Pension Reform in China: Its Progress and Challenges

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(Preliminary Outline)

1. Introduction
The presentation consists of three parts. The first part (Section 2) reviews the current old age pension arrangements focusing on the changes in recent years and outstanding problems. Section 3 discusses the problems concerning the transition from the old to the new system. Section 4 analyzes the financial issues of the transition and the conditions for ensuring the financial sustainability of the system.

2. The Current Pension Arrangements
2.1. Three Component System
The current Chinese pension arrangements consist of three components:

- A system that in principle covers most of urban employees.
- A system for government employees, armed forces and employees of public (but non-governmental) institutions such as universities and research institutes.
- A system for the rural population.

The first two are mandatory, the first only in principle but not in practice. The third is voluntary. The principal characteristic of these schemes is that they are run completely independently of each other. They are managed by different institutions and are financed differently. However, they share one common characteristic: they are all highly decentralised. Leaving aside the arrangements for government and public employees, the first is largely organised at the level of cities and the third at the level of villages or townships (the lowest government tier in rural areas). The important point is that the units of organization are too small to provide sufficient risk pooling for a sustainable pension scheme. Both the urban (the first) and the rural (the third) are in transition in that their final design remains yet to be decided.

2.2. Pension System for Urban Employees
Following a period of discussions and test trials, the principal foundations of the new pension system for urban employees were laid down in the 1997 State Council Circular. Compared with the old system, the new system introduced the following three important changes:
The old-age pension would cover the whole of the employed labour force, including the self-employed. Various industry specific pension schemes would be incorporated in the unified scheme.

The responsibility for the operation of the pension scheme, including the keeping of employee records and the payment of pensions, would be transferred from units of employment (work unit in Chinese terminology) to government agencies. The process is known as “socialisation” in China and “government agencies” refer to the Ministry of Labour and Social Security (as the Ministry of Labour was renamed in the 1998 governmental re-organization) and its territorial subsidiaries, Bureaux of Labour and Social Security at the provincial and municipal level.

The old-age pension would be multi-tiered. which after successive modifications is structured as follows:

<table>
<thead>
<tr>
<th>Tier</th>
<th>Pay-Out</th>
<th>Financing</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>A</td>
<td>Defined Benefit, equal to 20% of the Average local wage</td>
<td>PAYGO. Paid from a social pool financed by employer contributions with the government making up any deficit</td>
</tr>
<tr>
<td>2</td>
<td>B</td>
<td>Defined Contribution, dependent on accumulated reserve in the individual account</td>
<td>Pre-funded, in principle but as yet not in practice. Financed jointly by employers and employees, From this year only financed by employee contributions.</td>
</tr>
<tr>
<td>3</td>
<td>Voluntary</td>
<td>Employer sponsored</td>
<td>Employer contributions</td>
</tr>
</tbody>
</table>

Note: PAYGO: Pay-as-you-go

Effectively only the first tier (or pillar) is operational but its details are not fully finalized. The Pillar 1A (hereafter referred to as Pillar A), which is set at 20-30% of the local wage, is aimed at making sure that pensions cover a minimum subsistence for the locality. The exact percentage would depend on the number of years of contribution. The maximum of 30% would be payable to participants with contribution record of 15 years or more. Since 30% of the average wage may not be sufficient to cover a minimum subsistence, the assumption is that in most cases there would be at least enough in Pillar 1B (hereafter referred to as Pillar B) to cover the difference. Pillar B is an earnings-related component and tightly linked to the contribution record over the employee’s working life. Pillar A has a re-distributive aspect to it in that all retirees get between 20-30% of the average regardless of their actual wage before retirement.

The 1995 State Council circular that first introduced the new system set the goal of establishing a unified and socialized pension system by the end of 1999, a goal that has been realised in principle but yet not in practice.

The two-pillar system (A & B) follows principles that have been tested and tried in many countries. It is geared to fulfilling two principal aims of an old-age pension system on the benefit side: first, preventing

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1 The arrangement for the financing of 1A was changed at the end of 2000. The earnings-related component is to be financed entirely from employee contributions with all employer contributions going into the social pool. There was in addition also a voluntary employer-sponsored supplementary pension.
poverty amongst pensioners and, second, helping to maintain a living standard in retirement that conforms to earnings over the working life. The system also addresses the long-term financing issue by introducing the pre-funding of what eventually would be a larger component of the pension. The rest of the presentation goes on to discuss particular aspects of the system.

