

Structural Tax Reduction for Realization of Multi-Targets in China

Abstract:

Under the background of global economy's continuous fluctuating, China's economy is expected to experience slowdown of economic growth or long-term fluctuation. The macro-economic policies with constraint of current situation must focus on stabilizing economic growth, adjusting economic structure and curbing inflation. And the major clue to meet these targets is to implement structural tax reduction. This paper analyzes the justification and potential for Chinese government to introduce structural tax reduction policies. A proposal of identifying the appropriate amount of tax reduction and concentrating on VAT reduction which contributes to the main parts of Chinese tax revenues is suggested. We also argue that VAT reduction should be followed by both broadening tax base and cutting tax rate.

Keywords:

Structural Tax Reduction, Macro-economic Policies, Stabilizing Economic Growth, Adjusting Economic Structure, Curbing Inflation

Under current economic situation, Chinese government's macroeconomic regulation aims at stabilizing economic growth, adjusting economic structure and curbing inflation. Each of the three targets is important and the government must take into account all of them. With the constraint of multi-targets, the central government has to face trade-offs between them and search for a balanced policy.

It is an interesting thing that in China when a proactive fiscal policy is proposed and government investment is suggested to be increased, or when an expansionary monetary policy is proposed and currency supply is suggested to be increased, different voice would be often heard. However, when taxation reduction is spoken of, regardless of which concept is applied, structural tax reduction or general tax reduction, a unanimous consensus would be reached. Furthermore, the voice of "accelerating it" and "strengthening the reform" may be heard in many situations and many times.

So for Chinese government to regulate and control the economy's fluctuation, it seems tax reduction is a widely believed macroeconomic policy choice at

present as well as in the coming one-year. In another word, tax reduction has become the major clue and field of Chinese government's macroeconomic policy.

This paper focuses on discussion of tax reduction with constraint of multi-targets, especially of structural tax reduction.

1. Proceeding with fluctuation: A basic judgment for China's current economic situation

With the deep change and development of globalization, any analysis or judgment for China's economic situation should take into account all factors affecting domestic and overseas economic situation. From this point, we can make a judgment that "proceeding with fluctuation" following 2011's trace will be the trend for China's economic development although uncertainty of many aspects still exists.

This judgment includes two levels of meanings: The first meaning is that China's economy will not avoid fluctuation and the second is that the fluctuation of China's economy is the fluctuation in the process of recovery rather than arrival of another crisis.

The reasons why we say China's economy will not avoid fluctuation include:

1. The continuous economic fluctuation the U.S and some west European countries are experiencing will worsen the global economic situation through the transmission of global economic chain. If the global economy is not stable, any country in the world including China can not prosper by itself. The most important thing is that the fluctuation in these countries is still lasting and the range affected by it is being extended. Therefore, in the coming one year or longer time, the way forward of China's economy will be filled with uncertainty.
2. China's economy is experiencing structure adjustment and facing heavy pressures arising from the adjustment. And after implementing several-year's expansionary public policy which aims at stimulating economic growth by increasing government investment, the pressures faced by Chinese government become more and more heavier compared to the situation before 2008. Because economic structure adjustment may result in economic fluctuation and to change the economic development model needs a long time, China's economy will experience not only a period of slowdown of growing but a period of continuous fluctuation.

The reasons why we say that the fluctuation of China's economy is the fluctuation in the process of recovery rather than arrival of another crisis are as follows:

1. The running track of the global financial crisis so far states that the period from end of 2008 to beginning of 2009 is the most difficult time for the global economy. If we make a comparison between the present economic situation and that period, we can find although many economic indices are barely satisfactory, the global economy is still better than the recession in 2008 and 2009.
2. The USA and many European countries can not deal with the economic recession in the short-run, however, it does not mean they have no way to go in the long-run. And for China, today's government is completely different from that in the early beginning of crisis. At that time the government would be panic-stricken and did not know what to do while facing crisis. Now after several years' practice to deal with crisis, the government has accumulated lots of experience and has learned some laws and thought of some methods to resolve it. Therefore, although uncertainty existed in the foreign countries' economy imposed a negative effect on Chinese economy, the effect, in general, can not be worse than the situation in the period from the end of 2008 to the beginning of 2009. If only the economy runs above the level of 2008 to 2009, will the fluctuation of China's economy be the fluctuation in the process of recovery.

