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The Chinese pension system

by Heikki Oksanen

Pensions in China face a dual challenge: (1) the current system covers only a fraction of the population and does not function as intended, and (2) population ageing is progressing fastest in the world: the ratio of 65 year-olds to those aged 15 to 64 years, currently at eleven per cent, is projected to increase to 38 per cent by 2050.

The multi-pillar system established in the 1990s introduced individual fully funded accounts to top up the basic pension (20 per cent of average urban wage), but the accounts are virtually empty as contributions were used to pay the pensions of current pensioners. As for rural area employees, who are still the majority of workers, the coverage and level of pensions are very low. This is recognised by the Chinese authorities, who issued a new plan in 2009.

Urban system

The fragmented Chinese urban pension system covers only 55 per cent of employees. The contribution rate, at around 28 per cent, is commonly seen as an obstacle to increasing coverage, and even this level of contribution would be insufficient to support the current level of pensions as population ageing progresses. Our view is that coverage cannot be increased without reducing the pension contribution rate significantly and adjusting the benefits so that the system becomes credible for coping with the ongoing rapid ageing of the Chinese population.

The proposals to pay for the pension rights accrued until now by issuing government debt and establishing a truly fully funded pension system from now onwards is one option, but the capacity of the financial markets and institutions to absorb this is not self-evident and in China one should also recognise that the rate of return on the assets in fully funded accounts will in the medium-term future probably be less than the rate of growth of wages. Therefore, the conventional view that a fully funded system gives a higher return than a public PAYG system is not necessarily applicable.

As in western Europe from the late 1940s until the early 1970s, also in China it can be considered that at least the older members of the current working generation and current retirees have already contributed significantly to the wealth of the nation and can therefore justifiably be provided with pension benefits which exceed the level that they have paid for in the form of pension contributions. This principle can lead to an option which does not aim to accumu-

late significant reserves. It is also emphasised that the projected increase in longevity should be taken into account early enough — this means that the retirement age should rise significantly.

Implementing these principles under the so-called notional defined contribution (NDC) system is according to many experts the most promising option for China. We present here a couple of NDC reform scenarios where financial sustainability is secured. All previously accumulated pension rights are respected. However, the implicit pension debt or so-called legacy debt does not become explicit debt of the government, neither does it require the current working generation to pay 'a double burden' (as is the case when moving to a fully funded system). Instead, under an unfunded (or partially funded) public pension system this burden is shared by all current and future generations.

As longevity is increasing we assume a gradual but significant increase in retirement age. In the first scenario the contribution to the NDC pillar is 20 per cent of wage and in the second 16 per cent. We also assume a moderate Defined Contribution (DC) pillar with a four per cent contribution. In our scenarios, an additional (small) flat-rate pension can be paid on top of the NDC and DC components. With a 20 per cent contribution rate, the total pension first decreases to 40 per cent of the contributory wage. With the contribution rate at 16 per cent, it reduces to a little over 30 per cent.

Thus, the projected pensions are not generous. This mainly follows from population ageing over the next three to four decades. To have higher pensions requires higher pension contributions or a higher retirement age. Accepting this hard choice is not easy. The high cost of pensions primarily stems from the high expected number of years on retirement, at about 18 for men and 23 for women in our scenarios even though we assume a significant increase in retirement age. This should lead to consideration of whether the retirement age should be raised further than assumed in our scenarios.

Rural system

The Chinese government issued in August 2009 a new plan, targeting full coverage of the rural elderly by 2020 with pensions equal to 15 per cent of rural wages. This would involve a cost for the budgets of the central government and the higher-income provinces of 0.5 per cent of GDP in the early 2020s, increasing to 1.2 per cent by 2050. There could be social and political reasons for increasing rural pensions further. However, even a 0.5 to 1.2 per cent of GDP continuous expenditure has to be covered in an orderly manner from other revenue sources of the government as otherwise the credibility of the system is undermined.

Conclusions

As the Chinese population is ageing fast, we are presenting transition to a notional defined contribution (NDC) system as a model for adjusting the pension rules for increasing longevity. Transforming the accrued pension rights into NDC accounts and starting to apply the new NDC-inspired rules on indexation is not necessarily a jump into the unknown for the Chinese pensions system. Rather, it could be a useful and long-awaited clarification to the rules and a way to move towards a more uniform system nationwide.

One question is how to transform the existing nearly empty individual accounts into the new NDC accounts. One option could be that the government guarantees a rate of return which is at least equal to the rate of increase of average wages (in the region). The management of the assets, currently about 5 per cent of GDP, and increasing in our NDC scenarios, can be separated from the management of pensions.

The level of public pensions is relatively modest both in our NDC scenarios for the urban system and in the scenario depicting the new system for the rural population. This will mean that there will be a need for two additional schemes, namely basic social income support for the elderly financed from government budgets and additional individual pension savings managed by various types of financial institutions.

We present a wider range of results for an NDC pillar combined with moderate DC pensions, geared to be financially sustainable under the rapid population ageing in China. Designing coherent reform options and explaining their characteristics will hopefully facilitate political-level decision making.

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