

eJournal of Tax Research

Volume 15, Number 2
(Special Edition: Tax and Corruption Symposium)

December 2017

CONTENTS

- 140 Editorial
Chris Evans
- 144 Corruption, complexity and tax evasion
Vito Tanzi
- 161 Corruption, taxation, and tax evasion
James Alm and Yongzheng Liu
- 190 Corruption, taxes and compliance
Anja Baum, Sanjeev Gupta, Elijah Kimani and Sampawende Jules Tapsoba
- 217 The impact of corruption on tax revenues, tax compliance and economic development: Prevailing trends and mitigation actions in Africa
Bernd Schlenther
- 243 Causes and consequences of corruption in tax administration: An Indonesian case study
Christine Tjen and Chris Evans
- 262 Tax and corruption: Is sunlight the best disinfectant? A New Zealand case study
Lisa Marriott
- 290 Tax corruption and private sector development in Vietnam
Ngoc Anh Nguyen, Quang Hung Doan and Binh Tran-Nam
- 312 Applying foreign anti-corruption law in the Chinese tax context: Conceptual difficulties and challenges
Nolan Sharkey and James Fraser

CONTENTS CONTINUED

- 333** Morality associated with fraud, corruption and tax evasion in South Africa
Boela (AP) Swanepoel and Jacolize Meiring
- 359** Addressing aggressive tax planning through mandatory corporate tax disclosures: An exploratory case study
Heidi Zummo, Bronwyn McCredie and Kerrie Sadiq

Applying foreign anti-corruption law in the Chinese tax context: Conceptual difficulties and challenges

Nolan Sharkey¹ and James Fraser

Abstract

At the core of the international effort to combat corruption is the ‘home country’ anti-corruption legislation that penalises companies in their home state for engaging in corruption extraterritorially. This article examines the application of Australia’s foreign bribery legislation to the Chinese tax context. The legal test for Australia’s extraterritorial bribery legislation rests heavily upon a finding that an extra-legal advantage gained, or benefit provided, is ‘illegitimate’. While the assumption that formal law is aligned with legitimacy is reasonable in many contexts and practical in the application of the law, a focus on legality does not align well with legitimacy in China. In China, vague laws are created by the central government in order to facilitate flexible and localised implementation. In a system where formal legal institutions are underdeveloped, informal rules are significant in guiding the actions of local officials. Australia ought to consider the nature of the relationships between China’s central and local governments prior to implementing its extraterritorial jurisdiction. Upon doing so, it will become apparent that a strictly ‘legal’ analysis is an inappropriate yardstick by which to gauge the legitimacy of an official’s behaviour.

Keywords: Local state corporatism; China; corruption; bribery; Chinese tax law; rule of law in China; vague and flexible law; rule of mandates; informal rules; legitimately due; competitive advantage; regionally decentralised authoritarianism; local experimentation

¹ Winthrop Professor of Law, University of Western Australia and Barrister, Francis Burt Chambers.

1. INTRODUCTION

Corruption and bribery are regarded as highly undesirable and damaging phenomena. This is particularly thought to be the case in developing countries with weak institutions and, often, weak rule of law. As a result of concerns about bribery and corruption in developing countries there has been an international effort to curb them since the 1960s. This has been particularly aimed at preventing large multinational businesses from the developed world from engaging in bribery and facilitating corruption in the developing world. At the core of this international effort is the 'home country' anti-corruption legislation that penalises companies in their home state for engaging in corruption extraterritorially.

A country's taxation institutions are a key area of concern in the above context as they represent one of the major interfaces between the private and public sectors. Favourable tax treatment may provide a significant competitive advantage to a taxpayer while unfavourable tax treatment may impede success. Many countries have chosen to intervene in their economies through the use of taxation to encourage and discourage particular economic activities. Where this is the case, there is greater scope for the administrative process surrounding taxation to be corrupted.

The issue of corruption in China has received significant attention. Media, anecdotal and scholarly sources have focused attention on how business outcomes in China may be shaped by relationships and favours. This focus has grown since November 2012 when the Chinese Communist Party embarked on a heavily publicised Anti-Corruption Campaign under the leadership of Chinese President Xi Jinping.² However, it may be suggested that various phenomena observed in Chinese administration and government are difficult to typify as corruption according to concepts adopted in anti-corruption law and the academic literature dealing with the concept.

China's tax institutions and administration are significantly tied to the above discussion. China's tax is well known for a raft of variable treatments under the law through incentives and administrative practice. It is also well known that relationships and negotiation can shape taxation outcomes for businesses in China. Therefore the possibility of corruption in China's taxation is worthy of academic discussion. In addition, taxation in China allows for a general examination of the problems that arise in typifying many phenomena in China as being 'corrupt', notwithstanding their prima facie appearance as such.

Understanding whether Chinese tax practices are corrupt is important for understanding Chinese economic development. It is also important to countries like Australia that have significant economic interaction with China. While the Chinese central government attempts to rein in corruption, China continues to become an important trading partner of Australia.³ Australia's foreign bribery legislation operates to prohibit Australian firms from bribing Chinese public officials. In order to facilitate

² On 26 June 2015 President Xi Jinping emphasised the fundamental role of China's legal and regulatory institutions in ensuring the campaign's success: Dingding Chen, 'China's Anti-Corruption Campaign Enters Phase Two', *The Diplomat*, 2 July 2015 <<http://thediplomat.com/2015/07/chinas-anti-corruption-campaign-enters-phase-two>>.

³ For commentary on the Australian Government's White Paper, *Australia in the Asian Century* (2012), see Ken Henry, 'Australia in the Asian Century' (East Asian Bureau of Economic Research Working Paper No. 101, Australian National University, April 2015).

ongoing trade relations, it is important that Australian firms are able to understand with certainty the nature of these prohibitions.

This article uses the application of Australian foreign bribery legislation to the Chinese tax context to highlight the difficulties with typifying Chinese institutions as corrupt in general. In addition to this significant finding, the article achieves a subsidiary practical outcome of demonstrating the risks and issues Australian firms face in doing business in China. The article also provides information of a practical nature in relation to China's taxing institutions.

Finally it must be noted that this article does not seek to justify truly corrupt practices on the basis that they are part of the manner in which things work in China. Rather the goal is to show conceptual difficulties in defining something as corrupt in the Chinese institutional environment. True corruption cannot be dealt with effectively if the environmental circumstances mean that it is not correctly identified by relevant laws.

2. THE TAXATION ENVIRONMENT IN CHINA

While China has enacted tax laws and regulations, these are far from conclusive in determining taxation outcomes for businesses.⁴ Despite dealing with complex taxation concepts, the laws are brief.⁵ For example, China's *Enterprise Income Tax Law* of 2007 ('EITL') introduced the concept of a Controlled Foreign Company (CFC). This is a complex legal concept as 'control' needs to be carefully defined to determine when it can be found in the myriad legal and economic relationships possible in relation to corporate groups. The fact that China uses the concept of 'enterprise' instead of 'company' further complicates the control concept in comparison to a country such as Australia that relies on the company concept. Notwithstanding this, China's law devotes only a few articles to defining its CFC rules while Australia devotes numerous pages. This brevity of law is typical in Chinese taxation.⁶

In addition to the brevity of the law, China's laws use vague concepts that increase the scope for administrative discretion. Notably, items 'may' be exempted from tax or be subject to a reduced rate,⁷ and 'reasonable' amounts incurred may be deducted.⁸ In addition the Detailed Implementing Regulations of the EITL refer to 'certain prescribed criteria' and have numerous 'etc.'s.⁹ Such language adds to the conceptual uncertainty already inherent in words such as 'control', 'environmental protection' and 'new technology'.

⁴ Nolan Sharkey, 'Enterprise Income Tax in China: Simplicity to Complexity through Institutional Context' in Patricia Blazey and Kay-Wah Chan (eds), *Commercial Law of the People's Republic of China* (Thomson Reuters, 2012) 337.

