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INCOME INEQUALITY AND PROGRESSIVE INCOME TAXATION IN CHINA AND INDIA

DR. SUNIL GUPTA

Faculty

School of Management Studies

Indira Gandhi National Open University

NEW DELHI – 110 068

DR. VIJITA AGGARWAL

Associate Professor

University School of Management Studies

Guru Gobind Singh I. P. University

Delhi – 110 403

DR. ALKA MITTAL

Asst. Professor

Department of Management Studies

Maharaja Surajmal Institute

NEW DELHI - 110 058

ABSTRACT

This paper evaluates the income tax reforms in China and India. The combination of fast income growth and under-indexed tax schedule in China implies that the fraction of the Chinese population subject to the income tax has increase from less than 0.1 percent in 1986 to about 20 percent by 2008, while it has stagnated around 2-3 percent of the population in India. Chinese income tax revenues, as a share of GDP, increase from less than 0.1 percent in 1986 to about over 1.5 percent in 2005 and 2.5 percent in 2008, while the constant adaptation of exemption levels and income brackets in India have caused them to stagnate around 0.5 percent of GDP.

INTRODUCTION

Current debates about policy reform in LDCs often focus on improving the delivery of social service, the design of market-friendly economic institutions, the effectiveness of poverty reduction programs, or the role of trade and market liberalization. Perhaps surprisingly, they rarely deal explicitly with tax reform and the need to develop modern income tax systems in those countries. This is unfortunate for at least three reasons. First, poor countries often rely excessively on highly distortionary tax instruments such as taxes can help to increase the tax revenues needed to finance public goods. In countries such as China and India, tax revenues are currently around 10-15 percent of GDP, far below any country in the West that have been able to develop a proper education, health and infrastructure systems. Finally, may LDCs have witnessed a sharp rise in income inequality during the recent period. Progressive taxation is one of the least distortion policy tools available that controls the rise in inequality by redistributing the gains from growth.

In this paper, we choose to focus on the case of progressive income taxation in China and India. Although a progressive individual income tax system has been in place in China since 1980, it has received very little attention so far, probably because the fraction of the population with income above the exemption threshold was negligible until the 1990s (less than 1 percent). Using annual, 1986-2008 tabulations from urban household income survies on levels and shares of top incomes in China over this period, as well as series on theoretical numbers of taxpayers and total income tax receipt. We were also able to compare our Chinese findings with similar series for India. The Indian tax administration has been compiling detailed tabulations of income tax returns every year since the creation of a progressive income tax in India (1922). India tax returns tabulations were recently exploited by Benerjee and Piketty (2004-2005) to study the long run evolution of top income shares in India, and we use and update their results as a comparison point for our Chinese series. Our main result is simple, but powerful. The combination of fast income growth and under-indexed tax schedule in China implies that Chinese income tax revenues grow very fast as a fraction of GDP, while the constant adaptation of exemption levels and income brackets in India prevents the income tax from playing such a powerful role. According to our estimates, the fraction of the population in China subject to the income tax has increased from less than 0.1 percent in 1986 to about percent by 2008, while it has stagnated at around 2 percent-3 percent in India. Income tax revenues in China have boomed, from less than 0.1 percent of GDP in 1986 to over 1.5 percent by 2005 and 2.5 percent by 2008, while in India, they have stagnated at around 0.5 around 0.5 percent of GDP.

Data and Methodology

The Chinese data used in this paper comes from the urban household income surveys collected by China's National Statistical Bureau (NSB). These surveys are designed so as to representative of urban China. Between 13,000 and 17,000 households are surveyed each year until 2002, where the sample rose to 45,000-50,000 up to 2008. The micro-files for these surveys are unfortunately not available for all years, and we asked the NSB to provide us with annual, 1986-2008 tabulations and individual tabulations. Household tabulations report the number of households whose total household income falls into that bracket, their average total income and household size, as well as their average income broken down by income sources (wage income, business income, capital income and transfer income) for a large number of income brackets (and in particular a large number of top income brackets).

Individual tabulations report the number of individuals whose individual income and household size, as well as their average income broken down by income sources for a large number of income brackets. In practice, some from of income cannot be properly attributed to a specific individuals within the household (this is particularly true of transfer income and capital income). Hence, the total income aggregates reported in household tabulations are large than in individual tabulations, and various adjustments are necessary when one uses the latter. However, the important advantage of individual tabulations is that China's income tax applies to individuals' income (rather than household income).

We used standard Pareto interpolation techniques to approximate the form of the Chinese household and individual distribution of income, and we then used these structural parameters to compute top fractiles' incomes and to make income tax simulations. The Chinese data appears to be very well approximated by a Pareto distribution (for any given year, Pareto coefficients are extremely s stable within the top decile), although there is some presumption that top incomes are underestimated in the survey data. For each year of the 1986-2008 periods, we computed income thresholds and average incomes for fractiles P0-90, P90-95, P99.5-99.9 and P99.9-100. Projection for the 2004-2015 periods were made by assuming nominal income trends by fractile similar to those observed during the 1996-2008 period. We did not attempt to use similar tabulations from rural household surveys. According to the 2000 China Population Census, over 97 percent of households in rural areas are agricultural households, and are hence exempt from income tax. Average rural income was in 2001 more than 3 times smaller than average urban income. So given that our focus is on top incomes and progressive income taxation, the exclusion of rural households should not be too problematic. In fact, our simulated income tax revenues (based solely on urban household surveys) appear to be reasonably close to actual income tax revenues, both in levels and in trends.

