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China: The 3rd resolution and common prosperity

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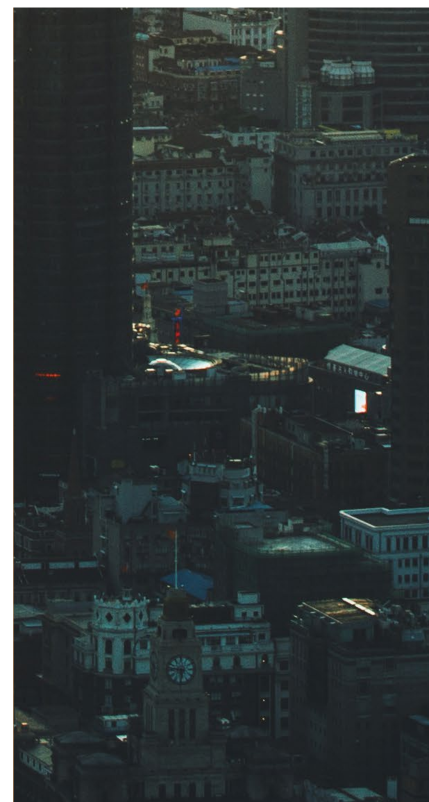


Part I

The 3rd resolution

Q1: On 16 November 2021, China officially published the Resolution of the CPC Central Committee on the Major Achievements and Historical Experience of the Party over the Past Century.[1] This is the 3rd resolution, following the first one in 1945 and the second in 1981. What's your summary of this important document?

Our key findings are as follows:

1. **Rewriting the CPC's mission.** The world probably needs to adjust its understanding for what CPC stands for: CPC may no longer be equated with communism. The 3rd resolution only mentions "communist ideals" twice (i.e., not as the main mission). To some extent, communism becomes more a flag rather than the mission of the CPC. In comparison, communism appeared 7 times in the 2nd resolution in 1981, where communism was described as the ultimate target / mission of the CPC.

   What's the CPC's mission now? Rejuvenation for the Chinese nation. The term rejuvenation appears 32 times in the 3rd resolution but did not exist in the 2nd resolution in 1981.

2. **Stability.** History is history. It cannot be a burden for today. The 3rd resolution is fully consistent with the CPC's position on historical key events, as illustrated in the 1st and 2nd resolution.

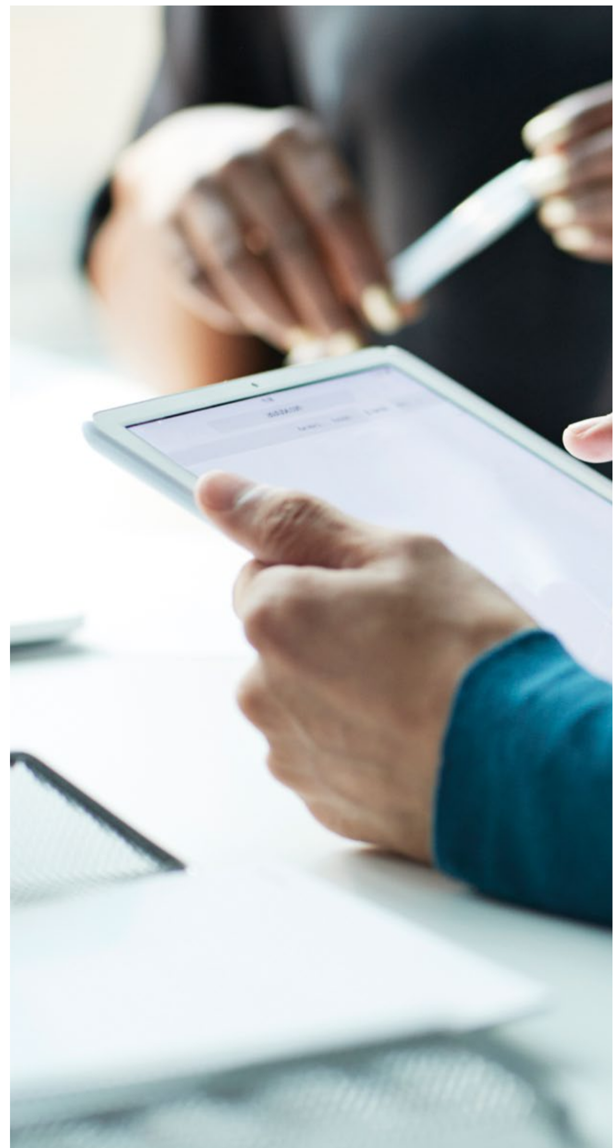
3. **Forward-looking.** The 3rd resolution is focusing on the future rather than history. The length of the respective chapters makes it obvious. The 3rd resolution uses 9,697 words to illustrate the pre-Xi Era (1919–2012) but has 19,249 words to describe the Xi Era (after 2012). Instead of a historic resolution, it's more like a bluebook or workpaper of the CPC to outline the vision and actions for the next decades.

