China ushers in landmark tax reform to prop up economy

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A staff member prepares a value-added tax (VAT) invoice for guest at Fuzhou Hotel in Fuzhou, capital of East China's Fujian province, May 1, 2016. VAT refers to a tax levied on the difference between a commodity's price before taxes and its production cost. Business tax refers to a levy on a business's gross revenues. The VAT began in 2012 to replace business tax in certain industries, as a major step in China's structural reform. Starting from May 1 this year, the replacement was extended to construction, real estate, finance and consumer services to avoid double taxation.[Photo/Xinhua]

BEIJING — China has expanded a pilot program to finally put all industries under a unified value-added tax (VAT) regime as part of a wider push to deepen the country's economic reform.

Experts have described it as the most significant tax and fiscal reform in decades as it further improves the country's tax structure and will sustain economic growth in the long run.

"The reform will reinforce the current performance of the economy, allow the market to play a decisive role, and eventually sustain momentum of its future development," said Rani Jarkas, chairman of Hong Kong-headquartered financial services firm Cedrus Investments.

Starting from May 1, the VAT replaced business tax (BT) in the sectors of construction, real estate, financial services and consumer services to avoid double taxation, a move expected to slash taxes by over 500 billion yuan ($76.9 billion) in 2016 alone.

The latest extension came four years after the first trial run of the services sector VAT reform in the financial hub of Shanghai. With that, the VAT has essentially taken the place of the BT in all sectors.

The VAT taxes only the value added at each link in the production chain. It is in line with international practices and more efficient as it avoids the double taxation of the BT regime, which is based on the gross revenue of a business, including the cost of input.

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Premier Li Keqiang has urged solid efforts to deliver the VAT reform and pledged lower taxes across the board.

It is expected to directly help the tertiary industry, which makes up more than half of the Chinese economy and is critical to China’s economic transition. Traditional manufacturing businesses stand to benefit too, as they enjoy more deductibles under the unified tax regime.

Promoting market’s role

Liu Shangxi, head of the Research Institute for Fiscal Science under China’s Ministry of Finance, said the VAT helps create a fairer market for business.

“The unified tax system covering the production, circulation and consumption of all goods and services is more neutral and provides a better tax environment for the market to play a decisive role in allocating resources,” said Liu.

Zhang Bin, a researcher at the Chinese Academy of Social Sciences, said the reform will promote the fair development of all the country’s sectors.

The VAT reform is the most significant step taken in reducing taxes in recent years. Premier Li told the national legislature in March that the government will ensure that tax burdens on all industries are reduced.

China faces the challenging task of pushing through vast economic restructuring while at the same time keeping its economic growth rate within a certain target range of between 6.5 percent and 7 percent this year.

The VAT and BT together contribute a large proportion of China’s tax revenue. “The sheer scale illustrates the significance of this reform, and the completion of the switch is far-reaching,” Zhang told Xinhua.

Services sector boost

A unified tax regime will help foster a level playing field for all businesses, especially those in the services sectors that were last put under the VAT regime.

“The business tax imposes a tax on tax, while the VAT levies only on the value added, which is fairer and more precise,” said Li Wanfu, director of the Institute of Tax Science (ITS), a research arm of China’s State Administration of Taxation.

Purchased services are deductible under the VAT scheme, which encourages firms to outsource more services rather than adopt a do-it-all business model, according to a report by China International Capital Corp Ltd, an investment bank.

Gao Liqun, head of Deloitte’s indirect tax group in eastern China, said the final step toward a full VAT scheme benefits the services sector with lower tax burdens and greater demand from other industries.

“Firms will thus have more capital to invest in research and innovation that propel the growth of the services sector,” she told Xinhua.

Creating more jobs

A more socially significant impact of the VAT reform is that it eases tax burdens for small- and medium-sized enterprises (SMEs), which experts say will encourage entrepreneurship and boost job creation.

“SMEs used to pay a 5 percent or 3 percent business tax on sales, but they now only need to pay a VAT of 3 percent,” said Zhang.

According to Li, the ITS director, many SMEs are in the services sector.

“Moreover, the business tax imposed on sales ignores the fact that some SMEs are actually not earning any profit,” he said. “Now they only need to pay tax for their gains, and at a lower rate.”

Liu stressed the social implications of favoring SMEs in the VAT reform.

“SMEs not only offer more jobs, but also improve employment quality, while promoting balanced and sustainable growth in both an economic and social sense,” he said.

Most important tax reform in decades

Experts said the VAT reform might be a key to unlocking wider reforms down the road, as it not only changes China's overall tax structure but also has bearing on how the central and local governments share tax revenue.

"Tax and center-local reforms are the thorniest and most fundamental elements of a true overhaul of China's economic system," Daniel H. Rosen, a partner at the Rhodium Group, said in a report.

The VAT reform is seen as the most important fiscal and taxation reform in China in more than two decades.

The final completion of the VAT reform is expected to occur with the enactment of a VAT law in a few years.

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