System innovation: the key to pension reform

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Along with the accelerated advancement of population aging, China's economic development has led Chinese residents' income to a moderate level. However, the unfair and unsustainable features of "dual standard of pension insurance" for both rural and urban cadre and employees have become so increasingly prominent that the time to change it has come. The top-level design of pension insurance should be taken shape on the basis of clarifying such concepts as old-age security, insurance, system, institution, and mechanism, and be carried out gradually in several steps at different levels. At the first level, basic pension insurance system should be reformed and created; at the second level, a new institution for pension insurance system should be reformed and created; at the third level, reform and improvements are made to compensate pension insurance system. Among these, the key is to establish a uniform pension insurance system for both urban and rural cadre and employees which is primarily dependent on individuals' payment and secondly by enterprises (units). Such institutional innovation requires initiatives from both government and market towards a market-oriented reform.

Keywords: the pension insurance system, system innovation, top-level design, market orientation

There has been heated discussion for quite a long time period on whether to extend the retirement age, to postpone the pension allocation, and to expand the duration of payment. These discussions center on the issue of pension payment and payout, but the ultimate concern is about the pension system and related mechanisms. System innovation is the key to reforming the pension system.

1. Breaking the institutional barrier of the double-dual structure

Pension practices worldwide can be grouped into the following five categories.

First is income-associated insurance, which is the traditional type of insurance. The main feature of this insurance type is that pension defrayment is linked to payment into the scheme from personal income, and that the employer and employee contribute to the scheme together.

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The coverage rate is not high, and the pension replacement rate is moderate. In this insurance system, the pension financial industry is well developed and therefore both payment into the system and pension allocation are relatively ensured. Examples of this insurance type are the United States, Germany, and France.

Second is the social welfare type. This type of insurance system emphasizes the principle of universal coverage. In this type of insurance system, the basic pension covers all eligible citizens, and the pension defrayments are funded from government tax revenue. Pension payments are not high in such a system, and other supplemental pension systems are necessary to fill the gap. Examples of this insurance type include the United Kingdom, Australia, Canada, and Japan.

Third is the savings type. This type of insurance system follows the criteria of self-guarantee, and it employs the fund model of full accumulation. In this system, various types of individual pension accounts or provident fund accounts are set up, and pensions are disbursed according to the amount of savings in the funding accounts. Examples of this type include Singapore, Chile and other emerging market economies.

Fourth is the mixed type. This type exists in some countries that traditionally applied the social welfare insurance system but where economic recessions or fiscal difficulties made the traditional system unsustainable. Reform is therefore carried out and a mixed-type pension system, which combines the traditional revenue-associated insurance with social welfare insurance, implemented. Examples of this type include the UK and Canada.

Fifth is insurance provided by the government with no payment. This type of insurance is usually employed in the societies with planned economies. In this kind of insurance system, pensions are provided free of charge for all workers in nationally or collectively owned economic entities. The government disburses pensions regularly according to individuals' length of service and wage level upon retirement. Yet, due to changes to the political landscape, no country employs this system today.

Then, which type of social pension does China employ? Some scholars generalize the insurance type in China as the "social pool plus individual accounts." But in my opinion this is simply a generalization of company pensions. Since it embraces neither the insurance type applied in government organizations and institutions, nor that in rural areas, the notion of "social pool plus individual accounts" cannot represent or reflect features of the whole insurance system. In effect, the insurance type applied in China today shares some similarities with, and also differences from, all the above-mentioned insurance types. As such, it may be termed as mixed transitional type. By "mixed," we mean that it has some features of all the five types mentioned above. By "transitional," we mean that it has been transitioning since 1949.

