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Pension Reform in China

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Background

China is a large, diverse, developing country with a very high rate of economic growth. Its record of reform and development over the last two decades has been one of the best—if not the best—in the world. Since the beginning of the market-based reforms in 1978, China has enjoyed strong economic growth, averaging 12% for the five-year period ending in 1995, slowing recently to about 8%.

China, however, faces a number of serious issues in its development. The rapid growth has widened the rift between rich and poor. Issues related to the effect of the rapid aging of the Chinese society on pensions and health care are a high priority of the government. Almost unique among the low-income countries, China has an extensive social security system for its urban workers, a system which is facing problems similar to those faced by the high-income countries.

With two decades of pronatalist policies in the Mao era followed by two decades of "one child" policy, China's demographic profile is particularly distorted. The baby boomers of the 1950s and 1960s will join the pool of pensioners in 2010-2020 precisely when the labor force growth, and thus the growth in pension contributions, will be slowing down dramatically as a result of the one child policy. The percentage of population 65 and older will double by 2025, reaching about 12%, only marginally lower than the same percentage for the United States, Canada and other developed countries. Thus China will have an old age problem similar to the developed countries, while it will still be a middle-income country without the resources of a developed country.

On top of this demographic burden, China has a challenge to reform state-owned enterprises, which is linked with its pension system. State enterprise reform is a national priority, but implementing it requires a social safety net for employees whose pensions had

been provided by the state-owned enterprises.

The Chinese government recognized this need, and in July 1997 mandated the introduction of a new unified pension system. In 1998, the government combined the Ministry of Labor with other parts of the government concerned with pensions to form a new Ministry of Labor and Social Security (MOLSS), with the clear mandate to implement the new social insurance system.

Pension reform will contribute in an important way to overall economic reform. First, by de-linking enterprise management from pension provisions, these reforms will help accelerate the reform of state-owned enterprises (SOEs). Second, pension reform will contribute to development of capital markets and provide a pool of long-term savings that can help finance infrastructural development. Third, these reforms would contribute to social and political stability by providing financial security to current pensioners and those close to retirement, many of whom are facing hardships and uncertainties about the future.

China Pension System Benefits, Contributions and Pooling - Current State

By late 1998, substantial progress had been made in implementing the new pension system. Some adjustments or clarifications to State Council Document 26 had been made in this process of implementation. Basic decisions on covered workers, contribution and benefit levels, transition rules and pooling of funds have been reached. Progress in these areas is described in more detail below.

Covered Workforce

Prior to the new reforms, only urban workers of state-owned enterprises were covered. The reforms brought workers of private and collective enterprises,

other than agricultural workers, into the system. Thus, the expansion in coverage applied to 1995 data would increase the number of covered employed persons from about 110 million to over 300 million.

Benefits Overview

Employees of state-owned enterprises were already covered under existing fairly generous benefit programs. Before 1998 pension benefits were about 75% of final salary. After retirement, the pension is generally indexed in accordance with increases in average wages although some plans will use inflation. Benefits are not subject to income tax, and are not subject to income or means testing.

New benefits rules will apply under the new pension program for retirees after the transition date. The new pension system features:

- A new three component pension approach
- An extension of the coverage to other than urban SOE employees
- The transfer of the pension assets and liabilities from the Enterprises to the new provincial social pools

The main components of the new system are described below.

Pillar I Defined Benefits

Pillar I provides a defined benefit component generally set at 20% of the average wage for the last calendar year for each province. This benefit is indexed to average wage increases, by virtue of the benefit formula. These benefits are only paid if the worker has contributed for at least 15 years.

Benefits are payable at age 60 for men, at age 55 for women who held management positions and at age 50 for other women. Benefits will not vary based on marital status or dependents. After death of the retired employee, there are no death benefits to spouses or

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dependents. Early retirement is only permitted in special instances authorized by the government policy.

Employer contributions to fund these benefits plus the transition benefits (see Table 2 on page 13) generally start at a rate of 13% of wages in 1998, increasing by 1% every two years to reach 17% in 2006. Contributions are paid into, and benefits are paid from, the provincial social pools.

employee contributions. In the future, the employer rate of contribution will decrease by 1% and the employee rate will increase by 1% every two years until the ultimate level of 3% from employer and 8% from employee is reached in 2006.

Interest is credited on the accounts at the bank rate of interest, which in recent years has represented a real rate of return close to zero.

accounts are exhausted, benefits are paid from the provincial social pool.

Account balances are not available prior to retirement in the case of disability, unemployment, other hardship, or any other reasons except death. Nor are the accounts available to be borrowed, or pledged as collateral for loans. In the event of death, individual benefits and accumulated interest are paid to the beneficiaries. Accumulated employer contributions are transferred at death to the provincial social pool.

