

Reforming the Current Model of Private Investment in Chinese Education

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INTRODUCTION

Private education has traditionally played a key role in Chinese culture, with a history of teaching students that dates back thousands of years.¹ In the decades following the rise to power of the Chinese Communist Party in 1949, however, the existing private education system was dismantled and replaced by a centrally-planned, state-run approach.² This new system was viewed by the central government as being more aligned with its national socioeconomic plan.³ This new, centrally-

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¹ See generally Yu Zhang, *Private Education in China: Issues and Prospects* 4 PERSPECTIVES 5 (2003), http://www.oycf.org/Perspectives2/23_123103/3._ZhangYu.pdf.

² *Id.* at 1, 2.

³ Jing Lin, *The Development and Prospect of Private Schools in China: A Preliminary Study* 6 (1994), <http://www.eric.ed.gov/PDFS/ED375495.pdf>.

formulated education system was designed to teach and at the same time transmit a distinctively political, socialist message to students.⁴

The Chinese government's implementation of economic reform policies in the 1970's led to unprecedented growth in the Chinese economy; however, China's national educational system has struggled to keep pace with the country's economic emergence.⁵ China's investment in education in the past two decades has lagged far behind the expenditures of other countries. While developed economies spend an average of 5.5 percent of GDP on education, and developing economies average 4.8 percent, China has never devoted more than four percent of its GDP to education spending.⁶ According to United Nations statistics, although China has seventeen percent of the world's student-age population, its current educational market share, in value terms, is only two percent.⁷ Indeed, the central government has shown little interest in providing funding for primary and secondary education.⁸ The previous two decades have seen the financial burden of providing education move from the central government to local authorities, which have in turn passed on the burden to the schools themselves.⁹

⁴ Ye Lan, *Social Development of 21st Century and Reform of China's Elementary Education*, 3 FRONT. EDUC. CHINA 359 (2006).

⁵ CARL J. DAHLMAN, DOUGLAS ZHIHUA ZENG & SHUILIN WANG, ENHANCING CHINA'S COMPETITIVENESS THROUGH LIFELONG LEARNING 15 (2007).

⁶ United Nations Educational, Scientific and Cultural Organization Institute for Statistics, *Global Education Digest 2009 – Comparing Education Statistics Across the World*, Table 13 “Public Expenditures on Education and Expenditure on Education by Nature of Spending,” available at <http://www.uis.unesco.org/Library/Documents/ged09-en.pdf>. To understand the size of the current education spending gap, it is necessary to examine how woefully short the government falls in meeting even its own goals for spending on education. In 1993, the government set a goal of having the “ratio of national financial expenditure on education versus national GDP . . . increase, and reach 4% percent by the end of this century.” Zhongguo Jiaoyu Gaige he Fazhan Gangyao (中国教育改革和发展纲要) [The National Education Reform and Development Plan] (jointly promulgated by the Cent. Comm. of the Communist Party of China and the State Council, Feb. 13, 1993, effective Sept. 1, 1993). This goal, however, was never realized, and was revised with a new deadline set for 2012. Guojia Zhongchangqi Jiaoyu Gaige he Fazhan Guihua Gangyao (2010-2020) (国家中长期教育改革和发展规划纲要 (2010-2020)) [National Mid-to-Long-Term Educational Reform and Development Plan (2010-2020)] (promulgated by the State. Council on Feb. 28, 2010, effective June 1, 2010). Even if this goal were achieved, however, this expenditure ratio would still be far less than that of most European and North American countries.

⁷ Dahlman, *supra* note 5, at 136.

⁸ Jing, *supra* note 3, at 8.

⁹ Wu Daguang, *Basic Characteristics and Particularities of Nongovernment Education in China*, 42 CHINESE EDUC. AND SOC. 63 (2009).

China's seeming reluctance to provide funding for education is surprising given the country's traditional focus on learning.¹⁰ In addition to striking a discordant note with the country's intellectual heritage, the government's relatively low spending levels on education may eventually hinder China's continued economic success.¹¹ Education is the foundation for economic improvement and international competitiveness.¹² Discussing the importance of education, scholars Sun Qi-lin and Kong Kai note that in "the global economy where knowledge is becoming increasingly fundamental, countries or families that lack opportunities for basic education have to confront the risk of being marginalized within the increasingly prosperous global economy."¹³

Research has shown that even the comparatively small investment in Chinese education since the country's market-oriented economic restructuring has been a great impetus behind economic growth.¹⁴ Education provides an opportunity for individuals to improve their economic and social standing in life, while laying the foundation for the sustainable development of the national economy.¹⁵

Realizing the importance of education as a mechanism for transmitting the skills necessary to continue China's modernization and economic development,¹⁶ the Chinese government has again turned to private education in an attempt to supplement its underfunded public education system.¹⁷ Chinese officials have signaled the importance they place on education's role in contributing to the country's economic and social progress,¹⁸ as well as their openness to using private education to

¹⁰ Jing, *supra* note 3, at 8.

¹¹ Fan Bo-nai & Lai Xiong-xiang, *A Study on the Rate of Contribution of Education Investment to the Economic Growth in China*, 4 FRONTIERS OF EDUC. IN CHINA 522 (2006).

¹² *Id.*

¹³ Sun Qi-lin & Kong Kai, *The Balanced Development of Basic Education in the Context of Globalization*, FRONTIERS OF EDUC. IN CHINA

¹⁴ Fan, *supra* note 11, at 531.

¹⁵ *Id.* at 522.

¹⁶ Yu, *supra* note 1, at 1-2 Fan

¹⁷ Han Min, UK Department of International Development and the World Bank Study, *Non-government/Private Education in China* 8 (2004), http://siteresources.worldbank.org/EDUCATION/Resources/278200-1126210664195/1636971-1126210694253/Non_Govt_Private.pdf.

