Regressive Effects and Countermeasures of individual income tax deferred pension insurance

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Abstract: In order to reduce the society's dependence on the first pillar of endowment insurance and improve its flexibility, it is imperative for China to develop personal pension insurance. Deferring individual income tax is a type of tax incentive that can stimulate middle and high income earners to participate in personal pension insurance, but it also creates the regressive effect of income reverse regulation, because middle and high income earners can enjoy a larger decline in current period's tax rate, more tax exemptions for capital gains, and greater gap between inter-period tax rates . Regressive effects originate from the regressive tax system in relation to personal income tax, this tax system's design can be optimised such that its incentive function can be taken advantage of, while its regressive effect is suppressed. By shifting part of the retirement responsibility to middle and high income earners' themselves, the government can concentrate its financial resources on providing elderly support to low income earners, thereby making these individuals the real beneficiaries of the individual income tax deferral preferential policy. The first pillar of the social security system is to seek fairness, while the third pillar is to pursue efficiency. The presence of regressive effect of individual income tax deferral should be accepted by society as long as it can be controlled within a tolerable extent.

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1. Introduction

Since the 1980s, in order to address the global aging population crisis, countries all over the world initiated a wave of global pension reform, which up to now has no sign of ending. The European crisis has once again put forward such reform agenda in front of countries all over the world.[1] In the past few decades, both developed nations and developing countries are actively engaged in the reform of the pension insurance system; some countries had to pay a high price during this process. The experiences and lessons learnt from the pension system reforms of various countries lead to the conclusion that the reform of China's pension insurance system must take place.

The great dispute caused by China's two most recent proposals to the reform of the pension insurance system – 'merging pension and insurance' and 'increasing the pension age to 65' – fully reflect the difficulty of such reform. Although increasing the retirement age is already the most popular and most common approach to the global pension reform, only six out of 34 OECD member countries have yet to increase the retirement age,[2] and the reason for not doing so is because these member countries have already raised the retirement age half a century ago. However, it is imperative for China to carry out necessary or partial reforms to the pension insurance system. Increasing the retirement age is the most desirable option for this reform under current circumstances where it is difficult to adjust the replacement rate and the payment rate. Yet, this proposal put forward by Tsinghua University was unanimously condemned in speech and in writing as 'highly unrealistic' and 'overly economically rational, lacking humanistic care', and was advised that 'delaying the retirement age should not be part of the discussion'. Few scholars publicly supported Tsinghua University's proposal. Yet, from both international experiences and China's current conditions, this proposal is an accurate and inevitable option, though without any support (He Ping, 2012; Zheng Bingwen, 2012). Nevertheless, the prospects of the 'merging' orientation and the 'Tsinghua University Proposal' are not the focus of this paper. This paper is concerned with why '94.5% of the individuals surveyed disagree with the retirement deferral'. Why is the reform of China's pension insurance system so difficult? This paper seeks to investigate how the society's tolerance of this reform is increased and how a smooth transition of the two systems should take place to reduce the impact on society. (Hu Xiaoyi, 2013)

[1] 郑秉文 [Zheng Bingwen], 欧债危机下的养老金制度改革—从福利国家到高债国家的教训 ['European debt crisis calling for reform: experiences from welfare state to debt state'] (2011) 5 中国人口科学 [Chinese Journal of Population Science] 2.

[2] 郑秉文 [Zheng Bingwen], 欧债危机对养老金改革的启示：中国应如何深化改革养老保险制度 ['Revelation of the European debt crisis on pension reform: how should China deepen its pension insurance system reform'] (2012) 2 中国社会保障 [China Social Security] 30.

