Enterprise Annuities and Tax Policy in China: Engaged, But Not Yet Married

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Enterprise Annuities and Tax Policy in China:
Engaged, but Not Yet Married

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1. INTRODUCTION

Since the early 1990s, the Chinese government has regarded enterprise annuities (employer-sponsored pension plans) as an important pillar of the pension system and tax policy as a key instrument for establishing enterprise annuities. Borrowing the metaphor from Prof. Graetz, enterprise annuities and tax policy were engaged to be married for the past 15 years. Yet the formal marriage has not taken place. This article explores why that is the case. The second part of the article discusses the role of enterprise annuities in China’s pension system, and the third part considers the regulatory framework. The final two parts describe the current tax treatment of enterprise annuities in China and analyse the reasons why tax incentive legislation has not been enacted.

2. ENTERPRISE ANNUITIES AND CHINA’S PENSION SYSTEM

2.1. “Enterprise annuity” defined

The term “enterprise annuities” is used in China to refer to occupational pension schemes or employer-sponsored pension plans. “Enterprise annuity” is defined in Art. 2 of the Enterprise Annuity Rules (see below) as a “supplemental pension system voluntarily established by an enterprise and its staff on the basis of participation in the basic pension plan”.

As early as 1991, the government began to call upon enterprises to establish supplementary pension plans for their employees. The same policy was written into the Labour Law (1994). In 1995, enterprise annuities were regarded as the second pillar of China’s pension system. In 2000, the State Council confirmed that enterprise annuities should take the form of defined-contribution plans and be managed in accordance with market principles. Some local governments introduced their own rules to regulate enterprise annuities. By 2004, most of the enterprise annuity plans were established by firms in Shanghai, Shenzhen, Dalian and other coastal cities that have enjoyed rapid economic growth as well as national enterprises in the railway, electricity, petroleum, chemical and financial sectors. The annuity funds were managed by local social security administrations.

In 2004, the Ministry of Labour and Social Security (MOLSS) introduced temporary measures to standardize the regulation of enterprise annuities across the country. These measures include the Enterprise Annuity Rules (Trial), the Enterprise Annuity Fund Management Rules, and a set of companion rules on the regulation of service providers.

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2.2. Pillar 1 and enterprise annuities as Pillar 2

On the basis of the recommendations of the World Bank, China adopted a three-pillar pension system in the mid-1990s. Pillar 1 is a mandatory public pension system; Pillar 2 is a voluntary, supplementary enterprise annuity system; and Pillar 3 consists of individual retirement savings. Pillar 3 hardly exists at present and is not supported by any specific government policy or regulation.

Pillar 1 is a government-sponsored pension system. It has two components: the pay-go-based or social pooling component and individual pension accounts. The pay-go component is funded by contributions by enterprises at a rate up to 20% of their payroll (which includes the portion allocated to workers’ individual accounts). Because the social pooling is at the provincial level, the exact rate of contributions is set by the provincial government. If a higher rate is needed in a province, approval must be obtained from the central government. An individual pension account is funded by contributions from both the individual and his/her employer. Typically, the worker contributes up to 8% of his/her pensionable earnings and the employer contributes 3%, which amounts to a total of 11% of the worker's pensionable earnings. The funds in the individual accounts earn interest every year and cannot be used for purposes other than old-age pensions. These accounts are portable when a worker changes his/her job.

Pillar 1 is designed to provide a basic pension of up to 40% or 45% of the average salary at the time of retirement. Individuals who start working after 1996 and contribute to the basic pension system for a total of 15 years are eligible for a monthly “basic pension” upon retirement. A basic pension consists of a minimum pension and the individual account pension. The former is paid out of the social pooling and is set at 20% of the average monthly salary in the particular province (or autonomous region or municipality directly under the control of the central government) at the time of payment. The pension paid out of the individual account is the balance in the account divided by 120. Individuals who fail to make contributions for 15 years are not eligible for the minimum pension, and the funds in the individual accounts are paid in a lump sum at the time of retirement.

