

**SOCIAL SECURITY REFORM IN CHINA:
FURTHER NOTES ON ISSUES AND OPTIONS**

January 27, 2005

China pension reform: Q & A

1. *The social security system in China is having trouble financing benefits currently, and future problems will be more severe as the Chinese population ages. What are the most important things that need to be done to alleviate the crisis?*

Reform should pursue five strategic directions:

- Reduce the fragmentation of the system. This will involve pooling at least at the provincial level, as already decided by the government, and preferably at the national level.
- Strengthen administration. This involves creating a national pensions administration for record keeping and financial accounting. Contribution obligations should be enforced by collection by the tax authorities.
- Eliminate early retirement abuses and enforce current retirement policy, while gradually raising the retirement age. Flexibility in retirement ages can be supported by paying higher benefits to workers who retire at later ages.
- Transfer state shares/assets to the NSSF to finance legacy obligations. The NSSF should not be permitted to sell those assets, but required to hold them, using the income to help to finance the cost of legacy obligations.
- Improve individual accounts by financing them in a different way.

2. *The transfer of state shares to the NSSF to finance pensions of older workers seems a good idea, but how can China's capital markets absorb the sale of so many shares in the near future?*

It is correct that capital markets in China are currently underdeveloped and not liquid. Sales of large volume of shares can disrupt the market, hurting both the NSSF and other investors. For these reasons, our recommendation is that the shares be transferred to the NSSF, but that the NSSF should *not* be allowed to sell them until such time as both capital markets and corporate governance are on a very firm footing. Making the shares held by the NSSF nontradeable gives a strong signal to financial markets and government agencies that their purpose is to provide dividends to finance pensions.

Indeed a major benefit of this approach is to contribute to the critical task of improving the governance of firms in China. It is important to have an agency like the NSSF as a long-term shareholder in large companies to apply pressure on firms to be well-run and on government both to improve the regulations affecting corporate governance and to strengthen the capacity to enforce those regulations.

3. *Isn't funding individual accounts necessary to address the aging crisis faced by China in the coming decades?*

The analysis of the role of funding is more complex than appears on the surface – funding is not an automatic cure for issues of an aging population. The ability to deal with the consequences of aging depends on the ability to produce output to meet the consumption needs of workers and pensioners, and the investment needs of firms. What matters for a country's ability to produce output are (a) the quantity and quality of capital (including human capital), (b) the quantity of labour, and especially (c) the ability to absorb and make

good use of better technology. These are the variables that really matter, not the way in which pensions are financed.

Funding can usefully contribute to the growth of output if it (a) increases national savings in a country with a shortage of savings and/or (b) improves the efficiency of financial markets. But China does not have a shortage of savings (rather, the reverse), and its capital markets are currently too weak to bear the weight of large, mandatory pension funds (encouraging voluntary pension funds would be a better way to foster financial market development). Thus funding the individual accounts is neither necessary nor desirable for China in the near future.

4. *What is the difference between the NDC arrangements which the report recommends and funded individual accounts?*

With a fully funded account, contributions are used each year to purchase individual assets – stocks, bonds, mutual funds and bank deposits. The earnings from these assets are reinvested. When a worker reaches retirement age, the accumulated value of the assets in his fund is used to finance an annuity, i.e. a monthly pension, either purchased on the market or provided by government. Thus, a fully funded account is similar to a personal (private??) investment account.

By contrast, a notional defined-contribution account is similar to a bank account. When you make a deposit, the money does not sit in a vault in the bank. Nor are particular assets held in your name. Rather the deposits are used by the bank for investments and loans. The returns on these investments and loans are used by the bank to pay interest on the bank accounts and to provide payment when you withdraw funds from the account. The amount of interest paid is set by the bank, in response to its level of earnings and competitive pressures.

Similarly, the contributions to a NDC account are combined and used by the social security authority to pay benefits to current pensioners and to purchase assets. No particular assets are held in your name. The returns credited to a NDC account are set by the government, based on the returns on the assets held and on the anticipated flow of new contributions. When a person retires, the accumulated value recorded in his account determines the size of the annuity provided by government out of its continuing flow of returns on assets and new contributions.

