



# Technical Assistance Report

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Project Number: 51021-001  
Knowledge and Support Technical Assistance (KSTA)  
October 2017

## People's Republic of China: Reforming the System of Personal Income Tax and Social Security Contributions

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Asian Development Bank

## CURRENCY EQUIVALENTS

(as of 29 September 2017)

Currency unit	–	yuan (CNY)
CNY1.00	=	\$0.1507
\$1.00	=	CNY6.6369

## ABBREVIATIONS

ADB	–	Asian Development Bank
GDP	–	gross domestic product
MOF	–	Ministry of Finance
OECD	–	Organisation for Economic Co-operation and Development
PRC	–	People's Republic of China
TA	–	technical assistance

## NOTE

In this report, "\$" refers to US dollars.

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## KNOWLEDGE AND SUPPORT TECHNICAL ASSISTANCE AT A GLANCE

<b>1. Basic Data</b>		<b>Project Number: 51021-001</b>	
<b>Project Name</b>	Reforming the System of Personal Income Tax and Social Security Contributions	<b>Department /Division</b>	EARD/PRCM
<b>Nature of Activity</b>	Policy Advice	<b>Executing Agency</b>	Ministry of Finance
<b>Modality</b>	Regular		
<b>Country</b>	China, People's Republic of		
<b>2. Sector</b>		<b>ADB Financing (\$ million)</b>	
✓ Public sector management	Public expenditure and fiscal management		0.30
		<b>Total</b>	<b>0.30</b>
<b>3. Strategic Agenda</b>		<b>Climate Change Information</b>	
Inclusive economic growth (IEG)	Pillar 1: Economic opportunities, including jobs, created and expanded	Climate Change impact on the Project	Low
<b>4. Drivers of Change</b>		<b>Gender Equity and Mainstreaming</b>	
Governance and capacity development (GCD)	Institutional development Public financial governance	No gender elements (NGE)	✓
Knowledge solutions (KNS)	Knowledge sharing activities		
<b>5. Poverty and SDG Targeting</b>		<b>Location Impact</b>	
Geographic Targeting	No	Rural	Medium
Household Targeting	No	Urban	Medium
SDG Targeting	Yes		
SDG Goals	SDG10, SDG12		
<b>6. Risk Categorization</b>	Low		
<b>7. Safeguard Categorization</b>	Safeguard Policy Statement does not apply		
<b>8. Financing</b>			
<b>Modality and Sources</b>		<b>Amount (\$ million)</b>	
<b>ADB</b>		<b>0.30</b>	
Knowledge and Support technical assistance: Technical Assistance Special Fund		0.30	
<b>Cofinancing</b>		<b>0.00</b>	
None		0.00	
<b>Counterpart</b>		<b>0.00</b>	
None		0.00	
<b>Total</b>		<b>0.30</b>	

## I. INTRODUCTION

1. The knowledge and support technical assistance (TA) will provide an in-depth review of international experience in reforming personal income tax and social security contribution systems in areas relevant to the reform agenda of the People's Republic of China (PRC). The TA is part of a broader initiative by the government to reform the tax and social security contribution systems and bring them into line with the PRC's current level of economic and social development. In 2013 the Third Plenum of the 18th Central Committee of the Communist Party of China called for reform of the tax and social security contribution systems to increase the share of direct taxes in overall tax revenues and improve income distribution. These objectives were further developed in the plan for deepening fiscal and taxation reforms approved by the Politburo in June 2014, and the Thirteenth Five-Year Plan (2016–2020)<sup>1</sup> approved by the National People's Congress in March 2016.

2. The TA will draw on the experience of selected member countries of the Organisation for Economic Co-operation and Development (OECD) that have demonstrated good practice in this area. Specifically, the TA aims to explore how reform of the personal income tax and social security contribution systems can (i) increase the contribution of personal income tax to tax revenue; (ii) have a greater impact on reducing income inequality; and (iii) address distortions in the personal income tax and social security contribution systems, notably those that affect the systems' progressivity and give rise to inequality and labor market segmentation. The TA is included in the country operations business plan, 2017–2019 for the PRC.<sup>2</sup>

3. An agreement was reached with the government during a fact-finding mission on the TA project's main features including the impact, outcome, outputs, activities, financing plan, terms of reference for consulting services, and implementation arrangements.<sup>3</sup>

