
Pension Reform in China: Progress and Prospects

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1. Introduction

7. China is currently in the process of building the largest pension system in the world, and it is doing this at a time of unparalleled economic and demographic transition. The 11th five-year plan (2006-2011) of the government has put the creation of a “harmonious society” as the ultimate goal of all its actions and a functioning old age insurance scheme seems essential to reach this goal.

8. In a characteristic mix of experimenting and learning-by-doing, China has followed a step-by-step approach to develop a system that can accommodate a rapidly aging society within a rapidly growing, but still largely underdeveloped economy. But in the transition from a planned towards a “socialist market” economy the complex interactions between numerous challenges such as the urban-rural divide, growing inequality and the ongoing reform of formerly State-owned enterprises make an incremental approach increasingly difficult. This paper therefore analyses how far the process of creating a national old age insurance system had proceeded by the end of 2006. It provides a detailed description of this system and an assessment of to what degree it has so far achieved “its primary goal of social security for more people” (Chinese government, Xinhua News Agency, Sept 15, 2006).

9. The paper is structured as follows. First, the social and economic environment relevant to the Chinese pension system is described. The second section describes the historical development of the old age insurance system since the 1950s. The third section provides an analysis of current pension arrangements. Trends in spending and recipient numbers are then examined to determine the scope of the current pension system. This is followed by a discussion of how the Chinese system compares to those in other countries and other regions of the world. The paper concludes with an assessment of the major challenges facing the Chinese system in coming years.

10. Several issues should be borne in mind while reading this paper. Although the Chinese pension system was redesigned in 1997, those already retired at that time were not affected by the reforms and transitional rules were applied to some of those already employed. This paper focuses on the post-1997 system and therefore does not discuss in detail the situation of existing retirees who still benefit from the more generous features of the old pension scheme. In addition, nor does the paper discuss the separate pension system for civil servants, military officers and employees of public institutions, which offers very generous benefits, covers about 40 million people, and is completely unfunded (Sin, 2005).

11. Additionally, it should be noted that while the central government is determined to install a national pension system, in practice the current system is administered mostly at provincial or county level, and consequently rules, contribution rates etc. can differ in different locations. For example, an employer in Shanghai has to pay 22% of the previous year’s average wage of its workers into individual pension accounts, while in Shenzhen a company needs to pay only 9% of the current wage. These differences should not be surprising at this early stage of the new system and in a country the size of China. However, provinces continue to have a significant degree of autonomy and therefore the Chinese pension system could be thought of as a number of systems, which take different forms within centrally declared guidelines. Local modifications can be expected to continue and also to influence guidelines from the central government in the future.

2.9. *Demographic structure is changing enormously*

23. A more detailed inspection of the demographic structure of China in 1950, 2005 and 2050 reveals a clear picture of the scope of demographic change within Chinese society and the number of older people it has to accommodate in the future.

24. According to UN population projections (Figure 6), the Chinese population of 560 million in 1950 had a demographically favourable form. Over the last 55 years this shape has transformed unfavourably and if one considers the medium variant of the UN projections for 2050 the situation worsens. The biggest age group will then be between 60 and 69 years instead of 0 to 10 years as in 1950.

3.4. *From 1991 all SOE workers are covered by a three tier system*

33. The 1991 Resolution constituted a significant step in the further development of the system. It aimed to bring all workers in SOEs into a uniform pension scheme with three tiers. These were a basic pension for all retirees jointly financed by the state, enterprises and the workers; a supplementary scheme funded by the enterprise from its trading surplus; and an account funded by individual worker, on a voluntary basis, and payable at retirement as a lump sum. As on previous occasions, the 1991 Resolution has laid down guidelines rather than binding directives. The Resolution recommended that social insurance funds should be set up at the provincial level and once established, the distinction between the permanent and contract workers' fund should be abolished and they should be unified under a system of pooling. The old practice of requiring individual enterprises to pay the pensions of their retired workers was now to be replaced by collective funds where the responsibility was shared between the state, the enterprise and individual worker. Some provinces also began experimenting with a more individually-focused, two tiered approach funded by employee and employer contributions without the guaranteed government-backed basic pension. This approach was particularly popular with employees in private and joint-venture enterprises. They often had few retirees on their payrolls and thus saw pooling as a form of subsidising state-sector retirees. Furthermore because contributions represented a percentage of payroll, private firms that paid higher salaries had to shoulder a greater burden.

