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**China and the World Bank's Multi-Pillar Pension Model
----Observations, problems and proposals**

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Content

Acknowledgments.....	1
Acronyms and Abbreviations.....	2
Abstract.....	3
1. Introduction.....	4
1.2 Methodology and Materials	5
1.3 Disposition of the Research	6
2. Theory Review and Background	6
2.1 The Urgency of Pension Reform	7
2.2 The Concept and Understanding of Traditional PAYG System.....	7
2.3 Objectives of Pension Systems	9
2.4 Choices for Pension Reforms.....	9
2.5 Trend of Pension System Reform: Toward a Multi-pillar System.....	13
2.6 Doubt and Critical Voice towards World Bank.....	13
3. Pension Reform in China	15
3.1 Brief Review of the Process of Chinese Pension System Reform.....	15
3.2 Current Pension System Frame in China	16
3.3 Problems and Challenges of Current Pension System.....	19
4. Problem Analysis and Solution Proposal	21
4.1 Low Coverage Rate.....	21
4.2 Fiscal Pressure	27
4.3 Poor Pension Funds Management.....	31
5. Conclusion	36
5.1 Suggestions to China Pension System Reform.....	36
5.2 China's Deviation from World Bank's Model	36
5.3 Further Research Proposals.....	37
Reference	39

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Acronyms and Abbreviations

COE	Collectively Owned Enterprise
EA	Enterprise Annuity
ILO	International Labor Organization
IMF	International Monetary Fund
MOLSS	Ministry of Labor Social Security
NCSSF	National Council for Social Security Fund
NSSF	National Social Security Fund
PAYG	Pay-As-You-Go
SIP	Suzhou Industrial Park
SOE	State-Owned Enterprise
UNESCO	United Nations Educational Scientific and Cultural Organization

Glossary (From World Bank 1994, *Averting the Old Age Crisis*)

Defined benefit: a guarantee by the insurer or pension agency that a benefit based on a prescribed formula will be paid.

Defined contribution: a pension plan in which the periodic contribution is prescribed and the benefit depends on the contribution plus the investment return.

Means-tested benefit: a benefit that is paid only if the recipient's income falls below a certain level.

Minimum pension guarantee: a guarantee provided by the government to bring pensions to some minimum level, possibly by "topping up" the capital accumulation needed to fund the pensions.

Pay-as-you-go: in its strictest sense, a method of financing whereby current outlays on pension benefits are paid out of current revenues from an earmarked tax, often a payroll tax.

Replacement rate: the value of a pension as a proportion of a worker's wage during some base period, such as the last year or two before retirement or the entire lifetime average wage. It also denotes the average pension of a group of pensioners as a proportion of the average wage of the group.

System dependency ratio: the ratio of persons receiving pensions from a certain pension scheme divided by the number of workers contributing to the same scheme in the same period.

Universal flat benefit: refers to pensions paid solely on the basis of age and citizenship, without regard to prior work or contribution records.

Abstract

Like most countries in the world, China is facing a rapid aging population and the traditional Pay-As-You-Go (PAYG) pension model is urgent to be reformed. At present, three hierarchies have formed in current pension system, namely basic pension system based on combining social pooling with individual accounts, supplementary pension system by establishing Enterprise Annuity (EA) system and voluntary individual saving. The design of those three hierarchies in current pension system is just the practical use in China of multi-pillar pension model proposed by World Bank in 1994.

In this paper, I focus on how China works with the World Bank multi-pillar pension model. I analyze the adoption and deviation of Chinese current pension system from World Bank's model, three main problems and challenges of current Chinese pension system are summarized and analyzed in this paper, namely low coverage rate, serious fiscal pressure and poor pension fund management. Meanwhile, I propose the corresponding solutions aiming at these problems, including establishing a sound legal system, lowering moderately the current contribution rate, more tax incentives of EA system, expanding pension funds invest channel and setting up an effective supervision and audit system etc.

Key Words: World Bank Multi-pillar system Chinese pension system
Basic pension system Enterprise Annuity system

1. Introduction

1.1 Research Problem

Since the end of 20th century, a rising tide of pension reforms have being spread in the whole world. As the vanguard of this reform, Chile firstly moved from an unfunded to a funded scheme of mandatory individual retirement accounts in 1981, also successfully actualized the privatized management of pension system. Then some other Latin American countries including Peru, Mexico, Argentina, Bolivia, Salvador, Uruguay and Columbia all began structural reforms of respective pension system. In 1994, World Bank published an important literature named “*Averting the old age crisis*” and firstly proposed three-pillar pension model. The idea of three-pillar model is spread widely in the whole world and many countries considered multi-pillar model as their priority options during the process of pension reform. Meanwhile the discussion of pension system reform and multi-pillar model is getting much popular in the academic research field (World Bank 1994, 2001, 2005; Gillion 2000; Gillion et al.2000; Kotlikoff 1999; Orszag&Stiglitz 1999).

Like many countries in the world, China is facing a rapidly population ageing. According to the data from World Bank, “*in 1990 almost half a billion people, slightly more than 9% of the world’s population, were over 60 years old. By 2030, the number will triple to 1.4 billion. Most of this growth will take place in developing countries, over half of it in Asia and more than a quarter in China alone*”(World Bank 1994).The implementation of one-child policy and substantial improvements of life expectancy are both accelerating the process of population ageing. In order to address the pressure from population aging and serious fiscal problem of an affordable pension system, the Chinese pension reform experienced a shift from a pure Pay-As-You-Go(PAYG) unfunded system to a partially funded system that combines social pooling with individual accounts. Furthermore, Chinese government proposed to develop a supplementary pension system, namely Enterprise Annuity (EA) system in China. Eventually, it forms three hierarchies in current pension system, namely basic pension system on the basis of social pooling and individual accounts, supplementary pension system by establishing EA and voluntary individual saving. The design of those three hierarchies in current pension system is just

the practical use in China of three-pillar pension model proposed by World Bank

Although the design of current pension system in China seems reasonable and feasible, the process of implementation is meeting a few difficulties and challenges (David D& Ling Li 2003; Li Nianchao 2006).

Observed from the situation of current pension system, I analyzed the main problems and challenges in three aspects: low coverage rate, serious fiscal pressure and poor pension fund management. I think the solutions of those three problems are quite important to further improve the development of multi-pillar pension system, especially under the background of the rapid population aging in today's China. What I also observed is a deviation between the World Bank's three-pillar model and the Chinese version. I will also try to explore the reason behind that deviation.

1.2 Methodology and Materials

In this paper, I mainly focus on how China works with the World Bank multipillar pension model. First of all, I reviewed the theoretical framework of multipillar pension model from World Bank, and also many other literatures in pension reform area. A review of those literatures is summarized into a theoretical part of this thesis. Then I describe the current implementation of a multipillar pension system in China, conclude and analyze three main problems with the system and propose my solutions under China's multi-pillar model. In the conclusion part, I mainly focused on a summary of my proposals of China pension system reform and an exploration that how to fit World Bank's model with China. Therefore, the primary and most important methodology applied in this paper is deductive reasoning¹. At the same, I use more qualitative data² rather than quantitative data³, although in some parts, quantitative data is also quoted.

¹ *Deductive reasoning* refers to a logical process of developing specific predictions (hypotheses) from general principles. This type of reasoning moves from the general to the particular. Definition from Babbie 2002, The basics of Social Research 2nd Edition

² *Qualitative data* refers to Information gathered in narrative (nonnumeric) form. Definition from Babbie 2002, The basics of Social Research 2nd Edition

³ *Quantitative data* refers to Information gathered in numeric form. Definition from Babbie 2002, The basics of Social Research 2nd Edition

Data collection in this paper is mainly including two aspects: data from China Social Security Forum in 2006 held in Beijing. At that time, I was just working as an intern in International Labor Organization (ILO), Office for Beijing and Mongolia, so I took an opportunity to attend this forum; the other data is mainly from official website and relevant newspaper.