When summarising the lessons learnt from the European crisis, scholars found that a pension crisis is hidden under the debt crisis (Li Kaisheng, Zhang Donglin, 2012). The out-of-balance pension insurance system was the ‘hidden cause’ that ‘directly led’ to the break out of the huge fiscal deficit (Zheng Bingwen, 2012; Zhang Xiuling, 2012). In comparison to south European countries, the development of China’s old-age security system is even more imbalanced. The first pillar of the social security system, the society’s basic pension insurance, bears the retirement pressure of the entire society, with high replacement rate and large funding gaps; The second pillar of the social security system, the corporate pension, has a very small scale and thus does not serve the functions of a pillar; The third pillar of the social security system, the personal pension insurance, has development that is lagging behind the most and therefore cannot form an independent pillar. The retirement pressure on the entire society is highly concentrated on the first pillar. Not only does it restrain the development of the second and the third pillar, it also makes the system more fragile by enhancing the inflexibility of the system. On the one hand, the public believes that their retirement life is fully secured, as the replacement rate of basic pension insurance is relatively high, therefore gradually forming a reliance on the basic pension insurance. Moreover, the public lacks the impetus to create corporate pension and purchase personal pension insurance. On the other hand, since the second and third pillars are not well-developed, the retirement burden on the first pillar cannot be shared and individuals’ rigid expectation of welfare forces the first pillar to maintain a relatively high replacement rate. As a consequence, the development paradox that the first pillar and the second, third pillars mutually inhibit each other is formed, causing the basic insurance and supplementary insurance to fall into a quagmire. Under the restraint of individuals’ rigid expectation of welfare, the more imbalanced the retirement system is, the more difficult it is to adjust this system. As the retirement pressure is excessively concentrated, the huge reliance on the first pillar abated the society’s tolerance of this reform, increased the public’s sensitivity to this reform, and increased the resistance to this reform. Therefore, a small-scaled reform could cause turbulence to the overall situation, and the high costs prevent this necessary reform from progressing (He Yang, Zhu Zikai, 2012). It can be seen that the reform of China’s pension insurance system cannot take place mainly because of the imbalanced development of the old-age security system’s pillars and the lack of flexibility of the system, not because the Chinese are less willing to bear the pain of reform than the Greeks. Under the restraint of the single pillar’s high replacement rate, the public elderly security system lacks a viable second option. The public is willing to, but cannot bear the pain of reform. Although the current system is difficult to maintain and reform is the only option, the public is evidently not prepared to bear the pain of this reform. Yet, it is not realistic to expect that the level of rationality of the public will reach a point where the public will take initiative of bearing the pain of this reform.

Thus, China should develop supplementary pension insurance, especially the personal pension insurance, in order to lower the entire society's reliance on the first pillar, reduce the retirement pressure on the first pillar, improve the flexibility of the system and enhance its sustainability.[3] Provided that the replacement rate of the entire system is stable, conditions for this reform should be created to achieve more room for development. From international experiences, tax incentives are a major driving force that promotes the development of the pension system's third pillar and stimulates individuals to participate in personal pension insurance. Individual income tax deferred personal tax is the optimal form of personal pension insurance that effectively promotes the development of the pension insurance system's third pillar.[4] The implementation of the individual income tax deferred pension insurance aims to use the benefit of the income tax deferred to stimulate middle and high income earners to participate in personal pension insurance and to engage in retirement savings planning, thus offsetting the deficiencies of public pension and corporate pension. Before retirement, middle and high income earners would prepare for themselves a supplementary pension, subsequently enhancing their self-support ability during retirement and bear responsibility of their retirement. Consequently, reliance on the first pillar will be lowered and the financial pressures on the public pension will be reduced, improving the multi-pillar elderly security system.[5] Although the individual income tax deferred pension insurance is widely used globally, China is still at the stage where it is being politically discussed and theoretically studied. A major reason is that the individual income tax deferred pension insurance provides high-income earners a simple and effective way to evade tax. Low income earners benefits little or do not benefit from the individual income tax deferred pension, which may lead to regressive effect of reverse income redistribution, widening the gap between the rich and the poor, damaging the benefits of low income earners and is not beneficial to the stability of the economy and overall society. In order to ensure the successful initiation and development of the individual income tax deferred pension insurance, there is high theoretical and practical value in recognising its regressive effect, analysing its formation and offering effective measures to address this issue so as to take full advantage of its stimulus effect on middle and high income earners participating in the personal pension insurance and to suppress its regressive effect.

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[3]李晓晟 [Li Xiaosheng], 基于税收优惠的我国个税递延型养老保险研究 ['Research based on the tax benefits of China's individual income tax deferred pension insurance'] (2011) 10 武汉金融 [Wuhan Finance Monthly] 24.

[4]柴玉珂 [Chai Yuke], 基于绩效视角对我国个税递延型养老保险的思考 ['Reflection on China's individual income tax deferred pension insurance from the performance perspective'] (2013) 3 财会研究 [Research of Finance and Accounting] 28.

[5]邹馨 [Zou Xin], 关于我国推行个税递延型养老保险的探讨 ['Investigations on the individual income tax deferred pension insurance introduced by China'] (2012) 4 保险职业学院学报 [Journal of Insurance Professional College] 62.

2. The effect of individual income tax deferred pension insurance on the benefits of policyholders

(i) The tax collection mode of the individual income tax deferred pension insurance

The individual income tax deferred pension insurance is a type of pension insurance where the premium can be deducted before tax from a portion of the policyholder's income or within a certain amount; the personal income tax will be paid when the pension is received. It is also a type of individual supplementary pension insurance that enjoys the benefit of tax deferral.[6]

The government can levy tax on the three stages of the pension insurance's operation: during payment, when returns on investment are obtained and when pension is received.[7] The 'individual income tax deferred' method of the individual income tax deferred pension insurance also relates to these three stages: whether payment can be deducted from taxable income, whether capital gains tax should be collected when returns on investment are earned and whether personal income tax should be levied when pension is received during retirement. According to these three stages, if T represents taxed, E represents exempted, the tax collection mode for pension insurance can be represented by the following eight combinations: EEE, TEE, ETE, EET, ETT, TET, TTE, TTT. The current practice used internationally is to implement the individual income tax deferred EET tax collection mode on personal pension insurance, i.e. tax is exempted during payment and when returns on investment are received while tax is levied when pension is collected.