¹⁸ Wu, *supra* note 9, at 63.

achieve these goals.¹⁹ The government has once again opened the doors to private education, with the passage of a series of supportive laws.²⁰

In response to this encouragement, the number of private schools has skyrocketed.²¹ These schools are investment-funded entities²² that do not rely on government subsidies or charitable donations.²³ Investors are especially drawn to the sector in the wake of recent financial crises because the education industry is counter-cyclical and offers stable cash flow.²⁴ The market is also appealing to investors because of the pent-up demand for education that currently exists.²⁵ The lack of access to quality primary, secondary, and higher education in today's Chinese education system has spurred demand on the part of citizens for all manner of educational services.²⁶ Students often find that the education they receive in government-run institutions doesn't equip them with the skills prospective employers require.²⁷ These students have proven to be eager for a non-governmental alternative.²⁸ Other factors help increase demand as well, including an increasingly urban population, a growing per capita income, and the importance Chinese culture places on education.²⁹

Although the education industry is an appealing opportunity for investors, the sector still faces many of the legal challenges that have arisen elsewhere in the developing Chinese economy, namely unclear and

¹⁹ *Id.* at 64

²⁰ See *Jiaoyu Fa* (教育法)[Education Law] (promulgated by the Nat'l People's Cong., Mar. 18, 1995, effective Sept. 1, 1995) available translated at <http://www.isinolaw.com/> (last visited Feb. 5, 2010) [hereinafter *Jiaoyu Fa*], See also *Minban Gaodeng Xuexiao Shezhi Zanxing Guiding* (民办高等学校设置暂行规定)[Provisional Regulations on Establishment Criteria for Private Higher Educational Institutions] (promulgated by the Nat'l Educ. Comm., Aug. 17, 1993, effective Aug. 17, 1993) available translated at <http://www.isinolaw.com/> (last visited Feb. 05, 2010) [hereinafter *Minban Gaodeng Xuexiao Shezhi Zanxing Guiding*].

²¹ With respect to higher education, for example, there are currently more than four million students enrolled in private educational institutions and over two hundred thousand fulltime teachers. See Dahlman, *supra* note 5, at 17.

²² Wu, *supra* note 9, at 66.

²³ *Id.*

²⁴ *Can China's Private Education Providers Make the Grade?*, Knowledge @ Wharton (Feb. 16, 2011), <http://www.knowledgeatwharton.com.cn/index.cfm?fa=viewfeature&articleid=2364&languageid=1>.

²⁵ *Id.* at 2.

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

inconsistently enforced regulation.³⁰ One private equity principal notes that:

In the private education industry, you don't get any support from the government. Private companies need to figure everything out for themselves. If an effective system of standards . . . were implemented by the government, the education and training market could be strengthened and more private capital is more likely to be invested in the sector.³¹

Responding to the exponential, chaotic rise in the number of private educational institutions, the Chinese government has tried successive attempts to impose a regulatory framework on the private education sector.³² This framework, however, is often ambiguous and contradictory. The basic certainty required for private capital investment is lacking, hindering growth in the sector. “[N]ongovernment education in its current stage constitutes a sort of spontaneous and improvised practice in an environment where the appropriate laws and policies are relatively non-existent.”³³ It remains an unsettled question under current Chinese law, for example, whether an investor has the right to a profit from a capital investment in the private education sector.³⁴

This article uses an investment regulation perspective to examine the current laws and regulations relating to investment in the private education sector in China and how they can be improved to encourage private capital investment. Specific issues that discourage private investment will be discussed, including the legislative contradiction between the “not-for-profit” principle under the Education Law³⁵ and the right to a “reasonable return” found in the Private Education Promotion Law.³⁶ It will be shown how some investors have sought illicit profits due

³⁰ *Id.*

³¹ *Can China's Private Education Providers Make the Grade?*, Knowledge @ Wharton 2 (Feb. 16, 2011), <http://www.knowledgeatwharton.com.cn/index.cfm?fa=viewfeature&articleid=2364&languageid=1>.

³² *Shehui Liliang Banxue Tiaoli (社会力量办学条理)* [Regulation on School Operations by Special Forces] (promulgated by the State Council, July 31, 1997, effective Oct. 1, 1997) *available translated at* <http://www.isinolaw.com/> (last visited Feb. 5, 2010) [hereinafter *Shehui Liliang Banxue Tiaoli*].

³³ Wu, *supra* Note 9, at 67.

³⁴ A discussion of the not-for-profit principle will occur later in the article.

³⁵ *Jiaoyu Fa*.

³⁶ *Minban Jiaoyu Cujin Fa (民办教育促进法)* [Private Education Promotion Law] (promulgated by the Standing Comm. of the Nat'l People's Cong., Dec. 28, 2002, effective Sept. 1, 2003) *available translated at* <http://www.isinolaw.com/> (last visited

to the difficulties in receiving a legitimate return on investments. The ambiguity surrounding the rights of investors when trying exit their investment will be examined, as will the regulations that serve as a barrier to obtaining financing for new educational institutions. Finally, legal and regulatory policy changes will be suggested to help lower the barriers to capital investment in the Chinese private education sector.

