, what should be the priority areas for reform.

The paper is organized into six sections. Following this Introduction, Section II summarizes the background to and impacts of China's tax administration reforms over the last 20 years. Section III describes the main features of China's tax administration today and how they have evolved since the early 1990s. The paper then assesses the challenges now facing the tax system in Section IV and Section V suggests a number of reforms for the State Administration of Taxation (SAT) to consider in formulating its new five-year modernization strategy. Lessons from the SAT's reform experience are summarized in Section VI.

II. BACKGROUND

In the late 1970s, China embarked on a bold journey toward a market-oriented economy by opening up trade and investment with the rest of the world and restructuring the domestic economy. Mandatory planning was relaxed, market forces and the non-state sector were allowed to play a greater role in the economy, and the institutions for conducting macroeconomic policy were transformed. These reforms have contributed significantly to the massive structural transformation and rapid economic growth since the early 1980s (IMF 1993).

As the economic reforms unfolded, it became increasingly clear to policymakers that the existing tax system was incompatible with the requirements of an economy that relied increasingly on the market for the allocation of resources and would require a substantial overhaul. Similarly, it was also recognized that tax administration required fundamental changes if it was to effectively secure tax revenue from a new tax system in an increasingly market-oriented economy.

The need to modernize tax administration was made even more urgent by worrisome declines in both the tax-to-GDP ratio and the central government's share of total revenue during the early-to-mid 1990s. As can be seen in Table 1, the tax yield dropped by about 5 ½ percent of GDP during the period 1990–96 while the central government revenue share declined by nearly 12 percentage points from 1990–93.

The decline in the tax-to-GDP ratio can be traced to three main factors: (1) structural economic factors involving shifts in the different components of GDP; (2) discretionary changes in tax policy; and, (3) changes in tax administration effectiveness. Although it is difficult to disentangle their relative importance, a 1997 IMF technical assistance mission found that these factors contributed to the decline in China's tax yield during the early-mid 1990s.² The impact of weak tax administration, which is the main concern of this paper, was manifested through in a growing incidence of tax evasion and the SAT's difficulties in controlling it. Some studies estimated that up to 30 percent of state-owned enterprises, 60

² Structural factors mainly involved: (1) the decreasing share of profits from (relatively highly taxed) SOEs to (more lightly taxed) non-SOEs; (2) a relative shift in value-added from goods to services, with the former having higher effective tax rates than the latter; and (3) an increase in the trade surplus which reduced the tax base as exports are excluded (with some exceptions) from the value-added tax (VAT) base. Discretionary changes in tax policy involved: (1) transitional refunds that were provided to domestic enterprises (to compensate them for elements of the former turnover taxes contained inventories) and foreign-funded enterprises (in accordance with guarantees that their indirect tax burdens would not increase) when the new VAT was introduced in 1994, and (2) various tax incentives that were given to enterprises.

percent of joint ventures, 80 percent of private enterprises, and 100 percent of individual street vendors failed to comply with their tax obligations in the mid-1990s (Yu, 1997).³

As for central government finances, the decline in its share of revenue during the early 1990s has been attributed mainly to the former intra-governmental revenue sharing arrangements.⁴ However, weak tax administration—in the form of loose central control over local tax offices—was also seen to have contributed to the decline. Prior to 1994, local governments played a major role in financing and directing the operations of the tax offices. As such, local authorities had strong incentive to concentrate revenue collection on local tax bases and shift the tax bases from those that had to be shared with the central government to those over which they had greater control (IMF, 1994).

Table 1. State Budget Tax Revenue to GDP and Share of Total Revenue 1990–96

(Percent)

	1990	1991	1992	1993	1994	1995	1996
Tax Revenue-to-GDP Ratio	15.1	13.7	12.2	12.0	10.6	9.9	9.7
Central Government Revenue-to-Total Revenue Ratio	33.8	29.8	28.1	22.0	55.7	52.2	49.4

Source: China Statistical Yearbook, 2014; IMF staff calculations. Note: Tax Revenue comprises both central and local government taxes. Central government revenue and total revenue include both tax and non-tax revenue.

It was in this highly challenging environment of rising noncompliance and declining tax yields that the Chinese authorities launched a major tax administration modernization program in the mid-1990s as an integral part of a broader fiscal and tax reform program. The overriding objective for the tax administration reforms was to achieve sustainable increases in tax revenue by improving taxpayers' compliance with the tax laws. This objective was to be achieved by replacing the previous form of tax administration with new approaches that were better suited to the rapidly changing economy and tax system.

The modernization program began in 1994 with the splitting of the tax agency into two separate organizations: a national tax service (to collect central and most shared taxes) and local tax services (to collect local government taxes and some shared taxes). Once the

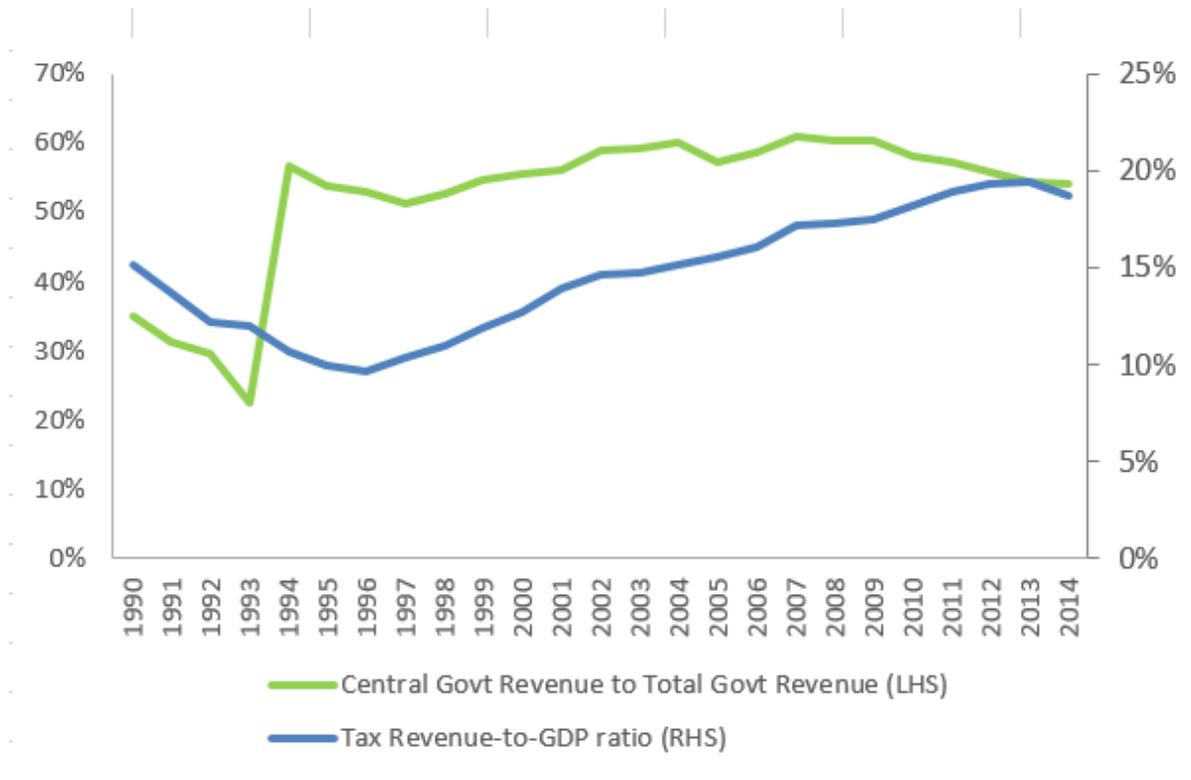
³ Rampant tax evasion and weak tax administration were also widely reported in the Chinese media in the late 1980s and early 1990s, including Xinhua General Overseas News Services, 1988 "Tax Evasion is Huge, at Times Violent Problem in China."

⁴ Prior to the 1994 revenue sharing reforms, local governments were permitted to keep revenues above a stipulated amount. Under this arrangement, the amounts that local governments were to remit to the central government could be reduced by, for example, investing in local industries, offering tax exemptions, or by placing resources in extra-budgetary funds that did not have to be shared with the center (Ahmad, 2011).

collection responsibilities for the various taxes were established, the focus of the reforms then shifted to designing and implementing new organizational arrangements, tax administration processes, and information systems.⁵ These reforms have continued, at varying intensity, through today.

Since the introduction of the tax administration reforms, both the tax-to-GDP ratio and the central government share of total revenue have increased sharply. As shown in Figure 1, the tax-to-GDP ratio, after steadily declining in the early 1990s, increased by nearly 10 percentage points of GDP through the early 2010s, reaching 19.4 percent of GDP in 2013. Similarly, the central government share of revenue, which had fallen to 22 percent of total revenue in 1993 (Table 1), more than doubled by 1995 and has averaged about 50 percent of total revenue since then (Figure 1).

Figure 1. State Budget Tax Revenue to GDP and Share of Total Revenue 1990–2014



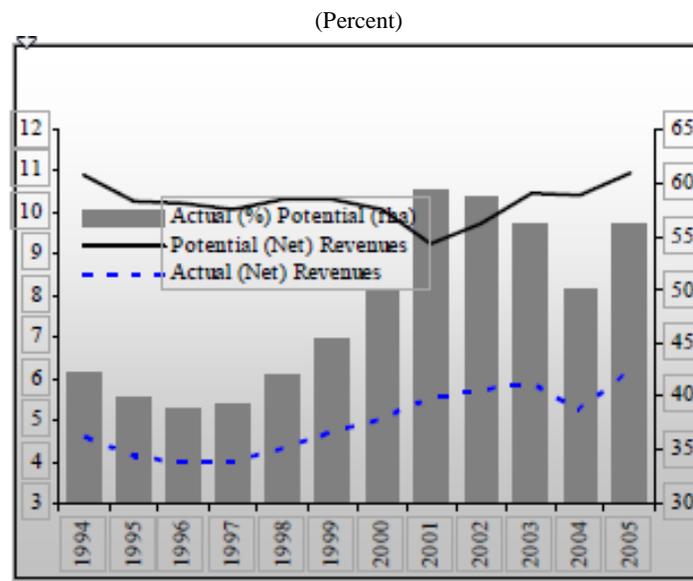
Source: China Statistical Yearbook (various years); IMF staff calculations. Note: tax revenue comprises both central and local government taxes. Central government revenue and total revenue include both tax and non-tax revenue.

⁵ These reforms were initially introduced in four pilot cities, then expanded to an additional 14 cities, and ultimately implemented on a national basis by the end of 2003.

The steady increase in the tax-to-GDP ratio since the mid-late 1990s resulted from changes in the same three factors that accounted for the decline in the tax yield during the early 1990s: structural economic shifts, tax policy changes, and tax administration factors. While structural shifts in the economy⁶ and tax policy changes⁷ had important positive impacts, tax administration improvements also played a major role.⁸ A 2007 IMF technical assistance mission estimated that the value-added tax (VAT) compliance ratio had increased from about 39 percent of potential VAT revenue in 1997 to 56 percent in 2005 (Figure 2).⁹

The tax yield, after steadily increasing for nearly two decades, posted its first decline in 2014, dropping to 18.7 percent of GDP as the economy slowed. Taxpayer compliance can be expected to come under pressure if the economy continues to grow slower than in past years. Maintaining compliance in the face of slower growth is one of the key challenges facing the SAT in the period ahead as described in section IV.A.

Figure 2. Value-Added Tax Compliance Ratio



Note: left hand scale: VAT actual and potential revenue as percent of GDP; right hand scale: VAT efficiency ratio in percent.

⁶ Structural factors center on the increasing share of the relatively highly taxed industry and service sectors (including construction and real estate) and the declining share of the lightly taxed agricultural sector (OECD 2013).

⁷ Important tax policy changes included the 1994 expansion of the VAT base and the introduction of a new consumption (excise) tax (Lin 2009).

⁸ These include OECD (2013), Lin (2009), and World Bank (2003).

⁹ The VAT compliance ratio is defined here as the ratio of actual VAT collections to an estimate of potential collections if taxpayers had fully complied with the provisions of the VAT law.

Source: International Monetary Fund staff calculations.

In addition to boosting tax revenue, there is also evidence that tax administration reform has helped to improve taxpayers' perceptions about the tax system, particularly in recent years. This can be seen from the results of the taxpayer satisfaction surveys that the National Bureau of Statistics of China has conducted beginning in 2008. As shown Table 2, there has been a steady increase in taxpayers' satisfaction with the tax system since 2008, including with both the National Tax Service (NTS) and the Local Tax Service (LTS). Further evidence of these improvements can be seen in the steady decrease in the average amount of time that taxpayers spend on tax matters, which has been reduced by over two-thirds since 2004 (refer to Section III.D).

To the extent that the increase in taxpayer satisfaction and the decrease in time spent on complying with the tax laws represent a reduction in taxpayers' compliance costs, it can be inferred that the tax administration reforms have had a positive impact on the business climate. Achieving further compliance cost reductions, with a view to promoting economic growth, is another major challenge for the SAT in the period.

Table 2. Taxpayer Satisfaction Ratings

(Percent)

	2008		2010		2012		2014		2015	
	NTS	LTS								
Score	76.2	77.7	79.1	79.2	79.8	79.7	82.6	81.5	82.8	81.2

Source: State Administration of Taxation (surveys conducted by National Bureau of Statistics of China).

III. CHINA'S TAX ADMINISTRATION TODAY

As noted, tax administration changed dramatically over the last two decades. To set the stage for analyzing the current challenges facing the State Administration of Taxation (in Section IV) and for identifying future reform priorities (in Section V), this section describes key features of China's tax administration today and how they have evolved since the mid-1990s.

A. Policy and Legal Framework

The policy and legal framework for China's tax administration comprises three main components: (1) the tax assignment system; (2) the substantive tax laws and associated regulations; and, (3) the Tax Collection Law. Each has undergone major reforms over the last two decades and, collectively, provide the legal foundation for administering the tax system today.

Tax assignment system

Prior to 1994, China's tax assignment system was based on a combination of tax separation and revenue-sharing approaches. Under it, certain taxes were designated as central government revenue and a portion of revenue from other taxes as local government revenue with the remainder allocated to a pool of shared revenue. Most of the latter was apportioned according to complex formulas stipulated in fiscal contracts between the central and local authorities (IMF, 1994). It was believed that the combination of fiscal contracting arrangements and the influence of local governments on tax administration contributed significantly to the sharp decline in central government share of total revenue in the early 1990s as was shown in Table 1.

To increase both total revenue and the central government share, the government introduced a new intra-governmental revenue system in 1994. It abolished the complex contracting schemes and replaced them with a more transparent (and easier to administer) tax assignment arrangement for central and local governments. Among the major taxes, the central government was assigned all revenue from the consumption (excise) taxes, customs duties, and international trade-related tax on VAT and consumption taxes. Shared taxes include domestic VAT (75 percent central, 25 percent local), enterprise income tax (60 percent central, 40 percent local), and personal income tax (60 percent central, 40 percent local). All remaining taxes are allocated to local governments including, most importantly, the business turnover tax on services, social security contributions, and stamp duties on real estate transactions.

Substantive tax laws

Tax laws in the early 1990s suffered from a lack of equity (different treatment applicable to different types of taxpayers and transactions), inefficiency (rate structure encouraging some types of investment over others), and administrative complexity (many taxes, multiplicity of rates and bases). To address these problems, major taxes were comprehensively restructured on January 1, 1994 with further reforms introduced in subsequent years. Importantly, the tax policy reforms included a number of provisions that have facilitated tax administration.

The tax policy reforms in 1994 (and in subsequent years) greatly simplified the tax system by reducing the number of taxes and converting many fees to taxes. China's 35 different taxes in the early 1990s were reduced to 18 today (including both central and local government taxes). This simplification has both lowered administrative costs for the SAT and reduced compliance costs for taxpayers.

For direct taxes, the previous domestic income taxes on enterprises with different forms of ownership were merged in 1994 into a uniform income tax for all domestic enterprises. They were later unified with the separate income tax for foreign-funded enterprises through the enactment of the 2008 Enterprise Income Tax Law. This law includes important administrative provisions: most importantly, a set of specific anti-avoidance provisions¹⁰ and a general anti-avoidance rule.¹¹ Taken together, the provisions are powerful tools for addressing international tax risks, though improvements are needed in some provisions to deal with emerging challenges from China's international dealings.

