

A Study on Improving the Expense Deduction System of Individual Income Tax Law in China

¹Ying Zhao

¹Business School, University of Shanghai for Science & Technology, Shanghai, China

Email:yingzhao403@163.com

Abstract—Although economy of China has a sustained and stable growth, income gap between individuals is aggravating. This is not only unfavorable to the realization of harmonious society, but also influences the healthy and sustainable development of China's economy. As an important tax to adjust income distribution, individual income tax own dual function of raising fiscal revenue and adjusting income distribution. The expense deduction standard is an indispensable part of the individual income tax; it will directly affect the amount of taxable income of taxpayer. This paper analyzes existing problems in the expense deduction system in China. And the writer puts forward some advices about how to perfect the expense deduction system of the present individual income tax on the basis of realistic conditions of China, so as to promote healthy development of individual income tax.

Key words—Individual Income Tax; Expense Deduction System; Tax Fairness

1. Brief introduction of the individual income tax in China

The individual income tax is a direct tax which is based on the individuals' taxable income levied by the government and it also has the closest relationship with peoples' vital interest. Individual income and its taxable income are two different concepts. The latter refers to the amount remaining from the gross income after deduction of costs, expenditures. Individual income tax is a tax levied on the taxable income of the taxpayer, rather than the total income. China's Individual Income Tax Law is promulgated since 1980, although compared with developed countries such as Britain and America; the Individual Income Tax Law appeared relatively later, its development speed is fairly fast. Since the introduction of Individual Income Tax in 1980, the expense deduction standard of wages and salaries has increased from the original 800 Yuan to 3,500 Yuan which is adjusted in 2011. The Individual Income Tax Law experienced a total of six large range of adjustment, four of which are about the expense deduction standard.

At present in China, it adopts the schedule pattern of income taxation, which means the different types of income taxpayer's gains will be deducted separately. Exemption deduction standard of individual income tax adopts the method which combined subentry quota deduction with subentry constant rate deduction. According to the Tax Law, the individual income from wages and salaries from September 1st, 2011, the taxable income is the balance after monthly income deducting 3,500 Yuan, apply to 3-45% for seven progressive tax rates; For expatriates and foreign experts working in

China, overseas Chinese and Hong Kong, Macao and Taiwan compatriots, and other personnel determined by the Ministry of Finance, apart from the 3,500 Yuan monthly exemption of wages and salaries, they have additional deduction of 1300 Yuan, that is, the total deduction is amount to 4800 Yuan; for the producing and operating income from self-employed industrial and commercial households and the operating and contracting income from enterprises and institutions, their taxable income is the balance from the gross yearly income after deducting necessary costs and expenses, apply to five progressive tax rates of 5-35%; for income obtained from individual services, royalties, author's remunerations, the lease of property, if each income does not exceed four thousand then deducting the cost of 800 Yuan, otherwise the amount of tax payable shall be reduced by 20%; for interest, dividends, bonuses, contingent income and other income cannot deduct any cost, the taxable income shall be the full amount gained from each payment.

2. Problems in China's individual income tax expense deduction system

In recent years, as the economy continued to grow steadily, the total income of Chinese residents also began to raise, many low and middle income classes are gradually added to the ranks of the taxpayers. The sources of individual income tax become richer, showing the tendency of diversification and recessive.

However, we should also be clearly aware that with the adopting of reform and opening up policy, the national economy has developed rapidly, followed by the

gap between the rich and the poor is widening. At the beginning of reform and opening up, China's Gini coefficient was 0.288, 0.339 in 1990, 0.409 in 2000, 0.469 in 2008. In the past two years, China's Gini coefficient is still rising, and had actually exceeded the international warning line of 0.5. The Gini coefficient is a proportional index which was proposed by Italian economist Gini, it was used to evaluate the fairness of residents' income distribution. The lower the Gini coefficient is, the fairer the income distribution; the higher the Gini coefficient is, the unfairer the distribution of income. The individual income tax should have the dual function of regulating income distribution and increasing fiscal revenues. But in terms of the current situation, the individual income tax did not perform effectively on regulating income distribution. Under the premise of the taxpayer's income and the applicable tax rates remain unchanged, the range of the tax deduction may directly determine the amount of taxable income. Therefore, as an important part of individual income tax, Expense deduction standard plays a vital role in regulating income distribution and narrowing the gap between the rich and poor.

2.1 Unfairness of the schedule pattern of individual income taxation

In recent years, with the development of the economy, individual income of residents in China are improving gradually, forms of the income became richer, showing a tendency of increased diversification and recessive. At present, China's individual income tax adopts schedule pattern of income taxation, the income of the taxpayer from different sources are divided into 11 categories and 11 categories of income have different tax rates and different expense standard deduction, they are taxed separately. This pattern of income taxation was established in the socialist transition period, at the time when people's source of income was pretty simple, the income differences between individuals were smaller, and the purpose of levying individual income tax was to adjust the small part of the abnormally high earners' income. The advantage of this pattern of income taxation is its collection and management level requirement is relatively low, it can reduce the trouble caused by the settlement and payment of income tax. But with the socialist market economic system continues to establish and develop, the defect of this tax pattern is also increasingly apparent, and it does not reflect the true ability to pay of the taxpayer. It is also not conducive for income tax to play the function in promoting the fair distribution of income.

