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Prospects for tax reform in China following the 18th CPC National Congress

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Abstract

After the 18th National Congress, the Chinese government should speed up tax reform and tax reduction. Tax structure should switch to direct tax. Consumption tax reform of lower tax burden could start within a short time. Replacing business tax by value-added tax should be quickly completed. Personal income tax reform should move toward comprehension. Uneven resource distribution should be taken into consideration in resource tax reform. Property tax should be included in the local financing service, and tax rate must be lower than other nation imposing private property rights. Looking at the long term, export should reinstate to zero export rate regime.

Keywords: China's tax reform; Fiscal policy; Chinese economy

Background

Now is a critical moment for the economy of China. The factors' driving growth is changing, as exports and demand for investments were both constrained by various factors both in and outside of the country. The policies established in response to the 2008 international financial crisis will continue for a while longer, as fiscal policies of increasing government expenditures cannot guarantee economic growth. Right now under current aggressive fiscal policies, the Chinese government should speed up tax reforms after the 18th National Congress of the Communist Party of China (CPC), combining fiscal policy tools and tax reforms to promote balanced development for the overall economy.

The focus of aggressive fiscal policy should be shifted from increasing expenditures to cutting taxes

It is well known that since 2008, the Chinese government has stressed structural tax cuts. In practice, the government has adopted the "balance of payment" strategy as its primary fiscal policy tool.

Following the 18th CPC National Congress, it is unlikely that the Chinese government will maintain its prevailing mindset of steady growth. The government should look to the market and let the market work its magic in resource distribution. Stimulating market demand by increasing government expenditures might yield instant results, but it also comes with negative consequences. There might be inequality on the benefit side of expenditures, resulting in the rich acquiring more resources while the poorer classes receive less or none. The 4 trillion yuan economic stimulus plan has strengthened the power of state-owned enterprises but at the same time weakened the competitiveness of private companies. If the policy of increasing expenditures is allowed to continue, more resources might flow to state-owned enterprises. This would be harmful to fair competition and may prove especially fatal to small- and medium-sized enterprises. This is the first reason that we should do away with the policy of increasing government expenditures.

The second reason is that ever increasing expenditures would require government investments, which might trigger institutional reversion resulting from an expansion of the process of administrative examination and approval.

The third is that increasing expenditures implies either increasing the debt financing scale or increasing government revenues. At present, there is still room for more government debt, but if local governments' debts problems are not resolved, local debts may transfer to the central government. Hence, expanding the debt scale will inevitably lead to more uncertainties for future government finances.

The fourth reason is that by increasing revenues to expand expenditures, there is a risk of destabilizing the economy, which will only make things worse for troubled firms.

Even though increasing government expenditures is not appropriate, that does not mean that the government has no other valid options. Adjustments to the structure of expenditures could still have a positive effect. By structuralizing expenditures and increasing governmental involvement in public services (such as spending on pensions, medication, education, and housing), disposable incomes could be increased, creating more demand for spending and providing further support for economic growth.

At the same time, reducing treasury revenues (including taxes) could play an important role in active fiscal policy and in the end would increase household disposable incomes. Tax-cutting policies should also include reductions on non-taxable incomes, such as fees and funds, thus lessening the burden on companies and strengthening their competitiveness. Tax cuts would place pressure on public finances, but the benefits are self-evident. Increased competitiveness of firms and increased disposable incomes of households would gradually push up revenues while driving economic growth.

As for the scope of tax cuts, scholarly opinions vary. Gao (2012) suggests tax cuts of 600 billion yuan, while Xie (2012) insists on a scale of at least 1 trillion. In this article, I have tried to integrate different theories on China's expansionary fiscal policy tools, ideas about transitioning tax structures, and existing scales of taxation in order to identify the optimal scale of tax cuts and to offer a number of recommendations.

