Public Finance and Pension Reform in China[1]

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I. Background

During the society and economy development, China's demographic transition has attained some new features, that is, the birth rate is kept low while people's average life span is prolonged bit by bit. According to a report by the World Health Organization, the average life span for men is 71 and for women is 74.5 in 2008 in China, compared to this, the average life span is only 68 years in Population Census in 1990, and the aging population above 60 accounts for more than 10% of the overall population. While the per capita GDP is only about $3000 in 2008, so this means that China is growing old before it can grow rich. Besides, China's aging problem is of a large size and accelerating rapidly. According to a forecast by the World Bank, the aging population above 60 in China will account for a quarter of its overall population by 2050. Therefore, China is facing an unprecedented challenge of aging. Meanwhile, China is rebuilding its pension system from pay as you go type to funded type and has a large demand for pension fund. The rapid changes of population

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structure lead to a contradiction between the demand and supply of pension.

Such a dilemma arises from the existing pension system implemented in China now. In 2008, the revenue of the pension fund is 1.37 trillion yuan, and the expenditure is 0.99 trillion yuan. The accumulated balance over the years is just a mere 993.1 billion yuan. China's mandatory pension system is pay-as-you-go type, which is based on a high percentage of working population and low dependency ratio as well as high productivity. However, if the dependency ratio goes up while the productivity is still low, it is very questionable whether this system can sustain? (Cai and Meng, 2004) Moreover, due to the change in population structure and systemic transition, a huge implicit debt is incurred, which made pension fund increasingly inadequate. Because of these serious challenges posed to China's pension system, it is very necessary to carry out further reform.

Governmental fiscal and tax policies can effectively influence a country's pension system option. A healthy and sustainable pension system relies on the public finance support. On one hand, government can directly support the development of pension system through public expenditure; on the other hand, government can stimulate old-age security and savings by tax policy. In addition to that, a government can promote the development of a fair pension system through fiscal policies.

II. Public Finance Options and Actions in Pension Reform

1. Fiscal subsidy and tax credit granted to pension system by government

Public finance generally supports pension system in two ways: fiscal subsidy and preferential taxation. The former is often used in basic pension system, and the latter is more often used to develop the second and the third pillars of pension system. Though preferential taxation will not result in more public expenditure, it will result in decreased fiscal revenue at a certain period, so it can be regarded as implicit tax expenditure.

2. The settlement of transition costs and implicit debt by public finance

For economies experiencing a transitional pension system, public finance should shoulder the costs resulted from the transition as well as the implicit debt. In the transition process, implicit pension debt is not paid immediately. So it should be allowed to be apportioned in a relatively long period of time. We will focus on how the government is going to settle the implicit debt, evaluate the government's capability of repayment of the debt in pension system in long term, and focus on how the debt is distributed between central and local governments.

3. Government's fiscal responsibility in pension system

Government's involvement in pension system is embodied by its fiscal responsibility, which brings heavy burden to some countries and impedes state-owned enterprises from market competition and explains the reason why a reform is needed. The renewed understanding of government's fiscal responsibility in pension system is of significant value to further reform.

4. The impact of pension system on public finance

Government's fiscal support has played an active role in the normal functioning of pension system. However, some countries set a very low contribution rate or their expenditure on it has gone out of control, the fiscal subsidy in pension fund by the government has become a heavy burden and it has even become an impediment to economic development since 1980s. Therefore, we need to research pension system's influence on public finance and build a pension system that is most fiscally effective.

III. The Analysis of the Current Pension System in China: from the Perspective of Public Finance

Major parametric reform for pension system has been carried out by the Chinese government in 2006. The system is now fundamentally in line with the five-pillar system of the World Bank. (See chart 1).

The mandatory pension system, i.e. the first pillar is the major part in

China’s pension system. The second pillar is small in size and the third pillar is still at its infancy.