3.5. *First attempts to broaden coverage during the 1990s*

34. The Government attempted to broaden coverage by introducing pension schemes for the rural population, initially on an experimental basis. In January 1991, under the "Basic Plan for Old Age Social Insurance in the Countryside" the State Council decided to develop old-age social insurance in rural areas and designated the Ministry of Civil Affairs to be responsible for the project.

35. In the 1990s the success of various experimental approaches, together with the sustained growth of the economy, encouraged the authorities to continue their efforts to reform the pension system, but in a more unified way than before. The two crucial policy documents were the 1995 State Council Circular on Deepening the Reform of the Old Age Pension System for Enterprise Employees and the 1997 State Council Document No. 26⁴ (see section 4 for a detailed analysis). In the first document, the State Council offered provinces a choice of two plans. Despite the fact that the provinces, in fact, adopted a wider range of variants the regulation established the principle that policy on pension design was a Government, and not an enterprise responsibility. Council Document 26 approved a plan to finally establish a unified nationwide basic pension insurance system to replace all pilot programmes in each province by the end of the century.

3.6. *State council documents lead the way to a national pension system*

36. Document 26 was the first of a number of state council documents, which show the adaptive approach to the national pension system by the central government. Although the three pillar system of document 26 is still at the heart of reforms to the Chinese pension system, various elements have been

4. These State Council Documents provide specific guidelines that are central to government policy reforms.

changed over the last ten years with the help of new state council documents. Among the most important ones are Document 42 from 2000, Documents 20 and 23 from 2004 and 35, 36 and 38 from 2006, which are explained in more detail below.

3.7. Pilot programmes are implemented on an experimental basis in various provinces

37. Although the theoretical basis was laid down in document 26 (“Decision of the State Council on Establishment of Unified Basic Old Age Insurance System for Enterprise Staff and Workers”) it took until December 2000 for Document 42 (“The Pilot Programme for Improving Urban Social Security System”) to put the system into practice on an experimental basis in Liaoning province. This province in the northeast of China has only 3.2% of the total Chinese population, but 7.2% of all SOE retirees in 2004 lived there, and consequently the burden of laid-off SOE employees was particularly large. Therefore the programme needed to be financed to a large extent from the central government. Nevertheless, the social security pilot has been extended to Jilin and Heilongjiang provinces in 2004 and 2005 (together these three provinces received nearly one quarter of the central state social security subsidies in 2004) and by 2006 another eight provinces were included⁵, extending the coverage to a total of 11 out of 31 provinces or 39 % of the Chinese population (China Statistical Yearbook, 2006). The aim of these pilot programmes is to develop a long-term effective system to achieve three objectives. Namely, 1) funding individual accounts of the basic pension system, 2) adjusting the benefit formula and 3) expanding pension coverage and collection (Zheng, 2006). Although contribution rates, replacement rates etc. differ between these eleven provinces, a successful outcome of the experiments in the sense that individual accounts and social pooling are managed in segregated accounts “would be a great boost to the confidence and determination of the central government to implement document 42 nationwide” (Pai, 2006). According to Zheng, this management setting has been achieved to a great extent and individual accounts are fully funded in Jilin and Heilongjiang. But by the end of 2005 this funding was only reached due to massive financial support from the central and local government, whose payments together accounted for more than 70 and 80% respectively of the funds in the individual accounts.

38. In 2006, Documents 35 and 36 introduced a proxy for life expectancy at retirement age into the benefit formula that had assumed an average retirement to last for 120 months. Furthermore in the same year Document 38 (Decision on Improving the Basic Social Insurance System for Enterprise workers) has changed the setting of Document 26 in the respect that it rewards retirees with a higher pension for every additional year that they have contributed (see Section 4 for details).