All of the Indian data are borrowed from Banerjee and Piketty (2004, 2005), who used Indian income tax returns tabulations publish in "All-India Income Tax Statistics" brochures (annual available since 1922) to estimate top income levels and national accounts to compute the average income denominator. Top income share estimates based upon income tax returns are likely to be higher than estimates based on survey data (as the latter generally underestimates top incomes), but there is no obvious reason why the trends should not be comparable. The Benerjee- piketty series provide annual income thresholds and average incomes for all fractiles up until 2001.

RESULTS

Real per capita GDP increased by almost 200 percent in China between 1986 and 2008 (6.4 percent per year), and by slightly less than 80 percent in India (3.3 percent per year). As we move up in the income hierarchy, the growth trend gets even bigger. Figure 1 show that, according to our estimates, the top 1 percent income share has increased by more than 120 percent in China between 1986 and 2008, and by approximately 50 percent in India. In the pre-reform era, all Chinese workers worked for the state and paid an implicit tax from their wages. Expansion of the private sector by the market reforms decreased the government's ability to tax directly. Following other countries, China developed and individual income taxation system, which officially began in 1980. In order to avoid negative public opinion, the deductible amount was set so high that virtually no one had to pay income taxes in 1980. China's income tax law has changed very little since its creation in 1980. Nominal income brackets and graduated marginal rates (from 5 percent to 45 percent) applied to both wage and non-wage income have remained unchanged since 1980. The only major change is that the nominal exemption threshold for wage earners (there exists no exemption for non-wage income) has been raised from 9,600 yuans per year in fiscal years 1980-1998 to 12,000 yuans in 1999-2003, 14,00 yuans in 2004-2005 and 19,200 yuans since 2006. This is substantially less than nominal income growth. In 1986, the exemption threshold was about 7 times larger than average individual income (1,400 yuans) and more than 3 times larger than the P99 threshold of the distribution (3,000 yuans). 2008, the exemption threshold has passed below average income (20,400 yuans), and was 4.5 times smaller than the P99 threshold (93,100 yuans).

In contrast to the Chinese income tax, the Indian income tax is a much older institution, since it was created in 1922 by the British. Moreover, it has always been an integrated system treating all income sources equally: Indian Progressive tax schedules apply to total individual income, irrespective of where the income comes from. Most importantly, the tax schedule has been changed almost constantly in India during the 1986-2008 period, with a general decline in tax rates and a continuous increase in the exemption threshold and the income brackets In effect, the rise in the exemption threshold – from 15,000 rupees in 1986 to 150,000 rupees in 2008 – has been almost as large as the rise in nominal income growth – from 4,400 to 56,300 rupees for average income, and from 14,00 to 192,400 rupees for the P99 threshold..

The simple but powerful implication of these sharply differing evolution is that the fraction of the population subject to the income tax has increased enormously in China – from less than 0.1 percent of the population in 1986 to about 15 perent-20 percent by 2008; while it has risen modestly in India: less than 3 percent of the population was subject to the income tax in 2008, versus less than 1 percent in 1986.The income tax has become a mass tax in China., while it has remained an elite tax in India (see Figure 4). Moreover, effective tax rates paid by the population subject to tax have raised considerable in China, due to the fact that income brackets have remained the same in nominal terms since 1980s to over 1.5 percent by 2005 and 2.5 percent by 2008, while they have stagnated around 0.5 percent of GDP in India.

We have also made projections for the 2008-2015 period assuming constant trends in income tax law parameters. India, if exemption level and income brackets keep being increased at the same pace as in the past decade, then both the proportion of population subject to tax and tax revenues will keep stagnating (around 2 percent-3 percent of population and 0.5 percent of GDP, respectively). For the case of China, we have assumed that the nominal exemption level will be increased during the 2008-2015 period at the same average annual rate as that observed during the 2003-2008 period, but that income brackets would remained fixed in nominal terms (as they did in the past). The consequences for tax revenues would be spectacular: the proportion of the population subject to tax would stabilize around 20 percent (roughly 30 percent-35 percent of urban wage earners), but income tax revenue would well exceed 5 percent of Chinese GDP before 2015. In cases the exemption threshold was to remained fixed in nominal terms during the 2008-2015 period, then by 2015the proportion of the population subject to tax would reach 50 percent (roughly 75 percent of urban wage earners), and income tax revenue would well exceed 10 percent of Chinese GDP.

CONCLUSION

If our projections appear to be correct, then China will have gone through its fiscal revolution. Moving from an elite income tax raising less than 1 percent of GDP to a mass income tax raising around 4-5 percent of GDP is exactly the kind of fiscal modernization process followed by Western countries during the 1914-1950 period (when their income levels were similar to current Chinese level). Although Indian income tax revenues might increase during the coming years, the prospects for India look less good, both because of lower income growth and higher exemption and bracket indexation. One reason why India faces more difficulties than China in making its income tax a mass tax might also be that the proportion of formal wage earners in the labor force is ridiculously low in India. There much that policy makers and economists can do in order to improve the functions and implications of progressive income taxation in countries like China and India. Given that income taxation in countries like China functions and implication of progressive income taxation in countries like China and India. Given that income taxation is about to become something big, it is urgent to put income tax reform at the top of the policy agenda. For instance, China's authoritarian government will probably not be able to under-index its exemption threshold forever and the preferential tax treatment of wage earners will need to be addressed at some point. Conversely, the Indian democracy still needs to find its way towards fiscal modernization, which requires convincing the electorate that a mass income tax is a useful policy tool. These are important democratic challenges for the economic development of China and India.

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