

# Fiscal Reform for Inclusive Growth in PRC

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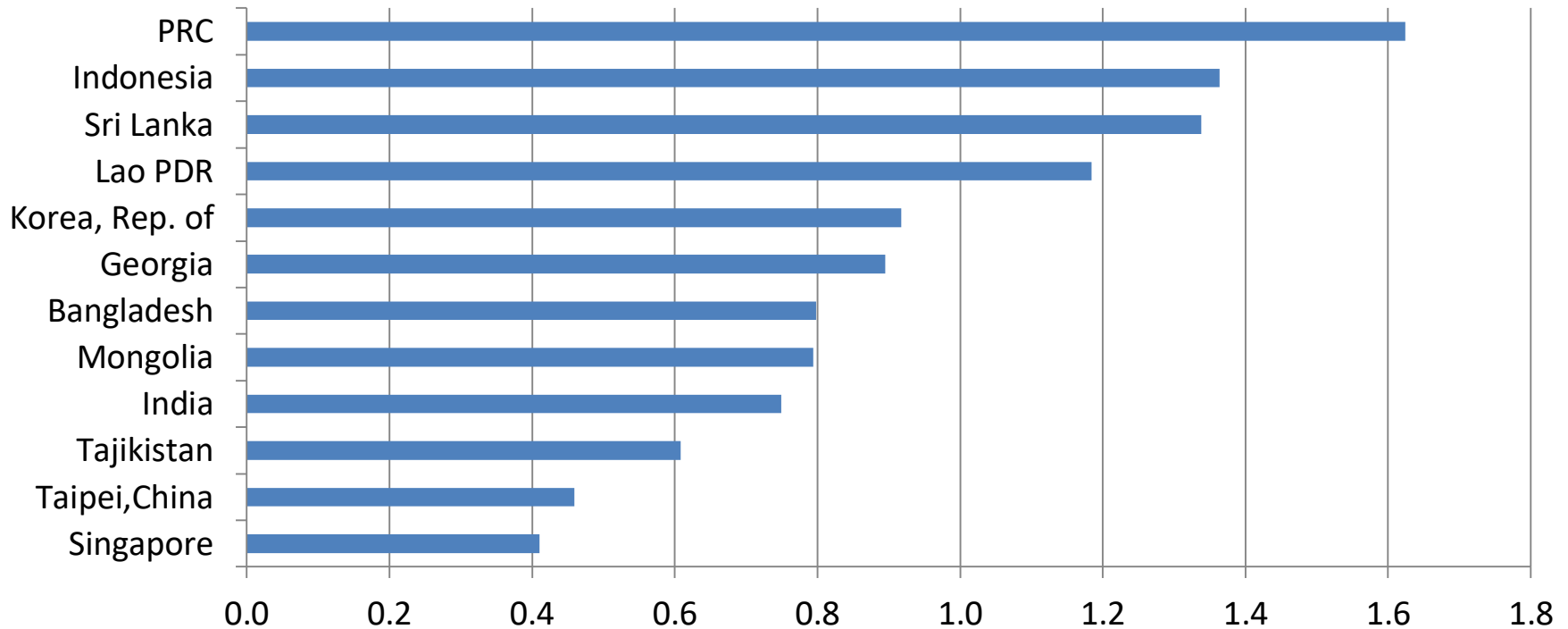
# Outline

- Inequality in PRC
- Inclusive growth and fiscal policy
- Fiscal reform for inclusive growth in PRC: Broad issues
- Summary

# I. Inequality in PRC

- Many Asian countries experienced rising inequality in recent decades, but PRC's increase was among the most pronounced.

**Annual increase of Gini coefficient from 1990s to 2000s, %**



- According to the National Statistical Bureau, PRC's Gini coefficient of per capita household income stood at 47.4 in 2012, among the highest in Asia.

# I. Inequality in PRC

- A recent ADB study highlights three drivers of rising inequality in Asia: technological change, globalization, market oriented reform:
  - Working through a falling share of labor income, rising skill premiums, and increasing spatial inequality;
  - Impacts of these have been compounded by unequal access to opportunity.
- This analysis is very much applicable to PRC.
- The ADB study calls for:
  - Efficient fiscal measures to reduce inequality in human capital;
  - Interventions to reduce regional inequality;
  - Growth that is more employment friendly to increase demand for labor ;
  - More broadly, moving towards inclusive growth.

