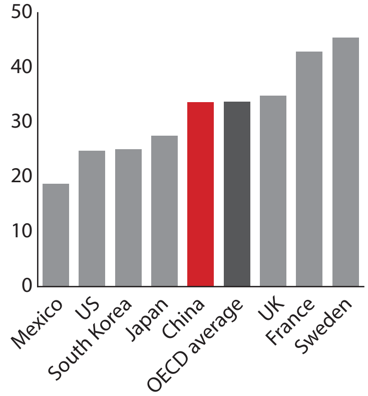
Fiscal reform

A better way to tax and spend

by Xinye Zheng and Li Zhang

Weighty coffers

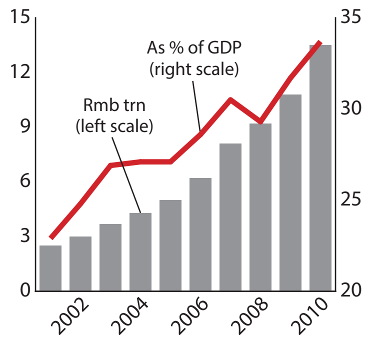
Total government revenue by country, % of GDP (2010)



Source: Author estimate, OECD

Taxing times

Total government revenue



Source: Author estimate

What sort of fiscal system does China need? The answer depends on what you believe taxes are for. Proponents of fast economic growth, who fear that China will struggle to hit its 7-8% growth targets, propose lower income tax rates and more public spending on infrastructure. Critics of the country's huge income inequalities, on the other hand, want higher income tax rates and more welfare spending. And green campaigners argue that carbon and emissions taxes are needed to prevent a looming environmental disaster.

Whatever your priorities, it is clear that China's current fiscal system is not fit for purpose. The bulk of spending obligations falls at the local level, but most taxes are diverted to the central purse. This encourages local governments to chase income and GDP growth at any cost. The current system does not do what it is supposed to do—pay for public goods, raise economic efficiency, and redistribute funds from rich to poor. China's new leaders, President Xi Jinping and Premier Li Keqiang, know that substantial reforms are needed. Changes to the fiscal system, however, must try to satisfy conflicting demands. The fundamental challenge is to create a more efficient system that keeps growth on track while simultaneously prodding the country towards a more sustainable development model.

We believe the fiscal system should attempt to do four things: maintain economic growth, smooth fluctuations in the business cycle, reduce the income gap, and discourage pollution. At China's current stage of development, redistributive income taxes are needed to create a more equal society, and pollution taxes are needed to prevent environmental meltdown. For two decades, China has pursued a simple growth model that created enormous wealth—yet policy makers must now address the negative consequences of this boom. These objectives must be balanced with maintaining moderately fast economic growth and mitigating growing economic volatility.

What are taxes for?

China needs a new fiscal system because the country has changed dramatically since the basic parameters of the current system were set 30 years ago. Since the early 1980s, when China began its race to prosperity, the main mission of government has been to ensure economic development. In addition to raising revenue, the tax system remains designed to do just that—to promote capital formation, increase the labor supply, and boost technological progress. When the system was overhauled in the mid-1990s, the chief objective was to replenish the central govern-

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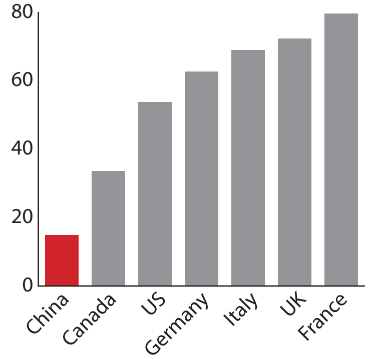
ment's shrinking revenues by diverting funds away from localities. But this only served to put more of the onus of growth on local governments, who had to attract industry and investment to makes ends meet.

Both sides of China's fiscal coin are designed to be pro-growth. On the revenue side, tax is mainly collected from industrial and commercial activities via business and value-added (VAT) taxes. By contrast, the levels of corporate income tax and personal income tax are intentionally kept low in order to increase the after-tax returns to capital and labor. This is good for growth, because it minimizes the negative impact of taxation on capital formation, job creation, R&D, and entrepreneurial verve. Yet because local governments are allowed to keep all business taxes and 25% of VAT receipts, they have a very strong incentive to expand local industry and commerce. On the expenditure side, this means that governments fritter away public funds on often dubious infrastructure projects, such as new industrial parks and "economic development zones." Relatively little is spent on income redistribution, still less on pollution control.

Tight-fisted

Central government expenditure as % of all government expenditure (2010)



Source: Author estimate, OECD

In Beijing we trust?