The current tax collection mode for personal pension insurance used in China is the non-deferred TEE method, i.e. payment cannot be deducted from taxable income, while tax is not levied on returns on investment received and personal income tax is not collected when pension is obtained. For China to implement the individual income tax deferred pension insurance and to stimulate individuals to participate in personal pension insurance by utilising tax incentives, the aim is to change the current TEE tax collection mode into the internationally used EET tax collection mode.

(ii) The effect of the change in personal pension insurance tax collection mode on policyholders

[6] 许栩 [Xu Xu], 个税递延型养老保险方案设计公平性问题刍议 ['Discussions on the fairness of the design of individual income tax deferred pension insurance'] (2011) 2 上海保险 [Shanghai Insurance] 11.

[7] 李良 [Li Liang], 对我国试行个税递延型养老保险的思考 ['Investigations on China's individual income tax deferred pension insurance pilot'] (2012) 11 学术论坛 [Academic Forum] 133.

Under the TEE mode, personal income tax must be paid during the premium payment stage when individuals participate in the personal pension insurance, i.e. premiums can be paid only using after-tax income, while personal income tax is not levied during principal accruement and pension collection stages. Under the EET mode, when individuals participate in personal pension insurance, personal income tax is not levied during premium payment and principal accruement stages, but is collected during the pension collection stage. To implement individual income tax deferral, changing tax collection mode from TEE to EET will create a relatively large impact on policyholders' benefits. Properly assessing and accurately estimating this effect on welfare will be advantageous in analysing the roots of the creation of regressive effect and in finding the optimal method to address this issue.

The change in tax collection mode from TEE to EET will bring an increase in welfare to policyholders from three aspects: larger decline in current tax rate, greater gap between inter-period tax rates and more tax exemptions for capital gains. In terms of larger decline in current tax rate, personal income tax adopts a progressive tax rate, the applicable tax rate is positively correlated with income, meaning the higher the income, the higher the tax rate.[8] To launch the individual income tax deferred pension insurance, policyholders can enjoy current period's tax incentives as premiums are tax-deductible; therefore, policyholders' current period's pre-tax income will decrease, the applicable tax rates will subsequently decline, and thus the tax burden is reduced. With regards to tax exemptions for capital gains, the returns on investment from funds in the individual income tax deferred pension insurance account are tax-exempt, resulting in excess tax-exempt capital gains for policyholders. For the gap between interperiod tax rates, the applicable tax rates are different because income levels differ for various stages of an individual's life. Policyholders' income during retirement is usually lower relative to their income while working. Under the current tax system, the marginal tax rate of pension collection stage is lower than that of the payment stage. Moreover, a lower tax rate applies to the lower income earned during retirement, and therefore tax deferral brings policyholders the benefits of lower tax rate for intervening periods.[9] If the total income earned during retirement, including pensions, do not reach the individual income tax levy threshold, policyholders can enjoy the benefit of tax exemption.

[8] 香伶 [Xiang Ling], 关于养老保险体制中再分配累退效应的几个问题 ['Questions on the redistribution regressive effect of pension insurance system'] (2007) 1 福建论坛(人文社会科学版) [Fujian Tribune (The Humanities and Social Sciences Bimonthly)] 31.

[9] 杨燕绥, 闫俊, 刘方涛 [Yang Yansui, Yan Jun and Liu Fangtao], 中国延税型养老储蓄政策的路径选择 ['The pathway selection of China's tax deferred retirement savings policy'] (2012) 8 武汉金融 [Wuhan Finance Monthly] 8.

It can be seen that implementing individual income tax deferred pension insurance will bring great tax advantages to policyholders. As the personal income tax adopts the progressive tax system, implementing individual income tax deferral is equivalent to establishing a legal tax-exempt account for policyholders. Policyholders can transfer a portion of its taxable income into this account, thus lowering current period's tax base and tax rate and gain the benefit of low tax rate in current period. At the same time, policyholders can obtain a wealth management product with returns on investment that is tax-exempt and a personal supplementary pension insurance that improves the quality of life after retirement, as well as enjoy the benefits brought by the differences in tax rates in various stages of life.