There has been a general funding problem in the pay-go component of Pillar 1 because current contributions are inadequate to finance current benefit payments. The funding problem was worsened by the increasing dependency ratio. For example, between 1993 and 1998, participants in the basic pension grew by 15.5%, but the number of retirees increased by 67.5%. Many cities experienced payment delays and protests by pensioners. Many enterprises were undergoing financial difficulties and could not make pension contributions. The financial crisis is expected to worsen. The government has not found a sustainable source of funding for the pension promises made to workers covered by the pre-1995 system (the “middle people”) or for the retirees drawing pensions from the pension pools. Many pension pools run a deficit and need to be bailed out by the central government. On average, about 5% of the budget revenue is used to fill the pension gaps. Most of the individual accounts are “empty” as a result of “borrowing” to finance the basic pension payments. These empty accounts need to be capitalized when the current workers retire.

Pillar 2 is intended to provide supplemental pension benefits to workers without imposing a financial burden on the government. It is hoped that enterprise annuities could function like their counterparts in the OECD countries. In the OECD countries, tax-assisted private pensions are important schemes in helping individuals (typically in middle or high-income groups) to save outside the public pension system.

2.3. Political, social and economic implications of pensions

Pensions are fundamentally important in China. China’s population is ageing at an accelerating rate owing to three possible factors: (a) the baby boom in the 1950s and 1960s; (b) the “single child per family” policy, resulting in a four-two-one family structure featuring four grandparents, two parents and one child; and (c) the increasing longevity of the Chinese people. The percentage of individuals aged 60 and older in China’s population was 10% in 1999 and is expected to be 20.42% in 2030. By 2030, retirees will account for more than 40% of workers.

China’s population is also aging faster than others. For example, the percentage of retirees (65 years and older) grew from 7% to 14% of the population in 115 years in France and 66 years in the United States, but only 25 years in China. All this means that there will be fewer young people in the future to pay taxes which can adequately support the elderly.

For the moment, pensions are also a political issue. The transition from the command economy to a market-based economy has been accompanied by impressive economic growth and the creation of millions of millionaires in China. At the same time, however, there are many “losers”. The income disparity problem in China is worse than that not only in the OECD countries, but also in countries in South-East Asia and the previous Soviet block.
This problem is worsening. Retirees fetch poorly from the fruits of economic reform, and thousands of them choose to demonstrate in front of government offices. The increasing income disparity among different income groups is considered a major source of social disharmony and political unrest. The government recently made “building social harmony” one of its major tasks in the future. Establishing a sustainable pension system is a key element of this initiative.

In addition to the political and social implications, the pension system has a significant economic impact on the reform of state-owned enterprises, the formation of China’s capital market, and the transition towards a market-based economy. This can be seen from the history of the pension system:

(a) Pre-1949. China was a predominantly agricultural, rural-based society. As such, the family was the main source of income support. As in other countries, the process of industrialization has been accompanied by the creation and development of social security programmes, including pensions. Although retirement income was provided to government officials as early as 2000 years ago, there were no social organizations that provided adequate income security to old people.

(b) Strict socialism (1949 to the early 1980s). A “socialist” pension system, that is, the “iron rice bowl” system, was practised to provide old-age income security for civil servants and workers in state-owned enterprises. Under this system, retirees received pensions directly from their previous work units (employers). This system was consistent with the centrally planned economic model under which enterprises were merely instruments to implement the state plans and were not profit-seeking enterprises. It worked reasonably well before the economic reforms in the late 1970s because there was virtually no labour mobility and the government implicitly assumed responsibility for all enterprises. Technically, it was a pay-go system, and no special pension fund was set up to finance the payment of pensions.

(c) Transition to a socialist market economy. The economic reforms that began in the late 1970s gave enterprises more financial autonomy and made them increasingly responsible for their own profits and losses. In order to “free” state-owned enterprises from the burden of providing pensions and other social security benefits to their workers, the government gradually shifted the burden to local governments, while requiring enterprises to make contributions. The public pension system was created in the mid-1990s to provide minimum retirement income security to workers.14

(d) Developing market fundamentals. Private pensions in Pillar 2 are intended to further facilitate the economic transition by creating a “win, win, win” system to the government, enterprises, workers and financial institutions. To the government, Pillar 2 can be a key element of the overall retirement income system by providing supplementary pension income to retirees. To enterprises, it can help them compete in attracting and retaining highly qualified employees. To workers, it is a useful vehicle for them to obtain better benefits and more retirement income security. Finally, to financial institutions, enterprise annuity funds could become a massive pool of capital for the capital market. It is estimated that pension funds in China could exceed USD 160 billion by 2030 and become the world’s third largest pension market.15

3. REGULATION OF ENTERPRISE ANNUITIES

3.1. Four basic principles

Four basic principles guide the development of China’s enterprise annuity system:16 (1) enterprise annuities are voluntary; (2) an enterprise annuity plan must be a defined-contribution plan; (3) tax assistance will be provided to enterprises (see 4.2.); and (4) enterprise annuities must be managed in accordance with market principles.

