INCREASING CHINA'S GOVERNMENT REVENUES: SOME OPTIONS

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Executive Summary

1. Following the 1994 fiscal reforms, China's revenues as a share of GDP (Gross Domestic Product) had risen rapidly until recently. Since 2016, tax revenues as a share of GDP have declined by some four percentage points.

2. The decline in revenue to GDP ratio was largely policy induced. The government has aimed to lower the tax burden of small and medium sized enterprises; in the wake of the COVID-19 pandemic, it has cut taxes and social security contributions to stimulate the economy.

3. The reduction of government revenues as a share of GDP comes at a time when China seeks to expand government social services as part of its Common Prosperity agenda. Moreover, cost pressures in traditional government services are likely to push up government spending as well.

4. Local governments are particularly squeezed between increased social spending, and lower revenues and central government transfers as a share of GDP. Subnational governments spend more than 80% of total government spending without having a substantial tax base of their own. Instead, they rely on shares in national taxes and central-local transfers.

5. China's tax revenues rely heavily on Value Added Tax (VAT) and Corporate Income Tax, whereas Personal Income Tax only raises a modest amount of revenue. Social security contributions are another big revenue source for the government.

6. VAT is a regressive tax as relatively poor parts of the population spend a larger share of their income on consumption. Social security taxes are also regressive as contributions are capped, and a minimum contribution is needed for eligibility, irrespective of income.

7. To make its tax system more progressive, China would do well to broaden the application of personal income taxes by gradually broadening the base and raising

tax rates on dividends and capital gains. Furthermore, to increase revenues for local governments, a local government surcharge on the personal income tax could be considered.

8. The long-debated property or real estate tax would be a good source of local government revenues, but introducing it may meet with several obstacles and transition challenges. Most notably, introducing such a tax now could be destabilising for the housing market.

9. One option is to introduce a real estate tax *gradually*, starting with new housing built from now onwards. Buyers will pay less upfront as the price of housing will decline with the future tax obligations. This could appeal to individuals and policymakers. Local governments would receive less for land transactions upfront, but will receive a flow of annual real estate taxes, which could be collateral for local government bonds.

10. For existing housing, a property tax could be introduced once the existing land leases run out. China's land is state-owned and leased to property owners. The oldest leases have been falling due. Instead of extending without imposing a fee, as is the current practice, the government could impose a real estate tax at the time of lease extension.