2. Justification and potential analysis for the structural tax reduction

Justification: the structural tax reduction determines success or failure of the present macroeconomic policy

The severe and complicated economic situation requires that we should attach more importance on economic growth and strengthen the magnitude of regulation. However, after the use of expansionary public policy for several years, the government is facing two kinds of difficulties while making macroeconomic policy choice today.

Due to the declining marginal utility, the effect of expansionary macroeconomic policy is declining in contrast to that in the period from the end of 2008 to the beginning of 2009. This means that even if we carry out the "large scale and extensive" expansionary macroeconomic policy similar to that in the period from 2008 to 2009, the policy can not result in a similar benefit.

Due to the nature of expansionary macroeconomic policy, compared with the period from 2008 to 2009, both proactive fiscal policy and expansionary monetary policy have showed negative effect on economic structure and price

level. This means that if we carry out the “large scale and extensive” expansionary macroeconomic policy similar to that in the period from 2008 to 2009, the negative effect arising from the policy will become more serious. So it is not desirable any more to implement proactive fiscal policy and increase money supply at the expense of worsening economic structure and pushing up the price level.

Under such circumstances, when searching for the available and appropriate macroeconomic policy, the government notices that policy alternatives have become much fewer. The urgent and challenging task facing the government today is to stabilize economic growth while at the same time not imposing negative effect on structural adjustment and pushing up the price level. With the constraint of many factors and weighing the gains and losses, the structural tax reduction appears to be the best choice to comply with the targets of stabilizing economic growth, adjusting economic structure and curbing inflation and of imposing the least negative effect on the economy. Different from the macroeconomic policy which focused on increasing government expenditures, the proactive fiscal policy with tax reduction being the heart will stimulate the economic growth by increasing disposable personal income rather than increasing government investment. So, in present China, the hot issue emerged in nearly all discussion about the current economic situation and macroeconomic policy is to perfect and advance the structural tax reduction. To a large extent, whether the structural tax reduction policy can be carried out well or not will determine success or failure of government’s macroeconomic regulation.

Potential: there is still a big space for structural tax reduction

Since the beginning of 2012, the government has issued some measures to advance structural tax reduction and these measures involve many kinds and items of tax reduction. But generally speaking, there is still a big space to go.

Most of the firms affected by the measures of tax reduction are small enterprises and taxes involved are negligible ones. But in China, more than 80 or 90 % of the total tax revenues arise from medium-and big enterprises. Even if all taxes collected from small enterprises are exempted, the effect of this tax reduction is a very small number.

The reform of changing business tax to value added tax which is now experimented in Shanghai and other places is one of the biggest structural tax reduction measures so far. But in Shanghai, the tax reduction resulted from this reform amounted to about 17 billions yuan so far. In other places, because the reform is carried out gradually and separately and started from the last part of this year, the tax reduction involved is at most tens of billions yuan.

The personal income tax reform that focused on increasing deduction for taxable salaries and adjusting tax rates was introduced from the end of 2011 and did not constitute the tax reduction items of the year of 2012. Even if the “carry-over effect” of this reform is taken into account, the amount of tax reduction involved may be no more than 100 billions yuan (according to the China State Administration of Taxation).

When adding up the above amount of tax reduction we can find that the total amount of tax reduction is not equivalent to the purpose of the structural tax reduction policy, especially not equivalent to what it should play in the pro-active fiscal policy of this year.

3. A general plan for the structural tax reduction

The process of implementing structural tax reduction so far has been moving slowly. We think one of the key reasons is that the general plan for the tax reduction has not been well designed, and the government did not propose the total amount of tax reduction and which taxes should be reduced. So to design an appropriate tax reduction plan and concentrate on the taxes which should be reduced will be of help for the government to push forward the structural tax reduction policy. This is also an important issue for the macroeconomic control and regulation at present and in the coming year.

The design of the general plan of structural tax reduction should take into account the two questions. The first question is how much tax should be reduced? This is to ascertain the amount of the tax reduction. Without a specific amount of tax reduction, the policy is only a qualified regulation absent of quantified index and has only direction but no identified scale, and the tax reduction policy will remain at abstract level and follow the feeling. As a result, not only the effect of the structural tax reduction can not be ensured but may ambiguous views and practices arise. The second one is which taxes should be reduced? This is to clearly identify the object of the structural tax reduction. Otherwise, if any tax is reduced or whatever is seen today is reduced, the policy will become blind. This, of course, departs from the normal tax knowledge and consequently, the structural tax reduction policy may deviate from the trail and target of the tax reform.