I. THE DEVELOPMENT OF PRIVATE EDUCATION LAWS IN CHINA

In the decades after the formation of the People's Republic of China in 1949, education in China was run exclusively by the state,³⁷ and education legislation was either poorly developed or non-existent.³⁸ It was only in 1980 that the Standing Committee of the People's Congress adopted its first education regulation—the Regulations on Academic Degrees.³⁹ In the 1980's, the State Council promulgated several educational regulations, each reflecting the policy that schools were to be run by the state.⁴⁰ The bias toward public education is evident in the Provisional Regulations on Establishment Criteria for Regular Higher Educational Institutions.⁴¹ These regulations set forth the criteria for the formation of higher educational institutions and specified in detail requirements for the size of the campus and the required minimum number of teachers, buildings, and books. The law was silent, however, on the question of who exactly would be the initial sponsor⁴² of the school. The only relevant provision required that “there must be a stable and secure source of capital for the infrastructures and educational operations needed for the establishment of the institution.”⁴³

In the 1990's, China's Reform and Opening-Up policy brought the first changes to the education sector. Legislators started to consider

Feb. 5, 2010) [hereinafter *Minban Jiaoyu Cujin Fa*].

³⁷ JING LIN, SOCIAL TRANSFORMATION AND PRIVATE EDUCATION IN CHINA 5 (1999).

³⁸ *Id.* at 7.

³⁹ Xuewei Tiaoli (学位条例) [Regulations on Academic Degree] (promulgated by the State Council, Feb. 12, 1980, effective Jan. 1, 1981, amended, Aug. 28, 2004) available translated at <http://www.isinolaw.com/> (last visited Feb. 5, 2010).

⁴⁰ Wu, *supra* note 9, at 68.

⁴¹ Putong Gaodeng Xuexiao Shezhi Zanzing Tiaoli (普通高等学校设置暂行条例) [Provisional Regulations on Establishment Criteria for Regular Higher Educational Institutions] (promulgated by the State Council, Dec. 15, 1986, effective Dec. 15, 1986) available translated at <http://www.isinolaw.com/> (last visited Feb. 05, 2010) [hereinafter *Putong Gaodeng Xuexiao Shezhi Zanzing Tiaoli*].

⁴² The term sponsor will be used in this article instead of investor because sponsor is the term used in the relevant legislation and regulations.

⁴³ *Putong Gaodeng Xuexiao Shezhi Zanzing Tiaoli*, art. X.

alternatives to public education. The Provisional Regulations on Establishment Criteria for Private Educational Institutions,⁴⁴ promulgated by the National Education Committee, set forth the formation criteria for establishing new private schools, along with the application procedures, the approval process, and the required management standards. These regulations were practical and provided a step toward establishing a basic framework for the creation of private schools, but the regulations' enforcement suffered from being put forth by a sub-department of the State Council, a relatively low department in the legislative hierarchy

In 1995, the National People's Congress promulgated the Education Law,⁴⁵ which attempted to clarify and expand the role of private education. The law specifically stated that "the state encourages enterprises, other organizations and individual citizens to form schools and other forms of educational institutions."⁴⁶ As to the capital required for the education development, "the state shall mainly use financial appropriation and in the meantime use funds through various approaches, [to] increase the capital contribution in education sector, and ensure stable sources of educational funds for state-run schools."⁴⁷ For privately run schools, the school sponsor was required to be responsible for raising the funds for school operations. The law also provided, with a certain ambiguity, that "the peoples' government at different levels may render proper support."⁴⁸ The nature and extent of this "proper support" was never specified.

It is important to note that while the Education Law turned to non-governmental actors to create schools, Article XXIV of the law specifically stated that "[n]o organization or individual shall run schools or other educational institutions for the purpose of profit making."⁴⁹ In 1997, two years after passage of the Education Law, the State Council promulgated the Regulations on School Operations by Social Forces.⁵⁰ This law was the first attempt to set out a comprehensive framework for the administration of all types of private educational institutions. Private schools were to "focus on vocational education, adult education, senior high school education and pre-elementary school education," with "the state strictly administrating educational institutions."⁵¹

⁴⁴ *Minban Gaodeng Xuexiao Shezhi Zanxing Guiding*.

⁴⁵ *Jiaoyu Fa*.

⁴⁶ *Id.* art. XXV.

⁴⁷ *Id.* art. LIII.

⁴⁸ *See id.*

⁴⁹ *Jiaoyu Fa* art. XXIV.

⁵⁰ *Shehui Liliang Banxue Tiaoli*.

⁵¹ *Id.* art. V.

The most recent development in the laws surrounding private education was the amendment and eventual replacement of the Regulations on School Operations by the Private Education Promotion Law⁵² in 2003 and the Implementing Rules to the Private Education Promotion Law⁵³ [hereinafter Implementing Rules] in 2004. These regulations encourage private organizations and individuals to establish and run multiple types of educational institutions, excluding military, police, and political schools.⁵⁴ Additionally, the newly established laws allow for organizations and individuals to earn a “reasonable return” on their investment. Currently, the Private Education Promotion Law and the Implementing Rules are the primary laws on private education in China.

II. THE CURRENT LEGAL AND REGULATORY FRAMEWORK

Theoretically, the Education Promotion Law and its implementation protect returns from investment in private education; however, in practice the law, as administered, discourages capital contributions, with many local authorities requiring capital investments to be made as “donations.”⁵⁵

Although the Private Education Promotion Law allows a reasonable return to school sponsors,⁵⁶ and the Implementing Rules specify the procedures and restrictions for sponsors to make the request,⁵⁷

⁵² *Minban Jiaoyu Cujin Fa*.

⁵³ *Minban Jiaoyu Cujin Fa Shishi Tiaoli* (民办教育促进法实施条例) [Implementing Rules of Private Education Promotion Law] (promulgated by the State Council, Mar. 5, 2004, effective Apr. 1, 2004) *available translated at* <http://www.isinolaw.com/> (last visited Feb. 05, 2010).

⁵⁴ *Id.* art XV.

⁵⁵ Min Weifang, Chairman of Univ. Council, Peking Univ., *Economic Transition and Personnel Reforms in China* (Apr. 20, 2006).

⁵⁶ *Minban Jiaoyu Cujin Fa*, art. LI.

