Pension Reform in China: Five Pillars of Transformation

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Overview of China’s Pension System

• The present pension system:
  • Pension for Urban Workers and Staff (PUWS);
  • New Rural Pension (NRP)
  • Pension for Urban (Non-Working) Residents
• The later two is to integrated into one program.
Policy Issues and Challenges

• The very high mandatory contribution rates for PUWS tend to curb the participation of low-income workers such as migrant workers and those employed in small and medium-size enterprises and in the informal sector.

• Locality pooling and the consequent fragmentation of the pension system lead to lack of economies of scale and high management costs, resulting in inefficient performance of the system.

• Central government regulations restricting investment vehicles for the pension funds lead to very low or even negative real returns.
• The substantial disparities in pension benefits between Government Insurance and the PUWS, and between urban and rural schemes.

• The rural-urban and inland-costal migration implies huge transfers in the form of pension contributions in the same direction.

• The financial sustainability of the pension system presents another serious challenge. At present, most public pension programs are heavily subsidized by the government.
• The “empty” individual accounts in the PUWS totaled more than Y 2 trillion at end-2011 and will continue to grow.

• Population aging and the consequent decline in the system support ratio will generate a large implicit pension debt in the decades to come.
• The impact of the above-mentioned problems goes beyond the pension system itself.

• The fragmentation of the pension system places barriers to spatial and social mobility of labor, impeding the development of an integrated national labor market.

• The second pillar of the PUWS is not allowed to invest in the capital market, thus preventing the scheme from being an important investor in the market.
A Proposed Framework of Five Pillars of Transformation

• I suggest a five-pillar pension system based on the current three-pillar system.

• the zero pillar is a noncontributory pension funded by the central budget, covering all urban and rural elderly 65 years and older.

• The first pillar is the national social pooling account based on defined-benefit and PAYG principles, covering all urban workers and the self-employed, at a lower contribution rate.
• The second pillar is the mandatory individual saving accounts operating as part of fully funded defined-contribution schemes, managed and operated nationwide by specialized pension asset management companies.

• The third pillar comprises voluntary occupational schemes, encouraged by favorable tax treatment.

• The fourth pillar is familial support to the elderly.

• I also suggest detailed measures to ensure a smooth transition from the old to the new system.
Zero Pillar: Noncontributory Pension for All Elderly

• China’s present pension system cannot provide the low-income elderly, especially the rural elderly, with adequate retirement incomes.

• Some studies propose noncontributory pension (or the “citizen pension” or the “zero pillar” pension) be introduced into China’s pension system (e.g., Holzmann and Hinz, 2005; Barr and Diamond, 2010; World Bank and Development Research Center of the State Council, the People’s Republic of China, 2013).
• Already practiced in some countries such as Australia, Canada, Chile, the Netherlands, New Zealand, and Korea.

• Some elements of a noncontributory pension are embedded in China’s NRP and PUR schemes.

• The question is how to upgrade these noncontributory elements into a full-fledged zero pillar.
• I propose that the central government provide all citizens 65 years and older with benefits equal to 5 percent of per capita GDP, regardless of residence, gender, or income level.

• Equivalent to about a quarter of rural household per capita income and close to 10 percent of urban income.
• Although rural and urban elderly would receive the same absolute amount, the rural elderly would benefit more relative to their per capita household incomes.

• The amount could be further increased to, for example, 6 percent of per capita GDP, which was Y2301 in 2012, just above the official rural poverty line (Y2300).
• A universal (rather than means-tested) noncontributory pension benefits for all individuals age 65 years and over can
  – foster public consensus on the new pillar,
  – simplify administration,
  – avoid discouraging the elderly to be engaged in paid jobs.
The noncontributory pension could be funded solely by the central budget. A centrally funded system can:

- foster the development of an integrated labor market in the country and alleviate this barrier to labor mobility, as compared with the alternative of locality funding.
- help reduce the imbalance between the central and local revenues and expenditures.
• In 2011, for instance, the central government accounted for about half of total fiscal revenues but for only 15 percent of total expenditures.