   The 3rd resolution establishes a two-stage strategic plan: In the first stage, from 2020 to 2035, the socialist modernisation is basically realised; in the second stage, from 2035 to the middle of this century, China will be developed into a great modern socialist country.

4. **Opening-up will continue.** Opening-up appears 59 times in the 3rd resolution. China will continue its opening-up policy.

5. **Common prosperity.** Common prosperity appears 5 times in the 3rd resolution. We will illustrate this further below.

6. **Age is not a problem.** The 3rd resolution states "The Party has opposed the selection of officials solely on the basis of votes, assessment scores, GDP growth rates, or age, or through open popularity contests." We consider that this will have profound impacts on the CPC's human capital policy.



[1] A full text in English can be found on: http://www.news.cn/english/2021-11/16/c_1310314611.htm

Common prosperity and 3rd distribution

Q2: What's common prosperity? How is it related to "3rd distribution"?

The 3rd distribution became a recent key word. It is considered as the main way to achieve common prosperity.

3rd distribution was proposed by Li Yining, an economist and honorary dean of Guanghua School of Management, Peking University, in his 1994 book Shareholding System and Modern Market Economy.

Prof Li Yining has been a leading voice for the privatisation of state-owned companies, and his advocacy led to the establishment of China's stock markets in 1990. Nicknamed "Mr. Stock Market", he is credited with providing the theoretical basis for the market-oriented reform that has propelled China's economic growth.

- Primary distribution (1st distribution): based on efficiency function of the factors in production.
- Redistribution (2nd distribution): redistribution refers to the use of taxation (income taxes, gift and inherence tax) and fiscal expenditure by the government to redistribute wealth between different income entities through social security, public services and subsidies.
- The third distribution (3rd distribution): philanthropy by the wealthiest through charitable public welfare methods.

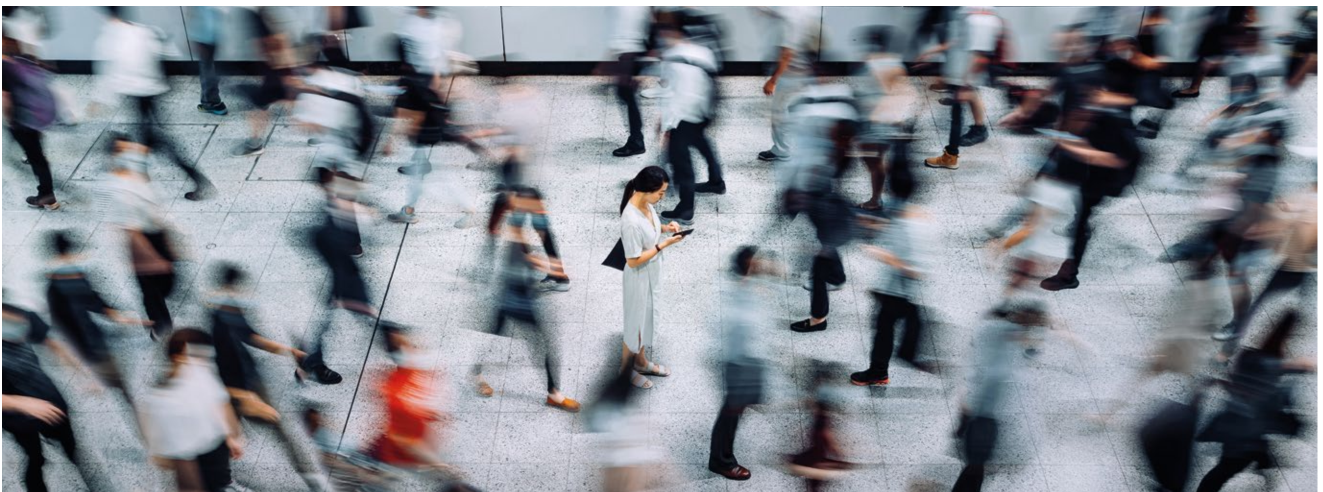
Apparently, the 3rd distribution comes after the 1st and 2nd distribution in terms of its importance and functions.