One way of viewing China's fiscal system is as a tussle between the central government and local authorities. Since the tax reforms of 1994, when Beijing demanded that a large chunk of revenues collected locally be diverted to central coffers, the central government has appeared on top. Responsibility for spending on social security, public welfare and environmental protection falls at the local level, but most local governments struggle to meet their spending commitments. Revenues have been centralized, but expenditures remain in local hands.

To plug the holes in their balance sheets, local governments have to rely on fiscal transfers from Beijing. Since the 1994 reforms, central transfers have accounted for an annual average of 46% of local expenditures. In 2008, for example, more than half of the fiscal resource in 21 out of 31 provinces came from the central purse. (Wealthier cities like Beijing and Shanghai, or provinces like Guangdong and Jiangsu, are less reliant on central transfers.) Even with these transfers, however, local governments still struggle to meet their spending obligations. So to make ends meet, they are forced to chase income, usually by selling land or attracting more industry.

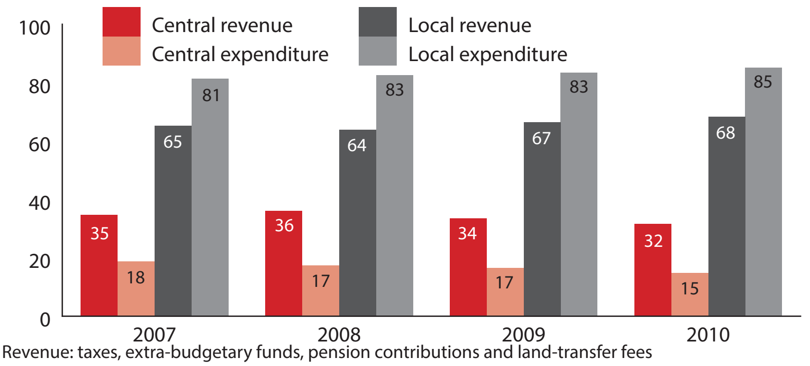
For Beijing, there are two possible solutions to this problem: either allow local governments to keep a larger chunk of revenues, or take more direct responsibility for local spending obligations. Unsurprisingly, central officials are reluctant to grant greater fiscal autonomy to local governments, which would weaken their own position. This leaves the central government no choice but to take greater responsibility for social-welfare spending and environmental regulation. This makes sense, because experience shows that many localities are only too happy to lower environmental standards or loosen labor standards in order to attract investment. In principle, it should also be good for social equity, because few local governments are willing to provide meaningful support for poor families for fear of becoming "welfare magnets."

International experience also provides compelling evidence for centralizing fiscal expenditures. Most advanced economies have strong central governments. In 2010, the central governments of the G7 countries provided, on average, 62% of total public services (excluding Japan, for which data are not available). In China, the figure was a paltry 15%. In market economies, where both labor and capital are highly mobile, it no longer makes sense to provide many public services locally. Central governments have little choice but to take responsibility for pension systems, welfare spending and environmental regulation.

What does this mean in practice? Specifically, all revenues from corporate and personal income tax should be directed to the central government. Beijing should then administer health insurance, unemployment insurance and social welfare programs on a national basis. Finally, transfers from the center to local governments must be reduced in accordance with this shift in responsibilities.

Fiscal mismatch

Share of revenues and expenditures by level of government, %



Revenue: taxes, extra-budgetary funds, pension contributions and land-transfer fees
Expenditure: regular spending and pension contributions

Source: China Fiscal Yearbook, China Labor Statistical Yearbook, China Land and Resources Statistical Yearbook

When this system was introduced three decades ago, it made sense: neither income inequality nor pollution were serious problems, and the business cycle (as far as there was one) had few negative effects. But the reality today is that a trade-off is needed between growth and sustainability. China, in other words, must design a modern fiscal system that can help mitigate market failures. One positive factor is that total government tax receipts have grown enormously since the tax reforms of the mid-1990s. In 2000, we calculate that total government revenues stood at just 21% of GDP; by 2010 they had risen to 34% of GDP (including all taxes, social security contributions, extra-budgetary funds and land sales). Government revenues are now exactly at the average for OECD countries—significantly above the United States and Japan, and not far behind the United Kingdom and Germany. The aim of policy should be to keep the size of the public sector constant, while redesigning revenue structures and expenditure targets.

Measures to reduce pollution must be a key part of fiscal reform

Clean the air, help the poor

One focus of fiscal reform should be the environment. The terrible air quality that enveloped northern China in early 2013 has focused attention, both at home and abroad, on China's appalling pollution problem. China is the world's biggest emitter of carbon dioxide and, therefore, the biggest contributor to climate change. Both the health consequences and economic costs of pollution are difficult to quantify. In 2010, government spending on environmental protection reached 1.6% of GDP, but the real costs of environmental degradation are much higher. Lax enforcement of environmental regulations means that new taxes on pollution and polluters—factories, power stations, steel mills, vehicles, etc—must be part of the solution. The government will also need to spend more on preventative measures and investing in cleaner technologies.