3.8. Corruption reduces public trust in pension funds

39. However, recent corruption scandals involving the misuse of retirement funds by officials have reduced public trust in the ability of funds accumulated in individual accounts to serve as an effective investment for their retirement. In particular, the Shanghai pension fund scandal has had far-reaching consequences within the administration of the Chinese pension system. In August 2006 investigators discovered that the Shanghai Social Security Fund had invested a large share (approximately one third) of its USD 1.25 billion fund in highly speculative real estate projects. This is clearly not in line with the investment guidelines of the State Council and it has been assumed that officials have personally benefited from these transfers. As a consequence, more than one hundred central government investigators were sent to Shanghai and the city’s Communist Party chief, Chen Liangyu, as well as the head of China’s National Bureau of Statistics, Qiu Xiaohua, have been jailed for corruption. Chen is the first member of the Communist Party’s 24-member Politburo to be sacked in more than ten years, and this is supposed to mark the central government’s determination to fight corruption on all levels. According to China’s official news agency Xinhua there have been approximately 100 000 cases of bribery and graft within the last five years

5. These provinces are Henan, Hubei, Hunan, Shandong, Shanghai, Shanxi, Tianjin and Xinjiang.

and more than 83 000 officials have been prosecuted. These circumstances partly explain the people's reluctance to contribute to a publicly managed pension fund.

3.9. Occupational pensions

40. Document 42 also introduced rules for a voluntary enterprise annuity (EA) and therefore clarifies the framework of the second pillar. In May 2004 Documents 20 and 23 were issued and further stipulated how the accumulated pension funds of the EA are supposed to be operated under an arrangement of services provided by trustees, custodians, investment managers and administrators, which need to be separate legal entities (Murton, 2005). Furthermore, the occupational pension schemes can pay the benefits either in the form of a lump sum or as regular payments. However in spite of these regulations the EA is voluntary and negotiated directly between employers, employees or unions. Government officials are only involved at the stage where the mechanism is put into practise and need to check whether the regulations are in line with State documents. More recently, Regulation 25 specified investment guidelines in order to ensure a degree of safety for the financial accounts and hence promote the development of occupational schemes.

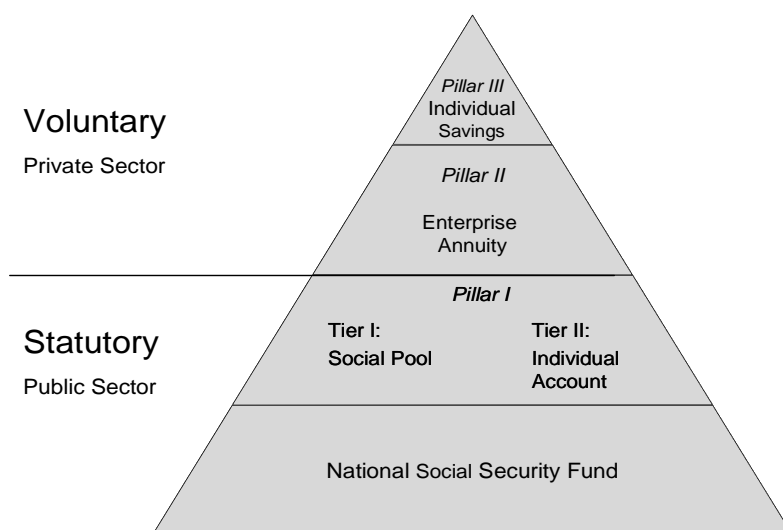
3.10. A last resort fund is created to cushion the financial effects of population ageing

41. The National Social Security Fund (NSSF) was established by the Chinese government in 2000 as a fund of "last resort". The fund is managed by the National Council for Social Security Funds and its main purpose is to develop a national long-term strategic reserve fund in order to finance future social security expenses. The council consists of five government representatives from the Ministry of Finance (MOF), the Ministry of Labour and Social Security (MOLSS) and trade unions, five regional representatives and five representatives from the central government. Currently there is no official legislation on the conditions and timing under which the Council would decide to make payments. For now the MOLSS and the Ministry of Finance (MOF) cover most of the pension liabilities of provincial governments, but at the point when the impact of population aging will be most severe it is expected that the NSSF will take over this responsibility. According to Li Keping (Director-General of investment for the National Council for Social Security Funds) the fund is not ready to make any major expenditure at this time or the foreseeable future, and definitely not before 2010 (Asia Asset Management, 2005).

