China Hits the Wall
The Yuan Devaluation and the End of the Economic Miracle
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For the first time since 2008, economic alarm bells are ringing in China. Hard on the heels of a two-month stock market rout, the Chinese yuan lost nearly five percent of its value in just two days. The stock market might have rebounded, but the economy is still in trouble. Three and a half decades of easy profits from one-way bets on China’s reintegration with the outside world have come to an end. China is now part and parcel of the global economy, and the normal laws of economic gravity apply in China, too. The first of those laws is that there’s no such thing as a free lunch.

There is a financial crisis brewing in China, but the usual bugbears of the stock market, declining exports, and even the yuan crash are only appetizers, not the main course. The coming crisis has much more to do with demographic stagnation, capital flight, and the decision in 2013 to give the market a “decisive” role in China’s economic development. These trends will combine over the next few years to make it increasingly difficult for administrators at all levels of the Chinese government to meet their financial obligations.

The problem in a nutshell is that as China develops into a middle-income country, the social demands placed on its government are rising faster than the country’s GDP. The recent slowdown in GDP growth has only exacerbated a long-standing trend. Social luxuries such as free public education, adequate health care, and old-age pensions are expensive, and as Americans and Europeans know all too well, their costs tend to rise faster than inflation. China’s rapidly aging population will require more and more of these services in the future.

THE TAXMAN COMETH
So far, China has kept up with expanding budgetary demands through improved tax efficiency and large-scale asset sales. These are both one-time fixes. In 2008–09, China restructured its value-added and corporate income taxes, reducing most headline tax rates while improving the efficiency of collection. Revenues from these sources have shot up in recent years, roughly doubling in nominal terms since 2009. In fact, total government revenue as a percentage of GDP has risen from an all-time low of just over ten percent in the mid-1990s to around 22.7 percent in 2013.

That is still on the low side, even for a middle-income country such as China. In Mexico, government revenue as a percentage of GDP is 24.4 percent. In Russia, it is 40.7 percent (or was pre-crisis), according to the latest data from the Organization for Economic Cooperation and Development. In Brazil, the ratio is around 34 percent. At 31.2 percent, the United States has the lowest government revenue as a percentage of GDP among rich OECD countries—and, of course, the United States spends well beyond these means. Major European countries score in the high 40s and low 50s.

It is often said that China will get old before it gets rich; it is perhaps equally true that the Chinese economy will get liberalized before it gets taxed. To be sure, China’s large social security tax revenues are opaque and are not included in these figures. They may account for an additional five percent of GDP, bringing total government revenue above that of Mexico. Anecdotal evidence suggests, however, that this locally administered system is extraordinarily corrupt and the social
security taxes actually paid into government accounts may be much less than the notional amounts that employers report.

After increasing rapidly in 2010 and 2011 owing to tax reform, China’s annual government revenue growth has since fallen below ten percent and is now roughly in line with GDP growth. In other words, China’s receipts are stable and rising in line with GDP. This is to be expected in a tax system such as China’s, which relies heavily on corporate income, consumption, and value-added taxes—all of which are flat or regressive. In theory, China does have a high and progressive personal income tax system, with a top marginal rate of 45 percent, but enforcement is extremely lax. Individual income tax receipts account for just five percent of total government revenue.

A FISCAL BRICK WALL

China’s ability to continue increasing the quality of social services in line with the expectations of its people depends on its capacity to increase taxes. Even existing levels of service provision will soon become impossible within China’s current fiscal framework, thanks to rising costs and population aging. The proportion of the population aged 65 and over will increase from ten percent to nearly 21 percent between 2015 and 2035, according to U.S. Census Bureau projections. The elderly are expensive users of government services, and after four decades of one-child families, there just aren’t enough younger people to care for them all.

Fully aware of the demographic time bomb, the Chinese government is desperately encouraging people to have more children—with little success. Ironically, if the government succeeds in raising the birthrate above the low levels found in Japan, South Korea, and Taiwan, its demographic crisis will get worse before it gets better. For the first 20 to 30 years of a baby boom, China would have to bear the costs of raising more children without any increase in its work force. In fact, its work force would decline further as (mainly) women take time off to raise families.

China’s leaders must be aware of the fiscal brick wall that blocks China’s road to development, and they must know how hard it will be to break through it. Finding new sources of revenue will not be easy. Capital gains go largely untaxed in China owing to rampant evasion, and most stock market gains are not taxed at all. China’s current plans for tax reform are relatively modest, but an obvious next step is to beef up the collection of capital gains taxes. Knowing that the taxman is on his way, China’s rich are doing everything they can to get their assets (or at least legal jurisdiction over their assets) out of the country.

Tax enforcement will be made all the more difficult by the government’s 2013 Third Plenum pledge to embrace a “decisive” role for the market in the economy, which was widely taken to mean that strategic, highly taxed sectors would be exposed to market forces. Its ensuing plans to open its capital account to full convertibility further compromised the government’s ability to harness the economy. As it now loosens its grip on the country’s financial sector, the government stands to lose another important tool in the fight against tax evasion. These reforms may be economically necessary, but they do reduce the government’s fiscal options. Companies that were once part of the government are increasingly operating in their own interests—and these may conflict with those of the country as a whole.

ROOM FOR MANEUVER

China escaped the 2008 global financial crisis almost totally unscathed, despite suffering a 16 percent decline in exports in 2009 as compared with 2008. The exports collapse was offset by a decisive government stimulus program that pumped $586 billion into the economy. Unlike the U.S.
stimulus program, which mainly provided supply-side capital to banks, the Chinese program was a classic Keynesian demand-side intervention. In addition to preventing an economic catastrophe, China got airports, subway systems, high-speed rail, and a bevy of much-needed infrastructure.

Today, a more liberalized China has much less room for maneuver. In 2008, the state-owned companies were under the direct control of government; in 2015, many are quasi-independent. In 2008, capital controls prevented foreign investment from leaving the country; in 2015, even Chinese funds have many avenues for exit. China can still borrow its way out of trouble, as it did in 2008, but the political climate is now poor for major public works, and liberalization has made the economy much leakier than it was before. And if China borrows now as it did then, it is not clear when it will be able to pay the money back.

It is often said that China will get old before it gets rich; it is perhaps equally true that the Chinese economy will get liberalized before it gets taxed. Liberalization without taxation will push the Chinese government into the familiar Third World pattern of perpetual fiscal crisis. A Chinese state that raises money primarily through regressive taxes and struggles to meet its welfare obligations will look a lot like the rest of the Third World that China supposedly left behind years ago. A declining yuan is only a prelude to this kind of crisis, not a final act.