So, the general plan of the structural tax reduction has to appropriately identify both the total amount and the objects of the tax reduction.

Identification of the total amount of tax reduction will be affected by the following factors:

1. The scale of fiscal deficit. There is no doubt that the structural tax reduction will be constrained by the government deficit. A certain amount of deficit can be used for supporting the arrangement of either increasing

government expenditures or reducing taxes. In another word, the scale of government deficit is the maximum limitation of the total amount of the tax reduction. For instance, in 2012, the published government budget report states that the government deficit which will be remedied by issuing government debts is 800 billions yuan and that which will be remedied by using the central budget adjustment fund is 270 billions yuan. By adding them up, the government deficit amounts to 1070 billions yuan this year. According to this calculation, even if half of the total deficit was used for supporting the arrangement of the structural tax reduction, the minimum amount would be 535 billion yuan.

2. The comparison between increased expenditures and reduced taxes. As we stated above, different from the past policies focusing on “increasing expenditures”, “reducing taxes” becomes the heart of the current proactive fiscal policy. Since the main part of the policy is the structural tax reduction rather than increasing expenditures and public investment, and even if the government attaches a little more importance on reducing taxes than increasing expenditures, within the constraint of government deficit of 1070 billions yuan, the scale of tax reduction in 2012 could exceed 535 billions yuan, and the target can be at least 600 billions yuan.
3. The situation of government revenues. Two indexes can be used to measure the situation of government revenues. One is the growth rate of government revenues compared to the corresponding period last year. The other is the growth rate compared to the government budget. Although both of them are important, the latter is of higher value of reference for implementing the structural tax reduction. For instance, the growth rate of government revenues from January to September in 2012 is 11.9% compared to the corresponding period in 2011. This rate is more than 10 points lower than that last year but 2.9 points higher than the rate of 9% required by the 2012 budget. This means the developing trend of our government revenues is slow-down of previous growing rate but not growing slower than the budget index requires. What the growing rate can affect is at most the scale of increment of government revenues. The increment of government revenues can amount to at least 300 billions yuan in 2012 if calculated according to the 2.9 points excess of the budget. So, due to the flexibility of the increment of government revenues, at least 600 billion of tax reduction is not only necessary but able to reach or even exceed (China Finance Statistical Yearbook).

In terms of the objects of tax reduction, V.A.T should be the main tax to be reduced. In order to identify the object of the structural tax reduction, we

may begin by looking at the components of the current tax revenues and the tax reform picture during “the twelfth five-year plan”.

Taking 2011 as an example, among the total tax revenues, revenues coming from turn-over taxes account for more than 70% and those coming from income taxes account for less than 30%; and tax revenues paid by all kinds of enterprises account for 92.06% and those paid by households account for 7.94%. It is believed that the tax revenues in China mainly come from turn-over taxes and paid by enterprises. This reveals an unbalanced tax system and results in an inappropriate component of tax revenues at present. The unbalanced tax system and inappropriate component of tax revenues have proved to encounter a series of trouble in the process of domestic economic and social development. Their negative effect will be revealed more under the circumstance where the global economy is going into continuous fluctuation (China Finance Statistical Yearbook).

Due to the above reason, the following words are written in the third section of the 47th chapter of the 12th five-year plan outline: “tax system should be improved according to the principle of optimizing the structure of tax system, equalizing tax burden, rationalizing income distribution and improving allocation of tax power”. Therefore, for the purpose of optimizing the structure of tax system and tax revenues, the taxes to be reduced should be turn-over taxes which can be transferred through the price system and paid by the enterprises. Furthermore, the turn-over taxes in current China’s tax system include the following four kinds: V.A.T, consumption tax, business tax and custom tax. Except the custom tax which has close relations with import and export situation, V.A.T is the biggest tax among the remaining three taxes. In 2011, the percentage of V.A.T in the total tax revenues is 41.1%, consumption tax and business tax, however, account for only 8.79% and 15.25% respectively (China Finance Statistical Yearbook).