⁵ Nolan Sharkey, 'China's New Enterprise Income Tax Law: Continuity and Change' (2007) 30(3) *University of New South Wales Law Journal* 833.

⁶ *Ibid.*

⁷ Enterprise Income Tax Law of the People's Republic of China, adopted by the Fifth Session of the Tenth National People's Congress of the People's Republic of China on 16 March 2007 art 27.

⁸ EITL art 8.

⁹ See Regulations of the People's Republic of China on the Implementation of the Enterprise Income Tax Law, promulgated on 1 January 2008 ('Detailed Implementing Regulations'), ch 4.

The lack of certainty inherent in Chinese written law is resolved through the interaction between taxpayers and tax officers.¹⁰ Courts are so rarely used that they cannot be considered a materially meaningful element in the current Chinese tax institutional context.¹¹ The interactions between a taxpayer and their tax office are decentralised. Taxpayers interact with the tax office in their relevant city or lower administrative level as opposed to the provincial or national level. This form of interaction provides significant certainty in administration but also results in a variety of outcomes across time and location.¹² The variety is inevitable given the decentralised decision-making and lack of interaction between offices in different locations. The lack of cooperation between tax offices across different locations is the product of a competitive localised orientation that is partly related to tax office local performance measures and partly related to formal and informal ties to the local economy and its administrators. The overall tax office administrative hierarchy requires such decentralised local decision-making in order to function.¹³

The Chinese tax institutional context outlined above necessitates a significant degree of interaction between administrators and taxpayers. Tax outcomes will be significantly impacted by these interactions.¹⁴ The role of written law, regulations and other normative documents in this process may be significant but is far less significant than it is in a country such as Australia. The law may frame the decision-making process but the lack of detail in the law means that a variety of outcomes are possible within this frame. In determining outcomes, decision-makers in China do not necessarily prioritise the principles implicit in the written law. A range of other factors can influence the decision-making process. The most significant of these factors is local economic management and development. This factor operates in an environment where local economies compete against one another for economic opportunity.¹⁵

Local economic interests are complicated by the fact that high-ranked administrators are often enmeshed in local business networks. As a result there can be a relationship between local economic interests and the private economic interests of high-ranked officials. These officials are not necessarily tax officers. However, the enmeshed nature of local governmental interests means that high level local officials can influence the decision-making of various bureaucratic departments at the local level including the State Administration of Taxation and the Local Tax Bureau. Ultimately, there is a significant blurring of the boundary between the local private economy and

¹⁰ Nolan Sharkey and Ian Murray, 'The Rule of Law and Leadership in Substitution and in Conflict: Social Psychological and Legal Perspectives on Chinese Tax Administration' (2015) 30(3) *Australian Tax Forum* 595.

¹¹ Wei Cui, 'What is the "Law" in Chinese Tax Administration?' (2011) 19(1) *Asia Pacific Law Review* 73.

¹² Nolan Sharkey, 'Localization of Central Taxation in China' in Nolan Sharkey (ed.), *Taxation in ASEAN and China: Local Institutions, Regionalism, Global Systems and Economic Development* (Routledge, 2012) 62.

¹³ Barbara Krug, Ze Zhu and Hans Hendrichske, 'China's Emerging Tax Regime: Devolution, Fiscal Federalism, or Tax Farming?' (Paper presented at the Annual Meeting of European Public Choice Society, University of Durham, 31 March 2005).

¹⁴ Sharkey and Murray, above n 11.

¹⁵ Sharkey, 'Localization of Central Taxation in China', above n 13.

the local state. At the same time, the local state plays a significant role in governing China.¹⁶

Thus a taxpayer company such as a foreign investment enterprise may be granted highly favourable taxation treatment based on a range of factors discussed above. On the other hand, highly unfavourable taxation treatment may also be imposed on other taxpayers in ostensibly similar circumstances. In some circumstances the range of treatment may be argued to fall within the vague limits of the law. However, it has been documented that the treatment may clearly depart from the principles inherent in the law and only be justified on a significantly strained interpretation of certain words, if at all.¹⁷ It would not be remarkable for treatment to be granted that simply departs from the law. For example, an enterprise that is not in any way using advanced technology may be granted an incentive aimed exclusively at those using advanced technology. Recourse to default and deemed assessments allows significant scope for administrators to simply determine a total tax burden for particular taxpayers.¹⁸ Finally, in cases where taxpayers are not generally granted the full benefit of a particular provision of the law, a taxpayer may be favoured by being granted it. For example, the law on Value Added Tax allows for the full refund of input credits on exported goods but this is not routinely given in China. Therefore a taxpayer can be favoured by being afforded the legal treatment.

It can be concluded that Chinese tax treatment varies significantly within the vague boundaries of the law and, at times, departs from these. Whether a taxpayer is granted the most favourable taxation treatment is influenced by a range of factors that includes, most significantly, competitive local economic development and management. At the same time, local government is heavily enmeshed in the local economy and it can be difficult to separate the private interests of local officials and their networks from the economic interests of the local state per se. A foreign investor's investment may be desirable because it involves a venture that will significantly benefit the local economy. For example, the foreign investor may employ people who need employment. Alternatively it may be desirable because it will partner with a local company or entrepreneur. This may be because the partnership facilitates the development of local skills and technology or because the local firm needs economic support to survive or thrive. Finally, the foreign taxpayer may simply provide some form of direct benefit to a decision-maker or influential local person. For example, a cash payment, the granting of an interest in the company or the employment of a particular person in a significant role may be made.

¹⁶ Krug, Zhu and Hendrischke, above n 14; Nolan Sharkey, 'Tax Evasion and Administration Realities in the People's Republic of China: Some Initial Findings from Discussions with Tax Officers in Fujian Province' in Margaret McKerchar and Michael Walpole (eds), *Further Global Challenges in Tax Administration* (Fiscal Publications, 2006) 175. Also Nolan Sharkey, 'Default Tax Assessments in Different Institutional Environments: An Australia/China Comparison of Rule of Law Implications' in G V Chang (ed.), *Tax Strategies in Economic Substance and Protection of Taxpayers' Rights* (Angle Publishing Co., Ltd., China, 2012) 631; Sharkey, 'Localization of Central Taxation in China', above n 13.

¹⁷ Sharkey, 'Localization of Central Taxation in China', above n 13.

¹⁸ Sharkey, 'Default Tax Assessments', above n 17.

3. CORRUPTION: THE AUSTRALIAN LAW

The context described above certainly indicates at least significant potential for corruption. However, it also indicates a lack of clarity in respect of where and when corruption can be clearly identified. This results in both typification problems and evidentiary issues. These can be explored in the context of both the practical operation of an anti-corruption law and from a normative perspective. The analysis below considers the Australian anti-foreign bribery law and the perspectives of other literature. This other literature both informs the understanding of the practical law and calls into question the operation of the law in China.

On 17 December 1999, the *Convention on Combating Bribery of Foreign Officials in International Business Transactions*¹⁹ entered into force in Australia.²⁰ Article 1(1) of the *Convention on Foreign Bribery* requires that Australia criminalise the act of bribery under Australian law.²¹ The *Criminal Code Amendment (Bribery of Foreign Officials) Act 1999* (Cth) ('Amendment Act') was enacted in response to the obligations created by the Convention. The Amendment Act operates to insert the offence of foreign bribery into the *Criminal Code Act 1995* (Cth) ('the Act'). Section 70.2 of the Act provides that:

1. A person is guilty of an offence if:
 - a. the person:
 - i. provides a benefit to another person; or
 - ii. causes a benefit to be provided to another person; or
 - iii. offers to provide, or promises to provide, a benefit to another person; or
 - iv. causes an offer of the provision of a benefit, or a promise of the provision of a benefit, to be made to another person; and
 - b. the benefit is not legitimately due to the other person; and
 - c. the first-mentioned person does so with the intention of influencing a foreign public official (who may be the other person) in the exercise of the official's duties as a foreign public official in order to:
 - i. obtain or retain business; or
 - ii. obtain or retain a business advantage that is not legitimately due to the recipient, or intended recipient, of the business advantage (who may be the first-mentioned person).