The 3rd distribution was endorsed by the Fourth Plenary Session of the 19th Central Committee of China Communist Party (CCP) in October 2019. In the communiqué titled "Decision of the Central Committee of the Communist Party of China on Several Major Issues Concerning Upholding and Improving the Socialist System with Chinese Characteristics, Promoting the Modernization of the National Governance System and Governance Capability", it was stated "…attach importance to the role of the 3rd distribution to develop charity and other social welfare undertakings".

The role of the 3rd distribution culminated on 17 August 2021, at the 10th meeting of the Central Committee for Financial and Economic Affairs chaired by President Xi Jinping who decided to promote "common prosperity". The highlights are:

- "Common prosperity is the essential requirement of socialism and an important feature of Chinese modernisation".
- "…adhere to the concept of people-centred development and promote common prosperity in the pursuit of high-quality development".
- "…build basic institutional arrangements for the coordination of primary distribution, redistribution, and the 3rd distribution, and increase the role of taxation, social security, transfer payments, etc.".

Thus conceptually, the 3rd distribution is positioned to achieve common prosperity.



Q3: What are the impacts of the 3rd distribution in practice?

A few Chinese tech giants have moved promptly by investing the following amounts to promote "common prosperity":

- Tencent: 100 billion yuan (approximately CHF 14.5 billion).
- Alibaba: 100 billion yuan (approximately CHF 14.5 billion).
- Xiaomi: Lei Jun, the founder of Xiaomi Technology, donated shares worth USD 2.2 billion (approximately CHF 2 billion) to charity.
- Meituan: Wang Xing transferred 57.3 million shares to the Wang Xing Foundation, which is dedicated to promoting public welfare undertakings such as education and scientific research. The Wangxing Foundation completed a charity donation of approximately 9.35 million shares (approximately HKD 2.9 billion or CHF 345 million).
- Pinduoduo: invested 10 billion yuan (approximately CHF 14.5 billion) to start the "10 billion agricultural research project".
- JC.COM: JD Logistics plans to drive a rural output value of 100 billion yuan (approximately CHF 14.5 billion) within three years and drive more farmers to achieve common prosperity.

Q4: Will real estate taxes be introduced to achieve "common prosperity"?

The short answer is no.

Firstly, tax is more likely a topic of the 2nd distribution. The 3rd distribution would not necessarily result in a tax reform. So far, there is no indication that the 3rd distribution would change the tax agenda.

Secondly, maintaining a tax friendly environment for foreign investors has been a key policy choice of the Chinese government. This is well indicated in the official CCP communiqué. On 24 March 2021, the General Office of the Central Committee of the Communist Party of China and the General Office of the State Council jointly issued the "Opinions on Further Deepening the Reform of Tax Collection and Administration". As mentioned in the preamble, its purpose is to "deepen the reform of 'decentralisation, management and service' in the tax field, create a market-oriented rule of law, and international business environment, and better serve the development of market participants".

Thirdly, in the past two decades, China has been the paradise for rich people not only because it provides massive business opportunities to make rich people even richer, but also offers preferential individual income tax regimes for rich people: investment income (dividends, interest, capital gains) is subject to a lower tax rate of 20 %, capital gains from sale of listed stock are tax free, there is no estate/gift tax, a lower tax may apply to the sale of real estate, there is no wealth tax thus holding real estate (even if such real estate is substantially appreciating in value) does not result in additional tax costs. Although China has a centralised and powerful government, imposing a new tax is never easy.

At its introduction, it was not the intention of real estate tax to achieve common prosperity:

- The initiative to levy a real estate tax can be traced back to 2006, as outlined in the Chinese government's 11th five-year plan. At that time, "common prosperity" was not on the political agenda yet. However, the real estate tax did not take off due to concerns that it may damage property demand and impact price levels, hurting household wealth and triggering a fiscal crisis for local governments relying on land sales to generate income. With Chinese President Xi Jinping's famous words "Houses are for living in, not for speculation" (first in 2016), China's government has accelerated its pace in implementing a real estate tax.
- Real estate taxes are about to take off, but very gently. On 23 October 2021, the Standing Committee of the National People's Congress issued a decision authorising the State Council to carry out a pilot project for a real estate tax reform over the next 5 years. This means that a nationwide real estate tax cannot be expected before 2026.
- The market will have 5 years to digest the impacts of a real estate tax, and the Chinese real estate market can expect a soft landing.