Firstly, schedule pattern of income taxation uses different expense deduction standard for taxpayers' different sources of income. This allows the taxpayer by different sources of income to transfer income types and decentralize gross income to reduce the applicable tax rates so as to achieve the purpose of dispersing tax burden and opens the door for criminals of tax evasion. And this will lead to different taxpayers with the same income or income derived from the same source but obtain different times to bear the tax burden

inconsistently. Thus making the taxpayers with wide income source and high gross income pay less tax and bear relatively light tax burden, the taxpayers with simple income source and low gross income pay more and their tax deduction amount is less while the tax burden is relatively heavy. For example, both A and B have obtained the income of 6,000 Yuan in June, 2012, but the difference is that all of A's income was salary from his work in Company F, for B, 4,000 Yuan is wage and salary, 1,000 Yuan was author remuneration, the rest was from remuneration for individual service. Then for A, his monthly payable tax amount was 145 Yuan $[(6000-3500) * 10\% -105]$, for B the monthly payable tax amount was 83 Yuan $(4000-3500) * 3\% + (1000-800) * 0.2 * 0.7 + (1000-800) * 0.2]$. It is thus clear that the two men acquire the same amount of income, but due to B has a wider source of income, so he has more pre-tax deductions and less tax amount payable. Therefore, schedule pattern of income taxation cannot accurately reflect the taxpayers' ability to pay. It can easily lead to a situation that taxpayers with high and comprehensive income who also has a wide source of income pay less taxes or even don't need to pay taxes.

Secondly, as the residents' sources of income show a trend of more diverse and recessive, the proportion of the residents' non-wage income in China continues to rise, especially the sources of high-income group are usually more dispersed.

Due to China's schedule pattern of income taxation adopts enumeration method for cost deduction items; a large number of hidden incomes have not been included in the taxation scope, resulting in a serious loss of the amount of taxation in China. At same time, it also increases difficulty of tax authorities in tax collection and management.

2.2 Expense deduction standard lacks of flexibility

Our current individual income tax use the standard of fixed expense deduction, such expense deduction method is based on a fixed amount as deduction standard and it is not linked to the price index. Since the introduction of individual income tax in 1980, with the deepening of the market-oriented economic system reform, China's social economy has been in a state of rapid development and residents' income has also grown faster. According to statistics, in 1989, China's urban residents' per capita disposable income was 1,374 Yuan, 602 Yuan per capita net income of rural residents; in 2011, per capita disposable income of urban residents reached 21,810 Yuan, per capita net income of rural residents arrived 6,977 Yuan. Accordingly, the basic expenses of the daily life of our residents also exponentially increased, per capita consumption expenditure of urban residents was 1,211 Yuan in 1989, the per capita consumption expenditure of rural residents was 535 Yuan; in 2010, per capita consumption expenditure of urban residents has risen to 13,471 Yuan, per capita living expenditure of rural residents was 4,382 Yuan. We must clearly see that the rise of the residents' basic consumption expenditure can not only owing to the positive motivation such as

socio-economic development, but also to the negative motivation such as price inflation.

Since the reform and opening up, along with the deepening of China's price reform and the increasing openness of the price controls, coupled with expanding investment and consumer demand, led to a significant rise in the price level. Although the Standing Committee made their 6th amendment of Individual Income Tax Law in 2011, the exemption of salaries and wages has risen to 3,500 Yuan and its rate range narrowed and the rate of 15% and 40% were cancelled. Compared with the exemption deduction of 2,000 Yuan, which was enacted on March 1st, 2008, the deduction of 3,500 Yuan has taken more consideration of a number of factors including the level of economic development, inflation, the increase in the basic individual living expenses. But only by frequently modifying and adjusting the exemption deduction and tax rate of individual income tax is just a temporary solution, which will not only affect the authority and stability of the tax laws and tax regulations, its time lag effect will also affect the inherent

stability of the tax system.

2.3 The individual tax unit is unreasonable

China's current individual income tax collection is based on the individual as a separate tax declaration unit. In other words, it only regards each individual taxpayer as a declaration unit, which takes no consideration of taxpayer's family situation, income structure. Such method for tax collection can control the sources of tax revenue and its procedures are simple, which in line with our current tax collection conditions. But there are also inadequate lies in this method, which mainly reflected in the following two aspects.

2.3.1 It does not consider differences in household income of the taxpayer constitute. That is, under the circumstance when family structures are different but their gross income is exactly the same, it will cause individual income tax inequity from the horizontal aspect.