3. The Benefit Side and the Transition Period
The benefit side of the new system (consisting of Pillars A & B) would not raise any major problem if it concerned an entirely new pension system. That is, a system which covered only new entrants to the labour force or employees with a long enough remaining working life to qualify for a full pension. The qualification is 10 years of continuous employment or 15 years’ total employment with periods of unemployment in between. To accumulate enough in the earnings-related component (Pillar B) so that the pension is commensurate with income over working life would require more than 15 years, likely between 25 to 30 years allowing for periods of unemployment. The implication is that Pillar B would not be fully operational before 2025-2030. This underscores that the period of transition will be long and raises the important issue of how to, first, determine and, second, finance the pensions of those who retire before the transition is completed.

To bring out the issues concerning the transition, the current and the future population can be divided into three categories:

♦ Those who retired before the introduction of the new system (that is, before 1998) – referred to in China as the “old group of pensioners”.
♦ Those who retire after the introduction of the new system but before the completion of the transition (that is, between 1998 and approximately 2025)) – referred to in China as the “middle group of pensioners”.
♦ Those who retire after the completion of the transition (that is, after, say, 2025) – referred to in China as the “new group of pensioners”.

The benefit formula for the first two categories is defined as follows:

♦ “Old Group”: pension determined according to the old formula (described below).
♦ “Middle Group”: the higher of the old and the new formula.

Focusing on the “middle group”, it would start to become preferable to switch to the new formula sometime after 2020. Thereafter there would be a period when some new pensioners would opt for the old formula and some for the new formula. To see how long pensioners would be receiving pensions determined according to the old formula, we have to take into account the average number of years in retirement. Relative to average life expectancy at birth of around 70 years, the retirement age is low in China: 60 years for men and 55 for women. In fact, a large number of workers retire before the prescribed retirement age. Although the new assumes the average period of retirement to be 10 years, the actual period is at least 15 years. Taking 15 years to be the average period in retirement, a large majority of pensioners
until 2030 or even later would be receiving pensions according to the old formula.

Focusing on the old formula, cash pensions are determined by a simple formula that is uniform across employment units, with a special treatment for particular categories of pensioners. Leaving aside inflation indexation, a full monthly pension is equal to a percentage of usually the last basic salary, which can be significantly lower than total salary. The qualification for a full pension is minimum 10 years of continuous employment or 15 years of intermittent employment. The replacement percentage depends on the rank and the dates of recruitment and of retirement. Currently the average replacement percentage (the ratio of the average pension to the average wage) in the state sector is around 75%.

The replacement rate of 75% is more generous than what is usual in most economies. However, many pensioners live in poverty. The average wage was low until the early 1990s, when many of today's pensioners retired. Full pensions are subject to a floor, set slightly higher than the local poverty line, which in some cities can be lower than what is needed to sustain a socially acceptable living standard.

Turning to other features of the benefit side of the old system that bring into focus the rationale behind the benefit structure of the new system. Among them of special importance is the use of last basic salary in the pension formula, which is a feature of many pension systems especially in economies in transition from a planned to a market economy. This raises two issues: first, arbitrariness in the level of pensions and, second, the possibility of the abuse of the system. These issues did not arise in the pre-reform period, when wages were centrally determined, employment was for life and employees had the same or similar income profile over the working life. None of these features hold in the present-day Chinese economy after 22 years of reform. Wage determination has been delegated to work units and government control over wage determination is of little significance. Lifetime employment that was previously the norm has largely been replaced with terminable employment. With the increasing importance given to performance related component in wages, the link between salaries and length of employment is much weaker than it was before the reforms. These changes have introduced wide variations in lifetime income profiles of individuals and thus diluting the link between their lifetime income and their incomes at retirement, or over a short period. For example, two individuals with exactly the same number of years of employment and lifetime income may get very different pensions merely on the basis of income at retirement. Moreover, the final wage rule introduces an element of arbitrariness in the treatment of different cohort of pensioners. The growth rate of wages has not been uniform but highly uneven. This means that two employees with exactly the same work history but retiring a year apart may get very different pensions.

To assess the benefit side of the old system, we have to take into account the following three elements:
Pensions are determined with reference to wages/salaries a short period before retirement.

Wages are no longer determined by the government but by enterprises.

Pension costs are pooled across enterprises.

