Pension Reform in China:
Meeting the Challenges Posed by Societal Aging[1]

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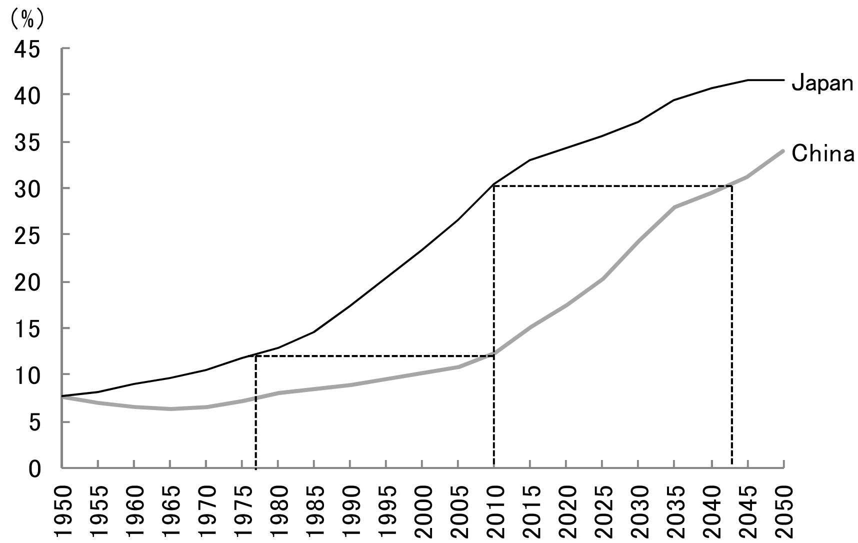
I. Introduction

China's population is aging rapidly. According to figures from the United Nations, the proportion of its population aged 60 or over in 2010 was 12.3%, the same as in Japan in the late 1970s, and is expected to rise to the same level as in Japan in 2010 (30.5%) in the early 2040s (Figure 1). Generally speaking, societal aging is a characteristic of developed economies. However, China will have to face the challenge of getting old before it has had time to get rich. Particularly urgent is its need for a proper pension system.

Figure 1: Comparison of societal aging in China and Japan
－Percentage of total population aged over 60－



Source: Nomura Institute of Capital Markets Research, based on United Nations, World Population Prospects, 2010 Revision (incl. estimates)

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II. China's current pension system

Until the early 1980s (i.e., when China was still a planned economy), the state bore the entire cost of the urban pension plan system. As a result, there was no need for individual workers to contribute. However, following a series of reforms to the system, the cost is now shared by the state, companies, and workers. In addition to the existing urban workers' basic pension, public service workers' pension, and rural pension schemes, China's public pension system now also includes two pilot schemes, namely, the “urban social pension scheme” and the “new rural social pension scheme” (Figure 2).

The urban workers' basic pension covers employees (of state-owned enterprises, collective enterprises, joint-stock companies, foreign-invested enterprises, private companies, and one-man businesses) and can be considered the cornerstone of China's pension system. Membership is mandatory. As of end-2011, there were 284 million members, 216 million of whom were still working and 68.26 million of whom were retired. The urban workers' basic pension is a two-tier pillar consisting of a (pay-as-you-go) social pooling element and (funded) individual accounts. Companies contribute 20% of their total wage bill to the social pool, while workers contribute 8% of their wages to their individual accounts. To receive a pension, members must have contributed for at least 15 years by the time they reach the age of retirement (60 for men, 55 for women in white-collar jobs, and 50 for women in blue-collar jobs). The income replacement rate is supposed to be 40–50%.

Unlike the urban workers' basic pension, the public service workers' pension is still financed entirely by the state and has a high income replacement rate of 80–90%.

Because of regional differences in economic growth there is no nationwide rural pension fund. Instead, membership of the rural pension scheme, which is also open to rural enterprises, is voluntary and on a (funded) individual account basis. Reflecting the fact that economic growth in rural areas has lagged that of the country as a whole and that rural incomes are insufficient to be able to make pension contributions, the rural pension scheme has the lowest coverage among the public pension schemes and a very low income replacement rate.

With a view to establishing a universal pension scheme, the government introduced two new pilot schemes in designated regions: the "new rural social pension scheme" in 2009 and the "urban social pension scheme" in 2011. The latter extends pension eligibility in urban areas to those not covered by the urban workers' basic pension scheme. As of end-2011, the two schemes had a total membership of 332 million, 240 million of whom were aged less than 60 and 91.85 million of whom were pensioners.

Both schemes are voluntary and have many basic similarities. First of all, their two main sources of finance are individual contributions and government subsidies. Scheme members can choose within a given range how much to contribute to their individual accounts each month. The more they contribute, the more they will receive when they retire. Furthermore, those who have contributed for at least 15 years will receive a basic pension of at least RMB55 each month along with 1/139th of the balance of the principal and interest in their individual account when they reach the age of 60.