China gift and inheritance tax

Q5: Will China levy a gift and inheritance tax to achieve "common prosperity"?

China's gift and inheritance tax is still far away.

There have been some concerns in the market that China will levy gift and inheritance taxes. Recently, since China People's Daily and academia are associating the 3rd distribution with the Gilded Age, the expectation for an introduction of gift and inheritance taxes seems to increase. The estate tax was meant to discourage the wealthy dynasties and estates of the Gilded Age (Flickr/ Wally Gobetz). When the estate tax was instituted in 1916, the United States estate tax had multiple purposes that remain relevant today: 1) raise revenue from those with the greatest capacity to pay; 2) encourage charitable giving and dispersal of wealth; and 3) put a brake on the concentration of wealth and power, with its threat to democracy and social stability. In the aftermath of the First World War, the estate tax was viewed to pay down war debt and prevent wealthy dynasties.[2] These topics are very relevant in China.

In China, gift and inheritance taxes have been under discussion for 70 years. The concept was first proposed in 1950 but such taxes were never levied. There have been different voices regarding whether China shall impose inheritance and gift taxes. For instance, on 8 March 2021, Wang Kang, a representative of the National People's Congress, a member of the Finance and Economics Committee of the National People's Congress, and the chairman of the Chinese Taxation Society, was advocating to levy inheritance taxes to reduce the gap between the rich and the poor.[3]

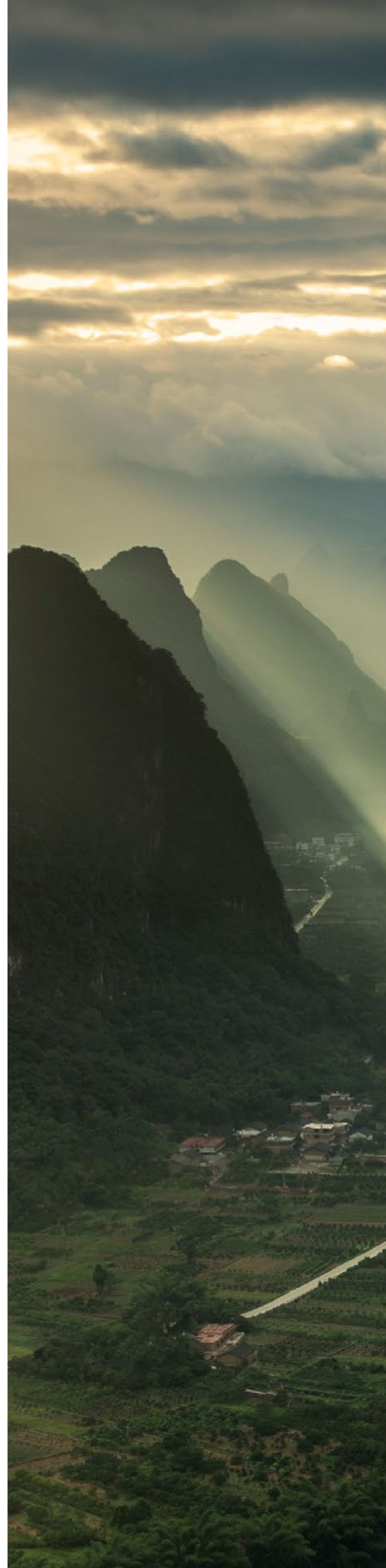
Our observation is: gift and inheritance taxes are not the priority of the tax reform in China. The likelihood that China introduces gift and inheritance taxes within the next five years is low. There are no indications that gift and inheritance taxes have been in legislation process so far.