Table 1

Total Population	1995	1996
Urban Areas	351.7	359.5
Rural Areas	859.5	864.4
Total	1211.2	1223.9
Total Number of Employed	1995	1996
Urban Areas	190.9	198.1
Rural Areas	488.5	490.3
Total	679.4	688.4
Number of Employed	1995	1996
Urban Areas		
State Owned Units	112.6	112.4
Urban Collective Owned Units	31.5	30.0
Other Types of Ownership	8.9	9.7
Private Enterprises	4.9	6.2
Individuals	15.6	17.1
Not Categorized	17.4	22.7
Rural Areas		
Township and Village Enterprises	128.6	135.1
Private Enterprises	4.7	5.5
Individuals	30.5	33.1
Not Categorized	324.7	316.6

(Source: China Statistical Yearbook, 1997, in millions)

Individual Account Benefits

Individual account benefits are based on mandatory individual account accumulations representing a portion of the contributions from the enterprise attributed to the employee's individual notional account plus a percentage of wages contributed by the employees. Combined contribution rates are currently equal to 11% of wages, 7% from employer contributions and 4% from

Account balances are annuitized at retirement by simply dividing the accumulated value of the individual account, including accrued interest, by 120. This factor does not vary by age at retirement or marital or dependency status. Benefits are guaranteed for life, with a 10-year certain period (but there is no other spousal or dependent benefits beyond that 10 years). The benefits are indexed for wage inflation. After the

Supplementary Pensions

Benefits under the prior programs will only partially be replaced by Pillar I defined benefits and the individual account benefits, even after time has allowed the account balances to accumulate. Consequently, supplementary pensions will be made available on a commercial basis for those who wish to supplement the pension income arising from mandatory contributions. These supplementary pensions will be voluntary; they may be provided through employer-based or individually purchased programs.

Transition Benefits

For employees earning pension rights under the old system and current retirees, a transition plan is necessary to ensure adequate benefits and fairness. Those currently retired will receive the same benefits that are currently being paid to them, with future indexation for wage increases, drawn from the provincial social pool. Employees who were working under the old system and who reach retirement under the new pension system will receive the full benefits of the new system plus an additional transition benefit, the formula for which varies by province.

As an example, one province provides 2% of salary per year of service up to 20 years, plus 1% of salary for each additional year up to a maximum of 35%, for each year of service prior to 1998. These percentages are applied to the weighted indexed

earnings for 1992-1997, and the benefit is indexed for future wage increases.

In some cases, employees covered under the prior special industry plans for 11 industries had somewhat more generous benefits. In those cases, the benefit levels (and sometimes also contribution rates) will be graded from those higher levels into these new provincial plan levels over a few years.

Pooling

All provinces are expected to move to provincial pooling of contributions and benefits by 1999. The previously separate special industry plans have had

including the difficult problem of the current unfunded liabilities. For several provinces or municipalities, the mandated employer contribution rates are not enough to meet the needs of pensioners. For the newly covered sectors such as township and village enterprises. Employer contribution rates are relatively high compared to their benefits (due to the need to fund the liabilities to those previously covered), which may create some problems in compliance. The individual accounts are largely notional accounts and the pension system may face problems when the payments become due on these accounts.

lower replacement rates than the old one, projected to be around 50% of final salary for the mandatory components combined. There is a tremendous need for supplemental pension plans to raise the replacement ratios. The new law provides for introducing those, but the system for doing that needs to be defined from scratch. Given the high savings rates in China, the potential long term market there is huge.

Finally, capital market reform will need to be continued to provide investment returns that can make these benefit and contribution levels balance. Earlier World Bank studies suggested that a real return of 0% would fall far short, while a real return of 3% would likely suffice. The growth of supplemental pensions could fuel the growth of capital markets. In addition, some government officials advocate that the mandatory individual accounts eventually be moved to privately managed employer-based plans, which could add tremendously to the growth of private capital markets.

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Table 2

	Employer Contribution to Social Pool	Employer Contribution to Individual Accounts	Individual Contributions	TOTAL
1998	13%	7%	4%	24%
2000	14%	6%	5%	25%
2002	15%	5%	6%	26%
2004	16%	4%	7%	27%
2006	17%	3%	8%	28%

(Source: China Statistical Yearbook, 1997, in millions)

their separate provincial asset pools added to the SOE pension funds. Contributions are paid into these pools, and benefits paid from them at the local level. The enterprises have no legal liability for benefits, beyond paying their contributions. There are some provisions for transfers to provinces where current contributions cannot cover benefit obligations.

Issues Still to be Addressed

While the broad framework for pension reforms has been determined, there are still a number of issues to address,

The contribution and benefit levels in general do not reflect rigorous actuarial analysis, and much further testing must be done. The impact of the benefit scheme and of the transition plans on various sectors of the society must be further evaluated.

The system also requires a lot of details for implementation—new legislation, regulations and regulatory processes, and administrative and management information systems. Along with this a massive amount of training to adapt to the new system is needed.

The new system provides much