Thus, to the individual worker the only difference between the NDC and a funded account is that with the former, the rate of return is set by rules based on overall fund availability, as in a bank account, while with the latter, it depends on future market returns on the particular assets held in the account. The rules set by government for a sustainable system will have less variability and more predictability than market returns which can vary sharply over a short time period. The confidence of the worker that he will get his pension when he retires depends not on whether there are assets in the account or not, but on his confidence in the government. This is like in a bank account; the depositor only cares about the strength of the bank where he has the account and the sustainability of the rules determining benefit levels, not how the money he deposited was used. With funded accounts, the individual worker faces much great uncertainty about how the markets will function, how much return he will get, and in the case of decentralized investment management, how competent and trustworthy is his investment manager

From the perspective of the government a funded account needs resources now to purchase assets. Notional accounts do not need those resources. Thus, a move to funding would impose a larger burden of contributions on the present generation of workers in order to give lower contributions or larger pensions to future workers who are likely to be much better off than today's workers. Such redistribution can be regarded as perverse. Also, funded accounts do not function properly without an expensive administrative structure and well-regulated, good-functioning asset markets. China has neither now.

5. *What is the difference between the NDC approach and the empty accounts that China now has?*

Empty accounts mark the failure of a social security program to work as designed. Workers face unnecessary uncertainty about their future benefits because they do not know what the government will decide when setting pensions for workers who have made deposits that did not get into their accounts, resulting in the empty accounts. Thus, workers do not know what the value of those pensions will be. The NDC approach is one way to determine future benefits in a manner consistent with the real availability of funds. This design avoids poor labour market incentives, and settles the rules for the future in a way that is financially sustainable.

6. *The creation of individual accounts is a key element in China's social security reforms over the past decade. Would the introduction of the NDC not mean a reversal of the reforms?*

Individual accounts can be funded or unfunded. Around the world, there exist funded individual accounts, unfunded individual accounts, and a combination of funded and unfunded accounts. A main characteristic of individual accounts is that they create a strong link between the contributions of a worker during his working life and the pension he will receive in retirement, thereby improving labor market efficiency. This characteristic exists whether the accounts are funded or not. Thus the NDC approach retains the key advantages of individual accounts without the necessity of funding.

The NDC approach (a) retains the principle of individual accounts, but (b) does so in a way that is better suited to China's present situation, and (c) leaves fully open the option of moving to funded individual accounts in the future. An attempt to fund the individual accounts in China now in face of the financing problem may result in a gradual reduction of the size of the individual accounts over time. The NDC approach will allow the government to decide on the optimum size of the individual accounts and not allow the size to be determined by the availability of funding.

7. *Is the NDC approach feasible in China?*

The NDC approach requires that government can (a) identify individual workers, (b) keep track of each worker as he moves between jobs and locations, (c) maintain an accurate record of each worker's accumulation over time, and (d) keep each worker informed about the size

of his accumulation. These are major tasks which will take considerable time, effort, and expense.

Funded individual accounts have all of these requirements and, in addition, further and even more stringent requirements of administration and asset management in potentially turbulent capital markets. The NDC approach, because it does not require the latter set of activities, can operate in countries where funded individual accounts are not yet feasible.

8. *Why should China not fill the empty individual accounts now?*

The accounts could be filled in either of two ways. One is to increase contribution rates or reduce benefit rates so that the funds earmarked for the empty accounts become available to purchase assets for the accounts. This is unsatisfactory given the current levels of contributions and benefits. Higher contribution rates would adversely affect the labour market, not least because the contribution rate in China is high for a country at this level of development. Reducing benefits would risk poverty and adverse political reactions, given the uncertainty and disruption from moving to a market economy. And funding is very risky when capital markets are underdeveloped.

A second approach is to issue large amounts of government debt to restore the empty accounts and to keep them filled as further contributions, which are used for current benefit payments, are matched with further government debt. This approach has serious shortcomings. With market-determined interest rates, higher government debt will drive up interest rates. And if the interest rate on government bonds is not a proper market rate, but one set by government, the question arises of the adequacy of pensions. In this case, of course, the rate of interest could be increased, but if the government is setting the interest rate to be credited to accounts funded with government debt, it seems better to have a systematic basis, embodied in legislation, for setting the rate of return on accounts on a basis that reflects the availability of funds. The NDC mechanism does exactly that. The adoption of the NDC approach, which suits conditions in China now, in no way prevents a move towards funding the accounts in the future as conditions – technical and financial – are met.