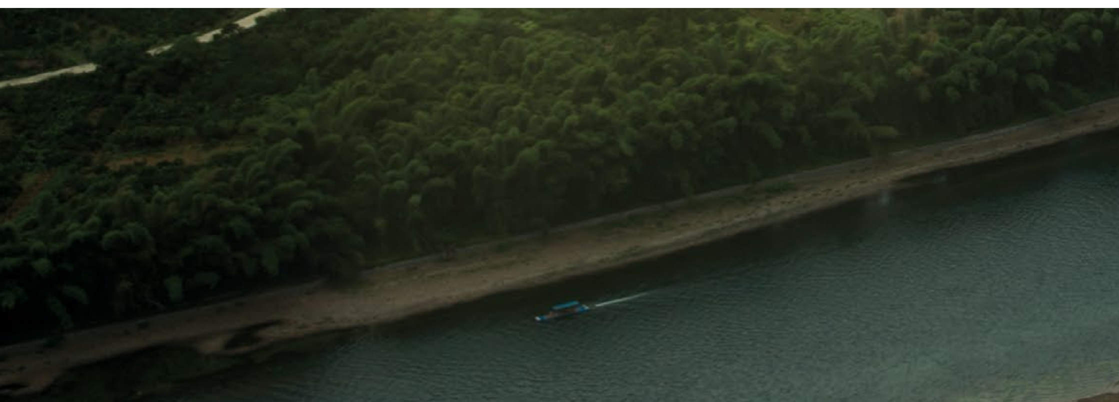
- Gift and inheritance taxes may be a signal to discourage the ongoing creation of wealth, which may have negative impacts on the Chinese economy that is facing demographic issues.
- Gift and inheritance taxes are a complex topic and difficult to levy. Furthermore, it seems that the tax revenue from such taxes is relatively low considering international benchmarks.
- Real estate tax has been prioritised as a better policy choice.

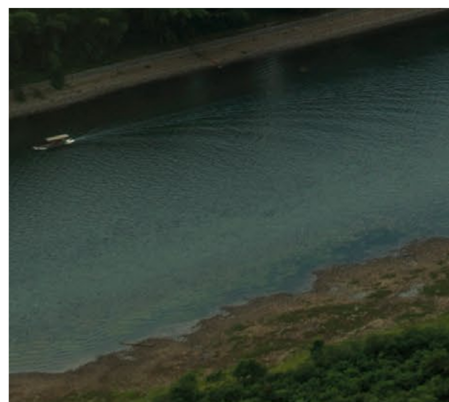
Gift and inheritance taxes may be a signal to discourage the ongoing creation of wealth, which may have negative impacts on the Chinese economy that is facing demographic issues.

[1] Chuck Collins, Fixing the estate tax could be the single most important intervention in reducing wealth dynasties in the U.S., April 15, 2014, https://ips-dc.org/fixing_expanding_the_estate_tax/

[2] https://finance.sina.cn/china/gncj/2021-03-08/detail-ikknscsh9320500.d.html (in Chinese).







Impacts on foreign investors

Q6: Recently, we have seen a lot of concerns regarding China's stock markets in the after-math of China's crack down of tech giants. Foreign investors are also concerned that "common prosperity" will have negative impacts on them. What is your view?

There are no indications that China's "common prosperity" has caught fire on foreign investors. In contrary, it's becoming clear that China is taking proactive measures to consistently attract foreign investment.

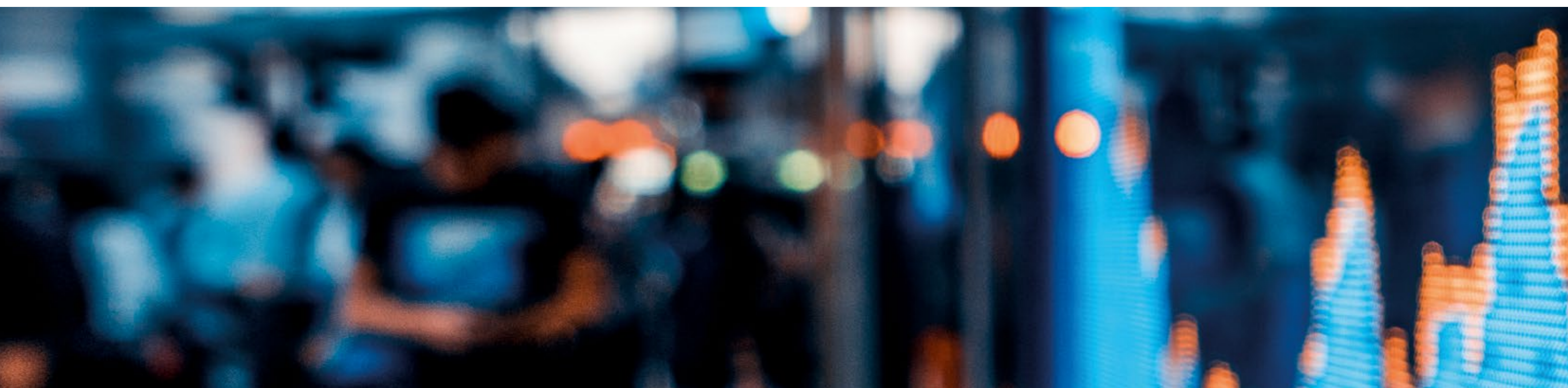
Firstly, as mentioned above, the term "opening-up" appears 59 times in the 3rd resolution. It is therefore to be expected that China will continue its opening-up policy.