## II. Inclusive growth and fiscal policy

- Inclusive growth means everyone can participate in and benefit from growth process on an equitable basis.
- Inclusive growth makes a distinction between
  - Inequality due to differences in individual efforts, and
  - Inequality due to differences in individual circumstance, or inequality in opportunity.
- Reducing or eliminating inequality in opportunity is at the heart of an inclusive growth strategy.
- So inclusive growth can also be defined as “growth coupled with equality of opportunities”.

# II. Inclusive growth and fiscal policy

Figure 1 Policy Pillars of Inclusive Growth



Source: Adapted from Zhuang (2010).

- Fiscal policy should aim to (a) address critical constraints to growth (infrastructure, human capital, counter-cyclical); (b) equalize access to opportunity, and (c) support social protection;
- Fiscal policy should not aim to equalize income through excessive taxation; but taxation is important to mobilize revenues to finance spending.

### III. Fiscal reform for inclusive growth in PRC: Spending

- Empirical studies show public spending on education and health reduces inequality.
- But spending on social protection and housing increases inequality in Asia, perhaps because these programs largely benefit the better-off urban population – suggesting the need to extend the coverage to rural areas.

#### Estimated marginal impact of government spending on the Gini coefficient

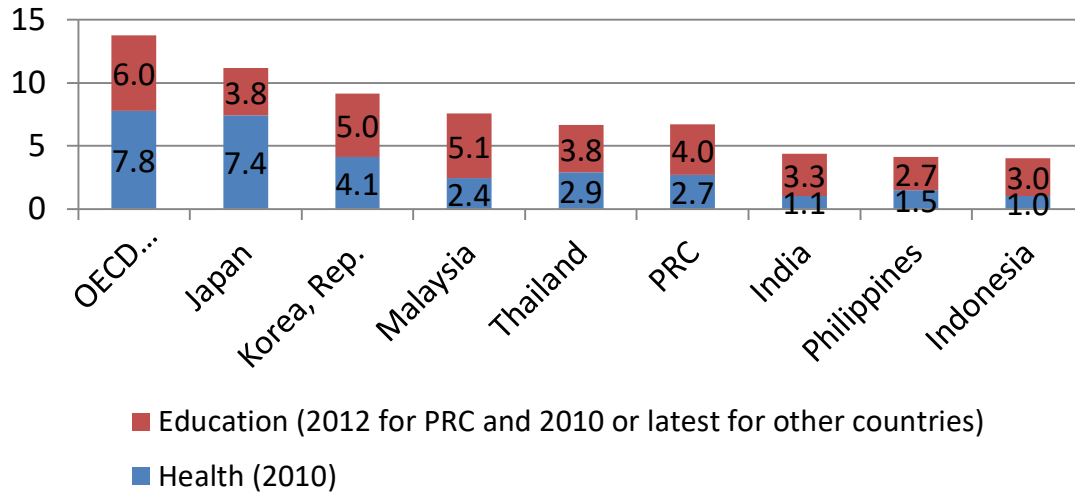
	Asia	Rest of the world
Social protection	0.490	-0.276
Education	-0.486	-0.034
Health	-0.241	-0.330
Housing	2.162	-0.614

Source: Claus, Martinez-Vazquez, and Vulovic (2012).

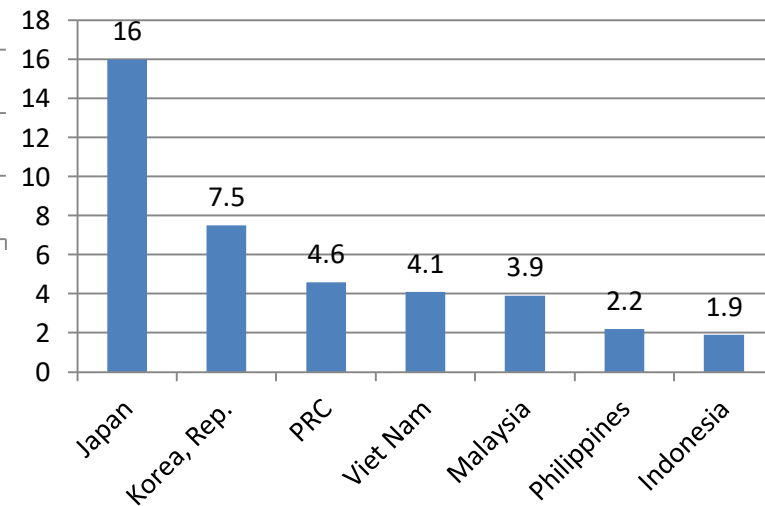
### III. Fiscal reform for inclusive growth in PRC: Spending

- PRC has a large scope to reduce inequality through social spending – its social spending is low compared with OECD and upper middle income countries.