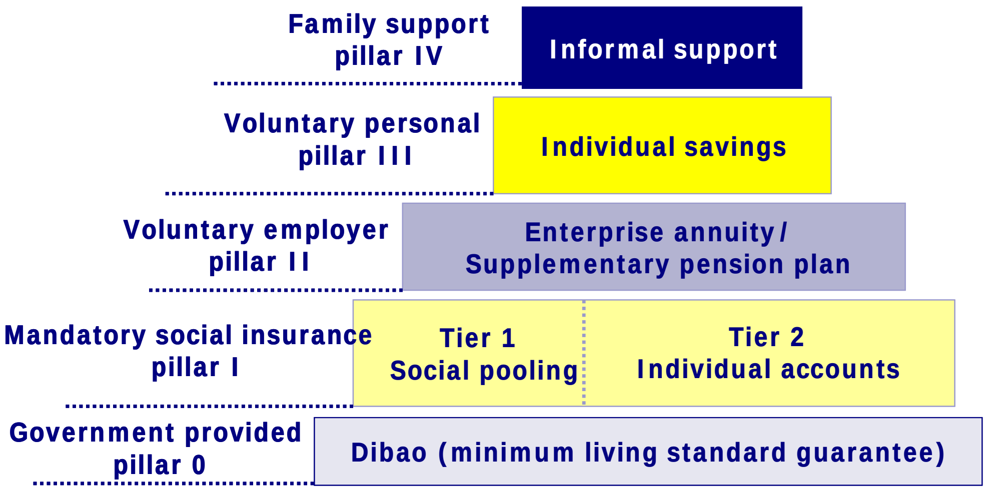


Chart1 Current Status of China’s Pension System

1. The role of public finance in current China’s pension system

Currently, among the five pillars, pillar 0, i.e. DiBao (the minimum living standard guarantee for urban poor family) is the one primarily subsidized by government. In some areas, for example, in Shanghai, special DiBao system for the elderly over 70 years has been piloted. The social pooling part in pillar I which is PAYGO and DB type is also the public finance’s fully responsibility.

The public finance doesn’t directly subsidize the individual account in pillar I as well as pillar II & III. The development of those parts is adjusted through tax policy, but historically the individual account in pillar 1 is not fully funded, the government may still be responsible for making it fully funded as a result. Attention will be given to what types of fiscal and tax policies the government should take in the five pillar system. In addition, China's current pension system is flawed with low coverage, low replacement rate and high contribution rate. How to expand the coverage of basic pension system, increase replacement rate and reduce contribution rate through government fiscal policy, i.e. how to coordinate a balanced development of each pillar in this multi-pillar system, are issues we are concerned with.

It is very important for the Chinese government to develop a government-sponsored pension system. Its significance can be shown in the following three aspects:

First, the coverage of pension system is expanded from part of urban residents to all the urban and rural residents, which will benefit every Chinese citizen.

Second, with the new pension system, enterprises are no longer saddled with the ultimate responsibility for its employees' old-age security. Chinese Ministry of Labor and Social Security has built a professional team to manage the pension fund. But there is still a long way to go before a sound and mature pension system comes into being. For instance, the current pension system only covers 40% of urban work force and 10% of rural labor force, and it needs to be further expanded.

Third, China's pension system varies widely among different regions.

There has not yet a unified system to manage the fund at the country level, and each region plays an important role in managing its pension fund. Take relatively developed cities and provinces like Shanghai and Guangdong for instance. They don't have big problems with pension contributions and pension payment. But some other provinces have a large shortage of pension fund.

Government pension system is having certain burden on China's public finance; therefore, it takes enormous efforts of Chinese government to establish a new pension system. Next, let's figure out how heavy the burden is to pay pension to future retirees.

2. The burden caused by China's pension reform on public finance

The burden on public finance posed by pension reform largely consists of huge transition costs and the cost of establishing pension system in rural area.

Five reasons contribute to the funding gap in the pension fund. (1) When new system was adopted, it would inevitably lead to some legacy problems, because a part of workers have no accruement in their individual accounts before the new system and this part of funding gap can only be subsidized by public finance. (2) As average life span increases and more and more workers who haven't paid any pension contributions or haven't paid in full retire one after another in the future, pension payment is bound to rise during a certain period of time in the future and this part of funding gap need to be bridged by public finance too. (3) Basic pension system is not well coordinated in China. Since funds with different social pooling levels couldn't be used across different regions, the funds' regulation function is very much restrained, resulting in a gap between rich and poor in social pooling balance and heavy burden on government finance. (4) Associated with implicit debt is pension rising with inflation and rising wage. As pension system transits from pay-as-you-go to accumulation in individual accounts, a large amount of implicit debt is going to arise inevitably. (5) Government expenditure on establishing pension system in rural areas. Presently, pilot programs of providing new type of pension insurance for rural elders is running in China and government provides a basic pension of 60 Yuan per month for each rural insurer.