42. The funding for the NSSF comes mainly from Budget allocations (at the end of 2004: 75% of total funding), income from sales of state-owned shares, normally ten percent of the proceeds, (17%) and national lottery profits (8%; Xinhua News, March 29 2005). The "less risky investments" (bank deposits, treasury bonds purchase, making up 82% of total investments in 2004) are operated internally by the NSSF, while the "more risky investments" (stock market investments, 18%) are carried out by ten investment organizations that were chosen by "strict selection" (Xiang Huaicheng, Head of NSSF, at a speech in 2005) and which need to follow a number of investment guidelines (see Pai 2006 for details). Since May 1 2006 the NSSF has also been authorized to invest in overseas assets (up to 20%), and so far two US banks have been officially announced as custodians and ten other institutions were chosen to be in charge of the NSSF's investments in foreign markets. There has also been an initiative to partly allocate shares of state-owned enterprises to the NSSF. In the light of successful recent initial public offerings (IPOs) this could improve the financial situation of the fund considerably.

4. Current social security arrangements

43. On the basis of State Council Document 26 the central government has outlined a nation-wide basic pension insurance system consisting of three pillars - in line with recommendations by the World Bank - plus an underlying investment fund (Figure 7 and Table 2).

Figure 7: Structure of the Chinese pension system

44. The mandatory first pillar is based on the NSSF. It consists of two tiers, namely the social pool and an individual account. The first tier works on a pay-as-you-go basis and is totally financed by employers. Contributions are 20% of the employee's wages, with a maximum base of three times the average provincial wages and at a minimum of 60% of this average (that is, workers earning less than 60% of the average wage are treated as if they do earn this level). The first tier ensures a fixed replacement rate at retirement of 35% of the city's average wage after 15 years of service. In order to qualify for these payments a worker in addition to having contributed for 15 years must reach the normal pension age of 60 for men and 55 for women (50 if engaged in physical work). However, Document 38 has altered the replacement rate in order to reward additional contributions. Following this document one gains an additional 0.6% for each additional year of service (Sin, 2005). The payments are adjusted according to an index combining local wage and price inflation.

45. The second tier of pillar I is managed as fully funded individual accounts that were originally financed with contributions of 8% from enterprises and 3% from individuals (Document 26). However, since January 2006 Liaoning, Jilin, Heilongjiang (the three "pilot" provinces) as well as eight other provinces have put Document 38 into practise, meaning that the second tier is funded solely by employee contributions of 8% of his or her wages. In practice 5% come from the state (3.75% from central government and 1.25% from local government) and 3% from individual's contributions. It is expected that all provinces will adopt the guidelines set by Document 38 in coming years (Pai, 2006), but it needs to be kept in mind that at this point of time the contribution rates can vary widely between and even within provinces. The target replacement rate from this tier is 24.2%, based on the assumption of 15 years of continuing contribution and a monthly payment formula of dividing the accumulated amount plus investments by 120. The total replacement rate from pillar I is therefore projected to be 59.2%.