Personal income taxes also underwent a major reform in 1994 with the enactment of a new law that applies to both Chinese and foreign nationals, thus replacing the previous separate personal income tax laws on Chinese taxpayers and foreigners. The current personal income tax law has preserved a number of important administrative provisions from the old law. These include imposing tax on individuals (instead of families), applying withholding regimes to many income categories, permitting few personal deductions, and restricting the requirements for filing a tax return.¹² These provisions greatly simplified tax administration

¹⁰ Chapter VI of the Enterprise Income Tax law establishes the arm's length principle for valuing related party transactions, the requirement for taxpayers to report related party transactions to the tax authorities, and the tax authorities' power to adjust a taxpayer's taxable income if the taxpayer failed to comply with the arm's length principle.

¹¹ In December 2014, the SAT issued the *Administrative Measures for the General Anti-Avoidance Rules (Trial)*. Under these rules, Chinese tax authorities are authorized to counter transactions deemed to have no commercial purpose other than avoiding tax by re-characterizing the transaction and denying the tax benefits. To avoid its abuse, the tax authorities may not initiate an anti-avoidance investigation until it is approved by the SAT headquarters; headquarters must also approve the final decision of an investigation.

¹² Only individuals with annual income greater than ¥120,000, more than one job, income that is not subject to withholding, or overseas income need to file a tax return.

and, by doing so, have reduced administrative and compliance costs. At the same time, the system's highly schedular nature—where 11 different categories of income are subject to different rate schedules—continues to complicate administration and creates opportunities for taxpayers to evade tax by illicitly reclassifying income to lower taxed categories.

Indirect taxes also experienced major simplification in 1994 and thereafter. In 1994, a broad-based VAT—covering production, wholesale and retail trade, and imports—with only two rates and few exemptions replaced the previous VAT (with 12 rates) and product tax (with over 150 rates). In subsequent years, the VAT underwent further reforms including allowing the crediting of VAT paid on purchases of capital goods (2008) and gradually extending the VAT to selected services (beginning in 2012 and continuing through today), which had been previously taxed under a non-creditable turnover tax (the business tax). Excises and business taxes were also restructured and simplified in 1994 while about a dozen minor taxes were eliminated.

China's VAT has been designed with its administrative requirements taken into account. In line with good international practice, the VAT provides relatively high registration thresholds to restrict the number of VAT registrants to a level consistent with the tax authorities' administrative capacity.¹³ More unusual from an international perspective, the issuance of VAT invoices is subject to very tight control and checks by the SAT, and many exporters are entitled to receive a refund on their export sales at less than the statutory 17 percent rate. While both provisions reflect the government's understandably high concern with VAT fraud, it is also important to recognize that their reportedly high compliance costs are negatively affecting the business environment.

Tax Collection Law

A third element in the legal framework for tax administration is the Law on the Administration of Tax Collection (commonly referred to as the Tax Collection Law) which was enacted in 1992. This law is critical to the operation of the tax system in that it provides the SAT with the legal authorities for administering the substantive tax laws (on VAT, enterprise income tax, and so on).

Prior to the Tax Collection Law's enactment, tax administration was governed by various tax statutes, administrative orders, and regulations whose scope and legal standing were unclear. The weak and often undefined legal framework hampered tax administration in a number of ways as market reforms gained steam in the 1980s and 1990s:

¹³ The threshold is set at ¥800,000 (about \$125,000) for goods and ¥500,000 (about \$79,000) for services.

- First, the inadequate enforcement powers left the tax system vulnerable to tax evasion, resulting in large revenue losses to the government.
- Second, the lack of clarity in the tax laws allowed local governments and tax officials to apply the laws arbitrarily—including by illicitly providing exemptions and other tax preferences to local enterprises—often at the expense of central government revenue (Phillips 1996).
- Third, tax officers were frequently subject to physical violence as they carried out their duties in an environment where many new taxpayers lacked knowledge of the tax laws and some aggressively resisted paying taxes.
- Finally, the absence of an administrative review process left taxpayers with little recourse for resolving disputes with tax officers.

To improve this situation, the Tax Collection Law was enacted to establish in a single law the common administrative provisions that apply to all of China's substantive tax laws. Among other things, this law sets out broad provisions for each tax administration function (such as registration, record keeping, filing and payment of taxes, auditing, penalties, and appeals), vests the tax authorities with various enforcement powers, defines the rights and obligations of taxpayers, and provides dispute resolution mechanisms. The Tax Collection Law has helped significantly to clarify the legal foundation for tax administration, but requires updating to address emerging challenges to the tax system as discussed in Section V.

B. Taxpayer Population

China's taxpayer population has undergone profound changes over the last two decades in its numbers, sectoral composition, and ownership forms. These changes, which have reflected the dramatic structural transformations in the economy, rendered the previous form of tax administration outdated and necessitated the adoption of radically different approaches to collecting taxes.

Table 3 shows the rapid increase in the number of taxpayers with the total number of registered taxpayers with business income nearly tripling since 2000. This resulted in a substantial increase in tax returns requiring processing, taxpayers requiring assistance, and audits. To meet the increased workload, the SAT introduced a series of reforms to raise the productivity of its workforce. These included the adoption of self-assessment, greater use of information technology, and new organizational arrangements as described below.

Table 3. Number of Registered Taxpayers (National Tax System)

	Taxpayers			
	Total	Enterprises	Self-Employed	Other
2000	11,840,000
2005	14,730,000	4,990,000	9,710,000	30,000
2009	19,090,000	7,200,000	11,890,000
2010	19,070,000	7,440,000	11,610,000	20,000
2011	20,670,000	8,310,000	12,330,000	30,000
2012	23,370,000	9,480,000	13,860,000	30,000
2013	26,790,000	11,270,000	15,470,000	50,000
2014	30,760,000	13,740,000	16,950,000	70,000

Source: State Administration of Taxation.

... = not available

Table 4 shows the changing form of ownership among registered industrial businesses. Private domestic enterprises increased tenfold during 2000-2010, enterprises from outside the mainland nearly tripled, and the number of state-owned enterprises declined substantially (including collectives and cooperatives). The growing role of the private sector in the economy also presented (and continues to present) challenges for the SAT. When the economy was dominated by state-owned enterprises (SOEs), the tax authorities had the relatively simple task of verifying that a small number of large SOEs had transferred the correct amount of revenue from one government account to another. With the growth in the private sector and the reforms to the tax laws, the SAT has had to develop new strategies and develop new skills for its tax officers to deal with the more difficult task of ensuring the compliance of a large number of private enterprises that respond to market incentives rather than incentives created by an economic plan.

Table 4. Number of Registered Industrial Enterprises

(Annual revenue over ¥5 million)

	2000	2010
Total	162,855	452,872
Domestic Funded	134,440	378,872
State-owned enterprises	42,426	8,726
Collectively-owned enterprises	37,841	9,166
Cooperative enterprises	10,852	4,481
Private enterprises	22,128	273,259
Other	74,682	80,344
Enterprises with Funds from Hong Kong SAR, Macao, Taiwan, Province of China	16,490	34,069
Foreign Funded	11,955	39,976

Source: China Statistical Yearbook, 2001 and 2011. Note: data is not presented after 2010 because the definition of registered enterprises was changed in 2011 to include businesses with annual revenue over ¥20 million (instead of the ¥5 million in the past) making comparisons to earlier years misleading.

Along with the increasing size and changing ownership forms, shifts in the sectoral composition of the economy has also presented challenges for tax administration. Here, one of the most profound structural changes has involved the decline in the primary sector's share in gross domestic product (GDP) and the growing importance of secondary (industry) and the tertiary (services) sectors (Table 5). This shift has been a major contributing factor to the steady increase in China's tax-to-GDP ratio since the mid-1990s, given the higher effective tax rates paid by the services and industry (including construction) sectors compared to the agricultural sector (OECD, 2013). At the same time, the rise of the tertiary sector to become the largest sector in the economy presents the SAT with the challenge of administering the growing numbers of service-sector companies, a major difficulty for tax administrations everywhere.

Table 5. Shares of Gross Domestic Product by Economic Sector

(Percent)

	Primary Sector	Secondary Sector	Tertiary Sector	Total
1990	27.1	41.3	31.5	100
1995	20.0	47.2	32.9	100
2000	15.1	45.9	39.0	100
2005	12.5	47.4	40.5	100
2010	10.1	46.7	43.2	100
2013	10.0	43.9	46.1	100

Source: China Statistical Yearbook, various years.

Further challenges to tax administration have arisen from China's integration into the global economy. The growing importance of the country's international dealings can be seen by the sharp increases in its exports and imports of goods and services relative to GDP that have taken place since the early 1990s (Table 6). Perhaps even more profoundly, the inward and outward stocks of foreign direct investment (FDI) have doubled and increased six-fold, respectively, over the same period.

Table 6. Trade and Foreign Direct Investment (FDI) 1990–2013

(In percent of GDP)

	Exports/GDP	Imports/GDP	FDI Inbound Stock/GDP	FDI Outbound Stock/GDP
1990	15.0	13.7	5.1	1.1
1995	20.5	18.1	13.4	2.3
2000	20.8	18.7	16.2	2.3
2005	33.7	29.2	11.9	2.3
2010	26.2	20.6	9.9	5.3
2013	24.1	20.6	10.1	6.6

Sources: UNCTAD (2015) and World Bank (2015a)

Note: FDI= foreign direct investment

While integration into the world economy has brought many benefits to the Chinese economy, it has also raised major risks to the tax system. In particular, the sharp rise of trade and foreign direct investment has left China's tax bases more vulnerable to cross-border tax avoidance and tax evasion through intra-firm transactions at non-arm's length prices, exploitation of mismatches in the tax legislation among jurisdictions, unreported income from overseas investments, and a host of other schemes.

To deal with cross-border tax compliance risks, the SAT has had to quickly put in place some of the mitigation measures that other tax agencies have developed over many decades. These have included changes in legislation (such as enactment of transfer pricing rules and anti-avoidance provisions), organization (including the creation of international tax divisions), and administrative programs (such as special audit programs focusing on international tax issues).

C. Organization

China's large size, huge population, and diverse economy present almost unique organizational and management challenges for tax administration. In response to these challenges, it has introduced major changes to the division of responsibilities for collecting national and local taxes, and to the SAT's organizational structure.

Tax collection responsibilities

Prior to the 1994 fiscal and tax reforms, the central government did not have strong control of the tax administration. Instead, the provincial tax bureaus and their subordinate tax offices were subject to a dual-reporting system. On the one hand, the tax bureau directors were accountable to the SAT for tax administration and tax policy implementation; on the other hand, these officials were appointed by, and dependent on local governments for budgetary support, staffing, and promotion policies (World Bank, 1990).

The absence of a strong national tax administration was a major factor in the decline in the central government share of revenue in the early 1990s. As mentioned in Section II, the influence of local governments on tax administration often gave priority to the collection of local taxes over central government taxes. The unclear legal framework for tax administration, which local governments could exploit to provide exemptions and other tax preferences to designated enterprises, exacerbated this tendency.

To deal with this problem, the government in 1994 created two separate tax agencies, in one of China's most sweeping organizational reforms in tax administration:

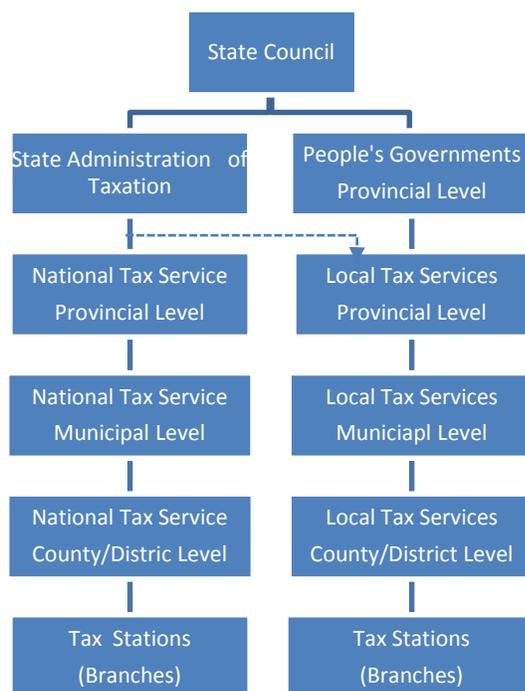
- A National Tax Service, which collects central government taxes and most taxes shared by central and local governments.

- Local Tax Services, which collects local government taxes and some shared taxes, including the personal income tax, in each jurisdiction.

Figure 3 shows the current division of responsibilities among the SAT, local governments, the National Tax Service and the Local Tax Service. As can be seen, China's tax administration comprises a five-tier organization consisting of (1) SAT headquarters, (2) provincial tax bureaus, (3) municipal tax bureaus (broken down into districts and other subordinate units), (4) county tax bureaus (outside of the municipalities) and district tax sub-bureaus (within the municipalities), and, (5) tax stations (also referred to as tax offices or branch offices). This same hierarchy applies to both the National Tax Service and the Local Tax Services.

According to this set up, SAT headquarters has direct (solid line) authority not only for overseeing the tax administration operations of the National Tax Service tax bureaus but also for appointing, promoting, and providing budgetary resources to the bureaus. It has also shared (dotted line) authority with local governments for overseeing the Local Tax Services tax bureaus. Under this arrangement, the SAT is responsible for monitoring and supporting the Local Tax Services' operations while local governments are responsible for appointing and promoting officials as well as resourcing the offices.

The separation of collection responsibilities, as described above, was intended to tighten central control over national taxes. This was to be achieved by vesting the National Tax Service with full and exclusive authority over the collection of central government (and most shared) taxes. In this way, the scope for local governments to influence tax collection would be limited to local government taxes. Together with the new tax assignment system, the creation of separate national and local tax services has helped bring about the intended increase in the central government share of revenue that has been achieved since 1994 (see Figure 1).

Figure 3. Organizational Chart of China's Tax Administration**Size and structure**

A defining characteristic of China's tax administration is its large size and geographic footprint: the SAT is the world's largest tax agency by the number of staff and offices.¹⁴ Both its size and structure present major challenges to effective tax system management.

Size. The national and local tax services together comprise some 750,000 staff in more than 30,000 locations (Table 7). A tax administration of this size faces enormous difficulties in designing and consistently applying its operational programs, human resource management policies, computer systems, and other activities.

Table 7. Number of Organizational Units and Staff by Level of Administration

	Number of Organizational Units		Number of Staff	
	National	Local	National	Local
SAT headquarters	1		850	
Provincial-level	36	35	13,286	13,416
Municipal-level	353	332	63,580	60,777
Counties and districts	3,020	2,584	212,049	141,651
Tax stations	10,151	16,729	101,171	145,812

Source: State Administration of Taxation (as of December 31, 2014).

¹⁴ By comparison, in 2013 the number of full-time equivalent positions in other large countries was as follows: Brazil 25,840 staff; India 40,756 staff; Russia 146,080 staff; United States 94,709 staff (OECD, 2015a).

Consistent administration is made even more difficult by the very small size of SAT headquarters relative to the rest of the organization. Whereas many effective tax agencies commonly assign 3–10 percent of staff to head office (IMF, 2015b), SAT headquarters has been allocated only about one-tenth of 1 percent of the organization’s staff (Table 7).¹⁵

While economies of scale generally allow the headquarters of large tax agencies to function effectively with a smaller proportion of staff than smaller tax agencies, a headquarters still needs a critical mass of staff to carry out its core functions regardless of the overall size of the organization. Lacking this, the SAT has had to adopt practical (but often less efficient and less uniform) approaches to managing the national tax system. For example, the SAT has frequently allowed the provincial tax bureaus to develop their own operational programs and then worked to achieve a consensus among provinces to adopt one of these programs as the national standard. This has resulted not only in duplication of design and investment but also in differences in administration across jurisdictions.