## II. ISSUES

4. Since the outset of economic reforms in 1978, the PRC has devoted significant effort to establishing an efficient, stable, and sustainable fiscal and taxation system. During 1996–2014, the growth of tax revenues exceeded that of nominal gross domestic product (GDP), resulting in an increase in the tax ratio, from 9.6% of GDP to 18.6% of GDP. However, changes in the PRC's economy since 2014 have reversed this trend, and the tax ratio declined to 17.5% of GDP in 2016. This is significantly below the OECD average of 25.1% of GDP in 2014.<sup>4</sup> Meanwhile, fiscal expenditure needs are continuing to rise, resulting in growing deficits in place of the former fiscal surpluses, and raising concerns about fiscal sustainability.

5. One reason for the decline in the tax ratio is that direct taxes contribute relatively little to tax revenues—instead, the PRC's current tax system relies heavily on indirect taxes on goods and services, the growth of which has slowed significantly since 2016 following reforms of the value-added tax that sought to lower the tax burden on enterprises. The current tax structure in the PRC contrasts with international experience, which suggests that as income levels increase, countries tend to move away from indirect taxes toward direct taxes on income and property. In

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<sup>1</sup> Government of the People's Republic of China. 2016. *The Thirteenth Five-Year Plan for Economic and Social Development of the People's Republic of China (2016-2020)*. Beijing.

<sup>2</sup> ADB. 2017. *Country Operations Business Plan: People's Republic of China, 2017-2019*. Manila.

<sup>3</sup> The design and monitoring framework is in Appendix 1. The TA first appeared in the business opportunities section of ADB's website on 2 August 2017.

<sup>4</sup> Data on tax revenue (excluding social security) in all OECD countries is only available until 2014. OECD. 2016. *Tax Levels and Tax Structures, 1965–2015*. In OECD. 2016. *Revenue Statistics*. Paris.

the PRC direct taxes—such as personal and corporate income taxes—contributed relatively little to tax revenue, amounting to 4.9% of GDP in 2014, much less than the OECD average of 11.2% of GDP in 2014.<sup>5</sup> This is mainly because collections from personal income tax (1.1% of GDP) are much lower than the OECD average (8.4% of GDP). Therefore, one area that the TA will explore is how other countries have increased revenue from taxation of personal income. Improving the revenue performance of the personal income tax would make a direct contribution to strengthening the revenue base of the budget. It could also potentially provide local governments with a robust independent source of revenue, if reforms are introduced empowering them to impose personal income tax surcharges.

6. The redistributive effect of taxes and transfers is still relatively limited in the PRC. Income inequality in the PRC, as measured by the Gini coefficient, remains relatively high. Estimates from various sources indicate the Gini coefficient was low in the mid-1980s (below 0.30) but rose to 0.49 in 2008 and remained around 0.46 since 2015.<sup>6</sup> Fiscal policy appears to do relatively little to narrow inequality, as reflected in the difference between Gini coefficients before and after taxes and transfers. Therefore, another area that the TA will explore is how personal income tax and social security contribution systems in other countries have been designed to increase their contribution to narrowing income inequality. It will also explore the steps taken to ensure that the personal income tax and social security contribution systems do not generate distortions in the labor market, including those stemming from high effective tax rates on wage income.

7. A preliminary literature review suggests that there are two features of the personal income tax and social security contribution systems in the PRC that the TA study could focus on:

- (i) The base for collecting personal income tax in the PRC is very small, relative to OECD economies. A number of factors appear to contribute to this. First, the highest marginal tax rate for personal income (45%) starts at the very top of the income distribution (about 35 times the national average wage) and consequently applies to few income earners; in contrast, the top marginal tax rates in OECD countries are imposed at around 4 times the national average wage. Second, the personal income tax has a relatively high basic allowance (CNY42,000 or twice the average national wage); in comparison, the average basic personal allowance in OECD countries is about one-quarter of the average national wage. As a result, less than 20% of workers are liable to pay personal income tax—individuals paying personal income tax in the PRC accounted for just 3% of the total population in 2016.<sup>7</sup>
- (ii) The effective contribution rate under the social security contribution system is highly regressive in the PRC. Employers and employees contribute to pension, medical insurance, and unemployment insurance systems. Contributions are withheld from wages and remitted directly by employers. Although employee contributions are raised via a flat, ad valorem rate on earnings, the contributions are subject to both a floor and a ceiling. The minimum employee contribution is based on an imputed earning set at 60% of the previous year's average wage in the locality. The ceiling is based on an imputed earning set at three times that average wage. It is estimated that around 30% of the urban labor force earns below the 60% threshold in several large cities. The current combination of a floor and a

<sup>5</sup> OECD. 2016. *Revenue Statistics*. Paris.

