In Case You Missed It: CSOP's Weekly China Wrap Up

China takes up climate leadership mantle after Trump reverses Obama legacy

US President Donald Trump signed an executive order on Tuesday to unwind the Clean Power Plan, Obama's flagship initiative to cut carbon emissions 26% from 2005 levels by 2025. Although the order does not formally withdraw the US from the Paris climate accord, it deals a severe blow to the international agreement and increases pressure on China to assume climate global leadership.

China's hesitantly progressive direction

China's state media issued a strongly worded editorial criticizing Trump's order, asserting that the United States must maintain its leadership and commitment to the Paris accord. China points to its own emission-reduction efforts as evidence of the country's continuing commitment. In addition to halting construction of over 100 new coal-fired power plants, China has allocated $360 billion to renewable energy. This shift will help the nation to meet its Paris goals of procuring 1/5 of energy from non-fossil fuel sources by 2030.

New balance of power?

China's promise to maintain its commitments has brought the country new allies and an opportunity to assert greater global influence. Miguel Arias Cañete, the European Union Climate Action and Energy Commissioner, visited China over the weekend to discuss the EU-China energy roadmap on clean energy, transportation, and emissions trading schemes, and has framed the partnership as the world's best hope for combating climate change.

China's personal income tax system poised for reform

A proposal to reform China's personal income tax system was submitted to the National People's Congress last week. It seeks to reduce the highest marginal tax rate from 45% to 25%, as well as fix the loopholes most commonly exploited to shelter wealth.[1]

The inefficient structure of China's personal income tax system

China's personal income tax rate is extremely high, exceeding that found in both developing and developed economies. China's taxation scheme is progressive and levies a marginal tax rate in seven brackets ranging from 5% to 45%. The 45% rate applies to earners with annual income exceeding USD 140,000 per year, a rate higher than Hong Kong (15%), Singapore (22%), Russia (13%), Brazil (27.5%), Canada (33%) and the United States (39.6%). Compounding the burden on high earners, China allows few deductibles. This contrasts to the US, where deductibles such as mortgage interest, medical care costs, charitable donations, and tuition help lower the effective marginal rate to closer to 25%.

To avoid paying the high rate, China's wealthy employ loopholes that allow company owners to pay themselves a negligible salary (as low as RMB 1 per year) to minimize their personal income tax.[2] These high earners instead compensate themselves with equity income from dividends, which are subject to a much lower rate of 20%.

Impact of the current structure

The simultaneous presence of a high marginal rate and capital gains loopholes serve to inequitably distribute China's tax burden. The year 2016 saw the total personal income tax reach RMB 1 trillion, 70% of which was paid by middle and upper-middle class salaried workers instead of the capitalist-class business owners.

China's lopsided tax structure also disincentivizes skilled workers and executives from residing in China; they prefer to establish Asian headquarters in Hong Kong or Singapore to take advantage of lower income taxes. This avoidance strategy deprives China's authorities of an important revenue stream and limits the country's prospects for future growth. As China attempts to shift from a manufacturing to an innovation-driven nation, the offshoring of the country's brightest citizens for tax reasons will hinder future development unless China can reform its personal income tax system.

Level	Annual Income in RMB	Equivalent Annual Income in USD	Marginal Tax Rate
1	<18,000	<2,400	3%
2	18,000~54,000	2,400~7,800	10%
3	54,000~108,000	7,800~15,600	20%
4	108,000~420,000	15,600~60,000	25%
5	420,000~660,000	60,000~96,000	30%
6	660,000~960,000	96,000~139,200	35%
7	>960,000	>139,200	45%

Source: State Administration of Taxation, March 2017. *For informational purposes only and should not be considered tax advice. Please consult your tax advisor for further assistance.*

China and New Zealand expand Free Trade Agreement, signaling new cooperation

China's Premier Li visited Australia and New Zealand to upgrade existing free trade agreements (FTA) and promote the China-led Regional Comprehensive Economic Partnership (RCEP). New Zealand's Prime Minister especially welcomed the closer cooperation and promised to send a delegate to attend the "One Belt One Road" summit in Beijing this May.

Why the China-New Zealand FTA cooperation matters

The FTA between China and Zealand, first signed in 2008, was China's first FTA with a developed country and New Zealand's biggest trade agreement. In the years since its passage, trade between the nations has expanded 15% per year. Under the agreement, China sells clothes and machinery to New Zealand in exchange for diary and agricultural products.

The benefits extend further than an exchange of goods, however. Diplomatic dividends are reaped as well. New Zealand has proven to be a loyal ally in the intervening years—one that is strategically crucial for China's RCEP initiative. New Zealand was not only the first partner to join the China-initiated Asian Infrastructure Investment Bank (AIIB), but also lobbied the UK and Australia to seek membership. Seeing an opportunity to consolidate regional leadership after the collapse of the Trans-Pacific Partnership (TPP), China is eager to win wider Western backing for RCEP as it did with AIIB. By showing off the upgraded FTA with New Zealand as an example, China hopes to win the hesitating hearts of other prospective RCEP member nations.

Value of A-Shares held by mutual fund houses falls to historic lows

The market value of A-Shares under fund house management fell 3.4%, less than half of the 7.9% high in 2008, according to the Asset Management Association of China. As a consequence, assets managed by mutual fund houses dropped to RMB 8.82 trillion at end of February 2017, compared with RMB 9.16 trillion at the end of 2016.

