Short Term Policy Brief 45

Tax and Pensions in China

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Main points

- As China’s age structure evolves it is facing the serious challenge of an expanding retired population supported by a shrinking working population. This has been further exacerbated by rapid urbanisation, uneven economic development and an imbalanced sex ratio for new births. In response, the Chinese government has introduced several pension reforms.

- Urban pensions:
  - In 1997, State Council Document No. 26 was issued, aimed at transforming an overly generous pension system into a three pillar model, broadly in line with the World Bank. The current pension system follows a revised five pillar template.
  - All state pensions enjoy tax exemptions on pension contributions, investments and benefits.

- Enterprise annuities:
  - An enterprise annuity (EA) plan is a voluntary defined contribution scheme with funded individual accounts that both employer and employees can contribute to.
  - Compared with the compulsory state pension plan, EAs have not achieved their expected growth since establishment. The lack of a uniform tax policy applied at the national level has slowed the rate of EA development.
  - China is still too reliant on the state pension system. A ‘partial TEE’ tax mode has been suggested for EA development by pension experts.

- Commercial pensions:
  - Commercial pensions are a voluntary supplementary pension system provided by licensed insurance companies.
  - In 2009, these group pensions were granted the same treatment as EA plans whereby employer contributions within 5% of total employee payroll are tax deductible. However, as with EA plans, commercial pensions offer no explicit tax preferences for employees in the pension contribution, investment and benefit process.

- Rural pensions:
  - Serious rural pension reform began in late-2008, following the central government’s promise to cover the entire rural population with a viable pension system by 2020.
  - The basic rural social pension pool will be fully supported by government. Government will also contribute towards supplementary individual accounts.
As with the state urban pension, the new rural pension scheme will enjoy tax exemptions on pension contributions, investments and benefits.

Nevertheless, the rural system remains far behind the urban system in terms of benefits and current assets.

- Pensions for expatriates:
  - 2011’s new Social Insurance Law requires expatriates to participate in all five social security programmes – pensions, medical insurance, work injury insurance, unemployment insurance and maternity payments. Only German and South Korean expatriates are exempt because their countries have bilateral treaties with China on social security provision.

- In light of the success of the recent EU-China Social Security Cooperation Project, further cooperation could be explored through:
  - Broadening the investment scope for state pensions;
  - Developing EA and commercial pensions with more preferential tax modes;
  - Facilitating the synthesis of central and local policies regarding social tax on expatriates.
**Background Briefing:** Tax and Pensions in China

**Introduction**

The sixth national population census revealed that the total population of mainland China reached 1.34 billion people by the end of 2010, of whom 13.3% were aged 60 or above. As the country’s age structure evolves, China is facing a serious challenge – a shrinking working population supporting a rapidly expanding retired population. The so-called 1-2-4 phenomenon, which stands for one child, two parents and four grandparents, is becoming increasingly apparent in China.

The Chinese government is fully aware of these issues and has introduced several pension reforms. Pension, as an elastic public good, is often heavily influenced by government tax policies, relating to three segments: 1) pension contributions - whether employees’ and employers’ contributions are deductible before paying income/corporate tax; 2) pension investment - whether investment income and capital gains are taxed; and 3) pension benefits - whether employees are tax exempted when benefits are paid either by lump sum or regular annuities. Conventional international tax modes for pension systems are summarised in Table 1.

**Table 1: Simplified tax modes and their effects on pension development**

<table>
<thead>
<tr>
<th>Tax modes*</th>
<th>EEE**</th>
<th>EET</th>
<th>TET</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pension contribution</td>
<td>Tax exempt</td>
<td>Tax exempt</td>
<td>Taxable</td>
</tr>
<tr>
<td>Pension investment</td>
<td>Tax exempt</td>
<td>Tax exempt</td>
<td>Tax exempt</td>
</tr>
<tr>
<td>Pension benefit</td>
<td>Tax exempt</td>
<td>Taxable</td>
<td>Taxable</td>
</tr>
<tr>
<td>Effect on pension development</td>
<td>Very strong impetus</td>
<td>Strong impetus</td>
<td>Some disadvantage</td>
</tr>
<tr>
<td>Example</td>
<td>State pension in many developed countries</td>
<td>US 401(k)</td>
<td>Commercial pension in Portugal</td>
</tr>
</tbody>
</table>

* Tax policy modes: E – Tax exempt; T – Taxable.

** Three letters in the acronym stand for tax policies in the three pension segments: the 1st E for pension contribution, the 2nd E for pension investment, and the 3rd E for pension benefit.
This paper aims to outline the pension systems in China, vis-à-vis:

- the urban pension system,
- Enterprise Annuities (EAs),
- Commercial pension business, and
- the rural pension system.