3. The cause of the formation of the regressive effects of individual income tax deferred pension insurance

(i) The cause of the formation of regressive effects

Personal income tax is a type of income regulation tax, and the means of regulation is the progressive tax rate that is aimed at implementing the principle "Leistungsfähigkeitsprinzip" that tax burden should be based on individual's taxability [10]Income is highly reflective of the taxpayers' ability to bear tax burdens. High income earners have greater ability and thus should bear heavier tax burden, while lower income earners have weaker ability and thus should bear lighter tax burden or do not have to pay tax at all. Under the progressive tax system, the tax rate and income are positively correlated, and therefore high-income earners bear heavier tax burden. Through progressive tax and the the principle "Leistungsfähigkeitsprinzip", personal income tax can adjust the amount of income earned by high income earners, facilitate the rationalization of income distribution, prevent the disparity between the rich and the poor from widening and promote social harmony. Tax incentives as a type of special provision in taxation law, give specific taxpayers and object of taxation encouragement and consideration, and in essence do not levy tax on individuals who have the ability to bear tax; therefore, tax incentives violate the the principle "Leistungsfähigkeitsprinzip" (Kitano Hirohisa 1996). Personal income tax follows the this principle and adopts the progressive tax rate, while the tax incentive of the individual income tax deferred pension insurance is a 'special provision' that opposes such principles. Hence, the 'tax deferral' preferential policy implemented for personal income tax will inevitably produce regressive effects, causing reverse income

[10]余显财, 徐晔[Yu Xiancai and Xu Ye], 税收递延型养老储蓄设计及其对投资行为的影响 ['The devise of tax deferred retirement savings and its effect on investment behaviour'] (2010) 3 改革 [Reform] 54.

redistribution.[11] This means that the personal income tax system itself determines that any preferential policy will produce regressive effect, and thus the regressive effect of individual income tax deferral is not the original sin of individual income tax deferred pension insurance.

Therefore, granting policyholders who participate in personal pension insurance deferral benefits becomes a variant of ‘regressive tax’: the higher the income, the greater the reduction in tax and thus the better the effect of tax deferral. High-income earners, especially those whose income is within the mid-high range will obtain greater benefits. Yet, low-income earners only enjoy relatively low benefits, while those with an income level near or below the individual income tax levy threshold do not obtain any benefits at all. According to the ability-to-pay principle, high-income earners should be the main objects of tax levy for personal income tax. However, by participating in the individual income tax deferred pension insurance, high-income earners will own a legal tax-exempt account and gain a simple and effective tool to avoid tax. High-income earners can transfer a portion of their income in the form of premium into this account. Under the condition that real income is constant, their taxable income will be lowered and thus the benefit of low tax rate in the current period can be obtained. At the same time, high income earners can enjoy the benefits of tax exemptions for returns on investment and low tax rate for pensions. In theory, low-income earners can also enjoy the individual income tax deferral benefits. However, as their income is near the individual income tax levy threshold, the tax rate is very low or equals to zero in the first place. Therefore, the room for decline is very small. Moreover, under the condition of low income, it is already difficult to maintain the current living standards, not to mention savings for retirement. Thus, the introduction of the individual income tax preferential policy will widen, instead of narrow, the disparity between the rich and the poor. By extending the income gap one step further to the period after retirement, the interest of low income earners are indirectly damaged, causing greater distribution inequity, deviating from the established objectives of personal income tax.

(ii) Analysis of the sources of regressive effects

The taxation benefits of the individual income tax deferred pension insurance is reflected in three aspects: larger decline in current period’s tax rate, greater gap between interperiod tax rates and more tax exemptions for capital gains. The regressive effects of individual income tax deferral are also formed by these three constituents.

[11] 王亚柯, 吕惠娟 [Wang Yake and Lu Huijuan], 资产规模、覆盖率与替代率:国际视野的我国企业年金现状 [‘Asset size, coverage rate and substitution rate: the current situation of China’s corporate pension from an international perspective’] (2012) 8 改革 [Reform] 141.

First, there is a greater decline in current period's tax rate for high income earners. High income earners are the main objects of tax levy for personal income tax, and initially face a relatively high tax rate. To implement individual income tax deferral, whether it is to defer a fixed amount or a fixed proportion, to permit premiums to be tax deductible will decrease the current taxable income of high-income earners and significantly reduce their applicable tax rate, thus they can enjoy a considerable amount of current tax incentives. Low income earners initially face lower tax rates, therefore the individual income tax deferral will also decrease their current pre-tax income and applicable tax rate. However, this reduction will be very limited and low-income earners can only enjoy a relatively low amount of current tax incentives. Those with an income level near or below the individual income tax levy threshold will not be able to enjoy any benefits.

Second, there is greater tax exemption on capital gains for high income earners. The amount of individual income tax deferred proportion is mostly restrained on the basis of proportional limit. For high income earners, the amount deferred is greater and the accumulated funds in their accounts are larger. Hence, the corresponding return on investment is high. Relative to low income earners, tax-exempt returns on investment brings greater benefits to high income earners.

