

Some Comments on the IMF Recommendations for the Reform of Personal Income Taxation in China

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Introduction

- ◆ The report of the International Monetary Fund team is very good, thoughtful, and comprehensive.
- ◆ It includes an excellent survey of practices around the world.
- ◆ I am in broad agreement with the recommendations of the International Monetary Fund report, e.g., the consolidation, unification and simplification of the personal income tax system and the indexation of the tax brackets.
- ◆ I also endorse their recommendation of a three-rate option of 10, 20 and 30 percent (four rates including the zero rate) as opposed to a single flat rate (in practice, there are always at least two rates including the zero rate).
- ◆ I have two principal differences with the recommendations of the report:
 - ◆ (1) the degree of inclusiveness of the comprehensive personal income tax; and (2) the degree of provincial/regional/municipal discretion.
- ◆ However, there are also two conditions that are prerequisites to the effective implementation of any new system of personal income taxation.

Social Objectives of Personal Income Taxation

- ◆ Raising revenue for the provision of public goods (e.g., maintenance of law and order, national defense)—Is there an “optimal” way for raising the net revenue (i.e., revenue collected less the costs of collection and enforcement) necessary to support a given level of public expenditure?
- ◆ Redistribution—improving the distribution of income
- ◆ Macroeconomic stabilization.

Some Principles in the Design of a System of Taxation—Fairness and Equity

- ◆ Horizontal equity—individuals facing the same situation (e.g., same age, same number of dependents, and same income) should have the same tax liabilities.
- ◆ Vertical equity—individuals with the greater “ability to pay” should bear proportionally a higher tax burden—a “progressive” income tax (redistribution).
- ◆ Progressivity can also be justified on the basis of diminishing marginal utility of income—the loss of utility of one additional dollar of taxes is higher for a low-income individual than a high-income individual.
- ◆ Perceived fairness is just as important as substantive fairness as it encourages voluntary compliance and hence reduces administrative costs. Perceived unfairness breeds contempt for the tax system and encourages tax evasion.

Some Principles in the Design of a System of Taxation—Neutrality

- ◆ Taxation of both individual and corporate income should be neutral, absent a compelling justification—e.g., an individual income tax is not intended to change the relative preference between two goods of a consumer (except possibly between current consumption and future consumption, i.e. savings--however, in the Chinese case, given the already high savings rate, there is no compelling reason to provide further incentives for savings.)

Some Principles in the Design of a System of Taxation—Efficiency

- ◆ The system of taxation should minimize unintended distortions—the values of the marginal product of every resource should be equalized across all uses.

Some Principles in the Design of a System of Taxation—Simplicity

- ◆ A simple tax is easy to understand and thereby encourages compliance.
- ◆ A simple tax implies low transactions costs for both taxpayers and tax collectors alike, thus resulting in gains for both.
- ◆ A simple tax is also easy to enforce.
- ◆ It is best to avoid a proliferation of deductions—that is why a “flat tax,” or a “piecewise flat tax,” under which the marginal tax rate is (locally) constant, has a great deal of appeal.
- ◆ However, keeping the personal income tax simple (i.e. free of itemized deductions) requires political resolve.

Some Principles in the Design of a System of Taxation—Incentives

- ◆ A 0% rate of taxation and a 100% rate of taxation both result in zero tax revenue.
- ◆ Based on worldwide experience, the maximum marginal tax rate on personal income taxation should not be much higher than 35%. Otherwise the incentive to work and save, and the incentive for faithful voluntary compliance, will be reduced as the incentive to evade taxes is enhanced.
- ◆ The marginal personal income tax rates should be constant for a relatively broad range of taxable income—the brackets should be reasonably “long”. (Thus taxpayers will know their respective marginal rates.)
- ◆ One should always focus on the net tax revenue that can be collected taking into account the costs of collection and enforcement and the incentive effects.

Some Principles in the Design of a System of Taxation—Indexation

- ◆ The bracket amounts should be indexed to the national rate of inflation so as to reflect the real burden.
- ◆ Indexation makes it unnecessary to tinker with the personal income tax code from time to time.

Some Principles in the Design of a System of Taxation—Universality

- ◆ Everyone, except those with either no or very low incomes, should have to pay some direct taxes. People who pay taxes are more likely to realize that any additional public expenditures will have to be financed through additional taxes, the burden of which they will have to share. Hence, the demands for larger social welfare payments and more social welfare programs and other forms of income “transfers” may be moderated.
- ◆ If universality is considered important, then the zero bracket amount cannot be set too high. But then a single positive marginal tax rate does not work very well because low-income individuals will be subject to the same marginal tax rate as high-income individuals.
- ◆ Paying taxes and filing annual tax returns should be made a habit for citizens and they should begin doing so even when their incomes are relatively low.