Researchers generally think that China's implicit pension debt is now some 3 trillion Yuan, excluding fund needed to establish pension system in rural areas.

According to the original institutional design, if we stick to an operation model with social pooling and individual accounts combined, this funding gap will be solved gradually as more and more people who have paid pension contributions in full go into retirement. However, this illusion is

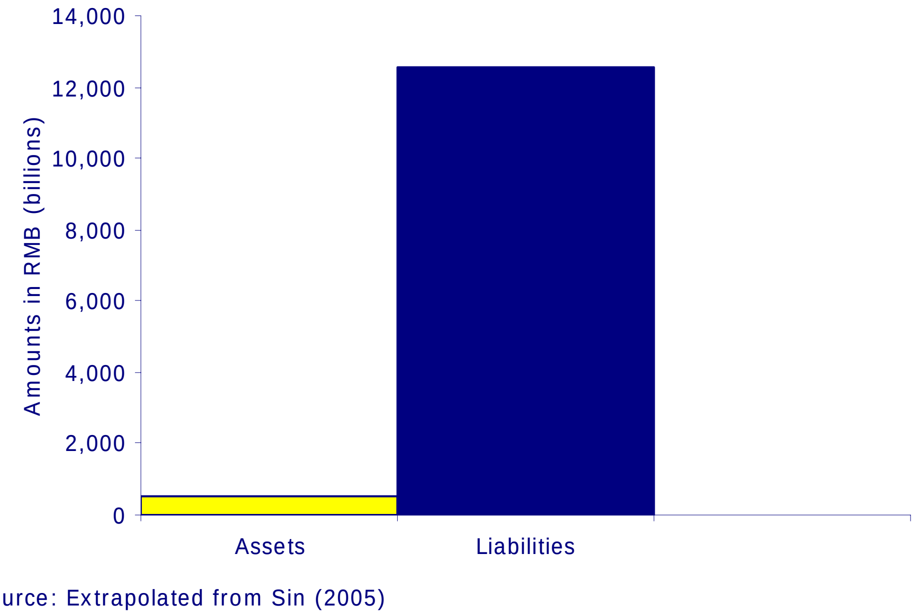


Chart2 Implicit debt of China's pension system

made impossible. With the decline in birth rate and extension of life span, the pension crisis might break out before the "spring of aging insurance" arrives.

Calculated in accordance with international standards with 65 as the retirement age, China's retirement population is 100 million presently, and it will reach 200 million in 2025 and 300 million in 2040 and afterwards, up from 8% to 25% in 2040.

The above calculation might have grossly underestimated the actual retirement population in China; because the retirement age for men is 60 and women is 55 (50 for female workers) in China. If Chinese government don't make any modification to this retirement age for the sake of creating more jobs, China's retirement population will reach 450 million in 2040, which will account for a third of China's total population.

So how heavy will the burden be with this dramatic increase in retirement population? If measured with international standards, every 10 workers now have to support 1 retiree. According to China's retirement system, every 10 workers now have to support 2 retirees currently, but 6.5 retirees in 2050, which means that every 2 work force have to pay for a pension. This will lead to heavy burden on public finance.

IV. Fiscal Policy for the Crisis and Current Fiscal Status in China

Though monetary policy is important in stimulating economic growth, fiscal policy is more effective in tackling the economic recession which was caused by a sharp reduction in demand triggered by financial crisis. All the policies currently adopted to deal with the crisis are to realize two objectives. One is to repair financial system; the other is to boost demand and confidence. Comparing with developed economies, developing economies suffered less impact on their financial system. Given the decrease in export to developed economies, it is an effective policy to increase demand by means of expanding public expenditure. Many economies adopted fiscal policy as an important means to stimulate their economy.