¹⁹ *Convention on Combating Bribery of Foreign Officials in International Business Transactions*, signed on 17 December 1997, OECD [1999] ATS 21 (entered into force 15 February 1999) ('*Convention on Foreign Bribery*').

²⁰ *Convention on Foreign Bribery*; Catherine Barker, 'Australia's Implementation of the OECD Anti-Bribery Convention' (Background Note, Department of Parliamentary Services, 7 February 2012).

²¹ *Convention on Foreign Bribery* art 1(1): Australia is required to 'take such measures as may be necessary to establish that the act of bribing a foreign official is an offence under Australian law'.

The offence refers to the provision of an ‘*advantage that is not legitimately due*’ as well as benefits that are ‘*not legitimately due*’.²² The concept of ‘*illegitimate advantage*’ is equivalent to the notion of an ‘*improper advantage*’ set out in Article 1(1) of the Convention.²³

Section 70.2 can be simplified into the following components:

1. to provide a benefit that is not legitimately due;
2. to influence a public official;
3. to obtain an advantage that is not legitimately due.

3.1 Defences to section 70.2

The meaning of an ‘advantage that is not legitimately due’ within section 70.2 is informed by the broader statutory context. As such, sections 70.3 and 70.4 may assist in the interpretation of section 70.2.²⁴ These are briefly considered below.

3.1.1 Section 70.3: lawful conduct defence

Section 70.3 provides that a person will not be guilty of an offence under section 70.2 where the impugned conduct is lawful in the country in which the foreign official operates.²⁵ The scope of this defence has been significantly narrowed in response to the 2007 UN Oil-for-food Program debacle.²⁶ Prior to 2007, the defence could be raised in any situation where the impugned conduct did not offend a written law of the foreign country.²⁷ The defence has since been restricted to situations in which the conduct is explicitly permitted by a written law.²⁸

The inclusion of the ‘lawful conduct’ defence amounts to an act of deference to the legal systems of foreign jurisdictions. Section 70.2 of the Act involves the exercise of Australia’s extraterritorial jurisdiction. The Australian Parliament has signalled its intention to respect the legal institutions of other sovereign nations through the inclusion of section 70.3. This parliamentary intention (of deference) should inform statutory construction of the term ‘advantage that is not legitimately due’.

3.1.2 Section 70.4: facilitation payment defence

Section 70.4 sets out a defence in relation to facilitation payments. The defence absolves criminal responsibility if ‘the person’s conduct was engaged in for the sole or dominant purpose of expediting or securing the performance of a routine government action of a minor nature’.²⁹ Central to this defence is the concept of a ‘routine government action’. A ‘routine government action’ is defined to include actions that are ‘ordinarily and commonly performed’ by a foreign official.³⁰ The meaning of a routine action is restricted by section 70.4(2)(b) of the Act. Notably, administrative

²² *Criminal Code Act 1995* (Cth) s 70.2(1)(c)(iii) (‘*Criminal Code*’).

²³ *Convention on Foreign Bribery* art 1(1).

²⁴ *Criminal Code* ss 70.3, 70.4.

²⁵ *Criminal Code* s 70.3.

²⁶ Barker, above n 21, 7.

²⁷ *Ibid.*

²⁸ *Ibid.*

²⁹ *Criminal Code* s 70.4(1)(b).

³⁰ See *Criminal Code* s 70.4(2)(a).

decisions relating to the ‘terms of business’ are excluded from the meaning of a ‘routine government action’.³¹ Therefore such decisions are excluded despite the fact that foreign officials ‘ordinarily and commonly’ make decisions of this nature.³² It would therefore appear that this defence would generally not be available in relation to tax treatment.

3.2 The meaning of legitimacy

A critical aspect of the statute is the provision of a ‘business advantage that is not legitimately due’.³³ The Explanatory Memorandum to the Criminal Code Amendment (Bribery of Foreign Public Officials) Bill 1999 indicates that the term ‘not legitimately due’ should be given its ordinary meaning.³⁴ Ordinarily, an act that is illegal will be considered to be illegitimate. In determining the ‘legitimacy’ of a benefit, ‘official tolerance’ to the provision of a benefit must be disregarded.³⁵ The Explanatory Memorandum goes further to require a ‘legal basis for receiving the advantage’, and proscribes ‘conduct which is in breach of a statutory requirement’.³⁶ The narrow interpretation adopted by the Explanatory Memorandum to the Bill is supported by the Commentaries relating to the *Convention on Foreign Bribery*.³⁷ Finally it has been argued that the perception that the benefit is ‘customary or necessary in the situation’ must also be disregarded.³⁸ The rationale behind this narrow interpretation is that any ‘allowance for cultural norms would undermine the offence’.³⁹

3.3 The ordinary meaning of ‘legitimately due’ in the context of academic discourses on corruption

The Explanatory Memorandum to the Criminal Code Amendment (Bribery of Foreign Public Officials) Bill 1999 indicates that the term ‘not legitimately due’ should be given its ordinary meaning.⁴⁰ In view of the context, it is appropriate to have regard to a wider understanding of corruption in determining what ‘legitimately due’ means. Corruption is the subject of considerable debate among scholars.⁴¹ Various approaches

³¹ *Criminal Code* s 70.4(2)(c)(iii).

³² See *Criminal Code* s 70.4(2)(a) and the interaction with s 70.4(2)(c)(iii).

³³ *Criminal Code* s 70.4(2)(c)(iii).

³⁴ David Hume and Geoff Healy, ‘Bribery and Corruption: Key Issues for Australian Companies Operating Overseas’ (2011) 34(3) *University of New South Wales Law Journal* 747, 752, citing Explanatory Memorandum to the Criminal Code Amendment (Bribery of Foreign Public Officials) Bill 1999 (Cth).

³⁵ Hume and Healy above n 35, 752.

³⁶ Explanatory Memorandum to the Criminal Code Amendment (Bribery of Foreign Public Officials) Bill 1999 [34].

³⁷ Hume and Healy, above n 35, 752, citing *Commentaries on the Convention on Combating Bribery of Foreign Officials in International Business Transactions* (adopted by the parties 21 November 1997) [5]; Explanatory Memorandum to the Criminal Code Amendment (Bribery of Foreign Public Officials) Bill 1999 [34].

³⁸ Hume and Healy, above n 35, 752; These observations were made by Hume and Healy in relation to the benefit provided to the public official in section 70.2(1)(b) of the *Criminal Code*. As the same terminology is employed (‘not legitimately due’) in section 70.2(1)(c)(ii) of the *Criminal Code*, these observations are also applicable in relation to the conduct of the officials themselves.

³⁹ Hume and Healy, above n 35, 752, citing Explanatory Memorandum to the Criminal Code Amendment (Bribery of Foreign Public Officials) Bill 1999 [33].

⁴⁰ Explanatory Memorandum to the Criminal Code Amendment (Bribery of Foreign Public Officials) Bill 1999[25].

⁴¹ Wolfgang Muno, ‘Clientist Corruption Networks: Conceptual and Empirical Approaches’ in Tobias Debiel and Andrea Gawrich (eds), *(Dys-)Functionalities of Corruption: Comparative Perspectives and Methodological Pluralism* (2013(Supp 1), *Zeitschrift für Vergleichende Politikwissenschaft*) 34, 34.

have been proposed in an attempt to understand the meaning of corruption. Three broad approaches to understanding corruption have been identified, namely: cause-based corruption; consequence-based corruption; and norms-based corruption.⁴²

3.3.1 *Cause-based approach*

The cause-based approach to corruption adopts a market-centric analysis. The approach draws on the concept of economic rationality to explain why an official acts in a corrupt manner. Public officials are charged with allocating scarce public resources. As demand for public services increases, officials respond by raising their 'price'. Within this paradigm, corruption is caused by an imbalance of demand and supply for government services.⁴³ The limitations of the 'market-centred' analysis are twofold:

1. the approach fails to encapsulate broader instances of corruption that do not involve resource allocation; and
2. the approach fails to describe the intrinsic quality of the corrupt act itself. That is, it describes 'why' corruption exists rather than 'what' it actually is.