46. Again the initial factor of 120 (which is based on an assumed average post-retirement lifetime of 120 months) has been changed during the various experiments in different provinces, and is likely to be further adjusted in the future in order to bring it in line with average local lifetime expectancies at retirement (Documents 35, 36 and 38). If the total payments exceed accumulated savings, the benefits continue to be paid out of a social pool. For example, in the case of Jilin and Heilongjiang the actuarial factor at a retirement age of 45 years is 216, while it is 170 at 55 and 101 at 65. This means that if a person

retires at the age of 45, his or her individual savings will cover him or her until 63 years of age, and from there on she is paid out of the social pool. For a 65-year old retiree the individual account will cover her until the age of 73.4 years, but of course at a higher rate of payment (more than double, assuming the same amount in the individual savings account). Furthermore, if an individual has contributed for less than 15 years he or she will receive the savings from the individual account as a lump sum.

Table 2: Contributions and benefits under the three pillar system

		Contributions	Benefits
Pillar I	<i>Tier I</i> (PAYG)	Employer 20% of employee's wages (max 300% min 60% of provincial wages).	35% of average monthly wages in province, where one was employed (if >15 years of service).
	<i>Tier II</i> (Funded)	Employee 8% of his or her wages.	Individual account divided by 120 (expected to equal 24.2% of average monthly wages in province).
Pillar II	(Funded)	Employers and employees make voluntary contributions.	Individual account.
Pillar III	(Funded)	Employees make voluntary contributions.	Individual account.
		TOTAL: 28% of employee's wages + voluntary contributions.	TOTAL: 59.2% of average monthly wages in province + voluntary employers/employee pensions.

47. Pillar II is a voluntary contribution-based old-age insurance that is financed either by the employing company or by a mix of company and employee payments. This supplementary pension concept was first mentioned in 1991 in Document 33, and the first voluntary corporate pension plans appeared in 1992. Only in 2000 did Document 42 put the various existing supplementary pension plans into the second pillar, which was then officially named the enterprise annuity. In May 2004 a trial measure specified a maximum of 1/12 of the total previous annual salary for enterprise contributions and 1/6 for enterprise-employee combined contributions. The design of allocating total contributions to the individual accounts as well as the payment method when the individual reaches the statutory retirement level is left to the company. However, to implement the employer's pension plan, four prerequisites need to be fulfilled. First of all the enterprise needs to meet certain criteria (participation in pillar I, being "financially sound", collective negotiation system established). Then it needs to file a plan with MOLSS, which then has 15 days to object to the concept. The company has to appoint a trustee that supervises the company's pension plan. This can be a management committee consisting of employees or people from a government-approved trustee corporation. Lastly, the trustee appoints an administrator, a fund manager and a custodian, all of whom need to be from different organizations and approved by the government. Furthermore the pension fund established by the company is legally limited in its investment policy. Short-term securities are required to be a minimum of 20% of the assets, while fixed income and long-term securities as well as equities are allowed to be a maximum of 50% and 20% respectively (Document 25). So far no foreign investments are permitted. In return the government grants tax benefits to these companies, although deductibility of the enterprise's contributions varies between provinces (in most provinces tax deductibility is limited to four percent). A recent survey among multi-national companies (MNC) has shown that about 23% of these MNCs participate in this programme, but this rate is assumed to be lower within local enterprises (Watson Wyatt Worldwide, 2006).

48. The third pillar consists of a voluntary complementary private savings account. This is meant for people who want to ensure a higher pension income for their post-retirement lives. However, the savings for pillar III are not supported by tax incentives and at this stage the role of this option is not significant.

5. Other retirement income systems

5.1. Private Savings

49. The Chinese economy as a whole is characterised by a high savings rate (according to the IMF gross national saving equal more than 40% of GDP), but this fact is not reflected in the private saving accounts of people who reach retirement age in coming years. Jackson and Howe (2004) found out that in 1995 about 53% of the urban population of 55 years and above held less than half of their annual earnings in financial assets. The wealth-to-income ratio also reveals that around 25% of the elderly have savings exceeding their annual income, but this is still hardly enough to finance a retirement period of about 20 years.