Structure. Each of the five tiers in the SAT organization, as depicted in Figure 3, have distinct functions. The SAT’s headquarters office is mainly responsible for designing and overseeing the implementation of national tax administration policies. It also has shared responsibility with the Ministry of Finance for formulating tax policy and drafting new tax legislation. The provincial, municipal, and county/district levels are primarily responsible for planning, monitoring, and supporting their subordinate offices. Most operational activities for tax administration (such as registering taxpayers, providing assistance, collecting tax returns, auditing taxpayers) take place at the grassroots level under the direction of the counties and districts. These grassroots units comprise specialized tax service halls, tax offices, inspection bureaus, and call centers.¹⁶

In carrying out its functions, SAT headquarters has adopted a hybrid organizational structure (Appendix 1). The provincial, municipal, county and district offices are organized largely in the same way. Under the SAT’s hybrid organization, staff is assigned to units based partly on tax type (e.g., goods and services, income tax, property tax), partly on type of taxpayer (e.g., large business), and partly on type of administrative function (e.g., audit and taxpayer services). This form of organization has given the SAT the capacity to design administrative programs and monitor the tax system from different *lenses* (such as tax, taxpayer, and administrative function), which is an important advantage in a highly dynamic environment

¹⁵ The current size of SAT headquarters resulted from a public sector downsizing initiative in the 1990s when the headquarters of government ministries was reduced by up to 50 percent. Yet even before this downsizing, SAT headquarters was very small compared to the tax agencies’ headquarters in other large countries.

¹⁶ The tax service halls provide various services to all taxpayers in a particular district; the tax offices provide services to taxpayers located within a particular geographic location, a particular industry, or a particular form of ownership; the inspection bureaus are responsible for auditing taxpayers; and the call centers provide service and assistance to taxpayer over the telephone.

like China. On the negative side, hybrid structures can lead to lack of coherence and overlapping responsibilities as highlighted in Section IV.

At the grassroots level (below the county and district bureaus), the SAT's tax offices have undergone major changes in their organizational structure since 1994. Prior to that time, tax office staff were assigned a set of taxpayers for whom they were responsible for performing a range of tax administration functions, including: receiving and reviewing tax returns, responding to queries, auditing, and dealing with tax arrears. The inherent inefficiencies of this *tax manager* system, due to the lack of staff specialization, rendered it unsustainable in coping with the huge increase in the taxpayer population that resulted from the shift toward a market economy.

To achieve the administrative efficiencies needed to manage a growing taxpayer population, grassroots staff in many locations were reorganized into units based on tax administration function (such as processing tax returns, taxpayer services, and audit). This *function-based* organization allows tax officers to develop specialized skills in different administrative functions, which is crucial to achieving higher rates of productivity.

Today, most grassroots tax offices have adopted the function-based system, particularly in the more economically developed areas. Other tax offices, mainly in less economically developed locations, continue to use the tax manager approach because they have insufficient numbers of staff need to create specialized units or because it is felt that the low compliance levels in these locations requires a one-on-one relationship between tax officers and taxpayers. But even in these locations, improvements in the tax manager system have been made, including by rotating the assignment of taxpayers to tax officers.

One of the more recent and important organizational reforms has been the creation of the Large Business Department in 2008. The rationale for this reform was that by providing large businesses with a higher degree of scrutiny and a higher level of service in their tax affairs, the department would increase revenue collection and improve the investment climate.¹⁷ The department's creation has helped advance both objectives: tax collections from large businesses have increased by 70 percent over the department's first three years of operation¹⁸ and large businesses, in a taxpayer satisfaction survey, have expressed a high degree of

¹⁷ The Large Business Department comprises a headquarters department and large business units in all provinces and many municipalities. The headquarters' LBD is responsible for developing and overseeing national policies for large taxpayer administration as well as overseeing the administration of 45 large enterprise groups mostly in Beijing, which account for about 22 percent of the SAT's tax collection. The provincial and municipal Large Business Departments administer another 300–400 large enterprise groups that are estimated to account for an additional 20 percent of SAT revenue.

¹⁸ Taxes paid by the 45 large enterprise groups under the direct supervision of LBD headquarters increased from ¥1.980 trillion in 2010 to ¥2.790 trillion in 2013.

satisfaction with its services.¹⁹ Nevertheless, the Large Business Department's full potential has not yet been realized due to its small size (at both headquarters and the field offices) and limited responsibilities as later in Section V.

D. Tax Administration Processes

As China's economic and tax policy reforms unfolded, the SAT found its core tax administration processes were ill-suited to the new environment and needed to be overhauled. A key feature of the overhaul was to replace the outdated administrative assessment system with a modern self-assessment system. This was accompanied by the introduction of new, supportive processes for registering taxpayers, assisting them to understand and comply with their tax obligations, processing tax returns and payments, auditing, and resolving tax disputes.

Registration

The registration function records key background information on each taxpayer and the taxes that they are liable to pay. It also assigns a unique identification number to each individual and business registrant. Such numbers play a crucial role in tax administration, particularly in an automated environment, by linking a person's tax-related information over time and across taxes as well as to other related and non-related persons.

In the early stages of China's tax administration reforms, taxpayer registration was highly cumbersome and inefficient for both enterprises and individuals. Enterprises were required to register separately with at least four different agencies (1) the Administration for Industry and Commerce for business licensing and regulatory purposes, (2) the Quality and Technology Supervision Bureau, (3) the National Bureau of Statistics for statistical purposes, and (4) the SAT for tax purposes. Each followed different registration procedures and issued separate identification numbers. For individuals, different provinces (and jurisdictions within provinces) adopted different identification numbering schemes that applied both to self-employed persons with business income and individuals with wage and salary income. The creation of separate national and local tax services added further burdens because the two tax services used separate registration processes and, in some cases, different identification numbers.

¹⁹ The SAT conducted a survey of the 45 large enterprises in July 2013 of which 34 provided anonymous responses. These respondents reported their overall level of satisfaction in the LBD's services to be 85.3 percent, with 32.4 percent reporting satisfied and 52.9 percent reporting generally satisfied.

Since 2004, the SAT has taken important steps to simplify tax registration with the issuance of the *Administration Measures of Tax Registration* instruction. Under this, both the national and local tax services have adopted a common business identification number based on the organization code issued by the Quality and Technology Supervision Bureau.²⁰ They have also adopted the national identification number, issued by the Ministry of Public Security, as the identifier for individual wage and salary earners. In addition, businesses now need to register for tax purposes only once with either a national or local tax bureau which have coordinated their registration activities. Together, these simplifications have streamlined administration and reduced the compliance costs for businesses.

Despite the progress in streamlining tax registration, enterprises continue to face the burden of registering their activities with separate government agencies. And the current practice of issuing separate business identification numbers to each of an enterprise's branches complicates the development of a whole-of-enterprise picture of its tax affairs. For individuals, the registration system is hampered by duplicate numbers issued by the Ministry of Public Security and the absence of a common identification number for self-employed persons (including individual industrial and enterprise households). Further improvements in the registration system will be needed to address these weaknesses and strengthen the administration of the tax system as discussed in Section V.

Taxpayer services

In the early 1990s, the SAT provided taxpayers with a limited range of services and assistance with their tax affairs. Tax returns differed across jurisdictions, instructions often only repeated the complex language in the tax laws, and taxpayers had to visit the tax offices in person to fulfill many of their tax obligations and seek assistance. The absence of an effective taxpayer service program became increasingly problematic as the restructuring of the economy was accompanied by the creation of large numbers of new businesses many of which had little knowledge of their tax obligations and how to fulfill them.

This situation began to change in the mid-1990s when the SAT recognized taxpayer services to be a basic tax administration function and made their improvement a priority. Following the 2001 amendments to the Tax Collection Law—which established a legal obligation for the tax authorities to assist taxpayers with their tax affairs—the SAT has made a concerted effort to enhance its service offerings by improving face-to-face access; implementing electronic services (including electronic filing and electronic payment options); and creating telephone call centers.

²⁰ The SAT business identification number is a 15 digit code of which the first 9 numbers is the identification number issued by the Quality and Technology Supervision Bureau and the other 6 numbers are an administrative region code.

Beginning in 1997 and continuing throughout the 2000s, the SAT invested substantially in creating a large network of taxpayer services halls throughout the country. These provided taxpayers with face-to-face assistance in registration, tax return filing, payment, invoice purchase and submission, and general tax law and procedural questions. In 2001, the SAT launched the tax service hotline (Hotline #12366) and created a network of call centers to answer taxpayers' inquiries on tax procedures, tax law, and other questions. This new service channel has greatly facilitated compliance by allowing taxpayers to get assistance on tax matters without having to visit a tax office.

To raise the organizational focus for assisting taxpayers, the SAT in 2008 created a specialized Taxpayer Services Department at its headquarters and soon thereafter set up taxpayer service divisions at the provincial level and below. By the end of 2013, this top-down service organization comprised over 9,775 taxpayer services halls, 70,516 multi-function tax service counters, 70 provincial-level call centers, and 70 provincial, as well as some municipal, websites.²¹ The creation of a dedicated taxpayer services organization within the SAT has provided the organizational focal point needed to deliver an effective taxpayer services program.

In 2014, further technological improvements to the taxpayer services function were introduced with the development of a mobile tax application and the opening of official accounts on the two dominant social media sites (Weibo and WeChat). Through these sites, taxpayers can now receive tax information on a timelier and more convenient basis. Tax officials also use text messaging to provide a range of services such as reminders about upcoming tax deadlines and information on important tax matters. In 2013, the Chinese tax authorities had sent 86.4 million SMS messages to taxpayers.

In line with good international practice, the SAT has established a performance measurement system for its taxpayer services program. As part of it, the National Bureau of Statistics has been engaged since 2008 to conduct taxpayer satisfaction surveys every two years. The steady increase in the survey scores, as Section II shows, has revealed that the SAT's service levels have been gradually improving over the last several years. In the last 20 years, it is clear that the SAT has evolved into an organization that gives the services function a high priority.

Filing tax returns and paying taxes

Prior to the mid-1990s, China had relied on an *administrative assessment* system for assessing, filing, and paying taxes. Under it, tax officers would help SOEs prepare their

²¹ In that same year, it distributed about 93 million pamphlets, guides, and questionnaires; answered 28.8 million hot-line (or telephone center) inquiries; and provided other advice and publicity on 2.5 million occasions to 1.1 million central taxpayers and 1.3 million local taxpayers. Source: SAT.

paper-based tax returns and tax payment forms. Other (non-SOEs) taxpayers were required to file their tax returns and supporting documents at the tax office where a tax officer reviewed them in the taxpayer's presence. Once the tax return was accepted, the tax officer would prepare a payment form for the taxpayer to submit to the bank for processing.

As China's economic restructuring proceeded, the inefficiencies of the administrative assessment system were found to be incompatible with a tax system in an increasingly market-oriented economy. In particular, the requirement for tax officers to either prepare tax returns for SOEs or review each return prepared by non-SOEs left the SAT struggling to keep up with the increasing workload that resulted from the rapid growth in the taxpayer population. In addition, the cursory reviews that tax officers performed on the tax returns were found to be insufficient at identifying the growing incidence and more complex forms of tax evasion. And the close one-on-one interactions between taxpayers and tax officers created opportunities for collusion.

To improve this situation, the SAT decided to replace the administrative assessment system with the modern *self-assessment* system by which taxpayers are now required to prepare their own tax returns and make their own payments without the direct involvement of tax officers. Under it, tax authorities accept tax returns at face-value, subject to *ex-post* arithmetic checks and selective audits based on risk-management principles.

Because it was felt that not all taxpayers had the capacity to self-assess their taxes, the SAT first piloted the new system with those taxpayers who could most easily adopt it (such as those with bank accounts) and then gradually extended self-assessment to additional categories of taxpayers. Today, the old administrative assessment system is limited to those self-employed persons who do not meet the criteria for establishing company accounts as stipulated in the *Provisional Regulations for the Establishment of Company Accounts for Self-Employed Businesses*. These taxpayers are subject to a simplified tax regime where the tax administration sets a fixed amount of tax to be paid at fixed periods based on the taxpayer's location and scope of operations.

Consistent with good international practice, the SAT took a number of steps to facilitate the introduction of self-assessment. Tax returns were standardized, electronic filing and payment options were introduced, and a computer system was developed to process the tax returns and maintain the accounts of the amount of taxes paid and owed by each taxpayer. Crucially, the SAT made huge investments in improving its taxpayer service programs, as described previously, to enable taxpayers to self-file and self-pay their taxes.

The filing and payment reforms have led to a steady reduction in compliance costs for taxpayers and greater administrative efficiencies for the tax authorities. The number of tax payments that companies have to make each year was reduced from 35 in 2004 to 7 in 2013. Over the same period, the take-up rate for electronic filing increased from 40–50 percent of

total tax filings to 80 percent on average across China and to 90 percent for some large cities, like Shanghai and Beijing (Mui, 2015).

As a result of the filing and payment improvements (and other reforms), the amount of time an average medium-sized company spends on tax matters was reduced from 832 hours in 2004 to 261 hours in 2013 (World Bank, 2015b), bringing China in line with the world average of 264 hours. This is still more than the average for Asian and Pacific countries (229 hours) and well above the levels achieved by leading tax agencies.²² These ratings suggest that while the SAT has made significant progress in reducing compliance costs in recent years, ample room remains for improvement.

Audit

Before the economic restructuring and emergence of the private sector, tax auditing was a fairly simple task. The taxpayer population was relatively small, which allowed the tax authorities to audit a large proportion of tax returns without requiring sophisticated systems for identifying high risk taxpayers. Similarly, audits focused on verifying that a small number of large SOEs had transferred revenue to the correct government accounts, which did not require strong auditing powers or robust audit methods. Auditing was made even easier because, in many cases, tax officers either assessed the amount of taxes for the taxpayer or provided detailed guidance on the assessment (Casanegra, 1992).

Tax auditing became much more challenging with the advent of a market-oriented economy and the introduction of a new tax regime. As was mentioned earlier, the restructuring of the economy and tax system was accompanied by a substantial increase in noncompliance by both SOEs and private businesses (JEN, 1993). The SAT's audit program was ill-equipped to deal with noncompliance of this magnitude and needed to be considerably strengthened to protect the tax bases.

In response to this changing environment, the SAT introduced a number of reforms to modernize its audit program. These began with the enactment of the Tax Collection Law in 1992 which included provisions that vested tax authorities with broad audit powers. This reform was followed in 1997 by the creation of a national network of Inspection Bureaus (from headquarters down to the county and district levels) to examine serious violations of the tax laws. More recently, provincial tax bureaus have removed their inspection bureaus from the county levels (and below) and placed them at the municipal level (and above) to better concentrate their resources. They have also assigned large audit cases to higher level inspection bureaus (at the municipal and provincial levels).

²² For example: Australia (105 hours), Canada (131 hours), Denmark (25 hours), Singapore (82 hours), United Kingdom (94 hours), United States (175 hours). See World Bank (2015).

These efforts have produced gradually improving audit results over the last 20 years. Evidence of the improvements can be seen in the sharp increase in the amount of taxes assessed by audits, which has increased from ¥41.9 billion in 2000 to ¥116.4 billion in 2010, and ¥185.6 billion in 2014. Further, the number of audit cases that have yielded ¥10 million or more in tax revenue has increased nearly eightfold since 2003 (Table 8). These results reflect improvements in the SAT's audit strategy, including its audit selection systems and audit methods.

Table 8. Number of Audits with Recovered Tax Revenue of ¥10 Million or More

	2003	2005	2010	2014
Number of cases	101	92	242	792

Source: SAT Annual Report, 2014.

Notwithstanding these improvements, the SAT's audit program still requires much further strengthening if it is to effectively deal with the increasingly complex forms of noncompliance in an increasingly complex economy. A standardized, risk-based system for selecting taxpayers for audit has not yet been developed (instead, different locations have developed their own audit selections systems), resulting in differentiated treatment of taxpayers in different locations. A detailed audit procedures manual has not been developed for auditors. Consequently, audits still tend to be conducted in a perfunctory manner; often focusing on a simple clerical verification of the company's books and records. Such superficial audits rarely detect the issues that result in large losses of tax revenue. Critically, the audit function is split across a number of departments (Inspection Bureaus, Large Business Department, Income Tax Department, Indirect Tax Department, and the International Tax Department) resulting in the lack of a unified approach to examining taxpayers and an inefficient duplication of work.