1. China’s fiscal policy for the financial crisis

(1) Proactive fiscal policy of China since November 2008

Since November 2008, the Chinese government has been adopting an expansionary fiscal policy (see Figure 1), which include: ① issue a 4-trillion Yuan investment package over the next two years to increase public expenditure; ② adopt tax policy to achieve structural tax reduction; ③ increase fiscal transfer payment and increase the income of low-income groups; ④ support science & technological innovation and industrial adjustment and revitalization; ⑤ strengthen social safety net and improve people’s livelihood.

(2) China’s fiscal policy pays more attention to people’s livelihood and sustainable development

China’s export dropped dramatically in the face of the crisis. To change economic growth pattern and boost domestic demand has become the main objective of the economic policies adopted by the Chinese government. Different from other economies, China keeps a large savings amount of 40 trillion Yuan (about US$ 6.5 trillion). How to decrease savings rate to stimulate consumption is an issue concerns whether China

Figure1. Fiscal Policy for Crisis in China

Policy	Main Content
1.Expand Public Investment	4 trillion Yuan stimulus package, account for 16% of 2007 GDP。The central government plan to invest 1.18 trillion Yuan, and induce local government and private investment into the stimulus plan.
2.Structural Tax Cut and Taxation Reform	• Increase Export Rebate Rate • Reduce & Cancel Some Kind of Tariff • Real Estate Tax Reform • VAT Reform • Reduce Tax on Buying Vehicles • Cancel 100 Administrative Fee • Fuel Tax and Fee Reform
3.Increase fiscal subsidy and the low-income people's living standard	• Increase Fiscal Subsidy to Farmer • Increase DiBao(minimum living standard guarantee) Level • Home Appliances Going to the Countryside
4.Support Science &Technological Innovation and Industrial Restructuring	• Support Science & Technological Innovation • Support Industrial Adjustment and Improvement
5.Improve the Social Security System	• Education • Health Care • Employment & Reemployment • Social Security System(include pension system) • Culture • Housing Security

could rid itself of the crisis and maintain fast growth in the long run. A survey conducted by the Chinese Academy of Social Sciences indicates that 39% of Chinese people believe that social security is the primary factor that influences consumption. To improve social security system (including pension system) is conducive to stimulating domestic consumption of China.

At the National People's Congress held in March this year, Premier Wen delivered a Government Work Report in which some minor changes were made to the 4-trillion Yuan investment plan announced last year. As chart3 shows, there is a decrease in infrastructure investment and an increase in social security investment. It proves that the government pays more and more attention to improving people’s livelihood.