The above reality reminds us of the following facts: First, V.A.T is the biggest tax in all turn-over taxes and the effect of tax reduction involved the value added tax may be maximized. Second, the reform of business tax being transformed into V.A.T has been written in the twelfth five-year plan outline and the pilot project has been issued. And the pilot range is extending from Shanghai to the whole country. It can be strongly believed that the business tax being eaten by the V.A.T can not be changed any more. Third, consumption tax has a special characteristic which levy only on luxuries and energy and resources and what it involved are normally high-income groups and products involved energy and resource. So whether to increase or reduce this tax has been a dispute and difficult to reach an agreement. In a word, the object of tax reduction should be focused on V.A.T if taking into account the targets of tax system reform and enlarging as big as possible the effect of tax reduction policy.

It is not a coincidence that the reform of business tax being transformed into V.A.T which is still a pilot project builds a good basis for reducing the tax

burden of V.A.T. First, by transforming business tax into V.A.T, the business tax payers in the past will become V.A.T payers. It is normally believed the business tax has the problem of double-taxing and the reform will eliminate double-taxing and consequently reduce the tax burden. Second, the comparative increase of the business tax burden resulted from the reform of business tax being transformed into V.A.T will disappear because V.A.T will replace the business tax gradually. And the tax burden of the former business tax payers will be reduced. Third, after the reform of business tax being transformed into V.A.T the tax rate of the V.A.T will be reduced and so the whole tax burden of V.A.T will be reduced.

4. Approaches to V.A.T reduction: extend the tax base and cut down the tax rate

After identifying the total amount and object of tax reduction, two alternatives can be taken into account. The first alternative: accelerating and extending the pilot project of the reform of business tax being transformed into V.A.T. At present, this reform is one which not only involves reducing the tax burden of V.A.T but the amount of tax reduction would be the largest. So, the more extensive of the range of the pilot project and the more industries involved, the bigger the total amount and the effect of the structural tax reduction would be. Extending the range of the reform of business tax being transformed into V.A.T and taking measures to push forward it will be helpful to realize the effect of structural tax reduction policy.

The second alternative: cut down the tax rate of V.A.T while extending the tax base (the reform of business tax being transformed into V.A.T). The current V.A.T system started from 1994 was designed for manufacturing industries. When this tax system whose design is based on the characteristic of manufacturing industries is used for service industries, it on one hand should be adjusted according to the characteristic of service industries and on the other hand, a new tax system arrangement should be taken into account to fit for both manufacturing and service industries. Now the adjusted measures of adding two rate brackets of 6% and 11% for V.A.T taken in Shanghai and some other cities can only deal with the pilot project in the short run rather than being a long run arrangement. And this measure can not guarantee the effect of the structural tax reduction.

Therefore, the tax rate of V.A.T should be cut down while extending the tax base for a long-run consideration. And the average tax rate and tax burden of VAT should be reduced. It is estimated that the tax burden of 200 billions yuan could be reduced while the VAT tax rate is cut down 1 percent. And consequently, the City Maintenance and Construction Tax, education surcharge and

local education surcharge based on the tax revenues of VAT could be reduced 24 billions yuan. Adding them up the total amount of tax reduction could reach 224 billions yuan. According to this estimation, if the standard tax rate of VAT is reduced from current 17% to 15%, the tax reduction resulting from this would be 500 billions yuan or so.

People have all kinds of expectations for the structural tax reduction policy. However, under the present situation where indirect taxes account for more than 70% in the total tax revenues and taxes paid by enterprises account for more than 90%, even if only for balancing the components of tax revenues, reducing the indirect taxes and taxes paid by enterprises should be the focus of the structural tax reduction.

In the present tax system, indirect taxes mainly paid by enterprises include V.A.T, business tax and consumption tax. For business tax, it will be completely transformed into V.A.T no later than the end of the twelfth five-year plan. And for consumption tax, it is taxed on the luxuries and energy and resources. Any policy change for the consumption tax should be very cautious because reduction of consumption tax would involve the nation's policy arrangement of income distribution and conserving energy and reducing emission. In contrast, V.A.T is the biggest tax in China which can collect revenues accounting for 41% in the total tax revenues and a little change for V.A.T will have an obvious effect on the total tax revenue. So, reducing V.A.T or mainly focusing on the reduction of V.A.T would be nearly the only choice for implementing the structural tax reduction policy.