Dispute resolution

In the early 1990s, the dispute resolution process was not governed by formal institutional arrangements and procedures. Where disputes arose, taxpayers would seek to resolve them mainly through informal discussions with the same tax officers within the tax administration whose acts were the subject of the dispute.

With the growth in the private sector and a growing incongruity of interests between taxpayers and the tax authorities, it became increasingly necessary to develop a more formalized dispute resolution system. Such a system is particularly important in China where the tax authorities tend to have more discretionary powers than their counterparts in OECD countries. This is the case, in part, because Chinese tax legislation tends to be broadly worded allowing the tax administration greater discretion in applying the law (Li, 1993).

An important step in formalizing the dispute resolution process was taken when the SAT issued the *Rules of Administrative Review of Tax Matters* in 1991. These rules were later extended and codified in the Tax Collection Law, and refined through subsequent amendments to the administrative review rules.²³ Together, the TCL and administrative review rules have created two formal mechanisms for resolving tax disputes: (1) tax administrative reconsideration within the tax authorities and (2) tax administrative litigation in the courts.

Under the administrative reconsideration, taxpayers are given 60 days to file an objection to a specific administrative act that was carried out by the tax authority. For disputes involving the assessment and payment of taxes, taxpayers are required to first seek to resolve the dispute through administrative review and, in doing so, fully pay the tax according to the decisions by the tax authorities before the administrative review may be heard. In such cases, taxpayers must exhaust the administrative review process and, importantly, satisfy the tax payment requirement, before appealing to a court.

The administrative reconsideration is conducted by the tax agency at one level above the tax agency whose action is the subject of the dispute.²⁴ The reconsideration process has been institutionalized within the SAT through the creation of *administrative review organs* in the tax office's legal department at each level of administration. These are responsible for hearing administrative review cases as well as representing the tax authorities in any subsequent litigation before a court.

Under tax administration litigation, taxpayers can seek to resolve some types of tax dispute by appealing to a people's court. To contest a prior tax administrative reconsideration decision, a taxpayer must file the appeal with an appropriate court within 15 days of the receipt of the decision. In those (limited) circumstances where a taxpayer can contest an administrative act without first completing an administrative reconsideration, an appeal must be filed within 3 months of the time of the administrative action that is the subject of the appeal that has been taken.

Despite the availability of a formal dispute resolution mechanism, Chinese taxpayers generally do not rely on administrative or judicial reviews to contest tax agencies' actions as frequently as taxpayers in other countries. For example, in 2011 only 473 administrative reviews and 166 tax litigation cases were finalized. By comparison, there were much higher

²³ In 2010, new tax administrative reconsideration rules were issued that aimed at promoting taxpayer protections by: (1) expanding the scope of acts that can be appealed; (2) allowing a hearing approach (as opposed to a desk review) for significant and complex cases; and, (3) introducing an alternative dispute resolution mechanism—based on reconciliation or mediation—for some categories of disputes (Zhang, 2012).

²⁴ For example, the actions of a municipal tax agency may be appealed to the provincial tax agency that has jurisdiction over the municipality.

numbers of administrative and judicial reviews in the following OECD countries: 24,513 in Australia, 50,485 in Canada, 8,463 in Japan, 56,228 in the United Kingdom, and 142,553 in the United States in the same year (OECD, 2015a).

Several factors may account for the low number of formal tax disputes in China. These could include the perceived benefits in maintaining a non-adversarial relationship with the tax authorities, the perceived low probability of prevailing against the tax authorities in formal proceedings, and the burden of having to first pay a tax assessment before contesting it compared to the alternative of negotiating a smaller tax payment without the formal proceedings. Other relevant factors could be the extensive opportunities for taxpayers and tax officers to interact with each other—including both to reach an ex ante understanding on the application of the tax law or an ex post settlement of a dispute through bargaining—that is afforded by China’s highly decentralized tax administration (Cui, 2015).

To the extent that the low number of review cases may indicate that taxpayers lack confidence in the fairness and independence of the dispute resolution process, the SAT is exploring various measures to promote the rule of law, improve the process including by revising the Tax Collection Law as described in Section V.

E. Human Resources

In 1992, China had over 500,000 tax administration personnel. However, less than one in twenty of its staff were college graduates and even fewer had backgrounds in taxation, accounting, or other relevant fields for tax administration. This shortage of skilled staff was a major constraint to modernizing the SAT’s operations. To overcome this constraint, the SAT adopted a two-track strategy for strengthening its workforce by: (1) in the short-term, enhancing the skills of existing staff in those areas that were most crucial to implementing the SAT’s modernization strategy and (2) over the longer-term, recruiting new staff with stronger educational background and skills.

In addressing its short-term skills needs, the SAT put in place a combination of vocational training by provincial government training institutions, teaming new recruits with experienced staff, and on-the-job training. Beginning in 2000, the SAT’s provincial tax offices took over the training programs formerly run by the provincial governments and set up specialized tax training academies in 36 provinces and municipalities. In addition, three national tax academies were created in 3 locations under the direct administration of SAT headquarters (in Changsha, Dalian, and Yangzhou). While the provincial academies delivered induction and technical training for tax officers, the national academies provided have targeted training to senior officials in selected topics (e.g., transfer pricing).

To address its longer-term skills requirements, the SAT gradually built up a cadre of university-trained officers. Through these efforts, the proportion of staff with college degrees

increased from less than 5 percent in 1995 to nearly 60 percent of the SAT's tax officers in 2014 (Table 9).

Table 9. Percentage of Tax Officials with University Degree

	1995	2000	2005	2010	2014
Percentage of staff with university degrees	4.8	12.1	38.9	53.3	59.6

Source: State Administration of Taxation.

The SAT's skills enhancement programs, as described above, have helped to create an increasingly capable workforce. On the other hand, the SAT has had less success at reforming other important elements of its human resource management regime. In particular, the SAT's position classification, staff evaluation, and promotion/salary policies have, until very recently, remained largely unchanged and tied to government-wide civil service regulations. Progress in these areas will be crucial to raising the productivity and ethical standing of the SAT workforce in the future.

F. Information Systems

In the early 1990s, most tax administration functions were paper-based and performed manually with very little use of information and communications technology (ICT). By the mid-1990s, the SAT realized that the lack of technology seriously weakened its capacity to administer the tax system. The reliance on manual-based systems required the SAT to allocate large numbers of tax officers to conduct routine tasks—such as reviewing and processing paper tax returns—resulting in low levels of productivity. The manual systems were also inherently error-prone, leading to inaccurate information in taxpayers' accounts, unnecessary disputes, and much re-work. The lack of automation also posed huge compliance costs on taxpayers who had to conduct most of their dealings in person at the tax office, which also created opportunities for collusion.

To improve its performance, the SAT made huge investments in its information technology system during the last 20 years. These investments centered on the development of two systems: (1) the China Tax Administration Information System (CTAIS); and (2) Golden Tax Project (GTP).

CTAIS is the SAT's core tax administration information system whose nationwide implementation was a major achievement for China's tax administration. The system provides automated support for the core tax administration functions (registration, tax returns and payment processing, taxpayer accounts, and others) for the main central government taxes and shared taxes. It also provides a platform for the tax administration to coordinate its activities with banks (on tax payments) and the national treasury. The system was first developed in 1999 and has now been deployed at all tax offices nationwide.

GTP Phases 1 and 2 created a specialized computer system for detecting and dealing with VAT invoice fraud. This system was designed to safeguard VAT revenue—China’s largest tax source—from the widespread incidence of fraudulent invoices that has plagued China’s VAT since its inception in 1994. In this connection, the system controls the issuance of invoices, authenticates invoices based on encoded information embedded in each issued invoice, and cross-matches seller and purchaser invoices (Box 1).

Together, CTAIS and the Golden Tax Project have provided a vital pillar for improving the effectiveness and efficiency of tax administration in China. The government has recognized their important contributions to increasing revenue performance.²⁵ Building on these systems, the SAT is currently implementing the GTP Phase 3 to replace CTAIS and, in doing so, provide automated support for all taxes (both central and local), include a broader set of tax administration applications (including risk management),²⁶ and, crucially, tie together the provincial-level databases of taxpayer information into a national network. This system, which was piloted in 6 provinces in 2013, is scheduled to be deployed nationally by the end of 2016.

²⁵ Former SAT Commissioner, Mr. Jin Renqing, reported at a tax conference on information systems in August 2002, that the incidence of fraud-related activities was greatly reduced since the GTP2 system was fully introduced in mid-2001. For example, the detection rate of fraud-related invoices decreased from 8.51 percent in February 2001 to 0.06 percent in mid-2002.

²⁶ GTP3 will include four sets of applications: (1) tax collection (registration, filing, payment, accounts management); (2) administration (financial management, human resources, internal audit); (3) analytical support (compliance risk management, performance measurement and reporting, policy analysis, statistical analysis); and (4) external information (information exchange with other government and non-governmental entities).

Box 1. Inside China's VAT Invoice Cross-Matching System

The SAT's Golden Tax Project (Phases 1 and 2) is an automated system that has been designed to control the issuance of VAT invoices and to detect potentially fraudulent invoices. The system, which was implemented nationwide by July 2001 (GTP Phase 2) comprises four sub-systems: (1) issuing VAT invoices; (2) certifying VAT invoices; (3) cross-checking and inspecting VAT invoices; and (4) coordinating investigations.

1. Issuing VAT invoices. To issue VAT invoices, taxpayers are required to obtain from the SAT proprietary software and hardware (an integrated circuit card, the "black box"). When sellers issue a VAT invoice, the software generates an 84-digit or 108-digit numerical cipher based on the data in the invoice. That plus the invoice number, taxable amount, VAT payable amount, issue date, and industry classification code number are printed on the invoice. The cipher is later used to certify the invoice's authenticity (subsystem 2 below). The invoice information is stored in this computer system as the invoices are issued. Once a month, VAT taxpayers are required to upload the data in their black box system to the local tax offices when filing their monthly VAT returns. This data is stored by the tax authorities and applied by the cross-checking and inspection systems (subsystem 3 below).

2. Certifying VAT invoices. In order to claim input VAT credit, purchasers must apply to have the authenticity certified for the VAT invoices they have paid. To do so, most taxpayers have received authorization to scan their paper invoices and transmit the electronic files to the certifying subsystem. As part of the certifying process, the information contained in the 84-digit cipher is decrypted to test the accuracy of its contents. If the decrypted data and the unencrypted data in the invoice match, then it is certified as accurate and the taxpayer that submitted it can use the invoice to claim input VAT credit.

3. Cross-checking and inspecting VAT invoices. Tax authorities use the cross-checking and inspecting subsystem to compare the information in the copies of VAT invoices submitted by issuers of the invoices (i.e., sellers) with copies submitted by taxpayers seeking input VAT credit (i.e., purchasers). If the data in both copies of the invoices match, then no further action is taken; if not, then the input VAT credit copy of the invoice is forwarded to the investigation sub-system for investigation. Cross-checking and investigation is conducted at the central government and provincial levels in order to expedite the process.

4. Coordinating investigations. If a VAT invoice is identified as fraudulent or otherwise invalid, it is sent to the subsystem for the coordination of investigations run by the SAT. The SAT manages a nationwide system for investigating VAT invoice fraud.

Source: This box is based mainly on Winn and A. Zhang (2013).

IV. EMERGING CHALLENGES AND OPPORTUNITIES

The SAT faces significant challenges in ensuring the health of the tax system over the next five years. These take two broad forms: (1) external challenges that emanate from the SAT's operating environment; and (2) internal challenges from within the SAT itself. There are also a number of opportunities that the SAT could exploit to enhance its operations. Identifying both the challenges and opportunities, as described in this section, is a key first step in setting the SAT's future reform priorities as described in the next section.

A. External

The SAT will operate in an increasingly complex external environment. Key challenges include slowing economic growth, structural shifts in the economy, and China's continuing integration into the global economy—all of which present heightened risks of lost revenue from noncompliance by taxpayers. Further challenges include the implementation of an ambitious tax reform agenda and the need to promote the business climate by reducing the compliance costs of the tax system.

Slower economic growth

China's slowing economy, from double digit to single digit growth under the so-called *new normal*, could have significant implications for tax administration. The economic slowdown can be expected to reduce the rapid growth in tax revenue that had been achieved in previous years. The revenue decline is not a concern in itself to the extent it reflects the normal operation of automatic stabilizers, but would pose a problem for tax administration if it causes a decline in taxpayer compliance. The latter can occur because economic stress creates incentives for distressed taxpayers to use tax evasion as an alternative form of finance for their operations and a means to avoid bankruptcy (Brondolo, 2009, CASE, 2013).²⁷ Compliance declines can be expected to differ across industries in line with their relative declines in economic activity. From this perspective, the SAT will need to give special attention to those industries most impacted by the slowdown such as industrial commodities (for example, steel), real estate, and mining.

The economic slowdown will also make it more important than ever to ensure that the tax administration avoids unnecessarily impeding the business climate. Although the SAT has taken many steps to reduce compliance costs over the last several years, Chinese businesses

²⁷ Recent experience, in Western countries and China alike, provides evidence that taxpayer compliance tends to worsen in an economic and tight credit conditions. During the global financial crisis, noncompliance with the value-added tax increased in almost all European Union countries and tended to worsen most where the output contraction was greatest (IMF, 2015b). In China, a study of close to 190,000 Chinese industrial firms (Cai and Liu, 2009) found that corporate income tax evasion is negatively correlated with access to credit.

still spend more time in dealing with tax matters than taxpayers from comparator countries in the Asia Pacific region and far more time than taxpayers in countries with high performing tax agencies (refer to Section III.D). A substantial portion of these costs is associated with the administration of the VAT: in 2006, more than 40 percent of the costs incurred by Chinese taxpayers in meeting their tax obligations were attributed to handling VAT special invoices (Xu, 2006).

Structural changes in the economy

Structural shifts in the economy can also be expected to pose additional challenges for the SAT in the coming five years. Three of the more significant shifts involve the increasing contribution of the services sector, the growing volume of cross-provincial transactions, and sharp increase in electronic commerce.

Regarding services, this sector is expected to continue to grab a growing share of the economy.²⁸ This trend will present two particularly significant challenges to tax collection. First, the services sector in China comprises larger numbers of small and unincorporated businesses, as compared to the industry sector (Rosen, 2015), many of whom have low rates of tax compliance. Second, the expected growth in the financial services industry and the introduction of new financial products will raise complex tax issues that will require increasing attention to ensure their correct tax treatment.

The increase in cross-provincial transactions presents further challenges to tax administration. Large businesses and high-wealth individuals (HWIs) in China are increasingly carrying out economic activities in multiple provinces. This increase in cross-provincial transactions is in contrast with the SAT's decentralized tax administration—with little exchange of information among the provincial tax bureaus—and points to the need for a more national approach to administering highly mobile taxpayers.

China's rapid growth in electronic commerce (e-commerce) presents a third, major structural shift in the economy and a growing challenge to tax administration. In 2000, it had yet to develop e-commerce applications and had only 2.1 million internet users. By the end of 2013, Chinese internet users reached approximately 600 million and e-commerce growth had topped 70 percent annually from 2009 to 2012. By 2020, China's e-commerce market is forecasted to be larger than those of the United States, United Kingdom, Japan, Germany, and France combined (KPMG, 2014).

²⁸ The State Council's Development Research Center forecasts the service sector share of GDP to increase from its 2011–15 average of 47.6 percent to an average of 51.6 percent during 2016–20 while its share of employment is expected to increase from 42.0 percent to 47.6 percent over the same period (World Bank, 2012).

The growth in e-commerce has been accompanied by the development of new business models, which commonly feature a third party facilitator who operates an on-line platform and charges a fee, arranges a sale of a good or service between a producer and consumer of a good or service.²⁹ The boom in e-commerce and new business models will confront the SAT with the challenges of identifying on-line transactions, determining the nature and value of the transactions, and establishing the taxable persons.