**Demographic dynamics**

The one-child policy became effective in China in the late 1970s. Without this, estimates suggest that China’s population would now be around 1.7 billion, i.e. 350 million greater than the actual current population. This low fertility policy led to a lower child dependency ratio and a higher working age to total population ratio; however, China now faces an aging population and deteriorating dependency ratio as severe issues.

The country’s population reached 1.34 billion at the end of 2010. The proportion of young people aged 14 or below has decreased from 27.7% to 16.6% in the past two decades, while the population aged 60 or above has increased from 7.7% to the current level of 13.3%. This trend is expected to continue according to EU projections. Furthermore, an imbalanced sex ratio for new births (currently 118 baby boys born for every 100 girls), rapid urbanisation and economic development inequality across the nation are posing significant challenges for China’s pension systems.

**Urban pension system**

The urban pension system was originally principally applied to State Owned Enterprise (SOE) employees, who received a pension after retirement equal to 80-90% of final salary. In July 1997, State Council Document No. 26 was issued, aimed at transforming the overly generous SOE system to a three pillar model, broadly in line with World Bank (WB) recommendations. In order to address certain limitations, including the separation of the social pool pension from the individual account pension and full funding of the latter, Document No. 42 was issued in December 2000.

Under the influence of the WB’s revised five pillar pension template, Table 2 sets out a summary of the current urban pension system using Chinese terminology. Contributions of around 20% and 8% of
employees’ monthly salaries are paid to Pillar Ia and Pillar Ib respectively, and in return these two mandatory state pension components theoretically provide the average urban retiree with 20% and 38.5%, respectively, of the average final monthly salary after a working lifetime of 35 years. Contributions are subject to a cap of 300% of local average city pay for the previous year. The current retirement ages as stipulated by the law are 60 for men, 55 for white collar women and 50 for blue collar women.

**Table 2: China’s Five Pillar Urban Pension System**

<table>
<thead>
<tr>
<th>Pillars (WB)</th>
<th>Chinese Terminology</th>
<th>Contributions</th>
<th>Benefits</th>
<th>Funded Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>State Zero:</td>
<td>Minimum guarantee (Di Bao)</td>
<td>N/A</td>
<td>Basic cost-of-living allowance</td>
<td>From government</td>
</tr>
<tr>
<td>I: Ia: Mandatory Social Pool Old Age Pension</td>
<td>ER*: 20% of salaries (regional differences exist)</td>
<td>Monthly pension based on average local monthly wage, indexed individual wage and years of employment</td>
<td>Pay as you go (PAYG)</td>
<td></td>
</tr>
<tr>
<td>II: Ib: Mandatory Individual Account (IA) Pension</td>
<td>EE*: 8% of salary</td>
<td>Monthly pension of 1/139 of IA balance at the time of retirement provided at least 15 years’ contributions are paid</td>
<td>Should be funded</td>
<td></td>
</tr>
<tr>
<td>Private III:</td>
<td>Voluntary Enterprise Annuity (set up by eligible employers)</td>
<td>ER; EE</td>
<td>Lump sum or annuity benefit</td>
<td>Funded</td>
</tr>
<tr>
<td>III: Other Voluntary Benefits, e.g. Insured Group Pension Plans</td>
<td>ER; EE</td>
<td>Lump sum or annuity benefit</td>
<td>Funded</td>
<td></td>
</tr>
<tr>
<td>Private &amp; State IV: Family support; subsidised healthcare and housing</td>
<td>N/A</td>
<td>Varies</td>
<td>From government or family</td>
<td></td>
</tr>
</tbody>
</table>

*ER – employer; EE – employee.

Source: Stirling Finance research.

With legacy SOE pensions and the PAYG structure designed for Pillar Ia, current cumulative pension assets are largely derived from Individual Accounts (IAs), which have experienced exponential growth (see Graph 1). Indeed, it is estimated that the total cumulative balances will amount to RMB 4.5 – 6 trillion (EUR 0.5 – 0.7 trillion)\(^1\) in year 2020 and RMB 10-11 trillion (EUR 1.2 – 1.3 trillion) by 2030.

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\(^1\) At the time of writing (24 April 2012), the exchange rate is €1= ¥8.30.
Graph 1: Growth in Urban Pension Cumulative Assets (RMB bn)

Source: Annual Reports of Ministry of Human Resources and Social Security

In terms of investment scope, Pillar Ib assets (and Pillar Ia, if any) are limited to bank deposits and government bonds, with an average return claimed to be around 2 percent p.a. in the past 10 years. Enterprise Annuity (EA) plans, however, are allowed more flexible investment scope (see Table 3).

