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No one likes to pay taxes

Louis-Vincent Gave | GaveKal | 29 April 2015 |

No one likes to pay taxes, and a good few try to find a way around it. Perhaps this is why the US tax code and associated practice notes runs to 74,000 pages. Pretty much everyone feels better equipped to spend their own money than the government, and rightly so (anyone who pretends differently is a hypocrite, or did not earn their money themselves). This is why, as people pay more tax, there is demand for a clear accounting of the services provided in return. Failure to provide this accountability will typically lead either to tax evasion on a grand scale, or open rebellion.

Historically, such moments have been reached when the state's tax demands on individuals' pockets increased. In both England and France, parliaments developed mainly as a mechanism to control the Crown's expenditure. And, of course, the United States was born on the premise of "no taxation without representation".

With this in mind, it is interesting to note that about two thirds of China's corporate tax receipts come from state-owned enterprises, collective enterprises and other entities where control rests with the government. Needless to say, an SOE paying tax creates no demand for representation, because it is simply an internal loop - the state paying itself. It is a different story when a private taxpayer, individual or corporate, hands over money to the state. To date, the compact in China has been for individuals to evade tax rather than demand more accountability over the use of funds. The private sector accounts for two thirds of Chinese GDP, and yet only about a third of tax revenues. Consider the fact that foreign firms account for fully two thirds of the private sector's contribution (they have little ability to dodge tax) and it is clear that domestic private enterprises are engaged in significant evasion - a phenomenon also visible in personal income tax returns.

In turn, this leads us to the following conclusion: for the past three decades, Beijing has silently acquiesced to a simple political pact; the government surrenders some of its taxation power over the middle class and, in return, the middle class accepts a lack of political representation. So far, the middle class has taken that "no taxation and no representation" deal. It prefers to pay less tax and not vote, rather than buy its right to elect the government by paying more taxes.

Unfortunately for the authoritarian state and the lightly taxed middle class, this "no taxation and no representation" pact is imperiled by demographic developments. This is why we argued in our book Too Different For Comfort that China was slowly marching towards a political Catch-22 of sorts. After all, here are the trends clearly unfolding in China today:

Trend #1: China is ageing and this will impact both growth and government spending.

Trend #2: The demands from the general population for a bigger social safety net and a "welfare state" of sorts are bound to grow as Chinese people start to travel abroad, find out about the outside world through the internet, etc.

Trend #3: In order to boost growth, the government has little choice but to deregulate industries in which it has held quasi monopolies, sell stakes in SOEs, or let unproductive operations go under.

Trend #4: The process of slowly breaking down SOE privileges means that the government is undermining its own revenue generating model.

Trend #5: If the Chinese government can no longer fund itself through its SOEs, it will have to build a proper tax system.

Trend #6: But an increase in the tax burden will likely trigger an increase in accountability (no taxation without representation), which is hardly something the Chinese Communist Party would welcome.

One option for Beijing is to evolve towards being a normal social democracy with elections, audit processes for government spending, etc. Clearly this is not the path favored by the CCP leadership!

So, how does the average member of the Politburo square the above circle? Obviously, with great difficulty! But, perhaps the task is not insurmountable, for at the risk of sounding like a crackpot conspiracy theorist, a fairly clear, multi-step roadmap seems to be unfolding in front of our eyes. Specifically:

Step #1: Crank up a bull market in the country's domestic equity and fixed income markets. Encourage retail participation (witness last Tuesday's *People's Daily* editorial claiming that at 4,000 the Shanghai bull market is only just getting started) and do all you can to make sure that, when the market looks like it might roll over, an injection of liquidity is provided (like the recent reserve requirement ratio cut) to investors who have been trained to behave like Pavlov's dogs by the world's central banks.

Step #2: As valuations get stretched, accelerate the pace of renminbi internationalisation and lobby the International Monetary Fund aggressively so that the renminbi becomes an official Special Drawing Rights currency.

Step #3: As the renminbi is internationalised and gradually becomes convertible, global index providers (MSCI, FTSE, Barclays, etc) are forced to confront a glaring anomaly in almost every global index – namely, the almost complete absence of Chinese assets, in spite of the fact that China now accounts for 14% of global GDP and about 10% of global equity market capitalisation and volumes. The re-weighting of China in global indices then forces every index fund, index hugger, and other "risk-controlled" asset manager to buy Chinese assets, irrespective of valuations. This "forced-buying" pushes those valuations and the weight of China in indices even higher. Index funds are basically left chasing their own tails.

Step #4: As every indexed investor scrambles to buy Chinese equities at the wrong price, the Chinese government starts to offload paper in various dubiously profitable SOEs, thereby achieving two goals: a) replenishing the government's coffers with the money necessary to build a welfare state; and, b) moving forward with the privatisation of large parts of industry.

In short, if asking the broader Chinese population to pony up for the rollout of the Chinese welfare state might prove too politically sensitive, perhaps it makes sense to stick the bill to foreigners instead.

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