3.3.2 *Consequence-based approach*

Corruption may be understood by reference to the way that it affects the public interest.⁴⁴ This is known as the 'consequence-based' approach. Again, this approach fails to describe the intrinsic quality of the act itself.⁴⁵ In simple terms, it describes 'why we are concerned' about corruption rather than 'what' corruption is.

The consequence-based approach characterises an act as 'corrupt' if it is adverse to the 'public interest'. The main limitation of this approach is the lack of clarity surrounding the meaning of 'public interest'. The term 'public interest' presupposes the existence of common interests within a community. What may be dysfunctional for one section of the community may be functional for another. Additionally, an act may have the quality of being functional in some ways, but not so in other ways.⁴⁶ The 'consequence-based' approach would appear to encapsulate what Fan and Grossman describe as the 'economic definition' of corruption. The economic definition of corruption 'equates corruption with purely unproductive rent-seeking activities'.⁴⁷

3.3.3 *Norms-based approach*

The norms-based approach to corruption focuses on an official's deviation from a set of formal norms.⁴⁸ The approach is formally expressed as 'the use of public office to pursue private gain in ways that violate laws and other formal rules'.⁴⁹ The violation

⁴² Rance Lee, 'Bureaucratic Corruption in Asia: The Problem of Incongruence Between Legal Norms and Folk Norms' in Ledivina Cariño (ed.), *Bureaucratic Corruption in Asia: Causes, Consequences and Controls* (NMC Press, 1986) 70.

⁴³ Lee, above n 43, 71.

⁴⁴ Tugrul Gurgur and Anwar Shah, 'Localization and Corruption: Panacea or Pandora's Box?' (World Bank Policy Research Working Paper 3486, January 2005) 1.

⁴⁵ Lee, above n 43, 71.

⁴⁶ Ibid 71.

⁴⁷ Chengze Fan and Herschel Grossman, 'Incentives and Corruption in Chinese Economic Reform' (2001) 4(3) *Journal of Economic Policy Reform* 195, 199.

⁴⁸ Lee, above n 43, 71.

⁴⁹ Fan and Grossman, above n 48, 198.

of norms must be motivated by private interest.⁵⁰ This approach is also known as the legal definition of corruption. Academic commentary on the norms-based approach tends to focus on formal legal norms. This preference relates to the contemporary dominance of government.⁵¹ The ‘norms-based’ approach to corruption has gained acceptance from the academic community.⁵²

The Explanatory Memorandum to the Criminal Code Amendment (Bribery of Foreign Public Officials) Bill 1999 indicates that section 70.2 of the Act must be interpreted in accordance with the norms-based approach to corruption.⁵³ The Explanatory Memorandum specifically requires that there be a ‘legal basis for receiving the advantage’ and that an advantage will be illegitimate where it involves ‘conduct which is in breach of a statutory requirement’.⁵⁴ The law also proscribes the consideration of ‘cultural norms’. However, the Explanatory Memorandum does contemplate consideration of the nature of the legal institutions in which the law is to be extraterritorially applied.⁵⁵

3.4 Applying the Australian statute to the Chinese taxation context

Considering the Australian law in the Chinese taxation context, it can be seen that there is clear potential for it to apply. It has been noted that tax treatment that is highly preferential and arguably exceeds the written law may be provided in exchange for a benefit. However, the application of the law is significantly complicated by the Chinese institutional context and that which may be considered ‘legitimately due’ within it. The concept of ‘legitimately due’ is at the very core of the Australian statute and the concept of corruption. However, what constitutes ‘legitimate’ behaviour in China may not be readily determined. The nature of China’s legal system informs the meaning of a ‘legitimate’ act in the administrative context. Local officials apply a lattice of flexible, unclear and, at times, contradictory laws, policies, notices and regulations in their decision-making. In the absence of a rule of law system, formal legality is a difficult and arguably inappropriate benchmark by which to gauge the legitimacy of a local official’s actions.

It must be noted that the analysis that this article provides in relation to what should be considered ‘legitimate’ in China is for the purposes of Australian law. The *Convention on Foreign Bribery* that guided the drafting of the Australian law and creates Australia’s obligations in international law uses a different concept, namely ‘appropriateness’. Therefore at a strict level, this article’s analysis is relevant only to the understanding of the Australian law. It is clear, however, that the Convention’s use of ‘appropriateness’ does not simply resolve the issues considered in relation to deciding what is legitimate in the Chinese context. This is because ‘appropriateness’ needs to be determined in accordance with some standard in the same way that ‘legitimacy’ does. Therefore the analysis in this article will have significant relevance to any analysis of the *Convention on Foreign Bribery* as well as other countries’ laws that implement it. However further research would be needed in relation to the

⁵⁰ Lee, above n 43, 71.

⁵¹ Lee, above n 43, 72.

⁵² Fan and Grossman, above n 48, 198; Lee, above n 43, 72.

⁵³ Explanatory Memorandum to the Criminal Code Amendment (Bribery of Foreign Public Officials) Bill 1999 [34].

⁵⁴ Ibid.

different approaches to reach concluded views on the operation of those regimes in China.

3.5 China's unclear legal system

Australia's foreign bribery legislation assumes the existence of a rule of law system.⁵⁶ Within a taxation context, a rule of law system allows for the rights and obligations of a taxpayer to be readily ascertained.⁵⁷ As such, obligations are assumed to be 'prospective, open and clear'.⁵⁸ Australia's rule of law system operates to restrain the power of its administrative bodies. In doing so, the system limits the capacity of an administrator to consider the individual circumstances of a taxpayer.⁵⁹

3.5.1 Law

China's tax system operates differently from the type of system found in Australia. The requirements of China's tax laws are unclear. Central government law employs simple, yet ambiguous language.⁶⁰ The brevity and simplicity of the legislation results in an inability to comprehensively explain complex issues.⁶¹ Consequently, significant questions remain unanswered in China's tax legislation.⁶²

Unclear legislation is a policy choice of China's central government.⁶³ Vague laws are created by the central government to facilitate flexible localised implementation.⁶⁴ As a result, uniform taxation treatment is not found in China's decentralised reality despite the existence of a uniform central statute.⁶⁵ Local circumstances vary significantly between regions. Vague laws allow local governments to tailor the implementation of what would otherwise be a rigid, uniform system to suit the needs of their locality. This flexibility is appropriate in China as local officials are best placed to tailor local policy to achieve their economic goals.⁶⁶

3.5.2 Directives

Guidance documents are issued by Chinese authorities in order to supplement the otherwise extremely brief and vague legislative provisions.⁶⁷ At times the supplementary documents fail to clarify the 'legal' position and actually cause further uncertainty.⁶⁸ Normative directions are issued across various levels of government, from different local regions.⁶⁹ Whether a document is applicable to an individual taxpayer will depend upon the locality from which it was issued and from which level

⁵⁶ Ibid.

⁵⁷ Sharkey and Murray, above n 11, 606.

⁵⁸ Ibid, citing: Joseph Raz, 'The Rule of Law and its Virtue' (1977) 93 *Law Quarterly Review* 195, 198-202.

⁵⁹ Sharkey and Murray, above n 11, 612.

⁶⁰ Ibid 613-4.

⁶¹ Ibid.

⁶² Ibid 613.

⁶³ Ibid 615.

⁶⁴ Ibid 615.

⁶⁵ Ibid 624.

⁶⁶ Mayling Birney, 'Decentralization and Veiled Corruption under China's "Rule of Mandates"' (2014) 53 *World Development* 55, 56.