Conditions for the Implementation of a Comprehensive Income Tax in China

- ◆ Full monetization and reporting of compensation and income in all forms, including in kind compensation—enforced at the level of the corporate and institutional payers, no report, no deduction of the costs.
- ◆ Establishment of a nationwide system of unique personal tax identification numbers—all income payments to individuals (salary and wages, fees, royalties, dividends, interest) must be reported with the tax identification number of the recipient to the National Tax Administration. For corporate as well as non-corporate businesses and institutions, the payments must be reported in order for them to be deductible as costs.
- ◆ Such a system of unique personal tax identification numbers will also reduce the use of nominees to hold assets and receive income.

Adjustments to Taxable Income

- ◆ Mandatory contributions to retirement, health care and education accounts, if any, should be excluded from taxable income. Income received from retirement accounts should be taxable as they are received.
- ◆ The only major issue is whether non-mandatory contributions to retirement, health care, and education accounts, up to ceiling amounts, should be excluded from taxable income.

Personal Income Taxation of Corporate Tax Dividends

- ◆ Elimination of double taxation on corporate earnings by making corporate cash dividends deductible from corporate income in the same way as interest payments.
- ◆ One can consider the exemption of personal income taxes on cash dividends from publicly listed corporations up to a ceiling amount as a means of encouraging broader participation in the Chinese capital market (through the ownership of cash-dividend paying stocks).

Standard Deductions for Dependents

- ◆ In addition to children, there should be provisions permitting parents, and grandparents to be claimed as dependents under some conditions (e.g., low income and wealth).
- ◆ The standard deductions for dependent children need to be considered carefully as there may be an incentive to under-report. One should take this possibility into account by having a more generous zero bracket.

Tax Treatment of Owner-Occupied Residential Housing

- ◆ The imputed income from owner-occupied residential housing is normally exempt from taxation.
- ◆ Given the exclusion of the imputed income from owner-occupied housing from taxable income, the costs of maintaining the owner-occupied residential housing, including interest payments on the mortgage and property taxes, should not be deductible against taxable income. The United States is the only major country in which mortgage interest payments on owner-occupied residential housing is deductible against income.
- ◆ Whether capital gains on the sale of owner-occupied residential housing should be taxed is a more subtle question—I am inclined to support a tax exemption on some form of capital gains from owner-occupied residential housing.

Is Progressivity Desirable?

- ◆ One key question of personal income taxation is: Is progressivity desirable?
- ◆ Given the huge range of variation of personal income in China, some degree of progressivity is necessary from the points of view of ability to pay, fairness, and the size of the target revenue.
- ◆ A progressive personal income tax can be used as an instrument of redistribution of income.
- ◆ Progressivity also has the additional desirable property of facilitating automatic macroeconomic stabilization—the effective marginal tax rate rises as income rises, and falls as income falls.
- ◆ Once it is clear that some degree of progressivity is desirable, it follows naturally that the personal income tax should be an integrated, comprehensive personal income tax, with the taxable income including as many categories of personal income as practicable. It does not make too much sense to impose progressivity on only a part of total individual income.

Additional Arguments for Progressivity

- ◆ If universality is considered important, then the zero bracket amount cannot be set too high. But then a single positive marginal tax rate does not work very well because low-income individuals will be subject to the same marginal tax rate as high-income individuals.
- ◆ Paying taxes and filing annual tax returns should become a habit and taxpayers should be encouraged to begin doing so even if their incomes are low.
- ◆ Progressivity of the personal income tax system can enhance its perceived as well as substantive fairness and equity. Perceived fairness is just as important as substantive fairness as it encourages voluntary compliance and hence reduces administrative costs. Perceived unfairness breeds contempt for the tax system and encourages tax evasion. Perceived fairness also enhances social stability.

The Inclusion of the Different Categories of Income in the Comprehensive Income Tax Base