These three factors both make it possible and provide an economic incentive to enterprises to be generous to older employees by granting them a higher basic wage at the end of their career, hence a higher pension in retirement. The cost to an enterprise of doing so is small because pension costs are pooled across enterprises. This phenomenon is known as “free riding” and its consequence is an increase in the total cost of pensions. It may also be a source of arbitrariness in that some employers may avail the opportunity but others may not. Evidence on this is necessarily anecdotal, but the opportunity and the incentive for the abuse of the system exist. Pillar B in the new system deals with the problem by determining the earnings-related component to the accumulated contributions in individual accounts over the working life. But given the long transition period of 25 to 30 years, the problem is far from solved. In principle, creating notional accounts for the period preceding the introduction of the new system can solve the problem. The creation of notional accounts raises two problems, each of which is massive.

The first is the logistic and administrative problem of creating notional accounts spanning 40 to 50 years. The problem is magnified by the fact that data on employment history are in most cases not held by Labour and Social Security Bureaux, who are now responsible for operating the pension system, but dispersed across a large number of employment units. Further, in most cases the data is not stored in a computer readable form. The second problem concerns how to finance the notional account, to which we now turn.

4. Financing
4.1. General Features
The current Chinese pension system operates under the dark shadow of the massive overhang pension liabilities accumulated over a period of 50 or so years by the old system. Since the abolition in the 1960s of the national pension fund, pensions have been financed entirely by employers either individually, as until the mid 1980s, or by pension pools since then. The old system was pay-as-you-go in the sense in that contributions broadly equaled pension expenditure, aside from a small deficit or surplus, and there was no accumulation of funds to finance future pension liabilities. As compared to other pay-as-you-go systems, the Chinese system had two very special features:

- It operated on the basis of very short-term considerations, geared to financing immediate pension liabilities and characterized by a rudimentary forward planning of benefits and contributions.
- It was highly decentralized in financing as well as administration, which are also central features of the present system.
Neither of the two is intrinsic to a pay-as-you-go system. The old system has left behind a legacy of huge liabilities and a comparatively very small volume of assets, which has had two effects:

♦ By default the liabilities of the old system have been transferred to the new system.
♦ As a result in many cities employers’ contribution far exceeds the ceiling of 20% of the wage bill laid down by the State Council, reaching as high as 30% in many cities and some provinces.

Delays and default in the payment of social insurance contributions on the part of state enterprises (SOEs) in difficulty have been common since the second half of the 19990s. This has been associated with two adverse effects:

♦ Many pensioners receive their pensions after a long delay or in some cases not at all. Thanks to the pressure and funds from the central government the problem has diminished but not disappeared. Moreover, delays and default on pension obligations will remain a permanent feature of the system until a way of financing the massive overhang of liabilities left behind by the old system is found.
♦ The earnings-related component (Pillar B) of the new system is largely notional. Employee contributions and a part of employer contributions that are supposed to go into individual accounts to pre-fund Pillar B are largely used up to cover existing pension liabilities.

Thus the pension system as it currently operates is the new system only in name and still the old system in practice.

4.2. Options for Financing the Overhang of Pension Liabilities
This points to the fundamental problem: it is simply infeasible to use the payroll contribution to do both finance the massive overhang of unfunded pension liabilities and also fund the earnings related component of the new scheme. The contribution rate this requires is too high to be enforceable. To give an idea, in the state sector the current pension payment alone in 1999 came to around 22.7% of total earnings in the sector. The new pension scheme envisages a contribution rate of 11% total earnings to fund the earnings related component\(^2\). The two together come to 33.7% of the total earnings, which is already 14 percentage points higher than the guidance ceiling of 20% laid down by the State Council. To this one should add another 15% or so of the wage bill in contributions to medical insurance, unemployment and maternity benefit and disability compensation.

The policy implication is that the sustainability of the old-age pension provision over time requires a separation of the funded component of the new pensions schemes from the unfunded pension liabilities left behind by the old system, and the financing of the latter from sources other than the payroll contribution. In principle this is provided by the State Council Circular of 2000

\(^2\) The State Council Circular of 2000 has reduced the contribution rate to the earnings-related component from 11 to 8%, which is to be financed entirely from employee contributions.
and moves towards setting aside a percentage of proceeds from the sale of state shares in enterprises in a fund to finance the overhang of pension liabilities. The suggested figure is 10%. But the details of a full solution to the problem remain yet to be decided.