The scale of tax cuts: determining the growth rate of taxes

Under current conditions, the Chinese government could bear a tax cut of more than 500 billion yuan in 1 year. In 2011, total tax revenue was 8972.031 billion yuan, an increase of 1650.952 billion over the previous year, for a YoY growth rate of 22.6 %. Such rapid tax revenue growth rates are not common. In 2010, nationwide total tax revenue was 7320.2 billion yuan, a YoY increase of 23 %. Since 1998, China's tax revenues have grown rapidly. From 2004 to 2011, tax revenue growth rates have exceeded GDP annual growth rates at 10.6, 8.7, 7, 20.7, 9.2, 0.6, 12.7, and 13.4 %, respectively. The only slow growth year was 2009, as a result of the international financial crisis. In previous years, tax revenues grew at the same rate as GDP. If tax revenues were able to balance the budget, there would be no problem establishing budgets, and tax cuts could be equivalent to the amount of tax revenues exceeding GDP. If the economy grew at a normal speed, the ceiling of tax cuts would be 10 % of tax revenues. In 2012, target tax revenue would be 9828.9 billion, 9 % higher than the previous year. The 2012 target GDP growth rate was 7.5 %. Based on these numbers, the ceiling of tax cuts would be 8.5 %. Following this logic, the tax cut ceiling would be 830 billion in 2012. If one takes decreasing tax revenues into consideration, the floor of tax cuts would be around 500 billion, based on conservative estimation and a tax cut scale of 5 %.

After the 18th CPC National Congress, it has become necessary to transform structural tax cuts into overall tax cuts. It would not be wise to increase taxes at this moment, not even under the auspices of carbon reduction or income redistribution. Not only should economic factors be taken into consideration for tax-increasing policies but also the perspective of public policy.

The scale of tax cuts could reach 1000 billion yuan if the government also reduces fees and its income from funds at the same time. There is also a connection between tax cuts and government revenue restructuring. Like levying taxes, levying fees and establishing funds are addictions that can be difficult to quit. Besides, some local institutions or sectors have had free rein over those funds, and it will be necessary to first remove those vested interests if such unreasonable charges are to be eliminated. Cutting taxes is never so simple an exercise as choosing a new policy, and nor is it just a matter of deciding how much to cut. The entire interest structure must be considered.

Never were tax cuts an easy task. Empirical evidence from tax reforms around the world demonstrates that ample tax revenues should be ensured before cuts can be made. Tax cuts should be made in consideration of our nation's economic structure, i.e., income from other sources could be used to offset deficiencies of disposable income brought about by tax cuts. Tax cuts should be linked to the government's budget reforms and used to elevate the efficiency of government expenditures by increasing the transparency of public budgets. Tax cuts should also be linked into the structure of national public expenditures, thus opening up more room for tax cuts by shutting down any projects which have already been out of date.

Stable income growth is fundamental to any tax reduction policy. In 2011, government revenue was 10374.001 billion yuan, an increase of 24.8 % over 2010. Thereafter it maintained rapid growth. After 1998, except for the first 6 months of 2009 when the economy was still reeling from the crisis, government revenues grew quickly. In 1995, government revenue accounted for 10.83 % of GDP. Since 1998, government revenues have hovered around 20 % of GDP, and it is estimated that government revenues will hit nearly 22 % of GDP in 2011.

Under the umbrella of "government resources," there are also governmental funds and bonuses paid out by state-owned enterprises. This will make it easier for the government to cut taxes in the future.

Tax code reforms should include adjustments to the overall tax structure

If the tax structure is centered on indirect taxes, commodity prices will rise

Many commodity prices in the Chinese domestic market are higher than those in other countries or regions. This is due to Chinese companies' high pricing strategies resulting from the market structure, or due to excess demand stemming from absurd consumption behavior in the domestic market, or even possibly due to high indirect taxes. The value-added tax, the consumption tax, the business tax, and various tariffs (including the export tax rebate) altogether accounted for 69.75 % of national tax revenues in 2011. Value-added taxes in most parts of the Asia Pacific region are 5 % or 10 %. The 17 % base rate of the value-added tax in China is therefore much higher than average. The scope of the consumption tax is also broader and so is the tax rate. The indirect tax structure has intrinsically determined a high ratio of tax to price for commodities. The sum total of Chinese taxes (at a great degree via tax transfer) acted together to increase commodity prices and led to consumption outflows, which in turn affected policies meant to spur domestic demand. In order to further increase domestic demand, China must adjust the current system, which is based on indirect taxation.

The indirect tax structure is harmful to the balanced development of the economy

Tax revenues increased after 1998 even without the passage of massive tax hike policies. On the contrary, all taxes introduced after 1994, including the value-added tax, the unified corporate income tax for both foreign and domestic enterprises, and the new personal income tax rates, could be considered tax cuts.