Figure 2: Comparison of urban workers' pension scheme and urban social pension scheme/new rural social pension scheme

		Urban workers' basic pension	Urban social pension scheme	New rural social pension scheme
Related policies		*Establishment of a Unified Basic Pension System for Enterprise Employees* (State Council Document No. 26 (1997)) *Strengthening Pension Reform for Enterprise Employees* (State Council Document No. 38, 2005)	*Guidelines on Development of Urban Residents' Social Pension Insurance Pilot Project* (State Council Document No. 18, 2011)	*Guidelines of State Council on the Development of Rural Social Pension Insurance Pilot Project* (State Council Document No. 32, 2009)
Coverage		Employees of state-owned enterprises, collective enterprises, joint-stock companies, foreign-invested enterprises, private companies, and one-man businesses	Urban residents aged over 15 (excluding those in full-time education) who fail to meet the criteria for membership of the urban workers' basic pension scheme	Rural residents aged over 15 (excluding those in full-time education) who are not members of the urban workers' basic pension scheme
Mandatory/voluntary		Mandatory	Voluntary	
Contribution basis		Enterprises contribute 20% of total wage bill, employees 8% of wages	Members can choose any of 10 different contribution levels (in units of RMB100) between RMB100 and 1,000/year	Members can choose any of 5 different contribution levels (in units of RMB100) between RMB100 and 500/year
Sources of finance		"Social pooling element" is employer contributions; "individual accounts" are employee contributions. Government subsidies are available in the event of a shortfall.	"Individual accounts" are employee contributions supplemented, where necessary, by government subsidies	
Eligibility criteria (official age of retirement)		At least 15 years of contributions (60 for men, 55 for women in white-collar jobs, and 50 for women in blue-collar jobs)	At least 15 years of contributions (at 60) (Note 1)	
Formula (Note 2)	Individual account	Balance of principal and interest in individual account / Average no. of annuity payments after retirement	Balance of principal and interest in individual account/ 139 (average no. of annuity payments after 60)	
	Basic pension	[(Regional average wage for previous year at time of retirement + average wage over period of contributions/2)] × years of contributions × 1%	Fixed amount (currently a minimum of RMB55/month throughout China, with the option of a larger amount in some areas)	
Membership (end-2011)		284 million (216 million still working, 68.26 million retired)	332 million (240 million below 60, 92 million pensioners)	
Scheme income (2011)		RMB1,689.5 billion (RMB1,395.6 billion in contributions, RMB227.2 billion in state subsidies)	RMB111.0bn	
Scheme payments (2011)		RMB1,276.5bn	RMB59.8bn	
Scheme balance (2011)		RMB1,949.7bn	RMB123.1bn	

Note: 1. As a transitional arrangement, from 1 January 2012, members who have reached the age of 60 will not have to make any contributions and will receive a basic pension. Members aged between 45 and 59 will receive a basic pension when they reach the age of 60 if they pay the balance of their 15 years' worth of contributions.

2. The formula for calculating pension payments under the urban workers' basic pension scheme in the above table is that for the "new group" (i.e., those who joined the workforce after the 1997 reforms). In addition to these benefits, the "middle group" (i.e., those who joined the workforce before, and were due to retire after, 1997) receive transitional benefits. The formula for calculating pension payments for the "old group" (i.e., those who retired before the 1997 reforms) is [(regional average wage for previous year) × 20% + (balance in individual account/120)].

Source: Nomura Institute of Capital Markets Research, based on various sources, including statistics published by the Office of the China National Committee on Aging in July 2012

III. Shortcomings of current pension system and direction of reform

As we have seen, China has made efforts to reform its pension system. Nevertheless, there are still many unresolved issues and considerable scope for improvement.

First of all, coverage is still low. According to a follow-up study on the demographic situation of the elderly population in rural and urban areas by the China National Committee on Aging (CNCA) published in July 2012, coverage in urban areas as of 1 December 2010 was 84.7%, whereas in rural areas it was only 34.6%. China will need to continue to try to extend coverage to people in rural areas and to the unemployed in urban areas.

Another unresolved issue is the wide discrepancy in benefit levels between the different pension schemes. Levels are higher in urban areas than in rural areas. According to the aforementioned survey by the CNCA, an average monthly pension payment of RMB1,527 in urban areas compares with one of only RMB74 in rural areas. And even in urban areas, pension payments to public service workers are much higher than those to company employees. The current system has therefore failed to redistribute incomes in the way that was expected and needs to be improved.

Another problem is a lack of pension portability as a result of the fact that each city tends to administer its own pension scheme. As China's labor market becomes increasingly mobile, shortcomings such as this make it difficult for migrant workers to join a public pension scheme. According to Article 19 of China's *Social Insurance Law*, which came into force in July 2011, when an individual is employed in another pooling region, arrangements for the individual’s basic pension, medical insurance, and unemployment insurance shall move with him/her to the new region, and the contribution years for the social security funds shall be calculated on a cumulative basis.

Last but not least, as societal aging in China accelerates and people live longer, the number of those in work and making contributions will decline while the number retired and receiving payments will increase, making it increasingly difficult to finance pension schemes. As investments are confined to a narrow range of financial instruments with low returns, there have been cases in some areas where the funds in individual accounts have been diverted to cover deficits in pay-as-you-go schemes. In order to make good this underfunding, the Chinese government will probably need to provide fiscal support and may ultimately have to raise the official age of retirement as well as the age of eligibility for social security retirement benefits.

Resolving these issues and building a better pension system are essential elements for China to achieve its goal of becoming a "harmonious society."