5.2. Family-related old age provision remains important, especially among the poor

50. Old age provision through the extended family network is a deep-rooted tradition in China and also institutionalised by the Family Support Law of 1981, which obliges younger generations to support their parents if their parents are not able to live by themselves. Yu-Wei Hu (2006) notes that the inter-generational contract will be sustainable in spite of opposing trends in other emerging economies. Taking Chinese Taipei as an indicator of how mainland Chinese culture might adapt to more affluent economic living conditions provides a similar picture: in 1995 more than 52.3% of Chinese Taipei's elderly depended on their children, compared to 14.8% that received state or enterprise pensions (Li, 1999).

51. A study by Cai, Giles and Meng (2005) about how well children insure their parents against low retirement income also supports Hu's (2006) conclusion. Although average intra-family transfers to the elderly amount only to 4.4% of average income within the old age population, this rate increases to more than 20% for very poor retirees (with income level below half the poverty line). Furthermore, it is argued by Hu (2006) that improving the public pension system is not expected to crowd out this family provision. However, so far no political measures have been taken to support this informal but necessary part of the retirement income system. One concern is that tax incentives for transfers among extended families would only reduce inequality within families but not across families. Furthermore, Cai *et al.* (2006) report that a large survey found that roughly 45% of the elderly live with an adult child and that 90% of Chinese respondents are willing to support their parents financially.

5.3. The rural pension system is still in its infancy

52. At this stage the government is still focused on establishing a functioning pension system in urban areas, whereas there is hardly any financial provision for old age by the state in rural areas. In recent years, only two out of 23 options outlined by the Development Research Centre of the State Council address the problems of the rural pension system.⁶ However, MOLSS has made it a national priority to extend social insurance to rural migrants in urban jobs (see the discussion on portability below).

6. According to Yu-Wei Hu (2006) this Centre plays a central role in initiating any economic reform in China.

53. Prior to reform, the “Five Guarantees”⁷ by the collectives ensured the livelihood of poor elderly in rural areas. In 1992 the Ministry of Civil Affairs promulgated the “Basic Programme for Rural Social Security Insurance and County Level” to adopt a rural old age insurance system with the county as the basic operational level. Individual contributions were supplemented by collectively-sponsored contributions and government support to set up individual accounts. In 1998 responsibility was transferred to MOLSS, which considered the system to be not mature and replaced it in 1999 by a commercial insurance programme. As a result, coverage declined significantly from 75 million in 1997 to 54 million in 2004, albeit both being only a small fraction of total rural labour force (down from 15.4% in 1997 to 11% in 2004; Wang, 2006). According to the “China Urban and Rural Elderly Survey” in 2000 about 7% of rural people aged 60 and above received pension benefits or social old age insurance, whereas 85% relied on family support. Other estimates are only slightly higher - 9 to 11% (Hu, 2006).

5.4. The minimum living guarantee

54. In 1999 the central government promulgated the “Regulations on Guaranteeing Urban Resident’s Minimum Standard of Living” to ensure a basic livelihood for all urban residents. If family income falls below a locally specified minimum income line, the local government will finance the gap out of its budget. In 2004 about 22 million urban recipients received CNY 15 billion (about USD 1.8 billion).⁸ In recent years several rural areas have started to introduce a similar minimum living standard security system (chinagate.com, 10/2006) and by the end of 2003 approximately 12.6 million people in rural China benefited from the minimum living allowance and subsistence relief for destitute households (China Pension Net, cnpension.net, 24/02/2006).

6. Trends in the urban pension system

55. China has increased its spending on social insurance significantly over recent years, with spending reaching 3.3% of GDP in 2005, compared with less than 1% in 1989. Pension spending constitutes by far the largest share at 0.7% of GDP in 1989 and 2.2% in 2005. In absolute numbers the old age insurance costs in 2005 were 404 billion CNY, which equals approximately 50 billion USD. Since 1989 retirement insurance revenue has consistently been higher than expenditures, so that a cumulative stock has been build up which is now equivalent to the total annual expenditures of 2005 (see Figures 8 and 9).

7. The “Five Guarantees” are food, clothing, medical care, housing and burial expenses.

8. The scope of these subsistence allowances has been increased dramatically in recent years, with the number of recipients increasing from 1.2 million in 1997 to around 22 million in 2004; for details, see Huang Yanfen and Yang Yiyong, “The Urban and Rural Poor in China and their Income Earning Potential (OECD, 2004).