Globalization

China has a worldwide income tax system under which its residents—both corporations and individuals—are taxed on income from sources both within China and outside China (with credit for taxes paid on foreign income) and non-residents are taxed on income only from within China. Since the country opened up its economy to trade and investment with the rest of the world in the late 1970s, the Chinese tax system has faced the risk of cross-border tax avoidance and evasion. As mainly a capital importing country until recent years, the international tax risks have centered on guarding against offshore profit shifting by foreign-funded enterprises that invested in China. These included such risks as transfer pricing, thin capitalization, and indirect transfer of Chinese assets.

With China having now become an increasingly capital exporting country (as shown in Table 6), the nature of the international tax risks that it faces is changing. While transfer pricing continues to be a central issue, the SAT must now be concerned not only with transfer pricing practices of foreign enterprises in China but also those practices of Chinese-owned subsidiaries in other jurisdictions. Other emerging international risks include cross-border restructuring of Chinese businesses (such as acquiring foreign companies and corporate inversions), deferred recognition of income by Chinese companies from their foreign subsidiaries in low tax jurisdictions, unreported overseas income and assets by Chinese residents,³⁰ and various aggressive tax planning schemes.³¹ The SAT will need to adapt its international compliance programs, in cooperation with other jurisdictions, to deal with these and other similar risks.

²⁹ In China, the new business models include both consumer-to-consumer transactions (e.g., the Taobao company) and business-to-consumer transactions (e.g., Alibaba, JD, and Tmall companies). In addition to selling goods, the new business models also deal in services such as “ride-sourcing” where a third party facilitator arranges for a fee a driver who uses his/her car to transport passengers for a fare (e.g., Uber and Didi Kuaidi companies). For further information see Consulate General, 2015.

³⁰ The under-reporting can take a wide range of forms from individuals not reporting overseas financial income to Chinese tour operators that fail to report income earned from their overseas tours.

³¹ For example, the United States, which also operates a worldwide tax system, has encountered aggressive tax planning schemes that sought to repatriate overseas profits to the U.S. without causing a U.S. taxable event. This can be done by various schemes including by arranging for the foreign subsidiary of a U.S. company to purchase the stock of its U.S. parent, as part of a triangular reorganization, instead of paying the parent an outright dividend that would be subject to U.S. income tax (Internal Revenue Service, 2006).

New tax legislation

The government's tax reform agenda presents additional challenges for the SAT. Over the next five years, major reforms are planned for six taxes: value-added tax, excise tax, resource tax, environment protection tax, property tax, and individual income tax. Such an ambitious reform program will require a major implementation effort by the SAT: taxpayers (especially individuals) will need to be educated in their new obligations, new administrative systems and procedures will need to ensure taxpayers comply with their obligations, and tax officers will require training in applying the new legislation and compliance procedures.

Along with the external challenges, there are also a number of opportunities emanating from the tax system's external environment that the SAT could exploit to strengthen tax administration over the coming years. Most importantly, the Communist Party of China's Central Committee Leadership Group to Comprehensively Deepen Reform has given high level political support for tax administration reform when it passed on October 13, 2015 the *Plan to Deepen Reform of the National and Local Tax Administration System*.³² Internationally, the growing cooperation among countries in exchanging tax information, both through bilateral and multilateral arrangements, provides the SAT with new opportunities for tackling cross-border tax evasion.

B. Internal

The increasingly complex environment facing the tax system will put pressures on the SAT's internal administrative capacity. Potential vulnerabilities include the SAT's organizational structure, staff skills, and information systems. The SAT will need to strengthen its capacity in each of these areas to deal with the emerging challenges that it faces.

Organizational stresses

The SAT's current organizational and staffing arrangements, which have evolved incrementally over the last two decades, have a number of stress points that present risks to the agency's capacity to deal with emerging challenges and implement its modernization strategy. These organizational stresses are manifested in four main areas:

- The small size of SAT headquarters hinders its capacity to design and implement national and international compliance strategies precisely at a time when Chinese taxpayers are increasingly engaging in cross-provincial and overseas taxable activities.

³² As described in Section V.

- The very large network of tax offices—while facilitating close support and monitoring of taxpayers—is costly to maintain and presents serious difficulties in managing, ensuring uniform administration, and avoiding collusion.
- The creation of separate national and local tax services—although providing a dedicated organizational focus for collecting national and local taxes, respectively—has had the disadvantages of high budgetary costs for the government (from maintaining two separate agencies) and additional compliance costs for taxpayers (who must deal with two separate agencies in carrying out their tax obligations).
- The SAT’s hybrid organizational structure—where staff are organized into units based partly on tax type, partly on type of taxpayer, and partly on tax administration function—has resulted in fragmentation of administrative responsibilities across the organization. This fragmentation is particularly pronounced and harmful in the areas of auditing and large taxpayer administration.

In addressing the above stress points, it is important to recognize that organizational restructuring is always very challenging, particularly for a large tax agency like the SAT. This suggests that priority should be given to implementing those organizational and staffing changes that are most critical to the successful delivery of the SAT’s modernization strategy.

Achieving greater uniformity in administration

The effective operation of a national market economy is influenced by the extent to which the tax system is applied in a uniform manner across the country. Notwithstanding the progress that the SAT has achieved over the past two decades in harmonizing its tax administration practices across China, there continues to be differences in the way the tax laws are applied from province to province and city to city.

To some extent, inconsistencies in administration and service delivery are inevitable in a very large country with a decentralized tax agency and weak communications, particularly where the tax agency has a very small headquarters as is presently the case in China. Nevertheless, such inconsistencies can be harmful to the economy by distorting competition across (and within) jurisdictions and industries. They can also raise serious questions in the eyes of taxpayers about the fairness of the tax system if tax laws are applied differently in different locations. With the government seeking to promote the business environment and the rule of law, it is increasingly important for the SAT to achieve greater standardization and consistency in the application of the tax laws.

Critical skills gaps

Ultimately, the SAT’s capacity to effectively administer the tax system depends on the skills of its managers and staff. While it has steadily strengthened the quality of its workforce over

many years, significant skill gaps remain in some important areas, particularly among auditors. Future reform initiatives, such as planned amendments to the Tax Collection Law and other changes in tax legislation, will create further demands for skills enhancement.

In this situation, the SAT needs to identify its key skill gaps and formulate a comprehensive strategy for closing them. Importantly, these efforts need to be directed not only at strengthening the SAT's technical skills but also at improving the capacities of its senior executives and managers. To achieve the best results, the SAT will need to adopt a broad range of skills enhancement approaches and technologies.

Weaknesses in information systems

Tax administration is an inherently information-intensive activity where appropriate data and well-designed analytics are critical to the effective administration of the tax system. While the SAT has made great strides in deploying a standardized information system across a large network of tax offices, it has not yet fully realized the potential benefits of its information technology. Key weaknesses include the lack of national databases of taxpayer information, the absence of third party information, and the high compliance costs that some of the SAT's computer systems impose on taxpayers.

Along with the internal challenges the SAT could also leverage a number of opportunities to advance tax administration reform. Crucially, the stability in its leadership—particularly among its commissioners and deputy commissioners—has provided a continuity in reform leadership that is crucial for implementing medium-term reforms. In addition, various ongoing tax administration reforms—to the SAT's legal framework, administrative processes, and computer systems—provide a strong foundation for future modernization.

The SAT will need to take into account both its challenges and opportunities as it formulates a modernization strategy for the next five years, which we turn to in the next section.

V. FUTURE REFORM PRIORITIES

Tax administration reform has an important role to play in supporting the government's economic reform agenda under the 13th Five-Year Plan (2016-20) by mobilizing adequate revenue to pay for high priority public sector expenditures and helping to promote the business climate. To contribute to these objectives, this section suggests measures that the SAT may consider incorporating into its tax administration modernization strategy for the next five years.

A. The State Administration of Taxation's Modernization Program

The importance of tax administration reform has been recognized at the highest level of the Chinese government. The 13th Five-Year Plan has reinforced the earlier call by the Third Plenum of the 18th Central Committee to strengthen the collection of national and local taxes.³³

The SAT has translated these goals into six broad objectives that aim at creating: (1) a fully-developed tax law system; (2) a sound tax administration system; (3) a high-quality and convenient service system; (4) a rigorous tax collection system; (5) a robust information technology system; and (6) an efficient organizational system (Wang, 2015). These goals and objectives are underpinned by several high priority initiatives that the government has identified in its October 2015 *Plan to Deepen Reform of the National and Local Tax Administration Systems*.³⁴

By early 2016, the SAT intends to develop a five-year action plan for modernizing tax administration in a step-by-step manner by 2020. In this context, the balance of this section provides guidance on a number of key reform initiatives.

B. Amending the Tax Collection Law

The TCL is crucial to the operation of China's tax system as it sets out the common administrative provisions that apply to all of its substantive tax laws. Updating the TCL, which has had only minor amendments since its enactment in 1992, is a key prerequisite for

³³ See *The Significance of and Guiding Thoughts on Deepening the Reform Comprehensively* as adopted at the Third Plenary Session of the 18th Central Committee of the Communist Party of China on November 12, 2013. Also refer to the *Plan to Deepen the Fiscal Reform* issued by the CPC Politburo on June 30, 2014.

³⁴ These initiatives include streamlining the division of responsibilities between the national and local tax services, introducing innovative taxpayer services, developing new tax administration approaches (including expanding the use of risk management), expanding co-operation with other jurisdictions to combat cross-border tax avoidance and evasion, refining the SAT's organizational structure at each level of administration, and strengthening the professionalism of tax officials.

strengthening tax administration by ensuring the SAT has the legal authorities needed to implement its modernization strategy and deal with emerging challenges.

In amending the TCL, the government should ensure that the revisions achieve an appropriate balance between the powers of the tax authorities and the rights of taxpayers. The former would provide the SAT with the powers needed to safeguard tax revenue while the latter would help promote the investment environment by providing businesses with greater protections and certainty on the tax treatment of their transactions.

Several amendments are needed to strengthen the SAT's enforcement powers. First, the amendments need to make clear that the TCL is not limited to enterprises, as is currently the case with some key provisions, but also applies broadly to all taxpayers. Second, the law needs to require private sector third parties—including financial institutions and other income payers³⁵— to provide the SAT with tax-related information and facilitate the SAT's receipt of tax information from for other government agencies.³⁶ Third, the SAT's arrears collection powers need to be enhanced, including by vesting the organization with the power to impose a tax lien on the property of tax debtors, require third parties who owe money to (or hold money on behalf of) a tax debtor to pay some portion of the monies owed (or held) to the SAT in satisfaction of the tax debt, and extend the length of time for eligible tax debtors to pay their arrears installments.

Other amendments are needed to enhance taxpayers' protections. Importantly, the provisions governing the confidentiality of taxpayer information need to be strengthened, taxpayers should be provided with a comprehensive set of procedural protections, and clear guidelines issued on how tax bureaus should apply the law's penalty provisions.³⁷ The current requirement for taxpayers to pay 100 percent of a disputed tax assessment before they can file an administrative review should be eliminated³⁸ and replaced by a provision that requires taxpayers to pay only some percentage of the disputed tax liability. In addition, the SAT should have the power to provide taxpayers, upon request, with a binding ruling on how the tax law applies to a particular transaction. Finally, steps need to be taken to ensure that the

³⁵ The tax laws in some countries vest the tax agency with the authority to require certain persons in highly non-compliant industries to report information to the tax agency on their payments to other persons in the industry. For example, some countries require general contractors in the construction industry to report to the tax agency payments to their sub-contractors.

³⁶ In other countries, the implementation arrangements for exchanging information with other government agencies is commonly set out in a memorandum of understanding between the agencies.

³⁷ The procedural protections could include, for example, establishing standards and timelines for the tax authorities to issue notices to taxpayers and decide on an administrative review.

³⁸ Interest should accrue in favor of the tax agency on the percentage of the tax liability not paid by the taxpayer and in favor of the taxpayer on the amount of the tax liability paid to the tax agency, depending on the outcome of the dispute.

SAT's administrative review organ has greater independence from the rest of the organization (as described in Section V.F below).

The SAT and Ministry of Finance in November 2014 jointly submitted draft amendments to the TCL to the State Council. During 2015, the SAT coordinated with the Legislative Affairs Office of the State Council in reviewing and addressing comments received from a wide cross section of society, held expert panel discussions, and did further research on improving the TCL. It is expected that the amendments will be enacted during 2016, which will be crucial for keeping the SAT's modernization program on track.

C. Aligning the Organizational Structure to the Modernization Strategy

The successful implementation of the SAT's modernization strategy depends critically on ensuring that its organizational structure is aligned with and supportive of the modernization strategy. In this connection, the SAT would benefit from rationalizing its current organizational structure, strengthening headquarters and consolidating the large network of tax stations, and establishing effective organizational arrangements for administering large businesses and high-wealth individuals.

Over the last 20 years, the SAT's organizational structure has evolved in an ad hoc manner with new departments created to deal with emerging priorities. For example, in 2008 the SAT created a new Taxpayer Services Department and Large Business Department with a view to improving its taxpayer services programs and strengthening the administration of large enterprise groups. As a consequence of this ad hoc evolution, administrative responsibilities have increasingly fragmented across the SAT's departments. The formulation of the SAT's modernization strategy provides both an opportunity and a need for the SAT to review its existing organizational arrangements, with a view to achieving greater coherence and efficiency.

As a starting point, the SAT needs to identify the key aims of its modernization strategy and then ensure that they are appropriately reflected in its organizational structure. For example, if the strategy is intended to provide more customized administration to different taxpayer segments—large business, medium businesses, small businesses, and high-wealth individuals—then the organizational structure should provide a clear accountability for each key taxpayer segment. Similarly, if the strategy seeks to better protect taxpayers' rights then it would be important to ensure that the SAT's administrative review function is organized in a way that provides it with a high degree of independence from the rest of the SAT.

A second organizational imperative is to clarify the division of responsibilities for the main tax administration functions. On this issue, it is essential to eliminate the current fragmentation of administrative functions that currently exists across the SAT. This is particularly important for the audit function where several departments are authorized to

conduct examinations.³⁹ Similarly, the administration of national and local taxes needs to be better coordinated—for example, by setting up joint tax service halls, co-locating the service counters in the public service centers of local governments, or establishing liaison counters in the tax service halls of the national and local tax bureaus—to achieve greater efficiencies in administration and reduce compliance burdens for taxpayers.

The extremely small size of the SAT’s headquarters relative to its overall staff is a third organizational issue that needs to be addressed. As mentioned in Section III.C, the small headquarters creates a huge impediment to designing, monitoring, and supporting national tax administration programs as well as ensuring their consistent application. While these shortcomings were not a major problem when the economy and tax system were highly provincial-centric, the need for a larger and stronger headquarters has become more important as the tax system has become increasingly national and international in scope. The first best solution to this problem would be to gradually increase the number of headquarters staff over time. A second best approach would be to designate certain municipalities as “centers of excellence” that, under the supervision of SAT headquarters, would be responsible for designing and implementing various national programs.

Along with strengthening headquarters, there is also a need to consolidate the more than 10,000 grassroots’ tax stations. While this wide office network provides convenience for taxpayers and allows close monitoring by tax offices, these advantages come at the cost of huge administrative inefficiencies (because the small tax stations are not conducive to specialization), difficulties in ensuring consistent administration, and risks of collusion (due to close contacts between taxpayers and tax officers).⁴⁰ With the growing capacity of the SAT’s telephone contact centers and its electronic services, substantial efficiencies could be gained without significant losses in convenience and monitoring by consolidating smaller tax stations into larger ones, particularly in urban areas.

An additional organizational issue is the need to strengthen the administration of two critical taxpayer segments: large businesses and high-wealth individuals. Both of these segments account for a large share of tax revenue,⁴¹ have growing volumes of cross-provincial and

³⁹ Responsibility for the audit function could be allocated as follows: (1) the tax bureaus should examine individuals, small businesses, and medium-sized businesses; (2) the Large Business Department should examine large businesses; and (3) the Inspection Bureaus should investigate serious violations of the tax laws, including those involving fraud and evasion.