Early in 1949, the first statute book, the *Common Program*, stipulated "gradually implementing a labor insurance system." In 1951, the *Labor Insurance Regulations of the People's Republic of China* stipulated for the first time that all workers in the state-owned industrial enterprises with more than 100 employees were eligible to enjoy labor insurance for work-related injuries, diseases, and support in old age. In 1958, the State Council passed the *Interim Provisions on Worker and Staff Retirement*, in which separate regulations were implemented for retirement for enterprise workers. Combined with the regulations for the retirement of workers at government organs, they constituted pensions targeting employees in enterprises, organizations, and institutions. In 1978, *the Interim Provisions on Worker Retirement* and the *Interim Provisions on the Resettlement of Old Cadres* declared the separation of retirement policies for workers from those for cadres, and set the corresponding endowment level at 60 to 90 percent of the monthly salary at the time of retirement in accordance with the duration of employment. In 1991, the State Council announced the *Decisions on the Reform of Old-Age Insurance System for Enterprise Workers*, in which the old-age insurance coverage was extended to collective economic entities, and the state, enterprises, and individuals were to bear the responsibility for pensions collectively. The *Decisions* also announced the establishment of a pension system combining basic old-age insurance, supplemental enterprise insurance, and individual savings insurance. In 1995, the *Notice of the Ministry of Civil Affairs on Further Improving Rural Social Pensions Forwarded by the General Office of the State Council* called for efforts from regions to develop rural social pension programs according to their own realities and also to lead farmers to participate in the program. And in 2009, the State Council issued *Guiding Opinions* on the pilot program of the new-type rural social pension insurance (NRSPI). Since then, new-type rural social pension insurance has developed rapidly and has achieved nearly full coverage.

The formation and developing process of the pension system just described has been quite "mixed" and "transitional" in nature. Gradually, it has developed into a system with a double-dual structure that treats rural and urban citizens, as well as government cadres and general urban workers, differently. The system has been useful in various stages of its history. Nevertheless, as society has marched toward a middle-income society with an urban population exceeding 50 percent and the average life expectancy reaching 73, this pension system is no longer suitable and it has begun to exhibit negative effects on development.

In terms of the dual structure that distinguishes rural and urban citizens, the system excludes the rural elderly who account for around half of elderly people national wide. Although the new-type rural social pension system has been developing rapidly in the past few years, the level of pension payment is still too low to support citizens in old age. In 2011, the urban workers' basic pension fund spent 1.28 trillion *yuan* (RMB) on 86.3 million retired workers, equaling a per capita pension allocation of 14,797 *yuan* on average. In contrast, the trial new-type rural social pension fund spent 58.77 billion *yuan* on 89.21 million eligible elderly individuals, with a resulting per capita distribution of 658.7 *yuan*, or only about 4.5 percent of the allocation level in the urban system[1].

Regarding the dual structure within the urban system, the enterprise workers need to pay 8 percent of their salary into the pension fund to form individual accounts, while enterprises must

[1] Data source: *China Statistical Yearbook 2012*.

pay 20 percent of employee salaries into the pension fund to form the supplemental account. By contrast, cadres and their affiliated institutions or organizations need not to pay anything into the pension fund. Moreover, the pension replacement level for enterprise workers is around 50 to 60 percent of their original wage, while cadres in institutions or organizations will receive a pension allocation equivalent to around 80 to 90 percent of their wage. Since the wage difference between cadre and enterprise worker is already significant, the different replacement levels further enlarge the allocation disparity to a level exceeding two times.

This situation has resulted in income inequality among the elderly. While some elder people have affluent pension allocations, others find it difficult to balance their incomes and expenditures. This is especially true for many farmers and some urban workers. To reform the pension system toward a more equal one, we must promptly break this double dual structural system.

2. Paying attention to top-level design in reform

After 34 years of reform and opening, China's reform has passed the so-called stage of "crossing the river by feeling the stones." Any reform should follow a general and overall perspective. By the same token, the reformation of the pension system should also pay attention to top-level design, and place itself into the overall old-age security system. Before we discuss the top-level design of reform, we need to clarify the key concepts of old-age security, old-age insurance, the old-age system, and old-age mechanism. These words have been used interchangeably in speeches, documents, and articles, but they actually have different meanings and definitions. This makes the whole issue difficult to understand and adds more practical complications to the system reform and the top-level design.

2.1. The concepts of old age security and pensions

In my opinion, old age security means the system and regulations to protect the right to be supported in old age, and it includes all the content, organizations, and perspectives of old age support. Pensions refer to collecting pension funding from all sources, having professional insurance agencies manage the funds, and allocating pensions regularly to the applicants and other eligible elderly people.