8.1. Low coverage

70. The fundamental objective of a public pension system is to ensure old age security for people in retirement. As shown in Section Five, it is apparent that China has a long way to go to achieve this objective, as coverage is still low. Apart from leaving many older people without any social insurance, a low coverage rate has several negative effects on the functioning of the pension system. To mention just one line of argument: low coverage implies limited possibilities for risk pooling and consequently higher contribution rates, which in turn might hinder or even decrease the number of old age insurance participants further. So what are possible explanations for the narrow reach of the three-pillar-system? What are the barriers to the obligatory pension system (i.e. pillar I), whose legal framework has been in existence since 1997, to reaching more widely than 48% among the urban population?

71. There are several reasons why a large share of the Chinese working-age population fails to participate in the pension system. First, there seems to be an incentive problem. The willingness to contribute to the public insurance system is low (Chen, 2004). This can be partly explained by an unattractive return on the individual accounts. In recent years the average nominal return on pillar I B was 2.4% (actual return on long-term social security funds equals approximately 6% internationally; Wang, 2006) compared to an average rise in wages of 12.4% (OECD, 2005). As long as wages are growing faster than the money put into (notional) defined-contribution accounts, this investment might not be regarded as a good investment, particularly given the fact that average wages still ensure only a very low standard of living and consequently the opportunity costs of every Yuan spent on old age insurance can be expected to be high. Furthermore, on the employers' side the support for the system appears equally low, as it increases labour and administration costs (Wang, 2006). In addition, so far, the ability or the willingness of the government to force private companies into compliance seems restricted, as monitoring costs are substantial.

72. A second explanation for the low degree of willingness to contribute is limited public trust in the system. Lack of transparency as well as mismanagement and corruption connected to the handling of individual accounts has eroded workers' confidence in receiving old age security at a level that will allow them to live from it. For example, the fact that the individual accounts are mostly notional so far could raise further doubts among the working population that they are only financing current pensioners and not accruing savings for their own retirement.

73. Third, even if workers and their employers want to participate in the system, the administrative procedures for contributing to and benefiting from the public old age insurance might turn out to be too difficult to understand and therefore hinder participation. As the State Council stated recently (PRC State Council, December 2006), the National People's Congress has promulgated about 200 laws, regulations and policies on old age insurance over the last 20 years. At this frequency of change and in a country as fragmented administratively as China (see above on financing and administrative issues), local

administrations might have difficulties in implementing the guidelines in an effective and comprehensible manner, especially during a period of switching from simple PAYGO pensions to a complex three-pillar, partly funded system.

74. Another issue is China's legacy of institutional segregation between urban and rural workers (Reutersward, 2005). This has not only exacerbated the problem of informal employment (which is self-evidently not covered by social insurance), but in the past it also excluded registered migrant workers in urban areas from the urban pension system. Rather these migrant workers were supposed to contribute to the old age insurance in their home county/province (see below on portability), which they might have left more than a decade ago on the quest for work. It is questionable if migrants are willing to entrust part of their salary to the various administrative units between their changing working places and their home county to build up individual pension accounts. The necessary administrative coordination to achieve this is substantial. In recent years, a start has been made both to reforming the *hukou* system and in providing access to urban pensions for migrant workers. This appears to be more on a trial basis, with initiatives coming from some provinces and municipalities, and considerable further effort is required.

75. The reform and partial privatisation of many SOEs and COEs has caused many former workers to lose their job and changed the retirement entitlements of the remaining employees significantly. The formerly high pension benefits have been aligned to the same level of any other employee's pension entitlements as a consequence of unifying the public pension system in 1997. Although workers in the restructured SOEs are still more likely to participate in the pension system, the decrease in the share of the labour market (in 1992 their share in total urban employment was 81 percent, in 2005 it was 27 percent; China Statistical Yearbook, 2006) has had a negative effect on the national coverage rate.