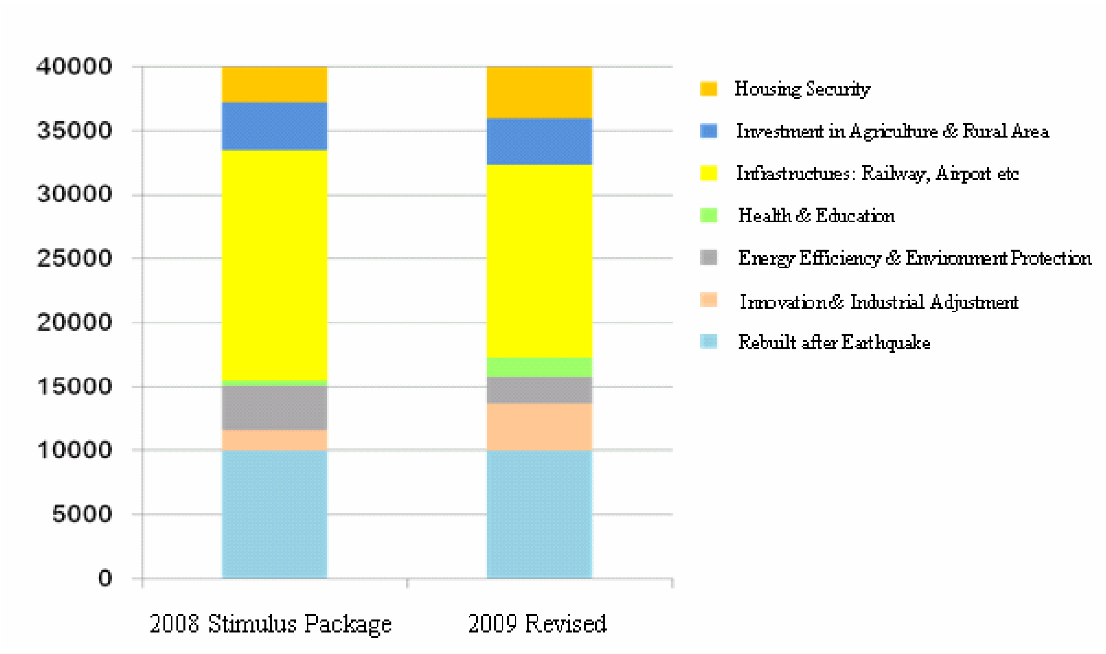


Chart3 Structure of 4 trillion public investment

The government is continuously increasing expenditure on areas concerning people’s livelihood. Meanwhile, expenditure on social security and employment is also increasing. From a long-term perspective, the high savings rate and depressed consumption will have a negative impact on the sustainable economic growth of China. International experience shows that the national consumption of a country is positively correlated with government investment in public products like education. Therefore, the measures currently adopted by the Chinese government are conducive to lowering savings rate, boosting domestic consumption and maintaining balanced economic development in the medium term.

2. China's fiscal revenue and expenditure

As the following figure shows, China has been enjoying a sound fiscal status with an annual growth rate of about 17% in fiscal revenue and expenditure since reform and opening-up. It even had fiscal surplus in 2007; however, due to the global financial crisis, fiscal expenditure in 2008 and 2009 will increase dramatically and fiscal revenue will decrease.

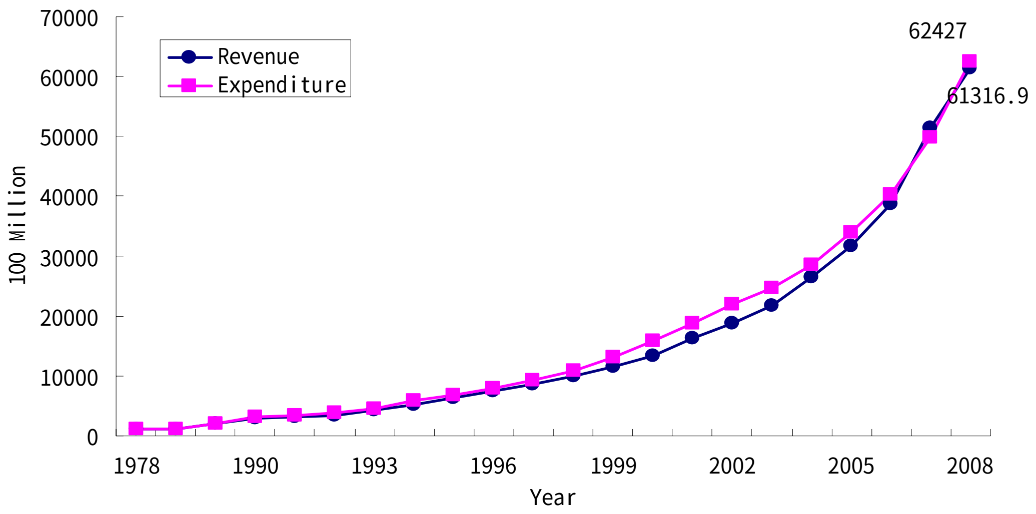
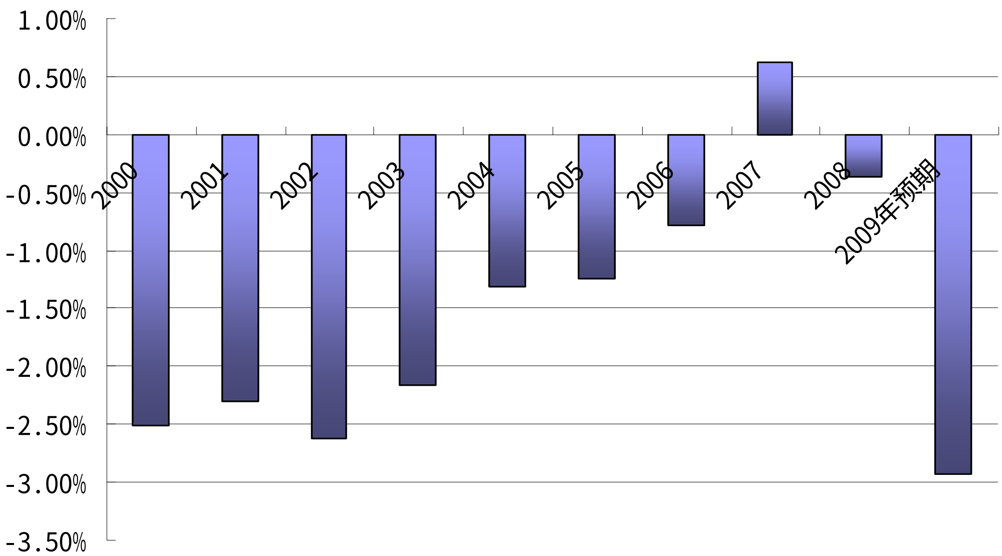