<sup>6</sup> J. Zhuang and S. Li. 2016. Understanding Recent Trends in Income Inequality in the People's Republic of China. *ADB Economic Working Paper Series*. No. 489. Manila.

<sup>7</sup> W. Lam and P. Wingender. 2015. China: How Can Revenue Reforms Contribute to Inclusive and Sustainable Growth? *IMF Working Paper*. No. 66. Washington, DC: International Monetary Fund.

ceiling on contributions therefore implies an effective contribution rate schedule that is highly regressive. This is detrimental to income equality, and may also contribute to the high degree of labor market segmentation present in the PRC.

8. The proposed TA provides an opportunity for the Asian Development Bank (ADB) to engage on a policy issue that is central to the government's economic reform agenda. As noted (para. 1), this policy issue was an important component of the Third Plenum reform agenda and its priority was subsequently reaffirmed at the highest level in government. Support for the government as it seeks to make reforms in key policy areas that are essential for the PRC to achieve high income status constitutes part of institutional and governance reform, which is one of the five priorities identified in the ADB country partnership strategy, 2016–2020 for the PRC.<sup>8</sup>

### III. THE TECHNICAL ASSISTANCE

#### A. Impact and Outcome

9. The TA is aligned with the following impact: the enhanced sustainability of the taxation system and equitable income distribution. The TA is expected to contribute to the following outcome: reform of the personal income tax and social security contribution systems accelerated in the PRC.

#### B. Outputs, Methods, and Activities

10. **Output 1: Research studies on personal income tax and social security contribution system reforms undertaken.** A main final report will identify key lessons from international experience that will help the PRC reform its personal income tax and social security contribution systems and align them better with the PRC's current stage of development. The report will draw on relevant theory and international experience in designing and implementing personal income tax and social security contribution systems. More specifically, it will draw on case studies of six selected OECD countries that have managed to substantially increase revenues from direct taxes and successfully reformed their personal income tax and social security contribution systems.

11. Six subreports will analyze the experience of the target countries in designing and implementing relevant reforms of personal income tax, social security contributions, and other taxes (where appropriate). They will focus on the following key issues the PRC government faces in implementing its personal income tax and social security contribution system reform agenda: how to (i) raise more revenue from direct taxes, (ii) ensure that the personal income tax and social security contribution systems make a greater contribution to reducing income inequality, and (iii) reduce distortions stemming from the severely regressive wage income taxation in the PRC. The latter will need to be achieved while also ensuring that the PRC's social security contribution system meets the needs of a rapidly ageing society with increasing labor mobility. The studies will identify key issues, challenges, and solutions encountered in the target countries during the reform process. The selection and design of the studies will take into account the different stages of social and economic development in the countries under study, and thus the relevance of their experience to the PRC.<sup>9</sup>

<sup>8</sup> ADB. 2016. *Transforming Partnership: People's Republic of China and Asian Development Bank, 2016–2020*. Manila.

<sup>9</sup> Candidates for the selected OECD countries are Australia, Germany, Japan, Republic of Korea, Sweden, the United Kingdom, and the United States. The selection will be finalized at the inception stage of the TA.

12. During TA implementation, two briefing notes will be prepared and submitted to high-level government officials in the Ministry of Finance (MOF) and other relevant ministries.

13. **Output 2: Enhanced awareness and knowledge of personal income tax and social security contribution system reforms.** Supported by the ADB Sustainable Development and Climate Change Department, an overseas training seminar will be held to enhance the knowledge and skills of MOF staff regarding the personal income tax and social security contribution systems. The seminar will also provide an opportunity for MOF staff members to exchange views with government officials from other countries. A domestic training workshop on the international experience in personal income tax and social security contribution system reforms will be conducted for selected participants.