8.4. Portability

84. Workers who change jobs between administrative units (county or provincial level) are in many cases still not entitled to take the savings in their individual accounts with them to the pension fund in the next province, and risk losing the right to claim pension benefits from local pension funds to which they have contributed in earlier jobs. What are the causes of and the effects (besides its above mentioned impact on coverage and contribution rate) of this restricted portability?

85. One reason for this problem is the inherent administrative difficulty of transferring individual accounts and pension claims across local borders (horizontal fragmentation), but also between different levels of administrative hierarchy (vertical fragmentation). Pooling at a local level is possibly the simplest approach to organise social insurance within a populous and geographically large country like China. However, large migration movements (a survey of the Ministry of Agriculture estimates the number of migrant workers to be 114.9 million in 2006) have left the administrative system incapable of caring for large parts of the population.

86. The direct result of this is the insufficient protection of migrant workers against poverty in old age. These migrants represent approximately 15% of the total labour force and come mostly from rural areas. The direct consequence of impoverished migrants at retirement age (and their families) is probably made even more severe by the indirect consequence: rural areas have suffered aggravated economic hardship due to the loss of their most productive workers to the coastal regions. Increasing the portability of pension entitlements for migrant workers could therefore improve also the situation of the older rural population, as old migrants could return to the countryside with a steady source of income.

87. As a result, another negative effect of non-portable pension claims is a more rigid labour market. Workers are less willing to move across administrative borders if they risk losing their old age insurance savings. A less mobile and flexible labour market, however, could be disadvantageous in the sense that it creates market distortions (wage differences might diverge further between provinces), and because it would make labour more expensive in some regions that could otherwise accommodate many more workers under conditions of greater mobility.

8.7. *Low return on fund investments*

98. A final point of concern when it comes to the sustainability of the public pension system is the low return on pension fund investments. Funds from the first pillar are currently invested in government bonds and bank deposits with average real-yields of 2-3% (Trinh, 2006) and the NSSF earned a return of 3.1% in 2004, up slightly from previous years (Xinhua, 29/03/2005). With an average year-on-year growth rate of GDP per capita of more than nine percent, it seems questionable whether the pension funds' low returns can a) attract many contributors and b) improve the funding situation to a degree that allows it to finance the retirement of a much larger number of pensioners in two to three decades from now. James (2001) calculated that with the current rule of employees contributing 8% of their wages to the individual account for 40 years and having a real wage growth rate of 3%, a real return on this account of 2% would yield a replacement rate of only 16% of final wages if it had to account for 20 years of retirement. In contrast, a real return of 5% is needed to approximately fulfil the targeted replacement rate of just below 40%.

99. Narrow investment restrictions limit possibilities to achieve a high return (which also implies high risk) investment strategy. However, recent guidelines for investments abroad have given more room to place funds in foreign markets and the nomination of foreign banks as custodians and managers of significant shares of Chinese pension funds have created new possibilities to achieve a higher return in the future.

100. Immature domestic financial markets are frequently cited as a major obstacle to higher returns (Trinh, 2006; Pai, 2006; Wang, 2006). Hu (2006) analysed the current situation of the stock market, bond market, institutional investors, banking sector and the money market and concludes that China fulfils "the basic conditions needed for a pension reform towards funded pillars", although the financial system is still underdeveloped when compared to more developed OECD countries. Notwithstanding this, Jackson and

Howe (2004) emphasise the mutual importance of a funded pension system and an evolving financial market at this stage of development. Growing pension funds will increase the size and the liquidity of the country's capital markets. Setting high standards in the management of these funds (the NCSSF may provide a role model in this case) will create better accountability, transparency and in the end higher long-term returns.

101. Above all, fraud is still a serious problem within the management of local pension funds, but apparently also on a larger scale as the Shanghai pension scandal has demonstrated. In this case the funds were used for financing politically prestigious projects rather than following a rational risk and return strategy. Consequently, fraud in any form needs to be continuously addressed not only to improve public trust in the system but also to prevent the rate of return from being diminished further.