ISSUE BRIEF
United Nations Development Programme
Domestic Policies

Empowered lives.
Resilient nations.

China: Tax policies and income inequality

With the adoption of the set of Sustainable Development Goals (SDGs) at the UN Summit in September 2015, Member States have committed to building a better world, where poverty will end anywhere permanently by 2030 and prosperity will be shared by all. This echoes China's own vision to build an "all-round well-off" society by 2020, which places poverty eradication and inclusive growth as top priorities.

Despite China's tremendous success in lifting 439 million people out of poverty, more than 70 million people are still left behind. Meanwhile, there is a significant deterioration in income inequality in China, with Gini-coefficient above 0.47 for ten consecutive years between 2004 and 2013 and peaking at 0.491 in 2008[i]. This has brought attention to China's fiscal policies, particularly tax policies, which have long been deemed as the primary instrument to collect revenue and redistribute income.

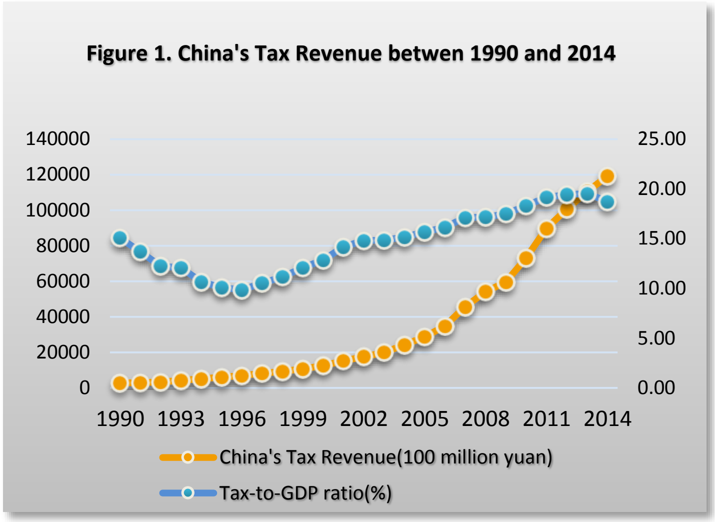
China's current tax system

China's tax system has gone through several major changes since 1978's opening-up. The current tax system was established as part of the 1994 fiscal reform, which is of the largest in scale and widest in scope[ii]. One of the key elements of the reform is the replacement of wholesale turnover tax with value added tax (VAT) to goods and a few services. Consequently, China today has in total 18 types of tax.

Another prominent component is the delineation of fiscal policy making and tax administration between the central and local governments. As a result, tax revenues are shared between the two according to varied forms[iii]. For instance, certain types of taxes such as those related to foreign trade are exclusively assigned to central government, while others (e.g., property-related taxes, business operation taxes) are under sole control of the local governments. Some are jointly managed, including personal and corporate income tax as well as VAT. In China, the legislation of taxation is, however, highly centralized. This means that, local governments have no autonomy to set tax rates and raise taxation.

Tax Revenue

Over the past decade, China's tax revenue has been steadily increasing (Figure 1), rising from RMB 282 billion (~US$ 45.5 billion) in 1990 all the way up to RMB 12 trillion (~US$ 2.0 trillion) in 2014. Despite some fluctuations, China's tax-to-GDP ratio has also increased (Figure 1). A slight drop of the ratio was witnessed between 1990 and 1996, from 15.1% to 9.9%. Afterwards, the ratio began to pick up and exceeded 1990's level, reaching 18.7% in 2014. Nevertheless, China's tax-to-GDP ratio is still relatively low compared to many advanced economies. According to the State Administration of Taxation, China's total government tax revenue was RMB 10 trillion (net of export rebate) (~US$1.6 trillion) in 2012, accounting for 19.4% of China's GDP. The corresponding figure was 33.7% on average in countries belong to the Organization for Economic Cooperation and Development (OECD)[iv].