• By comparison, local governments accounted for about half of total fiscal revenues, while accounting for 85 percent of total expenditures (National Bureau of Statistics, 2012).
• In 2012, the proposed spending on non-contributory pension would have been less than $\frac{1}{2}$ percent of GDP, equivalent to 2.2 percent of general government revenues and 4.5 percent of central government revenues.

• The central government has been providing enormous transfers to provincial governments every year in the form of earmarked funds, central provision of noncontributory pensions would, to a large extent, merely be a change in the form of the transfers.
Moreover, noncontributory pension expenditure would replace part of some other types of expenditure, such as:

- the centrally funded Y 55 per month benefit through the NRP and PUR,
- the government subsidies for contributions to the individual saving accounts in these two schemes,
- part of the government expenditures on poverty-alleviation programs as the noncontributory pension would lift the majority of the elderly poor out of poverty.
Nationwide Pooling of the First Pillar at a Lower Mandatory Contribution Rate

- The first pillar should be pooled nationwide and across all urban workers, including employees of the government, public institutions, and enterprises, and the non-wage workers as well.
- I propose a mandatory contribution rate of 12 percent for wage workers, to be contributed by their employees.
- In return, the first pillar provides these retirees an average replacement ratio of 40 percent.
the system would break even or perhaps run a surplus as long as the old-age dependency ratio remains less than 30 percent (or the support ratio remain at 3.3 or higher).
Close association between pension benefits and contributions

- It should be emphasized that the replacement ratio of 40 percent is an average across all retirees; to encourage participation, it will vary by individual, and depend on individual wages and years of contribution.
we can define the annual credit points for individual worker $j$ in year $t$:

$$
\beta_{j,t} = \frac{(1-\lambda) y_{j,t} + \lambda \bar{y}_t}{\bar{y}_t} \div 100,
$$

$$
\lambda \in [0,1]
$$
Worker $j$ can accumulate all annual credit points over his/her working years to get the overall credit points:

$$\beta_j = \sum_{t} \beta_{j,t},$$
After retirement, Worker $j$’s pension benefit is determined by

$$B_{j, \tau} = \beta_j \times \bar{y}_\tau$$
• Assuming that a worker’s overall credit points = 40, we can know from the Equation that his pension benefits in year will be 40 percent of average wage in that year.
The contributions and benefits of non-wage workers

- Non-wage workers consist of the agricultural laborers, the self-employed, and workers in the informal sectors.
- The State Council has decided to integrate the NRP and PUR into one program, URRP.
- In China, there are more than 200 million peasant workers moving between rural and urban sectors. If their entitlements to pension benefits are not portable when they migrate from rural to urban sectors, or when they return from urban to rural sectors, they tend to lose their entitlement to pension benefits.
• This situation generates sizable rural-urban and inland-coastal transfers, deteriorating the income distribution in the country.
Two Problems

1. It is difficult to calculate/report their labor incomes, as their labor incomes are often mixed with the incomes of other household members and with incomes of other assets.

2. There are no employers making contributions for them, they have to contribute to the pension schemes all by themselves. 12 percent contribution rate may be too high for them.
To resolve these problems, we propose that

1) they contribute based on average wages (of the wage workers);

2) they can choose a discount rate applying to the “standard” 12 percent contribution rate. They can choose a discount rate from a set of alternative rates, say, 20%, 30%, ……, 90%, 100%.
• For instance, if a non-wage worker chooses a discount rate of 20 percent, then his discounted contribution rate would be $20\% \times 12\% = 2.4\%$.

• Applying this contribution rate to the 2012 average wage of the urban workers and staff (Y47953) gives an annual contribution of about Y1150 or monthly contribution of about Y96, should be affordable for most non-wage workers.
• If in a given year, a non-wage workers chooses a discount rate, then his credit point will be discounted at the same rate.
• Since credit points can be accumulated over working years, workers will not lose their entitlement to pension benefits when they migrate between rural and urban sectors, and between formal and informal sectors.
A case for illustration

• If a worker earns an average wages when he works in urban/formal sectors.

