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The Hitched Stride

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In my previous post, I discussed the budget law related reform updates in China. This post continues such discussion by reviewing issues of China's tax administration and transfer payment systems.

Tax Administration and Collection

China's tax administration and collection system is unique in two ways. First, over 70% of the tax revenue is generated through indirect tax; only approximately 25% of tax revenue is from direct tax (i.e. income tax) including around 6% from individual income tax. Enterprises account for 90% of tax payment remittance while end consumers are the final tax burden takers thereof. Obviously, the room or opportunity left for using individual income tax to adjust income inequality is quite limited and narrow. Therefore, no matter how scientific the individual income tax system is or how advanced the tax collection approaches are, the function that direct tax serves is just unable to accommodate the goal of adjusting income disparity.

Second, China's tax administration and collection system still dwell on the development stage of "indirect tax collection" and "interceptive withholding." The administration of direct tax (income tax) is quite intrusive and is lack of itemization and consolidation in the collection and calculation of income tax. "Interceptive withholding" means that the current tax administration only focuses on cash flow for tax collection rather than on stocking or capital flow. Given the flesh of optimizing tax revenue and gradually reforming the property tax system over the past decade, the tax administration and collection system in China is the cornerstone or bottleneck issue to materialize the fiscal reform goals as designated in the Twelfth Five-Year Plan.

The Decision further clarifies that China aims to achieve structural tax cut and lowering income disparity. To this end, the reform of tax collection system should be advanced to reflect transactional reality and promote social justices, on which the fiscal and tax system reform relies. China has learnt a lot from the trial-and-error over the past two decades of outdated tax collection practices, and less administrative-over-intervention into collection activities has suppressed legal vitality and possibly bred corruption.

The Transfer Payment System and the Centralization

Local public finance and borrowing under the transfer payment system has been worsened in China. The 1994 Tax Sharing Scheme keeps larger share of revenue to the central government and creates limited access to tax proceeds for local governments, which have turned to alternatives to meet budgetary goals and increased social-service obligations in the past two decades, such as increasing sales of cultivable land to developers. Moreover, The Decision further recaps China's strategies for promoting urbanization and improving consolidation of rural development. Meanwhile, most local governments are not allowed to borrow directly from banks or through bond issuance, although special-purpose local financing vehicles are manipulated to get around limits to minimize ballooning debt levels. The dilemma created thereby somewhat has induced twisted abuses in local land sales and stocking resentments from local residents facing roaring high housing prices.

There is very slim chance to dismantle the existing tax-sharing system for bringing more revenue to local governments. Realistically, China should expand the current trial program allowing more local government to issue bonds, which was a reserved privilege for the central government. Currently, there are six fiscally strong provinces and cities can temporarily issue bonds; however, even the approved quota thereof increases, the total amount may still represent a tiny portion of the estimated local government debts of RMB 20 trillion, much of which may be hidden from an accurate accounting. For instance, the urbanization undertaking and lowering pernicious income disparity should prioritize the central government's worries on profligate local officials.

China should continue designing effective measures to promote the inter-province or inter-city transfer payment system to balance irregular development within China, the second largest economy in the world. China very likely will not see a Detroit-style default for local governments, although the weak standalone credit quality of manipulated local financing vehicles may pose a danger to banks, as well as central and local governments.

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