**Government spending on health and education, % of GDP**



**Social protection expenditure, % of GDP, 2008**



- The size of PRC’s non-social spending (20% of GDP in 2008) is comparable to OECD and upper middle income country averages.
- How to increase social spending: (a) switching spending from non-social to social and/or (b) finding additional revenue sources.



### III. Fiscal reform for inclusive growth in PRC: Revenues

- Composition

- PRC's consumption/VAT and corporate taxes (as % of GDP) are comparable to the levels of OECD, but the size of personal income tax at 1.3% of GDP (in 2011) is small.

Table B5.3-1 Composition of selected fiscal revenue sources,  
PRC and selected economies (% of GDP)

	PRC (2011)	Malaysia (2009)	Republic of Korea (2010)	Japan (2010)	OECD (2010)
Corporate income taxes	3.6	8.1	3.5	2.8	2.9
Personal income taxes	1.3	2.2	3.6	5.2	8.7
Consumption taxes	10.4	3.9	8.5	5.1	11.0

GDP = gross domestic product, OECD = Organisation for Economic Co-operation and Development, PRC = People's Republic of China.  
Source: ADB staff estimates for PRC using data from NBS, *Statistical Report on 2011 Economic and Social Progress and MOF, Final Report on Government Revenues and Expenditure*. IMF, *Government Finance Statistics* (for Malaysia); OECD.Stat (accessed August 2012, for Republic of Korea, Japan, and OECD).

### III. Fiscal reform for inclusive growth in PRC: Revenues

- VAT

- VAT is regressive, but is less distortionary and easier to collect than income taxes, and is a major source of revenues in most countries.
- PRC's VAT rate at 17% is lower than most OECD countries, but not low compared with non-OECD countries.
- The issue is to extend VAT coverage to the services sectors - the government is implementing a pilot program to replace the business tax with VAT in certain service sectors, such as the transportation sector – this should be continued.