3.2. Voluntary

An enterprise is not legally required to set up an annuity plan. If an enterprise chooses to sponsor an annuity plan, however, it must meet three key conditions: (a) it must fulfill its obligations to pay into the basic pension system; (b) it must have the capability to bear the economic burden; and (c) it must establish a collective consultation mechanism.

The sponsoring enterprise must consult with the trade union or the employees’ representatives about creating an annuity fund. The sponsoring enterprise must also prepare an annuity plan. If the enterprise is owned or controlled by the state, the plan must be approved by the workers’ congress. The plan must set out the following: scope of coverage; method of funding; method of managing the individual accounts within the annuity system; method of managing the annuity fund; method of computing and paying annuities; conditions for determining entitlement to annuity payments; system of administration and supervision; conditions for terminating contributions; and other matters. The plan should cover all workers who have completed the trial period, and it must be submitted to the local social security administration for approval. For enterprises directly controlled by the central government, approval must be obtained from the MOLSS.

An enterprise annuity fund is a supplemental occupational pension fund that is financed by contributions and accumulated investment earnings. In other words, an annuity fund has three sources of funding: enterprises’ contributions, employees’ contributions, and gains and earnings derived from investing the contributed capital. The assets

13. The pension system was created as early as the Han Dynasty (206 BC to 220 AD); under the system, officials could receive a pension up to one third of their pre-retirement salary when they retired at the age of 70. See Sun, Quangde and Keyong Dong, Introduction to Social Security (Revised ed., 2004), at 135 (in Chinese).

14. As early as 1991, individual accounts were created in some cities to keep track of an individual’s entitlement to basic pensions. See State Council, Guo Fa [1991] No. 33, supra note 2.


of the fund are segregated from those of the sponsoring enterprise. The fund is managed by a trustee.

3.3. Defined-contribution plans

Enterprise annuity funds must be defined-contribution plans. Contributions must be made by both the sponsoring enterprise and its employees. The enterprise’s contributions are, in principle, tax deductible up to a specified amount (currently 4% of its total salary). The enterprise’s annual contribution cannot exceed 1/12 of the previous year’s total salary, and the total contribution by the enterprise and the employees cannot exceed 1/6 of the previous year’s total salary. There are no specific formulae for determining the amount of contributions by employees, and their contributions are not tax deductible.

Some local governments have introduced detailed rules for enterprises within their jurisdiction. For example, the Shenzhen rules permit enterprises to contribute different amounts in respect of employees at different stages of their employment. For senior and close-to-retirement-age employees, contributions can be made at an accelerated rate. The Shenzhen rules also allow profit-sharing-type plans under which an enterprise can contribute additional amounts to the annuity plan if the enterprise’s profit exceeds a specified level.

Each covered employee has an account in the annuity fund which records his/her interest in the fund (including his/her contributions, the enterprise’s contributions allocated to him/her, and the investment earnings). The Enterprise Annuity Rules do not specify the formulae for allocating the fund to each employee’s account. The Shenzhen rules permit the use of any allocation method on the basis of salary level, seniority and position. According to the Shenzhen rules, an employee’s interest in his/her pension account cannot be deprived by the sponsoring enterprise as long as: (a) the interest is attributable to his/her own contributions; (b) the interest is vested after the employee has worked continuously for the enterprise for more than ten years; or (c) the interest is attributed to an employment contract that has been completed.

Moreover, if the employment of a covered employee is terminated for cause by the enterprise, the enterprise may not deprive the employee of his/her interest in the individual account. On the other hand, the enterprise has the power to confiscate all or part of the employee’s account if the employee has significantly violated the rights of the enterprise, has violated the rules of conduct and caused serious damage to the enterprise, or has engaged in competition with the enterprise after the employment relationship ended.