A second priority for the new leadership will be reducing income inequalities. Most analysts believe the official data released by NBS in early 2013—which showed that China's Gini index hovered between 47 and 49 over the past decade—underestimate the true extent of the problem. But this reading is still high compared with other major economies in the world. Chinese people are demonstrably more concerned about the gap between the rich and the poor than in years past, as their concerns shift to broader social problems from narrower issues of economic well-being. This change poses a significant challenge for a government that has always been more comfortable appealing to people's self-interest than to their values. As high inequality begins to threaten economic growth and social instability becomes a bigger concern, policy makers will have to take action.

Again, this means making changes to both revenues and expenditures. In 2010, personal income tax receipts contributed less than 4% of total government revenues—a puny proportion compared to other large economies. The tax system is not playing a redistributive role. Additional measures to improve social equity would include abandoning preferential treatment on capital incomes and introducing new wealth, property and gift taxes. China also needs to boost social-welfare spending, which is terribly low by international standards. In 2010, less than 1% of total government expenditure went on welfare, compared to 13% in the United States. The central government should significantly increase spending on minimum-income supplements, unemployment insurance, and other benefits to help the poor (See "Weaving the welfare net" on p31).

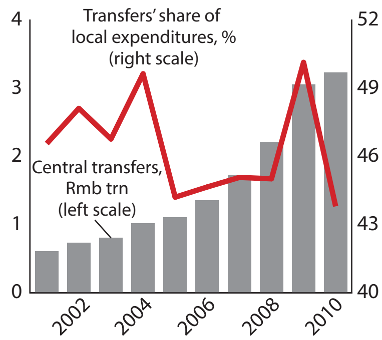
Reducing the income gap and controlling pollution means more taxation, and this will not come without a cost. Higher income tax rates will harm job creation and investment, while environmental taxes will push up power and manufacturing costs. The pressure on industry will intensify, and some companies are likely to fold. Without counter measures, moreover, the size of the public sector risks becoming bloated, to the detriment of economic growth. We therefore propose cutting VAT rates to balance the impact of higher taxes. Obviously, the size of the cut will depend on the extent to which other taxes are raised. But we believe halving VAT from the current level of 17% to around 9% is realistic. The aim should be to allow the ratio of government revenue to GDP to stabilize at a sustainable level of 32%.

The messy road ahead

To what extent can we expect China's new leaders to make these bold reforms? There are some positive signs that change is afoot. On the environmental front, both the Ministry of Finance and Ministry of Environmental Protection have recently proposed tax reforms to curb pollution. On the social equity front, in early 2013 the State Council approved an ambitious blueprint to reduce income inequality and released a detailed plan assigning specific responsibilities to government agencies. In addition, the State Administration of Taxation has begun investigating tax payers' income and assets. Pilot programs on property tax have been running for several years.

Plugging the funding gap

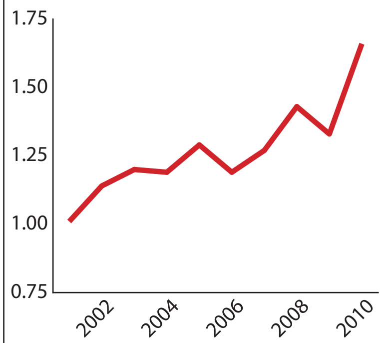
Central government contribution to local expenditures via fiscal transfers



Source: China Fiscal Yearbook, author estimates

Rising, but still puny

Environmental expenditure's share of GDP, %



Source: China Environmental Yearbooks (2002-11)

A new fiscal system

Suggested adjustments to the structure of fiscal revenues and expenditures

Revenues	
VAT	Lower
Business tax	Lower
Corporate income tax	Higher
Personal income tax	Higher
Inheritance tax	Higher
Expenditures	
Infrastructure investments	Lower
Unemployment benefits	Higher
Minimum-income benefits	Higher

Source: Authors

Crucially, China's leaders have begun to overhaul the fiscal relationship between the central government and local authorities—the first major tax reform since the central government wrested significant control over local revenues in 1994 (see "In Beijing we trust?"). Recent reforms will take this centralization process a step further, giving Beijing greater authority over local authorities and their fiscal expenditures. One example is the move by the Ministry of Environmental Protection to increase its authority by tightening environmental standards and punishing companies violating regulations and orders. Another is the Ministry of Social Security's plan to create a unified national pension system, which will allow individuals to transfer their portfolios between local pension funds. We believe that all these steps and actions are useful, and we expect more to follow. But the reality of fiscal reform will inevitably be messy, as compromises will have to be struck.