14. Other activities contributing to the output include (i) organizing a consultation seminar with government officials, think tanks, and scholars to discuss preliminary findings; (ii) undertaking a workshop to discuss the midterm reports of the TA project with government officials, experts, and scholars; and (iii) conducting a press conference to disseminate key findings to the public.

### C. Cost and Financing

15. The TA is estimated to cost \$375,000, of which \$300,000 will be financed on a grant basis by ADB's Technical Assistance Special Fund (TASF-other sources). Key expenditure items are listed in Appendix 2. The ADB will provide additional support in the form of ADB staff time.

16. The government will provide counterpart support in the form of meeting space, staff time, services to the consultants, assistance in arranging meetings with counterpart agencies, and other in-kind contributions.

### D. Implementation Arrangements

17. The Economics Unit in the ADB PRC Resident Mission will administer and coordinate TA implementation through a One ADB approach, (i) in close cooperation with the Public Management, Financial Sector, and Regional Cooperation Division of the East Asia Department; and (ii) supported by a public management specialist (taxation) from the Sustainable Development and Climate Change Department and an economist from the Economic Research and Regional Cooperation Department. This ADB team will be supported by a team of consultants as described below.

18. The MOF Tax Policy Department will be the executing and implementing agency for the TA. The Tax Policy Department will be responsible for establishing a TA steering committee; arranging meetings between the technical assistance team and relevant government agencies; reviewing midterm and final reports; disseminating TA findings; and helping to organize workshops, as needed.

19. The TA will be implemented over 18 months from 1 November 2017 to 30 April 2019. A total of 20 person-months of individual consulting services (five national consultants for a total of 15 person-months and two international consultants for a total of 5 person-months) will be provided.<sup>10</sup>

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<sup>10</sup> Terms of Reference for Consultants (accessible from the list of linked documents in Appendix 3).



### Implementation Arrangements

Aspects	Arrangements
Indicative implementation period	November 2017–April 2019
Executing agency	Tax Policy Department, Ministry of Finance
Implementing agency	Tax Policy Department, Ministry of Finance
Consultants	To be selected and engaged by ADB
	ICS   20 person-months   \$235,000
Disbursement	The TA resources will be disbursed following ADB's <i>Technical Assistance Disbursement Handbook</i> (2010, as amended from time to time).

ADB = Asian Development Bank, ICS = individual consultant selection.

Source: Asian Development Bank.

20. **Consulting services.** ADB will engage individual consultants in accordance with ADB Procurement Policy (2017, as amended from time to time) and the associated Project Administration Instructions and TA Staff Instructions. Lump sum payments or output-based contracts for consulting services will be considered in line with the Midterm Review of Strategy 2020 Action Plan Nos. 2.9.2. and 2.10.2.<sup>11</sup>

21. The TA team will submit the following reports to the implementing agency: (i) the inception report 2 weeks after the commencement of services, (ii) the progress report at an appropriate stage during TA implementation, (iii) the draft final report and two briefing notes (the notes will be translated into Chinese) before the conclusion of the contract, and (iv) the final report 2 weeks after receiving comments from the executing agency and ADB. All the reports will be subject to review by relevant ADB departments before submission to the implementing agency.

22. The TA team's reports will be presented at workshops and seminars organized to validate findings. Final reports will be posted on the ADB website in English and Chinese and published in accordance with the ADB's Public Communications Policy 2011.

#### IV. THE PRESIDENT'S DECISION

23. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance not exceeding the equivalent of \$300,000 on a grant basis to the Government of the People's Republic of China for Reforming the System of Personal Income Tax and Social Security Contributions, and hereby reports this action to the Board.

<sup>11</sup> ADB. 2014. *Midterm Review of Strategy 2020: Action Plan*. Manila.