Upon retirement, an employee participating in an enterprise annuity fund may withdraw the funds from the individual account in a lump sum or periodically. Under the present tax law, these benefits are taxed as income. The funds cannot be withdrawn by the employee prior to retirement. If an employee changes his/her employment, however, the individual account is portable to the new employer. If the new employer does not have an annuity plan, the individual account can be managed by the previous trustee.

3.4. Professional management

Each enterprise annuity fund is a trust. As such, the fund is legally separate from the enterprise and is managed by a trustee, with the sponsoring enterprise as the settlor and the participating employees as the beneficiaries.

According to the Enterprise Annuity Fund Management Rules, the assets of the fund are segregated from those of the sponsoring enterprise (or settlor), the trustee, the custodian, or the investment managers appointed by the trustee. The trust fund can be used only to pay debts associated with the trust.

The trustee can be the board of trustees established by the sponsoring enterprise or a corporate trustee appointed by the sponsoring enterprise. The board of trustees is comprised of members from both inside and outside the enterprise. No less than one third of the members, however, must be representatives of the employees. The only mandate of the board of trustees is to manage the annuity fund, and the board is prohibited from engaging in any other business activities. Appointing a corporate trustee must be done through a written contract. A corporate trustee must:

- be registered in China;
- have a minimum registered capital of CNY 100 million and minimum net assets at any relevant time of CNY 150 million;
- have a perfect management structure;
- have on its staff the required number of professional personnel who are qualified to manage enterprise annuity funds;
- have a business site, sound security measures, and other infrastructure necessary for managing the trust fund;
- have a perfect internal audit and assessment system and a risk-control system;
- not have committed any major illegal acts within the past three years; and
- have met the other conditions specified in other state regulations.

The trustee’s powers and obligations are governed by China’s Trust Law. The fundamental principles of the Trust Law are the same as those found in common law jurisdictions. In performing its duties, a trustee must abide by the principles of honesty and prudence. A trustee must follow the provisions of the trust deed and manage the trust in the best interest of the beneficiaries. In addition, a trustee must be “honest, creditable, prudent and diligent” in performing its duties.

19. Id., Art. 25.
The trustee of an annuity fund may enter into a contract with a third party as an account manager, investment manager or custodian of the trust fund. The Enterprise Annuity Fund Management Rules set forth the conditions that a financial institution or securities investment fund company must satisfy to qualify as a manager or custodian of an annuity fund. These rules also prescribe the maximum fees payable to the trustee and third parties. For example, the fee payable to the trustee may not exceed 0.2% of the net assets of the trust fund, and the fee payable to an investment manager may not exceed 1.2% of the net assets under his/her management. The trustee, account manager, investment manager and custodian all have the duty to provide true and complete information to the competent government agencies (such as the MOLSS) within the specified time periods.

The general investment policy goals are prudence, diversification, security and liquidity, and professionalism. The managers and staff of an investment manager may not hold any position in the fund’s sponsoring enterprise or as an investment manager for another fund. Moreover, the investment manager may not be the settlor or have any interlocking investment.

Investment choices include both debt and equity instruments as well as insurance products and mutual funds. The present investment mix is as follows:

- minimum 20% in savings accounts, bank commercial paper, short-term bonds and other money-market mutual funds;
- maximum 50% of net assets in term deposits, negotiable instruments, treasury bills (minimum 20% of net assets), financial debt instruments, corporate debt and other convertible debt obligations, and bond funds; and
- maximum 30% of net assets in equities, insurance products with savings features, and equity mutual funds (not more than 20% of net assets may be invested in equities).

The MOLSS will revise the investment mix in the future in accordance with market developments.

An annuity fund’s investment in a single corporation (or investment fund) is limited to the lesser of 10% of the net assets of the annuity fund managed by a particular investment manager and 5% of the securities of the invested corporation (or units of investment fund). Prior approval must be obtained from the trustee if an investment manager wants to invest the annuity fund in its own investment products.