Third, the gap between interperiod tax rates is greater for high income earners. Under normal circumstances, high-income earners or low-income earners do not have any other sources of income besides pensions after retirement. Yet, during working life, the tax rate faced by high income earners is much higher than low income earners. Thus, the degree of difference in tax rate will vary when they pay premiums and receive their pensions. High-income earners can usually enjoy a greater gap between interperiod tax rates.

4. *Optimising the design of the system to suppress regressive effects*

As the individual income tax adopts the progressive tax rate, individual income tax deferral will inevitably produce regressive effects, i.e. 'reverse regulation' effect of income distribution. The design of the system must be optimised in order to take advantage of the individual tax deferral's incentive function, to promote the development of the pension insurance's third pillar and to keep the reverse regulation effect minimal. This will form an endogenous system that suppresses regressive effects, that preserves the system's fairness.[12]

(i) Implementation of the double limitation in proportion and fixed amount

[12] 钟华欣, 赵瑞娟, 张雄潮 [Zhong Huaxin, Zhao Ruijuan and Zhang Xiongchao], 试论我国建立个税递延型养老保险制度的可行性 ['On the possibility of establishing an individual income tax deferred pension insurance system in China'] (2011) 2 现代经济信息 [Modern Economic Information] 204.

As high income earners form the largest group of beneficiaries of individual income tax deferral, they have strong motivation to participate in the individual income tax deferred pension insurance, and may even take this opportunity to achieve their tax avoidance objectives. However, at the same time high income earners are the main object of the tax levy, and thus granting them tax incentives will create a great impact on government revenue. The tax rate for high-income earners is higher due to higher income, and if a relatively large deferral amount is granted to them, the regressive effects will be aggravated. To address the issues of the deferral amount, implementing the double limitation in fixed portion and in fixed amount will keep the difference in the pension insurance received and in the quality of retirement life controlled to a certain extent.

In terms of setting the deferral limit, the U.S. 401k plan is the most successful. As high income earners are more willing to transfer current period's income into their personal retirement account to achieve the tax avoidance objective, the U.S. not only set a proportional limit for the deferral amount, but also placed a cap on the total amount to stabilize its tax income in the current period. Individuals cannot pay more than 25% of their monthly income and cannot exceed the set limit every year. However, this limit is linked with the consumer price index and will be adjusted periodically. Since 2000, the limit has risen from USD$10500 in 2001 to USD$17000 in 2012. China should refer to the experience of the 401K plan and set a limit to the deferral amount to ensure its tax income and suppress the regressive effect. However, to ensure the quality of life after retirement, the deferral limit should be set reasonably (Wang Guojun 2012). Moreover, this limit should be linked with the consumer price index and adjusted dynamically to stimulate personal coverage and to stabilise government revenue.

(ii) Implement a system to phase out the deferral preferential policy for high income earners

As personal income tax adopts the progressive tax rate, individual income tax deferral will inevitably possess regressive effect. To suppress this type of regressive effect, a mechanism where the preferential policy phases out as income rises must be implemented, to link the deferral amount and income. As income rises, the deferral amount will be less or completely phased out. Therefore, the targets of the preferential policy will be those below a certain income level. The emphasis will be to stimulate middle to high income earners and to avoid giving high income earners excessive benefits.

On the basis of the proportion and fixed amount double limitation, the U.S. IRA plan specifically implemented a preferential policy phase out mechanism. Under the traditional IRA, if an unmarried employee participates in another pension scheme with tax incentives annual income exceeds USD$55000, and when his or her income reaches USD$65000, the deferral amount will be zero. If the total household income of a married individual exceeds USD$89000, the deferral amount in IRA will start to decrease and reaches zero when his or her total household income exceeds USD$109000. If an unmarried employee does not participate in another pension scheme with tax incentives at the same time, the deferral amount in IRA will not decrease as his or her income increases. This is to reflect the system's fairness and to protect stimulus of personal coverage. Not only can this phase out system, in which the deferral amount and income are negatively correlated within a certain income range, alleviate the regressive effect of individual income tax deferral to a certain extent, it can also apply the principle "Leistungsfähigkeitsprinzip" more strictly.

(iii) Direct provision of subsidies to low income earners

As personal income tax adopts the progressive tax rate system, high-income earners will gain greater benefits from individual income tax deferral while low-income earners will gain less or no benefits at all. This will create a Matthew effect on income distribution. For low income earners with income below the individual income tax levy threshold, the individual income tax deferral preferential policy performs no practical function. Stimulating low income earners to participate in personal pension insurance and to improve their self-support during retirement should be the core of the design of the individual income tax deferred pension insurance system.[13]