⁵⁷ The Implementing Rules to the Private Education Promotion Laws place several restrictions on obtaining a reasonable return. First, the reasonable return request must be set forth with the private school’s articles of association, which are subject to the educational authority’s approval (art. XIV). Additionally, the school must allocate at least twenty-five percent of its net assets increase/net income as development fund for school development and maintenance (art. XXXVII). The base value for calculation of reasonable return is the surplus or net income of school operations, excluding donations, subsidies, development fund allocations, and any other fees that must be withheld according to laws and regulations (art. XLIV). Using other private schools for comparison, the ratio of reasonable return is determined by examining the school’s fee charge rates, the ratio of expenses on educational activities and school development versus the total charges, and the quality of the school’s operations (art. XLV). Before determining the ratio of reasonable return, the school is also required to make available to the public all materials reflecting its educational quality and financial status, and this decision is to be approved by the school board and filed with the educational authorities (art. XLVI). Finally, school sponsors cannot obtain a reasonable return in the cases of

in practice the return is rarely sought. One impediment is the uncertain tax treatment of the returns. Article XXXVIII of the Implementing Rules provides that the finance, tax, and other departments of the State Council shall jointly promulgate regulations on preferential tax treatment for private schools whose sponsors, but these regulations have never been issued. Another practical matter is that when approving applications for the formation of private schools, the educational authorities normally hold an anti-return attitude and discourage school sponsors' requests for a reasonable return, specifically or implicitly.⁵⁸ One sponsor, discussing his personal experience in several transactions, noted that when he applied for a reasonable return as part of an application for establishing a private school, the educational authorities discouraged the request and suggested that he amend the application documentation to remove the request or face having his application denied.⁵⁹ Therefore, although reasonable return is available in theory, sponsors rarely seek it in practice due to the implicit bias against doing so. Although sponsors have found quasi-legal ways to extract returns from schools despite these difficulties (discussed later in this article), it is important to note that under the current model, these sponsors should have no legal expectation of any return.

A. *Returns Generally Expected by School Sponsors*

Some authors argue that, even without any economic return, private school sponsors still gain from their contribution to the schools. They claim that merely by contributing, the sponsor's reputation is increased, which leads to higher economic profits in other business endeavors.⁶⁰ Indeed, this argument may make sense for some school sponsors. For example, Geely Group Company is said to have foregone any official economic return from its investment in Beijing Geely University, and instead runs the university for the company's public image and as a training ground for the company's potential workers.⁶¹ Such

certain violations of education, accounting, or tax laws, (art. 47) and any return obtained in violation of the regulations is subject to confiscation by the education authority. Under such circumstances, the education authority may also order the school to cease student enrollment and may even revoke the school's operation license in serious cases. Furthermore, when the violation constitutes a crime, criminal charges will be pursued (art. XLIX).

⁵⁸ See Min, *supra* note 55.

⁵⁹ *Id.*

⁶⁰ GU MEILING, ZHONGGUO MINBAN JIAOYU TANSUO [THOUGHTS ON PRIVATE EDUCATION IN CHINA] 16 (1999).

⁶¹ Guo Lanyan et al., *Zhongguo Minban Jiaoyu de Xi yu You [The Achievements and Worries of Private Education in China]*, CHINA YOUTH DAILY, Sept. 11, 2003, http://zqb.cyol.com/content/2003-09/11/content_731910.htm. It may be argued, however, that Geely is not entirely selfless because its school operations are a stable source of qualified employees for its business operations.

altruism, however, is not common among most private school sponsors. For example, retired intellectuals, who had no intention of donating their investment without a return, established many of the earliest private colleges and universities in the 1990's.⁶² When surveyed in 2002, only ten percent of private school investors did not expect any return from their investment, with ninety percent stating that they expected a profit from their educational investment.⁶³

Expecting schools to be started and run out of private largesse is an illusion in today's China, where few, if any, donations are actually available to private schools.⁶⁴ According to one survey from 2007 that sampled forty-five representative private schools, only two out of forty-five had ever received a donation of any sort.⁶⁵ It is unrealistic to expect the private education sector to flourish by expecting potential school sponsors to donate their capital with no hope of tangible economic benefits.

B. *Methods Sponsors Seek Returns Under the Current System*

Even though school sponsors are forbidden from profiting from the operation of private schools,⁶⁶ and despite the reluctance of local authorities to approve reasonable returns, sponsors have created various investment structures to circumvent these restrictions. Current laws allow private school sponsors the power to influence a school's board,⁶⁷ and thus control the school's expenditures.⁶⁸ As New Oriental Education & Technology Group Inc. ("New Oriental") has disclosed in its prospectus,⁶⁹ private school sponsors will routinely form a service company (in New

⁶² Lin, *supra* note 18, at 158.

⁶³ Ye Qilian et al., ZHONGGUO SIXUE, SILI XUOXIAO, MINBAN JIAOYU YANJIU [CHINESE PRIVATE EDUCATION, PRIVATE SCHOOLS, AND PRIVATE EDUCATION STUDY] 719 (Wang Bingzhao ed., 2002).

⁶⁴ Gu, *supra* note 73, at 17.

⁶⁵ Dong Shengzu, *Guanyu Minban Gaoxiao Faren Caichanquan de Sikao: Jiyu 45 suo Minban Yuanxiao Faren Caichan Zhuangkuang de Diaocha Fenxi [Thoughts on Property Rights of Private Colleges and Universities: Analysis Based on Survey of 45 Private Colleges and Universities]*, JIAOYU FAZHAN YANJIU [EDUCATION DEVELOPMENT RESEARCH], 7-8B (2007).

⁶⁶ *Jiaoyu Fa* art. XXV.

⁶⁷ *Minban Jiaoyu Cujin Fa*, art. IXX-XX.