⁶⁷ Nolan Sharkey, 'The Correctness of the Chinese Position of Enterprise Residence in Chinese Law: The Institutional and Treaty Implications' (2014) 68(11) *Bulletin for International Taxation* 617, 618.

⁶⁸ Sharkey and Murray, above n 11, 613-4, citing Cui, above n 12.

⁶⁹ Sharkey, 'The Correctness of the Chinese Position of Enterprise Residence', above n 68, 618.

of government it emanates. Furthermore, the validity of a normative document may be unclear where it operates to contradict the original law.⁷⁰

Due to the variable economic environments of each locality, regionally-based pronouncements may conflict with one another.⁷¹ For example, as one district experiences economic overheating in its housing market and attempts to stifle demand, another may be suffering from falling house prices. In these circumstances, contradictory interpretations of a body of real estate law would be issued by regional governments.⁷² It follows that the brevity of the 'nationally applicable' legislation may be considered a policy choice of the central government. Ambiguous national law invites discretion, and hence the application of flexible policy. Significant discretion is afforded to localities due to the information asymmetry that exists in relation to a locality's implementation challenges.⁷³ Ultimately, guidance documents fail to fully clarify the central government's expectations of a local official.

In the specific context of China's Enterprise Income Tax Law, numerous normative or guidance documents exist. These have created a confused hybrid of administrative-legislative direction. How do these documents interact and what determines their priority? Again, the Chinese approach to resolving these tensions diverges from that of Australia's.

In Australia's legal system, conflicts are resolved through the distinction between those directions that constitute 'law' and those of merely 'administrative' opinion.⁷⁴ Similar to China's normative documents, Australia's taxation bodies provide 'rulings' that set out how the tax office has interpreted a set of laws.

In Western Australia, the Commissioner of State Revenue routinely publishes 'Commissioner's Practices' and 'Rulings' in relation to 'decisions' under the *Duties Act 2008* (WA).⁷⁵ These 'rulings' do not operate to change the law of Western Australia. All rulings are subject to administrative review at the State Administrative Tribunal.⁷⁶

Pronouncements of administrative bodies in China operate differently to those of Australia's executive bodies. Taxation decisions issued by a local Chinese official, even if 'legally wrong', will not be subject to judicial review.⁷⁷ In this context, the relevance of determining the proper legal interpretation of a set of legal instruments is of very little practical relevance.⁷⁸ Ultimately, there is not a meaningful separation between China's legislative and executive power. This creates an environment in which it can be argued that all determinations of the local official are at least of a *quasi* if not *de facto* legislative nature.

In a system where formal legal institutions are underdeveloped, informal rules are significant in guiding the actions of officials. These informal rules may be in the form

⁷⁰ Sharkey and Murray, above n 11, 613-4.

⁷¹ Sharkey, 'The Correctness of the Chinese Position of Enterprise Residence', above n 68, 618.

⁷² Ibid.

⁷³ Birney, above n 67, 56.

⁷⁴ Sharkey, 'The Correctness of the Chinese Position of Enterprise Residence', above n 68, 618.

⁷⁵ See *Taxation Administration Act 2003* (WA).

⁷⁶ The State Administrative Tribunal is a statutory body under the *State Administrative Tribunal Act 2004* (WA) s 7.

⁷⁷ Sharkey, 'The Correctness of the Chinese Position of Enterprise Residence', above n 68, 618.

⁷⁸ Sharkey and Murray, above n 11, 613-4.

of normative documents as outlined above but more generally arise in the context of complex social relationship networks and hierarchies. Social institutions play a far more significant role in comparison to formal institutions in China than is the case in Australia. Social institutions and relations significantly govern human behaviour in this context.⁷⁹ Governmental actors are often ‘circumspect’ in their approach to official central tax law.⁸⁰ Gong and Zhou have observed the instructive nature of informal rules in Chinese governance.⁸¹ Informal rules operate as ‘codes, routines, and norms’ that constitute customary patterns of behaviour of a local official.⁸²

It is notable that China’s academic literature defines corruption to include both formal and informal norms.⁸³ The inclusion of informal norms allows for the notion of ‘corruption’ to more accurately reflect behaviour that deviates from public expectations. This perception accords with the distinction drawn by Ostrom between ‘rules-in-form’ and ‘rules-in-use’. Ostrom observes that many ‘rules-in-form’ fail to affect the behaviour of an official.⁸⁴ In order to determine the ‘presence of an institution’, Ostrom argues, the focus should be on ‘rules-in-use rather than rules-in-form’.⁸⁵ This would suggest that a country’s ‘rules-in-use’ accurately describe the nature of a country’s institutions. China’s ‘rules-in-use’ are of a predominantly informal nature.

3.5.3 Rule of mandates

China’s administrative governance structure may be appropriately typified as a ‘rule of mandates’ system.⁸⁶ The ‘rule of mandates’ system subverts the traditional understanding of an administrator’s role. Rather than being tasked with the implementation of stringent laws, officials are asked to pursue broad and often conflicting policy objectives.⁸⁷ Unlike a system governed by laws, not all mandates must be implemented. Mandates are ‘directives that are hierarchically ranked against each other’.⁸⁸ Officials must prioritise mandates that are of relatively greater importance to the central government. Laws that coexist within this system must be implemented only if their implementation is ‘compatible’ with prioritised mandates.⁸⁹ In China, the appropriate exercise of an official’s discretion may involve the non-application or contravention of formal law. Mandates are expressed in broad terms and fail to expansively set out their expectations.⁹⁰ The mandates speak only to the central government’s desired *outcomes* for a locality, rather than stipulating the

⁷⁹ Ibid 624.

⁸⁰ Ibid 616.

⁸¹ Ting Gong and Na Zhou, ‘Corruption and Marketization: Formal and Informal Rules in Chinese Public Procurement’ (2015) 9(1) *Regulation and Governance* 63, 65.

⁸² Ibid.

⁸³ Eight of 24 studies examined by Ko and Weng, see: Kilkon Ko and Cuifen Weng, ‘Critical Review of Conceptual Definitions of Chinese Corruption: A Formal–Legal Perspective’ (2011) 20(70) *Journal of Contemporary China* 359, 363.

⁸⁴ Gong and Zhou, above n 82, 65, citing Elinor Ostrom, *Understanding Institutional Diversity* (Princeton University Press, 2005) 138.

⁸⁵ Gong and Zhou, above n 82, 65.

⁸⁶ Birney above n 67, 55.

⁸⁷ Ibid 57.

⁸⁸ Ibid 55.

⁸⁹ Ibid 55.

⁹⁰ Ibid 56.

processes that must be followed to achieve them.⁹¹ In other words, only modest direction is provided to officials.

The above characteristics pose significant problems for an objective inquiry into whether an official has provided an ‘illegitimate advantage’. For example, is a tax incentive granted in contradiction to the formal law an illegitimate advantage? In this circumstance the ‘legitimacy’ of the local official’s action is unclear. Here, the local official has subordinated their mandate to collect central government revenue in favour of their mandate to stimulate the local economy. Whether this advantage is ‘legitimately due’ depends on whether the central government prioritises local growth over their own fiscal revenue streams. As the mandates themselves are often not publicly disclosed, substantial evidentiary difficulties arise in making this determination.⁹²

The situation is further complicated by China’s inter-regional differences. The flexible ‘mandate’ system allows broad central government policy to be pursued effectively across vastly different regions. Local officials are best placed to tailor local policy to achieve these overarching goals.⁹³ A decision to ignore a law or policy may be appropriate in Region A but not in Region B. This speaks to the argument in favour of a ‘relative’ standard for legitimacy and, consequently, corruption in China.⁹⁴ The ‘legitimacy’ of an official’s act is dependent not only on the way it interacts with conflicting central policy, but also on the unique needs of a locality.