1.3 Disposition of the Research

Besides introduction and conclusion, there are three parts in my thesis. The first part is theory review and background, which mainly summarize the main viewpoint of World Bank on pension reform, including objectives and options for pension reform, the form and development of multi-pillar pension model. At the same time, I also reviewed the doubt and critical voices by some scholars and organizations towards the World Bank's viewpoint. The second Part is about problems of current Chinese pension reform. In this part, I firstly review the historical background of the development of Chinese pension system and describe the current pension system framework, then list total five problems that the current pension system is facing. There are strong correlations among these five problems. By consideration of their relationships with World Bank's three-pillar model, I selected three main problems to have detailed analysis in Part Four. Therefore, the fourth part is about detailed problem analysis and solutions proposals. I mainly focus on low coverage rate in basic pension system and EA system, serious financial pressure and fiscal gap in current basic pension system and the problem of poor management of pension fund. Aiming at these problems of current pension system, I propose several solutions to these problems.

2. Theory Review and Background

The spreading of structural pension reform got accelerated during the 1990s. In many countries, especial in Latin America, pension systems were privatized by following the lines of the World Bank's "standardized prescriptions" and the experiences of the Chilean reform in 1981. The motivation of this "reform-mania" was mainly ascribed to the perceived threatening scenario of a demographic crisis that traditional social security system could not solve (Remi Maier-Rigaud: 2005:1). In 1994, World Bank published an

important literature named “*Averting the old age crisis*”, which firstly proposed and recommended multi-pillar pension model to the whole world. In the following decade, the multi-pillar approach to pension reform suggested by World Bank took the prominent role in global policy advice. In 2005, World Bank published another significant literature named “*Old-age income support in the 21st Century: an international perspective on pension reform systems and reforms*”. In this book, original multi-pillar pension model gained expansion and complementary.

As I have mentioned before, my thesis focuses on how China works with the World Bank’s multi-pillar model, therefore I will mainly review the literatures of World Bank in 1994 and 2005. At the same time, theoretical foundations and viewpoints held by other experts or scholars will be reviewed in this part as well, including some doubt and critical voice towards the World Bank’s multi-pillar pension model.

2.1 The Urgency of Pension Reform

Increasing life expectancy and decreasing fertility rates are causing population ageing. Although countries and regions differ in pace and sequence during the population ageing process, the phenomenon is worldwide (IMF 2004, United Nations 2004), which will lead to the steadily rising of average life expectancy in the whole world. The situation in developing countries will be especially serious, firstly 60% old people live in developing countries and it will reach to 80% by 2050; secondly, there is a special feature of population ageing in developing countries, that is, countries get old before they get rich (World Bank: 2005:40). Therefore, it is very important to design and carry out an effective retirement-income security system for those old people living in developing countries.

2.2 The Concept and Understanding of Traditional PAYG System

From World Bank’s point of view, the PAYG system is vulnerable in an aging society: *The high tax rates in PAYG system lead to evasion. Employers who cannot pass payroll taxes on to workers cut back on employment, reducing national output. Older workers who are eligible for large pensions retire early, reducing the supply of experienced labor.*

Meanwhile although the PAYG system produces low costs and large positive transfers to the first covered generation, it also inevitably produces negative transfers for later cohorts because of system maturation and population aging, increasing the labor market distortions and incentives to evade. And a dominant pay-as-you-go public pillar also misses an opportunity for capital market development. (World Bank1994:12-13).

There are also other papers regarding PAYG system. Blackburn in his paper (Blackburn: 2006) pointed out the PAYG system of funding pensions by payroll taxes was highly management-efficient and cost-effective to supply a universal basic pension, and PAYG system worked best when age cohorts were of the same size. But it came under strain when the ratio of workers to pensioners was unbalanced (Blackburn: 2006:138-139). The fund source of PAYG is from payroll taxes, the quantities of payroll taxes could reflect the numbers of working population and their wage levels. Therefore, the numbers of working population and productivity efficiency have a close relationship with incomes of PAYG. In an ageing society, it will appear the imbalance between pensioners and workers, with the numbers of pensioners rising sharply in relation to those contributors, PAYG system of funding pensions will encounter the challenges of shortfall(Blackburn 2004:18).

In Samuelson's article (Smuelson1958), he created a very useful starting point for any academic discussion of pension issues. He put forward that in an equilibrium situation, the real return rate of a totally unfunded PAYG was equal to the growth rate of aggregate real wages, that was, to the sum of population growth rate and productivity growth rate. Samuelson's theory showed PAYG was a reasonable policy if there is an economy without capital stock. However, in Feldstein's paper (Feldstein: 1999:1), he pointed out the economy has capital stock in reality and its marginal product of capital can exceed the growth rate of aggregate wages, which means one country could use a funded pension system to buy retirement income at a lower price than by a PAYG system, namely, if providing the same level benefits, the savings in funded system are less than the tax required in a PAYG system.

2.3 Objectives of Pension Systems

Any pension system should function simultaneously as a saving, re-distribution and insurance instrument.

Saving means smoothing income over a person's lifetime. Working people save money for their own aged time when they earn less or even nothing. Redistribution involves shifting lifetime income from one person to another, perhaps because if low-income workers saved enough to live on in old age, they would plunge below the poverty line when young. Insurance involves protection against the probability that recession or bad investments will wipe out savings. Inflation will erode their real value. People will outlive their own savings, or that public programs will fail (World Bank: 1994:10).

According to World Bank, the primary goal of pension system should provide people with *adequate, affordable, sustainable* and *robust* retirement income. (World Bank 2005:79)

- *Adequate* refers to pension system should ensure anybody regardless of their level or formers of economic activities to avoid suffering the threat of extreme poverty after their retirements.
- *Affordable* refers to financing abilities of individuals and society. Higher replacement rate usually seems more desirable, but which will bring higher costs simultaneously.
- *Sustainable* refers to the financial stability of pension system at present and in the future. Establishing a sound pension system is a precondition to ensure the stable financial situation.
- *Robust* refers to the ability of pension system to keep out the shocks from the aspects of economy, population and politics and to retain feasibility in the face of unforeseen conditions and situation.

2.4 Choices for Pension Reforms

According to different combinations of benefit type (defined benefit or defined contribution), administration way (private or public) and funding type (unfunded, funded or prefunded), World Bank proposed five main choices for pension reforms (World Bank 2005:100-110):

- Choice 1: *Parametric Reform*

This reform doesn't change the existing structure, including benefit structure, publicly managed, unfunded, but changes the parameters of pension scheme, such as increasing the retirement age, reducing accrual rate and so on.

- Choice 2: *Notional Defined Contribution Reform*

The reform refers to an individual account is established to record the contributions of individuals and employers and notional interest rate (Palmer 2005b). This reform changes the structure of benefits, but keeps unchangeable on public management and unfunded nature.

- Choice 3: *a Totally Market-based Reform*

The most important point of this reform is to change the manner of funding, namely from unfunded to pre-funded, meanwhile, it moves from public administration to private administration.

- Choice 4: *Public Prefunding Reform*

Some developed countries put forward public or centralized management of defined-benefit or defined-contribution prefunding to solve the problem of ageing population (Orszag and Stiglitz 2001). There are two main objectives for prefunding system: one is by improving the budget situation of government to reduce the fiscal burden of future generations; the other is by using a central public fund system to improve the level of risk pooling and reduce management expense.

- Choice 5: *Multi-pillar pension system reform*

Multi-pillar reform diversifies the structure of benefits, administration and funding of the pension system. In 1994, World Bank provided a specific definition for multi-pillar pension system. There are three main pillars in World Bank's definition (World Bank: 2005:110), include:

- Pillar 1:** *A (mandated) unfunded system of defined flat or means-tested benefits that is publicly managed and seeks to alleviate poverty*
- Pillar 2:** *A mandated funded (usually defined-contribution during the accumulation phase) system in which the assets are privately managed and that seeks to replace income*
- Pillar 3:** *Voluntary funded retirement provisions that compensate for any perceived retirement-income gap for individuals, particularly those with high lifetime incomes.*

A detailed description of the contents in each pillar is shown in Figure 1.