Table 3: Investment Scope

<table>
<thead>
<tr>
<th></th>
<th>Equities/Linked products</th>
<th>Financial/Corporate Bonds</th>
<th>Government-bonds/Deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pillar 1a (state)</td>
<td>-</td>
<td>-</td>
<td>100%</td>
</tr>
<tr>
<td>Pillar Ib (state) (IA)</td>
<td>-</td>
<td>-</td>
<td>100%</td>
</tr>
<tr>
<td>Pillar II (EA)</td>
<td>&lt; 30%</td>
<td>&lt; 50%</td>
<td>&gt; 20%</td>
</tr>
<tr>
<td>Pillar III (non-EA)</td>
<td>&lt; 20%</td>
<td>&lt; 20%</td>
<td>&lt; 100%</td>
</tr>
</tbody>
</table>

Source: Stirling Finance Research

Urban pension benefits are increased each year, usually by an amount between price inflation (averaging 2.1 percent p.a. in the last decade) and earnings escalation (typically 10 – 12 percent p.a.).
Regarding tax treatment, all state pensions (Pillar Zero, Ia and Ib) use EEE mode, meaning that all three segments in the state pension system enjoy tax exemption. To illustrate, mandatory pension contributions are tax deductible for both corporations and individuals, while investment returns and pension benefits (both lump sum and annuities) are tax exempted. However, any voluntary contributions above regulatory limit and the pension benefits derived therefrom are not tax deductible.

**Enterprise Annuities (EAs)**

An EA plan is a voluntary defined contribution scheme with funded, individual accounts, and both employers and employees can make contributions. Contributions by the enterprise are limited to a cap of 8.33% of the employee’s annual wage, i.e. one-twelfth of the previous year’s wages. From the SOEs’ perspective, an EA is an opportunity to bring replacement rates back up towards the 80%-90% level.

EA funds are required to be set up under trust in accordance with China’s Trust Law, through an unbundled model comprising of Trustee, Administrator, Investment Manager and Custodian. Two batches of 58 licences in total were awarded to 38 institutions in 2005 and 2007, with RMB 281 billion (EUR 33.8 billion) accumulated EA assets being held under trust as at the end of 2010 (see Graph 2).

**Graph 2: EA Development (RMB bn)**

![Graph showing EA Development](source: Annual Reports of Ministry of Human Resources and Social Security)

Regarding investment performance, EAs have achieved reasonable returns in recent years, with 3.4% in 2010 and an annualised return of 6.06% averaged over the last 6 years.
Compared to the compulsory state pension system, EA plans have not achieved the expected growth since establishment. Moreover, since tax deductibility should be a principal incentive for employers to offer EA plans, the lack of a uniform tax policy applied at a national level has initially slowed the rate of EA development. In December 2009, the tax regulation for EAs was finally codified by the State Administration of Taxation (SAT), but is still sub-optimal. Accordingly, employer contributions to an EA plan within 5% of total employee payroll can be deducted from profit before corporate tax. However, an employee’s contributions are not tax deductible and indeed employer’s contributions are treated as a separate income source for the employee and hence are subject to personal income tax.

Moreover, there is no explicit tax preference in respect of EA pension investments or benefits. In practice, investment income and capital gains are accumulated tax free, while the tax treatment for pension benefits varies according to provincial regulations. As a result, significant imbalances exist geographically and among enterprises, impeding EA development in the past several years. However, it has been suggested by Chinese pension experts to adopt a ‘partial TEE’ mode for EA plans, with employees’ pension contributions not attracting tax relief.

**Commercial Pension Business**

A commercial pension is a voluntary supplementary pension system provided by licensed insurance companies. As at the end of 2010, there were more than 50 group pension insurance business entities offering a wide variety of group pension and individual annuity products. Five specialised pension insurance companies have been set up to provide both EA insurance and group pension insurance, namely, Ping An Annuity Insurance, Taiping Pension, China Life Pension, Taikang Pension & Insurance, and Changjiang Pension Insurance. Due to significant competition from EA plans, the size of group pension assets has declined since 2005 as shown in Graph 3.
Compared with EA plans, group pension products enjoyed no tax preference initially, causing many former supplementary group annuities to convert to EA plans. In 2009, the tax regulation enacted by the SAT finally granted group pension insurance the same tax treatment as EA plans: employer contributions within 5% of total employee payroll are tax deductible. Also as with EA plans, there is no explicit tax preference for employees in the pension contribution, investment and benefit process. However, the insurance indemnity can be tax exempted for individual annuity.