3.6 Determining legitimacy in China by focusing on formal law

As a result of the above institutional factors generally, the Chinese institutional environment cannot be typified as a rule of law system.⁹⁵ The role of informal rules and social institutions in government has been noted. It is questionable whether these rules have become so pronounced that they can be used as a yardstick to measure what constitutes an ‘illegitimate advantage’ in China. The Explanatory Memorandum to the Criminal Code Amendment (Bribery of Foreign Public Officials) Bill 1999 requires that the customary nature of a benefit be disregarded.⁹⁶ However, this narrow construction fails to acknowledge that customs and social institutions fall within the wider notion of a country’s legal framework.⁹⁷

In principle, these informal rules should not be disregarded as mere ‘cultural norms’ under the Explanatory Memorandum.⁹⁸ The rationale that an ‘allowance for cultural norms would undermine the offence’ fails to appreciate the importance of informal rules in the Chinese context.⁹⁹ In China, informal rules are a constituent part of the administrative institution. The ‘rule of mandates’ system presents significant challenges to the legalistic approach adopted by Australia’s foreign bribery legislation. Within this context, legality based upon central government statute is an inappropriate benchmark to measure the ‘legitimacy’ of an official’s actions.¹⁰⁰ What in Australia is

⁹¹ Ibid.

⁹² Ibid.

⁹³ Ibid.

⁹⁴ Ibid.

⁹⁵ Sharkey and Murray, above n 11, 613-4.

⁹⁶ Hume and Healy, above n 35, 752.

⁹⁷ Sharkey and Murray, above n 11, 604.

⁹⁸ *Criminal Code Amendment Explanatory Memorandum* [33].

⁹⁹ Ibid.

¹⁰⁰ Cf. Ibid [34].

an *absolute* legal standard to assess ‘legitimacy’, becomes a *relative* standard in China.¹⁰¹ The critical question is ‘why’ rather than ‘whether’ an official has violated a law.¹⁰²

Australia’s foreign bribery legislation fails to contemplate the above context as well as China’s unique central-local legal relations. A simple formalistic application of Australia’s legislation to China’s unique system will produce arbitrary or meaningless results. Ultimately, in the absence of a rule of law system, formal legality is an inappropriate benchmark by which to gauge whether an advantage is legitimately due to a third party. It follows that the receipt of an ‘illegal’ tax advantage by an Australian private enterprise operating in China should not constitute conclusive evidence of criminal liability under the *Criminal Code Act 1995*.

3.7 Determining legitimacy by focusing on the administrative decision-maker

In view of the difficulties inherent in determining legitimacy in China by focusing on formal law, an alternative approach is to focus on the administrative decision-maker. However, such an exercise also presents significant difficulties in China. The role of a local administrator in China differs from the equivalent official’s role in Australia.¹⁰³ Local officials in China adopt a dual identity. They are simultaneously a state political agent to the central government and a local economic principal of their locality.¹⁰⁴ In their role as an economic principal, the provision of formally illegal tax treatment may be legitimately within the scope of their duty.

Under the principal-agent model, corruption is said to occur where an agent has betrayed the interests of their principal.¹⁰⁵ In equity, this occurs where the agent fails to fulfil their fiduciary obligation to act in the best interests of their principal. The principal-agent model of corruption assumes that the agent is in control of, but does not own, a valuable resource. As a result, the agent operates as a trustee to the principal with respect to that resource.¹⁰⁶ The principal for a Chinese official is not, however, as readily identifiable as may first be thought. Within the Chinese institutional context it is inaccurate to typify local officials as mere agents of the central government. The duality of an official’s role affects the inquiry here as to whether derogating from the law is *prima facie* illegitimate. The proper identification of a local official’s principal is required in order to determine whether an act is within that principal’s best interests.

China’s system of contemporary government is best understood through comparison to its system of local governance prior to the 1978 reform. Historically, the role of local government was confined to the implementation of central government policy directives.¹⁰⁷ Local governments were effectively a conduit to the centre. Any deviation from their role as agents of the State was strictly forbidden.¹⁰⁸ Local

¹⁰¹ Birney, above n 67, 57.

¹⁰² Ibid 55.

¹⁰³ Jean Oi, ‘The Role of the Local State in China’s Transitional Economy’ (1995) 144 *The China Quarterly* 1132, 1136; Feng Wang, *Boundaries and Categories: Rising Inequality in Post-Socialist Urban China* (Stanford University Press, 2008) 140.

¹⁰⁴ Ting Gong, ‘Corruption and Local Governance: The Double Identity of Chinese Local Governments in Market Reform’ (2006) 19(1) *The Pacific Review* 85, 86.

¹⁰⁵ This model is used to explain the economic definition of corruption. See Munro, above n 42, 35.

¹⁰⁶ Munro, above n 42, 36.

¹⁰⁷ Gong, above n 105, 87.

¹⁰⁸ Ibid.

administrative discretion was eliminated in order to strengthen the Chinese Communist Party's grasp over the localities.¹⁰⁹ The State maintained a system of vertical leadership (*chui zhi ling dao*) that ensured that all decisions were made at the top. Local officials functioned as mere agents of a paternalistic state.¹¹⁰ Prior to the reform, if a local official did the equivalent of providing an illegal tax advantage to a foreign firm they would have been accused of localism.¹¹¹

After 1978, the State began to devolve central power to local arms of government.¹¹² The motivation for the diffusion of central power was to provide fiscal incentives for local governments to pursue economic growth.¹¹³ Prior to 1994 local regions benefited from a decentralised tax revenue system.¹¹⁴ Additionally, local officials were provided freedom to approve private investment projects within their region.¹¹⁵ As such, local officials were transformed from being *unproductive* political entrepreneurs into *productive* economic entrepreneurs.¹¹⁶ This reform process led to the creation of China's system of local state corporatism.¹¹⁷ Under this system, corporations and local officials are expected to operate together as one corporate whole.¹¹⁸

Local officials may consider it appropriate, having regard to the interests of their locality, to make decisions that are inconsistent with the State's legal framework. Published formal law may impede regional growth when local opportunities are fully accounted for. In their role as local economic principals, local officials are able to enhance regional growth through assisting private enterprise to navigate burdensome rules. One such example is the act of providing a formally illegal tax advantage to foreign firms. Under Jean Oi's concept of 'local state corporatism', this action is an appropriate commercial decision between partners working towards a common objective.¹¹⁹

On the face of it, local officials have a conflict of interest between the central government and local regions.¹²⁰ On the one hand they are tasked with implementing the law and policy of the central government, while on the other, they are responsible for the promotion of regional growth.¹²¹ By focusing only on local economic growth,

¹⁰⁹ Ibid 88.

¹¹⁰ Ibid 87-88.

¹¹¹ Localism in China is known as '*difang zhuyi*': Jae Ho Chung, *Central Control and Local Discretion in China: Leadership and Implementation during Post-Mao Decollectivization* (Oxford University Press, 2000); Gong, above n 105, 88.

¹¹² Gong, above n 105, 88.

¹¹³ Ibid.

¹¹⁴ Since 1994, a process of fiscal recentralisation has occurred to reign in local government power. Nonetheless, the decentralised governance system and corresponding growth incentives that were kick-started in 1978 remain firmly in place today: Jean Oi et al, 'Shifting Fiscal Control to Limit Cadre Power in China's Townships and Villages' (2012) 211 *The China Quarterly* 649, 650.

¹¹⁵ Gong, above n 105, 88.

¹¹⁶ Fan and Grossman, above n 48, 197.

¹¹⁷ See also comments in relation to 'socialist development state' and 'state entrepreneurialism'. Each expression emphasises the active role of local government in facilitating economic growth: Chunyu Wang, Jingzhong Ye and Jennifer Franco, 'Local State Corporatism or Neo-Guanxilism? Observations from the County Level of Government in China' (2014) 23(87) *Journal of Contemporary China* 498, 500; Fan and Grossman, above n 48, 198.

¹¹⁸ Oi, above n 104, 1132; Fan and Grossman, above n 48, 198.

¹¹⁹ Oi, above n 104, 1132.

¹²⁰ Gong, above n 105, 87.