The reasons that tax revenues increased so quickly relative to GDP were rapid economic growth, tighter controls on tax collection, rising commodity prices, and the indirect taxation structure. That means that any economic activity, profitable or not, is subject to taxation, from the value-added tax, the consumption tax, or the business tax. And that, in the end, had undermined the competitiveness of domestic companies and contributed to outflows of consumption overseas. Under the present circumstances, there is a great divergence between the growth rate of government income and that of individuals and companies. Only by adjusting the indirect taxation structure can we hope to balance the income of all three sectors, thus unifying their growth rates.

High direct tax rates would be harmful to international taxation competitiveness

In September 2011, China decreased the income tax burden for middle- and low-income individuals in an attempt to promote social equity. However, individuals with high income now have to bear a higher tax burden, especially those individuals who fall within the highest marginal tax rate, 45 %, and those who have to pay monthly taxes of up to 80,000 yuan. This is harmful to developing China's international tax competitiveness. In this age of economic globalization, global factors should be taken into consideration when reforming a nation's tax code. In 1982, China set its highest marginal tax rate bracket at 45 %, relatively low among major nations at the time. In 1986, the US passed major tax reforms, and many other major nations followed suit, making the Chinese 45 % rate exceptionally high. This led to brain drain and also led to some overseas resource taxes going uncollected. In some regions, the government even decided to pay back certain individuals' individual income taxes in order to keep professionals around.

Prospects for tax reform

Consumption tax reform

Reforms should be made to the consumption tax in the short term. Those reforms should reduce the tax burden and should include a reduction to taxes on luxury goods.

We should do away with the mindset of "no matter how high the taxes, luxury consumption will not be affected." The trends of overseas and online shopping amply demonstrate consumers' behavior. Luxury goods are bought with the short term in mind, and so individuals' consumption behavior changes as their income increases. When people have enough income for daily life, they tend to spend excess money on luxury goods, and so regulations on their shopping behaviors may not be necessary. On the contrary, this kind of shopping behavior should be encouraged in order to stimulate consumption. Also in light of the fact that some middle- or low-income individuals prefer to save up for expensive goods, reducing consumption taxes would decrease their overall tax burden.

Reforms to the business tax and the value-added tax

On 1 January 2012, the Chinese government began a pilot program of levying a value-added tax in lieu of the business tax. The two rates of the pilot tax program, 11 and 6 %, have had the effect of reducing overall taxation. Not only does the new tax eliminate double taxation on targeted industries but also reduce the overall tax burden on firms which participated in the pilot program.

The government is also launching the pilot program in Beijing, Tianjin, Jiangsu, Zhejiang, Fujian, and Guangdong from 1 August 2012 to the end of 2012. To avoid regional competition for tax resources, the government should speed up the pilot program and extend it to the entire nation, thereby promoting the development of the service sector and adjusting the economic structure by reducing double taxation and overall tax burdens.

In the mid- to long term, the business tax should be consolidated into the value-added tax. Currently, there are too many brackets within the value-added tax, which reduces the neutrality effect. This is an issue which should be solved gradually. The existing 17 % basic rate and 13 % low rate should be reduced, but it could take 5–10 years to reduce to 10 and 5 %, respectively.

We should also formulate reforms other than the business tax and value-added tax targeted at reducing the tax burden on small- and mid-sized enterprises (SMEs). Reducing taxes would not solve all the problems for SMEs, but increasing the tax thresholds of the value-added tax and business tax would effectively reduce their burden.

Personal income tax reform

To make the personal income tax more fair, we must create conditions conducive to comprehensive tax reforms. In the wake of the 18th CPC National Congress, the Chinese government should actively create conditions specifically for the reform of the personal income tax. Before that, the Chinese government should focus on reducing tax burdens.

Under the progressive income tax system, we should coordinate every tax level. The amount to be deducted from individual wages and salaries has increased multiple times. Now, it is the time to reduce the tax burden on incomes such as laborers' wages and author's fees. In September 2011, the government further increased the standard amount to be deducted from wages and salaries, effectively reducing taxes on low- and middle-income individuals while increasing taxes on higher income individuals. This has caused some high-income individuals to move to other countries or regions, thus reducing China's potential taxation revenue. If the highest marginal tax rate were reduced, tax revenues thus gained could be used to help lower income groups.