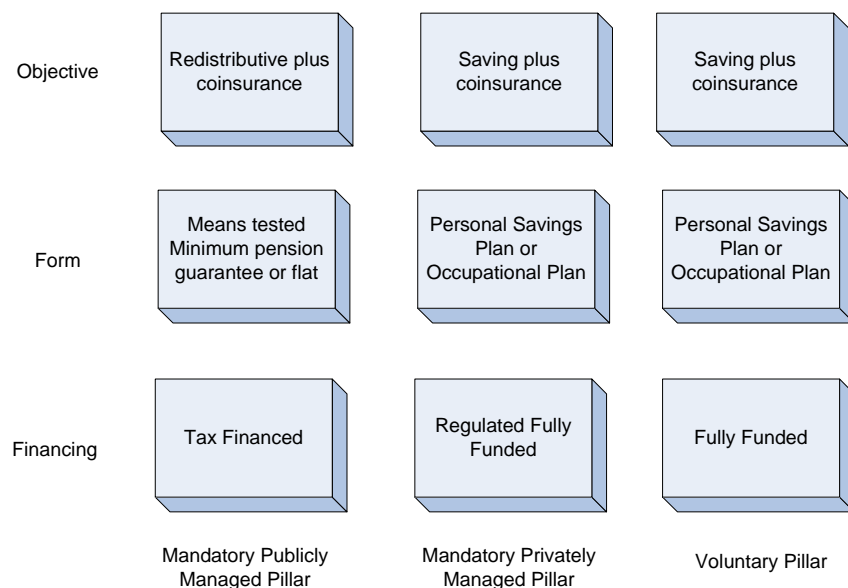


Fig.1 Three-pillar model of pension system

(From World Bank 1994, *Averting the old age crisis*)

In the World Bank's three-pillar model, the function of re-distribution and saving of a pension system is separated. From World Bank's point of view, government is only responsible for minimum or flat pension that is an anti-poverty and non-contributory pillar. While the second pillar is a mandatory saving that provides benefits only to contributors, and the benefits are always relating to the amount of contribution.

Furthermore, it is even very aggressive that World Bank insisted the second pillar including personal provident fund account or occupational plan should be managed by private financial organization. Pillar 3 is a voluntary saving pillar quite similar to pillar 2 regarding its forms and objective, which is available to people who care to supplement the retirement income provided by the first two pillars.

In 1999, some World Bank staffs unofficially revised the three-pillar pension system and claim the three-pillar system should be: 1) Pillar 1: public managed pension funds no matter contributory or non-contributory; 2) Pillar 2: private managed and full funded pension funds; 3) Pillar 3: voluntary saving for old age in the form of assets, insurance contracts, housing etc (Larry 2000:2). The main difference from the 1994's version is that pillar 1 here also consists the public managed contributory funds that are very common in many countries, especially in Asia. However, some of the other World Bank staffs did not agree with this revised version due to confusion with the 1994's version.

In 2005, World Bank officially enhanced the original definition of the 1994's version of three-pillar model. This latest multi-pillar model mainly includes three changes (World Bank 2005):

- 1) A noncontributory zero or basic pillar was named aiming at the lifetime poor people and those who work in formal or informal sectors haven't enough qualifications to gain a formal pension when they retire.
- 2) A public managed contributory system as a complementarity for the original "First Pillar".
- 3) A fourth pillar was added as an informal security form. It provides informal intra-family or intergenerational sources of both financial and non-financial assistance to old people, including access to health care and house.

With this newly release recommendation of World Bank's multi-pillar pension system, every possible entity of pension fund or system is included. It is a more neutral version from my point of view comparing with the 1994's version.

2.5 Trend of Pension System Reform: Toward a Multi-pillar System

As the PAYG system worked very difficultly in many countries (World Bank: 1994:13), many governments started to explore better options for pension reform. Many of them I have mentioned in previous paragraph. However, any single pillar system seemed unrealistic. Single public managed funded plan usually leads to low return rate and high possibility of appropriation especially in developing countries. Single private managed funded pension system like occupational plan do not protect those with limited labor market experience or high mobility. (World Bank 1994:14)

Since the beginning of 1990s, countries in Latin America began a series of structural pension reform, which began with the Chilean reform in 1981. Since most of these countries all established a mandatory funded pillar of individual accounts managed by private pension providers, World Bank thought all these structural reforms in Latin America could be grouped broadly as “multipillar”. (World Bank 2005:191). According to James’s presentation⁴, he pointed out after new pension system implemented in Chile more than 20 years, the average real rate of return has reached 10%, financial markets gained developed and total factor productivity increased 1% per year due to pension reform. Apparently, the result of pension reform roughly conforms to objectives of pension system mentioned above.

As we know, for the choices of pension reforms, there are different preferences and abilities for different individuals and countries. However, a system that incorporates the relevant elements as many as possible is possible for providing more effective and efficient retirement income, because factors affecting each pillar are not completely correlated and in some situation, the correlation is minimal or even negative association, which means the given level of retirement income or return could be gained under the condition of low risk by diversifying to a multipillar system. (World Bank 2005:62)

2.6 Doubt and Critical Voice towards World Bank

Although there are plenty of compliments to the multi-pillar system, we also can hear

⁴ <http://www.estellejames.com/presentations/chinamof.ppt>

doubts. The International Labor Organization (ILO) thinks the demographic problem is exaggerated by World Bank. In contrast to the crisis framing of the World Bank, ILO thinks the reform pressures mainly come from the globalization context(ILO 2004b:21-29, Ervik 2005:40), including poverty, coverage problems and serious hardship of large population in the world(Remi Maier-Rigaud: 2005:18). Comparing with the World Bank favoring private pensions, the ILO emphasized the stability and reliability of public insurance scheme (Deacon et al.1997:73-77). The ILO is doubtful about the assumed advantages of private pensions:

“Funded schemes do not provide additional protection against ageing population; private schemes are not necessarily cheaper to administer than public ones, nor are they necessarily more efficient at investing contributor’s money” (Gillion et al. 2000:406).

Moreover, Stiglitz (Stiglitz: 2004:3) also held a skeptical attitude to the three-pillar model proposed by World Bank. He pointed out World Bank more favored fund private management. But in fact, the idea of private management was not reasonable in those countries with relatively undeveloped capital market and people’s insufficient cognition of complexity of capital market. Meanwhile, he pointed out even in those countries with well-educated population and relatively mature capital market, the transaction cost of private management is very high. In addition, Stiglitz thought individual account by private management could not provide sufficient insurance and escape some major risks, such as inflation.

In Larry’s paper, he thought the only purpose of a pension system is to provide some sort of minimal “safety net for the poor pension”, rather than covering the needs of the wealthy for retirement income. Larry suggested an ideal pension system is one where a universal first pillar covers every resident and is exclusively financed by tax. People are more fortunate can by additional annuity plan to supplement the basic state pension. There is no need for any mandatory contributory pension plan that is pillar 2 in the World Bank’s 1994 version. Larry claimed that New Zealand is a practical example for his proposal and the system operates quite well. And the model is more realistic for

developing countries. (Larry 2000)

3. Pension Reform in China

3.1 Brief Review of the Process of Chinese Pension System Reform

Usually, the process of Chinese pension system could be roughly divided into four phases:⁵

- **Phase One: Establishment of Traditional Urban Pension System (1951-1984)**

The Chinese pension system was firstly established in 1950s, marked by the promulgation of “*Labor Insurance Regulations of People Republic of China*”. The system mainly covered the urban employees of State-Owned Enterprises (SOE) and Collectively Owned Enterprises (COE). Under the traditional pension system, China had an enterprise-based social security system. People working in the formal sectors as well as at the same enterprise during the whole working life, the enterprise would provide housing, medical care and old-age security. Each enterprise paid pension benefits for its own workers based on PAYG system, while workers individuals need not contribute. The number of pension relied on the length of working time and the wage level before retirement. At that time, the wage level was quite low, as a kind of compensation; the pension replacement rate was relatively high.