¹²¹ Ibid 86.

the loyalty of the local official to the central government appears to be impugned.¹²² It could be questioned whether this factor may inform a test of illegitimacy in the Chinese context. However, the apparent conflict in interest is not as clear as it may appear to be at first glance.¹²³ It is submitted that what appears to be a conflict between local and central governments is more correctly regarded as a policy conflict throughout the State and stems from the overall administrative model implemented from the centre in China.

Localised economic governance and administration is in fact central policy. Centrally-imposed performance assessment mechanisms are structured to encourage officials to act as local economic principals. The focus is not on whether an official has strictly imposed central laws.¹²⁴ Instead, it is on whether an official has been able to improve the financial wellbeing of their jurisdiction.¹²⁵ Specifically, local government performance is assessed on the basis of their 'economic output, revenue growth and improvement in living standards'.¹²⁶ Local officials may determine that a low technology enterprise that employs people is desirable within their jurisdiction despite the central move to only incentivise advanced technology enterprise. In response the local government may grant such an enterprise favourable taxation treatment regardless of formal law and central policy.¹²⁷ However, in doing so they are actually carrying out their ultimate duty to the State.¹²⁸ This context reconciles with the rule of mandates system outlined above.¹²⁹ In this context it cannot be argued that a local economic prioritisation in decision-making in and of itself makes a decision illegitimate.

Finally it should be noted that various studies have indicated that local government in China has been forced by central budget restraints to resort to entrepreneurial activities and extra-legal revenue raising to fund the responsibilities imposed on them by the centre.¹³⁰ Some areas that have been studied are land expropriation,¹³¹ off-budgetary funds and off-budgetary enterprises.¹³² While such activity lacks transparency and may be argued to be conducive of corruption,¹³³ the role of the Chinese central policy in creating the situation makes calling it illegitimate simplistic and inaccurate.

¹²² Ibid 87.

¹²³ Cf. observations by Gong that the system indicates a 'divergence of local economic interests from those of the center': Gong, above n 105, 94 (our emphasis).

¹²⁴ Ibid 93, citing Fanghua Zhang, 'The Effective Control over Irregular Behavior of Local Governments in the Transitional Period' [*Zhuanxing shiqi defang zhenfu feizhengdang xingwei de youxiao kongzhi*] (2002) 1 *Shanghai Social Science Academy Academic Quarterly* 67.

¹²⁵ Gong, above n 105, 93.

¹²⁶ Ibid.

¹²⁷ Sharkey and Murray, above n 11, 615.

¹²⁸ The creation of Special Economic Zones in China involved the provision of tax concessions in a bid to attract enterprises to operate in the given region. See Maria Edin, 'Local State Corporatism and Private Business' (2003) 30(3-4) *Journal of Peasant Studies* 278, 287.

¹²⁹ Birney, above n 67, 56.

¹³⁰ Oi et al, above n 115, 654.

¹³¹ Ibid 653; Daniel Rosen and Beibei Bao, 'China's Fiscal and Tax Reforms: A Critical Move on the Chessboard' Rhodium Group Note, 11 July 2014, <<http://rhg.com/notes/chinas-fiscal-and-tax-reforms-a-critical-move-on-the-chessboard>>.

¹³² Gong, above n 105, 94.

¹³³ Ibid 95.

4. CENTRAL ADMINISTRATIVE POLICY AND LEGITIMACY

Corruption is traditionally understood to have debilitating effects for the economic development of a country.¹³⁴ However, in many aspects of China's society, extra-legal decision-making (say, formal illegitimacy) is developmental and facilitates economic growth.¹³⁵ Chinese officials disregard formal law to facilitate the creation of an efficient market system. In addition, they adopt an informal, consultative approach to governance in order to generate market certainty for investors.¹³⁶

The form of local governance has developed within the context of institutional deficiencies of China's socialist-market economy.¹³⁷ Local officials draw on *Guanxi* networks to navigate China's hybrid system and expedite business activity.¹³⁸ During the transition period this has allowed for the creation of a 'shadow-economy' to facilitate a more efficient allocation of resources.¹³⁹ With the strengthening of formal institutions, the demand for formal illegitimacy should 'erode'.¹⁴⁰ Formal illegitimacy in China will cease to be 'functional' when the transformation to a market system is complete.¹⁴¹ In order to understand extra-legal decision-making as being 'functional', the institutional deficiencies of China's formal institutions must first be acknowledged. China's informal administrative system allows for an official to tailor the regulatory climate of the local region to the needs of an individual foreign investor.¹⁴² The functional nature of an official's flexible approach calls for the corrupt quality of their actions to be re-examined.

4.1 Central corruption policy impacting legitimacy

During China's transition it has been observed that local officials have been allowed to benefit from the private sector as a form of compensation and performance measure.¹⁴³ In support of their argument, academics Fan and Grossman explain that the private sector is in a better position to reward performance than the 'distant' central government.¹⁴⁴ The performance of officials has not been related to their nominal salary.¹⁴⁵ It can therefore be argued that the central government has made

¹³⁴ Tobias Debiel and Andrea Gawrich (eds), *(Dys-)Functionalities of Corruption: Comparative Perspectives and Methodological Pluralism* (2013(Supp 1), *Zeitschrift für Vergleichende Politikwissenschaft*) 1.

¹³⁵ Charles Wolf Jr, 'Developmental Corruption in China' (2013) 177 *Policy Review* 99, 100-1, referring to Andrew Wedeman, *Double Paradox: Rapid Growth and Rising Corruption in China* (Cornell University Press, 2012).

¹³⁶ Sharkey and Murray, above n 11.

¹³⁷ For commentary on China's socialist-market system, see John Wong, *Understanding China's Socialist Market Economy* (Times Academic Press, 1993).

¹³⁸ For academic commentary relating to the relationship between corruption and *guanxi* practice, see Jacob Harding, 'Corruption or *Guanxi*? Differentiating between the Legitimate, Unethical, and Corrupt Activities of Chinese Government Officials' (2014) 31(2) *UCLA Pacific Basin Law Journal* 127; Ling Li, 'Performing Bribery in China: Guanxi-Practice, Corruption with a Human Face' (2011) 20(68) *Journal of Contemporary China* 1.

¹³⁹ Markus Taube, 'Relational Corruption in the PR China: Institutional Foundations and Its (Dys)Functionality for Economic Development and Growth' in Tobias Debiel and Andrea Gawrich (eds), *(Dys-)Functionalities of Corruption: Comparative Perspectives and Methodological Pluralism* (2013(Supp 1), *Zeitschrift für Vergleichende Politikwissenschaft*) 89.

¹⁴⁰ *Ibid.*

¹⁴¹ *Ibid.*

¹⁴² Sharkey and Murray, above n 11, 621-2.

¹⁴³ Fan and Grossman, above n 48.

¹⁴⁴ *Ibid.* 200.

¹⁴⁵ *Ibid.* 202.

instrumental use of such compensation, has acquiesced to the situation and ultimately institutionalised it.¹⁴⁶

The context is further complicated by the fact that the central government has historically used anti-corruption policy as a macroeconomic management tool. Rather than implementing uniform anti-corruption measures, corruption campaigns have historically been employed by the central government in order to stifle inflation.¹⁴⁷ Such selective enforcement of anti-corruption laws suggests a disinterest in the inherent quality of the behaviour that is proscribed. During an anti-corruption campaign, local officials face the prospect of criminal punishment rather than mere internal disciplinary action.¹⁴⁸ Each of the four major anti-corruption campaigns between 1981 and 1997 coincided with the introduction of macroeconomic austerity policies.¹⁴⁹ The former General Secretary of the Chinese Communist Party has acknowledged that in order to ‘cool down the feverish economy’ the central government ‘must combat corruption’.¹⁵⁰ During periods of political calm, the central government has been tolerant of corrupt activity.¹⁵¹ The use of corruption as a macroeconomic policy instrument diverts the focus from the inherent quality of the proscribed act itself.