Secondly, the new Foreign Investment Law ("FIL") came into effect on 1 January 2020. The FIL has opened a new chapter of attracting foreign investment to China. It presents significant opportunities for foreign investors by providing more flexibility on joint ventures and by streamlining the procedures to establish a new entity.

- The regulatory burden has been simplified. The FIL has adopted a "pre-access national treatment + negative list" approach. It provides for the same treatment of foreign investors and their investments as for the Chinese investors if it comes to accessing investment opportunities. For all investments in business fields that are not covered by the negative list, a foreign invested enterprise can be established and registered in the commercial register with no need of obtaining the approval from the Ministry of Commerce (MOFCOM) or its local counterparts. This has been a significant change and reduces the regulatory burdens.
- Additional industries will open for foreign investments and new opportunities will arise. Notably, the negative list has been shortened substantially in the recent years. Thus, it can be expected that more opportunities will arise for foreign investors.

The law also provides the following notable protection for the rights of foreign investors:

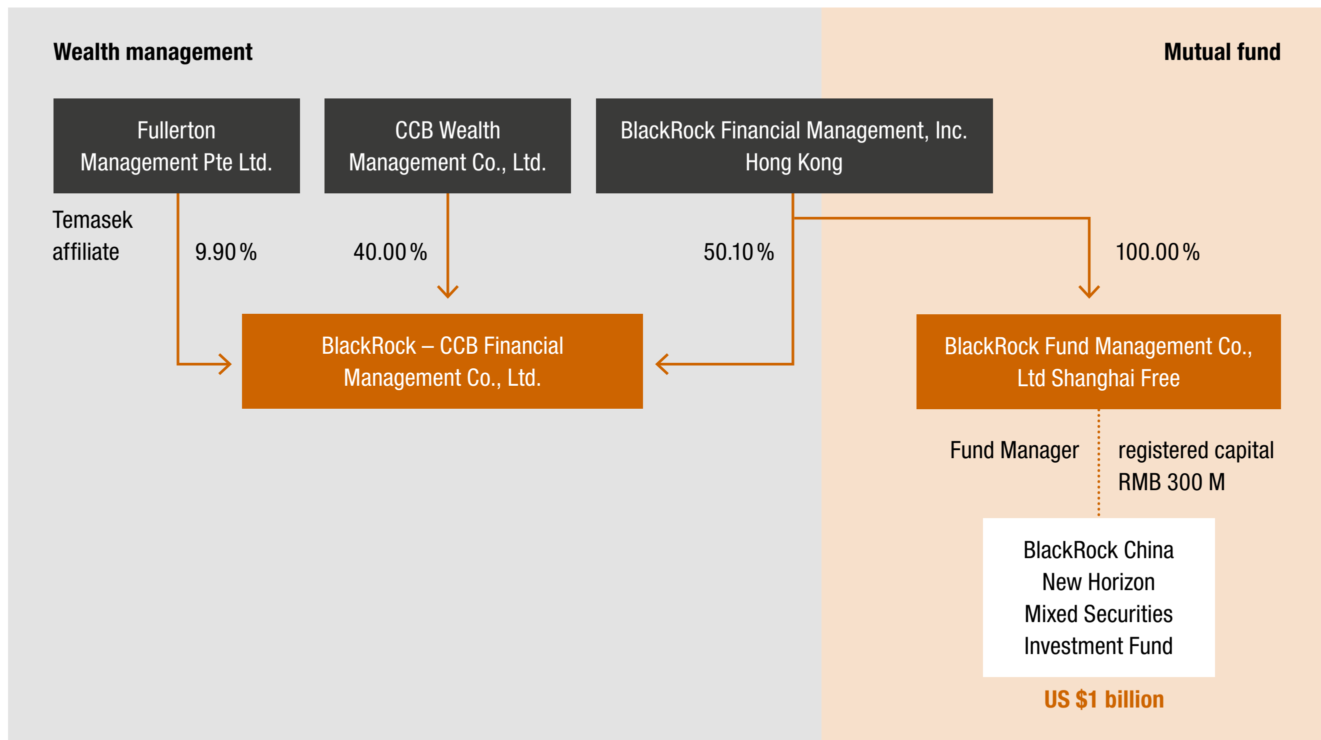
- Access to government procurement, given that the goods are produced, or services are provided within China.
- Participation in the process of standardisation for the industry.
- Intellectual property protection: The conditions for technical cooperation shall be determined through equal negotiation by all investors in accordance with the principle of fairness. It's prohibited to force the transfer of technology.
- Trade secret protection: To strengthen the protection of trade secrets of foreign investors and foreign-invested enterprises, the Chinese administration shall keep trade secrets of foreign investors and foreign-invested enterprises confidential.
- Financing: Foreign-invested enterprises can raise funds through an IPO, corporate bonds, other securities, etc.
- Freedom of capital repatriation: Foreign investors have the right to repatriate nominal capital, additional paid in capital, profits, capital gains, income from asset disposal, income from intellectual property licensing fees, and liquidation income in renminbi or in a foreign currency.
- Expropriation prohibited: The government cannot expropriate foreign investment, except where an expropriation is implemented to secure public interest, in such case, a reasonable compensation shall be paid.
- Enforceability of investment agreements with the government – from gentlemen agreement to legally binding.