⁶⁸ Article XXI of the Private Education Promotion Law sets forth the powers of the school board, which include approving the school's financial budget and final accounts, as well as the salary standards for teachers and staff.

⁶⁹ New Oriental Education & Technology Group Inc. Form 424B4, 2007, "Corporate Structure" 41-44, http://www.sec.gov/Archives/edgar/data/1372920/000119312507025132/d424b4.htm#rom19490_11.

Oriental's case, its Beijing Division) that provides a variety of services to the private school in exchange for service fees. The New Oriental prospectus shows that the scope of these services is vast, including contracts for teaching support, enrollment system development agreements, website development and use agreements, trademark license agreements, and sales of educational software, just to name a few.⁷⁰ In practice, agreements on almost any form of profitable service are commonly seen, ranging from dormitory management to dining and canteen services.⁷¹ The service companies are the default providers for profitable services needed by the private school.

III. PROBLEMS WITH THE CURRENT INVESTMENT MODEL

By stifling legitimate profits, the current model creates incentives for school sponsors to flout the law in order to extract a return from their investment. The school and the sponsor-owned service companies are placed in a dubious position with respect to Chinese contract law, with an increased likelihood of tax and accounting non-compliance. The current model also has the effect of forcing schools to make inefficient use of their capital. Without the freedom to bargain with service providers in a competitive market, the schools are likely to pay above market rates and receive substandard goods and services.

The legality of this current investment model is questionable under Chinese contract law. When a service agreement is simply a tool to extract profits from a private school, there is a strong disincentive for the service company to not provide genuine services to that school. If there is no genuine service provided, then under current Chinese contract law, the service agreement is deemed to be a shield of an illegal transaction and is void.⁷²

Additionally, under the current model, even if a service company owned by the sponsor is providing genuine services to the private school, the price paid for the services is unlikely to reflect the value of the services rendered, which is a violation of tax laws. Because the sponsor is taking profits from the private schools through the service company, the sponsor's service company's total charge will be higher than the market rate for the service provided. Under the Enterprise Income Tax Law, where the taxable income of affiliated parties reduces by virtue of their failure to abide by the arm's length transaction principle, the tax

⁷⁰ *Id.* at 43.

⁷¹ Min, *supra* note 55.

⁷² See Hetong Fa (合同法) [Contract Law] (promulgated by the Nat'l People's Cong., Mar. 15, 1999, effective Oct. 1, 1999) available translated at <http://www.isinolaw.com/> (last visited Feb. 05, 2010), art. LII.

authorities may adjust the transfer pricing, recover the tax payments, and charge an additional interest for the late tax payment.⁷³

Finally, the current model is economically inefficient in terms of the school's capital use. Since extracting profits from the school is dependant on the service agreements, sponsors who want a return on their capital contribution have an incentive to steer the schools into agreements with their own service companies to the greatest extent possible. From the school's perspective, this self-serving arrangement severely limits its choices by denying schools access to services available in a competitive market; the service company, realizing that the school has no other alternative, may in turn provide lower quality services without fear of any consequences.

School sponsors generally have an incentive to run schools so as to achieve the highest returns possible. When the profit comes from the service companies, and not from the school itself, sponsors will be tempted to focus on extracting profits from the service companies, rather than providing quality services to the school.

Indeed, if a private school finds itself generating more income than expected, sponsors have every incentive to use their influence with the school board to increase the type or amount of services that the sponsor's service companies provide or simply to increase fees charged to the school. The private school is thus saddled with unnecessary expenditures because it has been effectively cut out from shopping for services in a competitive market.

IV. PROPOSALS FOR IMPROVING THE REGULATION OF INVESTMENT

The government should reform current private education investment legislation. The existing legislation causes school sponsors to flout the law in order to receive profits. Practical and enforceable legislation is needed that allows school sponsors to invest in and openly obtain reasonable returns from the private education entities that they have created.

A. *The Not-for-Profit Principle and Reasonable Return*

The Education Law requires all educational institutions to be run for social benefit but not for profit. For the reasons discussed above, however, requiring private school sponsors to run schools for no profit is unrealistic. To resolve the conflict between the demand for education and the sponsors' need for capital return, the current Private Education Law and its Implementing Rules allow a private school sponsor to obtain a

⁷³ See *Qiyè Suode Shuifa* (企业所得税法) [Enterprise Income Tax Law] (promulgated by the Nat'l People's Cong., Mar. 16, 2007, effective Jan. 1, 2008) available translated at <http://www.isinolaw.com/> (last visited Feb. 5, 2010), arts. XLI-XLVIII [hereinafter *Qiyè Suode Shuifa*].

reasonable return. However, the conflict between the not-for-profit principle and the permissible reasonable return remains an unanswered question under current Chinese law.

From a legislative hierarchical perspective, the Education Law was promulgated by the People's Congress, while the Private Education Promotion Law was promulgated by the Standing Committee of the National People's Congress. Technically, the Standing Committee of the National People's Congress does not have the authority to promulgate laws that are against the basic principles set forth in the laws promulgated by the National People's Congress.⁷⁴ Thus, it may be argued that because the not-for-profit requirement is a basic principle already set under the Education Law for all educational institutions, the legality of the permission of reasonable return under the Private Education Promotion Law is questionable.

The not-for-profit principle under the Education Law should be amended to specifically allow the sponsors to obtain reasonable returns in conformance with the Private Education Promotion Law. This would effectively resolve the conflict between the two laws, while maintaining the legislative hierarchy. Recognizing the private school sponsors' right to reasonable returns in the form of a law promulgated by the National People's Congress would also provide the sponsors with certainty as to the law and encourage further investment in the private education sector.

