Development of Private Pension Market: How to Strengthen Incentives for Participation[1]

CF40 Research Department

Abstract: The key to the robust development of the private pension market is to increase people's incentives for participation, which depends on policy support and higher returns from market-based operations. Looking forward, developing the private pension scheme requires continuous improvement of institutional arrangement by addressing at least the following four issues: 1) the structure of the three-pillar pension system; 2) the level of preferential tax treatment; 3) the cap on the annual contributions; 4) the flexibility of private pension accounts.

I. THE DEVELOPMENT OF PRIVATE PENSION SCHEME IS ACCELERATING RAPIDLY AND HAS HUGE POTENTIAL

China has long been trying to build a multi-level and multi-pillar pension system that adapts to its national conditions. In this system, the first pillar is backed by the government, with the aim to cover the whole population. But as China's population ages faster, the basic old-age insurance will face huge payment pressure in the future. By the end of 2021, the basic old-age insurance had covered 1.03 billion people. The second pillar, backed by enterprises, develops slowly with a low coverage. As of the end of 2021, around 70 million had participated in the enterprise (occupational) annuity plan, whereas over 90% of people covered by the basic old-age insurance did not enroll in it, partly because a large number of them are self-employed individuals

[1]This article is part of the CF40 briefing series.

and freelancers that are not eligible for the plan. The third pillar, which is the private pension scheme, is still in its infancy.

Given the challenges facing the first and second pillars of the pension system, building a private pension scheme that enjoys tax advantages and requires no corporate involvement can meet individuals' need for supplementary pension and is fundamental to the development of a more equitable and sustainable social security system.

Since 2018, China has begun to develop personal pension products, but thus far the scale is limited. The size of pension target funds is around 100 billion yuan, while that of individual tax-deferred commercial pension insurance is even smaller. Unlike previous pilot policies, **in April 2022, the General Office of the State Council issued t*he Opinions on Promoting the Development of Private Pensions* (hereinafter referred to as "Opinions"), which lays out the top-level design for the third pillar of the pension system.** Following that, the China Banking and Insurance Regulatory Commission (CBIRC) and China Securities Regulatory Commission (CSRC) issued supporting policies respectively, greatly speeding up the institutional development of the third pension pillar. The market generally believes that private pensions have huge potential. Some institutions estimate that by 2031, the potential size of private pensions in China is expected to approach 120 trillion yuan.

II. THE DEVELOPMENT OF THE PRIVATE PENSION SCHEME ENTAILS CONTINUOUS IMPROVEMENT OF INSTITUTIONAL ARRANGEMENT

Some experts thought that **the key to the robust development of the private pension market is to increase people's incentives to participate, which depends on policy support and higher returns thanks to market-based operations.**

Currently, policy support plays a limited role in promoting the development of private pensions. Looking forward, developing the private pension scheme requires continuous improvement of institutional arrangement by addressing at least the following four issues:

First, the structure of the three-pillar pension system. Internationally, the third pension pillar in developed countries usually accounts for 30%-40% in a country's overall pension system. In comparison, the third pillar in China is still in its infancy, and the structure of the pension system is yet to be adjusted.

In addition, **the institutional design should pay attention to the pension replacement rate under the first pillar**. The replacement ratio is defined as gross pension entitlmenet divided by gross pre-retirement earnings, which is used to measure pension adequacy. If the replacement ratio under the first pillar is too high, it will reduce people's willingness to participate in the supplementary pension schemes and increase fiscal pressure as well.

Second, the level of preferential tax treatment. In 2018, six ministries and commissions piloted individual tax-deferred commercial pension products in some cities, but it didn't fare well due to limited scope and insufficient tax incentives. Based on the institutional arrangement of the previous pilots, it is more likely that China will continue to adopt the model of individual income tax deduction, known as the "Exempt-Exempt-Taxed" (EET) model most widely used internationally (a regime where both contributions and returns on investment are exempted from taxation while benefits are treated as taxable income upon withdrawal). **However, given China's high personal income tax threshold, the preferential tax treatment won't bring much incentive.** It is estimated that the EET model cannot benefit 95% of the low and middle income groups.