⁴⁰ See IMF 2015b for a description of the disadvantages of too large a network of local tax offices and the potential benefits from streamlined office networks.

⁴¹ As was mentioned in Section III. C, the SAT estimates that the largest 45 large enterprise groups account for about 22 percent of the SAT’s tax collection while another 300–400 enterprise groups are estimated to account for an additional 20 percent of SAT revenue. In 2012, the top 10 percent of households accounted for about 50 percent of market income and a

overseas transactions, and deal with some of the more complex provisions in the tax laws. For these reasons, a strong organizational focus with a national span of control is required to manage their compliance.

For large businesses, the SAT took an important step toward strengthening administration with the creation of the Large Business Department in 2008. Despite this important reform, the department's potential for safeguarding revenue and promoting the business climate has not yet been fully exploited because the department does not have full administrative authority over large businesses but instead shares its authorities with other SAT departments. This situation could be improved by expanding the Large Business Department headquarters' authority in overseeing the provincial Large Business Departments.⁴² It would also help to vest the department with exclusive responsibility for auditing and issuing tax assessments to large businesses⁴³ and to increase substantially the number of staff assigned to the department's headquarters, provincial, and municipal departments.

For high-wealth individuals, the SAT has not yet created a special organizational unit for this important group of taxpayers. Despite their increasingly national and international scope of activities, wealthy individuals are currently administered separately by each local tax office where they receive income. Consequently, the SAT cannot easily monitor their tax activities across provinces and overseas. This weakness could be addressed by creating a specialized high-wealth individuals' unit similar to that of (and, possibly, incorporated within) the Large Business Department.⁴⁴ This unit would be responsible for a range of tax administration functions for high-wealth individuals, including taxpayer services, risk assessment, and audit. It would comprise a centralized high-wealth individuals unit at SAT headquarters to oversee, coordinate, and provide technical support to high-wealth individuals units at the provincial or municipal levels.

D. Extending the SAT's National and International Reach

China's large size, diversity, and intragovernmental revenue sharing regime has necessarily led to a decentralized system of tax administration. Under this system, taxpayers are

somewhat lower share of personal income taxes (based on data from the National Bureau of Statistics of China and China Household Finance Survey).

⁴² An intermediate step may be to arrange for the LBD's in a small number of large municipalities to fall under the direct management of the headquarters' LBD in the same way that some the large enterprise groups in Beijing are administered.

⁴³ Ideally, the municipal level Large Business Departments would be designated as a "bureau" in which case they would operate as a separate tax office (with a broad set of administrative authorities for large businesses) instead of a one of several "departments" within a municipal tax bureau (with lesser authorities) as is currently the case.

⁴⁴ Because high-wealth individuals often have significant ownership stakes in large businesses, some tax agencies place their high-wealth individuals unit within the large business department.

administered separately in each province where they earn income, with insufficient coordination across provinces or, in some cases, even within provinces. This decentralized, provincial-centric approach is becoming increasingly incompatible with the growing number of enterprises and individuals with taxable activities that stretch across provincial borders and overseas.

On the domestic front, protecting China's tax bases in the face of increasing cross-provincial transactions will require the adoption of a more national approach to tax administration.⁴⁵ Such an approach depends on, among other things, three important preconditions: (1) a nationally standardized tax identification number, (2) a centralized database of taxpayer and third party information, and, (3) effective organizational arrangements for coordinating the cross-provincial (and overseas) administration of taxpayers.

A nationally standardized taxpayer identification number is crucial to the creation of a national tax administration by tying together individuals' and businesses' tax-related information across locations as well as over time and in relation to other taxpayers. Recognizing this, the SAT is adopting a new identification number for enterprises as part of a whole-of-government reform to business registration. Similar effort will be needed to strengthen the identification system for individual taxpayers. Both of these issues are discussed further in Section V.F.

A second important precondition involves the creation of centralized master-files⁴⁶ of taxpayer and third party information. Since it is not feasible, under current conditions, to immediately create such information depositories for all enterprises and individuals, priority should be given to those taxpayers who are most likely to have cross-provincial and overseas income. Accordingly, the creation of national master-files should begin with large enterprises and high-wealth individuals since these persons tend to carry out more taxable activities in multiple locations than other persons.

A third prerequisite is to establish proper organizational arrangements for coordinating the administration of large enterprises and high-wealth individuals across different locations. As mentioned earlier, coordination could be improved by leveraging the SAT's Large Business Department and by creating a new, high-wealth individuals unit at headquarters and the provincial/municipal levels as was discussed in Section V.C.

⁴⁵ The need for a national approach to tax administration will be further amplified by the authorities' plans to reform the personal income tax by replacing the current schedular system (where different income categories are taxed under separate schedules) with a more comprehensive system (where some income categories—including those earned in different provinces—are aggregated and taxed under a common schedule).

⁴⁶ A taxpayer "master-file" refers to a database of tax-related accounts information for each taxpayer (type of taxes that they are liable to pay, frequency of filing and payment, amounts of tax paid and owed, assessment of additional tax, interest, penalties, etc.).

On the international front, China's large and growing volume (and complexity) of international transactions poses substantial risks to tax collection through cross-border base erosion and profit shifting (BEPS) by businesses and individuals.

In addressing the international tax risks posed by businesses, a key priority involves implementing the package of 15 measures in the BEPS action plan that has been developed by the OECD and G20 countries (OECD, 2015b). This will require introducing changes to China's domestic legislation and the SAT's administrative practices as well as tax treaty provisions. In making these changes, the SAT will give particular attention to the following BEPS measures:

- Improve the transfer pricing rules—which govern the valuation of transactions within a multinational enterprise group—to better align the apportionment of profits across the entities in the group with the economic activities that generate the profits. This will require revisions to the SAT's *Implementation Measures of Special Tax Adjustments (Circular No.2)*.
- Introduce a country-by-country (CbC) reporting regime that will require China-based parents of large multinational enterprise groups to file with the SAT an annual report containing tax-related information for each jurisdiction in which the groups do business and for the SAT to share this information with other tax agencies. Implementing this regime will require revising Circular No.2 (referred to above) and signing the CbC-MCAA (Multilateral Competent Authority Agreement).
- Incorporate anti-abuse provisions into China's tax treaties with other countries. These will include adopting a new definition of permanent establishment (PE)—the existence of which entitles a country to tax the profits of a foreign enterprise—to prevent the artificial avoidance of PE status, for example, by replacing distributors with commissionaire arrangements. The SAT intends to introduce these changes both through bilateral renegotiations of China's tax treaties and the adoption of a new multilateral instrument.
- Improve the operation of the mutual agreement procedure (MAP), which is a mechanism that tax agencies use to resolve tax treaty-related disputes (typically involving double taxation) between taxpayers and tax agencies. The SAT will strengthen its capacity in this area by allocating additional resources—including personnel, funding, and training—to its MAP function.

In addition to above international issues, the SAT will also need to pay greater attention to the tax risks associated with the increasing overseas investments by Chinese enterprises, including their acquisitions of foreign companies. For countries like China that operate a worldwide tax system, these risks include under-reporting of foreign income (as in the case

when a foreign subsidiary makes a loan to or purchases the shares of its China-based parent company as a way of avoiding tax on repatriated income) and taking excessive deductions (as in the case when a China-based enterprise acquires a foreign company and claims excessive royalty payments for licensing the technology of its newly acquired foreign subsidiary). Controlling these risks will require changes in China's tax legislation and strengthening the SAT's international compliance programs.

In mitigating international tax risks posed by individuals, a crucial task will be to implement the multilateral and bilateral exchange of information agreements that China has entered into with other jurisdictions.⁴⁷ These agreements require, among other things, foreign financial institutions to report to the SAT information and assets held by Chinese taxpayers (and Chinese financial institutions to report the same information on foreign taxpayers to foreign tax agencies). Putting these agreements into operation will require, among other things, translating their reporting and due diligence requirements into domestic law, creating the administrative and information technology infrastructure needed to collect and exchange information, and establishment of confidentiality safeguards on the use of the information.

E. Expanding the Use of Compliance Risk Management

Over the next five years, China's tax system will face a range of new and complex compliance risks. Some risks, such as those discussed in this paper, have already been identified; other risks not presently known are also likely to arise in the future. To safeguard revenue in an environment fraught with many complex risks, the SAT needs to fully develop a compliance risk management approach to tax administration.

In essence, compliance risk management provides a systematic approach to identifying and ranking the major tax compliance risks, developing a comprehensive set of treatments for mitigating the risks, and establishing a set of indicators to assess the treatments' impact on the risks identified. Leading tax agencies typically develop compliance management strategies at three levels,

- Tax level, by identifying the most material compliance risks facing each major tax (irrespective of market segment or industry),
- Segment level, by identifying the major compliance risks that are prevalent to relatively homogenous groups of taxpayers (e.g., large, medium-sized and small

⁴⁷ China signed the Multi-lateral Convention on Mutual Administrative Assistance in Tax Matters on August 23, 2013 and on December 16, 2015 ratified the Multi-lateral Competent Authority Agreement on automatic exchange of information. China also entered into an agreement in substance to the bi-lateral exchange information with the United States in relation to the United States Foreign Tax Account Compliance Act (FATCA) on June 26, 2014.

businesses, and high-wealth individuals) and, in some cases, for important industries within those segments, and

- Taxpayer level, by evaluating the risk posture of individual enterprises and persons.

In recent years, the SAT has taken important first steps toward developing a risk management approach to tax administration. Beginning with the large taxpayer segment, the SAT has piloted the development of compliance management strategies at the taxpayer level.⁴⁸ This assigns each taxpayer into one of three risk categories—high, medium, and low—and then applies different treatments depending on their risk level. Building on this, the SAT issued the *SAT Opinion Concerning the Strengthening of Tax Risk Management Work* in September 2014. This is intended to standardize tax risk management nationally by establishing uniform approaches for risk identification, rating and ranking risks, risk treatments, and evaluation and feedback.

In the period ahead, it will be important for the SAT to extend its risk management approach beyond assessing the risks of individual taxpayers to identifying and dealing with major compliance risks at the tax level and taxpayer segment level. In doing so, a separate compliance management strategy should be developed for each major tax (such as individual income, enterprise income, value-added) and major taxpayer segments within each tax (e.g., such as large taxpayers, high-wealth individuals, and small businesses). As an example, Appendix 2 provides an illustrative template of a compliance management strategy for a taxpayer segment (in this case, medium-sized businesses) that the IMF assisted in developing for another country's tax agency.

To ensure appropriate headquarters direction and oversight, it would be useful to assign a senior headquarters official with the responsibility for designing and overseeing the implementation of each compliance management strategy.⁴⁹ To facilitate coordination among the provincial tax bureaus, the SAT could establish a national compliance management steering committee, chaired by headquarters and including the tax heads of selected provinces, to approve the compliance strategies and coordinate cross-provincial activities (such as cross-provincial audits). To avoid conflicts and duplication of work, it would also be important for all departments to adopt a common risk management framework which should be applied in a coordinated manner to cover all of the SAT's compliance improvement

⁴⁸ In addition to large businesses, the SAT is piloting the development of risk management strategies for other taxpayer segments in Jiangsu and Henan provinces.

⁴⁹ For example, for each major compliance risk, the Australian Taxation Office assigns a senior executive as the “risk owner” with overall responsibility for overseeing the management of a particular risk and another senior official as its “risk manager” with responsibility for the risk's day-to-day management in terms of coordinating the rating of the risk, developing the risk mitigation strategy, formulating operational plans for implementing the risk mitigation strategy, and monitoring the strategy's impact on bringing the risk under control.

activities (e.g., taxpayer services, audit, arrears collection, proposed legislative changes, and so on).

F. Enhancing Core Tax Administration Processes

The SAT's core tax administration processes—including those involving registration, taxpayer services, audit, arrears collection, and dispute resolution—need to be enhanced to deal with emerging tax compliance risks and to exploit the new authorities that the SAT is expected to be granted under the planned amendments to the Tax Collection Law. It is also important to ensure that the administrative processes—and, hence, the tax laws—are applied in a more uniform manner across China than is currently the case so as to achieve a level playing field among taxpayers and to avoid distorting economic activities.

To this end, the SAT intends to upgrade its core tax administration processes in two stages by standardizing the processes around the SAT's current best practices and then by introducing a new set of innovative practices. The first stage was completed with the nationwide implementation of the *National Tax Administration Standards (version 1.0)* on May 1, 2015.⁵⁰ The second stage will be guided by the *National Tax Administration Standards (version 2.0)*, which is to be introduced over the next several years beginning with pilots at the national level in Jiangsu and local level in Henan provinces. In designing the new practices, the SAT could consider some of the suggestions below.

Registration

To reduce business compliance costs and facilitate exchange of information among government agencies, the government is adopting a whole-of-government approach to enterprise registration. Under it, four government agencies—the SAT, National Bureau of Statistics, Administration for Industry and Commerce, and the Quality and Technology Supervision Bureau—will adopt a single business identifier and a one-stop registration process based on the new 18 digit Uniform Social Credit Code. The new business identifier is to be issued by the Administration of Industry and Commerce (AIC). Most agencies are expected to adopt this new identifier by 2017.

Although the AIC will be the custodian of the taxpayer identification numbers, the SAT has a very strong interest in maintaining the integrity of the numbers given their importance in tax administration. To this end, appropriate governance arrangements need to be put in place to ensure that the SAT has a role in deciding on critical issues concerning the design, operation, and ongoing maintenance of the national identification numbering system. One possibility would be to create an inter-agency steering committee that would be responsible for

⁵⁰ These standards unified the processes for 612 tax administration matters under 11 major categories, 152 subcategories, and 1,087 forms and certificates.

reviewing and approving the system’s strategic direction, its key operational features, and infrastructure decisions. The SAT should have membership on and an important role in this steering committee.

For individuals, the SAT has not yet incorporated into its reform plans improvements in the registration processes and identification numbers for self-employed and other natural persons into its reform plans. With the expected reform of the personal income tax and property tax as well as the tax information exchange initiatives that China is contemplating with other tax jurisdictions, it is imperative to strengthen the taxpayer identification system for individuals. This will require arrangements for introducing a nationally standardized identifier for self-employed persons (including individual industrial and commercial households), identifying and eliminating duplicate identification numbers for natural persons, and developing a centralized taxpayer register for individuals. These arrangements could usefully begin with high-wealth individuals—due to their extensive cross-provincial and international dealings—and gradually expanded to additional categories of individual taxpayers.

Taxpayer services

Consistent with the government’s objective of reducing taxpayers’ compliance costs and promoting the business climate, the SAT has launched its “Spring Breeze Project”. This initiative has been designed to streamline frontline tax administration procedures, delegate decision-making authority to lower levels in the organization, and improve services for taxpayers—all with a view toward making it easier, faster, and cheaper for taxpayers to fulfill their tax obligations. In implementing the project, further gains in service delivery could be achieved by the following:

- Benchmarking the SAT service offerings against those of leading tax agencies. Here, leading tax agencies have achieved substantial benefits by expanding the types of queries that can be handled by the telephone contact centers, making greater use of email and text messaging in taxpayer service delivery, introducing online applications (such as electronic registration, request to pay a tax debt in installments), and creating individualized taxpayer portals that allow businesses and individuals to have access to and self-manage their personal tax information and history.⁵¹
- Migrating taxpayer assistance from relatively costly and burdensome in-person visits at tax offices to (less costly and more convenient) use of call centers and websites. This would require enhancing the range of online and phone services provided by the SAT as described above. Adopting a more centralized approach to service delivery would allow the SAT to achieve potentially large gains in administrative efficiency

⁵¹ Refer to OECD 2010 for relevant benchmarks.

by reducing the large number of small tax offices whose main function is to provide basic services to taxpayers.

- Preparing taxpayers for the anticipated changes to the business, individual income, and property taxes. The latter two reforms will add to the tax rolls large numbers of new taxpayers many of whom have little previous experience in paying taxes. A dedicated taxpayer services program will be needed to help these new taxpayers to understand and fulfill their new tax obligations.