By offering every citizen two benefit options in the form of tax cuts and direct subsidies at the same time, Germany's Riester reform not only maintained the stimulus of tax incentives, but also controlled its regressive effect within a reasonable range. Furthermore, low income earners have been provided relief and their ability and enthusiasm to participate in the Riester pension have been improved, therefore reflecting the fairness of the system. In 2008, German citizens who chose tax cuts can gain the highest exemption amount of 2100 Euros per annum, which is used to pay the Riester pension. German citizens who chose direct subsidies can obtain an allowance of 154 Euros; however, employees must use 4% of their wages to pay for the Riester pension.[14] In addition, German citizens who participate in the Riester pension will receive an allowance of 185 Euros per annum for their children. Generally speaking, low-income earners will gain more benefits by choosing the direct subsidy, while high income earners can gain more benefits by choosing tax cuts. By providing two options, the Riester reform not only exploited the stimulus function of individual

[13] 周建再, 胡炳志, 代宝珍 [Zhou Jianzai, Hu Bingzhi and Dai Baozheng], 我国商业养老保险个税递延研究—以江苏省为例 ['Research on China's commercial pension insurance – case study on Jiangsu Province'] (2012) 11 保险研究 [Insurance Studies] 3.

[14] 李俊飞 [Li Junfei], 德国个税递延型养老保险改革及评述—以里斯特改革为例 ['Review of Germany's individual income tax deferred pension insurance – case study on Riester reform'] (2012) 3 武汉金融 [Wuhan Finance Monthly] 34.

income tax deferral aimed at middle to high income earners, but also used direct subsidies to suppress the regressive effect of individual income tax deferral, thereby achieving social equity.

Owing to different conditions, China's social structure is far from the optimal 'olive-shape'. With relatively greater social heterogeneity, large disparity between the rich and the poor, a smaller proportion of middle-income earners and a larger proportion of low-income earners, the potential regressive effect of individual income tax deferral will be significant. Therefore, when devising individual income tax deferral policies, China should refer to experiences of the Riester reform and allow middle to high-income earners bear more retirement responsibilities through tax incentives, thereby using more of the limited financial resources on low-income earners. Through direct subsidies, low income earners will be incentivised to participate in person pension insurance, thus assisting them in enhancing their self-support abilities and suppressing the regressive effect of individual income tax deferral.

(iv) Offering different deferral amounts to different groups

The regressive effect of individual income tax deferral not only exists among different income groups, it also appears within different age groups and occupation groups.

The demand for pension insurance will vary between individuals of different ages, and hence the regressive effect of individual income tax deferral will exist among different age groups. As retirement pressure is immediate and pressing, older workers, relative to younger workers, will have weaker ability to bear tax. If the deferral amount for different age brackets is the same, then relative to the potential demand for pensions, young people with stronger ability to bear the tax burden will receive greater security, while elderly people with weaker ability to bear the tax burden can only obtain minimal support. Owing to limited rationality, the employed are often inclined to seriously consider retirement issues as they approach retirement. Therefore, individual income tax deferral preferential policies should consider limited rationality of the public, and increase the deferral amount for older workers appropriately in order to provide them an opportunity to improve their self-support ability. For those above the age of 50, the U.S IRA permits an extra USD$1000 in addition to the tax exemption limit for those below the age of 50, to achieve fairness among insurants of different age groups. When enacting the individual income tax deferral policy, China should learn from IRA's practices and offer relatively high deferral amounts to older workers. During the transition period, individuals who are still working but are about to retire should be offered a relatively high deferral amount in order to increase the accumulation in these individuals' personal accounts, thereby achieving the expected replacement rate and ensure their security after retirement.

Furthermore, the regressive effect of individual income tax deferral exists among different occupation groups, especially among the employed, unemployed and self-employed. Restricted by the tax system and the power to levy taxes, the Chinese government cannot obtain information relating to the income status of individuals and households. Therefore, although individual income tax deferred pension insurance is categorised as a commercial pension insurance, individuals cannot participate independently and can only operate under the model where their individual participations are arranged collectively into a group by their companies or organisations,[15] i.e. all policyholders must participate in groups separated according to the different enterprises or institutions. As such, individuals with high and stable income will enjoy the benefits of individual income tax deferral, while individuals with low and unstable income, such as the unemployed, self-employed etc., cannot enjoy such tax incentives. Yet, individuals with low and unstable income lack endowment insurance the most and form the group that most needs insurance products with tax incentives to plan retirement. Likewise, as China's personal income tax adopts the classified income tax system, the individual income tax deferral policy currently can only be implemented for wage earners. Hence, large groups of individuals whose main sources of income are not wages, such as sole-proprietors and other self-employed individuals are excluded from the preferential policy. The U.S. IRA designed various IRA plans for different regional and occupation groups to choose from, in order to overcome the inequity among different occupation groups. When devising individual income tax deferred pension insurance, China should focus on wage earners. Simultaneously, other groups should be offered tax incentives through tax credits and introduction of accounts with multiple functions to suppress the regressive effect of individual income tax deferral across occupations.

