

CHINA TAX RATIONALIZATION AND PUBLIC EXPENDITURE PROGRAMS

Source: JFU

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In our note of October 12, we looked at the current revenue structure that indicates that the average citizen could be the main group that bears the cost of public expenditure in terms of effective tax burden. This itself is not necessarily a cause for concern if taxpayers feel that what they receive justifies the burden they share. However the call to ease the feeling that the tax burden is too heavy suggests that some do not think so. Such a sentiment should be taken seriously, as a part of the continuing feedback between policy setters and the public.

The total cost of public expenditures as projected in China's fiscal budget for 2011 is about 10,000 billion, or 25% of GDP. Of the total, about 55% is expected to be spent on programs where taxpayers should feel the benefits directly, such as education and social security. As one may reasonably expect, education and social security are the two most notable policy areas attracting the largest allocation of public funds: education 14.23% of the budget total or about 4% of GDP; and social security, 10.35% of the budget total or 3% of GDP. Surprisingly, only 5.35% of the budget total or 1.34% of GDP is provided for health care costs that usually inflict the greatest pain to patients' families with average income and savings. See Schedule 1 below for an analysis.

To put the matter in context, let's take the US as a comparable. The total budget outlay for the US for 2011 is also about 25% of its GDP, with social security at about 4.8%, and medical care and assistance, 5%. Any claims based on a direct comparison must of course be taken with a grain of salt, but such a variation clearly establishes health care as an obvious candidate for greater policy attention. Personal experience of observers may help confirm this claim.

While the overall allocation of domestic production to public expenditure (25% of GDP) does not seem unreasonable, as pointed out above, certain individual areas need to be examined. Moreover, not only the quantum of allocation matters, the quality and effectiveness of policy implementation can be more directly responsible for how taxpayers feel about the benefits they receive and whether the level of tax they pay is justified.

Although this note focus on the government's allocation function, particularly allocation of funds on expenditures for services that benefit the average citizen directly, it is not our general assertion that the sharing of tax burden among the public should relate merely to how government services are allocated. There are other important functions that the government has to exercise, notable stability and redistribution. Also, this note assumes that the average citizen group is more inclined in their expectations to rely on government services in respect of

education, social security and medical care; other groups such as high income earners with more savings and better skills may have different expectations, taking economic environment and institutional development as factors more important to their future and livelihood.

In general, on tax rationalization, it is our view that the sharing of tax burden should correspond to the distribution of income and wealth. Thus, the degree of consistency and disparity of income and wealth should drive the shape of the revenue structure. In a society where income disparity is becoming a concern, progressive direct taxes should play a heavier role and regressive broadly based indirect taxes should be given less weight. It would seem China tax rationalization should be trending in this direction.

SCHEDULE 1

	<u>In Billions of RMB</u>		<u>As a % of Budget</u>	<u>As a % of GDP</u>
<u>2011 GDP, Estimate</u>	<u>40,000.00</u>			
<u>2011 Total expenditure, Per Budget</u>	<u>10,022.00</u>	<u>100.00%</u>		<u>25.06%</u>
<u>2011 Programs for services directly to taxpaying public</u>			<u>54.97%</u>	<u>13.77%</u>
<u>Analysis of expenditures by nature in order of magnitude</u>				
Education	1,426.29	14.23%	14.23%	3.57%
Social security and employment	1,037.27	10.35%	10.35%	2.59%
General public services	976.58	9.74%	9.74%	2.44%
Agriculture Forestry and Water	933.02	9.31%		
Community services	659.92	6.58%	6.58%	1.65%
Public security	624.42	6.23%		
Transport	614.63	6.13%	6.13%	1.54%
Defense	601.16	6.00%		
Health care	536.01	5.35%	5.35%	1.34%
Science and technology	368.98	3.68%		
Resource exploration, electricity, and information	365.07	3.64%		
Other charges	296.00	2.95%		
Environmental services	281.10	2.80%		
Housing	258.36	2.58%	2.58%	0.65%
Government bond interest charge	221.93	2.21%		
Cultural sport and media	171.34	1.71%		
Food and reserves	157.94	1.58%		
Geographical resources and observatory	147.25	1.47%		
Business and commerce	137.77	1.37%		
Provisions	114.00	1.14%		
Financial regulatory services	59.27	0.59%		
Foreign relation	31.79	0.32%		
Post natural disaster reconstruction and recovery	1.90	0.02%		
	<u>10,021.99</u>	<u>100.00%</u>	<u>54.97%</u>	<u>13.77%</u>