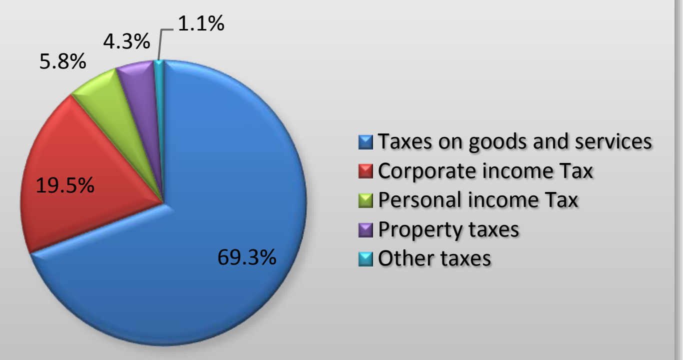
Source: China Statistics Yearbook 2014, available at: http://www.stats.gov.cn/tjsj/ndsj/2014/indexch.htm; and the authors' own calculations.

Tax Mix

China has a tax system that relies heavily on indirect taxes; namely taxes on goods, consumption and property taxes, according to OECD classifications[v] (Figure 2). With 69.3% contributed by taxes on goods and services and 4.3% by property taxes, China's indirect taxes accounted for 73.6% of China's total tax revenues (net of tax rebate) in 2012[vi]. By contrast, direct taxes, including personal and corporate income tax, made a mere contribution of 25.3% to China's total tax revenue, of which corporate and individual income taxes accounted for 19.5% and 5.8% respectively.

The Chinese tax mix holds the complete opposite structure to the ones in OECD countries. In 2012, indirect taxes accounted for only 38% of total tax revenue in OECD, while corporate and personal income tax contributed with 8.5% and 24.5% respectively[vii].

Figure 2. China's tax structure in 2012



Source: China Statistics Yearbook 2014, available at: http://www.stats.gov.cn/tjsj/ndsj/2014/indexch.htm; and the authors' own calculations.

How progressive is China's tax system?

Income tax, especially personal income tax (PIT), is generally expected to exert positive impacts on equalizing income distribution[viii]. Indeed, its effectiveness has been witnessed in many developed nations in reducing inequality. In the case of China, the tax schedule of PIT is progressive in itself, with tax liability increasing as income increases. The highest marginal tax rate is as much as 45% for the top income earners. This, however, has negligible effects in narrowing income inequality. At least 5 factors may help with the explanations[ix].

First, in spite of the progressivity of PIT, the top marginal tax rate applies to very few people, who earn 35 times of national average wage. On top of this, basic personal allowance is high, amounting to RMB 42,000 annual wage. This has led to only a limited amount of taxpayers, who account for less than 3% of the working population[x]. Therefore, PIT equals to around 6% of the total tax revenue (Figure 2), which is unlikely to produce any significant distributional outcomes.

Second, besides PIT, what matters for redistribution is also contingent upon the distributional effects of other taxes. As is pointed out above, China relies heavily on indirect taxes, which are often regressive in nature, as they are levied on consumption rather than income. In fact, it is often poorer households who spend a relatively larger proportion of income on consumption. Hence, even though China has progressive PIT, its effects does not really offset the adverse impacts of indirect taxes on redistribution.

Third, other sources of income are taxed under different rate schedules in China. For instance, capital income (e.g., dividends, interests, royalties) subject to 20% of taxation on average. This allows individuals with higher income – who in many cases possess multiple income sources – to split their pay check under different terms, so as to take the lower tax brackets. Again, the tax burden tends to fall disproportionally on the poorer, who pay more comparatively given that they are mostly solely wage earners.

Fourth, tax evasion of the richer may erode the progressivity of the tax system in China. As is commonly known, the richer have a more diverse asset portfolio, including property deals, stock market exchange and so forth, which have not yet been effectively taxed in China[xi]. For example, most property and land-related taxes are levied on transactions instead of the assessed value in China.

Last but not least, the implications of the corporate income tax on income distribution remain uncertain, due to the potential shift of tax burdens to consumers who purchase goods and services. This could render corporate income tax become less progressive than otherwise.

