

China Macro Brief

Tax deduction to promote middle-class income & consumption

Comments on proposal of Additional Individual Income Tax Deductions

On October 20, the Ministry of Finance and the State Administration of Taxation issued the Interim Measures for Additional Individual Income Tax Deductions (draft for circulation)^[1], introducing more details concerning the six additional “deductible items” introduced by the amended individual income tax law, namely expenditures on children’s education, continuing education, critical illness treatment, mortgage interest payment, rental expenses and elderly care. The implementation of additional individual income tax deductions, marking an important milestone, will increase household disposable income and promote consumption upgrade.

The introduction of the specific guidelines concerning tax deductions marks an important milestone in China’s individual income tax reform.

The additional deductible expenditures will be excluded from the base of taxable “comprehensive income” of taxpayers. The “comprehensive income” includes employment-related income items – wages and salaries, labor service remuneration, author’s remuneration, and franchise royalties. In 2016, Rmb709.6bn or 70% of the individual income tax was derived from these four income items. We estimate this amount will reach Rmb1trn in 2018, extrapolating from the growth rate of individual income tax in the past two years. Taxing employment-related income together as “comprehensive income” and allowing additional deductions are both important measures to reform the individual income tax system.

Tax payers will enjoy fixed-amount deductions for expenditures on children’s education, continuing education, critical illness treatment, mortgage interest payment, rental expenditure and elderly care.

Fixed-amount deduction is more straight-forward and cost-effective, as it creates little incentives for rent-seeking. The fixed deduction amounts for each of the six additional deductible items are as follows (first-home mortgage interest payment and housing rental expenditure cannot be deducted at the same time):

- ▶ **(Deductible amount for, same below) children’s education:** Rmb12,000 per child per year (Rmb1,000 per month).
- ▶ **Continuing education:** Rmb4,800 per year (Rmb400 per month) for academic education and Rmb3,600 per year for vocational qualification education.
- ▶ **Critical illness treatment:** Rmb60,000 per year for medical expenses borne by individuals in excess of Rmb15,000.
- ▶ **Mortgage interest payment:** Rmb12,000 per year (Rmb1,000 per month).

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- ▶ **Rental expenditure:** Rmb14,400 per year (Rmb1,200 per month) in municipalities, provincial capital cities, and cities separately listed in state plans; Rmb12,000 per year (Rmb1,000 per month) in cities with a registered urban population of over 1mn; Rmb9,600 per year (Rmb800 per month) in cities with a registered urban population of 1mn or less.
- ▶ **Elderly care:** Rmb24,000 per year (Rmb2,000 per month).

Families with more expenditure in the areas of children’s education, elderly care, housing-related expenses and critical illness are eligible for more deductions. The amount of pre-tax deductions varies according to the taxpayer’s status in terms of family composition, housing, education and healthcare needs. The deductions for children’s education and housing expenses are family-based, and naturally, families with children can usually enjoy more deductions than singles (Figure 1).

- ▶ **Singles:** Assuming that their parents are under age 60, they can enjoy additional deductions of Rmb800-1,600 per month, depending on whether they receive continuing education and where they live.
- ▶ **Families with children:** We assume that both husband and wife have elderly people to support and they are paying mortgages and do not receive continuing education. If one child is educated, the couple can enjoy additional deductions of Rmb3,000 per capita. If two children are educated, the couple can enjoy additional deductions of Rmb3,500 per capita.

Figure 1: Six additional individual income tax deductions and the amount of deductions enjoyed by typical taxpayers

6 additional deductible items		Deduction (Rmb)		Note
		Per annum	Per month	
Children's education	For each child	12,000	1,000	The children's education expenditure can be either deducted by one parent or evenly split between the two parents
Continuing education	academic education	4,800	400	
	vocational qualification education	3,600		
Critical illnesses treatment		60,000		Medical expenses borne by individuals in excess of Rmb15,000
Mortgage interest payment		12,000	1,000	Only first-home mortgage interest is deductible; the interest can be deducted by only one party of a married couple
Rental expenditure	Municipalities, provincial capital cities, and cities separately listed in state plans	14,400	1,200	Mortgage interest payment and rent expenditure cannot be deducted at the same time. Rent can be deducted by only one party of a married couple who work in the same city.
	Cities with a registered urban population of over 1mn	12,000	1,000	
	Cities with a registered urban population of 1mn or less	9,600	800	
Elderly care		24,000	2,000	Deduction is fixed no matter how many elderly people to support
Typical tax payers				Assuming: no critical illnesses treatment; no continuing education
Single		12,000	1,000	Assuming: no children; no elderly care; housing expenditure of Rmb1,000
Married couple	with 1 child	36,000	3,000	Assuming: both the married couple have elderly care; housing expenditure of Rmb1,000
	with 2 children	42,000	3,500	

Source: Interim Measures for Additional Individual Income Tax Deductions (draft for comments), CICC Research