(v) Enforcement of measures to restrict pension collection

Owing to limited rationality, the possibility of high income earners exploiting individual income tax deferral to avoid tax and other reasons, the successful implementation of individual income tax deferral preferential policy requires enforcement of strict measures to restrict pension collection, and the key is to restrict improper collection of funds or pension from their personal account.

As the aim of developing individual income tax deferred pension insurance is to stimulate individuals to participate in personal pension insurance through tax incentives and to save for retirement in advance, policyholders and their beneficiaries can only withdraw funds from their personal account in advance under exceptional circumstances, such as death and serious disability; otherwise, additional penalties

[15] 朱文君, 王裕明, 张宵临 [Zhu Wenjun, Wang Yuming and Zhang Xiaolin], 上海个税递延型养老保险的方案设计 ['The project design of Shanghai's individual income tax deferred pension insurance'] (2011) 9 劳动保障世界 [Labour Security World] 12.

apply.[16] Individuals who need to withdraw in advance due to death or serious disability are required to provide certification issued by relevant public security departments to prove the condition of the insured, and the insured must verify this. Additional penalties should apply to other situations where funds are withdrawn in advance, and the insurers should fulfill their withholding obligations. Moreover, those who enjoyed tax incentives must give up their right to cancellation. The aim of enforcing restrictions on withdrawals in advance is to prevent the participation in pension insurance for the purpose of tax avoidance. Furthermore, a minimum age to start collecting pensions must be set to prevent policyholders from succeeding their pensions to beneficiaries, thereby achieving their aim to avoid tax.[17]

5. Conclusion and recommendations

First, the existence of the regressive effect is inevitable. As personal income tax adopts the progressive tax rate, regressive effect will inevitably occur when the individual income tax deferral preferential policy is implemented, i.e. the reverse system to progressive tax rate. Both are two sides of the same coin. Under the conditions of the regressive tax rate, abandoning the individual income tax deferral preferential policy is the only way to completely remove the regressive effect. However, as the marginal tax rate of progressive tax rate is greater than the average tax rate and the substitution effect of taxation is notable, even if the benefit of deferring individual income tax is non-existent, high-income earners will use other measures to avoid tax. Hence, the regressive effect originates from progressive tax rate rather than the individual income tax deferral policy.

Secondly, the policy objectives of the individual income tax deferred pension insurance and the personal income tax are different. Every system has its own design goals. The aim of the personal tax is to regulate income distribution in order to prevent the widening of the income gap. Progressive tax rate is a major tool used to achieve this aim. The objective of the individual income tax deferred pension insurance is to motivate middle to high income earners to participate in personal pension insurance and to encourage them to enhance their self-support ability so that they can bear their own retirement responsibilities, thereby promoting the development of the third pillar of pension insurance and improving the multi-pillar elderly security system. Therefore, the individual income tax deferred pension insurance and the policy objectives of personal income tax are not completely compatible: the former cannot and does not

[16]柯甫榕, 涂东阳, 钱敏 [Ke Furong and Tu Dongyang, Qian Min], 推进个税递延型养老保险试点 [‘Promote the individual income tax deferred pension insurance pilot program’] (2012) 19 中国金融 [China Finance] 59.

[17]李超, 魏巧琴 [Li Chao and Wei Qiaoqin], 我国延税型个人养老保险相关问题的探讨 [‘Investigation on issues related to China’s individual income tax deferred pension insurance’] (2010) 6 上海保险 [Shanghai Insurance] 8.

need to contribute to accomplishing the goal of the latter. Likewise, although a function of the social security system is to regulate income distribution, this is not the main purpose of the system. The principal goal of social security system is to provide effective elderly security to all members of the society and to control regressive effects within a tolerable range. The task of regulating income distribution should be completed through the personal income tax.

Thirdly, the target group of individual income tax deferral preferential policy is middle to high income groups instead of low income groups, which need social security the most. Through tax incentives, middle to high income earners have the enthusiasm and the ability to participate in personal pension insurance, thereby bearing a portion of their own retirement responsibility. Due to low income, individual income tax deferral cannot stimulate low income earners to participate in personal pension insurance. Therefore, demanding individual income tax deferral to directly 'benefit low income earners who need elderly security the most' is evidently a wrong interpretation of this policy. Low income earners are not the target group of individual income tax deferral preferential policy. However, this does not imply that low income earners cannot become the final beneficiaries of this preferential policy. Through using tax incentives to stimulate middle to high income earners to transfer a portion of their retirement responsibilities to themselves, China can concentrate its financial resources to achieve the 'full coverage' of basic pension insurance. Provide basic support', or even directly offer low income earners subsidies to counter the regressive effect of individual income tax deferral. Hence, low-income earners can directly benefit from subsidies, instead of enjoying benefits from the individual income tax deferral, which they do not have the ability to take advantage of. Undoubtedly, the fact that the individual income tax deferral preferential policy is termed as 'preferential' implies that not all social groups can become beneficiaries. Otherwise, the term 'preferential' should not exist.