4.3. Government Contribution and the Budgeting Unit
The new pension scheme envisages a government contribution towards the basic pension (Pillar A) in addition to the employers’ contributions. The introduction of a government contribution towards urban social security, rather than being a novelty, simply formalises what has implicitly been the case. Municipal governments have long subsidised old-age pensions and health care expenditure of loss-making enterprises in their charge. There is also a fiscal justification for a government contribution in that it partially spreads the cost of urban social security across the whole of the tax base rather than concentrating it all on the payroll tax, which is a tax and is already high in China. The principal problem in the government financing of urban social security is that it takes place at the level of municipal governments. The social insurance budget is compiled at the highly disaggregated level of 226 cities; the surplus at the national level goes together with unsustainable deficits in numerous cities, a problem that can be addressed by upgrading the level of budgeting to provinces. The fiscal capacity of municipal governments in China varies very widely and there is at present no regular system of fiscal transfers across municipal governments within a province, let alone across provinces. As a result, municipal governments caught in the pincers of an eroding tax base due to the poor financial performance of local enterprises, on the one hand, and a rising expenditure on social security benefits, on the other, find it very difficult to meet their statutory obligations. As a result, although urban social security schemes are supposed to be fairly uniform, the coverage of the schemes and the level of benefits vary widely across cities. The pooling of social security contributions and expenditure at the provincial level is the professed policy aim but most provinces do not have a road map for the province-wide integration of social security schemes.

4.4. Long-Term Viability of the Pension System
Leaving aside employees of the government and of public institutions who are served by a separate system, the total number of participants in the urban pension scheme is 86.7 million, which is around 46% of the urban labour force that should be covered by the system. The 86.7 million participants are distributed as follows across different types of enterprises:

<table>
<thead>
<tr>
<th>Enterprise Type</th>
<th>% of Participants</th>
</tr>
</thead>
<tbody>
<tr>
<td>State-Owned</td>
<td>74.6</td>
</tr>
<tr>
<td>Collective</td>
<td>17.1</td>
</tr>
<tr>
<td>Others</td>
<td>8.3</td>
</tr>
</tbody>
</table>

Although the pension scheme, in principle, covers the whole of the urban labour force, around 92% of contributors are from state and urban collective
The problem is that the percentage of the urban labour force employed in state and collective enterprises has been falling since the middle of the 1990s and the trend is likely to continue. Excluding government and other public employees covered by another scheme, state and collective enterprises currently employ less than 50% of the urban labour force.

The total number of pensioners covered by the urban pension scheme totals 28.6 million, which means that there are 33 pensioners per 100 contributors. The ratio of pensioners to contributors is likely to fall given the trend towards a reduction in the number of employees in state and collective enterprises. Every lay-off in the state or the collective sector means one less contributor, while the number of pensioners remains unchanged. It may even mean an increase in the number of pensioners because laid-off employees of state enterprises are often allowed to retire well before the age of retirement. Here it is important to emphasise the current high ratio of pensioners to contributors and the rising trend has little with the demographic phenomenon of ageing. They simply reflect the fact that the urban pension system is largely limited to state and collective enterprises, which are shedding labour. Leaving aside other aspects of financing, the urban pension system is not sustainable without a substantial increase in the number of participants from non-state enterprises.

The possible sources of new participants are foreign-invested and private enterprises in urban areas and rural enterprises. But the extension of the old-age pension scheme even in urban areas faces two closely related problems. The first is the operational one of collecting contributions from small enterprises with a rapidly rising share of urban employment. The second is the doubtful credibility of the promise of a pension in the distant future in return for contribution over the near future, which is what the extension of the scheme to non-state sector employees would involve. Given the widespread delays and default on the payment of pensions to current retirees, this promise does not inspire confidence. The implication is that the possibilities of partly financing the rising cost of old-age pensions in the short to medium term by extending the coverage of the scheme are extremely limited. Raising the contribution rate does not provide an answer either. As pointed out above the contribution rate is already too high. A rise in the contribution would accentuate an already serious problem of non-compliance and further impede an extension of the scheme. The implication is that the future sustainability of the scheme depends crucially on, first, funding the pension liabilities left behind by the old system and, second, on part government funding from general tax revenue.

For the present purposes collective enterprises can be regarded as a form of state enterprises.