- **Phase Two: Initial Reform of Traditional Urban Pension System (1984-1993)**

In this phase, pension reform experienced the shift from the enterprise-based pension system to a social-based pension system, which temporarily solved the problem of pension payment crisis of SOEs. The main two steps of this period include: In 1986, the State Council promulgated the “Decision of the State Council on the issues of Reform on Labor System” (state made [1986] 77). The Chinese government encouraged to establish social pooling of pension insurance at the municipal level based on the PAYG system; and in 1991, the State Council issued the “*the Decision of Reform on Pension System for Workers*” (state made [1991] 33). This document proposed the pool of pension system should be enlarged to the provincial level and to national level gradually. Meanwhile, it

⁵ <http://info.service.hc360.com/2005/09/19114524575.shtml>

pointed out individuals also should share responsibilities to their own pension payment not only depend on the state and enterprises. In addition, establishing a multi-pillar pension system is firstly mentioned.

- Phase Three: Initiating A New Urban Pension System (1993-2000)

In 1993, Chinese government put forward to establish pension system combining social pooling and individual accounts trying to solve the problem of inter-generational equity. In 1997, the State Council promulgated the “*Decision of Establishment of a Unified Basic Pension System for Enterprise Employees*”, the basic pension model combining social pooling with individual accounts was formally identified.

- Phase Four: Establishing A New Urban Pension System (2000-now)

In 2000, the State Council issued “*Notification of pilot program of improving urban social security system*”, which proposed the new regulation of enterprise annuity and specified that enterprise annuity should be identified as the second pillar of current Chinese pension system, thereby, the multi-pillar pension system was basically established; On May, 2004, “*Enterprise Annuity Trial*” and “*Enterprise Annuity Management Measure*” were formally carried out, which stood for multi-pillar pension system has been established formally.

3.2 Current Pension System Frame in China

The current pension system frame in China basically has three pillars (Yang Yuanwei, Wang Daoshu, Zhang Qiong, and Wu Xiaodan 2006; Li Nianchao 2006):

The first pillar is basic public pension system combining with social pooling and individual accounts. The basic public pension system is mandatory, publicly managed, and legally intend to cover all workers in urban area, which is contributed by both employees and employers. According to latest policy implemented since 1st Jan, 2006, the size of individual accounts is unified by 8% of individual wage base in stead of the

original 11%⁶, individual contribution will be totally used as a pension saving to solve his/her own pension payment in the future. While the contribution of employers will not be calculated into individual accounts, but totally calculated into social pooling to ensure the pension payment for current retirees. The main purpose of new policy is to make a real individual account and reduce the original risk of “empty account operation”. Up to the end of 2005, the total covered people of basic pension system is 174.87 million, including 131.2 million covered workers and 43.67 million pensioners, the covered workers occupied 17.3% of total working population, and the dependency ratio(covered workers/pensioners) has reached 33.3%⁷. Apparently, low coverage and high dependency ratio made the developmental perspective of basic pension system not so optimistic.

The second pillar is supplementary Enterprise Annuity (EA) system, which is established by enterprises themselves voluntarily and supported by relevant state incentives. In the decade of 1991-2000, only 16 thousand enterprises established EA system, the number of participated employees was 5.6 million; accumulated fund was 19.1 billion RMB. As of the end of 2005, the corresponding data has respectively reached 24 thousand, 9.24 million and 68 billion RMB. The capital flux has increased 256% compared with the number in 2000. Although the EA system has gained rapid development in recent years, the start point of Chinese EA system is quite low. At present, the people covered by EA in China is 9.24 million, not a small number seemingly, however, which only accounts for 6% of the total people participating the basic pension system. Obviously, the current development of EA is still insufficient.⁸

The third pillar includes voluntary personal savings and individuals purchase commercial insurance, which commonly belong to individual behavior. Usually it is not listed into the calculation of social pension.

Generally speaking, the current design of pension systems in China mainly originated from the multi-pillar pension model proposed by World Bank, which aims at realizing the

⁶ <http://gov.people.com.cn/GB/46736/3945751.html>

⁷ http://finance.ce.cn/macro/jiuye/mcjs/200606/17/t20060617_7400093.shtml

⁸ Data from the speech by Mr. Cheng Liang at China social security forum in 2006, who is the general director of department of fund supervision of MOLSS

goals of pension system—redistribution, savings and insurance. I depict it in figure 2. However, according to historical background and actual situation of Chinese pension system, the basic public pension system is always the main pillar and it always plays a significant role in the pillar design. In recent years, enterprise annuity system, as the second pillar, has aroused high attention by Chinese government to improve further the current pension system.

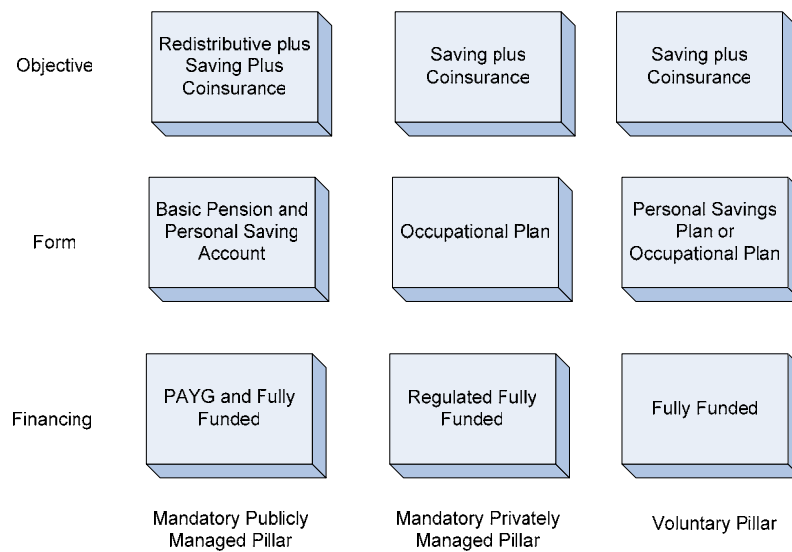


Fig. 2 China's Three-Pillar Model of Pension System

And if a strict comparison is taken between World Bank's 1994 version of multi-pillar model with our Chinese version (between figure 1 and 2), there is an obvious deviation in pillar 1. While the World Bank version insist pillar 1 is non-contributory and only covering minimum pension, the Chinese counterpart consists contributory provident funds as well. And the enterprise annuity or occupational plan in China can be categorized into pillar 2 and 3 depending on mandatory or voluntary. Therefore, I think the China system follows the World Bank's 1999 unofficial revised version, rather than the original World Bank three-pillar pension system in 1994. Our Chinese pension system is not a pure-blood of 1994's version three-pillar system. It is a revised version, and coincides with the new World Bank's model in 2005.

This deviation also conforms to World Bank's own claim in their 2005 report saying, *"The Bank increasingly recognizes the importance of initial conditions and the extent to which conditions in a particular country necessitate a tailored or tactically sequenced implementation of the multi-pillar model"*. (World Bank 2005)

However when those reforms of pension system is on going, there inevitably exist a few problems and challenges, which I will describe in the following part. And the main part of this thesis is to analyze the reasons for those problems and challenges, and propose solutions.