Chart4 China's Fiscal Revenue and Expenditure since 1978

Statistics shows that in the first quarter of 2009, national fiscal revenue dropped to 1464 billion Yuan, down by 8.3% or about 133 billion Yuan over Q1 of 2008; national fiscal expenditure hit 1281 billion Yuan, up by 34.8% or about 330 billion Yuan over the same period last year. The fact is an outcome of proactive fiscal policy. On the one hand, fiscal revenue will decrease due to economic slowdown and reduced tax on enterprises and individuals; on the other hand, the government has to increase investment and expenditure in order to stimulate economic growth, improve people's livelihood and deepen reform. The decrease in fiscal revenue and the increase in expenditure will create a large fiscal deficit to the government this year.

In terms of the ratio of fiscal deficit to GDP, the Chinese government has been enjoying a favorable fiscal status since 2000. The ratio of fiscal deficit to GDP decreased year by year since 2004. In 2007, the government had a fiscal surplus. But due to the financial crisis, the Chinese government adopted a proactive fiscal policy, which will definitely further enlarge the deficit.



International Standard 3%

In 2009, to fill the gap between decreasing fiscal revenue and increasing fiscal expenditure, the Chinese government arranged a fiscal deficit of 750 billion Yuan, up 570 billion Yuan over last year. In addition, the State Council approved that the Ministry of Finance could issue bond of 200 billion Yuan for local governments. So the total fiscal deficit reached 950 billion Yuan, accounting for less than 3% of GDP and lower than the international standards. Though there is much increase in deficit this year, given the continuous decrease in deficit in the previous years, the accumulative national debt accounts for about 20% of GDP. This is a percentage that we can afford and it is safe in general.

Given the facts mentioned, there is no much fiscal surplus in the government due to the financial crisis. The increase in fiscal deficit will have a negative impact on fiscal sustainability and ultimately on the pension system in the long term.

3. The fiscal status of China is capable of supporting pension system reform

China might be having a tight fiscal budget in recent years, but we believe that its fiscal status is good enough to support the pension system reform. The reasons are as follows:

(1) China maintains a high growth rate despite the financial crisis

The World Bank cut its forecast for China's growth this year to 6.5% in its report issued this March. The report also forecasts that China's economy will be bottoming out by mid-2009 and fully recover by 2010. The situation is much better than that in other economies in the world. The Chinese government set its growth rate target at 8%. Many Chinese scholars and researchers hold that China can achieve this goal for three reasons: one, China's financial system felt less impact of the financial crisis; two, the Chinese government adopted proper measures; three, China has a large domestic market to boost its economic growth. Given the three reasons, China can realize the economic growth target of 8%.

Economic growth is not only the foundation for fiscal sustainability, but also the foundation for further reform in pension system.

(2) China's fiscal status is relatively stable and fiscal sustainability has not been affected.

As I mentioned earlier, though the ratio of fiscal deficit to GDP is nearly 3%, the accumulative national debt accounts for only about 20% of GDP, much lower than EU's 60% standard. China's fiscal status is relatively stable and a long-term fiscal sustainability can be expected.

(3) The government and the people keep a large amount of savings and

resources

As for savings deposit, by the end of 2008, the savings deposit of China was nearly RMB 40 trillion, accounting for 130% of GDP. At the same time, the proportion of household savings deposit in many developed countries to their GDP is between 15%～20%. The proportion of household savings deposit in Asian countries is generally between 30%～50%.