The above factors add further to the difficulty in characterising the actions and decisions of officials as illegitimate in the Chinese context.

4.2 Experimentation, subsequent control and legitimacy

The role of regulation and law in China has been significantly different to its role in other places. A final significant aspect in this regard is the manner in which regulation can be experimental and officials can be retrospectively rewarded for departing from the rules. This is again highly significant for defining a departure from formal law, currently or historically, as illegitimate.

Since the start of the transitional period, the central government has created incentives for experimental governance through its system of ‘regionally decentralised authoritarianism’.¹⁵² China’s regionally decentralised authoritarian system encourages local officials to compete with neighbouring regions to achieve efficient outcomes for China’s economy.¹⁵³ This process is known as experimental governance.¹⁵⁴ Within this system, China’s ‘M-form’ central-local relationship provides local government with significant autonomy to innovate.¹⁵⁵ The ‘M-form’ relationship can be contrasted to

¹⁴⁶ Ibid 201.

¹⁴⁷ Elizabeth Quade, ‘The Logic of Anticorruption Enforcement Campaigns in Contemporary China’ (2007) 16(50) *Journal of Contemporary China* 65, 65.

¹⁴⁸ Ibid 67, citing Melanie Manion, *Corruption by Design* (Harvard University Press, 2004) 168.

¹⁴⁹ Fubing Su and Dali Yang, ‘Political Institutions, Provincial Interests, and Resource Allocation in Reformist China’ (2000) 9(24) *Journal of Contemporary China* 215; cf. Quade, above n 148, 69.

¹⁵⁰ Quade, above n 148, 70, citing Bruce Gilley, *Tiger on the Brink: Jiang Zemin and China’s New Elite* (University of California Press, 1998) 207.

¹⁵¹ Su and Yang, above n 150, referring to ‘special interests and lobbying’.

¹⁵² James Kai-sing Kung, Chenggang Xu and Feizhou Zhou, ‘From Industrialization to Urbanization: The Social Consequences of Changing Fiscal Incentives on Local Governments’ Behavior’ in David Kennedy and Joseph Stiglitz (eds), *Law and Economics with Chinese Characteristics: Institutions for Promoting Development in the Twenty-First Century* (Oxford University Press, 2013) 491, 494.

¹⁵³ Ibid.

¹⁵⁴ Yingyi Qian and Chenggang Xu, ‘Why China’s Economic Reforms Differ: The M-Form Hierarchy and Entry/Expansion of the Non-State Sector’ (1993) 1(2) *Economics of Transition* 135.

¹⁵⁵ Taube, above n 140, citing Qian and Xu, above n 155.

the former Soviet Union's 'U-form' system of governance.¹⁵⁶ Within a 'U-form' system, local regions are interdependent.¹⁵⁷ In an interdependent system, the costs of an unsuccessful regional reform will be borne by the system as a whole. It follows that 'U-form' governance allows only for 'top-down' rather than 'bottom-up' economic reform. That is, economic reform initiatives can be initiated by the central government only.¹⁵⁸ By way of contrast, China's 'M-form' system of governance 'gives a green light for local experimentation'.¹⁵⁹

During China's economic reform, local experimental governance allowed the Chinese Communist Party to pursue market reform without political ramifications. Movement towards a capitalist market economy was in conflict with the traditional communist ideals of the Party. Through 'bottom-up' reform, the central government was able to maintain its Marxist ideals while reaping economic gains from a newly developed market system. Former Chinese Communist Party chairman Deng Xiaoping described the local experimental process as 'groping for stones to cross the river' (*mozhe shitou guohe*).¹⁶⁰ Through the use of this idiom, Deng Xiaoping appears to have been actively encouraging otherwise unsanctioned experimental methods of incremental reform.

An early example of local experimental reform was the development of Township and Village Enterprises ('TVEs'). In 1988 Deng Xiaoping hailed the advent of TVEs, acknowledging that the Chinese Communist Party was initially unaware of their development.¹⁶¹ These innovations were 'in principle illegal' as they departed from the established institutional framework.¹⁶² Another example of 'bottom-up' local government innovation was the development of the 1980s foreign exchange swap market.¹⁶³ As with TVEs, due to their success, local foreign exchange swap markets were retrospectively legalised.¹⁶⁴

Notably, only successful reform experiments were given the retrospective approval of central government.¹⁶⁵ Failed reform attempts were considered 'corrupt' derogations from the lawful administration of a locality. This aligns with contemporary observations that the central government will allow for significant exploitation of a local official's position only in so far as it leads to successful economic reform.¹⁶⁶

As part of the experimental process, local governments were vulnerable to allegations of corruption and lived in fear of the central government.¹⁶⁷ Selective tolerance of an official's 'corrupt' actions meant that local officials had no choice but to remain politically loyal to the State.¹⁶⁸

¹⁵⁶ Qian and Xu, above n 155, 137.

¹⁵⁷ Ibid.

¹⁵⁸ Ibid.

¹⁵⁹ Ibid 154.

¹⁶⁰ Ibid, see associated footnote at 161.

¹⁶¹ Ibid, citing *Zhongguo xiangzhen Qiye*, 1989.

¹⁶² Taube, above n 140, 101.

¹⁶³ Ibid 102.

¹⁶⁴ Ibid 103.

¹⁶⁵ Qian and Xu, above n 155, 154.

¹⁶⁶ Nolan Sharkey, *Social Institutions and Tax Design: The Case of Income Tax and Chinese Society* (PhD Thesis, The University of New South Wales, 2010) 185.

¹⁶⁷ Fan and Grossman, above n 48, 202, citing Susan Shirk, *The Political Logic of Economic Reform in China* (University of California Press, 1993) 144.

¹⁶⁸ Fan and Grossman, above n 48, 202.

Experimentation and associated selective regulation has a significant bearing on how the substantive legitimacy of an official's actions should be judged. Again it can be seen that formal law and regulation in China has not been held sacrosanct and economically successful departures from law have been tolerated, rewarded and embraced. In this context extra-legal decisions on economic laws such as taxation cannot be assumed to be illegitimate.

5. CONCLUSION

The legal test for Australia's foreign bribery law rests heavily upon a finding that an extra-legal advantage gained or benefit provided is illegitimate. Reference to the Explanatory Memorandum Criminal Code Amendment (Bribery of Foreign Public Officials) Bill 1999 as well as other surrounding material indicates that legitimacy should be given its ordinary meaning. However, much of the same commentary appears to indicate that legitimacy should be gauged by reference to the application of formal law. While the assumption that formal law is aligned with legitimacy is reasonable in many contexts and practical in the application of the law, a focus on legality does not align well with legitimacy in China.

Australia must consider the nature of the relationship between China's central and local government prior to implementing its extraterritorial jurisdiction in relation to China. Upon doing so, it will become apparent that a strictly 'legal' analysis is an inappropriate yardstick by which to gauge the legitimacy of an official's behaviour. The application of Australia's foreign bribery legislation must be appropriate for the Chinese context. Failure to do so will render criminal convictions under Australia's foreign bribery legislation arbitrary and inequitable. Law and regulation have not been used for the same purposes in China as they are used elsewhere. Officials are expected to apply laws flexibly in view of competing priorities and successful experimental departures from the law have been rewarded in China. Local economic success is a key priority, as is successful local government that does not place administrative strain on the central government. A central reliance on local corporatism understands that a reward system for economic success operates in China that is not determined from the centre. In this sense, anti-corruption campaigns might be understood less as an attack on this institutionalised system than as macroeconomic and political management tools.

While China's institutional and rule of law situation is changing, a transformation to a strict legal system is far from complete or even near. This is particularly apparent in taxation in China, a matter which goes to the heart of economic administration. In addition, action taken in response to corruption and similar issues are often historically focused. Therefore the actions of firms and administrators must be understood within their context of the time. There are, of course, truly illegitimate actions in China and the lack of a formal benchmark to judge them creates significant practical issues for the law. However, these practical issues should not create an allowance for injustice to occur.