Some experts pointed out that compared with other countries, **the biggest disadvantage of developing private pensions in China is the absence of capital gains tax**. It is thus very difficult to attract investors through tax deferral among other tax preferential treatment when the earnings from investment in over-the-counter securities are exempt from tax.

Third, the cap on the annual contributions to the private pension scheme. The Opinions stipulates that the yearly contributions of each individual are capped at 12,000 yuan, and will be adjusted by the Ministry of Human Resources and Social Security and the Ministry of Finance in line with factors such as the level of social and economic development and the development of the multi-level and multi-pillar pension system. On the one hand, due to the high threshold for personal income tax, **the contributions ceiling of 12,000 yuan is not that attractive for most taxpayers.** On the other hand, if an individual contributes 12,000 yuan annually to the personal account for 10 years, the accumulated amount is only about 120,000 yuan, with which the financial products available for purchase are very limited.

Fourth, the flexibility of private pension accounts. Currently, once a private pension account is established, the funds in the account cannot be withdrawn at will after enjoying tax benefits, rendering this portion of the funds illiquid. Under this arrangement, the combination of limited amount of funds, uncertain returns, and lack of liquidity will reduce people's incentive to set up private pension accounts.

III. POLICY RECOMMENDATIONS

First, policymakers should specify the development model of private pension and continue to improve the top-level design for the system. Some experts held the first thing to do is to make clear the development model and functions of private pensions. Internationally, the development of private pension follows two paths and two models, which can **be divided into replaceable model (dumbbell-shaped) and additional model (pyramid-shaped)** according to the relative coverage of the three pillars. In the replaceable model, the 2nd pillar has a low coverage because the insured must be employees, while the 3rd pillar has a high coverage, perhaps even as high as the 1st pillar. In the additional mode, the coverage gradually decreases from the 1st, 2nd, to the 3rd pillar. Moreover, based on the experience in the previous pilots, once the development model of private pension is established, more resources should be mobilized to create an enabling policy environment for the development of the third pillar.

Second, it is essential to balance the private pension's attribute of old-age support and the liquidity demand by enhancing the flexibility and accessibility of private pension accounts. A locked-in pension account that does not permit withdrawals before retirement can ensure that the funds are truly used for retirement, reflecting the private pension's attribute of old-age support. However, this is in conflict with the liquidity demand for individual assets. Many institutions find that financial products with maturities of 5 years or more are not easily accepted by the market.

It is suggested that a private account system with conditional yet relatively open access should be established. Conditional access is to ensure that the funds are used for old-age support, while relatively open access is to enhance liquidity. For example, in addition to the annual contribution of up to12,000 yuan, people should be allowed to put other funds into their private pension accounts, thereby creating a larger scale of accounts for unified asset allocation and management.

Third, supporting policies and detailed regulations based on the Opinions should be further improved.

1. A mechanism that connects the three pension pillars should be set up. The Opinions states that private pensions should connect to the basic old-age insurance system and enterprise (occupational) annuities, which requires rules to regulate the capital flow, channels, and complementary mechanism among the three pillars, and to address practical issues such as means of investment management, contributions, transaction recording, fund transfer and continuation.

2. The details of adjusting the cap on private pension contributions should be clarified. On the one hand, it can raise the expectations of the potential enrollees and financial institutions involved in the scheme; on the other hand, a dynamic adjustment mechanism for contributions standards could be established by pegging it to indexed average social wage growth and taking into account factors like the number of years to pension receipt. Moreover, the relatively low contributions ceiling prevents people from making more contributions, which restricts the scale of the private pension. In response, **it could be considered to adjust the contributions ceiling and introduce differentiated tax benefits to achieve fairness.**

3. Policy details of the scenario where a private pension account is closed should be set up. The Opinions stipulates that “when the enrollee dies, the funds in his/her private pension account can be inherited.” When necessary, the policy details should be laid out in accordance with the Civil Code, the inheritance law, and other relevant legal norms.

4. The tax policy design of private pensions should be diversified. China can learn from the experience of other established markets, continue to expand the coverage of the scheme, and diversify tax incentives. For example, we can consider adopting both the TEE model (taxable contributions, exempt accumulations, exempt withdrawals) and the EET model (exempt contributions, exempt accumulations, taxable withdrawals), and provides other types of tax subsidies for low-income group, so as to improve the attractiveness of the private pension scheme.