Filing and payment

As mentioned in Section II, the SAT has made good progress in reducing the time and effort in complying with the tax laws. Nevertheless, Chinese businesses still spend more time on tax matters than those in some regional competitor countries and far more time than in leading tax agencies. To promote the investment climate, additional measures are needed to further reduce these costs.

One important area for reducing compliance costs involves the VAT. As noted in Section IV.A, the VAT is estimated to account for about 40 percent of business tax compliance costs. The high costs occur because the VAT administration in China requires more documentation, more reporting, more steps in the process, and more involvement of tax officers than in most other countries.

A number of actions could be taken to reduce these high compliance costs. A large amount of paperwork could be eliminated by simplifying the VAT return and its data requirements.⁵² Further cost reductions could be achieved by better aligning the SAT's rules with commercial practices on the timing for crediting VAT paid on inputs.⁵³ Perhaps the biggest gains could be made through technological improvements to the VAT computer system as described in Section V.H. In these and other areas, the SAT would benefit from consulting and co-designing the reforms with key external stakeholders, including industry associations, tax professionals bodies, and software vendors.

⁵² For example, Chinese taxpayers may need to file up to two VAT returns (the main return and export refund Return) and more than 10 appendices with up to 800 data fields every month—which imposes far greater compliance costs than most other VAT countries, including China's regional competitors.

See Ernst and Young (undated) for a further description of the complexities of China's VAT and opportunities for reducing compliance costs.

⁵³ Under current arrangements, a taxpayer is not able to claim an input VAT credit unless it has actually received the VAT paper invoice and has had the invoice formally verified by the tax authorities. Hence, an unverified input VAT invoice cannot be credited on a taxpayer's VAT tax return even though it has most likely been booked in the taxpayer's accounting system. This disconnect in timing between a taxpayer's accounting system and the SAT's VAT system results in large variances that require businesses to undertake substantial manual interventions to adjust (Ernst and Young, undated).

A second promising area for compliance cost reduction is to further simplify the taxation of very small (micro) businesses. While the personal income tax law currently includes a simplified lump-sum payment regime for small businesses, many of its cost-reducing benefits have been eroded by requiring each small business to prepare an annual statement that the tax authorities use to determine the value of the lump-sum payments. This requirement adds substantially to the compliance costs of small businesses (who must prepare the annual statements) and the tax authorities (who must process large numbers of statements in setting the lump-sum assessment). These costs far outweigh the trivial amount of tax revenue these small businesses pay—both individually and collectively—and thereby undermine the very purpose of a simplified regime.

To reduce the costs of the lump-sum regime, all micro-businesses could be subject to the same lump-sum payment regardless of their actual amount of sales or industry. This arrangement would eliminate the need for these businesses to file an annual statement and tax authorities to process the statements. Eligibility for the regime would be limited to very small businesses with sales below some very low threshold. Under this regime, the lump-sum payment(s) could be linked to and made a requirement for the issuance of an annual business license. While applying the same lump-sum tax to all micro taxpayers, as proposed here, would result in some inequities, this cost would be the price for greatly simplifying the system and, thereby, reducing its compliance and administrative costs.

As important as it is to reduce existing compliance costs, it is equally important to avoid increasing the cost of compliance from new reforms. This would be particularly important in reforming the personal income tax (PIT). Here, the SAT should seek to preserve, to the extent possible, the existing features of the PIT that help to minimize compliance costs for taxpayers and administrative costs for the SAT. These include maximizing the withholding of tax at source, minimizing the number of persons who are required to file tax returns, limiting deductions to those that can be easily incorporated into the withholding regime, and avoiding the introduction of expenditure-based tax allowances (e.g., allowances based on the amount of mortgage payments, educational expenditures, and charitable contributions).

Audit

To date, the SAT has relied heavily on cross-matching tax invoices between sellers and purchasers as the main vehicle for identifying and dealing with noncompliance.⁵⁴ While invoice cross-matching appears to have helped bring under control the previous rampant incidence of fraudulent VAT invoices, it has been far less successful at mitigating other

⁵⁴As described in section II.F.

forms of underreporting that have plagued the VAT.⁵⁵ Nor will the cross-matching of VAT invoices, by itself, mitigate underreporting of tax due for other taxes such as the corporate and personal income tax.

Reducing tax underreporting and safeguarding revenue will require the SAT to considerably strengthen its audit program beyond cross-checking invoices. Priority areas for enhancing audit capacity should include:

- **Making greater use of analytical methods.** The growing amount of data that is becoming available to the SAT—and the additional amounts of third party information that may become available with the planned amendments to the Tax Collection Law—provides a rich repository of information for developing analytical methods to detect emerging compliance risks and the taxpayers who pose such risks.
- **Improving basic audit methods.** This will require auditors to be trained in and provided tools to examine the entire operations of a business, identify material issues and inconsistencies in the taxpayer's accounts, and probe until these issues are resolved. As a starting point, the SAT should develop a nationally standardized audit manual setting out the methods for auditing each of the main tax types.
- **Adopting limited scope audits.** The SAT's audit program currently relies on comprehensive audits covering multiple taxes, tax periods, and tax issues. Broader audit coverage could be achieved by making greater use of limited scope audits covering one (or a few) taxes and tax issues.
- **Developing industry specialization.** Like in other countries, revenue risks in China differ across industries due to differences in their contributions to tax revenue, relevant provisions in the tax laws, and compliance patterns. For this reason, the SAT's audit program needs greater industry specialization, including by developing industry-specific audit technique guides and methods.
- **Introducing coordinated audits for large enterprises and high-wealth individuals.** Given their complex and increasingly national (and international) scope of operations, the SAT will need to adopt a coordinated, cross-provincial approach to auditing these two segments. It will also require the SAT to strengthen its

⁵⁵ Examples include failing to charge VAT on final sales to consumers, failing to submit VAT tax returns and pay VAT despite issuing VAT invoices, improperly classifying a taxable transaction as exempt, improperly charging VAT at a lower rate, sham invoices for transactions that have not taken place (including sham invoices issued by bankrupt companies in collusion with taxpayers claiming credit on the basis of these invoices), incorrectly deducting VAT input tax from exempt sales, and structuring transactions to gain a tax advantage in a way that was not intended in the law (aggressive tax planning).

international compliance programs in relation to outbound investment by Chinese residents.

Arrears collection

International experience has demonstrated that tax arrears tend to increase, sometime sharply, in countries that experience a significant slowdown in economic growth. In such situations, tax agencies need sufficiently strong powers, on the one hand, to recover tax arrears and, on the other hand, provide those viable businesses with good compliance histories appropriate breathing space to pay their tax debts. With China's rapid economic growth slowing, it will be important to strengthen the SAT's arrears collection powers and the administrative procedures for applying these powers.

In this context, the planned amendments to the Tax Collection Law are crucial. These are expected to vest the SAT with the authority to allow taxpayers to pay their tax arrears over an extended period of time and to impose a tax lien on a tax debtor's real property. In addition, the TCL should authorize the SAT to issue a default assessment against those taxpayers who fail to file a tax return. Key issues in each of these areas include the following:

- **Installment arrangements.** The draft amendments to the TCL would extend the period taxpayers could pay tax arrears from three monthly installments (under the current law) to 12 monthly installments. Implementing this new provision would require the SAT to (1) develop administrative policy on the terms and conditions for granting an installment arrangement and design the administrative guidance for applying the policy, (2) prescribe the type of information that a taxpayer must provide to the SAT to support a request for an installment arrangement, (3) train collection officers in evaluating requests for an installment arrangement,⁵⁶ and (4) set the level of management approval required to accept an installment request.
- **Tax liens.** A lien is a legal encumbrance on an asset owned by a tax debtor that allows for the recovery of monies if the asset is disposed of. The lien is also a necessary legal step before an asset can be seized and sold to satisfy a debt. Implementing this provision would require the SAT to: (1) develop administrative policy and guidance on when and how a tax lien may be imposed (and removed), including whether the lien may be imposed on an administrative basis or must first require certification of the debt by a court; (2) determine the types of property that may be subject to the lien; (3) train collection officers in identifying and locating properties on which the lien may be imposed, and the procedures for imposing (and removing) the lien; (4) determine the notification procedures and forms for imposing

⁵⁶ The evaluation should include an *ability to pay analysis*, which is a detailed assessment of the taxpayer's current and future capacity to pay or borrow funds based in part on the financial statement prepared by the taxpayer.

a lien; and (5) decide the level of management approval required before a lien may be imposed.

- **Default assessments.** When a taxpayer fails to file a tax return many tax agencies are authorized to use any reasonable method for determining the amount of tax owed by the taxpayer. In doing so, some tax agencies are allowed to use a previous period's tax liability (plus an uplift factor) to establish the tax liability for the current tax period. Such a *default assessment* has the advantage of more quickly establishing the tax liability and thereby accelerating its collection than by auditing the taxpayer. Moreover, the issuance of a default assessment does not prevent the tax agency from eventually auditing a delinquent taxpayer if it is believed that the actual tax liability could exceed the default assessment.

Dispute resolution

A well-designed system for minimizing disputes between taxpayers and the tax authorities, and for resolving disputes when they arise, is an essential element of an effective tax administration. Such a system can help promote the business climate by reducing taxpayers' compliance costs in their dealings with the tax agency. To this end, a number of measures could be considered for improving the dispute resolution system:

- As a first step, the SAT could reduce the potential for tax disputes by converting more of its informal guidance into formal regulations and providing greater detail in the regulations. Traditionally, the SAT has been lower than average issuer of formal regulations compared to other ministries and agencies (Cui, forthcoming). By publishing more regulations—following public consultation—with greater detail the SAT could provide both taxpayers and tax officers with a clearer and more reliable basis for applying the tax laws, thereby promoting the rule of law and reducing the scope for disputes.
- The draft amendments to the Tax Collection Law provide for the establishment of a private advance ruling regime. Such a regime allows taxpayers to request from the SAT a written ruling on how the tax laws apply to a particular fact pattern described by the taxpayer. Experience in other administrations—and feedback from stakeholders within China—indicate that such a service would be very popular by providing taxpayers with greater certainty on the application of the tax laws prior to making an important investment decision. Implementing this provision will require the SAT to design administrative guidelines and procedures governing its application.
- No matter how clearly the tax regulations are publicized and how widely advance rulings are made available, disputes on the correct application of tax laws are inevitable. Therefore, ensuring the community's confidence in the fairness of the tax system requires, among other things, an administrative review mechanism that is

perceived to be fair and independent. This could be facilitated by creating within the SAT a network of administrative review units that report vertically to a higher level administrative review unit instead of to the head of a higher level tax bureau as is the existing arrangement.⁵⁷ Although the current statutory framework for administrative reviews, which applies to all ministries, may limit the opportunities for reform in this area, the SAT may have scope to pilot in a few locations a quasi-independent review organ along the lines described here.

G. Strengthening Human Resources and Information Technology

Human resources

Earlier human resource management (HRM) reforms equipped tax officers with the skills required to deal with the most pressing challenges to the tax system in previous periods. Addressing the emerging challenges to the tax system will require further HRM reforms. To this end, the SAT needs to formulate a comprehensive human resources management strategy to right-size the workforce, enhance staff skills, and improve the incentives for staff to achieve high levels of productivity and ethical behavior.

Right-sizing the workforce entails ensuring sufficient numbers of staff are allocated to the different levels of the organization and across administrative functions. One priority in this area should be to increase the size of the headquarters' staff. With only 800 officials, headquarters is far too small to effectively carry out its functions—including designing national policies and programs, monitoring the operations of the tax offices, and providing guidance to the tax offices—in an organization comprising some 750,000 tax officers spread across 30 provinces.

Another right-sizing priority is to ensure sufficient numbers of tax officers are allocated to each tax administration function. Here, the SAT could usefully benchmark its staff allocation against the norms in other tax jurisdictions. In this connection, OECD tax agencies allocate on average 36 percent of their staff to verification activities (including audit), 27 percent to account management (including taxpayer services), 11 percent to tax arrears collection, 9 percent to other tax operations, and 17 percent to support and other activities (including 3 percent to human resources management).⁵⁸ Notwithstanding some of China's unique features, the SAT's staff allocation would not be expected to diverge too sharply from the

⁵⁷ Administrative reviews are currently heard by an administrative review organ at one level within the SAT organization above that where the dispute has arisen. Although this arrangement provides some degree of independence, it still creates a perception of bias in favor of the tax authorities since the administrative review organ reports to the head of a (higher level) tax bureau who has an interest in achieving a collection target and thereby in sustaining lower level decisions, particularly in those cases involving substantial amounts of tax revenue.

⁵⁸ See the OECD report *Tax Administration 2015 Comparative Information on OECD and Other Advanced and Emerging Economies* (2015)

international averages. Where it does, the SAT should carefully analyze the factors accounting for the divergence to determine whether they are justified or require correction.

Concerning staff skills, the SAT needs a strategy for identifying and prioritizing those areas for skills and knowledge enhancement. Such a strategy should begin with an evaluation of current skills levels against future requirements and then provide a plan for filling identified gaps. This approach is needed not only to enhance the capacity of SAT staff at dealing with current challenges, but also to prepare staff for implementing key reforms in the SAT's modernization strategy.

In implementing its skills enhancement program, SAT headquarters should play a greater role in establishing the training priorities and standardizing course curricula, which in the past the provincial training academies have been given wide discretion. In delivering training, the SAT could usefully exploit modern training technologies—including e-learning—to extend training opportunities to more staff.

In addition to right-sizing and enhancing the skills of its workforce, the SAT's HRM reforms also need to strengthen its performance management policies. Here, the SAT's recent *Digital HR* initiative holds great promise. Under this pilot project, organizational units and individual staff members are now evaluated on the basis of a broader set of performance measures than just the revenue target as described in Section V.H. To create incentives for staff to achieve greater productivity and more integrity, the new performance evaluation system needs to be linked more closely to remuneration increases and promotions, and the pilot project should be implemented throughout the SAT.

Information technology

As described in Section III.F, the SAT has made impressive progress over the last 20 years in developing a standardized information system (China Tax Administration Information System) to support core tax administration functions and a specialized system (Golden Tax Project 1 and 2) to control VAT invoice fraud. Further information will need to be made to the SAT's information systems—including to its data stores, analytical tools, and technologies—in order to safeguard revenue and reduce compliance costs.

Although the China Tax Administration Information System has been deployed at all provincial and municipal levels, these subnational computer networks have not yet been tied together at the national level to create centralized databases of tax information.

Consequently, the SAT cannot easily compile the type of national data that is crucial for assessing the evaluating the performance of its operational programs and field offices, conducting data mining and risk analysis, and tracking taxpayers' activities across provinces and with related entities. To address these shortcomings, it will be essential for the SAT to create a national data center (or centers) of tax-related information as envisaged in the

Golden Tax Project 3 which is to replace the China Tax Administration Information System, as described earlier.

In creating a national data center, the SAT will need to take decisions on a wide range of technological and non-technological issues. These include the number of data centers and their geographic and organizational placement, the types of hardware and software to acquire, the types of information to be collected, and the applications for processing the information and using it to detect noncompliance. Two prerequisites for data centers are the existence of a national taxpayer identification numbering system and robust legal authorities for the SAT to collect third party information, both of which were described earlier.

Other information technology challenges concern the SAT's specialized system for VAT administration. As mentioned in Section III, this system has been designed to certify and cross-match invoices between purchasers and sellers to detect fraudulent invoices. Although the SAT views the VAT system as having contributed significantly to the increases in VAT collections, it should also be recognized that the system imposes very high compliance costs on taxpayers. In addition to simplifying the information reporting requirements of the VAT return itself, two technological improvements could help reduce the VAT's compliance costs.

First, the VAT system software should be designed to automatically extract the VAT information required by the SAT from companies' internal accounting systems. As it stands now, businesses spend substantial time and resources in printing invoices, manually extracting information from their internal systems, and transmitting/receiving transactions level data with the SAT. The costs associated with these tasks could be eliminated or, at least, greatly reduced by better aligning the SAT's computer systems to the accounting systems used by businesses. This points to the importance of the SAT working in closer cooperation with other stakeholders—including tax professionals' bodies, industry associations and software vendors—in developing new versions of the VAT software.