Fourthly, individual income tax deferred pension insurance is conducive to improving, rather than lowering, the support level of low income earners. The elderly security system possesses the redistribution function and does not require or imply that every pillar of the elderly security system have the redistribution function. The first pillar, 'full coverage and basic support', aims to provide every member of the society with elderly support and to seek fairness in the elderly security system. It has the characteristics of public goods and can only be provided by the government. The second and third pillars belong to the supplementary pension insurance system, and are aimed at linking the pensions received by individuals and their contributions. This is to stimulate companies and individuals to bear a portion of their retirement responsibility and to decrease the retirement pressure on the first pillar, thereby reducing the retirement burden on public finances. These two pillars can 'facilitate workers to gain societal benefit under the principle of equity' (Xiang Ling, 2007), because 'equity' itself does not refute the positive correlation between pensions received and individuals' contributions. The establishment of the second and third pillars is aimed at utilising the market mechanism to improve the security level of participants and to improve living standards after retirement. These pillars have characteristics of private goods, and should prioritise efficiency while taking into account equity, instead of pursuing equity as the sole objective. As long as the regressive effect of individual income tax deferral can be controlled within a tolerable range, the public should bear the existence of such effect and pass on the 'basics' that middle to high income earners require which the Chinese government cannot guarantee. Therefore, the limited financial resources can be used to concentrate on providing 'basics' required by low income earners and to achieve 'full coverage' of basic pension insurance as soon as possible, thereby completing the 'merger' of two pension systems, enhancing overall planning and facilitating labour circulation. Therefore, while the introduction of individual income tax deferral pension insurance appears to create regressive effect, it is conducive to improving the benefits of middle to high-income earners. By transferring a portion of the retirement responsibility of middle to high-income earners to themselves, China can focus its efforts on supporting the retirement of low-income earners. In the long term, this will benefit rather than harm the improvement of low income earners' welfare. Hence, workers should receive relatively equal preferential treatment. Moreover, the design of the system should promote efficiency, fairness and harmony, but the efficiency of every pillar need not be sacrificed to ensure fairness. In short, fairness is the core issue that pension insurance seeks to resolve, while efficiency is a problem that needs to be solved by individual income tax deferred pension insurance. Fairness and efficiency are interdependent rather than contradictory.

Finally, individual income tax deferral has its advantages and disadvantages, its advantages should be utilised while its disadvantages should be restrained. In practice, the accomplishment of any policy objective will have corresponding costs. Therefore, costs must be paid for the Chinese society to achieve the policy objectives of the individual income tax deferred pension insurance. China needs to give up some tax levy power and a part of its tax revenue if it intends to transfer a portion of middle to high income earners' retirement responsibility to themselves, rather than having the government bear the entire retirement burden. This means that China wishes to provide less elderly security and retirement responsibility. The tax incentive of individual income tax deferral is this type of 'tax expenditure', 'hidden cost' and 'indirect subsidy'. Owing to the acceleration of the aging population, it is imperative for China to improve its pension insurance system. Under the constraints of a disparity between the rich and the poor and a low income per capita, middle to high income earners are a possible group that can enhance the personal supplementary pension insurance. Individual income tax deferred pension insurance aims at incentivising middle to high income earners to participate in personal pension insurance, thereby creating a relatively great stimulus effect on middle to high income earners and increasing middle to high income earners' demand for individual income tax pension insurance. This is the initial objective when devising the individual income tax deferred pension insurance system. However, the actualisation of this objective will inevitably lead to the regressive effect of income redistribution reverse regulation. In fact, under the condition of great social heterogeneity, any preferential policy will improve the welfare of some group, but at the same time harm the interest of another group (Wang Guojun 2012). Yet, compared to tax fairness, China faces greater pressure to improve its pension insurance system. The society needs to utilize the tax benefits of individual income tax deferral to promote the development of the third pillar of pension insurance, and while regressive effects cannot be removed, measures can be taken to suppress the influence of regressive effects (Kitano Hirohisa 1996). From an international perspective, there is no strong evidence to suggest that individual income tax deferral will cause a widening of the gap between the rich and the poor (Yang Yansui 2012). Hence, to tackle the aging population crisis through enhancing the social security system, the regressive effect of individual income tax deferral should be tolerated to a certain extent (Tang Yun 2012). In addition, the regressive effect of individual income tax deferral should be treated dynamically. Although China’s social heterogeneity is relatively great and the size of the middle-income earners is comparatively small, the size of the middle-income earners will increase along with economic development and increase in income per capita. Consequently, the regressive effect of the individual income tax deferred pension insurance preferential policy will be reduced and the social security level will increase steadily due to this policy.

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