Alternatively, the Standing Committee of the National People's Congress may exercise its interpretation rights⁷⁵ to interpret the not-for-profit principle in such a way that reasonable returns are allowed. A possible interpretation that has been put forth by scholars arguing for the legality of the reasonable return provision is that the law limits the reasonable return, and because the return is restricted, it is therefore different from a profit from operating schools.⁷⁶ These scholars further argue that a reasonable return is merely an inducement granted to school sponsors to encourage their capital contribution to the private schools;⁷⁷ therefore, permitting reasonable returns does not conflict with the not-for-profit principle.⁷⁸ However, this interpretation is not entirely convincing

⁷⁴ Lifa Fa (立法法) [Legislation Law] (promulgated by the Nat'l People's Cong., Mar. 15, 2000, effective July 1, 2000) *available translated at* <http://www.isinolaw.com/> (last visited Feb. 5, 2010), art. VII.

⁷⁵ Under the Legislation Law, the Standing Committee of the National People's Congress has the right to interpret laws to clarify the meaning of certain law provisions, or to clarify the application of law when new circumstances arise after the promulgation of certain laws. *See Id.* art. XLII.

⁷⁶ Gu, *supra* note 60 at 17.

⁷⁷ *Id.* at 18.

⁷⁸ Hou Xiaojuan, *Taxation and Reasonable Return of Private Schools*, ZHONGGUO JIAOYU BAO [CHINA EDUCATION DAILY], May 12, 2003, at 4.

and may foment further confusion. If the reasonable return is a bounty, as is argued, then who is granting the bounty to the school sponsors? If it is the school, then the net result is that the school, an entity into which the sponsors invested money, pays a bounty to the capital contributor. Isn't such a bounty by definition a profit?

The government is not providing the inducement. The reasonable return actually comes from the private school itself. Furthermore, even if the sponsors do not expect a reasonable return, under the current law such operation surplus does not go the government.⁷⁹ It would stay within the school for the school's future operations.⁸⁰ In other words, the government does not sacrifice any of its income or reserves to grant this inducement. All these traits make reasonable return more like a sponsor's profit from school operations and less like a government inducement. The law should, while protecting the healthy development of private schools, be further clarified to enable reasonable returns in practice.

First, pursuant to Article XXXVIII of the Implementing Rules, the finance, tax, and other relevant departments of the State Council should jointly promulgate regulations to specify the preferential tax treatment for the private schools whose sponsors request a reasonable return. When specifying the tax treatment for the private schools, the regulations should honor the desire to promote the development of private education in China expressed in its title and preamble.⁸¹ The regulations should be based upon the interests and sustainable development of the private schools, rather than other considerations, such as the tax income the schools can provide to the government.

The government should also be careful not to impose a different tax treatment on the private schools whose sponsors request a reasonable return. The tax burden should be standardized and should not penalize those sponsors who request a reasonable return.

Second, the rate of reasonable return should be set so that it equitably balances the interests of both the private school and the school's sponsors. Although the current laws allow reasonable return, what is reasonable is still an unanswered question. In a survey that asked eighty-two private school sponsors what constituted a reasonable return, 11.1 percent believed that the allowable return should be equal to the bank deposit interest rate, 33.3 percent believed that the standard should be the bank lending interest rate, and forty percent believed it should exceed the bank lending interest rate.⁸² In this instance, the annual bank lending rate is the proper rate to use. Reasonable return acts as an incentive to

⁷⁹ *Id.* at 3.

⁸⁰ *Id.*

⁸¹ *Minban Jiaoyu Cujin Fa*, ch. I, arts. I, III, V, VI.

⁸² Ye, *supra* note 63, at 719.

encourage private entities and individuals to contribute capital to educational institutions; the reasonable return rate must be higher than the bank deposit rate to be effective. Otherwise, there will be no incentive to keep potential sponsors from simply storing their funds in banks.

On the other hand, to avoid speculation and promote the sustainable development of private schools, the reasonable return rate should not be too high. The annual bank lending rate should be used as a benchmark for the reasonable return rate. Of course, when determining the exact rate applicable to specific school sponsors, the educational authority should consider other factors, including those set forth in the Implementing Rules, such as the school's fee charge rates, the ratio of expenses on educational activities and school development versus total expenditures, and the school's operation quality, compared to similar private schools.

Finally, the education, tax, and other relevant authorities should strictly implement and enforce the relevant laws. The education authorities should accept applications to request reasonable return when an eligible school sponsor applies to form a private school; when an application is rejected, the reason for rejection should be given, and there should be a procedure for appeal or re-application available to the applicants.⁸³

B. *School Sponsor Qualification*

Currently, the law specifies few qualifications for private school sponsors beyond the basic requirement that a school sponsor must be a legal person (if a private entity) or have political rights and full civil capacity (if an individual).⁸⁴ Instead of examining the sponsor's level of educational management experience, the law and regulations look to whether the sponsor has the sufficient, legally required funds for school construction and operation.⁸⁵

⁸³ Enforcement of the laws and policies can vary widely across cities and provinces, and even among different districts in larger cities. See *Can China's Private Education Providers Make the Grade?* at 4.

⁸⁴ *Minban Jiaoyu Cujin Fa* art. IX. For the purpose of forming a private college or university, for example, the Provisional Regulations on Establishment Criteria for Private Higher Educational Institutions provides a plethora of criteria that a new school must meet. The sponsor must ensure that college or university has a fixed, independent, and relatively concentrated campus. This campus must include classrooms, a library, a laboratory, and school administration and other buildings. The aggregate area of the campus must be no less than ten square meters per student for liberal arts schools and sixteen square meters per student for science and engineering schools (art IX). In addition, the sponsor must ensure that the college or university meets the requirements in a host of other areas, including educational equipment and number of books.