Table 1: Family's tax payable comparison table

unit: RMB

Family		Working conditions	Income/month	Wage and salary income exemption amount	Tax payable
family X	husband	on-the-job	6000	3500	145
	wife	Unemployment at home	0	3500	0
family Y	husband	on-the-job	3000	3500	0
	wife	on-the-job	3000	3500	0

From Table 1 we can see that the total income of family X and family Y is the same, but the family structures are different. According to the Tax Law, family X should pay taxes while family Y do not need to pay taxes, which is obviously contrary to the horizontal equity of the tax. According to the tax fairness principle, taxpayer with same economic ability should bear same tax burden, while taxpayer with different economic ability should pay different amount of taxation. From the family's point of view to consider, family X's gross income and life burden is the same with family B, but the reality is their payment of taxation is inconsistent. It is this difference that makes the fair surface of the individual income tax hidden unfair.

2.3.2 It did not consider the taxpayer's family environmental factors. The current expense deduction system does not take the economic burden of the taxpayer's family into account, including the taxpayer's marital status, the upbringing of their children's education expenses, the maintenance of the population, health status, and it did not take the taxpayer's actual tax burden affordability into account which makes it deviate from the function of individual income tax to adjust income distribution.

In short, if our expense deduction system still leaves the taxpayer's family structure, marital status, maintenance expense and upbringing expenses out of consideration, only taxes the taxpayer as an individual unit and calculates expense deduction fees, then the after-tax income redistribution is impossible to achieve a

truly fairness.

3. Proposals to improve expense deduction system of China's individual income tax

3.1 Adopt mixed pattern of income taxation

Although mixed pattern of income taxation has been accepted and adopted in most countries of the world and it has become an important development trend of contemporary income tax pattern. However, considering the development of tax collection system in China still has a long way to go, the residents' awareness and knowledge of the tax law is not high enough. If we adopt the global pattern of income taxation, although it will benefit the fair tax burden most, but it requires a high tax collection and management level. At present, it is hard for China to apply this taxation pattern. At this stage, we can use the experience of Japan for reference, which is, adopting the mixed pattern of income taxation. Such pattern can make the utmost of our information technology, experience and other resources, which were accumulated under the schedule pattern. And it can help China successfully change from the schedule pattern into the global pattern of income taxation. The specific approach is to tax recurrent items in accordance with the global pattern, including wage and salary income, income from remuneration of individual services and royalties, the producing and operating income from self-employed industrial and commercial households,

the operating and contracting income from enterprises and institutions. And for some non-regular items continue to tax them with schedule pattern.

As for recurrent items, tax shall be levied on an annual basis and paid in advance in monthly installments. Taxpayers should declare their taxes by themselves at the end of each year, but the taxes that the taxpayers have paid monthly can be deducted from the annual payable taxes. This will not only reflect the fairness of tax principle, but also treat the income from different sources differentially.

3.2 To realize indexation of the expense deduction

The Individual Income Tax Law of China regulates fixed expense deduction for each category, which leads to taxpayer's taxable income applies a higher tax rate when his or her nominal income rises. Thereby, the amount of payable tax increases resulting in an additional tax burden for taxpayer to bear. Tax indexation means expense deduction will be adjusted in accordance with the annual fluctuation of Consumer Price Index (CPI) so as to reduce the impact of inflation changes in the nominal income of the taxpayer. Such practice by linking the annual expense deduction to the Consumer Price Index will in a certain extent ease the pressure on taxpayer's tax burden and protect the interests of low-income group.

Of course, we should also clearly see that the implementation of tax price index linkage mechanism in our country will encounter a variety of difficulties and resistance, which requires the tax authorities have a higher level of collection and management. It also requires the relevant government departments to provide timely and accurate data changes of the price index in order to minimize the impact of inflation on the taxpayer's actual ability to pay.

3.3 Family tax unit, taking various factors into account.

Family is the basic elements of the composition of the community, the Chinese residents' daily life, consumption, savings and other social economic activities are all based on the family unit. So the adjustment of the income distribution should also be focused on the regulation of the family income. Since China entered aging society in 1999, the problem of the aging population is increasingly serious. At the same time, China's social care service system development is still in its infancy. For those types of taxpayers who still have the elderly with no source of income to support in the family, even if their income is relatively high, but their burden is still heavy and very difficult to withstand

the high tax burden.

Therefore, China should gradually establish an individual income tax system based on the family unit, to take full account of the taxpayer's family structure, income and expenditure of the various family members, increasing housing costs of the taxpayers and their family medical expenses, education expense. It can also increase an additional disabled, widowed, elderly deduction at a proper time. This will fully reflect the principle of tax fairness, so that China's individual income tax law will be more humane and conducive to the establishment of a harmonious society.

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Vitae

Ying Zhao, was born in Jiangsu province. She obtained a bachelor of economics in 2011 from Shanghai Finance University. She is studying at Business College of University of Shanghai for science and technology as a graduate student who majored in finance.