3.5. International aspects

There are some notable international aspects in the Enterprise Annuity Rules and Enterprise Annuity Fund Management Rules. First, enterprises that are eligible to establish an annuity fund are not limited to those owned by the Chinese. Chinese-foreign joint ventures, wholly foreign-owned enterprises, and Chinese companies invested in by foreign investors are eligible as well. Indeed, these companies are better positioned to create annuity funds as their workers tend to be younger and their financial position is stronger than that of state-owned enterprises. Second, there are no rules limiting covered employees to Chinese citizens. Therefore, foreign citizens working in China can be covered. If a covered employee leaves China before retirement, the balance in the individual account can be withdrawn. Third, investment managers, account managers and other service providers are not limited to Chinese-owned companies. Chinese-foreign joint venture investment fund companies that meet specified conditions may be appointed as investment managers. Finally, international investment by an annuity fund is neither specifically allowed nor specifically prohibited.

4. TAX POLICY

4.1. Crucial role of the tax system

Tax subsidies play a crucial role in the development and expansion of employer-sponsored pension plans in the OECD countries. These subsidies typically take the form of a tax deduction for pension contributions and/or a tax exemption for the investment earnings of a pension trust. The tax on the contributions and investment earnings is deferred until the pension benefits are received by the pension plan member. The value of the deferral depends on the marginal tax rate applicable to the enterprises and employees. The higher the tax rate, the more tax savings result from the tax subsidies. In progressive income tax systems, the taxpayers who benefit most from tax-assisted private pension plans are naturally those in the middle and high-income groups. Indeed, it is arguable that these groups of individuals are by design the targeted beneficiaries of the tax assistance.

4.2. Current tax treatment of enterprise annuities

Under the general principles of the income tax law applicable to enterprises, the wages and salaries paid by an enterprise are clearly deductible to it in computing its profit. In the absence of specific authorization, the payments made by an enterprise to a pension fund for the benefit of its current workers are generally not deductible. The enterprise income tax legislation has no specific provision on the deduction of pension contributions.

The Enterprise Annuity Rules provide for an employer’s contribution to an annuity plan of up to 1/12 of the previous year’s total payroll, but are silent on the tax deductibility.
of the contribution. The Ministry of Finance has not adopted companion tax measures to clarify this issue.

Despite the legislative void, enterprises that have sponsored annuity plans have been able to deduct their contributions, albeit at different levels determined by local governments. The “green light” for such a deduction was given in a State Council document entitled “Plan for the Trial Implementation of Perfecting the Social Security System in Cities and Townships” (Guo Fa [2000] No. 42): enterprises could deduct up to 4% of the total salary. Some local governments have introduced their own tax measures to allow a deduction, ranging from 4% to 8% (or more) of the total salary. For example, in Jiangsu Province, a sponsoring employer may deduct contributions up to 1.5% per month of the salaries paid to its employees.

As regards employees, the value of an employer’s contribution to an annuity plan is not taxable to the employee as a fringe benefit. On the other hand, the employee’s contributions to an enterprise annuity are not tax deductible under the Individual Income Tax Law, and they may be made only out of after-tax income. In contrast to the deduction for employers, there has been no State Council policy or local government position on the deductibility to individuals. It seems clear, though, that the benefits received from an annuity plan are taxable.

In the absence of legislative provisions or government policy, the investment earnings of an annuity trust are not currently taxable to the trust or to its beneficiaries (i.e. employees).

5. REASONS FOR POSTPONING THE MARRIAGE OF TAX POLICY AND ENTERPRISE ANNUITIES

Tax subsidies to private pensions are tax expenditures. They can be justified on several policy grounds, such as overcoming myopia by inducing individuals to save, promoting firm productivity, providing capital supply for investment, and correcting market failure. These policy justifications appear to be equally valid in China. In fact, the need for a tax subsidy seems obvious as well. According to one survey, 85% of the state-owned medium-sized and large enterprises prefer to wait for a more generous tax subsidy before establishing an annuity fund. Why has the promulgation of tax incentives to assist enterprise annuities been postponed? Several reasons might be offered as explanations.

5.1. Tax subsidy to “profitable” enterprises

For obvious reasons, an enterprise will be interested in a tax subsidy for creating an annuity plan if the enterprise is in a financial position to establish an annuity plan and can actually benefit from the tax subsidy. Enterprises that are already in financial difficulties cannot benefit from the tax subsidy. At present, the vast majority of annuity plans has been established by enterprises controlled by the central government or enterprises that enjoy a high-level monopoly (such as in the railway, banking, energy, telecommunications and electricity sectors). These enterprises are already the envy of other enterprises. Providing profitable enterprises with more assistance by way of tax subsidies is difficult to justify in the current situation. On the other hand, the tax incentives for enterprise annuities granted by local governments generally do not benefit enterprises controlled by the central government. The lack of national tax incentives is a real hurdle to these enterprises in expanding their annuity plans.