The encouraging fact is: the pilot project of the reform of business tax being transformed into V.A.T which begins to be carried out in Shanghai from this year is not only a reform aiming at reducing the tax burden but also being extended to other places such as Beijing, Tianjin, Jiangsu, Zhejiang, Anhui, Fujian, Hubei, Guangdong, Xiamen and Shenzhen. And extending it to the whole country has entered the view of the policy makers. It is widely agreed that the reform of business tax being transformed into V.A.T is the largest and most extensive measure to reduce tax so far. And this reform has obtained high recognition from the policy makers, entrepreneurs and the community. Focusing on the reform of business tax being transformed into V.A.T is the basic approach for the government to carry out the structural tax reduction policy.

The following question is, what should we do under the circumstance where the present economic situation entails macroeconomic regulation focusing on the structural tax reduction?

The reform of business tax being transformed into V.A.T is a reform aiming at reducing tax burden. An estimation based on Shanghai pilot project stated that the decreased tax in this city could reach 10 billions yuan or so. And another estimation from the national tax bureau states the total amount of tax reduction could reach over 100 billions yuan if the reform of business tax being transformed

into V.A.T is extended to the whole country. So the more extensive this reform extends, the bigger the total amount of tax reduction would be. So at present it is very necessary to accelerate extending the reform of business tax being transformed into V.A.T or to carry it out through the whole country at the same time.

The reform of business tax being transformed into V.A.T must be accompanied by cutting down the tax rate. Assuming that other taxes are equal, the percentage of V.A.T in the total tax revenues will rise to more than 55% after the reform of business tax being transformed into V.A.T. This will prevent from not only avoiding fiscal risk but improving the balance of the component of tax revenues. Therefore, for the purpose of “extending VAT but not increasing its percentage in the total tax revenues” and “enlarging the effect of the tax reduction arising from the reform of business tax being transformed into V.A.T”, the reform of cutting down the tax rate of V.A.T should be started while implementing and extending the reform of business tax being transformed into V.A.T. One point of the V.A.T standard tax rate is cut down the amount of tax reduction could reach 200 billions yuan. By adding up the City Maintenance and Construction Tax, education surcharge and local education surcharge based on the tax revenues of VAT, the total tax reduction is expected to reach 250 billion yuan or so.

In a word, when the situation to select a macroeconomic policy is so difficult for the policy makers, the importance of the reform of business tax being transformed into V.A.T which is the focus of the structural tax reduction should not be ignored. Focusing on the reform of business tax being transformed into V.A.T, attaching importance on both extending the tax base and cutting down the tax rate and realizing any arrangement of the structural tax reduction are a basic picture which we can draw for the current macroeconomic policy arrangement (China State Administration of Taxation).

Conclusion

Under current economic situation, Chinese government's macroeconomic regulation aims at stabilizing economic growth, adjusting economic structure and curbing inflation. Tax reduction is widely believed to be Chinese government's macroeconomic policy choice at present as well as in the coming one-year. We also argue the government should carry out and extend this policy. How to implement the tax reduction policy? First, we believe there is still a large potential for the total amount of tax reduction, and at least a reduction of 600 billion yuan can be achieved according to our analysis. As far as the structure of tax reduction is concerned, we believe V.A.T should become the focus of tax reduction, and reform measures should involve both extending the tax base and cutting the tax rate.

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Abstrakt:

Strukturální snižování daní pro uskutečňování vícenásobných cílů v Číně

Očekává se, že čínská ekonomika v letošním i následujících letech zpomalí v důsledku pokračujících globálních ekonomických fluktuací. Čínská hospodářská politika se proto musí soustředit na stabilizaci hospodářského růstu a potlačování rostoucí inflace. Jedním z hlavních prostředků, jak těchto cílů dosáhnout, je implementace strukturálního snižování daní. Tento článek analyzuje důvody, předpoklady a možné dopady zavedení takové daňové politiky. Autoři zároveň navrhnou adekvátní kroky a míru snížení daní, přičemž se koncentrují na daň z přidané hodnoty, která tvoří hlavní část čínských daňových příjmů. Podle autorů by snížení daně z přidané hodnoty doplněno rozšířením daňového základu a snížením daňových sazeb.

Klíčová slova:

Strukturální snižování daní, makroekonomické politiky, stabilizace hospodářského růstu, strukturální změny, snižování inflace