Figure 2: Deductions under different scenarios

(Assuming: no critical illnesses treatment)	No elderly care			Elderly care		
	Single	Married couple		Single	Married couple	
		with 1 child	with 2 children		with 1 child	with 2 children
Monthly deduction per taxpayer (Rmb)						
No housing expenditure						
No continuing education	0	500	1,000	2,000	2,500	3,000
Vocational qualification education	300	800	1,300	2,300	2,800	3,300
Academic education	400	900	1,400	2,400	2,900	3,400
Renting house in cities with a registered population of 1mn or less						
No continuing education	800	900	1,400	2,800	2,900	3,400
Vocational qualification education	1,100	1,200	1,700	3,100	3,200	3,700
Academic education	1,200	1,300	1,800	3,200	3,300	3,800
Paying mortgage interest / Renting house in cities with a registered population of 1mn or less						
No continuing education	1,000	1,000	1,500	3,000	3,000	3,500
Vocational qualification education	1,300	1,300	1,800	3,300	3,300	3,800
Academic education	1,400	1,400	1,900	3,400	3,400	3,900
Renting house in municipalities, provincial capital cities, and cities separately listed in state plans						
No continuing education	1,200	1,100	1,600	3,200	3,100	3,600
Vocational qualification education	1,500	1,400	1,900	3,500	3,400	3,900
Academic education	1,600	1,500	2,000	3,600	3,500	4,000

Source: Interim Measures for Additional Individual Income Tax Deductions (draft for comments), CICC Research

Introducing additional deductions is equivalent to further lifting the tax exemption thresholds for individual income, so that more existing taxpayers will no longer pay individual income tax – the measure benefits middle-income families the most. Taking a typical family with one child as an example, the couple can enjoy additional pre-tax deductions of Rmb3,000 per capita, which is equivalent to raising the tax exemption from Rmb5,000 to Rmb8,000. According to data from the National Bureau of Statistics^[2], the average annual wage of non-private enterprise employees in urban areas (including social insurance and housing provident fund contributions) was Rmb74,318 in 2017, equal to an average monthly wage of Rmb6,193. Assuming an average annual wage increase of 9% in 2018 and 2019, the average monthly wage will grow to Rmb7,358 in 2019, or Rmb5,702 after deducting social insurance and housing provident fund contributions. Non-private enterprise urban employees earning the average wage, regardless of whether they are single or have children, will no longer pay income tax in 2019.

The specific tax cut for a taxpayer depends on his/her income level (Figure 3). In general, middle-class families in tier-1/2 cities will benefit more.

- ▶ **Taxpayers earning the average wage of urban non-private enterprises in the country:** We estimate the average monthly wage in 2019 at about Rmb5,700 after deducting social insurance and housing provident fund contributions. Singles or families with one child can enjoy a per capita annual tax reduction of about Rmb250.
- ▶ **Taxpayers earning the average wage of urban non-private enterprises in Beijing and Shanghai:** We estimate the average monthly wage in Beijing and Shanghai in 2019 at about Rmb10,000 after deducting social insurance and housing provident fund contributions. Families with one child can enjoy a per capita annual tax reduction of about Rmb1,440.
- ▶ **Taxpayers with a monthly salary of Rmb30,000 after deducting social insurance and housing provident fund contributions:** Families with one child can enjoy a per capita annual tax reduction of about Rmb7,200.
- ▶ **Taxpayers with a monthly salary of Rmb60,000 after deducting social insurance and**

housing provident fund contributions: Families with one child can enjoy a per capita annual tax reduction of about Rmb11,000.

- **Taxpayers with a monthly salary of Rmb100,000 after deducting social insurance and housing provident fund contributions:** Families with two children can enjoy a per capita annual tax reduction of about Rmb19,000.

Figure 3: Tax cut for typical taxpayers at different income levels

	Monthly wage before tax		Without additional deduction	With additional deduction					
				Singal			Married couple, with elderly care		
	Including social insurance & provident housing fund	Excluding		no elderly care	1 child	2 children	no elderly care	1 child	2 children
Average wage of urban non-private enterprises in 2019			Monthly tax payment	Monthly deductible income			Annual deductible income		
National	7,358	5,702	21	1,000	3,000	3,500	12,000	36,000	42,000
Beijing, Shanghai	13,000	10,075	203	40	120	140	480	1,440	1,680
				Monthly tax cut			Annual tax cut		
National				21	21	21	253	253	253
Beijing, Shanghai				203	40	120	480	1,440	1,680
Threshold of tax tiers									
3% / 10%		8,000	90	30	90	90	360	1,080	1,080
10% / 20%		17,000	990	100	300	350	1,200	3,600	4,200
20% / 25%		30,000	3,590	200	600	700	2,400	7,200	8,400
25% / 30%		40,000	6,090	250	750	875	3,000	9,000	10,500
30% / 35%		60,000	12,090	300	900	1,050	3,600	10,800	12,600
35% / 45%		85,000	20,840	350	1,050	1,225	4,200	12,600	14,700
		100,000	27,590	450	1,350	1,575	5,400	16,200	18,900

Source: Interim Measures for Additional Individual Income Tax Deductions (draft for comments), National Bureau of Statistics, CICC Research

Additional individual income tax deductions will increase the disposable income of middle-class families and promote consumption upgrade. In particular, there may be more visible boost to expenditure on healthcare and (continuing education). The deduction for housing rent is also favorable to the long-term development of the rental market. Fixed-amount tax deductions will mainly have income effects. The tax cut will be the most significant for families in tier-1/2 cities, conducive to the consumption of goods and services preferred by this group of families. For children’s education and first-home mortgage interest, fixed-amount deduction means that an increase in spending will not result in a greater deduction. However, the deduction for expenditures on treatment of serious illnesses and continuing education should still promote related spending. The deduction for housing rent is also favorable to the healthy development of the rental market.

[1] <http://yizi.chinatax.gov.cn/hudong/noticedetail.do?noticeid=1701566>

[2] http://www.stats.gov.cn/tjsj/zxfb/201805/t20180515_1599424.html

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