Rural Pension System
The rural population of China has just reduced to under half of the total population, resulting from a strong rural-to-urban migration trend: young people from the countryside move to the cities and often settle as urban residents. This trend leaves the rural elderly vulnerable to losing their main historic pillar, namely, family support.

In late-2008, serious rural pension reform finally began after the central government’s official promise to cover the entire rural population with a viable pension system by 2020. Rural residents aged 16 and above, who are neither students nor currently participating in the state pension system as urban workers, are eligible to join the rural system on a voluntary basis, with pension payments starting from age 60 irrespective of gender.
As illustrated in Table 4, the basic social pool pension will be fully supported by government, providing no less than RMB 55 (EUR 6.6) per month for each individual, on an unfunded basis. For individual accounts, the government will contribute no less than RMB 30 (EUR 3.6) per year while individuals choose to contribute between RMB 100 (EUR 12.0) and RMB 500 (EUR 60.2) annually, at RMB 100 (EUR 12.0) intervals. Moreover, as an incentive to participate in the new scheme, rural residents who are already 60 can immediately receive the basic social pool pension benefit provided that their children participate in the new system and make contributions into their individual accounts. Regarding tax treatment, the new rural pension system has adopted the EEE tax mode, the same as the state urban pension.

Table 4: China’s New Rural Pension System

<table>
<thead>
<tr>
<th>Terminology</th>
<th>Contributions</th>
<th>Benefits</th>
<th>Funded Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic Social Pool</td>
<td>100% from government budget</td>
<td>No less than RMB 55 (EUR 6.6) per month</td>
<td>Unfunded</td>
</tr>
</tbody>
</table>
| Individual Account         | **Individuals:**
|                            | RMB 100/200/300/400/500 (ranging from EUR 12.0 to EUR 60.2) per year | Monthly pension benefit of 1/139 of IA balance at pension age assuming at least 15 years’ contribution; otherwise, lump sum payable | Funded (accumulated in accordance with 1-year bank deposit rate) |
|                            | **Government:**
|                            | No less than RMB 30 (EUR 3.6) each year            |                                                              |                                 |
|                            | **Other sources**                                  |                                                              |                                 |

Source: Stirling Finance Research

Pension for Expatriates

On 1 July 2011, China’s new Social Insurance Law came into effect, requiring expatriates to participate in all five social security programmes, namely, pension, medical insurance, work injury insurance, unemployment insurance and maternity payments. Under this new law, Germany and South Korea are the only countries whose expatriates are exempt, due to bilateral treaties with China on social security provision. However, only five local governments have released their implementation rules and significant disparities exist. For example, although Chinese nationals from Hong Kong, Macao and
Taiwan are explicitly excluded by central regulation from paying social insurance contributions, Chengdu and Suzhou are enforcing mandatory contributions through local implementation rules.

**Conclusion and Implications**

To conclude, China has achieved great progress with pension reforms during the last two decades, but major concerns still remain:

- Facing demographic challenges, China has established a multi-pillar pension system for the urban sector. Accumulated state pension assets are experiencing exponential growth, facilitated by EEE preferential tax treatment. However, unsatisfactory investment returns pose a huge challenge for long-term pension assets.
- China is still too reliant on the state pension system, while both EA plans and commercial pension business have not achieved expected growth. Currently these supplementary plans lack preferential tax treatment, and a ‘partial TEE’ tax mode has been suggested for EA development by Chinese pension experts.
- The new rural pension has just started, and is expanding rapidly with government support. However, there is still a huge gap between the two systems and the benefits and current assets of rural systems cannot be compared to the urban position.
- Geographic disparities exist in China regarding social security, private sector pensions and tax treatment for expatriates.

In light of the success of the recent EU-China Social Security Cooperation Project, further cooperation could be explored regarding tax and pensions in China.

- More pension investment expertise could be introduced by the EU, to help diversify China’s state pension investment channels and grow the assets. The average investment returns for these accumulated assets, at only 2% p.a., should be compared with the three different types of inflation in China, namely, price inflation (5.4% in 2011), wage inflation (averaging between 10-12% p.a.) and asset inflation (e.g. 15-20% p.a. for residential property).
• Preferential tax policies should be utilised in the supplementary pension sector as a stimulus to accelerate growth. It is strongly recommended that an EEE or EET tax mode be introduced for both EA business and commercial pension insurance, exemplifying the US 401(k) scheme.
• More cooperation could be explored regarding expatriates’ pensions. Apart from Germany, more countries should seek bilateral treaties with China on social security provision, and to facilitate synchronising the process among central and local policies.