2.2. The concepts of the old age support system, regime, and mechanism

The old age support system corresponds to the concept of old age security. It refers to the unity formed with and engaged by agencies that are related to old age support, under a specially designed framework. The old age support regime refers to the normalized regime formed by the state, enterprises, units, and individuals. It corresponds to the term of pensions. The old age support mechanism refers to the process and the means of interaction between the organizations and individuals in the old age support regime.

According to these definitions, old age security is the most macro-level concept, followed by pensions. Therefore, we need to put pensions into the old age security system. Combining the useful lessons learned from experiences abroad with China's reality, old age security and pension reform and the top-level design could be designed at three levels, and these detailed reform designs should progress step by step.

2.2.1. To reform and set up a basic old age security system

The bottom line is to build up a minimum pension system that covers all elderly. In China, this consists of social insurance, social welfare, and social assistance for old age support. These three components are connected with each other and supplement each other. And taken together, they form the foundation that underpins the old age security system. Yet, these three components are not parallel. Among them, social insurance forms the main body and keystone of reform and also the focus of the following discussion. Social welfare and social assistance are two wings of the system, and they are essential to the system. For instance, it is necessary to have social assistance for the widowed elderly, including financial support, medical support, care and nursing, and so on. Social assistance in cities such as Beijing supplies the oldest of the elderly (those above 80 years) an allowance of 100 *yuan* per month. The oldest elderly are also entitled to visiting parks and ride buses freely with their free preferential card. These entitlements are additional social welfare to the oldest elderly, and they are meaningful for their health and quality of life. However, we still have a long way to go before social assistance and social welfare arrangements are sufficient. This is especially urgent as the population ages and the oldest elderly population grows. The state and governments at all levels should increase funding, extend their scope of service, and improve service quality. All of these efforts are aimed to build up a "safety island" for vulnerable elderly.

2.2.2. To reform and build a basic pension system

This is the core of the overall old age social security system, and it is also the most difficult and important point of reform. The direction of reform is to break the double-dual structure of the pension system and to build a new, uniform pension system national wide. The new system should be an accumulation of pension funds supplemented by government support. It can be established with the following three supporting points.

The first supporting point is that pensions should be accumulated mainly through individual payments, which would then form the predominant evidence by which to disburse pension payments. This is related to, and also distinguished from, the ongoing system of "social pool plus individual account." The relationship between the two systems lies in that individual accumulation accounts in the new system are upgraded from individual accounts. The difference lies in that in the current system, individual accounts are basically nominal, and pension allocation is actually linked with original wages, time of employment, and duration of work, rather than with the balance of the individual account. Therefore, reforms in the following three aspects are called for. (1) To make the individual pension account in enterprises a true account, to link pension allocation to individual accounts, and to gradually develop individual accounts as the key evidence for pension allocation. (2) To bring government agencies and institutions into the system, to set up individual pension accounts similar to those in enterprises in those organizations, and to make them the key evidence for pension allocations. This reform poses the greatest challenge, and we must take time to achieve this goal. Methods for synchronizing the enterprise and government systems could be released simultaneous to reform documents. (3) To include the new-type rural social insurance into the system. This can be done by raising the level of individual payments and increasing public input from the government, banks, and other financial agencies in concert with economic development in rural areas.

The reforms from these three aspects will ultimately lead to a unification of all the pension programs in society. The goal is to develop a pension system based on individual accounts, which links the allocation of pensions directly with a system of accumulation in individual accounts supplemented by government finances.

The second supporting point is to develop the accumulation-supplement accounts of enterprises with a moderately lower payment rate. The ongoing "social pool plus individual account" system in enterprises specifies a supplemental payment equivalent to 20 percent of a worker's wage. This payment rate has overburdened many enterprises and made profits and development more difficult. This is especially true in less profitable industries. Accordingly, reform should lower the enterprises' payment rate to a level comparable to or slightly higher than the individual payment rate. The duration of payment could be extended until a worker's retirement. This reform could relieve enterprises' burden and make it sustainable, while also improving the fulfillment of enterprise payment, preventing incidents of nonpayment or delinquency, and making the pension system operate safely. It should be noted that after carrying out this reform in government offices and institutions, those government offices and institutions should make payments at the designated rate as well.