# III. Fiscal reform for inclusive growth in PRC: Revenues

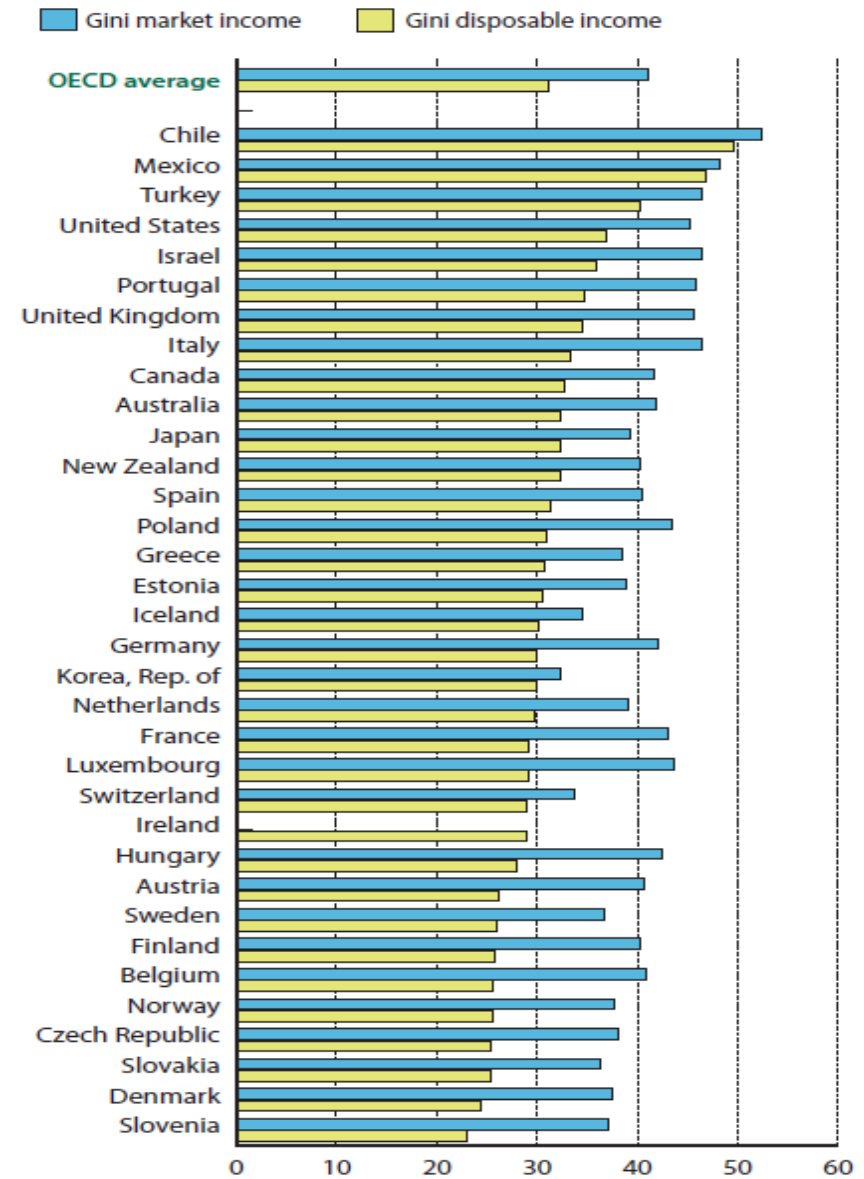
- Personal income tax
  - PRC's personal income tax so far has only had a limited role in reducing inequality, in comparison with OECD.

## Redistribution effect of personal income tax in urban PRC

Year	Pre-tax Gini	After-tax Gini
1997	30.1	29.6
2002	32.5	31.8
2005	35.2	34.2
2008	36.3	35.1
2009	34.7	33.5

Source: Li et al. (2012).

## 2.2.9 Gini coefficients of OECD countries, 2005



Source: OECD Stat database (accessed 24 February 2012).

### III. Fiscal reform for inclusive growth in PRC: Revenues

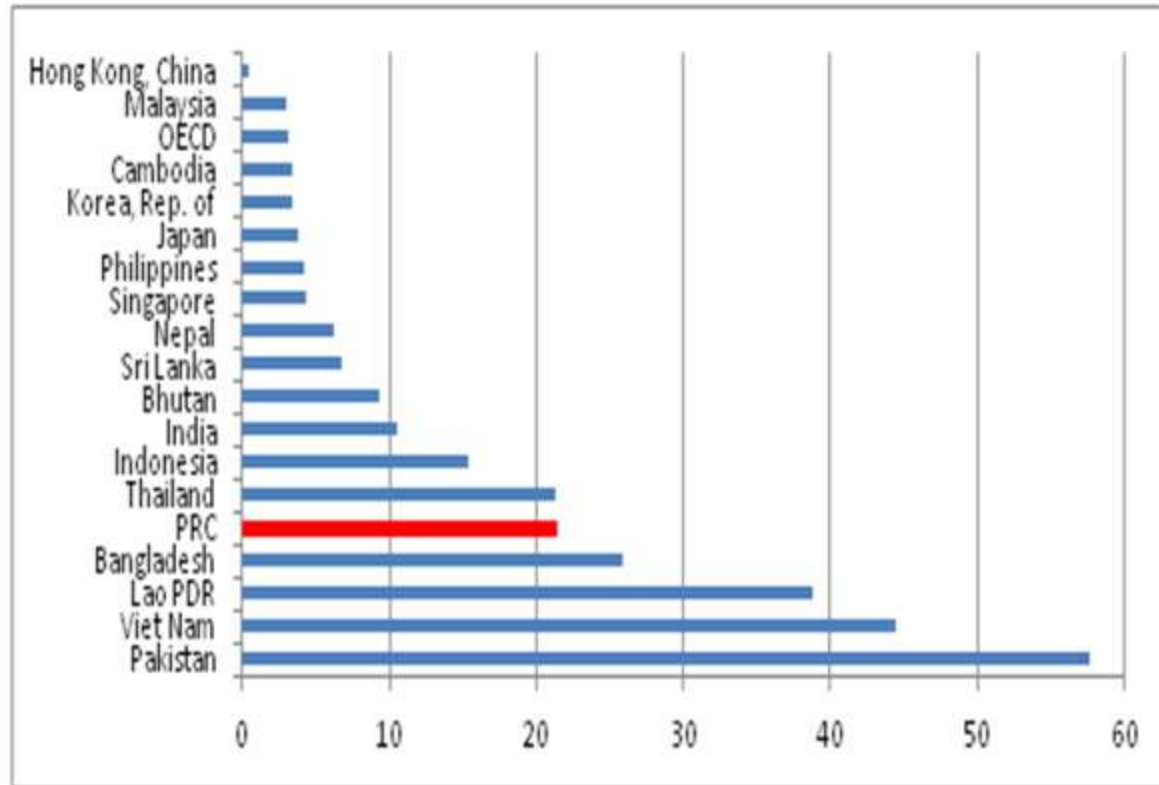
- PRC's top marginal income tax rate at 45% is high globally.
- Key issues are: Broadening the tax base, making the tax system fairer, and improving tax collection.