⁸⁵ *Id.*

The definition of what funds can be counted toward this mandated funding threshold creates a barrier to entry for potential sponsors. The Implementing Rules specifically prohibit sponsors from counting government subsidies, fees charged from students, and other donations or borrowings as capital contributions to the private school. These criteria are overly onerous and present unnecessary obstacles to demonstrating the sponsor's sufficiency of capital capacity for the construction and operation of the private school.

In order to ensure the stable, sustainable development of the education sector, the law should allow these items to be included toward a showing of capital sufficiency. Prohibiting borrowed funds from counting toward the capital sufficiency requirement is an undue burden to investors that will discourage their entry into the market.

C. *School Sponsor Rights*

Reading through the current private education law, it is striking that the term sponsor's rights is neither defined nor regularly used.⁸⁶ This may reflect China's traditional emphasis on the role of charitable donation as a funding mechanism for private schools.⁸⁷ Viewed in this light, it is not surprising that any substantive discussion outlining sponsors' rights is absent from the law. Under the current law, a sponsor is given two major rights: the right to manage a school through his representatives in the school board and the right to a reasonable return.

As discussed above, sponsors exercise their right of school management through representation on the school's board. Thus, a sponsor's right to manage the school depends directly on the sponsor's right to appoint directors to the school board. Currently, the law only requires that the school board consist of five or more members, including the school sponsor or its representative, the school principal, and representative(s) of the teachers and staff.⁸⁸ There is no legally specified ratio of board members a sponsor may appoint.⁸⁹ In practice, the sponsors and their representatives dominate the vast majority, if not all, of private school boards.

This school management right creates potential conflict between a sponsor's economic interests and a school's educational quality. This is one of the few cases where the existing regulatory scheme has struck the proper balance between investor autonomy and safeguarding the quality of

⁸⁶ The term sponsor's rights appears only once, in Article VI of the Implementing Rules to the Private Education Promotion Law, which provides that "[a] public school sponsoring a private school is entitled to the sponsor's rights as provided by law . . ."

⁸⁷ Yu, *supra* note 1, at 8.

⁸⁸ *Minban Jiaoyu Cujin Fa* art. XX.

⁸⁹ *Id.* art. IX.

private education. First, the law sets reasonable qualifications for board members—at least one-third of the board members are required to have at least five years educational or teaching experience.⁹⁰ This ensures that the school management has at least some knowledge about the industry. Second, in order to achieve economic success and sustainable development, the management is incentivized to pay attention to the school's education quality. As indicated by some private school principals, the school management does understand that “the life of private school lies in the education quality.”⁹¹

It is worth noting that under current tax laws, a private school sponsor does not have any property rights over school assets.⁹² According to Article XXXV of the Private Education Promotion Law, such property rights belong to the private school. The new Regulations on Administration of Private Higher Educational Institutions, promulgated by the Ministry of Education in 2007, in addition to reiterating the above principle, further require that the title to a private college's or university's assets be transferred to the school within one year after the governmental approval of establishment. Any failure to complete such title transfer renders the sponsor jointly and severally liable for the school's debts.⁹³

So long as reasonable return is not practical to obtain, school sponsors who are not willing to donate their assets to the school will resist this requirement to transfer school assets, in order to protect their interests. This concern can be addressed if sponsors are enabled to obtain reasonable returns in line with the law reform previously discussed.

The Guaranty Law also promotes the tendency of sponsors to retain title in school assets by limiting the sponsors' financing options. Specifically, the law places legal restrictions on the mortgage of school assets,⁹⁴ which encourages school sponsors to leave the title of school

⁹⁰ *Id.* art. XX.

⁹¹ Ye, *supra* note 63, at 724.

⁹² *Minban Jiaoyu Cujin Fa*, art. XXXV.

⁹³ Minban Gaodeng Xuexiao Banxue Guanli Ruogan Guiding (民办高等学校办学管理若干规定) [Regulation on Administration of Private Higher Educational Institutions] (promulgated by the Ministry of Educ., Feb. 3, 2007, effective Feb. 10, 2007, Order No. XXV) *available translated at* <http://www.isinolaw.com/> (last visited Feb. 5, 2010), arts. VI, VII.

⁹⁴ *See* Danbao Fa (担保法) [Guaranty Law] (promulgated by the Standing Comm. of the Nat'l People's Cong., June 30, 1995, effective Oct. 1, 1995) *available translated at* <http://www.isinolaw.com/> (last visited Feb. 5, 2010), arts. IX, XXXVII. Under the Guaranty Law, a school, as a not-for-profit institution, is not allowed to either act as a guarantor or provide its educational assets as collateral.

assets in their own names or under the names of affiliated entities in order to obtain bank financing.⁹⁵

D. *Exit of Investment*

Currently, the laws do not provide clear guidance as to how a sponsor may exit an investment in a private school. This key area of legal uncertainty significantly affects any potential sponsor's investment decisions.

1. Dissolution

The Private Education Promotion Law allows school to voluntarily terminate and dissolve.⁹⁶ Upon dissolution, school assets should be distributed in the following order: (1) to return to students' tuitions and pre-charged fees, (2) to pay salary and social insurance contributions for faculties and employees, and (3) repayment of other debts; and any surplus after the above distribution shall be disposed in accordance with "relevant laws and regulations."⁹⁷ The former Regulations on School Operations by Social Forces provided that, of the surplus, a portion equivalent to a sponsor's contribution would be returned to the sponsor and the remainder would be disposed of by the educational authority and used in private education development.⁹⁸ Although these regulations have been rescinded, anecdotal evidence suggests the practice remains the same.⁹⁹ This practice is consistent with the not-for-profit principle set by the law.