3.3 Problems and Challenges of Current Pension System

By reading relevant literatures and surfing Internet (Yang Yuanwei, Wang Daoshu, Zhang Qiong, and Wu Xiaodan 2006; Li Nianchao 2006), I come to know the main problems and challenges we have in China for the huge scale pension system that is destined to serve 1.3 billion people. Therefore I summarize my understanding here and list five main issues of China's pension system as:

- ❖ **Low Coverage Rate.** Until 2005, the coverage rate of National's Pension Scheme in urban area is less than 50 % (see Table 2). Consideration for the employee in informal economy is getting focused.

- ❖ **High Fiscal Pressure.** To hand a pension system with 1.3 billion populations and an aging population is undoubtedly a big money problem to a developing country like China.

- ❖ **Poor Pension Funds Management and Low Return Rate.** Invest pension funds on stock market, foreign currency market and other investment means create high return rate and distribute risks, which is very normal in western countries and somehow just starting in China. Lack of experience, regulation and proper supervision makes the start difficult.

- ❖ **Contribution Transfer Difficulty.** Contribution of pension is difficult to transfer from city to city, province to province, and even difficult between formal economies to

informal economies in the same region.

❖ **Noncompliance and Evasion.** The evasion of pension contribution is a common phenomenon for private sectors. The distrust of the stability and credit of national pension system also triggers individual's evasion.

Undoubtedly, insufficiency of relating legislations and government policies is another main concern for China's pension reform. However this insufficiency exists in every other problem area, from coverage rate to contribution transfer, I will mention it time by time when I proceed to the next part rather than take it as a main topic of this thesis. Because my purpose of this thesis is to analyze the Chinese way to the multi-pillar pension system suggested by World Bank, it is better to understand the interaction between those five problems and those pillars in the pension system model.

As shown in the table 1, I put a tick when certain problem is relating to a pillar in the pension system. Remember here those pillars refer to China's three-pillar model (World Bank's 1999 version). Because pillar 2 and 3 is quite similar in forms, I group them together here in the table and also in the following discussion. (In China three-pillar system, pillar 3 is basically consists of voluntary enterprise annuity and similar personal pension insurance saving plan.)

	<i>Pillar 1</i>	<i>Pillar 2&3</i>
<i>Low Coverage Rate</i>	✓	✓
<i>Noncompliance and Evasion</i>	✓	
<i>High Fiscal Pressure</i>	✓	✓
<i>Poor Pension Funds Management and Low Return Rate</i>	✓	✓
<i>Contribution Transfer Difficulty</i>		

Table 1 Relationship between current problems and China's three-pillar model

As you can see from table 1, the problems “Low Coverage Rate”, “High Fiscal Pressure” and “Poor Pension Funds Management and Low Return Rate” is related with all three pillars. Hence, in next part, I will analyze them in details and give my proposed solutions. For problems “Noncompliance and Evasion” and “Contribution Transfer Difficulty”, I will briefly go them through as supplementary topics when I analyze the former three problems.

As I mentioned, the China three-pillar model has a deviation from World Bank’s classic model. By discussion the problems of current pension system in China, I also want to get some clues about this deviation which I will discussed in conclusion part.

4. Problem Analysis and Solution Proposal

4.1 Low Coverage Rate

In the current pension system, as the pillar 1--basic pension system and pillar 2---Enterprise Annuity (EA) system, both of them are facing with the problem of coverage rate. Here, I will analyze the problem and propose my suggestions.

4.1.1 Low Coverage Rate in Pillar 1--Basic Pension System

With the rapid economic development and urbanization in recent years, rural-urban migrants are getting more and more, and the employment forms also become more and more diversified. Urban workers not only include workers in SOEs and COEs, but also involve those people working in informal sectors, such as migrant workers, self-employed individuals, flexible workers and workers in private sectors. Originally the basic pension system mainly covers only most of SOEs and COEs. Until 1999, the Chinese government started to enlarge the coverage to foreign-invested enterprises, private sectors and self-employed individuals. In 2002, the government required flexible workers to participate the basic pension system. Obviously, on the one hand, we have observed government is intended to enlarge coverage rate by promulgating relevant regulations. But on the other hand, the result of implementation of these regulations is not so satisfactory, because there is always a time lag between the decision of central government and local ones, which is quite common in China. Firstly let’s take a look at

table 2 below:

Year	Covered Urban-Workers (A) (millions)	Total urban-workers (B) (millions)	Total enterprise workers (SOEs+COEs) (C) (millions)	Workers in Private and self-employed sectors (D) (millions)	Urban-Workers participation rate (A/B)	percentage of (D)/(B)
2000	104.48	212.74	93.25	34.04	49.11%	16%
2001	108.02	239.4	89.31	36.58	45.12%	15.28%
2002	111.28	247.8	82.84	42.67	44.91%	17.2%
2003	116.46	256.39	-	49.22	45.42%	19.20%
2004	122.5	264.76	-	55.15	46.27%	20.83%
2005	131.2	273.31	72.98	NA	48%	NA

Table 2: Urban Labor Employment and Participate Rate

(Source: Data from Statistical Report of Ministry of Labor and Social Security 2000-2005 and National Statistic Bureau Report. Partial data is missing)

The table 2 provides current and historical data of urban labor employment and participate rate. From this table, we can get the following information. Firstly, the urban-workers participation rate has not achieved any improvement even with the steady increase of the numbers of covered urban workers, participation rate of urban-workers are always less than 50% of the total urban working population. Secondly, the numbers of SOE and COE enterprise employees are declining. Thirdly, the numbers of workers in private and self-employed sectors are steadily rising and the percentage of numbers of worker in private and self-employed sectors/ the numbers of total urban workers is steadily upward as well. For the latter two, you also can see from figure 3 below.

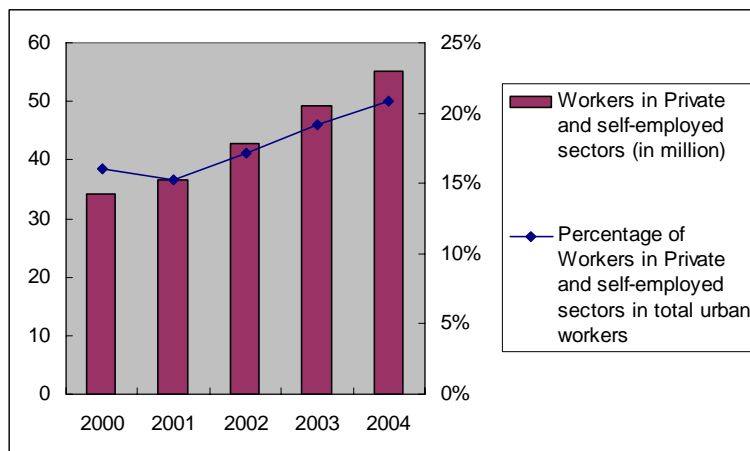


Figure 3: *the Trend of people working in the Private and self-employed sectors*

(Source: Data from Statistical Report of Ministry of Labor and Social Security 2000-2005)

Considering the information provided in above table and figure, and combining the relevant actual situation of current pension system, I think the reasons of low coverage rate mainly concentrating on following points:

- Decrease numbers of enterprise workers

Firstly, here “enterprise workers” mainly refer to those workers in SOEs and COEs. As we have seen, the numbers of enterprise workers are declining. SOE reform brought many enterprises change their ownership and some of them announced bankrupt due to furious competition under the market economy. The direct consequences are massive laid-off workers and decrease of enterprise employment opportunities. As we know, usually the participation rate of basic pension system in SOEs and COEs is relatively high, but now the number of enterprise workers is always decreasing. Meanwhile partial laid-off workers and more and more workers are flowing into informal sectors, where are just the weakest chain of the coverage of basic pension system.