Despite the collapse, mutual fund houses nonetheless remain the biggest professional institutional investors in China's A-Share market.

Reasons for the fall

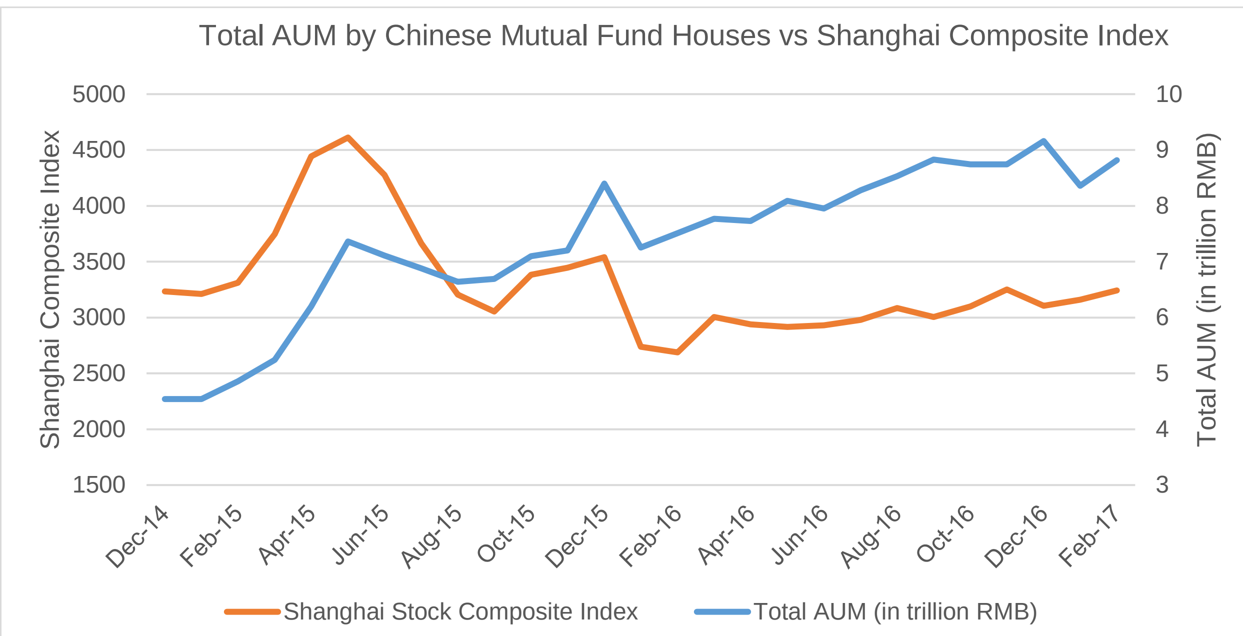
Lackluster A-Share performance coupled with increased competition from Wealth Management Product (WMP) purveyors has served to assault fund house from all angles.

The problems for fund houses started in mid-2015, when equity market turmoil drove investors out of the A-Share market. Investors not only worried about the rapidly-plummeting share prices, but also fretted over the haphazard government response, which imposed arbitrary trading restrictions that have only recently been lifted. A-Share market performance in the intervening years has failed to inspire confidence; the Shanghai Composite index fell 12% in 2016, among the world's worst yielding.

Compounding matters, investors seeking opportunities are presented with compelling new options from banks and securities offering high-yielding WMPs. These products often invest in loans and credit assets rather than A-Share stocks, contributing to the tepid demand for Mainland securities. According to Xinhua, WMP assets exceeded fund house AUM by RMB 16.8 trillion at the end of 2016.

Why does it matter?

The increasing gap between the AUM of WMPs and mutual fund houses signal that Chinese investors are shying away from Mainland stock exchanges, especially in an environment of continuous underperformance. Reassuringly for fund houses, if China's government moves forward with plans to regulate WMPs, fund houses will likely benefit in the form of returning customers.



Source: Bloomberg, March 31, 2017

China's car buyers embrace financing, indicating maturation of consumption patterns

Chinese car sales increased 15% in 2016 as buyers rushed to capitalize on an expiring tax credit. Despite the waning subsidy, the pace of consumption remains high as auto lenders emerge to fill the financing void. At present, an estimated 1/3 of cars are purchased with auto loans, compared to less than 1% three years ago.

Auto-financing as a signal of China's shifting consumption patterns

Despite the growth, China's auto-finance penetration ratio is still lower than that found in developed markets like the US (80%) and Japan (50%). The historically low rate is partially due to cultural factors that discourage borrowing money to purchase consumer goods. Representing one example, Chinese credit card users tend to repay the full balance each month, whereas US consumers are far likelier to make a minimum payment.

This cultural hallmark shifted subtly when China's central bank and banking regulator jointly instructed lenders to support new consumption in 2016—an implicit attempt to alter consumption patterns and boost the domestic demand. The policy shift mimics China's 1998 mortgage reforms, whereby the PBOC China allowed home buyers to use mortgages for the first time. The rise of mortgage financing with politically expedient; it provided a trap for China's excess liquidity while spurring demand. Onlookers surmise that auto loans could play a similar role in mopping up this decade's excess liquidity.

Notes:

1. RMB: Renminbi, the national currency of China