The way forward

To sum up, China has made remarkable progress in reforming its tax policies, which have significantly raised revenue in recent years. There is, nevertheless, even greater scope to further ameliorate the tax structure in order to strengthen the progressivity of the entire tax system. This could be achieved by streamlining administration and expanding PIT tax base through continuous reform of VAT on services and property taxes. The adjustment of tax rates and brackets may also be worth considering separately to accommodate more effective taxpayers.

While tax policies play a vital role in shaping income distribution, they do not serve as the panacea for inequality reduction. Taxes are crucial to sustain the fiscal base. But it is equally important to spend them wisely, with purposes to improve access to education, healthcare and social security that constitute the cornerstone of individual capacity building[xii]. This in turn could help broaden the tax base.

There is still much for China to share with the rest of the world in its experiences of tackling inequality to date, and much for China to learn from others. UNDP China stands ready to facilitate the process of knowledge exchange. Fiscal policies, alongside other approaches will be jointly explored and discussed with regards to inequality at the workshop "BRICS: Inequality and Sustainable Development", which will take place on 6 November 2015 as a result of collaboration between UNDP China, ActionAid China and Beijing Normal University. These issues will also be closely investigated in the forthcoming 2015 National Human Development Report.

This Issue Brief forms part of a series to promote understanding of China's poverty and inequality issues. Thanks to the Economist Team, especially Ms. Yuan Zheng and Ms. Xuan Guan, for their work on this Issue Brief. For more information, please contact the Economist Team at: economist.cn@undp.org.

---

[i] Gini index: Inequality of income distribution in China from 2004 to 2014, the Statistics Portal. Available at http://www.statista.com/statistics/250400/inequality-of-income-distribution-in-china-based-on-the-gini-index/

[ii] China's current tax system. China State Administration of Taxation. Available at:http://www.chinatax.gov.cn/n810351/n810901/n848188/c1161503/content.html (in Chinese)

[iii] Wang, X. and Herd, R., 2013. The system of revenue sharing and fiscal transfers in China. Economics Department Working Papers No.1030, Organization for Economic Co-operation and Development.

iv Average tax-to-GDP ratio in OECD countries. Available at: http://www.oecd.org/ctp/tax-policy/revenue-statistics-ratio-change-all-years.htm

[v] Tax on goods and services in China include VAT, business tax, consumption tax, city maintenance and construction tax, as well as resource tax, tobacco leaf tax, the vehicle purchase tax, the vehicle and vessel tax and the custom duties. Property taxes in China include housing property tax and deed tax. Classification method could be seen in Tax Policy and Tax Reform in the People's Republic of China. Available at: http://www.oecd-ilibrary.org/taxation/tax-policy-and-tax-reform-in-the-people-s-republic-of-china_5k40l4dlmnzw-en;jsessionid=thupvqbjr375.x-oecd-live-02

[vi] China's tax structure in 2012. Available at: http://szs.mof.gov.cn/zhengwuxinxi/gongzuodongtai/201301/t20130123_729605.html.

[vii] OECD tax data. Available at: https://data.oecd.org/tax/tax-on-goods-and-services.htm.

viii Xu.,J. and Yue., X.M., 2013. Redistributive Impacts of the Personal Income Tax in Urban China. In: Li.,S., Hiroshi., S., and Sicular, T. (ed.) *Rising Inequality in China: Challenges to a harmonious society*, 362-382.

[ix] Lam, W.R. and Wingender, P., 2015. China: How can revenue reforms contribute to inclusive and sustainable growth? International Monetary Fund Working Paper, WP/15/66.

[x] Cevik, S. and Correa-Caro, C., 2015. Growing (unequal): Fiscal policy and income inequality in China and BRIC+. International Monetary Fund Working Paper, WP/15/68.

[xi] Krever, R., and Zhang., H., 2011. Progressive income taxation and urban individual income inequality. Asia-Pacific Tax Bulletin.

[xii] Zolt, E.M. and Bird, R.M.,2005. Redistribution via taxation: The limited role of the personal income tax in developing countries. Law & Economics Research Paper Series. Research Paper No., 05-22. University of California, Los Angeles