## DESIGN AND MONITORING FRAMEWORK

<b>Impact the TA is Aligned with</b> Sustainability of the taxation system and equitable income distribution enhanced.			
<b>Results Chain</b>	<b>Performance Indicators with Targets and Baselines</b>	<b>Data Sources and Reporting</b>	<b>Risks</b>
<b>Outcome</b> Reform of the personal income tax and social security contribution systems accelerated	By 2020 At least three policy reform recommendations submitted to the government (2017 Baseline: 0)	Government announcements and publications	Leadership and political will to implement the reforms are not sustained
<b>Outputs</b> 1. Research studies on personal income tax and social security contribution reforms undertaken  2. Awareness and knowledge of personal income tax and social security contribution system reforms enhanced	By 2019 1a. One main report with six subreports produced (2017 baseline: 0) 1b. Two briefing notes produced (2017 baseline: 0)  2a. Twenty stakeholders report enhanced awareness of personal income tax and social security contribution system reforms (2017 baseline: 0) 2b. Five Ministry of Finance staff members report enhanced knowledge of personal income tax and social security contribution system reforms (2017 baseline: 0)	1a. Progress reports on the TA and the TA team's report 1b. Progress reports on the TA and the TA team's report  2a. Workshop evaluation forms  2b. Participants' back-to-office reports	Differences in institutional opinion and priorities make achieving consensus difficult
<b>Key Activities with Milestones</b>			
<p><b>1. Research studies on personal income tax and social security contribution reforms undertaken</b></p> <p>1.1 Conduct literature research to summarize related theories, studies, and data by February 2018. 1.2 Submit draft inception briefing notes by March 2018. 1.3 Conduct inception workshop to confirm scope of study and TA team's workplan by April 2018. 1.4 Submit the final inception report by May 2018. 1.5 Conduct case studies on selected OECD countries from June–August 2018. 1.6 Submit draft midterm reports, including the main report and six subreports by September 2018. 1.7 Submit draft final reports, including the main report and six subreports by November 2018. 1.8 Submit two briefing notes by December 2018. 1.9 Submit the revised final reports by February 2019.</p> <p><b>2. Awareness and knowledge of personal income tax and social security contribution system reform enhanced</b></p> <p>2.1 Organize a training seminar for selected government officials from various Asian countries, supported by the Sustainable Development and Climate Change Department by May 2018. 2.2 Organize a consultation meeting with government officials, think tanks, and scholars to discuss preliminary findings by July 2018.</p>			

<p><b>Key Activities with Milestones</b></p> <p>2.3 Organize a workshop to discuss consultants' midterm reports with government officials and experts by August 2018.</p> <p>2.4 Organize domestic training for selected participants by November 2018.</p> <p>2.5 Conduct final report dissemination press conference by April 2019.</p>
<p><b>Inputs</b></p> <p>ADB: \$300,000</p> <p>Note: The government will provide counterpart support in the form of meeting space, counterpart staff time, services to the consultants, assistance in arranging meetings with counterpart agencies, and other in-kind contributions.</p>
<p><b>Assumptions for Partner Financing</b></p> <p>Not Applicable</p>

ADB = Asian Development Bank, OECD = Organisation for Economic Co-operation and Development, TA = technical assistance.

Source: Asian Development Bank.

**COST ESTIMATES AND FINANCING PLAN**  
(\$'000)

Item	Amount
<b>Asian Development Bank<sup>a</sup></b>	
1. Consultants	
a. Remuneration and per diem	
i. International consultants	110.0
ii. National consultants	99.0
b. International and local travel	24.0
c. Reports, publications, and communications	2.0
2. Training, seminar, workshop, and meeting <sup>b</sup>	
a. International training seminar	10.0
b. Domestic training workshop and meeting	10.0
3. Miscellaneous administration and support costs <sup>c</sup>	10.0
4. Contingencies	35.0
<b>Total</b>	<b>300.0</b>

Note: The technical assistance (TA) is estimated to cost \$375,000, of which contributions from the Asian Development Bank (ADB) are presented in the table above. The government will provide counterpart support in the form of meeting space, counterpart staff, services to the consultants, assistance in arranging meetings with counterpart agencies, and other in-kind contributions. The value of government contributions is estimated to account for 20% of the total TA cost.

<sup>a</sup> Financed by ADB's Technical Assistance Special Fund (TASF-other sources).

<sup>b</sup> Includes an international training seminar, a domestic training workshop, and a domestic consultation meeting.

<sup>c</sup> Includes costs for translations, interpreters, supplies for events, printing of banners and leaflets, meeting assistants, reproduction of materials, and other workshop support.

Source: Asian Development Bank estimates.

**LIST OF LINKED DOCUMENTS**

<http://www.adb.org/Documents/LinkedDocs/?id=51021-001-TARreport>

1. Terms of Reference for Consultants