The third supporting point is to improve the oversight system and ensure the increasing value and sustainability of pensions. This can be achieved further through the following three steps. (1) To improve the supervision mechanism and complete the related system. For some time, pension funds have occasionally been misappropriated. This phenomenon emphasizes the incompleteness of regulation, policy, and management in the pension system. Therefore, it calls for pension system reform. To this end, it is necessary to learn from successful experiences internationally, to build up a law-based, clearly defined and independently operated, top-down oversight and management system, and to that pension funds are used for their specified purpose only. Moreover, it is necessary to develop financial markets for pensions in order to ensure the increasing value of pension funds. (2) To fill in shortfalls in individual accounts appropriately. At present, the shortfall in individual account coincides with surplus in the overall balance. It is undesirable to neglect the individual account deficit, though it is also unnecessary to fully fill it. As the population ages, the number of retired elderly will increase, and the amount of pension payments will rise as well, it is projected that pensions could amount to 10 percent of the GDP and 29 percent of total wages by 2030, which is very close to the warning line recognized internationally. By then, the two trends are likely to conflict with each other drastically. Therefore, the way to counteract the potential risk is to fill in the shortfall to some extent. This would bring the pension reserve to an appropriate level, just like the reserves in banks. The criteria is to assure the pension system operate safely and effectively. It is undesirable either to leave the shortfall alone or to fill it incompletely in this sense.

2.2.3. To reform and complete the supplemental pension program

The top-level design of the pension system is solid, and the supplemental pension program is a necessary supplement to the basic pension program. As discussed above, the ongoing supplemental pension program stipulates that enterprises pay the supplemental premium equivalent to 20 percent of a worker's wage. This premium rate is high and could be lowered to a level closer to the worker's payment, i.e., 8 percent of wages. In addition, as the actual life expectancy is likely to be longer than the projected one, there is an implied risk of longevity surpassing the level that a regular pension plan could afford. Pension reform should take this risk into account. The state, enterprises, and social organizations should take the responsibility to cover the risk of longevity, and take it into consideration in the social supplemental pension reform.

3. Giving full play of the enthusiasm of both government and market

The international experiences suggest that the leading role of government is necessary for the establishment and operation of any pension system. This is especially true for China. Reform means redistribution of resources, benefits and rights. Therefore, the role of government is indispensible for any reformation. To break the double-dual structure system, and to unify the urban and rural pension systems and the urban insurance system for cadres and that for workers, redistributing the benefits of cadres, workers, and farmers is inevitable. This needs to operate under the regulations of the law. As "coach" and "referee," the government plays an important role in organizing, promoting, supervising, and regulating the process of benefit redistribution. Therefore, it is imperative to reinforce (rather than to weaken) the role of government in the pension system reformation.

To reinforce the role of government is not to make it the whole show and replace the role of market. Marketization should be the main orientation of pension system reform. It has been proven that the reform using forceful administrative means is neither sufficient nor cost-efficient. In contrast, market-oriented reform can optimize the allocation of resources easily and is more vigorous and effective. Under the reform framework that is put forward above, the reform to set up a basic pension system, which relies mainly on individual payment accumulation and links allocation to payment, is made to reinforce the input-output effect of the market. Yet, the reform to set up a supplemental enterprise accumulation and lower the payment rate is done to include the pension into an enterprise's development. The market rule still applies here.

Our pension system faces a great challenge in guaranteeing the increasing value of pensions. This is partly attributable to the underdevelopment of the financial market. To reform this area, we need to learn from the lessons and successes of western countries and set up a suitable pension financial market system according to the reality that we have. From 1981 to 2011, the Asian financial crisis, the subprime crisis in the US, and the European debt crisis have risen one after another. Yet, statistics show that the social pensions increased steadily during this period in most of these developed countries, despite the fact that their economies declined. For instance, the investment-return rate of the pension funds in the US, Germany, UK, Canada, the Netherlands, and Switzerland averages 6.25 percent. This contrasts greatly with their recessive economies. The lessons learned from these countries are to introduce private agencies into the pension management, expand investment channels for pensions, reinforce oversight of pension investment as to mitigate financial risks and enable the value of pension funds to increase sustainably. At the very beginning of China's pension financial market reform, it is meaningful and necessary to learn from these successful experiences from around the world.