- Lacking of enough awareness

Lacking of enough awareness of participating basic pension system is quite common for some employees and employers. Why some employers and employees are reluctant or even resist participating basic pension system. On the one hand, from the side of employers, they underreport part of employees or refuse participation in order to evade contribution due from employers. Some employers try to cut down enterprise’s cost by the way of evasion and non-compliance. On the other hand, from the side of employees, some employees still not realize the importance of participating basic pension system. Usually, they prefer to get more cash into their own pockets directly. Especially for those employees with low salary, they will get less salary if they choose to participate it. Monthly contribution deducting from their low salary is a heavy burden for them, after all, which means they have less cash could be used every month.

- Too low coverage rate in informal sectors

As we have seen in figure 3, the numbers of workers in private and self-employed individuals are steadily rising. If we plus the numbers of inflexible employees and migrant workers, the numbers will be larger. All those people belong to informal sectors, which are just the weakest chain of pension system coverage. I think there are main reasons. First, the wage level of employees in informal economy is relative low and they need more cash for current consumption. They have to care for about how to maintain the daily life and they have not enough capability to save for their older life. They always think retirement is very far. Secondly, the employees in informal sector are relative young and commonly with relatively strong fluidity, especially for those migrant workers. On the one hand, employers often don't want to pay the high employer's contribution for them; on the other hand, many employees in informal sectors, such as migrant workers are always under a passive attitude. Even they really want to participate in the basic pension system, they dare not to express out to their employers, because it is not easy for them to find a job in urban and they don't want to lose their jobs just because their request for pensions.

- Lacking of effective management mechanism

Aiming at the noncompliance and evasion of basic pension contribution of employers, lack of an effective governmental management mechanism is the key point. There is no systematic supervision system or punishment mechanism to those employers escaping their obligations.

Solution proposal

- Promoting propaganda of basic pension system

The government should promote further propaganda of basic pension system, especially in informal sectors. Education and policy propaganda could help more people realize the importance and meaning of participating in the system instead of a myopia attitude.

- Moderately lowering the current contribution rate

Current contribution rate is relatively high, which has been a heavy burden for some of

the employers and employees. Therefore, the government should consider calculating a reasonable contribution rate in order to make more employers and employees join the basic pension system. A leveled contribution rate system can be also considered which corresponds to the income level. For example, worker with lower income can choose to contribute less percentage to individual accounts. A good example is Suzhou Industrial Park experiment in which you have three pension plans to choose. Plan A require a 22% contribution from employee side, plan B contribute 18% and plan C contribute 14%.⁹

- More focus on the coverage rate of informal sectors

According to my analysis above, extending the coverage rate of informal sectors is urgent. I think ILO has provided a good prescription about this problem. ILO suggests¹⁰, *“The contribution rate for flexible employees, employees of small establishments and their employers, as well as that for self-employed persons, should be lower than the contribution rate for enterprises and enterprise employees. The difference should be made by government subsidy”*.

- Establish a sound legal framework and an effective management mechanism

By legislation, the central government should give local agencies of labor and social security sufficient executing power. The local agencies must take serious measures to those employers with noncompliance and evasion. The detailed punishment measures could include certain amount of cash penalty, revoking its business license etc. At the same time, working people of local social security agencies should spot-check aperiodically the participation situation of employers and give relevant punishments for those employers with noncompliance and evasion.

4.1.2 Low Coverage Rate in Pillar 2---Enterprise Annuity System

The EA development in China is facing the problem of low coverage as well. Until April of 2004, the government promulgated legislation intending to formally provide a framework for EA system. Obviously, the history of formal development of EA is very

⁹ Data from www.sipspf.org.cn, the website of Suzhou Industrial Park Social Security Agency

¹⁰ Report by a study team of the International Labor Office, Extending old-age insurance coverage in the People's Republic of China, 2006

short. Up to the end of 2005, the people covered by enterprise annuity in China is 9.24 million, which only occupy 6% of the total people participating the basic pension system¹¹. I think on the one hand, the insufficient EA development could be due to its very short-time development. However, I think there are still another three reasons to cause the low coverage rate.

- The different coverage target comparing with the pillar 1

As a supplementary pension system, EA is a kind of voluntary corporate pension. According different actual situations of enterprises, it could be decided by employers to establish EA or not. Usually, only those enterprises with better profitability choose to establish EA in current China. Apparently, comparing with the coverage target of covering all urban workers of pillar 1, the coverage target of pillar 2 is much narrower.

- No effective promotional approaches and no sufficient awareness

Currently, only 40% employers know EA, meanwhile only 30% of which really understand what enterprise annuity is. One-third employers think they have no responsibility to establish enterprise annuity system for employees.¹² Currently, many employers and employees are still know quite limited knowledge about EA. Meanwhile, insufficient propaganda is an important reason. Most enterprises prefer to choose short-term or more direct way to provide welfare to employees, such as house allowance, traffic allowance to solve the problem of buying house and car, children education and so on, while employees also think they prefer to accept more direct and prompt welfare policies.

- Lack of tax incentives

Lack of tax incentives is the thorniest issue of EA development in China. At present, the tax incentive still has not gained enough attention by relevant government departments. Observing from the international experience, tax policy is the most important incentive

¹¹ Data from Data from the speech by Mr. Cheng Liang at China social security forum in 2006, who is the general director of department of fund supervision of MOLSS

¹² Data from the speech by Mr. Cheng Liang at China social security forum in 2006, who is the general director of department of fund supervision of MOLSS

element for any occupational plan like EA. Currently, the state only allows a tax exempt of enterprise annuity within 4% of total wage and even this policy is only carried out in small scales (Yang,Wang,Zhang and Wu:2006). Therefore, there are no universal, national-level tax incentives for EA development in China.

Proposal solutions

- Promoting Propaganda of Enterprise Annuity (EA)

In this point, I think government at central and local level should play an important role. Especially during the implementation of EA system, local government should provide a good platform and opportunities to exchange ideas with enterprises.

- Balance well the relationship between pillar 1 and pillar 2

Currently, the basic pension replacement rate of the pillar 1 has averagely reached about 60%¹³, the percentage is higher in some certain fields and regions. While according to the original design; the total pension replacement rate includes: the replacement rate of pillar 1 is about 50% while pillar 2 is about 30% (Deng & Liu, 2005). High replacement rate of pillar 1 will be adverse to EA's development.

- Move from “voluntary” to “mandatory”

Currently, the enterprises can decide to establish EA system or not, which is voluntary. I think in some rich provinces and cities with high level of economic development, the EA system should shift form “voluntary” to “mandatory”

- Tax incentives are necessary

By establishing sound tax incentives, on the one hand, it can encourage more enterprises to establish EA system; on the other hand, sound tax incentives could bring positive effect on funds operation and management.

4.2 Fiscal Pressure

Currently, serious fiscal pressure is a main problem facing by the basic pension system.

¹³ Data from the speech by Mr. Cheng Liang at China social security forum in 2006, who is the general director of department of fund supervision of MOLSS

In the early of 2005, the Ministry of Labor and Social Security (MOLSS) of China published a research report and pointed out the Chinese pension gap is 6 trillion RMB in the future 30 years¹⁴. Meanwhile, on May 2005, World Bank also published a research report pointing out if according to the current pension system and under certain assumptions, the basic pension payment gap will reach to 9.15 trillion RMB from 2001 to 2075¹⁵. Although different organizations have different calculated measures, even differ greatly in their respective calculation result, the most conservative estimate is enough to arouse concern. Where the fiscal pressure is from? I think there are three main points:

1) Rapid aging population

The implementation of one-child policy and substantial improvements of life expectancy are both bringing on rapid aging population in China. According to, the latest statistic data from National Ageing Working Committee, the population at and over 60 years old has reached 145 million, occupying about 11% of total population,¹⁶ at present China has entered the aging society.¹⁷, it is obvious China has entered the aging society. Moreover, Official projections indicated that China's population was ageing faster than in any other country and the dependency ratio was deteriorating more seriously then elsewhere (Leckie 2003:147). No wonder with such a large aging population, the payment capacity for pension system is getting a lot of pressure.