As indirect taxes are reduced, direct taxes must be increased. However, it is not necessary to increase direct tax rates in order to reorder the taxation structure. The personal income tax rates of many other nations are lower than in China, but they still contribute to the same pool of personal income tax revenues. As personal incomes have risen, so have income tax revenues continuously risen. Better tax collection controls would ensure more government revenue from individual income taxes.

It is inevitable that the personal income tax system will be replaced with a comprehensive income tax system. In the future, the focus of personal income tax reforms should be on deductions that improve people's livelihoods, such as elder care, medication, education, and housing. The comprehensive income tax system should be aimed at reducing the tax burden for middle- or low-income groups and increasing international competitiveness for high-income groups. It should also at the same time be focused on expanding the income tax structure for middle-income groups. In addition, more measures should be taken to decrease the income tax burden for companies, mitigating the double taxation problem for both companies and individuals.

Resource tax reforms

The Chinese government has implemented reforms aimed at increasing the tax burden for the use of resources. At the present, there is little wiggle room for increasing resource taxes. The front-line issue is imposing more regulations on international markets. If Australian coal could be exported to Southeastern China at a lower cost than coal from Northern China, the public would naturally respond to the difference by demanding a higher tax burden on the imported coal. In a democratic society, tax rates and policy decisions are not solely the domain of government insiders but should reflect public opinion. As the tax burden increased, natural resources would in turn become more expensive. Apparently, higher resource prices are not better. As natural resources are unevenly distributed among the Eastern and Mid-western regions of China, it will be a complicated task to reform the resource taxation system. China cannot tax resources in the same way that resource-rich nations do, nor could it adopt the policies of resource-poor nations. We must build a resource tax system in Chinese style.

Property tax reform

On 28 January 2012, personal property tax pilot programs were begun in Chongqing and Shanghai. So far, no other cities have begun the pilot program. Following the 18th CPC National Congress, personal property taxation is still being implemented slowly and cautiously. We are currently awaiting more analysis before proceeding further.

Many nations and regions now levy personal property taxes, but this fact alone should not prompt the Chinese government to act in kind. Why should we blindly follow in their footsteps? We in China have many sources of government revenue that other nations and regions simply do not have. Why should the Chinese government have more sources of income than other governments?

Property tax is a local tax in many nations, but that does not mean that the local governments rely on the revenue from that tax. The local governments of many nations rely to a large extent on allocations from higher levels of government, including central governments, to provide local public services. As the central Chinese government has collected a great amount in indirect taxes, the key to solving local governments' financial issues is to differentiate the revenues taken in by different levels of government. If local governments have to rely on property taxes as their main source of revenue, we must first reduce indirect taxes.

Many nations do not collect revenues from transferring the usage rights of publicly owned land. Land transfer fees settle the problem of who has the right to use what land in China. If it was necessary to establish a property tax system using our current state-owned land-transferring protocols, then personal property taxes would be much lower in China than in nations of private ownership of land. The tax rate of the latter is only 1 %, and for the former it would be 0.5 % or less.

Technological conditions are only one of the basic requirements to implement a personal property tax, not the only requirement. Before there are changes to supply and demand in the real estate industry, any hope that personal property taxes will help regulate the runaway real estate industry is in vain. Even if most of society agrees on levying personal property taxes, local governments should think twice before acting. Levying personal property taxes would directly promote the transparency and openness of government. Could local governments provide satisfactory explanations to their citizens?

Progressively reinstating a zero tax rate on exports

In the long term, we should restore the export tax to zero. The frequently adjusted export tax rebate is closely related to our exchange rate policy, to the insufficiently reformed pricing mechanisms for resources and energy, and also to the high ratio of indirect tax revenues to total tax revenues. The current export rebate policy is termed a policy, not a system. The frequently fluctuating export rebate tax rate is not beneficial to the export rate system for firms, making decision-making more risky for companies, and thus affecting the whole economy. Now, most of the nations in the world have implemented a zero export tax rate, and China should not be excused from joining this trend. A zero export tax rate can promote the competitiveness of Chinese products in the global market, stabilizing companies' expectations and creating a healthy, predictable tax structure.

Conclusions

In the wake of the 18th CPC National Congress, the biggest change to Chinese tax reforms, as compared to the past three decades, is that tax reforms are not simply linked to economic development but now include more functions of public policy and the structure of local tax revenues. The focus of tax reforms is therefore no longer on economic effects alone but also on the integration of the public opinion into public policy.

Competing interests

The author declare that he has no competing interests.

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