**Effective personal income tax burden on urban residents by decile, 2008**

Income decile group	Effective tax rate (%)
1 (Lowest)	0.004
2	0.022
3	0.054
4	0.069
5	0.123
6	0.171
7	0.299
8	0.483
9	0.825
10 (Highest)	2.058

Source: Calculation based on 2007 Chinese Household Income Project data

**Threshold for the top personal income tax rate , times of per capita GDP, 2009-2012**



Source: ADB 2012.

### III. Fiscal reform for inclusive growth in PRC: Revenues

- SOE dividend payment

- In 2010, SOEs produced 27% of the gross industrial output and owned 42% of total industrial assets.
- Many SOEs pay no dividends, and the top rate for even the most profitable ones is 15% of profits. By contrast, SOEs in other countries issue dividends that average 33% of profits.
- According the World Bank's China 2030 study, if SOEs were to pay out half of their profits to the budget—a ratio prevailing in developed countries—budgetary revenues would grow by about 3% of GDP.

### III. Fiscal reform for inclusive growth in PRC: Revenues

- Taxation of land and property: Move towards a modern property tax: market value-based transfer taxes and annual taxes
  - Property tax revenue collection on average amounts to about 2% of GDP for OECD and less than 1% for developing countries.
- Social insurance contribution: The rates of contribution by urban workers are high by international standards:
  - Pension 20%; unemployment insurance 2%; medical insurance 6%; total 29-31% of the payroll.
- Inheritance tax.

### III. Fiscal reform for inclusive growth in PRC: Intergovernmental fiscal relations

- Better aligning revenue and expenditure responsibilities at all levels of government.
- Enhancing stable local government revenue sources (property tax, green tax, etc.).
- Allowing local governments to access financial markets, while mitigating risks through effective regulation.
- Greater fiscal accountability and transparency and better management of off-budget funds.
- More effective fiscal transfers to reduce regional fiscal disparity.

### III. Fiscal reform for inclusive growth in PRC: Intergovernmental fiscal relations

#### Redistributional effects of fiscal transfers: OECD and PRC

	Inter-state/province economic imbalance	Inter-state/province fiscal disparity: Per capita local tax revenues, before and after transfers		
		Gini coefficient of per capita GDP	Gini coefficient, before transfers	Highest to lowest ratio, before transfers
Average of selected OECD	13	13	2.6	5
PRC (2010)	33	31	10.3	18
PRC (2000)	36	33	14.4	25

Source: OECD study



# IV. Summary

- Fiscal policy should be a key part of an inclusive growth strategy (by addressing constraints to growth, equalizing opportunity through social spending, and supporting social protection).
- PRC's public spending on education, health and social protection is low compared with high and upper middle income country averages and there is a large scope for increasing.
- There is a large scope for PRC to enhance revenue mobilization and make it more equitable by undertaking further reforms in
  - VAT,
  - Personal income tax,
  - SOE dividend payment,
  - Property tax,
  - Inheritance tax,
  - Individual social insurance contributions, and
  - intergovernmental fiscal relations.

Thank you!