2) Operation of "Empty individual account"

The Chinese basic pension reform experienced the transition from pure PAYG model to a model combining social pooling with individual accounts. The reason for having individual accounts is to establish a funded account which can be paid when the contributors reach their retirement ages. However, in fact the individual accounts in China are nominal without any assets in them, working just as a bookkeeping device and could not solve the problems associated with population aging in former PAYG system

¹⁴<http://www.e-economic.com/info/3570-1.htm>

¹⁵ http://news.xinhuanet.com/fortune/2005-10/23/content_3671441.htm

¹⁶ http://news.xinhuanet.com/misc/2006-03/05/content_4260305.htm

¹⁷ According to UNESCO's definition : aging society refers to a country or a region's population aged 60 and above accounted for 10% of the total population of the country or region or more, or to the population over the age of 65 or over 7% of the total population

(James 2002:62). There are large unfunded liabilities of former pension system and the contributions are not sufficient enough to the revenues needed to pay current pensions. Consequently, much of the revenues that should be put into the individual accounts have to transfer to the payment of pensions. As a result, the individual accounts are actually nominal and empty. Up to the end of 2005, the scale of “empty account” has exceeded 800 billion RMB and is growing at the speed of 100 billion per RMB.¹⁸ This situation should not be allowed to be deteriorated because it will make more difficult in the future to ensure a sustainable financial ability to the rapid aging population. How to make the individual accounts real has become a big challenge.

3) Relative low coverage and low collection rate

As I have mentioned above, the coverage rate of basic pension system and EA system are still relatively low, especially the latter one. Moreover, in the basic pension system, the phenomenon of unpaid premium or not-sufficiently paid is common. Both low coverage and low collection rate have brought negative impact on the sum of total fund accumulation.

Solution proposal

Aiming at the serious fiscal pressure, the government has taken corresponding measures. An important act is to establish the National Council for Social Security Fund (NCSSF) in 2000. The purpose of foundation of NCSSF is to address the potential pension payment crisis in the future by establishing a necessary national strategy reserve. Currently, the National Social Security Fund (NSSF) has gradually built up the assets of about 230 billion RMB¹⁹. The sources of NSSF are mainly from national budgetary allocation, income from selling off state-owned stock shares and investment return. The total accumulation of NSSF will be used to remedy the fiscal gap of pension payment and the long-term challenge of population ageing in China.²⁰

Obviously, the Chinese government is actively addressing the fiscal pressure by

¹⁸ <http://finance.news.tom.com/1001/1002/20051117-299865.html>

¹⁹ Data from speech by Mr.Xiang Huaicheng in Dialogue Programme of China Central Television Station.

²⁰ <http://www.ssf.gov.cn>

establishing national reserved fund of social security. And sound investment of pension funds into capital market is undoubtedly a good way to reduce the fiscal pressure, which I will discuss in more details in next problem “poor pension funds management”. Moreover, personally I think there are several other important ways could alleviate the serious fiscal pressure.

- Moderately increasing retirement age

The legal retirement age in China is 60 for men and 50 for women (55 for women working in the managerial position). But it is allowed that 5-year earlier retirement for those working in dangerous fields, or suffering enterprise bankrupt and restructuring. Consequently, therefore the actual retirement age is usually lower than the legal one. In recent years, massive deficits could be resulted from the flood of early retirements.(Dow Jones Newswires, June 25,2001) If people’s working life cycle is getting shorter and shorter, this will bring a large financial burden to basic pension system, which will be worse when labor force shrinks. I think a moderate increase of retirement age is feasible in China; especially there is substantial improvement of life expectancy in China.

- Decreasing replacement rate of basic pension system

Currently, the promised replacement rate of basic pension system is about 70% of final wage, which is very high comparing with 40% in the US and 50% in many other countries.(World Bank 1997,Dorfman and Sin, 2001) In recent year, the pensions have been rising faster than average SOE wages or per capita income, even some retirees get more in pension than their former wage .(James:2002:64) Decreasing replacement rate on the one hand, could ease the fiscal pressure, on the other hand, it could lighten the current contributors’ burden as well.

- Promoting the development of EA system in China

Above I mention to alleviate fiscal pressure by decreasing replacement rate; it may bring some negative impact on the level of retirement life. I think development of EA could just remedy this disadvantage. On the one hand, as a supplementary pension system,

the development of EA benefit the life level after retirement, consequently, it could make the possibility of reducing the replacement rate of the basic pension system, on the other hand, the development of EA is beneficial for developing capital market, and providing the possibility to alleviate the current fiscal pressure of fund collecting and future pension payment crisis.

4.3 Poor Pension Funds Management

First of all, I think it is necessary to provide a specific definition “pension funds” here. According to my research topic, the pension funds discussed below mainly include two aspects: basic pension fund of pillar 1, which is managed by local government and enterprise annuity of pillar 2. By reviewing literatures (Bruno 2006 and Cai Qingshan 2006), I come to know there are mainly two aspects of poor management of pension funds -- narrow investment channels and insufficient supervision.

4.3.1 Narrow investment channel

In China, pension fund of pillar 1 is mainly managed by local government and there are not any professional assets management companies to be introduced to the basic pension fund investment. Consequently, it is lack of the notion and skills of modern financial investment and corresponding risk management abilities. According to policy regulation, the investment of basic pension funds is strictly controlled, which only could be invested in government bonds and national bank deposits. Both two means pay relatively low return rates that are lower than the growth in average wages. According to the latest data in ILO’s report (2006), current government bonds pay interest of 3% while bank deposits pay interest of 2.5%. In comparison, average urban wages have increased at speed of 11% average annually. Obviously, the investment safety of pension funds is especially emphasized while the return rate of pension funds is ignored. I think although the first priority of control the investment risk of pension funds is unshakable, overemphasizing safety while ignorance of diversified investment and its return rate is not reasonable.

The reason here is the immaturity of capital market in China, and low knowledge and skill base of local basic pension funds managed by government bureaus. To the former,

China has started to build up the capability and the capacity of national capital market. The institutional investor like privately managed funds, banks and insurance companies have grown up in last several years and start to act as the main player in capital markets just as their western counterparts.

Compared with the narrow channel of basic pension, the experiment of NSSF maybe could bring some enlightenment. Up to the end of September 2006, on 1st of December 2006, NCSSF authorized 10 foreign privately managed funds to invest more than 1 billion U.S.dollars in the initial stage on overseas stock and bond markets. It has been marked as a historic step for China pension fund investment²¹. Mr. Xiang Huaicheng, the chairman of NCSSF, said, “*Overseas investment is very important for SSF to broaden its investment channels, diversify its investment risks and preserve the increase value of the fund.*”

Solution proposal:

● Establish 2 or 3 national publicly managed pension funds

The successful demonstration of NSSF can be extended in China. Just like its South Asian neighbor Singapore, a national-wide publicly managed pension fund system called central provident funds works quite well for many years. Considering the large population of China, 2 to 3 national publicly managed pension funds can be established. Local pension funds bureaus can transfer a certain percentage of the money in individual accounts to any of those national pension funds by contracting and guaranteeing a minimum return rate. The competition between those national funds can be also encouraged to some extent.

● Establish a wholly privately managed individual account

To avoid the low return rate of local pension funds managed by government, and utilize the high efficiency of privately managed funds, individual accounts which are now under the public pillar can be transferred to privately managed pension funds. This leaves

²¹ <http://www.e-economic.com/info/9036-1.htm>

government only responsible for an unfunded and flat basic pension scheme. While individual accounts is still mandatory but managed by funds companies.

The combination of solution 1 and 2 can also be practical considering China's immature capital market

4.3.2 Insufficient supervision

In July 2006, the scandal that Shanghai Labor and Social security Bureau officials are accused of lending 3.2 billion yuan of city pension fund to a private real estate developer, most of which involved 3.2 billion RMB is enterprise annuity.²² With the exposure of Shanghai scandal, the National Audit Office began a large-scale audit of the social insurance fund. The audit result is quite shocked and there are totally 7.135 billion RMB used improperly²³. Obviously, there are serious loopholes on funds supervision.