Q7: Can you give some concrete examples?

Sure. The financial industry is a key area of the opening-up policy. Key players have already taken actions.

BlackRock Fund Management Co., Ltd. was established on 10 September 2020 as the first 100 % foreign-owned Fund Management Company (FMC) in China. It launched the BlackRock China New Horizon Mixed Securities Investment Fund on 7 September 2021, the first mutual fund by a foreign investor.[4] It raised USD 1 billion in 4 days from 111,000 investors (on average USD 9,009 per investor).



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Other key players such as Neuberger Berman, Fidelity International, Van Eck Associates, Schroder Fund, etc. may have an FMC soon.

Recently, Goldman Sachs received approval from China's securities regulator to take full control of its mainland securities business as well.

[4] https://www.blackrock.com.cn/products/hunhe/013426/index.html (in Chinese)

Q8: Is China still tax-friendly for expatriates?

Yes. The way China handles income tax rules for expatriates that are working in China is a good example for China's policy choices. In a nutshell, the Chinese government has been very cautious in maintaining a tax-friendly environment for foreign investors.

When China started to open-up in the 1980s, foreign invested companies and expatriates working in China had enjoyed a privileged tax treatment. The tax treatment was unified for foreign invested enterprises when the Enterprise Income Tax Law became effective as of 1 January 2008.

When the Individual Income Tax Law was amended in 2018, the key tax benefits for expatriates working in China were nevertheless maintained. The tax residency rules are becoming even more lenient, thus the expatriates only need to pay taxes to China on their China-sourced income whereas their foreign-source income is exempted from taxation in China.

How does it work? The secret lies in the definition of domicile and tax residency. Beginning on 31 August 2018, a foreign national would only be subject to taxation in China on his worldwide income if all of the following three conditions are satisfied: (1) He stays for more than 183 days each year and six years consecutively in China, (2) he does not have any single trip exceeding 30 days in any year to a foreign country, and (3) he stays for more than 183 days in China in the 7th year. Thus, you can imagine that it's quite easy to get out of full taxation in China. An expatriate can avoid being a full tax resident in China simply by arranging a single trip of 30 days during a six-year period.

Another interesting area is transfer pricing. On the one hand, China has actively participated in both developing and implementing the G20/OECD Base Erosion and Profit Shifting (BEPS) project to defend its tax sovereignty and attack base erosion. On the other hand, China has been cautious to initiate transfer pricing audits against multinational enterprises. During the Covid-19 pandemic, the tax authority's priority is to create a friendly investment environment for MNEs, thus no harsh TP practice is to be expected in short to mid-term.

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