As far as state-owned assets are concerned, in the past, the government took a majority of the social resources and this is how the current state-owned assets came into being. According to the statistics from the Ministry of Finance of China, the total assets of the state-owned enterprises were about RMB 19 trillion with RMB 1.62 trillion as profit and RMB 1.57 trillion as tax.

The government may allocate part of state-owned assets to make for social security fund.

China also has large scale foreign exchange reserve.

The foreign exchange reserve of China has reached nearly $2 trillion by the end of March 2009.

All of these resources mean that Chinese government can afford larger fiscal deficits and support the pension system reform.

(4) A large proportion of the public expenditure goes to social security and pension reform

I have mentioned this point earlier and will not elaborate on it any more.

V. Current Measures and Suggestions to Further Reform

1. New measures taken by Chinese government in pension system

Since 2008, in the face of the global financial crisis, Chinese government has conducted a series of parametric reform to expand pension coverage and raise its standard as well as systematic reform to the pension system for public institutions and rural residents. By the end of 2008, 219 million people had participated in mandatory social insurance for urban residents, with a year-on-year increase of 17.53 million people and an average increase of 110 RMB in pension per month for retired enterprise employees. Pilot reform on basic pension system for public institutions was also launched in 2008, and the establishment of a new type of pension system for rural residents, rural migrant workers and farmers whose land was expropriated are going steady as well.

According to the Government Work Report by Premier Wen Jiabao and other government documents, new measures to be taken in 2009 on pension reform include:

First, China will press ahead with institutional development. We will improve the mandatory social insurance system, continue to carry out pilot projects to fully fund individual accounts, and comprehensively carry out planning at the provincial level. A method for pensions for rural migrant workers will be formulated and implemented. The pilot projects for establishing a new type of pension system for rural residents will cover approximately 10% of the counties and county-level cities in the country. And a method for transferring pension accounts for workers moving from one region to another will be introduced.

Second, China will expand coverage of pension system, focusing on coverage for employees in the non-public sector, rural migrant workers, farmers whose land was expropriated, people with flexible employment arrangements and so on. We will strengthen supervision of pension funds to ensure their safety.

Third, China will increase pension benefits. We will continue to raise the mandatory social insurance for enterprise retirees by an annual average of about 10% per person for the next two years.

Fourth, China will finance National Social Security Fund through diversified channels. The central government plans to spend 293 billion

Yuan to National Social Security Fund this year, up 17.6% or 43.9 billion Yuan over the estimated figure for last year. Local governments will also increase funding in this area.

2. Future measures in pension reform

(1) Pension fund system should be coordinated in the whole country as soon as possible

The central government has set a timetable for the reform: a coordinated pension system at provincial level will be realized by the end of 2009 and national level by 2012, which will provide favorable conditions for fund accumulation system in the whole country. This is a most effective way to solve the problem of unbalanced funding surplus at different regions.

(2)Individual account should be fully funded and investment system for individual account pension fund should be improved

Currently, part of the fund in the individual account is managed by the National Council for Social Security Fund and the rest of the fund is managed by each provincial government. The investment channels for the fund are still very limited. The government should try to explore more means of fund management and try to increase earnings from the fund investment.

(3)Retirement age could be postponed

Currently, the legal retirement age for male is 60, 55 for female officials and 50 for female employees in China. As people’s living standards improve, the average life expectancy has also been significantly extended. According to UBS, if the retirement age is properly postponed (say 65), the deficit for pension fund in China could be made up before 2020.

(4)Social security fund could be consolidated by distribution of dividend from national assets and transfer payment

(5)Commercial pension insurance and enterprise annuity should be encouraged.

Due to the limited fiscal resources, the government has focused on covering all people with lower pension to meet the basic needs of old-age security. In view of the development trends of pension system worldwide, market-oriented commercial pension insurance is going to play a more important role. Commercial pension insurance is still at a preliminary stage in China and needs further policy support from the government to expand its scale, improve professionalism and enhance external business environment. As an important part of social security, commercial insurance and enterprise annuity can play complementary roles in the current pension system. In this respect, pilot projects have already started in China.

(6) Finally, strengthen management of pension fund, entrust the pension account to professional fund management agencies and improve internal and external management.

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