A related tax policy issue is the sharing of tax revenue and tax expenditure between the central government and local governments. Under China’s current constitutional and tax laws, the sharing is not done in accordance with any legislative rules; rather, it is negotiated on a case-by-case basis. Unless the central government can make up the revenue loss from the tax subsidy for enterprise annuities, local governments (with the exception of Shenzhen, Shanghai and a few other local governments that are financially healthy) will not be very interested in giving up more tax revenue to subsidize profitable enterprises.

5.2. Limited coverage and tax inequity

By the end of March 2004, less than 3% of urban workers (about seven million individuals) were covered by enterprise annuity plans. In comparison, in 2003, the public pension system covered over 60% of urban workers (about 155 million individuals). Rural workers were generally excluded from both public and private pensions: less than 1% of working-age peasants are covered by public pensions.

Using tax expenditure to benefit a small percentage of workers (the elite class in China’s working population) raises serious equity concerns. It is easily perceived as a reverse tax subsidy, worsening the income disparity problem in China. Because of regional economic disparities and the lack of a national pension law or standard, the tax...
subsidy for enterprise annuities also raises equity issues among workers in economically developed coastal regions and less developed inland regions. Such a disparity is already obvious in the public pension system. In affluent regions, the benefit level is much higher. For example, in 2004, the average per capita monthly pension was CNY 1,800 in Shenzhen and CNY 885 in Beijing, but only CNY 496 in Jiangxi, while the national average was CNY 620. Enterprise annuities are expected to further amplify the income disparity.

5.3. Myopia unlikely corrected by tax subsidies

The assumption that tax subsidies help individuals save for their retirement makes sense as a practical matter if the tax subsidy can result in changes in the behaviour of employers and employees. Even with generous tax incentives, many enterprises are unlikely to change their policy on pensions for two possible reasons. First, enterprises that are not in compliance with contributions to public pensions are unlikely to set up an annuity fund. Many enterprises are not financially capable of making contributions. Others deliberately avoid contributory obligations by reporting only the “nominal” wage (i.e. excluding the cost of benefits, bonuses and other remuneration) or delay their payment of pension contributions. The non-compliance problem is so serious that the government has taken some drastic measures to address it. For example, the MOLSS once summoned the managers of over 200 large non-compliant enterprises to attend a “training session” and made the managers sign an agreement with the government to make the pension contributions that were long overdue.

Second, enterprises probably face little pressure from organized workers. Workers are often not unionized. Even where unions are formed, trade unions in China do not function as bargaining units. The huge pool of migrant workers from less developed regions and rural areas keeps the industrial wage low and makes it difficult for workers to bargain for better remuneration packages, including enterprise annuity benefits. The market for enterprise managers is being developed in China, and the turnover rate of management personnel is high. Thus, using annuity benefits as a tool for retaining managers may not be considered very effective. Neither workers nor managers seem to be pushing their employers to set up annuity plans. Individual workers, while they welcome any additional benefits to be gained from the enterprise annuity system, may not be highly enthusiastic in fighting for them. Moreover, individual workers will be unlikely to modify their savings pattern because of a tax subsidy for enterprise annuities. They generally prefer to save for their child’s education and for purchasing a home. There seems to be a lack of confidence in the pension system, which may be due to reasons such as the short history of the pension system, the poor performance of the stock market, and the financial crisis in the basic pension system.

6. CONCLUSIONS

The importance of enterprise annuities is gaining recognition in China, especially by the central government, profitable enterprises and the capital market. The crucial role of tax policy in promoting the development of enterprise annuities has been proved in developed countries and is being acknowledged in China. While limited tax incentives have been granted by some local governments, it may take some time for the central government to formulate the national tax policy in this area. The marriage of enterprise annuities and tax policy will eventually take place, and it will undoubtedly determine the speed of growth of Chinese pension funds, which in turn will have a significant impact on the size of China’s capital market.

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