In China, existed legislations and regulations are lack of effective restriction on pension funds appropriation. At the same time, the supervision strength is still quite weak. In the whole country, there are only 11 provinces established an independent bureau for fund supervision²⁴. There are very few specialized institutions to supervise the funds at the municipal and state level. Including all levels of social security department, the numbers of people working in fund supervision are no more than 100.

While as the second pillar of current pension system, the supervision of Enterprise Annuity (EA) is also facing with a few problems. As I have mention before, until 2004, with the promulgations of “*Enterprise Annuity Trial*” and “*Enterprise Annuity Management Measure*”, development of EA in China is walking towards a formal direction. There are two main operation models of EA before 2004. Firstly, the vast majority of large and middle-sized SOEs have chosen the “Internal Managed Model”. The risk of this model is that there is no effective separation between EA assets and

²² Zheng Bingwen, Latin American study by the Chinese Academy of Social Sciences.
http://news.xinhuanet.com/fortune/2006-10/13/content_5196919.htm

²³ http://news.xinhuanet.com/politics/2006-11/28/content_5401534.htm

²⁴ Currently, a total of 34 provincial-level administrative regions of China, including 23 provinces, 5 autonomous regions, four municipalities and two special administrative regions.

enterprise assets. Secondly, some of the coastal provinces or cities with the rapid economic development have chosen the “External Managed Model”, such as Shanghai, namely EA is operated by specialized agencies established by local social security administrative department. The risk of this model is that there is no effective separation between EA assets and local public powers, which leads to more local government interference factors and high possibility of appropriation. ²⁵Obviously, the fund operation under these two models is not totally integrated with capital markets. Meanwhile, the EA operation is always tightly connected with the government administration or enterprise administration.

After 2004, EA development experienced a process from government oriented to market oriented. However, there is still a great gap between current EA development and the capability of supervision. If we take Shanghai Scandal as an example, the operation of EA in Shanghai is managed by Shanghai Enterprise Annuity Development Center, which actually belongs to one of divisions of Shanghai Labor and Social Security Bureau. Apparently, so-called Enterprise Annuity Development Center is in fact controlled under local government. This model is relatively easy to produce corruption, collusion between funds executives and officials. The funds are also vulnerable to “moral hazard” of local government. Shanghai Scandal showed us it is dangerous for a single body acting as both administrator and regulator in a pension system. Just as said: “*you cannot have a system in which a regulator is overseeing its own activity.*” (Bruno 2006)

Above, I analyzed the insufficient supervision in the fields of basic pension and enterprise annuity. Here I put forward several proposals to how to improve supervision abilities respectively.

Aiming at the supervision of basic pension operation:

- Firstly I think it is necessary to clarify the main entity for basic pension management.

²⁵ Zheng Bingwen, Latin American study by the Chinese Academy of Social Sciences.http://news.xinhuanet.com/fortune/2006-10/13/content_5196919.htm

According to the audit result of National Audit Office, entities involved in illegal invasion are not only including social security department, but also including tax department, financial department and local governments. Therefore, by clarify and legislate the main management entity of pension funds, it will provide a direct and specific target to monitor.

- Secondly, establish a sound legal framework to improve the efficiency and completeness of supervision.
- Thirdly, establish a specialized organization in the nationwide for fund supervision and representatives of fund supervision which could be made up of government officials from relevant departments, employers, employees, professional experts and scholars. By doing this, it could concentrate the strength in all stockholders and it should benefit for doing supervision better.
- Fourth, the operation of fund management is necessarily to be transparent; the National Audit Office should spot-check aperiodically the situation of fund operation in the nationwide.
- The last but not the least, private operation of individual accounts can be promising when we can separate the supervision and operation of the pension funds. I think the mainland government of China can learn from the funds supervision in Hong Kong Special Administrative Region. There are a very clear role-separation under the Hong Kong Mandatory Provident Fund System, government role--regulatory, trustees role—trustee and asset management companies role—investors.

Aiming at the supervision of enterprise annuity, especially after Shanghai Scandal's exposure, the MOLSS issued the No.36 document, proposed a specific requirement that the local social security bureau cannot hold any new EA plan. Those existing EA established before 2004 should be transferred to the qualified privately managed funds before the end of 2007. It shows the government determination to privatize the operation of enterprise annuity. The management of EA has shifted from the hands of government to the hands of market. Undoubtedly, it is a milestone for EA development in China as well as an important change of government role. This privatization can boom the capital market. However a privately managed EA fund system needs more regulations and

supervision which is lack in current China. In the near future, the role of government will only be legislator and supervisor. I think it will make the supervision easier and more transparent. Legislation about EA operation and information transparency needs to be improved.

5. Conclusion

5.1 Suggestions to China Pension System Reform

As I have analyzed in previous parts, the main concerns of current China pension system is its low coverage rate, high fiscal pressure and poor pension funds management. Based on the three-pillar model of World Bank, my proposed several solutions as:

- 1) Promoting propaganda of current pension system including publicly managed basic pension system and privately managed EA funds. Establishing sound legal system to avoid intentional evasions.
- 2) Moderately lowering the current contribution rate, especially for those workers in informal sectors. A leveled contribution rate system can be considered which corresponds to the income level.
- 3) Adjust the replacement rate of public managed part in the pension system and make EA a mandatory pillar. Meanwhile more tax incentives should be introduced regarding EA.
- 4) Moderately increasing retirement age
- 5) Widen pension funds investment channel by establishing several national publicly managed pension funds, or transforming the individual accounts into wholly privately managed scheme.
- 6) Setting up an effective supervision and audit system for pension funds management and investment. To separate the multi-roles of government in pension system to external financial institutions.

5.2 China's Deviation from World Bank's Model

Back to the deviation I have mentioned in Part 2 that between the World Bank's 1994 three-pillar model and current China's three pillar model, I think I can put forward some

clues here. Basically the deviation is about the management role of fully funded pension, which in China is the individual account in the government managed basic pension scheme. While according to World Bank's definition, those contributory individual accounts should be controlled by privately managed funds.

A successful forerunner of government managed fully funded pension system is the Singapore Central Provident Fund. However considering the huge difference between Singapore and China in population, government administration and economy scale, I don't think China can copy Singapore on pension system design. The other way round, the government bureaucracy in China has showed its low efficiency on pension funds investment and lack of supervision on pension funds operation. An NCNSSF is not enough for a population of 1.3 billion and its capability will be doubted when its capital accumulation is getting higher and higher. The only way to handle all the individual accounts and invest them in an efficient way is to allow privately managed funds takeover the business, and put government bureaus as regulators and supervisors. It will bring a boost for capital market and also a steady and relative high return rate for pension system participants.

Therefore from my side, I believe the future reform of our pension will go close to the WB's 1994 version in which individual account is managed by privately managed pension funds. The current deviation will finally disappear. The promotion of EA is just a starting point for this inevitable transformation. And the maturity of national capital market will facilitate this transformation.

5.3 Further Research Proposals

As I worked on this thesis, I found the research on pension system reform is very broad. Facing the aging population problem, most of the countries in the world now are tackling this problem. From my point of view, I think two of the topics can be very interesting for further research in China's pension system reform:

- 1) The implementation and operation of EA in China. As occupational plan and privately managed pension funds is common in western world, it is just starting in China. EA is definitely a brand-new concept for most of the Chinese. How to learn from western

examples and how to practically implement EA in China could be very interesting, especially considering the growing up Chinese capital market.

2) The coverage of pension system to informal sector. As China is moving fast to the direction of fully market economy, more and more people will work in private sectors, or work as flexible worker or self-employed. Their requirements to pension system could be varied with former state enterprise workers. I believe investigation and research on this topic could be also interesting.

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