While at first blush the way dissolution functions may seem to be a hindrance to investors, the authorities clearly have an interest in assuring that speculators do not simply close down school operations when a better investment opportunity presents itself. To balance the investors' interest in safely exiting investment and the government's interest in the sustainability of the private education sector the government should institute more effective regulation of sponsor change, as discussed below.

2. Exit Through Sponsor Change

Article LIV of the Private Education Promotion Law provides that a sponsor change shall be initiated by the school sponsor, and before applying for approval to the educational authorities, the school shall go through financial liquidation, with the school board approving the sponsor

⁹⁵ Min, *supra*, note 55.

⁹⁶ *Minban Jiaoyu Cujin Fa*, art. LIX.

⁹⁷ *Id.*

⁹⁸ *Shehui Liliang Banxue Tiaoli*, art. XLIII.

⁹⁹ Min, *supra* note 55.

change.¹⁰⁰ The law, however, does not specify how the transfer price should be determined. One may think that in the absence of legal restrictions, the old and new sponsors would be free to bargain on the transfer price as they would in an ordinary market. In practice, however, educational authorities normally only approve transactions at par value, i.e., at the value of the old sponsor's contribution, as recorded on the school's operation permit.¹⁰¹ The rationale for this approach is that since private schools are not-for-profit, no profit should be made by a sponsor seeking to exit his investment other than through the legally permissible reasonable return.¹⁰² This is a flawed rationale, which creates a tremendous barrier to entry into the sector. Because of the theoretical existence of a reasonable return and the profits available from self-serving service agreements, the school sponsor right carries economic value. To require two sponsors to sell and purchase school sponsor rights at par is simply not realistic. This practice explains why current sponsor change transactions are normally done with two sets of agreements—one to be filed with the authorities with the price at par, and another “under the table” agreement reflecting the agreed price that the new sponsor is willing to pay.¹⁰³ The law should be reformed to allow sponsor change to go forward at prices that reflect the market value of the school.

3. Donation and Private Education Fundraising

Under current tax laws, donations for social benefit are encouraged.¹⁰⁴ The Enterprise Income Tax Law and its Implementing Rules provide that an enterprise may deduct donations for social benefit from its taxable income, so long as the amount does not exceed twelve percent of the enterprise's total annual profit.¹⁰⁵ Similarly, the Individual Income Tax Law and its Implementing Rules provide that donations for educational or other social benefit may be deducted by an individual up to thirty percent of her taxable income.¹⁰⁶ Both the enterprise and individual

¹⁰⁰ *Minban Jiaoyu Cujin Fa*, art. LIV.

¹⁰¹ Min, *supra* note 55.

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ Hou, *supra* note 78 at 6.

¹⁰⁵ Qiye Suode Shuifa, art. IX; Qiyuesuo de Shuifa Shishi Tiaoli (企业所的税法实施条例) [Implementing Rules to the Enterprise Income Tax Law] (promulgated by the State Council, Dec. 6, 2007, effective Jan. 1, 2008) *available translated at* <http://www.isinolaw.com/> (last visited Feb. 5, 2010), art. LIII [hereinafter *Qiyuesuo de Shuifa Shishi Tiaoli*].

¹⁰⁶ Geren suo de Shuifa (个人所的税法) [Individual Income Tax Law] (promulgated by the Nat'l People's Cong., Sept. 10, 1980, as amended by the Standing Comm. of the Nat'l People's Cong., Dec. 29, 2007, effective Mar. 1, 2008) *available*

tax laws, however, require donors to donate funds through a qualified fund or charitable institution.¹⁰⁷ Individual tax laws do not specify the qualifications of such intermediate institutions, but the Implementing Rules to the Enterprise Income Tax Law provides that the asset surplus upon termination of such institutions shall not belong to any individual or for-profit organization.¹⁰⁸ This requirement excludes private colleges and universities from directly receiving donations from taxpayers.

Currently, there is no charitable organization specially approved for raising funds for private colleges and universities.¹⁰⁹ To encourage donations, the education authorities should coordinate with private school sponsors to form an institution to facilitate fund raising through taxpayer donations. Alternatively, the legislature may consider granting exemptions to private schools so that they may be qualified to directly accept donations from taxpayers.

V. CONCLUSION

Establishing a legal infrastructure for protecting and regulating investment in private education is necessary to ensure continued growth in the sector. With the central government's inability to adequately fund public education, private education will be increasingly relied upon by the state. The current laws and policies relating to investment in Chinese private education thwart private capital investment in the sector, creating an environment of uncertainty for investors. Investors are left to wonder about key issues, such as their ability to legally receive a reasonable return or even how they can exit their investment.

Providing a legal infrastructure for regulating private investment in education is not an easy task. The Chinese government must try to foster growth in a market that has an inadequate and contradictory regulatory framework. This article provided recommendations for reforming the laws and policies surrounding investment in this sector, with the goal of removing some of the uncertainty that investors face under the current structure. Reforming the current model is a necessary first step toward ensuring the continued flow of private investment into the education sector.

translated at <http://www.isinolaw.com/> (last visited Feb. 5, 2010), art. VI; *Genren suo de Shuifa Shishi Tiaoli* (个人所的税法实施条例) [Implementing Rules to the Individual Income Tax Law] (promulgated by the State Council, Jan. 28, 1994, as amended by the State Council on Feb. 18, 2008, effective Feb. 18, 2008) *available translated at* <http://www.isinolaw.com/> (last visited Feb. 5, 2010), art. XXIV [hereinafter *Genren suo de Shuifa Shishi Tiaoli*].

¹⁰⁷ *Qiyuesuo de Shuifa Shishi Tiaoli* art. LI; *Genren suo de Shuifa Shishi Tiaoli* art. XXIV.

¹⁰⁸ *Qiyuesuo de Shuifa Shishi Tiaoli* art. LII.

¹⁰⁹ Hou, *supra* note 78, at 5.