• He works for 20 years in urban/formal sectors, and for another 20 years in rural/informal sectors choosing a discount rate of 30 percent for his contribution to the basic pension.

• Then after retirement, his overall credit points namely his pension replacement ratio would be $(1\times20 + 0.3\times20)/100 = 26\%$. 
The reform in the management of the second pillar

• The individual saving accounts under the new system should be funded on a defined-contribution basis.

• Management of the individual accounts should be transferred from local governments to licensed and competitive pension asset management companies.

• These asset management companies should operate nationally or even globally and have more flexibility in choosing investment portfolios.
• Local governments or enterprises should be allowed to choose among them to encourage competition.
• The operation of the pension funds should be closely monitored by the government and the owners of the pension assets.
Measures in transitional period: two principles

- First, the replacement ratio should remain unchanged, if not improved, during the transition period.
- Second, the financial responsibilities should be shared between the central and local governments, with the center playing the pivotal role.
The central government is responsible for providing 40 percent of replacement ratio to all retirees.

For a given locality, if there are any gaps between the pre-transition replacement ratio and the central provision of 40 percent, the local governments are responsible to make up these gaps.
• In 2010, the average replacement rates was 39.3 percent for the 32 provincial-level administrations (Zheng, 2012).
• Of all the provinces, 18 had replacement rates below 40 percent.
• The remaining 14 provinces have replacement rates higher than 40 percent.
• Among them, eight had replacement rates between 40 and 50 percent, four between 50 and 60 percent, and two about 65 percent.
• The burden of making up the difference should be manageable for the provinces and their localities, and could be financed by the local transitional funds in general.

• If the local transitional funds are not sufficient to cover the relevant costs, they should be subsidized by, in turn,

  • fiscal revenues at the local level,

  • other available local resources (such as profits from local state-owned enterprises), and

  • transfers from the provincial and central governments.
Transitional Arrangements and Rules for Different Groups

- During the transition period, individuals could be classified into the following three groups:
- Already retired before transition to the new system; and not retired but have participated in the scheme for 15 years or longer by the time of the transition (“older workers”);
- Participated in the scheme for fewer than 15 years (“middle-aged workers”); and
- Participate in the scheme after the transition (“young workers”).
Older workers

- **Old retirees** would continue to receive pensions at the same replacement ratio as under the old system, with no obligation to make contributions to the scheme. Their pension benefits would grow with average wages.
- For those older workers who are still working, their contribution rates would remain at 20 percent of the total payroll from employers, and 8 percent of individual wages from individual employees.
- Contributions from employers would be divided into two parts: 12 percent would go to the National Basic Pension (NBP), with the remainder, together with the contributions from individual employees, going to the local transitional funds.
• The whole defined-benefit scheme should be on a PAYG basis, while refilling the “empty accounts” of this set of workers should be abandoned.

• The NBP would provide older retirees and older workers with an average replacement ratio of 40 percent. The local transitional funds would make up the difference between the replacement ratios promised under the old system and provided under the new one so that the replacement ratio would remain the same as under the old system.
Middle-Aged Workers

• would continue to have the social pooling account and the individual saving accounts. Their employers should contribute 12 percent of total payroll to the NBP, with employees contributing between 4 and 8 percent of their wages to the second pillar. On retirement, the pension would consist of the benefits derived from the NBP and from their individual saving accounts.
• One transitional issue is how to deal with the contributions that the employers of “middle-aged workers” made under the old system.
• These contributions are, in general, 20 percent of payroll.
• At least part of the difference should be transferred to the individual saving accounts of the middle-aged workers.
• In addition, the exact amount of the empty accounts, including transfers from the social pooling accounts, for each of the middle-aged workers should be specified.

• A plan on how to “refill” the empty accounts within 15 years should be made in each of the localities.
• Employers of young workers should contribute 12 percent of their payrolls and the workers could choose to contribute between 4 and 8 percent of their wages to their individual saving accounts.

• When they retire, they would be entitled to receive pension benefits derived from both the NBP and their individual saving accounts.

• They would be able to get higher returns from the assets in their individual saving accounts because of the new management of the funds.
Thank you very much!