Second, steps should be taken to facilitate the introduction of electronic invoicing (e-invoicing). International experience has shown that e-invoicing not only has the potential to substantially reduce businesses' compliance costs with the tax system but also to expedite commercial transactions and increase business competitiveness (Toro, 2007). At this time, the SAT is at an early stage in deploying an e-invoicing system. To move this initiative forward, the authorities will need to establish a legal mechanism for authenticating electronic invoices (i.e., an electronic signature) as well as establish a robust technological platform to operate the system. Such a platform will require major investments in software development and hardware, including high-speed Internet connection, wide area communication networks with high transmission capacity, and robust applications and database servers. As in the case of the VAT system software, the SAT could achieve many benefits by developing the e-invoicing system in close cooperation with external stakeholders in the tax system.

H. Building a Modern Performance Measurement System

Traditionally, the SAT has relied on the annual tax collection target as a key measure for evaluating the performance of its tax offices. This measure has had the advantages of the close link to the government's key fiscal objectives (mobilizing tax revenue) and its relative ease of measurement.

Despite its advantages, over-reliance on the collection target for measuring performance can have significant (negative) unintended consequences by creating perverse incentives for tax officers to take inappropriate actions to achieve their target.⁵⁹ Not only does this risk undermining taxpayers' confidence in the fairness and integrity of the tax system, but it can also have a negative impact on the economy by interfering with the operation of automatic stabilizers. That is, when the economy slows down and, as a consequence, tax receipts fall behind the collection target, tax officers will tend to intensify their actions to achieve the target. Such actions could put further pressure on businesses and worsen an economic downturn.

For this reason, the SAT should adopt a more balanced set of measures than the tax collection target for evaluating the performance of its tax offices. These measures could include targets for: (1) tax administration results (with quantitative and quality measures for each tax administration function), (2) taxpayer satisfaction (typically measured by independent surveys), and, (3) tax officer engagement (also commonly measured by a survey). The targets can be set at the organizational level (provinces, municipalities, districts, and so on) and then cascaded down to managers and tax officers as part of their individual performance evaluation.

Given its long history and well-entrenched use, the tax collection target is likely to remain a key performance measure for the SAT. To lessen its disadvantages, it would be important to supplement the collection target with a broader set of measures as described above. This would be facilitated by the nation-wide deployment of the Golden Tax Project 3 computer system—which will give the SAT the capacity to compile national data on key tax administration operations—and the national implementation of the *Digital HR* pilot project as described earlier in this section.

⁵⁹ For example, by encouraging auditors to issue inflated audit assessments when tax collections are falling behind the target or encouraging taxpayers to incur tax arrears in current periods (which can be paid in subsequent periods) when collections are exceeding targets.

VI. CONCLUSIONS

China's tax administration has reached an important juncture. Over the past 20 years, the SAT has successfully transformed its operations to administer a new tax system in an increasingly market-oriented economy. As China embarks on its 13th Five-Year Plan, the SAT once again needs to adapt itself to deal with a new and challenging environment.

The SAT's capacity to mobilize tax revenue is facing growing challenges. The slowdown and structural changes in the economy are reducing the growth of China's tax bases and creating incentives (and new opportunities) for tax avoidance and evasion. Further revenue pressure can be expected as Chinese businesses and individuals increase their overseas investments, creating additional scope for noncompliance.

In addition to safeguarding revenue, the slowing economy makes it more important than ever for the SAT to help promote the business climate by reducing business compliance costs. It also heightens the importance of creating a more even playing field across sectors and locations through more uniform tax administration.

While addressing the mounting challenges to the existing tax system, at the same time the SAT will need to implement the government's ambitious tax reform agenda. This will require a major effort to train tax officers and educate taxpayers in applying the changes to the tax laws.

The above-mentioned challenges create a new and complex environment for tax administration much like the situation that the SAT confronted in the early 1990s. This will require the SAT will need to implement a comprehensive modernization strategy just as it did 20 years ago. Key reforms priorities could include:

- The Tax Collection Law needs to be amended to expand the SAT's enforcement authorities and enhance taxpayers' protections. Enforcement authorities should expand the SAT's to access tax-related information from third parties and to recover tax arrears. Taxpayer protections should be enhanced by strengthening the confidentiality of taxpayer information, providing greater procedural protections to taxpayers, introducing an advance rulings regime, and eliminating the current requirement for taxpayers to pay 100 percent of a tax assessment before filing an administrative review.
- The SAT's organizational structure should be aligned with and supportive of its modernization strategy. This would entail increasing the size of headquarters, eliminating the current fragmentation of administrative responsibilities across different departments, consolidating the large network of grassroots tax offices, strengthening the organizational arrangements for large taxpayers and high-wealth

individuals, and creating a more independent administrative review organ within the SAT.

- Comprehensive compliance risk management strategies should be developed—for each major tax, taxpayer segment, and individual taxpayers—to identify, rank, and mitigate the main risks to the tax system. These should give priority to mitigating the compliance risks associated with large businesses and high-wealth individuals, the growth of the services sector (including electronic commerce), international tax issues, and increasing tax arrears that could result from the slowing economy.
- Core tax administration processes need to be strengthened and standardized. The SAT’s audit and arrears collection programs require strengthening while the information reporting requirements for the value-added tax and the tax assessment procedures for micro businesses should be simplified. In addition, a system needs to be established for monitoring tax offices’ adherence to the new national standards for the core administrative processes.
- The SAT’s computer systems need to be both strengthened and made easier for taxpayers to use. Priority areas for strengthening include creating nationally centralized databases of taxpayer-information (beginning with large enterprise groups and high-wealth individuals) and exchanging data with third parties. Simplifying ease of use should focus on reducing business compliance costs of the value-added tax computer system.
- In the human resources area, key priorities should be to substantially increase the number of staff assigned to headquarters, ensure that appropriate numbers of staff are allocated to each tax administration function, align the SAT’s training programs with the requirements of its modernization strategy, and introduce human resource management policies that create incentives for staff to achieve higher productivity and greater integrity.

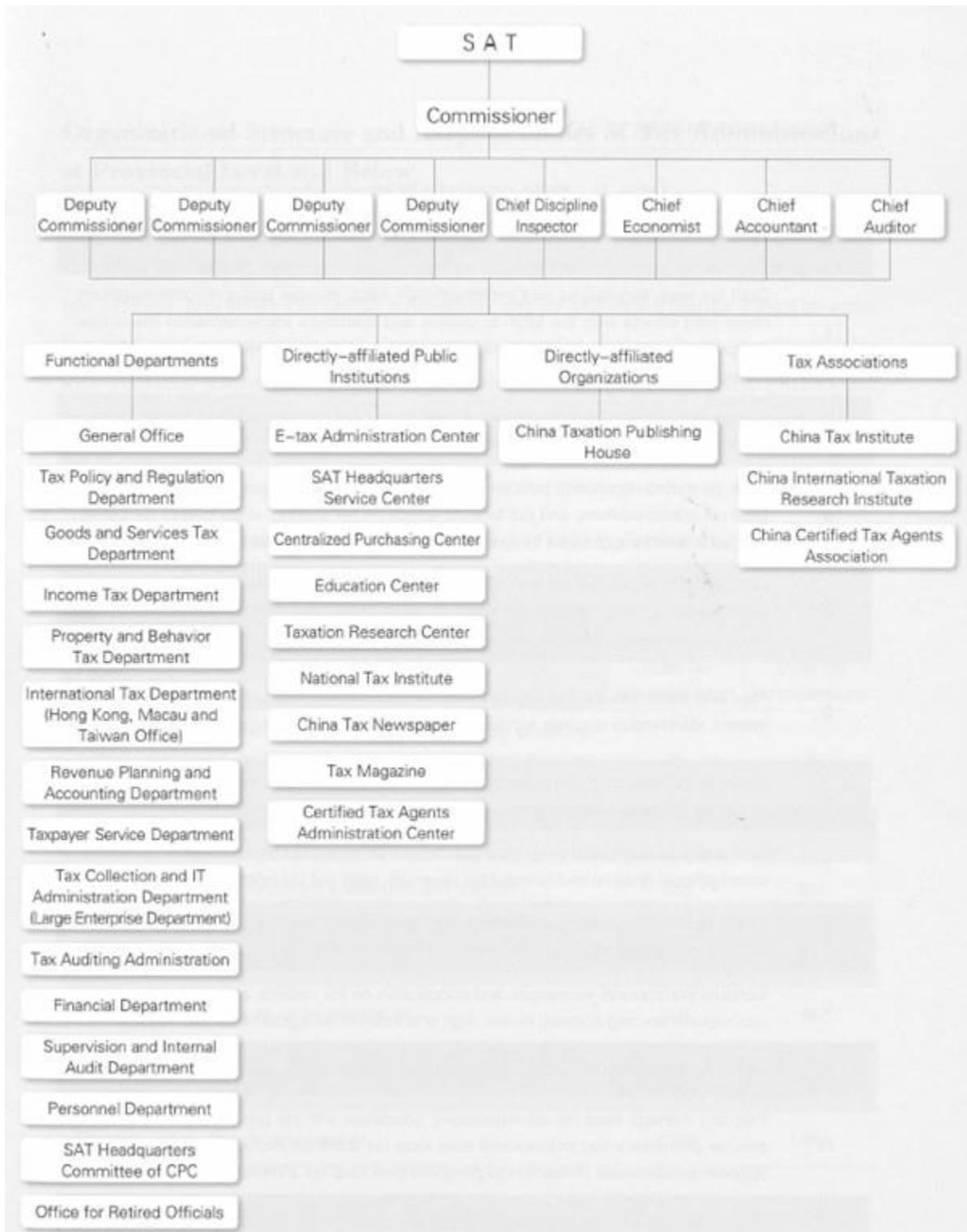
The initiatives suggested above represent an ambitious reform agenda that needs to be carefully managed. In doing so, the SAT can draw upon the lessons it has learned in reform management over the past two decades. These confirm the following good practices:

- Strong and stable leadership is crucial to medium-term institution building. The stability in the SAT’s leadership has facilitated business continuity, coherence of direction, and effective reform management. These advantages need to be preserved.
- In designing new tax legislation, due consideration needs to be given to the SAT’s administrative capacity and taxpayers’ compliance abilities. The planned amendments to the personal income tax, for example, should minimize the number of taxpayers

required to file tax returns, maximize the withholding of tax at source, and limit deductions to those that can be easily incorporated into the withholding regime.

- Implementing major tax administration reforms requires sustained efforts over a prolonged period. Such efforts are best guided by a medium-term strategic plan that clearly sets out the reforms' goals and objectives, key initiatives, broad timetable, and measures of success.
- Piloting major reforms prior to their national implementation has been an integral part of the SAT's reform management. This approach has provided the SAT with many benefits—including minimizing risk, developing consensus, and providing opportunities for learning-by-doing—and should be continued.
- The SAT has benefitted substantially from technical cooperation with other tax agencies and international institutions. While international practices can provide useful reference points for reform, they need to be adjusted to the local conditions in China and implemented with these conditions in mind.

Appendix 1. State Administration of Taxation Headquarters Organizational Structure



Appendix 2. Illustrative Compliance Management Strategy for Small Businesses

<p>1. Strategy Overview:</p>	<p>To support business development and encourage voluntary compliance, small businesses will be provided better access to professional services and bookkeeping tools. Strategies for this segment are guided by risk profiling and rely on strengthening intelligence. Risk treatments are designed to be preventative, low cost, and project based.</p>																			
<p>2. Segment Profile</p>	<p>3. Priority Risks (high, medium, low)</p>	<p>4. Risk Treatments</p>																		
<p>2.1 Definition Businesses with sales below the VAT registration threshold, excluding those eligible for the patent or benchmark regime</p> <p>2.2 Amount/type of tax revenue:</p> <table border="1" data-bbox="88 516 478 792"> <thead> <tr> <th>Tax Type</th> <th>Revenue (billions)</th> </tr> </thead> <tbody> <tr> <td>PIT</td> <td>27.52</td> </tr> <tr> <td>CIT</td> <td>5.24</td> </tr> <tr> <td>VAT</td> <td>7.43</td> </tr> <tr> <td>ROY</td> <td>0.12</td> </tr> <tr> <td>EXC</td> <td>0.014</td> </tr> <tr> <td>WHT</td> <td>5.73</td> </tr> <tr> <td>Other</td> <td>7.12</td> </tr> <tr> <td>Total</td> <td>53.17</td> </tr> </tbody> </table> <p>Revenue from this segment represents about 1.9% of total tax collections</p> <p>2.3 Number/type of taxpayers: Mostly sole traders, limited liability companies and partnerships. Around 50,000 legal entities; almost 150,000 Sole Traders, with varying levels of business/financial skills.</p> <p>2.4 Number/type of tax returns: SB have multiple tax obligations and entities are required to file quarterly. Most do not require audit certification.</p> <p>2.5 Key industries: : Wholesale & retail, Construction, Manufacturing, and Professional services.</p>	Tax Type	Revenue (billions)	PIT	27.52	CIT	5.24	VAT	7.43	ROY	0.12	EXC	0.014	WHT	5.73	Other	7.12	Total	53.17	<p>3.1 Registration risk: Medium Some are unregistered others not registered for all Taxes.</p> <p>3.2 Filing risk: Medium SBs are prone to drop out of the system due to complexity or cash flow problems. Some drop out because of competition from unregistered businesses.</p> <p>3.3 Under reporting risk: Medium Both deliberate and inadvertent underreporting occurs. Low business acumen results in errors and the informal economy sees deliberate omissions.</p> <p>3.4 Payment risk: Medium Cash flow pressures are prevalent and payment default is common. Almost 80% of arrears cases are small, representing only about 5% of debt by value.</p>	<p>4.1 Measures for facilitating compliance Simplified registration, filing and payment processes to reduce errors. New business assistance program (“Right from the Start” approach). Easily accessible MTA advice tailored to the needs of SBs and delivered through multiple channels. Improved accessibility to professional advice in partnership with SME Incubators Free electronic and paper-based bookkeeping tools Early intervention calls, visits and letters to prevent errors from occurring. Closer working relationships with State Registration Department.</p> <p>4.2 Measures for dealing with noncompliance Comprehensive audits for highest risk cases. Hidden economy campaign. Limited scope risk based audits. Use of small business benchmarks for prevention and detection. Income verification program. Outbound telephone calls for small arrears cases. Voluntary disclosure initiative with concessional penalty imposition.</p> <p>4.3 Measures for simplifying tax policy design Small Businesses will be taxed under a simplified regime (based on turnover or cash-flow) with simple tax returns & no requirement to submit financial statements</p>
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	<p>5. Compliance Indicators</p> <p>Registration: % increase in registration % Reduction in lost registrants</p> <p>Filing: % increase in on time filing</p> <p>Reporting: % increase in audit strike rates % of audit acts sustained on dispute</p> <p>Payment: % reduction in arrears % increase in collections of Audit Acts</p>	<p>6. Workflows</p> <table border="0"> <tr> <td>Number of:</td> <td>Number of:</td> </tr> <tr> <td> <ul style="list-style-type: none"> Assistance products Voluntary Disclosures Registration Checks Outbound calls Pre-filing letters </td> <td> <ul style="list-style-type: none"> Advisory Visits Limited Scope Audits Comprehensive Audits Debt Collection Actions </td> </tr> </table>	Number of:	Number of:	<ul style="list-style-type: none"> Assistance products Voluntary Disclosures Registration Checks Outbound calls Pre-filing letters 	<ul style="list-style-type: none"> Advisory Visits Limited Scope Audits Comprehensive Audits Debt Collection Actions 														
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<p>7. Capacity Development</p>	<p>Information Systems, Data Management & Analytics Fully implement self-assessment and optimize e-tax. Streamline registration, filing and payment processes. Ensure Risk Management supports compliance strategy (rather than driving them). Staff Development General and functional management, Technical, Industry specialization, Service and Communication skills training.</p> <p>Administrative Tools and Procedures Develop Channel management strategy, optimize call center and web services. Design a new business program. Build alliances with the Tax Profession and other agencies servicing SB. Management and Organization Integrate compliance strategies into operational plans. Appoint a senior headquarters official to oversee development of small business compliance strategy.</p>																			

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