- ◆ A comprehensive personal income tax should include at least the first eight categories of taxable income, and perhaps even the tenth category instead of only the first five as recommended in the IMF report. This is especially the case if progressivity (real or perceived) is considered desirable and redistribution of income is a social objective.
- ◆ The alleged administrative efficiency of a constant withholding rate on different categories of income, e.g., interest income is predicated on the premise that there will be no zero bracket amounts on the different categories.
- ◆ Only a comprehensive income tax including most categories of income can lead to true progressivity.
- ◆ The problem is that once progressivity is taken into account, there is no way to avoid the filing of a tax return. For example, those taxpayers with the lowest total incomes should be entitled to file a tax return for a refund of all of the withheld taxes on the interest payments on their bank deposits. Those with the highest total incomes will not have enough taxes withheld from their interest income because of their higher marginal tax brackets and will owe additional taxes.
- ◆ For administrative purposes one can choose a single withholding rate for bank interest payments, perhaps the lowest positive marginal rate, as suggested by Dr. Howell Zee (even though, in principle, there is no reason why a bank cannot withhold taxes as if the interest payments were the entire income—for example, an individual depositor with a million Yuan of interest income per year from the same Bank can have taxes withheld as if he or she had monthly total income of 83,333 Yuan.) However, the filing of a tax return for a refund seems inevitable for the lowest income individuals.
- ◆ The same argument applies to the tax treatment of cash dividends.

The Degree of Provincial/Regional/Municipal Discretion

- ◆ The report proposes to allow provincial/regional/municipal governments to modify the standard exclusion amount (zero bracket amount). Since it is most unlikely that any local government will want to reduce this amount, the only possibility is that they may wish to raise it. But raising it reduces the central government's net tax revenue, other things being equal. It is therefore far better for the central government to set the nationwide zero-bracket amount sufficiently high so as to eliminate this problem. Otherwise since individuals can receive income from different provinces it can lead to unnecessary complications and gaming. The local government is of course free to do whatever it wishes with its share of the personal income tax revenue, including redistributing it to its permanent residents.
- ◆ The report also proposes to allow provincial/regional/municipal governments to impose a surtax based on the individual tax liabilities to the central government. I believe this possibility can be allowed on conditions that the central government remains solely responsible for the collection of the total taxes and that the surtax appears reasonable (i.e., it should not be excessive relative to the local income--there should be some limits to total (central and local combined) tax burden as a percentage of income in relation to the prevailing local per capita income.) Thus, a poor province will not be permitted to levy a heavy surtax. (The central government should try to alleviate the conditions in a poor province through more direct inter-governmental transfers.)

A Flat Tax versus a Piecewise Flat Tax

- ◆ The desirability of a (Hall-Rabushka) “flat tax”—simplicity—no itemized deductions and a single positive marginal tax rate.
- ◆ Some degree of progressivity can be introduced into a flat tax, resulting in a piecewise flat tax. A piecewise flat tax with more than one positive marginal tax rate can be made more optimal than a flat tax with a single marginal tax rate for the simple reason that there are more instruments.
- ◆ The spirit of a flat tax is not so much the single positive marginal tax rate but the elimination of all itemized deductions.
- ◆ However, even in the case of a piecewise flat tax, it is best to keep the number of brackets, including the zero bracket, to no more than four (e.g., one can have 0, 10, 20 and 30).

The Economic and Administrative Efficiency of a Flat Tax with a Single Positive Marginal Tax Rate

- ◆ The theoretical economic efficiency of a flat tax is predicated literally on the existence of only a single constant tax rate. In most practical applications, there will be at least two marginal tax rates, zero and a positive rate. Given the existence of two marginal rates, the efficiency property no longer holds. It is an open question whether a two-rate personal income tax system is more or less efficient than a three- or four-rate system. It depends on the specifics of the situation.
- ◆ The administrative costs of a flat tax and a piecewise flat tax (with more than one positive marginal tax rate) are virtually the same. The savings in the administration of a flat tax arises almost exclusively from the absence of itemized deductions. If all categories of income have zero bracket amounts, even an identical single marginal tax rate for all such categories does not help to reduce administrative costs.
- ◆ China can leapfrog and introduce on-line filing of individual income tax returns—the equivalents of the W-2's and 1099's (notifications sent by payers of income to recipients and the National Tax Administration) can be automatically linked and made accessible to the individual taxpayers to facilitate the filing of their tax returns.

Personal Income Taxation—A General Consumption Tax

- ◆ A general consumption tax (this is different from the commodity specific retail sales tax which is also referred to as a consumption tax in China) as an alternative to an income tax—a consumption tax may be regarded as a means for promoting savings—the unconsumed income is not taxed immediately but eventually taxed when it is consumed over the life-cycle of the individual.
- ◆ In a country such as China, where the saving rate is already high enough (perhaps even too high), the justification for a general consumption tax is not that strong. A general consumption tax in the form of a general retail sales tax is likely to be regressive.

Concluding Remarks

- ◆ A well-designed system of personal income taxation can accelerate economic growth and enhance social stability in addition to meeting the revenue needs of China.
- ◆ In addition, one should avoid the institution of the comprehensive personal income tax turning into a permanent employment act for tax lawyers and accountants in China. However, simplicity in administration should not be the sole criteria for the choice of a personal income tax system for China.